Conference report: Five challenges for Europe

Ditchley Park, Oxfordshire
15-16 November 2019

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Summary

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Last week, *The Economist* journalist Duncan Robinson asked Twitter users their views on the biggest problems facing Europe. Many people replied with their pet peeves: "the rise of fascism", "Brexit", "Russian aggression". But there are broader, structural shifts at work. In November, our annual economics conference focused on our choice of the five biggest problems facing Europe: an ageing society, growing competition between the US and China, gridlock over eurozone reform, climate change and regional inequality. Our view is that a stuttering European economy and regional divergence are big reasons for the continent's political troubles, and in the next decade, rivalry between the US and China, climate change and ageing will force governments to make choices that will result in winners and losers.

At the conference, there were common threads in the debate on these apparently disparate subjects: how public investment, especially on curbing climate change, could balance the needs of an ageing society with the needs of young people and future generations; how to limit the damage from populism at home and abroad; and whether the EU should strengthen rules or have greater power to act strategically.

The 50 leading economists at Ditchley agreed that Europe's ageing society, which would have more over-65s than people of working age by around 2030, required people to work until later in life. There was a lot of scope for raising the employment rates of people in their 50s and 60s, as Sweden, the UK and Germany had done. State pension ages would have to rise. And governments would have to take more account of young people and future generations, with participants proposing higher public investment in training, education and climate and fiscal rules that took account of assets and liabilities (so that governments could raise debt if they invested in welfare-enhancing assets). Others suggested mandating paid leave from work for retraining, and giving qualifications a 'best before' date, after which more training was required.

Growing strategic competition between the US and China was largely seen by participants as a battle for technological superiority. The US aim was to try to prevent China from becoming rich, and to prevent Western technology from helping China to achieve parity with America. There was broad agreement that China had no interest in becoming a 'Western' liberal democracy or market economy. And Europe's interests were changing: Northern Europe's exports had been driven by Chinese demand for capital goods in recent years, but as Chinese technology improved, Beijing was increasingly a rival. Participants differed over what to do: for some, the EU should continue to try to agree rules with China to govern international trade and investment, and climate change. For others, the EU needed to provide alternative sources of funding for infrastructure investments in poorer member-states to stop China from undermining the bloc's solidarity. Still others argued that the EU's large market and sophisticated regulatory regime gave it power, and it should focus its attention on countries in its neighbourhood and elsewhere in Africa and Asia, offering market access in exchange for EU rules and standards.

Participants were pessimistic that far-reaching eurozone reform would happen any time soon. While most agreed that greater risk-sharing between countries and co-ordinated fiscal policy were both needed, North-South divisions were too entrenched for the gridlock to end. One speaker said that in some ways the gridlock was consensual: governments could live with a fragile eurozone because reform would alienate too many voters. But there were some chinks of light: a German government paper on the banking union, published shortly before the conference, broke some taboos in the German debate, accepting the possibility of a common deposit insurance scheme alongside other measures to strengthen the eurozone's banking system.

Adding to the gloom, most agreed that tackling climate change would require an unprecedented collective political effort: the investment needed to achieve a 2 degree rise in temperatures, let alone a 1.5 degree one, was enormous. There was praise for the EU for getting the Emissions Trading Scheme working again after a decade of under-pricing carbon, and Europe's relative success in reducing emissions from electricity generation. But decarbonising transport, buildings and agriculture would be much harder, and many believed that it could only be done through a carbon tax that penalised all forms of emissions. Political consent could only be achieved if revenues from a carbon tax were distributed effectively. For some participants, the EU should impose penalties on carbon-intensive imports from the rest of the world, in order to sharpen incentives for other countries to take action.

Our last session, on regional divergence, offered some practical ideas on how to overcome the economic shifts that were favouring metropoles over peripheries. Improvements in information technology and the offshoring of manufacturing were drawing skilled workers and capital into the major cities, with post-industrial and remote areas struggling. Some of the needed reforms were unglamorous, with more investment in local transport in industrial areas to allow residents to get to city centres quickly and cheaply. Some member-states needed to strengthen security in certain regions, because investors were deterred by crime, and improve tax administration and the enforcement of contracts. And climate investment, if carefully managed, could offer a new source of middle-skill jobs in poorer areas.

Despite the serious problems that Europe faced, it was obvious that the only way they could be managed would be through collective action by the EU's member-states – in close co-operation with its neighbouring countries and allies. While the EU had had a miserable decade, it remained the only tool to deal with the continent's problems. A new generation of politicians, activists and thinkers was welcomed, as they pushed for a stronger and more strategic Union.

Session 1: The demographic time bomb

The demographic profiles of many European countries are worrying: baby-boomers are retiring and the generations that follow are smaller. Since 2003, the median age of the EU's population has risen from 39 to 43 years and the share of the population above 60 years of age has increased from 22 to 26 per cent. But these averages belie huge regional differences. There are barely any regions in Central and Eastern Europe that have not seen population decline in absolute terms since 1990. Southern Europe is losing population in its crisis-affected regions, while the North is a magnet for migration from within and outside Europe. How will economic growth, both in absolute and per-capita terms, be affected by changing demographics? Can migration from outside Europe stem the ageing of Europe's population? Are current government debt calculations under-estimating the implicit liabilities in pension systems? Is ageing affecting inflation and interest rates, posing new challenges for policy-makers? And what policies are required to take account of future generations' interests, in terms of investment, debt levels, environmental damage and innovation?

