CENTRE FOR EUROPEAN REFORM conference

Highlights from the CER conference on

THE FUTURE OF THE EUROPEAN ECONOMY

Ditchley Park, 4-5 November 2005

In November 2005, the CER took more than 40 of Europe's top economists, policy-makers and commentators to the Ditchley Park in Oxfordshire to discuss 'The future of the European economy'. Participants included Graham Bishop, Jean-Philippe Cotis, Daniel Gros, Will Hutton, DeAnne Julius, Anatole Kaletsky, John Kay, Mart Laar, Richard Layard, Mario Monti, Jean Pisani-Ferry, André Sapir and Norbert Walter. A full list is attached at the end of this note.

During two days, we looked at questions such as: Has Europe really performed that badly compared with the US? How can Europe improve its growth and employment record? How has eastward enlargement changed the European economy? How can we cope with globalisation?

The debates were lively and of outstanding quality. Rather than trying to sum up the debate artificially, we decided to publish a few highlights from the plenary discussions and working groups. The debates took place under Chatham House rules so we do not attribute quotes, with the exception of the introductory speeches.

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Katinka Barysch

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Centre for European Reform
29 Tufton Street
London SW1P 3QL UK

T: 00 44 20 7233 1199
F: 00 44 20 7233 1117
info@cer.org.uk / www.cer.org.uk

1. INTRODUCTORY REMARKS

Norbert Walter

Europe suffers from complacency: Europeans think they live in the kingdom of happiness. The current system offers a majority (relatively) secure jobs AND lots of leisure. People are quick to dismiss calls to adjust to the harsh reality of globalisation.

What Europe needs to do now:

★ demographics: family friendly policies and controlled immigration;

★ investment: Europeanisation of regulation; shift of taxation towards consumption;

★ social security: move towards more private provision of healthcare and pensions – both future growth sectors;

★ environment: gradual shift towards more environmentally friendly policies.

Businesses, NGOs and the media must make the case for reform. They need to drive the agenda at a time when Europe suffers from unprecedented political weakness. Tony Blair has the courage to talk about economic reform in the EU, but he does not follow up on it. The other EU leaders do not even talk about European reform.

Mario Monti

The gloom about the EU has been overdone; many of the member-states are doing very well. The Nordic countries outperform the US on many indicators, such as growth, employment, innovation, education and social equity. However:

★ Resurgent protectionism implies the risk of disintegration or rolling back existing EU achievements, such as the single market. The debate about the services directive shows that the principles of the single market are not universally accepted.

★ Internal developments are getting more important in driving policies in EU countries, so the risk of populism is growing. Before the euro, countries always needed to worry that irresponsible economic policies would result in currency crises, such as the collapse of the ERM. The single currency takes outside pressure off governments. The Lisbon process is not enough to exert discipline.

★ The Union is unpopular at the moment, so member-state governments can no longer sell reforms in the name of the EU. If the EU launched new efforts to write an EU constitution / new treaty now, it would struggle to get agreement even on the clauses on market opening and competition that are in the Rome Treaty.

The EU paradox is that those countries that need reforms most are now the most anti-reform. Germany needs to rediscover the foundations of its economic success: the social market economy with a strong emphasis on the market. France practices reform by stealth. President Jacques Chirac says that liberalism is as dangerous as communism, but his government does usually follow EU reform agenda.

The EU needs to move into new areas. For example, some degree of tax co-ordination is needed within the EU. Tax competition erodes the tax base, which means that governments lack the resources to sustain social standards. Governments that cannot pay for social cushioning may turn to protectionism instead.

Anatole Kaletsky

The EU's main economic problem is not on the supply side or in the social system. It is a problem of demand, and of the interaction between these three areas. Europe could combine high social standards with low wages, low interest rates and competitive exchange rates. The current mix of high wages and social standards with tight macro policies is unsustainable.

The big difference between the US and the UK, on the one hand, and the eurozone, on the other, is demand management. ECB interest rates may be historically low. But they are still too high for today because we live in a structurally deflationary environment. Most micro reforms are deflationary, especially those of social security and pension systems. The effect is more acute in large economies that need to generate their own demand. At a time when EU governments are struggling with reforms, the ECB is overly worried about inflation. Recent experience suggests that inflationary risks have diminished. In Japan, for example, the economic revival needed a long period of negative real interest rates and active exchange rate management. The Bank of Japan has spent $1 trillion on keeping the yen low, the ECB has spent nothing on managing the euro. In the US, Fed rates were down to 1 per cent in 2003 but inflation did not take off.

