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Conference report: Is Europe's economic stagnation inevitable or policy driven?

The European Union is caught in a profound economic malaise. Demand is chronically weak and on current trends unlikely to return to 2007 levels until 2020. Is this just temporary – the aftermath of a deep financial crisis and institutional-building in the eurozone – or is something bigger going on?

The conference explored the extent to which economic stagnation in Europe was a cyclical phenomenon or a structural problem. If it was structural, why had it happened and what could governments do about it? To what extent could the growth slowdown be explained by developments over which governments have limited control, such as demographics and changes in the structure of the global economy? And to what extent was it the result of policy failures – macroeconomic, financial or structural?

Executive summary

October's conference focused on the extent to which Europe's economic stagnation was a cyclical phenomenon or a structural problem. If it was structural, why had it happened and what could governments be about it? To what extent could the growth slowdown be explained by developments over which governments had limited control, such as demographics and changes in the structure of the global economy? And to what extent was it the result of policy failures – macroeconomic, financial (including corporate governance and regulation of the financial sector) or structural (such as labour and social policies)?

Does Europe face secular stagnation? There was broad agreement that Europe's economy was stagnant. Demographics were partly to blame – working age populations were actually shrinking in some countries. But the chronic weakness of eurozone demand was largely a macroeconomic problem, requiring fiscal and monetary stimulus. However, the politics of the eurozone precluded this. Supply-side factors were also important: competition was often weak, markets fragmented, regulation excessive, and human capital patchy. The longer stagnation persisted the greater the damage to economies' supply sides and the greater the risk of secular stagnation.

How should Europe respond to demographic change? Without policy changes, some European countries will suffer significant declines in GDP growth due to their demographics. They needed to boost labour market participation and productivity, and to actively encourage immigration. Unfortunately, many European countries spent too much on the old and the rich, too little on the young and the poor, and did not innovate enough. Stagnation had worsened these biases: education budgets had been slashed and firms were investing less in training. Popular resentment against immigration had risen, making it harder for governments to deploy immigrant-friendly policies.

Is rising inequality holding back the European economy? There was broad agreement that the factors driving inequality were holding back growth: the financial crisis had not ended rent-seeking by the financial sector; governments found it increasingly difficult to tax capital, meaning that income taxes were too high; technology posed a threat to an increasing number of low-skilled jobs. Wage competition between eurozone countries combined with ill-judged fiscal austerity was hitting consumption and investment, in the process deepening inequalities within and between member-states. The currency union lacked the institutions to cope with these developments.

What kind of banking system does Europe need? Banks needed more capital, as stronger banks increased lending whereas weak ones did not. For some, the public recapitalisation of banks was the best use of tax payer monies; others argued that banks should be compelled to raise money from investors. Banking union required a much bigger fiscal backstop too. The single banking supervisor was a step forward but banking systems had become more national in ownership and focus. With banks shrinking their balance sheets, governments needed to encourage non-bank forms of finance for firms. However, a capital markets union required harmonised solvency laws across Europe.

What can macroeconomic policies do to improve Europe's prospects? To be effective, structural reforms required a sufficient level of domestic demand which, in turn, required expansionary macroeconomic policies. The eurozone needed monetary easing, fiscal stimulus and structural reforms to be undertaken simultaneously. Policy-makers needed to understand that unless they could agree such a co-ordinated strategy, the single currency risked collapse. Finally, the ECB needed to work much harder to meet its mandate. By allowing inflation expectations to fall sharply the ECB had worsened the challenges facing the eurozone and eroded its own credibility.

Session 1: Does Europe face stagnation?

Europe is caught in a profound economic malaise. Demand is chronically weak and unlikely to return to 2007 levels until 2020. Productivity growth, already lacklustre in the run-up to the crisis, has weakened still further and business investment has fallen to an all-time low. Is this just temporary – the aftermath of a deep financial crisis and institution-building in the eurozone – or is there something bigger going on?