The first panellist said that the 'time bomb' metaphor was an exaggeration. It failed to account for countervailing factors such as healthcare improvements and the increased workforce participation of older workers. While worsening demographics was estimated to subtract 0.4 percentage points from the growth rate of EU per capita GDP in coming years, we had already seen improved employment rates in the 55-59 age bracket, and there remained significant scope for improved workforce participation among 60-64 year olds. They also pointed to further off setting factors: positive trends in female employment; a greater focus on lifelong learning in government training programmes; and reforms to make pension systems more sustainable. All accounted for, these trends and measures could halve the negative economic impact of worsening demographics in Europe. In summary, governments had to determine how to dole out the costs of ageing between retirees and workers. There was a risk that some countries would ignore demographic challenges or even implement harmful policies, through a combination of economic illiteracy and electoral pressures, by refusing to raise the pension age or reform healthcare systems.

The second panellist discussed principles for assessing the inter-generational fairness of government policy. They proposed one simple criterion: that future generations should be able to enjoy living conditions at least as good as those experienced now. Against this criterion, existing pension systems were failing: older generations were benefiting more from pension systems than younger ones. A solution required governments to stop avoiding trade-offs, and for government institutions to focus on the longer-term and to stop operating in silos. Existing means of measuring inequality between generations only provided a partial picture. For example, while 'national transfer accounts' allowed policy-makers to estimate intergenerational differences in labour income, consumption and savings, and the flow of resources between different age groups, they failed to account for environmental degradation. The panellist proposed three principles that governments should work from. First, government should prioritise areas where it was possible to reverse negative trends in intergenerational degradation: for example, climate change. Next important were policies that were economically beneficial to current and future generations, such as efforts to increase productivity. Third, governments should develop the right set of indicators to assess inter-generational disparities in living conditions, and use them in policy-making.

The third panellist emphasised that Europe was the oldest continent on earth. They highlighted that the EU's old age dependency ratio – those aged over 65 compared to those of working age – will match present day Japan's from 2030 onward. The US would not "turn Japanese" until 2065. Africa was the big outlier as a relatively young continent, estimated to host three billion people by 2070. While demographic projections that far out were unreliable, these trends had big implications for public policy, particularly on how to manage migration. However, we should not assume that population ageing would have dramatic effects on living standards. Technological progress could help to offset downward pressure on productivity and GDP per capita associated with ageing societies. And the jury was out on whether ageing put downward pressure on interest rates and inflation (as a shrinking workforce put upward pressure on wages).

The fourth panellist agreed that the economic impact of worsening demographics depended on how much older people worked. But the trends varied by country. Whereas countries like Sweden and the UK had succeeded in raising the employment rates of older men, the employment rate of men aged over 60 in Italy, France and Belgium was below 50 per cent. Germany had initially looked much like the latter group of countries, but had seen notable improvements in recent decades. Germany's example showed that public policy could effectively counter the economic and fiscal effects of ageing. Yet increasing workforce participation of older people threw up second-order questions, such as the impact of older workers on workplace productivity. The panellist argued that the UK had reached a turning point, with the main parties rebalancing government policy towards younger people. Across the political spectrum, parties had committed to loosen fiscal rules to allow for increased investment spending and to significantly reduce CO_2 emissions by 2050; and both the Liberal Democrats and Labour party planned to consider public sector net wealth in fiscal frameworks, not only gross debt: this would allow government to raise the debt ratio if it created revenue-generating assets through investment.

The discussion started with the shakiness of demographic projections. Many participants voiced their scepticism, and were reluctant to rely on them when designing government policy. However, a panellist was quick to clarify that while demographic projections were certainly flawed, they were less uncertain than macroeconomic predictions: unlike many macro-events, we knew exactly when people became pensioners.

Many worried about the political consequences when the public realised that they would be working longer for a smaller pension. One speaker said that millennials would begin retiring in 2045, and one-eighth of them would live until they were 100 years old. Ageing populations tended to result in lower interest rates, which might mean that pension pots would not be big enough to sustain the living standards to which they were accustomed. A respondent argued that a change in mentality was needed: rather than focusing on savings, Europe should think instead about investment. In a manner similar to the US and its 401(k) retirement investment accounts, Europeans should be encouraged to take more risk on financial markets, and seek higher yields. Pension reform was deemed necessary, but politically toxic, as shown by the continuing strikes in France. One discussant framed the political issue succinctly: "people just want to stop working".

The conference differed over the extent to which immigration could counter the bad effects of ageing. Migration within Europe was beneficial to Western European countries suffering from shortages of labour. But across countries it was zero-sum: Poland and other states lost workers as a result. Romania had lost one-fifth of its working age population following the 2007 extension of freedom of movement to its citizens. In the context of immigration from Africa and the Middle East, one panellist wondered whether the EU was reaching the political limits, as shown by the rise in far right and anti-immigrant sentiment across the continent.

As for improving labour productivity, Singapore was highlighted as an example of innovative life-long learning: the country was beginning to give diplomas a ten-year time limit, as opposed to qualifications that lasted for life. This approach would encourage people to learn new skills throughout their lives. One speaker pointed to the French personal training account – a policy that allowed French employees to claim up to 150 hours of paid leave from work to pursue training and tuition – as an interesting public policy initiative that could be taken up across Europe. There was general consensus in the room that public policy had an important part to play in encouraging citizens to change their behaviour to offset the risks of an ageing society.

