CENTRE FOR EUROPEAN REFORM

Conference report: Has the euro been a failure?

Ditchley Park, Oxfordshire
6-7 November 2015

#CERditchley

MAP MACRO ADVISORY PARTNERS

CITY OF LONDON

Vanguard

Executive summary

November's conference, which brought together 50 leading economists, considered whether the euro was a failure. A host of questions were debated. How should the euro be judged? Purely by the fact that it has survived? Or by the fact that is has become a significant international reserve currency? Or by comparing what its proponents said it would do for Europe with what had actually happened? Had the euro helped Europe to address the economic and political challenges facing it? Or had it made it harder to address those challenges, while also creating new ones? Could a dismantling of the eurozone open the way for economic recovery and an easing of political tensions? Or would it unleash unmanageable economic and political instability?

There was broad consensus that the euro had been a disappointment: the currency union's economic performance was very poor, and rather than bringing EU member-states together and fostering a closer sense of unity and common identity, the euro had divided countries and eroded confidence in the EU. While only a few participants thought it possible or advisable to dismantle the eurozone, there was broad pessimism over the ability of the eurozone political elite to sell the needed integrationist steps to their increasingly disillusioned electorates.

For most participants there was a widening gap between what was needed – more integration, risk sharing, and solidarity – and what electorates were prepared to support. The eurozone could only flourish with institutions founded on democracy; rules were a poor substitute and lacked legitimacy as they were effectively set by a select group of member-states and the ECB. For a minority, the rules were the right ones, and the eurozone could work if countries abided by them. For another minority, the problems were the result of policy mistakes, not the eurozone's institutional set-up.

For some participants, dismantling the eurozone would cause devastating financial dislocation. And it would not help countries regain competitiveness or cut real interest rates as their problems lay in industrial structures and monetary sovereignty was illusory. Others countered that there would be financial instability in any case, as weak growth and inflation led to debt write-downs. Dissolution would be messy, but misaligned real exchange rates were a problem and required adjustment. National institutions would be better able to deliver the needed mix of fiscal and monetary policies.

Participants broadly agreed that both euro breakup and muddling through carried political risks. For some, dissolution would do fatal damage to the EU, rendering Europe even less able to cope with the myriad challenges facing it. Others were less pessimistic: dissolution would create legal uncertainty, but contracts would be resolved to the benefit of the debtors, easing populist pressures in those countries. And, in any case, if eurozone growth remained weak, the number of eurozone citizens backing populist parties would continue to rise, leading to paralysis of the political system.

Finally, the participants discussed the impact of the crisis on Britain's membership of the EU. The worst scenario would be muddling through in the eurozone as this would mean continued large-scale migration into the UK, inflaming hostility to the EU. An integrated and successful eurozone was certainly in the UK's interests and should be consistent with continued EU membership so long as Britain engaged constructively and the eurozone showed sensitivity to British concerns.

Has the euro been a failure? Such a suggestion draws a fierce response from Brussels and national capitals, and is perceived as tantamount to calling the EU into question. But it is a legitimate question to ask. How should the euro be judged? Purely by the fact that it has survived? Or by the fact that is has become a significant international reserve currency? Or by comparing what its proponents said it would do for Europe with what has actually happened? Has the euro helped Europe to address the economic and political challenges facing it? Or has it made it harder to address these challenges, while also creating new ones? Could a dismantling of the eurozone open the way for economic recovery and an easing of political tensions? Or would it unleash unmanageable economic and political instability?

Session 1: Has the euro been a failure?

The euro was supposed to boost economic growth and living standards, strengthen public finances and hence the sustainability of welfare states. Politically, it was supposed to bring EU member-states together, fostering a closer sense of unity and common identity. Have these objectives been met? Is the euro making it harder for economies to adjust to the changes wrought by technology, globalisation and demographics? Does the euro threaten the future of the EU? How would the European economy have fared in the absence of the single currency?

The first panellist argued that the euro could be seen as a success or a failure: euro-optimists should be disappointed by how things had turned out, whereas pessimists had to acknowledge the eurozone's resilience. Pundits and financial markets had underestimated political elites. Support for the euro was high even in southern Europe. And economies were recovering quickly, albeit from a low base: reforms had been implemented and were paying off. The speaker also argued that anti- and pro-austerity commentators were missing the point. Those arguing that the crisis resulted from fiscal ill-discipline underestimated the seriousness of the eurozone's design flaws, whereas anti-austerians often failed to acknowledge the damage that had been caused by the failure to fix the banks and reform the eurozone's financial system. Austerity had not been that much greater in the eurozone than in the US.

But the panellist went on to note that adjustment within the currency union had been unbalanced: member-states with trade deficits had redeployed capital and labour to the tradable sector faster than those with surpluses had shifted towards domestic sources of demand. Adjustment needed to be symmetric if the economic recovery was to gain momentum. Meanwhile, the fiscal stance of the eurozone as a whole should be given more weight in the eurozone's fiscal framework. 'Risk sharing' and 'risk reduction' were needed to proceed in tandem, but for that to happen the core and periphery had to trust each other.