The idea that reforms only happen when growth collapses is wrong. Reformers need political legitimacy, which comes from good economic performance. Even the ECB admitted in a 2005 report that supply-side reforms are more likely to be sustained in a high-growth environment – although a crisis may help to get radical reforms off the ground initially. All of Thatcher's tougher reforms happened after 1984, when growth was steady and unemployment declined.

The single currency, the stability pact and other EU rules now prevent EU governments from managing their own economies. It is therefore not surprising that the people are turning against the EU and European integration. Europe has an economic policy bias towards masochism, which is a hangover from the days of high inflation: policy-makers think that progress requires pain. They do not dare to follow growth-boosting policies such as Thatcher's privatisation of social housing, which then created the growth conditions for more difficult reforms.

Jean-Phillippe Cotis

Europe's main problem is not its 'social model' but that the way we implement this model is out of date. For example, Europeans support a high standard of social welfare. But the universal coverage of the entire spectrum of social benefits means that there is not enough personal responsibility, and the acceptability of high taxes is declining.

Social expenditure in Europe is now so high that any marginal rise means less money is available for investment in infrastructure, research, education and other growth-boosting measures.

The main problem with EU social security is that social policies are:

★ captured by vested interests: for example, rent-seeking by healthcare providers impedes healthcare reform;

★ used for other policy purposes, in particular redistribution: for example, high earners pay more into health insurance funds although they are not sick more often than low-wage earners; and pension systems are used to fight unemployment through early retirement schemes;

★ too slow to adapt to new challenges, in particular demographic change.

The employment gap between the EU and the US is caused in part by differences in weekly working hours and in part by differences in employment rates, in particular for workers over 55. EU countries have sent hundreds of thousands of workers into early retirement, which means they are spending a fortune to persuade people NOT to work. OECD studies show that tax and pension systems can be used to encourage older workers to stay in their job. EU countries should copy Sweden which has moved to actuarial neutrality: people who retire earlier get lower pensions. The idea that early retirement would reduce unemployment turned out to be wrong. Early retirees are a massive burden on state budgets. The higher taxes required to pay for them have impeded job creation, which has mainly harmed new job market entrants, that is young people.

2. THE WORKING GROUPS

A: Labour markets and social policies

Is high unemployment the inevitable consequence of growing global competition? There is no agreement on whether there is more dislocation than in the past: global trade is growing fast while the pace of technological change is slowing. However, Europe is less capable of dealing with outside pressures because its labour markets and social institutions have become sclerotic.

Employment: Today employment is the EU's main economic challenge. If we did not have high unemployment in the large eurozone countries, there would be no talk about a crisis in the EU, just about the need for change. The EU as a whole will not achieve its key employment objective of the Lisbon reform agenda, namely to get 70 per cent of all people of working age into jobs by 2010. Most solutions to Europe's employment problems have to be found at the member-state level. The EU can help by facilitating learning and peer pressure among EU countries, and competition between different models. There are also more direct ways in which EU policies impacts on job creation or destruction in the member-states, in areas such as immigration, the mobility of workers within the EU, higher education and training, market integration (for example the services directive) and fiscal rules (in particular for the sustainability of public finances).

Many of the structural reforms included in the Lisbon agenda are designed to raise productivity, for example policies on market opening, support for small enterprises, improving education and higher spending on research and development (R&D). Higher productivity means that at a given level of demand, the EU needs fewer workers to produce the same amount of output. Lisbon structural reforms, therefore, need to be accompanied by measures that encourage job creation. However, job creation in Europe is faltering. There are several possible explanations:

★ Restrictive labour market regulations: There is no consensus about the impact of employment protection rules on employment levels (OECD study 2004) – although there is evidence that excessive hiring and firing costs disadvantage first-time job seekers.

★ A high tax burden on labour: Economists argue that high payroll taxes do not necessarily impede job creation because businesses pass on the costs to workers in the form of lower wages. However, high payroll taxes are a disproportionate burden on low-cost / low-skilled employees. And they drive economic activity into the shadow economy, so further shrinking the tax base.

★ Overly generous unemployment benefits: Some EU countries have cut back unemployment benefits, but they still need better job-search assistance and conditionality for receiving benefits. There is evidence that the conditionality of unemployment benefits is linked to employment levels across countries and over time. In the 1999-2000 boom, Germany and France had very high numbers of vacancies but unemployment did not fall. Some EU countries introduced tougher conditionality and time limits for unemployment assistance, and offered retraining. In these countries unemployment fell much more during subsequent upswings (notably in Denmark, the Netherlands and the UK). However, in some regions, mobilising the unemployed will not help because there are simply not enough jobs around, for example in Germany's eastern Länder, Southern Italy and parts of Spain, where wages are too high.