One issue drawn out by a number of discussants was that cultural approaches to child and health care in Northern and Southern Europe differed. In Southern Europe, grandparents are often heavily involved in the raising of children; so while elderly people in Southern Europe may be counted as absent from the workforce this was not entirely accurate – they were still working, just not being paid. This led to a discussion on whether technological innovation could ever displace labour in the social care sector. Most participants thought not. One panellist suggested that the growing social care sector could actually provide jobs for people displaced from other professions by technology. But questions about government spending on social care loomed large: wages were low in this sector, which in many cases was government-funded.

Session 2: Europe's role between the US and China

The US's strategy towards the rest of the world seems to be changing. Erstwhile partners are increasingly perceived as strategic competitors. The Trump administration sees the EU as a free-rider that needs to earn Washington's support and protection. China's growth is fuelled by government-subsidised investment, aggressive industrial policy and impressive technological progress. Both superpowers are pursuing narrow strategic goals across the globe, from bilateral trade rebalancing (the US) to supplanting Bretton Woods institutions (both the US and China). The EU needs to find a response. How does Europe's growth model need to change if China rebalances towards domestic consumption and the US continues to use protectionism as a strategic weapon? What is the right political balance between strategic autonomy from the US, and a unified Western stance towards China? Can Europe be the guardian of multilateralism, if China and the US withdraw their support? And how can the EU project its power, which remains largely latent aside from trade policy?

For the first speaker, the EU's strategy since the start of Trump's trade war with China had been largely to keep its head down. On the one hand the EU claimed it supported multilateralism, but on the other it supported the US's aims and opposed those of China. The US's true strategy towards China was not so much about the bilateral trade balance as about geopolitical competition and a struggle for technological superiority. Whoever would be the next US president would try to form a coalition of the willing with other countries to counter industrial espionage and the transfer to China of 'dual use technology' (which had both civilian and military use). As for Europe, Germany and China had had complementary interests to date, with China's economic development being fuelled by imports of German capital goods. But the EU needed a stronger regime for dual use technology exports to China and other countries, which would shield it from attempts by the US to impose its own rules extra-territorially. And the EU needed a consistent approach to dual use imports, for example on allowing Huawei to construct 5G networks. The patchwork of national

decisions threatened the US relationship, and the EU would have to choose sides on the flows of new technology to China.

For the second panellist, the EU was caught between the transatlantic alliance and the perceived benefits of trade with China. But Europe had lost ground in the integration of value chains: Europe's exports of intermediate goods had been shrinking globally and regionally; and imports of Chinese intermediate goods had grown, meaning that China's proportion of value added in its trade with Europe had also grown. The speaker said that while only 10 per cent of Chinese foreign direct investment (FDI) was located in the EU, 70 per cent of China's mergers and acquisitions were in Europe, with a particular focus on robotics and industrial technology. Meanwhile, European investment in China's services market had been very small. Rebalancing Europe's economic relationship with China would be difficult. Europe needed to induce market reforms in China to allow more European inward investment, but the EU had little leverage, and the prospects for a fair bilateral investment treaty were bleak. Therefore, the EU might have to prioritise trade relationships with the rest of the world, rather than seeking to intervene in the troubled US-China relationship.

The third speaker did not believe that the EU had to find a balance between strategic autonomy and relations with the US. If the US defected and became a competitor with Europe, then the EU had tools available to protect its interests. For its part, China was creating a rival way of doing things, using its economic heft to draw states into its orbit. It focused on infrastructure investment abroad and investment in achieving technological superiority at home. What should the EU do to achieve its strategic goals? It should deepen the single market further, especially in services and technology, in order to compete with China and the US. It should offer a proper alternative to Chinese infrastructure investment in member-states that were poorly connected to the rest of Europe. South Asia and Africa could be offered nearly frictionless market access if they signed up to EU standards and rules in goods and services. Imported carbon should be taxed at the EU's border, sustainable development chapters of EU trade agreements should be more strictly enforced, and there should be strict rules on data transfers to third countries. But there were areas where China and the EU should collaborate, such as climate change. There should be more ambitious co-ordination on global governance, especially in payments technology, which was changing rapidly. And the EU should preserve – and enhance – its pre-existing advantages in competition policy and regulation compared to the US, China and elsewhere.

The fourth speaker emphasised that China's aim was not to become a market economy – still less a democracy. It combined state-led economic development with authoritarian social control, and would continue to do so. As a result, the German debate was shifting: the federation of industry, the BDI, had recently pressed for China to be considered a rival. Nonetheless, Chancellor Angela Merkel had agreed to let Huawei take part in German 5G infrastructure, despite concerns that domestic critical infrastructure would be provided by a state-run company from a strategic competitor. Merkel did so partly because she worried about Chinese retaliation against German car exports, and partly because Germany did not have an alternative provider to hand that could deliver quickly. As for Chinese influence on EU policy-making, we were past the point where the EU could control it: some Central and Eastern European states and Greece had been unwilling to sign up to tougher rules on Chinese inward investment.

The ensuing discussion focused first, on how the US and Europe should respond to China's strategy, second, whether China would succeed, and third, the extent of Europe's ability to engage in strategic competition.

One participant argued that China would not change its authoritarian economic model, and it would develop its own technology and sphere of influence if the US sought to isolate Beijing. Meanwhile, the EU would not be able to maintain its export-led growth model if it tried simultaneously to keep close to the US and to avoid Chinese influence. Another argued that China's refusal to embrace market liberalism meant that the US and the EU were cursed to co-operate.