The second panellist drew attention to the poor relative performance of the eurozone. Between 2008 and 2015, it had hardly grown at all in real terms – unlike the UK, the US, or the other EU countries that were not in the euro. Unemployment in the eurozone stood at 11 per cent, while in the other EU countries it had fallen to 5 per cent. This divergence was not explained by supply-side deficiencies in the eurozone, but reflected a classical boom-bust recession, with too much consumption and investment, and very fast rises in private sector debt, giving way to a demand crisis. The emphasis on the supply side led eurozone policymakers to administer the wrong medicine.

This panellist said that eurozone governments had lost the ability to stabilise their economies. There was no lender of last resort when the currency union fell into crisis – and automatic stabilisers could not play their part. There was nothing at the federal level to take over from constrained national governments. Policymakers also displayed a deflationary bias – there had been more austerity in the eurozone than elsewhere in the EU – this austerity was first forced on governments by markets and then by EU officials. While the ECB had started to construct a federal stabilisation policy, by promising to act as lender of last resort, there was still no eurozone authority in charge of stabilisation through fiscal policy.

The third speaker disagreed that there had been too much emphasis on fiscal profligacy. Before the crisis, some countries had grown in nominal terms by 8 to 10 per cent a year, whereas normal nominal growth was around 4 per cent. Output gaps had been positive, with demand growing faster than these countries' supply capacity. This meant that fiscal policy did matter – once the crisis came, these countries faced collapsing tax revenues. Had governments been running strongly counter-cyclical fiscal policies before the crisis hit, they would have been in a position to impart more stimulus during the crisis.

He said that reforms were paying off: government deficits were in many countries now below 2 per cent, and unemployment was falling – by five percentage points in three years in Spain, for example. Bank capital had been strengthened. But there were still major problems: the ECB's decision to act as lender of last resort, and to enact quantitative easing, had led it to provide blanket insurance for government debt. This heightened the risk of moral hazard, and it was important that there was more fiscal discipline provided by sovereign debt markets. This panellist argued that the banking union needed to be fully implemented, with bail-in rules used to ensure that financial institutions took more responsibility. The reforms to the stability and growth pact were worthwhile, but the rules were being politicised – and since market discipline was weaker, the eurozone needed laws to ensure discipline. He did not think that the macroeconomic imbalances procedure needed to be symmetric, because that would mean strong countries weakening themselves.

The fourth panellist stressed that the eurozone was not an optimal currency area, not least because of differences in tax rates and limited labour mobility – and that the currency bloc was not becoming more optimal. Germany was integrating with central Europe, not the south: German foreign direct investment was four times higher in the former than the latter, and trade with eastern countries was growing more quickly than with southern ones. Meanwhile, private investment in the UK and the US had recovered – or was recovering, unlike in the eurozone, and unemployment was much lower. The eurozone's potential growth was 1.5 per cent a year at best.

This speaker said that the eurozone had made progress, but had a long way to go. Banking and capital markets unions were not enough: the euro needed a fiscal union, which in turn required political union. The latter was necessary because moral hazard concerns were real and could not be dismissed. Countries needed to trust one another, which could not happen when, say, retirement ages were so different. Above all, structural reforms were needed, with the ECB providing political space to allow that to happen, by providing monetary stimulus.

Q&A: In the discussion that followed, some participants noted that the discussion had not focussed sufficiently on the question, and that simply stating that a lot had been done was not an adequate response. Were the costs of divorce too high? And would politicians' determination to keep the eurozone going weaken if they were driven simply by a fear of the alternative? Had the 2008 crash happened with multiple currencies and floating exchange rates, would the outcomes have been much different? Other participants weighed in, arguing that the euro was poisoning support for integration and dividing the EU; for example, Britain was peeling off from other member-states. Another said that supply side improvements were being swamped by macroeconomic failure, which was likely to continue. And internal devaluation as a mechanism of adjustment was politically destabilising. The social capital built up since 1945 was being frittered away, and support for anti-euro parties would rise. Although many market participants had learned that betting against eurozone leaders could be costly, eurosceptic politicians were doing well, and they would not have the same commitment to the single currency if they came to power.

Other participants counted that the costs of divorce were simply too high, leaving policymakers with no option but to make the monetary union to work. They needed to proceed with the next stages of the 'five presidents' report'. However this required trust – there was no political consensus for the ECB acting as lender of last resort between 2009 and 2011. It was only possible after the banking union had been established, which addressed moral hazard sufficiently to allow ECB president Draghi to say he would do whatever it took. The second speaker added that we had no idea what the costs of dismantling the euro would be, and it was possible that break-up would radicalise European politics, rather than restoring calm to the EU. It would be better to try to make it work.