★ Other rigidities: In Europe, structural rigidities in education and housing prevent people from moving around in search of jobs like in the US. We have known about this for a long time, which is why we had a debate about whether the euro area would constitute an 'optimal currency area' (which among other things requires high worker mobility so that different parts of the area can adjust after asymmetric economic shocks). However, more recently the lack of flexibility has become more acute because of globalisation.

It is not clear a priori that changing labour market institutions would lead to more employment creation. European employment policies perpetuate a dual labour market, where some workers are over-protected and others not at all. Today's reforms mainly take place within the existing framework, so they often exacerbate the insider-outsider problem, and make future reforms even more difficult.

It is important to remember that Europe does not have a general employment problem: male, skilled, prime age workers do have jobs. The key challenge consists in creating employment for the unskilled, young, older workers and women. But this needs differentiated analysis of each problem. For example:

★ Youth unemployment is high in France but low in Germany. Why? Differences are partly related to the apprenticeship system and partly to tertiary education. Germans are in university until they find a job, but this also means that the social return on education one of the lowest in the OECD. Youth unemployment will be much less of a problem in the future, when large numbers of workers retire while fewer and fewer enter the labour market.

★ Older workers: Finland has managed to raise employment levels among older workers by reducing incentives for early retirement. But not all early retirement is voluntary. In Poland, for example, the over-55 employment rate is only 25-30 per cent, which is largely the result of industrial restructuring, not people seeking early leisure.

★ Female employment: a clear case for fine-tuning social policy. For example, governments would do better to subsidise childcare (which can encourage higher female labour force participation AND higher birth-rates) than to pay lump-sum benefits to families. However, the EU should be cautious to suggest that a high female employment rate is in itself desirable. Mothers may want to stay at home.

★ Unskilled workers: The EU's 'solidarity model' (with its emphasis on consensus between business and trade unions, or 'social partners') is good at imposing wage moderation across the board. But it fails to allow wage differentiation according to skill levels. As a result, EU industry as a whole does not have a competitiveness problem due to high wages but low-skilled workers have been priced out of the market.

★ Other non-working groups: The UK, the Netherlands, Poland, Hungary and others have very high numbers of people on invalidity benefits. This is partly because of government attempts to push people off the unemployment register and partly because of lack of preventive healthcare to address stress or mental illnesses.

Social Europe: The EU's main – and most successful – area of activity is liberalisation, for example through the creation and supervision of the single market, state aid rules, competition policy and the Lisbon agenda. But the EU has no competences for achieving equity, so people feel that the EU is unbalanced and they are calling for the EU to strengthen its 'social pillar'. But:

★ There is agreement that the EU cannot deliver a one-size-fits-all social policy solution because the challenges vary from country to country. For example, countries such as Germany and France offer high levels of social protection within the labour market, which has led to labour market rigidities. Denmark, on the other hand, couples flexible labour markets with high protection levels outside the labour market. A country like the UK has flexible labour markets and low levels of social protection. Fact is: all models need to adjust to the pressures of globalisation.

★ The EU should not try to define and defend a 'European social model'. Instead, it should agree on a limited number of policy priorities. These should be objectives that can be better addressed at the EU level AND on which there is consensus among the member-states. Such a consensus will be difficult to forge because EU countries do not agree on whether and how the EU should play a role in social and employment policies beyond the existing directives. At the end of 2005, the EU governments agreed to establish a 'globalisation adjustment fund' to help workers who have been laid off as a result of global competition to find a new job. However, the new fund is limited to ¤500 million a year (paid out of unspent EU budget allocations). Some people criticise the fund as tokenism. It is too small and its rules too complicated to make a difference. Others say that the symbolism is important: at least it shows that the EU cares about the losers from globalisation. Some also argue that the EU could achieve real results with relatively little money. For example, a fund for an EU-wide minimum income guarantee could cost as little as 0.5 per cent of EU GDP.

Education: Everyone agrees on the importance of education reform for improving labour market performance. Yet there are not enough practical proposals around. Even suggestions such as the creation of six top-class European universities are not ambitious enough: the EU has hundreds of universities, and only six top ones will not allow us to compete with the US. Moreover, an excessive focus on improving universities and creating centres of excellence could fail to equip the workers with the skills they need to adjust to new circumstances. Our working lives are getting longer while our knowledge is getting out of date more rapidly. Yet our first-round education (school plus college) still takes far too long, and there is not enough training and lifelong learning.