Other participants argued that Europe's China strategy would be different from that of the US. One said that the US and China were locked in a power struggle, and the US wanted to prevent China from becoming rich. A few people feared that zero-sum thinking in both the American and Chinese camps would result in escalating conflict. For Europe, the aim should be to get China to play by the rules, and to promote democracy. Another said that Huawei was trying to become a Western company; Huawei wanted to take part in 5G in Europe so that it could sell its kit in Africa and elsewhere with a mark of quality. There were no back doors found in its 5G technology so far, and the technology was vulnerable due to omission, thanks to some weaknesses in the quality of its software, rather than commission. Another pointed out that the City of London had worked with China to agree standards for investment in its One Belt, One Road programme. But sceptics argued that the space for EU-China collaboration was limited: China would not open its financial markets to overseas investors (with one participant saying that it was unclear such a move would be in China's interest in any case, given the destabilising capital flows that other developing countries had endured).

Some participants thought that Europe should not assume that China would succeed in becoming a rich country – it had a very high level of private sector debt, and its population was ageing far earlier in the development process than other East Asian countries that had moved from middle to high income status.

In any case, could the EU act strategically, and if so how? One participant said the EU was a global player in trade, on privacy regulation, and on payments infrastructure, and it had the power to shape global climate policy through border carbon taxes. But it lacked a perception of itself as a strategic power. And a panellist pointed out that the EU needed to update its competition and innovation policies in the tech sector: outdated rules on artificial intelligence and health

data meant that much of the innovation was happening in the US; and China was ahead on big data. Several argued that the eurozone's unco-ordinated macroeconomic policy weakened its ability to act autonomously; to achieve the power that a reserve currency provided, the eurozone needed safe assets of some kind. Lacking a reserve currency, the EU had less power to bend trade policy to its strategic aims than the US. One speaker argued that China was pulling ahead on digital payments, and the eurozone should respond with an ECB-backed digital euro that could be used for trade.

And because the eurozone did not have the tools to swiftly stabilise its economy during a recession, one participant argued, it was inherently vulnerable, as it had to rely on export-led growth during the recovery.

Several people observed that one of Europe's main strategic concerns was being neglected – its neighbourhood. If the EU wanted to strengthen its influence there, it had to find a way to offer an ever-closer economic relationship with surrounding countries by using deeper trade and investment agreements.

Session 3: Gridlock in the eurozone

The eurozone has passed the peak of its economic cycle: growth is half of what it was a year ago, inflation expectations are heading downwards and risks to the European economy from Brexit and Trump's trade wars are mounting. At the same time, institutional reforms and changes to the eurozone's policies are going nowhere. Some institutional tweaks were agreed at a European Council meeting in December, but with a new Hanseatic bloc emerging and continuing populism in Italy, there is little hope for more fundamental changes. But are they needed? How should eurozone policy-makers react to a further slowdown of the economy? If monetary policy has run out of road politically, and a fiscal boost needs pan-European consent, will the eurozone become trapped in a Japanese trap of zero growth and inflation? Can coalitions of the willing move further than the rest within the eurozone, for example in building a common stabilisation budget or unemployment reinsurance?

The first panellist explained why Italy was still central to the eurozone debate. Italy's economic performance was poor – not only compared to 'core' countries such as Germany, but also to other 'peripheral' countries, which in contrast to Italy had implemented reforms. Worse, there had been almost no growth for 20 years, and prospects for future growth were weak. The US trade wars were not to blame: Italy had so far been spared because it mostly exported to less affected countries. The problems, the panellist argued, were internal. The current Italian government was in constant survival mode, and its proposed budget contained little to boost growth, either in the short or medium term. Moreover, the political momentum behind populist parties in Italy would remain, given popular discontent. That would limit the government's room for manoeuvre, as the debate about the reform of the European Stability Mechanism showed. Italy would thus continue to be a stumbling block for eurozone reform.

The second panellist argued that the eurozone's fragile construction contributed to financial instability and risked creating further economic divergence. There were three approaches to overcoming the gridlock. The first was to keep proposing packages of policies that offered something for everybody: making public debt restructurings easier while also creating a eurozone safe asset; or combining common deposit insurance with tougher rules on sovereign exposures of banks. The failure to get such packages implemented should not discourage us. Governments' perceived trade-offs might change: the weakening transatlantic alliance had fostered debate about the international role of the euro, for example. The second approach was to make marginal changes to existing policies, such as improving the pass-through of monetary policy to consumers; strengthening the communication of policies in countries that were resistant, by challenging Germany's opposition to loose ECB policy, for example; or reforming 'macro-prudential' financial regulation to amplify the ECB's monetary stimulus. The third option was to change the game, and work on policy areas such as climate investment that also had second-order macroeconomic effects. The panellist praised proposals to create a European carbon central bank that would help stabilise the price of carbon and set it on a steadily increasing path, thereby helping firms to plan ahead for investment.