The participants differed over the ECB's intervention in sovereign debt markets. One participant said that the decision to allow credit risk in sovereign debt before 2012 had made the crisis worse. The ECB rejected quantitative easing in 2009, and this had caused a run on periphery debt markets: if the guarantor of the key risk-free asset in the economy were absent, a run was inevitable. Spain, Greece and Portugal had been bankrupted by wrong-headed monetary policy, which led to the need for bail-out programmes. In response, the third speaker said that without reforms the markets would not have calmed down. Another participant argued that the key function of a central bank was to act as a lender of last resort to the banking system. Central banks must provide liquidity to institutions that are solvent. But the ECB declared some Greek banks to be solvent, only to deny them liquidity a few months later. The fourth speaker countered that reform momentum had been weakened by ECB activism. Europe moved forward in crises, but with risk-free sovereign debt, this would be difficult. For example, Portugal had just elected hard left-wing parties – but spreads had hardly moved.

Another theme was Germany's current account surplus. One participant asked if the third speaker found it problematic that the surplus had been recycled into southern European assets. The speaker said that the surplus was not policy driven – and was now mainly with countries outside the eurozone. The falling euro had pushed up the surplus. And the government did not control wages in the economy – the government could not push up consumption that way even if it wanted to. Another speaker responded that economic fundamentals – industrial factors and demographics, for example – only explained some of the surplus. More government investment was needed in order to reduce it.

Session 2: How to make the euro a success

The eurozone's economic prospects remain poor, with even optimists expecting weak growth, low inflation and persistently high unemployment. Pessimists fear that economic stagnation combined with a worsening of relations between eurozone governments could lead to revolts against the euro in hard-pressed countries. If they are correct, will these revolts be the catalyst for eurozone governments to broker the necessary deal to rescue the eurozone? What would such a deal look like? Or could revolts be a trigger for a partial or full break-up of the currency union?

The first speaker argued that the euro had been an opportunity for many member-states: they could have taken advantage of lower interest rates and lower inflation. The problem was less with the euro itself than with the decisions policy-makers had taken. In order to function, the eurozone needed an insurance union – not a transfer union – with the European Stability Mechanism and the banking union dealing with credit risks. A eurozone finance minister was needed, who could veto national budgets that violated rules, and could preside over common unemployment insurance. The ECB had been made a scapegoat, and had gone far enough toward becoming a lender-of-last-resort. It should now guard its independence from national governments.

For the second speaker, the ECB's interventions in sovereign debt markets were unsustainable. To boost economic growth and inflation, the ECB would have to buy far more Italian bonds than German ones, and this would prove politically impossible. The financial stability crisis was over but the eurozone crisis was not – governments had to focus on addressing problems that would arise from 'normal' shocks, not those that arise out of banking crises. In particular, policies were needed that would help the eurozone to escape its low-growth, low-inflation, high-unemployment trap. Even a huge supply-side effort would not work; the only way out was to cut debt to sustainable levels.

The third speaker thought the session's question ought to be: 'What should we do to make the euro worth it?' The ECB needed to target a higher inflation rate, which would facilitate relative price adjustment – and help to deal with secular stagnation. Fiscal austerity had to end. Banks had to be separated from governments – the eurozone needed common deposit insurance, as well as a common resolution system, with a fiscal back-stop as well as bail-in rules. Government bonds needed to be safe assets, and this should not be country-specific. And there needed to be fiscal federalism, which would require political union. The latter was needed because it was comparatively politically acceptable for technocrats to control policies that make most people better off – such as competition policy or financial regulation, but not for them to control fiscal policy, where there are big distributional effects. The ECB together with a few governments should not determine the monetary union's rules.

For the fourth speaker, the refugee crisis had highlighted the lack of trust in the EU: Germany deserved some solidarity from the rest of Europe. However the influx of refugees should lead to a German stimulus of around 0.5 per cent of GDP in 2015 and in 2016, which would benefit the eurozone as a whole, and the increase in the supply of labour would comprise a positive supply shock in the medium-term. The eurozone was also near agreement on some aspects of eurozone crisis management and the banking union. However, there were some major unresolved issues. The aggregate fiscal stance of the eurozone was one. Another was what might happen in the next recession in the absence of a fiscal union. More broadly, the speaker asked what would be the basis for trust in the eurozone: would it be rules or political institutions? Germany thought that good rules, which countries stuck to, would work. For the speaker, that was unlikely, and the eurozone needed legitimate institutions founded upon democracy. This was because of agglomeration effects: capital and labour would concentrate in wealthier regions, which raised major distributional issues in the eurozone. Transfers and investment funds for regional development would require political institutions.

Q&A: The discussion that followed focussed on rules versus institutions, democratic accountability, the role of the ECB, and reform of the EU's financial sector. For one participant, the root of the crisis lay in member-states disregarding the rule of law; only by governments abiding by rules could the eurozone hold together. But others countered that there was a big difference between the "rule of law and the law of rules": the rules themselves were the problem and as such lacked legitimacy. Neither national democracies nor European democracy were working. Governments had to have the scope to lower unemployment and inequality, but eurozone membership precluded this. Where policies had large distributional consequences political institutions were needed, which had to respond to democratic concerns. Democracy was not about signing up to rules and handing power to technocrats.