Demographics: We are still underestimating our demographic challenges. Longevity is now rising at an accelerating pace, but people are not aware of the fact that they will live 30 or more healthy years after retirement. The fall in the retirement age in the EU took place during a time when there were large numbers of new labour market entrants and few pensioners, so it was natural. Now that the demographics have changed, the retirement age is being raised again. However, politicians always have an incentive to delay the actual change until well after the next election. In the meantime, EU countries should at least scrap schemes for early retirement and create incentives for people to work longer (such incentives will pay for themselves if they create employment).

Immigration: Low birth rates and early retirement mean that labour forces across the EU will start shrinking soon (in countries such as Germany or Hungary they are shrinking already). Immigration can help to alleviate this problem, but it also creates new policy challenges. Most people agree that in an integrated European labour market the EU needs to play some kind of co-ordinating role in immigration policy. But there is no consensus on how far this should go. It is a very sensitive subject in most member-states. EU-wide quotas are not politically acceptable. Also, if immigrants come with the objective of getting access to social welfare in EU countries, any EU immigration policy will have huge implications for the social systems of the member-states. Perhaps the best way forward would be for some EU countries to form an avant-garde group to co-ordinate immigration policies and let others join later (following the example of the Schengen agreement of passport free travel).

In recent years, a lot of immigration has consisted of family members of workers already in the EU, and of illegal immigration. Therefore, the share of the unskilled among immigrants is very high. Unskilled immigrants pose particular policy problems since they can create downward pressure on the wages of socially vulnerable groups and they are more likely to become reliant on welfare benefits (40 per cent of young male immigrants in France are unemployed). This makes immigration as a whole less acceptable. Most member-states are now trying to attract more skilled workers. For the EU to play a role in this area, there would have to be agreement on the meaning of 'skilled', which would be difficult. For example, how should we compare a degree gained in Poland to one gained in Sri Lanka?

B: Europe and globalisation

The EU is changing so fast (single market, euro, enlargement) that Europeans risk missing the importance of global changes. The integration of China and India is a supply shock that is adding 50 per cent to the global labour force and vastly increases global demand for natural resources. But Europeans are insular, they focus on the consequences of eastward enlargement, which for them represents a kind of mini-globalisation. Today, the EU is growing at 1.5 per cent a year, which means it is falling behind in a dynamic global economy. It is inevitable that the EU's share of global output will decline relative to the US and Asia. But individual EU countries and regions will be affected in very different ways.

Competitiveness: To predict the impact of globalisation, one has to start with an idea of what it means to be 'competitive'. Competitiveness is the ability to create rents from endowments that cannot easily be replicated. Europe has many such abilities, for example first-mover advantage in financial services (UK); English language for media (UK); good design and flair (Italy); well-known brands (foods across the EU such as champagne). The size of the EU's single market is another asset. Marginal returns on investment may be higher in emerging markets such as China. But companies will still want to be based in Europe. To have strength abroad, a company needs to have economies of scale in its home market. Most emerging markets are too small to provide a solid base from which to compete in global markets. Even China's economy is only about the same size as that of the UK or France (measured at exchange rates), although of course it is growing much faster.

Globalisation will result in growing gaps within the EU between those countries and regions with competitive advantages and those without. Over time, the EU will have to become more specialised.

The new EU member-states will be the first to suffer from the rise of Asia since they currently specialise in the same goods as China (consumer electronics, basic manufactures, including textiles) and they have few established brand names or other competitive advantages. Moreover, the Central and East European countries have to cope with the same global pressures as the EU-15 while having weaker institutions, such as infrastructure, education systems and political systems.

Even where competitive advantages exist in the old member-states, it is not certain that they are sustainable. Emerging countries, in particular in Asia, are getting ever quicker at adopting and spreading new technologies (partly through disregard for intellectual property rights). They have also woken up to the importance of education to support rapid economic upgrading. The EU itself is helping to train Chinese financial analysts and Indian software engineers. Even European brands may lose their attractiveness. Tastes may shift away from preferences for Western goods and towards say, Japanese design or Indian movies.

Policy implications:

★ The EU has to face fact that it needs faster economic change and more specialisation. It should stop subsidising yesterday's industries (through the CAP but also the structural funds) and focus on innovation, IPR, competition policy and better regulation. The EU's support for R&D should focus on basic research: we will not be able to compete with the Chinese on engineering applications. Both national and EU policies need to do a lot more to improve education to create a more adaptable labour force. And the EU should actively seek to keep multinational headquarters in Europe – the spill-over effects will be worth the effort.

★ If the EU fails to adjust to new competitive pressures, its external trade policy could become more protectionist. Europeans are therefore getting more critical of EU trade policy, and some national governments want the EU to take a tougher stance in the Doha trade round. Meanwhile, European multinationals are lobbying to Commission to pursue a liberalising agenda. The outcome might be an EU trade policy that simply defends the status quo. But paralysis will leave all sides frustrated.