The third panellist focused on the causes of the slowdown, which had been led by the weakness of manufacturing in Germany. Uncertainty caused by the US-China trade war mattered, but was not the most important reason. Slowing growth in Turkey and China – and Brexit – had contributed to lower growth. These causes were more likely to be structural than temporary, with consumers turning away from diesel cars (a specialism of Germany's), and the maturing of the Chinese economy. Inflation was below the ECB's target, but there were signs that wages were rising. However, higher wages were not yet leading to higher prices. The ECB's negative interest rate policy was benefitting consumers: while net savers lost out, net borrowers (with a higher propensity to consume their income) were gaining, resulting in rising consumption. Fiscal policy in the eurozone was mildly supportive, with a scheduled expansion of around 0.4 per cent of GDP in 2020. Fiscal rules were too focused on reducing deficits, and should prescribe higher deficits to boost growth at this stage in the cycle. The eurozone needed a co-ordinated fiscal stance, as the currently planned eurozone fiscal capacity was insufficient.

The fourth panellist proposed two kinds of gridlock: antagonistic gridlock, in which the opposing sides of

the argument agreed that status quo was untenable, but disagreed on how to get out of it; and consensual gridlock, in which both sides could live with a sub-optimal outcome and agreed that changing the status quo entailed large risks. The eurozone was suffering from a mixture of the two. There was little urgency to resolve many of the eurozone's problems because voters would not like the solutions. As for those problems that were untenable, such as being trapped with low inflation and low interest rates, there was too much antagonism about how to get out of them. The eurozone should prioritise reforms that could be made without exposing either side to high risks. Improving the banking union was in that category: increasingly, policy-makers in Europe rejected the status quo and antagonism was lessening. Policy-makers could focus on bank resolution, harmonising insolvency rules and sharing risks to government balance sheets in a way that did not involve permanent fiscal transfers between countries. Common deposit insurance could be replaced by a re-insurance scheme in which national insurance schemes were exhausted before European funds stepped in. And banks' excessive holdings of their own government's debt could be dealt with by 'concentration charges' (penalties for banks that hold too much of one government's debt), phased in over a long period of time, instead of more contentious solutions like changing the risk weights of different countries' sovereign debt. They praised the recent German non-paper on banking union, which was exactly in that vein. But considering the political realities, they argued that rather than completing the banking union, we might well end with minimal changes that do little more than shift the current status quo into a new consensual gridlock.

The discussion initially focused on fiscal policy. One participant said that fiscal space was not a properly defined concept, arguing that, despite high levels of public debt, low interest rates expanded fiscal space. And another pointed out that space was in part created by the ECB. Some discussants added that the fiscal rules were serious constraints. Fiscal policy in the eurozone was, after all, a very tricky collective action problem, with rules that were politically difficult to change. One participant countered that reform of the fiscal rules was possible: more countries were moving away from them, with French President Emmanuel Macron distancing himself publicly from the 3 per cent limit. Co-ordination of fiscal policy and a centralised fiscal stabilisation capacity were politically unworkable, argued another. The fear of transfers was too great, and politicians did not understand the need for a budget that remained unused most of the time. Their suggestion was to boost automatic fiscal stabilisers at the national level by baking lower tax revenues and higher spending in recessions into the design of fiscal policies, and vice versa in periods of expansion.

The discussion repeatedly returned to monetary policy, after one participant argued that, far from having reached its limits, monetary policy could still deliver inflation if policy-makers were bold enough – for example by subsidising lending through negative rates, and using so-called 'helicopter money' to transfer newly created money directly to households in order to boost consumption. But there was some scepticism about whether policy-makers could turn the ECB into a 'fiscal machine' along these lines. Some pointed to practical complications (the ECB did not have direct access to individuals' bank accounts); and some to political clashes, with Italy loving the idea and Germany going berserk; others to the legal constraints upon the central bank. One panellist argued, however, that Europe had not tested these legal limits yet and should.

Repeatedly relying on the ECB to solve the fiscal problem was the wrong solution, concluded another panellist, urging participants not to give up on fiscal policy so easily. It was unacceptable that fiscal policy was not contributing more. Another panellist added that, as with financial regulation and supervision, fiscal policy would eventually become more centralised in Europe.

Italy's ability to play a constructive role on eurozone reform was another source of discussion. One participant argued that Italy held a veto, and much of the Franco-German discussion about the eurozone was seen very critically in Italy. One panellist added that Italian policy-makers were also outliers in their preferences for more fiscal risk-sharing and redistribution. The conference disagreed on whether the new Hanseatic League was another powerful veto player, or whether it would ultimately fall in line behind Berlin.

The recent German non-paper on banking union was seen by some to be significant. It was not only a serious proposal, but put the right emphasis on issues where progress could be made and that were crucial for European stability, such as efficient bank resolution, which was not working well. One panellist added that the paper showed that constantly pushing on the important issues in the eurozone eventually paid off.

Participants disagreed on whether common European deposit insurance and the treatment of sovereign bonds on banks' books should be priorities. Some argued that Italy would reject such changes, as the banking system was seen as a crucial domestic shock absorber. Others pointed out that small packages on these issues could be agreed. Common deposit insurance was at least no longer a taboo in Germany, argued one panellist, which meant the only remaining taboo was a European safe asset.

The situation of banks, in light of the banking union and negative interest rates, was also discussed. One participant argued that the toll negative rates were taking on banks was lowering lending to the real economy. Another participant disagreed, arguing that the data so far did not show that banks were suffering from negative interest rates. Banks' costs were simply too high. One panellist added that banks were facing several headwinds, including the challenge from 'fintech' (financial services provided by new online players). And while negative rates had not yet hurt bank profits, if they were not passed on to customers, then they would be less effective in boosting inflation.