For these participants, the eurozone had to move towards political union and direct elections. It could only survive with redistribution between its constituent states, which in turn required a high degree of political accountability at the eurozone level. Without it, the currency union would (and should) founder. Others doubted the political sustainability of such a union. Given the heterogeneous character of the eurozone it needed a particularly aggressive redistribution policy, which would create severe political tensions between governments. For one former central banker, the mooted capital markets union could provide much of the solution. In the US, 80 per cent of the risk transfer between the states was conducted through private equity markets. This meant that if a region suffered a downturn the losses were spread across the economy, and it also meant that the market was pricing risk, unlike in sovereign debt markets. However, there was a broad consensus that private risk sharing would be slow to develop, not least because of half-hearted German support.

The discussion then turned to the role of the ECB. For some participants, the central bank's lack of democratic accountability was as a much of a problem as the EU's lack of such accountability. The ECB was too political. For example, by closing ATMs in Greece it had forced political change in the country in favour of creditors. Being too closely aligned with the interests of its creditor members also explained the ECB's decision to raise interest rates in 2011, the three year delay in announcing the Outright Monetary Transactions programme and the five year delay in launching quantitative easing. The ECB would end up monetising debt as weak growth and low inflation would continue to undermine debt sustainability, leaving the central bank with little scope to sell its government debt holdings. In the absence of fiscal stimulus, the ECB would also need to get involved in fiscal policy by conducting 'helicopter drops' – crediting peoples' bank accounts with newly created money. Negative interest rates did not work, and helicopter drops would be the only way that the ECB could meet its price stability mandate. For others, monetisation had to be avoided as it would destroy the credibility of the ECB and the political backing of the creditor states for the single currency. The ECB could put out fires but a lasting solution to the crisis required politicians to write down debt and adopt counter-cyclical fiscal policies.

But there was little optimism among the participants that there would be such an agreement, not least because of the refugee crisis. According to one speaker, the inflow of refugees into the EU from the Balkan in the 1990s was relatively easy to cope with because the EU was then more united. But now there was a broad political crisis in the EU, with member-states much less trusting of one another. Sovereigntists – which was a much more accurate description than 'populists' – were on the march. Germany was perceived by other governments to be acting unilaterally on refugees. Its normative power had been sharply reduced; its unilateral dropping of the Dublin rules had opened the way for others to be unilateral. And at the same time, it was not clear that Germany's body politic was ready for the big step needed to bring the EU together.

Session 3: The economic consequences of dismantling the euro

The immediate impact of a dismantling of the euro would be far-reaching financial dislocation, as contracts were redenominated, capital controls imposed, risk re-priced and real exchange rates realigned. But what about the long-term effects on economic growth, debt sustainability and financial stability? Would it improve or diminish Europe's chances of confronting its economic and demographic challenges? What would be the distributional implications, both within and between countries? Would floating exchange rates be consistent with the maintenance or deepening of the single market?

The first panellist pointed to the 1930s collapse of the Gold Standard, which restored growth, especially for those countries that quit early. It caused plenty of uncertainty, but reduced protectionism, raised inflation and reduced real interest rates, and therefore the size of the primary surpluses needed to maintain stable debt dynamics. All of this was achieved without capital flight. There is no doubt that the ECB was the wrong kind of central bank for the eurozone, but the case for dismantling the currency union was less clear cut than it was for dismantling the Gold Standard. It was far from clear that a country could exit the euro without a banking collapse and a big recession, not least because the exiting country would have to reinstate a national currency. The country could default, impose capital controls and enforce a period of financial repression. But its long-term performance would depend on the supply-side reforms it implemented. And leaving the euro could well be the result of a surge of political populism, which is not typically associated with sensible supply-side reforms.

The second panellist stressed that the breakdown of monetary regimes had always been associated with higher inflation: following the collapse of the Gold Standard, the unravelling of the Bretton Woods and the end of the Soviet Union. However, there were some reasons to doubt that a breakdown of the euro would have a similar effect. Sterling fell sharply following the 2008 financial crisis without triggering a jump in inflation, while the weakening of the euro over the last two years had not prevented core inflation from hardening at very low levels. However, there was no doubting the scale of the adjustment challenge within the eurozone. Whereas Spain and Italy outperformed France and Germany over the 15 years running up to the crisis, the opposite is now the case. Italian GDP per capita was 90 per cent of German levels prior to the introduction of the single currency, but had slid to 75 per cent and on current trends would slump to 60 per cent by the late 2020s. A break-up of the euro would probably force the necessary adjustments in real exchange rates, but continental Europeans had shown a marked reluctance to live with floating exchange rates.

According to the third panellist, the dismantling of the euro would cause financial chaos and no improvement in long-term economic performance. Just the hint of exit would lead to massive bank runs, which capital controls would be ineffective against. A lot of private debt held by eurozone countries was under foreign law and it was unclear whether this could be easily redenominated into newly introduced national currencies. Countries would struggle to establish the credibility of national institutions in such chaotic circumstances. Financial chaos combined with corporate bankruptcies would do long-term economic damage. And the inevitable mutualisation of private debt would push up public debt, leading to emerging market-type problems. Currency wars would ensue as countries attempted to boost exports at their neighbours' expense. Dismantling the single currency would also aggravate long-term growth challenges because it would undermine pressure to push through structural reforms. Finally, there was no empirical evidence of a link between monetary regimes and GDP growth.