The first panellist pointed out that the eurozone had decoupled from the US around 2011, and argued that secular stagnation was a problem for many advanced economies but probably mostly for Europe, given its chronic lack of demand and the incomplete institutional architecture of the eurozone. There was more asymmetry in the monetary union than ever before, with little capacity to cushion future shocks. Since there was little reform of that architecture on the cards, the most we could hope for was reform within it: rising wages in core countries and some structural reforms in areas other than labour markets. Whether that would be enough to avoid secular stagnation was uncertain.

The second panellist discussed the traditional version of secular stagnation: very weak investment leading to prolonged periods of growth below potential. Some factors, such as ageing populations and the difficulties of improving already high levels of human capital, suggested that European growth had weakened permanently. Other factors, such as rapid technological change should foster higher growth. But there was a clear gap in productivity growth between Europe and the US, which could partly be explained by weaker competition in Europe, smaller and fragmented services markets, stricter regulation, and some weaknesses in terms of human capital. The probability of reforming the supply side was now lower rather than higher because stagnation has made it harder for governments to push through reforms. As a result, Europe was in greater danger of falling into secular stagnation than the US.

The third panellist argued that there were two different economic equilibria, one of deflation and one of normal levels of inflation. Currently, the eurozone was moving towards the Japanese deflation equilibrium. The panellist was pessimistic about the ability of the ECB to return the eurozone economy to the normal inflation equilibrium: the balance sheet expansion was not aggressive compared to that of the US Federal Reserve or the Bank of England, and the latest measures were not forceful enough to convince markets that the ECB was serious about raising inflation expectations. Consequently, markets expected interest rates in the eurozone to increase by 2017, which, given the currency union's dire growth outlook, indicated a serious policy failure on the part of the central bank. Some eurozone governments placed too much emphasis on the supply-side, other excessive faith in demand-side policies, when clearly a combination of the two was needed.

Unfortunately, there was little reason to be optimistic about the prospects of a 'grand bargain' with the one side conceding the needs for fiscal and monetary stimulus and the other accepting the need for more structural reforms.

The final panellist argued that one can view Europe from two angles: glass half-full or glass half-empty. The half-full view saw low borrowing costs, gradual improvements in fiscal positions, and some potentially significant structural reforms. The half-empty view pointed to the persistence of large sovereign bond spreads in the eurozone, contracting credit, stagnation and persistently high unemployment. In his view, the challenges were excessive labour costs, the debt overhang, and lack of product market liberalisation. Targeted fiscal expansion of 1-2 per cent of eurozone GDP was essential, financed by the eurozone as a whole. Labour costs needed to be reduced by cutting taxes rather than wages themselves. And finally, governments had to open up their service sectors to more competition and hence investment. The ECB, in his view, had done its job but needed to stop with its quantitative 'teasing' and push ahead with large-scale purchases of government bonds as the private assets available for purchase were limited.

Q&A: There was disagreement over the impact of structural reforms on inflation: for some they were deflationary whereas others argued that certain kinds of reforms can have an immediate positive impact on investment. The debt overhang was singled out as a particular obstacle to economic recovery in Europe. However, there is disagreement over the feasibility of private debt restructurings because most of the debt was held domestically and writing it down would pose serious economic and political challenges. There was broad agreement that the eurozone needed fiscal stimulus, with the optimists arguing that France, Italy and Draghi would eventually team up to push for more spending, and pessimists doubting their ability to form a united front. The issue of wage levels was controversial; some questioned whether an economic system that exerted constant downward pressure on wages was desirable, whereas others wondered why German wages were not growing faster.

There was broad agreement that the ECB was the only truly European institution (as it was not subject to a German veto), and hence was the best hope for enlightened policy-making. Some argued that purchases of private assets and funding-for-lending type schemes might be more effective than standard quantitative easing in the eurozone, whereas others argued that the situation was so grave that they ECB needed to do both. In addition, it was important for the ECB to provide strong forward guidance about the direction of interest rates. A weakening of the euro, while helpful, was not regarded by some as a strong short-term driver of growth, citing the example of Japan and the UK.