As in many other sessions this year, climate change also featured in the discussion on the eurozone: it could be used

as a pretext for more joint European expenditure, which would have macroeconomic benefits. But participants disagreed strongly on whether that is a good idea. Some warned that this would drag a vital issue into the eurozone gridlock. One panellist pointed out that rhetorically mixing fiscal and climate policy did not guarantee progress, as the disappointingly small German climate package had shown. Others argued that it was a helpful way to create momentum towards a common European fiscal policy – and even eurobonds – while at the same time tackling a quintessentially transnational issue. The amounts of investment needed were staggering, demanding a European rather than national solution. One discussant suggested that the European Investment Bank should issue common green bonds, to be bought by the ECB as part of its monetary policy.

A missing element in the eurozone debate was that economists were terrible at creating narratives that the public could understand, according to one discussant. But such narratives were needed to counter two German misperceptions: the 'what about the savers' argument about low interest rates (they had benefitted the owners of assets by raising asset prices and employment), and the 'transfer union' argument (there was no desire to create a transfer union, merely to share risks).

Session 4: The political economy of climate change

The world's climate is changing rapidly. Drastic measures are required to keep the rise in global temperatures below 2°C: world carbon emissions need to fall by a quarter by 2030, and reach zero by 2070. After a period of stagnation, carbon emissions have grown by about 1.5 per cent in both 2017 and 2018, and the temperature rise is projected to reach 1.5°C by 2040. The Paris Agreement was a major political step to commit countries to reducing emissions to keep below 2°C, but the deal is threatened by the US commitment to withdraw from it in 2020. What is Europe's role in fighting climate change? Is the current national patchwork of price incentives, regulation and subsidies the right policy mix? Do we need a pan-European carbon price, or can the current emissions trading system be reformed to set the most efficient incentives? Should Europe start to use the power of its large market to force other countries to do more, for example through carbon border taxes? And is there a realistic prospect for integrating agriculture, heat and transport into European climate policies?

The first panellist considered why the member-states in Central and Eastern Europe more sceptical about climate action. The first reason was that policy rarely followed proper cost-benefit analysis, but rather a state planning process where political deal-making influenced the decisions that were made. Second, control over energy policy was political power, and lowering electricity prices was still a vote winner. Furthermore, fossil fuel projects usually involved large sums of money and established energy businesses, sometimes with close ties to the state. That made them more prone to corruption than, say, investments in decentralised solar power or small-scale investments in energy efficiency. The panellist joked that the best way to help climate policies in some member-states in the region was to "green" corruption: to make it easier for corrupt officials to make money from green investments. The third reason was the 'transition' to a low carbon economy, even if it could be designed to be socially just. Central and Eastern Europe had bad memories of 'transitions': the post-communist one had been highly disruptive. So despite pressure for climate action, led by youth protests in the region, people were wary. The challenge was to make sure that citizens understood that fighting climate change was necessary for their own well-being.

The second panellist provided a perspective from Sweden on how to implement climate policies. Sweden had a net-zero emissions target for 2045, which in practice meant that most sectors needed to be fully decarbonised by that point: energy, heating, cooling, transport, and even industries as carbon-intensive as cement or steel production. 'Negative emissions' from carbon sinks, such as forests, were necessary to offset the emissions from agriculture that were hard to avoid. Sweden was far away from reaching its 2045 goals, and its policies together with European mechanisms such as the carbon emissions trading scheme (ETS) were not providing a mechanism to bring traded carbon emissions to zero by 2045. The recent reforms of ETS were going in the right direction, even though the panellist would have preferred an 'auction reserve' price – a minimum carbon price – rather than the EU's approach of a market stability reserve (MSR), which tried to reduce the number of surplus certificates in circulation. Irrespective of Europe's efforts, 80 per cent of global carbon emissions went unregulated or taxed. In order to lead on climate policies, the EU needed to avoid carbon 'leakage', whereby heavy emissions sectors moved offshore to avoid domestic climate action. One way to do that was to tax carbon-intensive imports. Another was to impose a consumption charge on certain carbon-intensive materials, whether they were produced in the EU or outside it.

The third panellist said that the EU's climate targets for 2020 had almost been reached, but not by every country (Germany was missing its targets) and not in every area: the biggest gap was in energy efficiency. For the next period, to 2030, the EU had a mandate to review countries' energy and climate plans; had fixed the ETS trading system, which according to market prices was working again;

and introduced further complementary regulation, for example to curb car emissions and to preserve carbon sinks. By 2050, the EU Commission was aiming for climate neutrality. This meant zero carbon energy production and near zero emissions from industrial production – both of which was already technically possible but expensive. It also entailed larger carbon sinks to compensate for agriculture and aviation, which remained the biggest problems. The EU had to offer others a viable model for such a green transformation. The panellist argued that there were no member-states blocking progress. Rather, some member-states were raising legitimate questions on how the necessary investment should be financed. Europe had seen a green political wave in 2019 that was pressing traditional parties to take action on climate change, not just boosting green parties.