According to the final panellist, eurozone rebalancing would be long and unpleasant without a very large real appreciation in the value of the 'German euro'. Dissolution of the eurozone and a 50 per cent rise in the real value of the German currency would lead to rapid fall in Germany's current account surplus. Things would certainly be messy but once they stabilised, there would be a period of floating exchange rates; there would be no repeat of the European Exchange Rate Mechanism, although some countries would no doubt fix their currencies to the German Mark. This would not spell the end of the EU's single market: floating currencies were compatible with it. And with truly floating exchange rates, the risk of protectionism would be limited. However, the end of the euro would put paid to attempts to integrate the eurozone financially. It would be impossible to have deep financial integration with multiple currencies, and this would undermine the efficient allocation of resources.

Q&A: In the following discussion, some pointed out that the cost of keeping the euro together could still outweigh the costs of dismantling it. A country leaving the euro would be quitting a currency union that lacked a proper lender of last resort or deposit insurance, which afforded its members limited scope to engage in counter-cyclical fiscal policy, had no mechanism for forcing adjustment on to countries with large current-account surpluses and which was undemocratic. The point of quitting the currency union would be to address these institutional weaknesses, not simply to regain trade competitiveness. National institutions would be better able to deliver the necessary mix of fiscal and monetary policy. These participants stressed that the eurozone countries did not suffer from such large current-account balances prior to the introduction of the euro; the system as a whole was misbehaving, not just national countries. This would get steadily worse, increasing the loss of potential GDP and worsening political tensions. Also, it needed to be remembered that there would be huge balance sheet effects if the euro survived, given the slow growth of nominal GDP in the future which would probably result in debt restructuring. Dissolution would be costly, but the world would survive.

Others argued that dissolution alone would achieve little, or make matters worse. In addition to the balance sheet effects, several participants questioned whether dismantling the euro would help countries to regain competitiveness or to engineer falls in real interest rates. They cautioned against placing too much emphasis on relative prices; competitiveness problems lay in outdated industrial structures rather than exchange rate misalignments. Devaluation in small open economies did not make much difference to competitiveness. Moreover, in a globalised world, monetary sovereignty was largely illusory, as attested by how closely UK spreads track US ones. Greece's and Italy's problems lay in their institutions, not their lack of monetary independence. And in any case, the euro would quickly be replaced by an exchange rate mechanism of some kind, which might be worse than the current set-up.

The discussion then turned to Germany. If it would not accept regime change to make the eurozone more inflationary, should it not leave the currency union? Some argued it could do so with minimal ill effects. Contracts would be redenominated into a stronger currency, so there would not be damaging balance sheet effects, and Germany could handle a banking crisis in any case. Other participants conceded that a eurozone without Germany could work, but that it would not be painless. There would still be dislocation and a big recession, and capital flight to Germany. But another group questioned whether it would be possible at all, because many countries would probably opt to stay with Germany. There was general consensus that Germany had strong political and economic incentives not to leave. Moreover, the French elite were incapable of thinking about divorce, at least for the time being. One official pointed out that Germany's current account surplus was now mainly with non-eurozone economies, so Germany leaving would not change much, but others countered that it was still in surplus with the eurozone and that creditor/debtor problems within the eurozone had just been pushed to another part of the world.

Several participants maintained that the fundamental problem – an unresolved debt crisis – could be resolved within the eurozone. Countries could default within the euro and engage in fiscal repression (the practise of holding interest rates below the rate of inflation and hence transferring resources from lenders to borrowers). Rather than dismantling the currency union, which would be impossible to do in an orderly fashion, eurozone governments needed to focus on reforming the institutions of the currency union, by completing the banking union, reforming the ECB, adopting strenuous macroprudential regulation and forcing countries to address imbalances in their economies. A few participants were optimistic that these changes could come about. However, most were pessimistic about the necessary reforms being embraced any time soon. Some argued that if France and Italy joined forces and demanded reforms, the Germans and their allies would have little option but to acquiesce. Others countered that this would turn German popular opinion against the euro.

In the face of such political constraints, it was suggested that the eurozone needed a half-way house. Fixing nominal exchange rates did deepen integration, but as things stood the eurozone was a fair weather construct; fine in good weather but a straightjacket in bad. In the absence of an agreement between the participating governments on the required institutional reforms, the eurozone needed an emergency escape in the form of adjustable currency pegs. There would be big transaction costs in going down this path, but it would help preserve some of the gains of integration. Others were sceptical that such intermediate solutions would work, as they would still require agreement between the participating countries and that might not be forthcoming. Moreover, fixed exchange rate regimes did not work well with unimpeded capital flows. Dual currency regimes were considered but discounted as stop-gap measures. The general conclusion to the session was that neither option – keeping the euro together as it was or breaking it up – offered a path out of the current problems.