★ Globalisation may require a stronger EU foreign policy. The rise of China and India means that the world may have entered a new era of scarce resources. China seeks to secure resources not through open markets but through power bargaining and political influence, something at which the EU is ineffective.

EU legitimacy: There is a risk that Europe's slow and averse reaction to globalisation could undermine the EU's own legitimacy. Europeans have been told for decades that the EU will deliver 'peace and prosperity'. But more and more people think that today the EU is not delivering economic benefits, only increased insecurity. It is the EU, not the member-states, that negotiates global trade agreements. But the EU itself has no mechanism for alleviating the economic consequences of its trade policies (unless it allocates much more money to the new globalisation adjustment fund). Similarly, EU enlargement has increased low-wage pressure within the EU at a time when many national governments are trying to slim down social security systems. Moreover, Europeans – unlike Americans or Japanese people – face the double strain of economic and political change. Like people in other developed countries, EU citizens struggle to come to terms with globalisation. But they also have to come to terms with EU political integration. At least in the US and Japan, the political framework is stable. The result is a perception of threat coming from the economy, and of helplessness as political power moves to a level where voters cannot control it.

Global imbalances: Globalisation means that Europe will be affected by the unwinding of global imbalances, be it through exchange rate adjustment (a plunge in the dollar) or retrenchment in US domestic demand or both. There is no agreement on how much Europe would suffer. A fall in the dollar and/or US domestic demand would be bad for the European export sector, and Germany's in particular. But if one assumes that the unwinding of global imbalances will affect the EU in a major way, one cannot at the same time argue that Europe is merely a victim of imbalances that are created by irresponsible policies in the US and/or Asia. Are macro-economic policies in Europe too tight? Should the EU not have a current-account deficit and absorb some of the exports that are driving Asian growth?

Europe may currently have a growth deficit (lack of domestic demand). But if it manages to pursue reforms, it will be in a much better position when global growth slows down: at least it does not start out with massive twin deficits. And if imbalances unwind through a fall in the dollar, the Asian currencies will also depreciate. This will stimulate domestic demand in China, Japan, and elsewhere, which will benefit EU exports. A falling dollar means cheaper raw materials.

C: Enlargement and the changing European economy

On the whole, enlargement has been good for the European economy. The integration of the Central and East European countries into the EU single market has created trade and investment opportunities for West European companies. And it has helped to transform the accession countries into open and competitive market economies. The immigration of East European workers has brought economic gains for those three EU countries that opened up their labour markets in 2004. Growth in the new members will continue to outpace that of the EU-15, thus adding some dynamism to a sluggish EU economy. Moreover, the new members tend to be less averse to economic change and more likely to support the EU's liberalising agenda.

However, the 'big bang' enlargement has overwhelmed the EU politically. The backlash against enlargement is mixed up with backlash against globalisation.

Enlargement of the eurozone: The new members will be much slower to join the euro than initially expected. Only Slovenia and the Baltic states are on course to join in the next couple of years. Slovakia could follow soon thereafter, but the Czech Republic, Hungary and Poland are highly unlikely to join this decade. In these countries, large and persistent fiscal deficits will be the main obstacles to joining the euro. Some economists (and politicians in the new member-states) argue that the Maastricht criteria were designed to keep Italy out of the euro and that they are in no way appropriate to test whether the new members have converged in a sustainable fashion. For example, since there are now large inflation differentials within the eurozone, the inflation criterion requires the East European countries to be too close to those EU countries with the lowest inflation (and growth) rates. This will be particularly tricky since inflation in the new members is structurally higher (the Balassa-Samuelson effect: fast growing countries have higher inflation as their productivity and price levels catch up with those in richer countries).

The ECB and many of the current eurozone members insist on a strict interpretation of the Maastricht criteria. Perhaps it may be better to redefine the criteria, but to be more explicit about the fact that the eurozone is club, and therefore the members can (and should) control who joins. If admitting additional members threatened to make eurozone macro management more difficult, the existing members should be able to use this as reason to delay eurozone enlargement. Conversely, no country should (or can) be forced to join the euro. The EU should acknowledge this reality. Some EU countries, however, may be tempted to stall eurozone enlargement for political reasons, since they want to turn the current euro members into a 'core Europe' as a basis of further political integration. If such an idea catches on, the bar for future euro members will be significantly higher.