The fourth panellist claimed that climate change was not the biggest problem of humankind, which was poverty; nor was it even the biggest environmental problem. That was air pollution, from which already seven to eight million people were dying each year, compared to a projected 1 million in 2100 from climate change. But he agreed that climate change needed policy action, and the best tool to fight it was a carbon tax: which offered the best and most stable regime to guide business investment, and it provided the best incentives for research and innovation in climate-friendly technologies. International agreements were not effective, given the incentives for countries to free-ride on the efforts of others. International co-operation on carbon cap-and-trade systems was also unviable: Americans would not trust Italy's legal system to enforce the rules, and there should be considerable doubt whether Europe would want to link China's cap-and-trade system to its own. The best way to co-operate across borders was through technology and markets. He mentioned the remarkable technological progress, that had made wind and solar the cheapest sources of energy in some places today, and everywhere by the year 2030. There was promise in biofuels, thanks to genetic engineering. The problem remained the capital stock in brown technologies, such as coal plants that were currently being built. But the future was carbon-free, the transition had already started, without much help from climate policy – and not even Donald Trump could stop the march of technology.

The discussion started with one participant arguing governments should not repeat their mistakes over globalisation, where they failed to provide appropriate compensation to losers. Another participant said that there were two types of losers: first, consumers, who could be easily compensated for higher prices of carbon-intensive goods; and second, workers in 'brown' activities. More creativity was needed to compensate workers, and potentially more funds such as a variant of the existing globalisation adjust fund. Those workers were currently being used as 'bio shields' by climate-sceptic politicians, added a panellist, and they deserved empathy. But we needed a clearer idea of how we wanted to retrain workers from brown activities, cautioned one panellist: they needed skills to be productive in today's economy. One participant added that taxing carbon and redistributing the proceeds would make the transition both just and popular, as it would boost the real incomes of poorer people.

Another participant cautioned that 'compensation' was the wrong way to frame the transition: the history of the post-communist transition showed that compensation for workers in heavy industry led to permanent transfers. One panellist added that Hungarian prime minister Viktor Orbán was not looking for solidarity from the rest of the EU, but was trying to use climate change to blackmail the Commission for more EU funding. It was important to channel transition investment funds through entities rather than the central government, as local buy-in was crucial, argued some participants.

There was wide agreement that a carbon price or tax was the ideal policy and had to be the backbone of any successful climate policy. But it was politically unrealistic, argued one speaker: maintaining a steadily increasing carbon tax was a massive challenge for any government, and a club of 27 would never manage it. Experience also showed that people wanted to be green and not pay taxes at the same time. A carbon tax would be insufficient if it was not accompanied by public investments – such as green transport – to give people choices, argued another. The scale of investment needed was large, but the way to finance it was simple, another added: just borrow. Old, rich people were buying those bonds, and essentially paying governments to borrow from them, given negative real interest rates. As they had emitted roughly eight times more carbon than millennials will, this was only fair.

It was also important, said one participant, that policy remained on a credible path. Otherwise the private sector would not invest in green technologies. One panellist added that while stock markets believed carbon policy announcements, as shown by their repricing of carbon intensive stocks, there was no similar price changes after governments announced new climate targets.

The conference offered some more granular suggestions. The EU should stop to subsidising carbon-intensive activities, such as agriculture. Another was to combine the fight against air pollution and against climate change under one roof, so appealing to people's concerns about their health as well as the environment. Some saw that as a good way of tackling climate change, especially in Central and Eastern Europe. But often, less air pollution meant more carbon emissions, argued one panellist: diesel cars emitted less CO_2 than petrol ones, but did more to damage air quality.

The conversation turned to the role of different energy technologies in curbing climate change. One panellist argued that nuclear would not play a big role in fighting climate change, despite being mostly carbon-free. Carbon capture and storage (CCS) was too expensive to be viable, according to one panellist, with the cost of cement rising by 70 per cent if it had been produced with CCS. One participant countered that there may be a case for limited uses, such as using old oil and gas fields in the North Sea, which would otherwise have

to be decommissioned, to store captured carbon. Overall, the question was raised whether Europe needed to co-ordinate its investment, as it would be inefficient if all countries invested in different technologies.

How to make finance greener – and potentially monetary policy, too – was also part of the discussion. On green finance, Europe needed a clear taxonomy of which investments should be considered to be climate friendly, argued several participants. It was important, however, that such a taxonomy was a public decision that was not left to the private sector alone, added one discussant, to avoid conflicts of interest. Such a taxonomy could then be used by regulators and the ECB in their own policy-making. It was an opportunity for Europe to establish itself as a standards-setter, as the Fed in the US struggled to define its own standards, thanks to Donald Trump's climate denial.

Session 5: Growing regional divergence

In Western Europe, the economies of capital cities have been growing faster than smaller cities, towns and the countryside since around 1995. Unlike companies in the industrial sector, which search for cheaper regions in which to produce, research-intensive technology and high value-added services companies are increasingly clustering together in successful cities. So too are the graduate workers that make up these companies' labour force. What should national governments – and the European Union – do about this? Should public investment focus on expanding successful cities to allow more people to take advantage of the benefits of agglomeration? Or should more money be spent on universities and research centres, transport and communications technology in industrial cities and towns to make them better able to attract private investment and educated workers? Should we expand the graduate workforce further, or focus public expenditure on adult training and education for people with fewer marketable skills? And how does EU regional policy need to change in response? Does it need more focus on human capital and knowledge, and less on physical infrastructure? How can we avoid a one-size-fits-none regional policy in Europe?