Session 4: The political consequences of dismantling the euro

The dismantling of the euro would be a blow to the credibility of the EU in Europe and internationally. But would it help to counter the rise of political populism by restoring some policy autonomy to national governments? Or would it further bolster populist forces by discrediting established political elites? What impact would it have on relations between countries? Could the EU survive the inevitable tensions? Or is it possible that it might preserve some of the economic and political integration that has been achieved?

The first panellist played down the rise in populism, arguing that there were large pro-EU majorities in all member-states apart from Hungary and the UK. He further argued that populist movements in Europe differ from country to country, and that eurosceptics polled at most 30 per cent. It was important not to allow the populists to dictate policy as this would divide Europe and lead to the collapse of the euro, which would further deepen political divisions. A dismantling of the eurozone would lead to economic chaos in the south and hence to systemic political instability. Fiscal policy would be ineffective because the banks would be insolvent, opening the way for a wave of beggar-thy-neighbour currency devaluations. In the north, the shock could be absorbed economically, but politically, the creditor countries would lose control over European economic policy, with destabilising effects; France would turn into a non-establishment country as a euro breakup would discredit the country's elite.

The second panellist argued that the euro had deeply polarised European politics. The current rise of eurosceptic movements was a classical backlash against globalisation, similar to the 1930s. Support for these movements would only dissipate once economic growth recovered and demonstrated the benefits of openness. If growth remained weak, the number of Europeans backing populist parties would continue to rise, leading to political paralysis. However, dismantling the eurozone would not return the 28 member-states to happy co-existence. Frustration at the impact of globalisation, immigration and stagnant living standards would be channelled elsewhere, for example into regional independence movements, destabilising countries and the EU. Europe needed to find simultaneous solutions to a series of interlocking crises: the political stand-off within the eurozone holding back the necessary changes of governance; the war in Ukraine; the refugee issue; the crisis of democracy; the future of energy and climate policy; and the failures of corporate governance. One potential trade-off would be for the Germans to accept a degree of debt mutualisation in return for other eurozone countries doing more to share the burden of refugees.

The third panellist went through two scenarios for how the euro could break up, each of which would have different political consequences. The first was a populist coming to power in an important member-state, as may happen in France with Marine Le Pen. As a euro breakup cannot be pre-announced but must happen overnight, she might moderate her language before the election, and then spring a decision to quit after a few months in office. France could leave the eurozone without cataclysmic economic and financial consequences; it was a reasonably balanced economy, so the balance sheet effects would be manageable. The country would formally leave Schengen, but whether or not it would leave the EU would partly depend on what happened in Britain. If the UK had already voted to leave, the likelihood of France doing so too would be greater. If France opted to remain, it would be an uneasy member.

The second scenario was a centrist politician such as Italy's Matteo Renzi deciding that that he had to campaign to leave the euro in order to hold on to power. Italian membership of the eurozone would be unsustainable in the absence of stronger economic growth and the growth outlook was poor. The country was experiencing an extremely modest recovery from a deep slump and even this was vulnerable to the global slowdown. Italy's economy had major imbalances, so the costs of an Italian exit would be higher than a French one, especially for German banks. As a result, Germany would be very hostile to such a move.

The final panellist argued that the goal of prosperity in Europe had been sacrificed on the altar of rules, with poisonous political consequences. 'Sovereignism' was rising across the continent, and not all these sovereigntists were europhobic; some were responding to legitimate concerns. The panellist laid out several scenarios for dismantling the eurozone, each with different economic and political costs attached. The first was consensual breakup, perhaps following a conference convened by President Sarkozy and Prime Minister Renzi. This would pose significant economic challenges, but would be relatively benign politically. It would be preferable to where the eurozone finds itself today, but it was unlikely that there was sufficient trust between governments to pull off such a delicate operation. The second scenario was a violent breakup of the single currency. The economic costs could be lower than feared as banking systems had already to a large extent been re-nationalised, and capital controls could be implemented (they already had been in Greece and Cyprus). But the political costs would be high. It would comprise a huge political failure and could fatally wound the EU. The final scenario was that political conflicts within the EU lead to its dissolution, which would inevitably spell the end of the euro.

Q&A: The discussion initially focused on populism. Populism was a response to the crisis but also risked becoming an obstacle to solving it. A number of participants made the point that economic trauma eventually led to political trauma. Elites were being destroyed, and party democracy weakened. One discussant argued that the young generation of Italian politicians were increasingly ambiguous about Europe. Another said that Italy in the early 1990s served as a stark warning: the crisis then may have washed away the old corrupt elite, but it had arguably been replaced by something worse. However, one participant made the point that the failure of mainstream parties to question the dominant 'German consensus' had opened the way for populism. Populism, in turn, had become a major obstacle to the needed reforms, not just in countries with strong populist movements, but in Germany too. Finding solutions to the problems besetting the eurozone required a lot of political capital, but this was eroding.