Session 2: How should Europe respond to demographic change?

Europe's population is ageing rapidly and Europeans have the world's shortest working hours. How much of the slowdown in the pace of economic growth in Europe can be attributed to an ageing population? And what role do political choices regarding the balance between work and leisure play? Is Europe's approach to intergenerational distribution and welfare provision holding back its economy?

The first panellist argued that German demographic trends would lower the country's potential economic growth, assuming constant GDP growth per worker, which was a reasonable assumption given past experience. This partly explained the German government's opposition to fiscal stimulus: Germany's fast ageing demographic profile meant its fiscal position was much weaker than it appeared. It would be very hard for other eurozone governments to convince Germany to alter their approach, as there was a broad political consensus in favour of the country's balanced budget rules. He was pessimistic about the likelihood of Germany pushing through the structural reforms of its own economy, which are needed to boost the rate of growth of GDP per worker.

The second panellist argued that demographic change affected different European countries differently. Without policy changes, some countries will suffer a significant decline in GDP growth due to their demographics, in particular Germany and Italy. By contrast, France and the UK faced far less severe demographic challenges. Economic decline in fast ageing societies was not inevitable: policy changes can counter demographic pressures by improving labour market participation, boosting productivity, and encouraging immigration. Unfortunately, many countries in Europe spend too much on the old and the rich, too little on the young and the poor, and too little on R&D. The recent crisis had worsened these biases. There was also rising popular resentment against immigration.

The third panellist argued that fears of demographic change might be overblown, as it was living standards rather than GDP growth that were important; the two were not the same thing. He argued that two issues needed to be tackled nonetheless. First, Europe needed to exploit the opportunity afforded by unprecedentedly low interest rates to invest in its increasingly inadequate infrastructure. This would provide a short-term stimulus but also bolster growth potential. Second, youth unemployment should be addressed urgently in order to ensure that potential future growth is not lowered unduly. This requires a mixture of demand and supply policies, depending on the country in question.

The final panellist argued that there are striking similarities between Japan in the 1990s and the eurozone now, including mounting deflation risks and demographic pressures. He observed that deflation started in Japan just when the working age population peaked, and that the eurozone's was peaking now. Labour supply needed to be increased, mostly by increasing labour force participation, where there was still potential (in some countries female participation in the labour market was very low, for example). Far from trying to discourage immigrants, as is the case across much of Europe at present, governments will have to compete to make themselves attractive to immigrants in the future. With much of the available supply coming from Europe's immediate neighbourhood, this raised the prospect of bidding wars for immigrants in an aging Europe. It would pose serious economic challenges for those countries that struggle to hold onto their young and skilled, a trend already evident in the eurozone periphery.

Q&A: The discussion focused on three issues. First, there was considerable doubt over the meaningfulness of population forecasts; they had often proved inaccurate in the past. Others pointed out that we should not be optimistic because of these previous forecasting errors: the speed of population ageing could be even quicker than projected. The second issue was whether labour force participation would rise independently as more productive workers chose to work longer, or whether it would require aggressive policy intervention. Finally, most agreed that more investment was necessary but one discussant questioned whether investment really had the high rate of return that most assumed, given the weakening of consumer demand implied by population ageing. Others countered that an ageing population required stronger productivity growth which in turn increased the need for higher investment. Finally, there was criticism of Germany for demanding wide-ranging reforms from other countries while resisting even minor reforms at home. For some, this was politically unsustainable.

Session 3: Is rising inequality holding back Europe's economy?

Inequality of income and wealth across Europe is rising. Labour's share of national income has declined while the return on capital has risen. Are these trends a cause or consequence of weaker economic growth? Have they increased financial and macroeconomic instability? What role has corporate governance played in the rise of inequality and fall in labour share? What can governments do to address these trends?