Turkey: Whether Turkey will ultimately join the EU will depend on several factors: 1) whether growth revives in the eurozone, since opposition to enlargement is related to fears of unemployment; 2) whether France can overcome its existential crisis and find a new role in a larger Union; 3) whether the EU embraces 'variable geometry' as a way of allowing deepening among some countries despite ongoing widening; 4) whether Turkey keeps up the pace of political and economic change and thus impresses the West Europeans; 5) and, of course, whether Turkey still wants to join in ten years or so.

★ Turkey will have to continue modernising its economy irrespective of EU accession. With its heavy reliance on textiles and other low-value added manufacturing goods, Turkey is coming under intense pressure from Asia. And Turkey needs to create jobs for a growing labour force and to absorb workers coming from the countryside.

★ The objective of EU accession provided a solid anchor for reforms in the Central and East European countries. And it has already led to remarkable reforms in Turkey. Over the medium term, however, the EU anchor could be weaker in Turkey because the outcome of the negotiations is less certain.

★ Turkey is aware that big majorities in Germany, Austria, France and other EU countries oppose its accession. France, Austria and probably other members too will hold referendums on Turkish membership, once the negotiations have finished. But the outcome of these referenda cannot be predicted today. By 2015 or so, the EU will have moved much further towards variable geometry. A more flexible Union will find it easier to take in new members. Also, over the next ten years or so, the impact of eastward enlargement and globalisation will force the old EU members to accept growing income and wage inequalities in their own countries. Low-cost competition from Turkey will look much less threatening.

★ The biggest economic advantage for the existing EU would come from labour mobility – which is unlikely to be allowed for many years after accession, if ever. It is, in any case, tricky to use Turkey's potential labour supply as a key argument for Turkish accession. In the past, Turkish immigrants tended to be low-skilled, and they often came with large families, so their net contribution to public finances (and the sustainability of pensions) was unclear. A key year will be 2011, when the transition periods for the free movement of labour from the Central and East European countries run out. If fears of large-scale inflows prove unfounded, German and French workers may become as relaxed about the free movement as Brits and Swedes are today. If there is a large inflow of workers from Poland, Hungary and elsewhere, Turkey may have to accept permanent safeguards on free movement.

3. HIGHLIGHTS FROM THE PLENARY DISCUSSIONS

The EU and the US: Should the EU compare itself to the US during the last ten years, a period of extremely strong growth? And is real GDP growth the best measure of relative performance? The EU does much better in terms of GDP growth per head and productivity per hour worked. Moreover, the US suffers from problems that the EU does not have, in particular high levels of household debt and large fiscal and external deficits. The EU has high levels of wealth, a more equitable distribution of incomes, strong companies with sound balance sheets. Some EU countries have higher employment levels than the US.

However, the US has outperformed most EU countries in productivity growth since the mid-1990s, which is worrying. One explanation is that Europe's superior performance in job creation (at least until 2001) has come at the expense of productivity growth, since EU countries have brought low-skilled workers back into the work force. Low productivity growth is also the result of a lack of product market competition and finance opportunities: the EU is not as good as US in replacing less productive with more productive companies.

Half of the growth differential between the US and the EU is due to differences in labour supply, partly because of better demographics and higher employment levels, but also because Americans work much longer hours and take fewer holidays. Why? Possible explanations: 1) growing income inequality in the US: low-income households are forced to work longer hours to make ends meet; 2) taxes: the marginal income tax rates in the EU are so high that they discourage extra work 3) labour market institutions: Americans may want to work less collectively, but cannot achieve this result individually because there are no collective bargaining systems.

Performance differentials within the EU: Europe's small countries are doing well: they have solid growth rates, high employment levels, innovative companies and healthy public finances. It is the big-3 eurozone countries that are the problem, but why? Culture? Or economic structure? 1) The bigs' relative decline is partly the result of EU integration itself. Before the single market and the euro, industries had to locate in big markets to reap economies of scale. Now they can produce anywhere and serve the whole EU market. Countries with big markets have lost one of their competitive advantages. 2) The incentives for reform work differently. Outside constraints are weaker in large countries, so their economic policies can be less disciplined. For example, Portugal and Ireland have to comply with the stability and growth pact but Germany and France can try to change the rules themselves. Generally, the political economy in large countries adapts more slowly to outside pressures and there are more vested interests.

Economic co-operation in the eurogroup: Theoretically there is a strong case for the eurozone countries working more closely together on 1) tax (base) harmonisation 2) co-ordinating structural reforms 3) representation in international financial institutions, such as the IMF. However, in practice:

★ The main driving force for tax co-ordination is German/French/Austrian fears of low-tax competition from Central and Eastern Europe. They want the new members to adopt a minimum rate of corporate profit tax. If tax harmonisation takes place within the current eurozone, the outcome might be a high minimum rate that would further undermine competitiveness of the eurozone countries.