There was broad agreement that both euro breakup and muddling through carried considerable political risks. Some participants argued that dissolution of the euro would do fatal damage to the EU, in the process rendering Europe even less able to cope with the myriad of challenges facing it. Others were less pessimistic about the political implications. Indeed, there would be legal uncertainty, but contracts would be resolved to the benefit of the debtors, easing populist pressures in those countries. Others countered that this would cause political problems in the creditor countries, which did not see themselves as sharing responsibility for the crisis. Germany resented how little the rest of the eurozone was doing to alleviate its refugee problem after it had shown so much solidarity during the euro crisis. There was little sign of an end to competing narratives of the crisis. Indeed, Germany was becoming less, not more, willing to compromise.

A political vision for Europe needed to encompass more than economic rule-making, but include security issues too. Europe needed a '*Gesamtkonzept*' (masterplan) involving a range of trade-offs to address issues from the euro, to refugees and security. However, such a gesamtkonzept required support for federalism, and this was lacking. The problem was that Germany was convinced that it had already delivered, and it was hard to see what the rest of Europe could offer Germany to persuade it otherwise. However, one discussant noted that German power would wane, given demographic changes, and this would make Germany more open to a grand bargain.

A key lesson from the crisis was not to let politics overrule economics again. One discussant pointed to the parallels between the euro and Schengen, arguing that both created facts on the ground without being followed by the necessary institutions – and that rules were no substitute for proper institutions. However, there was disagreement over how much integration would be needed to prevent the currency union coming apart. Some argued that much could be improved within the existing institutional constraints: eurozone governments could agree to write down debt and adopt more counter-cyclical fiscal policies. However, others countered that decisions were poor because decision-makers were taking decisions that had implications for the eurozone as a whole with a close eye on national electorates.

Session 5: Lunch debate: The UK, the EU and the eurozone

Like other neighbouring countries, the UK has suffered serious collateral damage from the eurozone crisis. Very weak domestic demand in the currency union has undermined the British government's attempt to rebalance the UK economy. At the same time, the eurozone governments' inability to plot a way out of the crisis has emboldened British eurosceptics, who (with some justification) argue that the crisis results from elites failing to understand the limits of integration. What impact could the various scenarios for resolving the crisis have on Britain's membership of the EU?

The first panellist focussed on the UK's relationship with the eurozone. One important question was whether Britain should join the banking union, which could make sense, but which would entail significant institutional changes, including of the ECB. It might also ultimately lead to the end of Sterling, which made it unlikely as the majority British view was that the Bank of England's ability to set monetary policy was the reason for Britain's relatively good performance after the crisis. The scenarios for a post-Brexit arrangement all looked unattractive: the Norway option would mean that Britain was de facto an EU member, but without any influence on the EU's future and regulation; the Swiss option crucially did not include financial services; trading on a WTO basis would not include services more generally. The only real option was staying in and engaging, but it was not clear how that would work alongside an expanding and deepening eurozone.

The second panellist argued that the UK would never join the eurozone but that it is clearly important for Britain that the euro succeeds. The EU referendum itself would not settle the issue of Britain's EU membership as it would at most yield a conditional yes. And the stability of the UK's relations with the EU depended on how the reforms of the eurozone progressed. Britain wanted an ever closer union of the eurozone but did not want to be part of it. The real problem would be if the eurozone continued to muddle through, as this would mean continued large-scale migration from the eurozone into the UK. The speaker argued that free movement would remain a divisive issue for the UK as long as labour migration remained the most important shock absorber in the eurozone.

The third panellist cautioned against overstating the challenges posed to the UK by the eurozone's problems. For example, the eurozone was not responsible for the UK's current account deficit, or for Britain's pervasive euroscepticism. The key to whether the UK could thrive outside the eurozone but inside the EU was the financial sector. Would a more powerful ECB – with banking supervision as well as monetary policy powers – foster financial sector protectionism? The UK had successfully challenged the ECB's drive to ensure settlement and clearing of the trades in euro-denominated assets take place within the eurozone. On systemic risk and capital markets, the UK was part of the relevant committees, and the capital markets union did not entail – at least for now – a strong common European regulator.

The final panellist argued that policy-makers on the continent did not seem to appreciate the scale of the challenges facing the eurozone. Germany, in particular, did not understand the economics and political economy implications of a monetary union. The US, meanwhile, was very clear about the consequences of Brexit: a serious blow to the UK's and the EU's standing in the world. The UK on the other hand was in denial about its dwindling importance in the world, as the global stature of London seduced policy-makers into thinking the country was more powerful than it really was. For this speaker, France was key: if management of the eurozone was to improve it would be because the French assumed leadership.

Q&A: The discussion kicked off by focusing on what the UK brings to the eurozone. Discussions within Ecofin (the Council meeting of finance ministers which included the UK) were more enlightened than those among the Eurogroup (which did not). The UK was a consistent supporter of greater economic openness and an EU capital markets union would mean little without the UK. But there was little sympathy for or understanding of Britain's concerns elsewhere in the EU, crucially in Germany, where Britain's drive to win protection against potential eurozone caucusing was seen as an attempt to gain special treatment. The idea of concentric circles – an Italian initiative to formalise the status of the nine euro 'outs' – could have solved the UK/eurozone issue but its day had passed, argued one discussant.