The first panellist argued that the eurozone had become a mechanism for economic divergence, deepening inequalities within and between member-states. Since the crisis, there had been a big rise in inequality between countries – especially between the young in different countries because of divergent rates of youth unemployment. This rising inequality threatened to thwart efforts to integrate Europe. A major issue in the eurozone was the lack of transfers between countries. The eurozone needed automatic stabilisers to prevent countries having to slash spending in economic downturns, which was the source of much of the rising inequality.

The second panellist argued that weak investment was exacerbating inequality in the eurozone, but that this appeared to be a cyclical phenomenon (related to the handling of the eurozone) rather than a structural one, as was the case in the US and UK. In the latter, corporate profits had risen, labour shares had declined and business investment had fallen, reflecting a system of corporate governance which rewarded executives for short-term share performance and discouraged the long-term investment needed to boost productivity levels. There was little to suggest a comparable fall in labour share in the eurozone.

The third panellist argued that there were three channels through which inequality could negatively affect the economy. First, inequality was a symptom of an underlying problem such as a lack of competition and the unjust rents that arise as a result. For example, in the run-up to the financial crisis, lots of economic 'rents' were made by the financial sector firms, which aggravated inequality. Second, popular frustration about inequality can lead to damaging, growth-retarding policies. Third, low levels of equality of opportunity meant that the potential of human capital was being wasted, which was bad for economic growth. However, this was not the main story in Europe, where there were good levels of investment in health and education. He concluded by arguing that governments needed to focus on reforms which were both fair and growth-enhancing, such as Germany's Hartz IV reforms, and which would challenge the source of perceived unfairness, such as financial sector remuneration.

The final panellist focused on three issues that were driving inequality. First, the financial crisis had not put an end to rent-seeking by the financial sector. Second, it was

becoming increasingly difficult to tax capital, meaning that income taxes were too high, especially for those on low incomes, relative to taxes on capital. In order to lower inequality, redistribution needed to be targeted towards the poor and disadvantaged. In the US, taxes were low but the tax system was quite progressive; in Europe, taxes were high but much less progressive. There was a clear need to tax immobile factors of production, especially land, as property taxes were the most efficient and effective way of tackling inequality. Unfortunately, this was notoriously difficult politically. Third, technology threatened to worsen inequality by wiping out an increasing number of jobs for low-skilled workers. It would be difficult to create jobs in the future by holding down wages – because technology would make it ever easier to substitute labour.

Q&A: The discussion focused first on China as a driver of globalisation and rising inequality. While Chinese wages were rising, it was argued that there was still potential for further increases in labour supply (and hence, downward pressure on wages) in India and across Africa. There was broad consensus that new technology would further aggravate inequality in the absence of far greater redistribution of income and wealth.

A number of participants argued that Germany's role within the eurozone was exacerbating inequality. Germany was accused of pursuing a zero-sum strategy which depressed domestic demand and increased the price competitiveness of German exports. This was neither a desirable model nor one that could be replicated by others. Germany needed higher wages and a programme of public investment. Excessive and pro-cyclical fiscal austerity was reducing expenditure on the poor, and exacerbating inequality. The eurozone lacked the institutions to cope with growing inequality within and between member-states. To be effective, structural reforms required a sufficient level of domestic demand which, in turn, required expansionary macroeconomic policies. An efficient financial system was also essential (to ensure that resources were allocated to where they could be used most effectively), as was a functioning welfare system.

There was some disagreement over the role of finance and corporate governance in driving inequality. For some, financialisation had led to huge financial sector rents and accompanying decline in business investment. Finance was eating the economy upon which it depended. For others, the weakness of investment was a cyclical story – the entire system had been traumatised by two almighty shocks: the global financial crisis and then the eurozone crisis. Also, the official data were likely to be underestimating investment, because much of it now took the form of spending on intangibles, which was difficult to capture.