★ It is exactly the big eurozone countries that have made the least progress with Lisbon-type reforms. If further co-ordination efforts centre on the eurozone (and leave outside the UK, the Nordic and East European countries), the overall pace of reforms in the EU could even slow.

The euro and economic reform: The euro has increased price transparency and competition for the eurozone and further reduced the risk of cross-border trade and investment. Therefore, the euro has reinforced the need for rapid economic adjustment and reforms. At the same time, however, the single currency insulates countries from the impact of their policy mistakes because it eliminates the risk of currency crises. Financial markets do not sufficiently punish undisciplined governments through higher interest rates. The euro therefore encourages free riding on reforms in other countries.

The countries that have stayed outside the euro have gone further with reforming their economies than those that have joined. However, it would be wrong to conclude that the euro is to blame. In the UK and Sweden, reforms were triggered by crises in the 1980s. And both countries had already gone further in deindustrialisation and shifting to services before the late 1990s. Even without the euro, Germany, France and Italy would face a substantial reform agenda.

Is Europe's low growth a micro or macro problem? The 'Brussels consensus' (Commission and ECB) says that only micro-reforms matter. But the macro-framework can facilitate, and creates incentives for, reform.

Some argue that ECB interest rates are too high for Germany. Germany is the world's biggest exporter so it does not have a competitiveness problem. What it does have is a domestic demand problem. But there is no agreement on whether the EU as a whole suffers from a shortfall in domestic demand. Demand has grown in line with output, otherwise the current account would have moved into a massive surplus (although output has been below capacity).

If there is a general demand problem in the eurozone, it is not clear whether this is the result of an overly tight macro-stance or micro-economic problems.

★ Argument 1: micro-rigidities create high unemployment, which creates job insecurity and necessitates high tax rates on those that do have a job. People who are insecure and overtaxed do not spend. High unemployment is also a burden for the public purse so governments cut back social security and welfare, which makes unemployment even more painful.

★ Argument 2: EU macro-economic policy is too tight, and the EU's system of economic governance is out of date. Just like generals tend to fight the last war, the EU's macro-economic system is designed to fight the past evil of inflation. Most structural reforms are deflationary, so the ECB's interest rates are too high. Moreover, the EU's fiscal rules are too restrictive and they are pro-cyclical (they only bite when a country is already in trouble).

★ Argument 3: Europeans are simply too gloomy. Politicians and the media need to stop talking Europe down. However, scaremongering also takes place in the US (witness the debate about 'the China threat') but it does not seem to affect consumption.

★ Proponents of argument 1 advocate Anglo-Saxon micro-policies but not Anglo-Saxon demand policies, like the (Keynesian) demand stimulus programmes followed by both the UK and the US. Even if the problem is (partly) micro, can we wait for it to be fixed? True, France has the highest costs of unskilled labour in the OECD, which is one of the reasons why unemployment is so high. But in terms of wage flexibility, the eurozone is lagging the US by decades. European growth cannot wait for this to be addressed fully.

★ Packaging of reforms could be the key. Some supply-side reforms are deflationary, such as those of labour markets and social security, because they result in a redistribution from wages to profits and a reduction in consumption. But other reforms can boost growth, for example those of financial and product markets. Governments should carry out growth-boosting and growth-reducing policies simultaneously.

★ US economic policy makes the consumer king. The EU has so far focused on producer interests, be in the CAP or in competition policy. European consumers do benefit from the single market but transaction costs for shopping or payments across borders remain too high. The EU could help to stimulate demand by speeding up the liberalisation of product and service markets and creating a pan-European payment system.

★ It has become increasingly fashionable to blame the EU itself for micro-rigidities: too much red tape coming from Brussels. However, EU rules do not determines the level of demand. National rules are much more important. For example, EU countries with inflexible housing markets and less competitive financial markets have higher savings rates. People in the UK (and US) have easy access to mortgages, and housing markets are flexible. Home-ownership is widespread and owners can leverage their real estate assets and spend the gains on consumption. Continental European countries could create demand through lowering transaction costs in housing and financial market.

What are the best preconditions for reform? The message of the German election outcome was: things are not that bad, we don't need radical change. Reforms can happen in crisis situations (UK, Scandinavia) or against the background of fast growth (Baltics). But they are very difficult in situations of sluggish growth or stagnation at a high level of wealth, where people have a lot to lose. Is stagnation a price that Europeans are willing to pay for slow reform? Perhaps Europe need extraordinary political leadership. Perhaps, after years of scaremongering, politicians can win elections on a pro-reform platform. Or, one former prime minister said: "You shouldn't worry about being voted out because of reforms, you will be ousted anyway."