The first panellist discussed two types of convergence across EU regions: the dispersion in income per head, and whether poorer regions were catching up with richer ones. Since the Great Recession, regional inequality measured by income per head had risen. But, over the long term, regions that had been lagging behind were catching up with richer ones. This disparity was explained by cities and capital regions doing much better than elsewhere, including in poorer countries, while some poorer, more remote regions, were underperforming especially in Southern Europe. Technological change meant that manual work was becoming less valuable, while cognitive skills commanded higher wages. Services companies that made use of these skills clustered in successful cities, taking advantage of economies of scale and a growing talent pool, that increasingly drew in highly educated workers from poorer regions. As a result, Europe's politics were becoming more antagonistic, and identity divides between metropolitan centres and left-behind places made redistribution from rich regions to poorer ones harder.

The second panellist focused on Italy, where the long-standing economic problems in Italy's south – the Mezzogiorno – had been amplified by the euro crisis. The region had been performing worse than Italy as a whole in recent years – its economy had been shrinking, and young people were leaving for northern Italy and other countries. There were some bright spots, such as Puglia, but to turn the Mezzogiorno around, policy-makers needed to understand the nature of modern agglomeration forces, which were founded upon 'intangible' capital: skills, patents, marketing and software, as opposed to machinery, factory space and other physical assets. The focus of policy should therefore be on transport and communications, to expand the labour and supplier pool that is available to services companies and to make it easier for them to access markets. Another focus should be the quality of public administration, so that investors could rely on the state to enforce contracts, and so that taxes were paid rather than evaded or avoided. That would also ensure that companies responded to incentives that the state provided. And, finally, security remained a problem in some parts of southern Italy, with criminal activity discouraging investment in legitimate enterprise.

For the third panellist, the divide was between cities: in the US the gap between successful, coastal metros and struggling cities had grown substantially over several decades, but Europe also faced this problem (with the UK's divide largest, and Germany's smallest). New tech jobs may open the rift further. The mantra for policy-makers had been 'help people not places': redistribute income to people, help them to move to more successful regions, and don't try to push economic activity into failing regions. Under this paradigm, it makes sense to subsidise superstar cities, creating rents from further agglomeration, and then redistribute tax revenues to the left-behind. That approach had failed, because people did not want redistribution – they wanted good jobs. And outmigration from poorer regions was not high enough: 60 per cent of British people did not leave their region, and in Germany, the figure was even higher. Subsidising poorer places could in fact be efficiency enhancing: the growth of superstar cities may raise GDP but not necessarily welfare, because they became increasingly congested. And there was convincing evidence

that markets delivered too much agglomeration, because the negative externalities (congestion, pollution) outweighed the positive externalities (knowledge spillovers, larger pools of labour). And by drawing in educated workers, successful cities imposed negative externalities on left-behind regions (fewer knowledge spillovers and smaller workforces). And, since less-skilled people were less likely to move, investment in their skills, perhaps through applied universities and institutes in poorer cities, would bring in better jobs.

The last panellist, focusing on Britain, pointed out that on one indicator of regional inequality – employment – the UK had improved, because there were high levels of employment in all regions. The problem was that differences in job quality and wages were very high. He agreed that internal migration was a problem, though, because the benefits of agglomeration were largely capitalised into house prices, which meant that a poorer person living in a poorer region had less incentive to move to a richer, more productive place, because housing costs would be higher. The panellist offered three policy areas to work on. First, universities were key anchor institutions: more young people needed to go, and there were urban centres that did not have a higher education institution, and should have one. Second, local transport links were important: Lyon and Birmingham were of similar size, but two million Lyonnais lived within a half-hour commute of the centre, while the equivalent figure for Brummies was 900,000 – and as a result, Birmingham's satellite towns were poorer. Third, climate investment should be considered regional policy: in Britain, an offshore wind hub was developing on the Humber, a historically deprived area on the North Sea coast, and tidal energy by its nature had to be spread around the country in order to capture tidal flows at different times of the day.

The discussion revolved around wealth taxation and housing policy, universities and the knowledge economy, and internal migration. One participant pointed out that the standard policy response to unearned wealth, such as a rise in house prices because a region had become more productive, was to tax it. Another said that European countries did not tax agglomeration effectively, because taxes on housing wealth were low. An American participant argued regional convergence had stalled in the US for 25 years, largely because of housing shortages. There was some hope for change in the US, with deregulation of planning to allow successful cities to grow, higher density housing and more extensive public transport networks.

An Italian participant was sceptical that new universities in poorer cities would help: there were several universities in Italy's south, and they were poorly managed and could not compete in the global market for academic talent. Another participant questioned whether applied higher education institutions, like community colleges, were required: research universities were more knowledge-intensive and new businesses could be spun out of them, leading to a virtuous cycle of a larger pool of skilled, specialist workers, and clusters of businesses providing research-intensive products. There were questions about labour market institutions and hiring practices, too. One participant pointed out that survey evidence showed that graduates living in East London were struggling to find work despite there being plenty available. And another person argued that the decentralisation of government would help to spread the knowledge economy around countries: there were a lot of high-knowledge activities in government, such as planning and research, and more could take place outside of capital cities.

Finally, one participant pointed to French experiments with rent vouchers. They were subsidies for movement to regions where workers could be more productively employed, and had raised mobility. Another said that the US experience had been that lower-skilled people had been moving away from big cities as rents became unaffordable, and migration had become a weak driver of convergence as people 'sorted' into different regions by levels of education and skill. And another pointed out that places are communities, not simply areas of economic activity, which meant that ensuring that they do not fall behind was an imperative irrespective of the economic logic of different policies. Rising 'deaths of despair' in the US were largely happening in the country's poorer regions.

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