It was also argued that the UK's reform agenda was of little interest to the British people, who were most concerned about free movement, which the UK government was powerless to do anything about. Economists had succeeded in convincing the public of the benefits of free trade, but had had little success in explaining the benefits of free movement. The UK's immigration debate was tendentious and ill-informed, with the facts being critically at odds with common myths and statements by politicians. Politicians were urged to make the empirical case for free movement, prompting one panellist to remark that this would be very risky for a politician in today's political climate.

There was broad agreement that frightening voters about the risk of exit could help win the referendum, but it could backfire in the long term unless UK governments succeeded in addressing the reasons for antipathy towards the EU. One panellist argued that it would depend on what reforms the EU enacted over the next 10 years rather than on those under discussion under the current negotiations between the UK and the rest of the EU. Finally, another stressed that the close referendum vote in Scotland over whether to remain in the UK should serve as a warning. Nearly half those who voted did so for independence, which made even less economic sense than Brexit.

January 2016

List of participants

Joaquín Almunia	Former European Commissioner for Competition
László Andor	Former European Commissioner for Employment, Social Affairs and Inclusion and Senior Fellow, Hertie School of Governance
Angus Armstrong	Director of Macroeconomics, National Institute of Economic and Social Research
Ryan Avent	Senior Editor, *The Economist*
Ed Balls	Former Shadow Chancellor of the Exchequer and Senior Fellow, Harvard University Kennedy School
Mark Boleat	Chairman of Policy and Resources, City of London Corporation
David Bowers	Head of Research, Absolute Strategy Research
Marco Buti	Director-General for Economic and Financial Affairs, European Commission
David Claydon	Co-Founder and Partner, Macro Advisory Partners
Nicholas Crafts	Professor of Economic History and Director of CAGE Research Centre, University of Warwick
Paul De Grauwe	John Paulson Chair in European Political Economy, London School of Economics
Henrik Enderlein	Professor of Political Economy and Vice Dean, Hertie School of Governance and Director, Jacques Delors Institut – Berlin
Stephen Fidler	Brussels Editor, *The Wall Street Journal*
Marcel Fratzscher	President, DIW Berlin
Charles Goodhart	Professor Emeritus of Banking and Finance, London School of Economics
Charles Grant	Director, Centre for European Reform
Megan Greene	Chief Economist, Manulife Asset Management
François Heisbourg	Special Advisor, Fondation pour la Recherche Stratégique
Jonathan Hopkin	Associate Professor of Comparative Politics, Department of Government, London School of Economics
Faisal Islam	Political Editor, Sky News
Harold James	Professor of History and International Affairs, Princeton University
Anatole Kaletsky	Economic Commentator, Reuters and the *International New York Times*
Stephen King	Group Chief Economist, HSBC
Matthew C Klein	Alphaville Columnist, *Financial Times*
Philippe Legrain	Visiting Senior Fellow, European Institute, London School of Economics
Rachel Lomax	Non-Executive Director, HSBC
Eric Lonergan	Macro Fund Manager, M&G Investments
Wolfgang Münchau	European Columnist, *Financial Times* and Managing Director, Eurointelligence
Christian Odendahl	Chief Economist, Centre for European Reform

Kevin O'Rourke	Chichele Professor of Economic History and Fellow of All Souls, University of Oxford
George Pagoulatos	Senior Advisor, Macro Advisory Partners
George Papamarkakis	Managing Partner & Chief Investment Officer, North Asset Management
Jean Pisani-Ferry	Commissioner General for Policy Planning, France Stratégie
Richard Portes	President, Centre for Economic Policy Research and Professor of Economics, London Business School and European University Institute
Jonathan Portes	Principal Research Fellow, National Institute of Economic and Social Research
Lucrezia Reichlin	Professor of Economics, London Business School
Hélène Rey	Professor of Economics, London Business School
Martin Sandbu	Economics Editorial Writer, *Financial Times*
André Sapir	Professor of Economics, Université Libre de Bruxelles and Senior Fellow, Bruegel
Ludger Schuknecht	Director-General, Strategy and International Economy, German Federal Ministry of Finance
Andrew Smith	Chief Economic Advisor, Industry Forum
John Springford	Senior Research Fellow, Centre for European Reform
Poul Thomsen	Director, European Department, International Monetary Fund
Simon Tilford	Deputy Director, Centre for European Reform
Paul Tucker	Fellow, Harvard Kennedy School
Shahin Vallée	Senior Economist, SFM UK Management LLP
Peter Westaway	Chief Economist, Head of Investment Strategy Group, Europe, Vanguard
Karl Whelan	Professor of Economics, University College Dublin
Simon Wren-Lewis	Professor of Economic Policy, Blavatnik School of Government, University of Oxford
Jeromin Zettelmeyer	Chief Economist, German Federal Ministry for Economic Affairs and Energy