Economics and EU legitimacy: The nature of European integration has changed: the era of top-down policy making (or integration by stealth) is over. Now, all major steps will require referendums in many EU countries. So public opinion matters much more. The single market, the euro, eastward enlargement would not have happened if they had required popular support in every EU country.

Today, economic uncertainty is one of the factors behind rising anti-EU sentiment. A large number of unskilled workers voted against the EU constitutional treaty in France and the Netherlands (but not only: unlike in the French referendum on Maastricht, many middle class and public sector workers were in the No camp). Any further progress on EU political reform and integration needs progress on the economy first: people need to see the benefits of European integration again. But it is unfair to blame the electorate for becoming anti-EU. It is the fault of politicians who blame Brussels or enlargement for their own inability to implement reforms.

The future of the single market: Businesses will not allow the single market to unravel. But further progress is in doubt. By speeding up trade integration and inter-dependence, the euro should have created a greater constituency for more openness (arguable whether it has). Instead, there is a loss of momentum in economic integration, in particular in services. If services market integration does not proceed, it will cost the EU 4-5 percentage points of its GDP. The services directive should concentrate on the free movement of self-employed workers and leave out questions of employees that are too contentious at the moment.

THREE RECOMMENDATIONS FOR EUROPE

★ **Stop talking Europe down!** Europe needs to move away from economic determinism and seeing markets as a threat rather than an opportunity. European politicians need to soften their rhetoric and create a constituency for steady reform.

★ **Stop subsidising unemployment!** Instead, EU countries need to subsidise jobs for the low-skilled, create more opportunities through better education and put more money into demand policies.

★ **Embrace change!** EU industries should dare to move into new areas, such as renewable energy, which will be a big market opportunity in the future.

4. PARTICIPANTS

Katinka Barysch, Chief economist, Centre for European Reform

Iain Begg, Professor, London School of Economics

Erik Berglöf, Executive director, Stockholm Institute of Transition Economics

Giuseppe Bertola, Professor, Università di Torino

Ashish Bhatt, Deputy director, The Ditchley Foundation

Graham Bishop, Founder and principal, Grahambishop.com

Tito Boeri, Professor, Università Bocconi

Jeffries Briginshaw, Head of international political & regulatory affairs, British American Tobacco

Willem Bröcker, Global managing partner, PricewaterhouseCoopers

Jean-Philippe Cotis, Chief economist, Organisation for Economic Co-operation and Development

Bronwyn Curtis, Head of European broadcasting, Bloomberg

Stephanie Flanders, Economics editor, BBC Newsnight

Andrea Gavosto, Chief economist, Telecom Italia

Charles Grant, Director, Centre for European Reform

Daniel Gros, Director , Centre for European Policy Studies

Lord Hannay of Chiswick, Member of the EU select committee, House of Lords

Lord Haskins of Skidby, Chairman, European Movement

Peter Havlik, Deputy director, Vienna Institute for International Economic Studies

John Hawksworth, Head of macroeconomics, PricewaterhouseCoopers

Sarah Hewin, Senior economist, American Express Bank

Catherine Hoye, Office & events manager, Centre for European Reform

Will Hutton, Chief executive, The Work Foundation

DeAnne Julius, Chairman, Chatham House

Anatole Kaletsky, Editor at large, The Times

John Kay, Economist and author

William Keegan, Senior economics correspondent, The Observer

Mart Laar, Former Estonian Prime Minister

Michael Landesmann, Director of research, Vienna Institute for International Economic Studies

Lord Layard, Professor, London School of Economics

Jürgen Michels, Economist, Citigroup

Mario Monti, President, Università Bocconi

Wolfgang Münchau, Associate editor, Financial Times

Alasdair Murray, Deputy director, Centre for European Reform

Erik Nielsen, Chief European economist, Goldman Sachs

Fiorella Kostoris Padoa Schioppa, Professor, La Sapienza University

John Peet, Europe editor, The Economist

Jean Pisani-Ferry, Director, Bruegel

Vicky Pryce, Chief economic advisor, Department of Trade and Industry

Christof Ruehl, Deputy chief economist, BP plc

Güven Sak, Executive director, TEPAV Economic Policy Research Institute

André Sapir, Professor, Université Libre de Bruxelles

Holger Schmieding, Economist, Bank of America

Lord Simon of Highbury, Director, Suez Group and Unilever

Andrew Smith, Chief economist, KPMG

Duncan Stephenson, External relations manager, Unilever

Norbert Walter, Chief economist, Deutsche Bank Group

Aurore Wanlin, Research fellow, Centre for European Reform

Stewart Wood, Economic advisor, HM Treasury

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