Session 4: What kind of banking system does Europe need?

Europe's financial system is dominated by universal banks and (in many countries) shallow capital markets. Would reducing barriers to entry (and hence the size of banks) help? Is the answer greater marketisation of finance? Have governments and regulators been 'captured' by financial interests or have they misunderstood the sector? What kind of eurozone banking union is needed to make capital flow 'downhill' to poorer countries again?

The first panellist pointed out that recapitalisation of banks is crucial, as stronger banks increased lending whereas weak ones did not. Capital strengthening had been substantial in the eurozone and European banks had increased their capital by more than US banks. The problem was the way the capital had been raised: European banks had cut back new lending rather than raising capital and cleaning up their balance sheets. In general, the bank clean-up in the eurozone had taken too long because national governments protected their banks. Investors needed to realise that bank debt was not safe. It was a concern that of the €120bn raised by European banks in 2013, just €55bn had taken the form of equity. Given that the private sector was highly leveraged in some areas, debt for equity swaps were needed. Corporate indebtedness also needed to be reduced. Securitisation would be useful but no panacea as it shifted debt around rather than reducing it. The centralising of eurozone banking supervision was a major step forward as it ended the practice of national regulators pushing national champions.

The second panellist argued that financial regulation tended to be pro-cyclical: too lax before a crisis and then too strict during the recovery. Specifically, two things needed to change in Europe. First, mortgages (which constituted a large share of bank lending) needed to be financed differently. Shared responsibility mortgages should be the norm, as otherwise first time buyers were put at a huge risk. Second, Europe needed to use public funds to forcefully recapitalise banks. Instead of doing so, it had let its banks deleverage and its financial system fragment. Sometimes using public funds to recapitalise banks was the best use of taxpayers' money, and the eurozone crisis was one such case. Finally, more needed to be done to change the incentives facing banks – the pressure to maximise returns on investment was damaging banks' ability to allocate capital to where it could be used most productively.

The third panellist argued that governments needed to eliminate the tax advantage of debt. Tax systems currently imparted a debt bias because interest payments could be set off against taxes, firms financed themselves with too much debt and too little equity. Whereas a high degree of leverage (that is, more debt relative to assets) boosted return on equity when asset prices increase, it exacerbated the losses on equity when asset prices fell. He pointed out

that the concentration of derivatives and equities trading in a small number of central counterparty clearing houses meant that these institutions had huge exposures. This posed a major future risk to financial stability and should frighten policy-makers in Europe.

The fourth panellist argued that financial reform and regulatory tightening following the crisis had been made more difficult by the failure to employ off-setting counter-cyclical macroeconomic policies. In Europe, transparency was being improved with the asset quality review and stress tests, but Germany's Landesbanken remained an obstacle to a full clean-up (they had done more to blow up the UK commercial property market than anyone else). The planned ECB purchases of asset-backed securities would not stimulate the market as much as the ECB was hoping because of the lack of a big government guarantee. On capital markets union, he argued that it was so far a slogan without content. He suggested harmonising solvency laws across Europe to achieve something equivalent to the US Chapter 11 bankruptcy code, as without it, there could not be a capital markets union. On the securities regulator, the issue was less clear as national capital market supervisors were less captured than national banking supervisors. Finally, he argued that Europe needed an equity culture to channel investment into the right uses.

The final panellist argued that common deposit insurance was an issue that should be tackled, however politically difficult that might be. He argued that the risk of bank runs had increased because some governments were too weak fiscally to be credible backstops. Moreover, the ECB had no clear lender-of-last-resort framework for banks, and had acted arbitrarily and politically in past cases, notably in Ireland and Cyprus. He also noted a lack of venture capital culture that was holding Europe back.

Q&A: A number of participants questioned whether the banking union was a significant step forward. The eurozone had a single supervisor but national banking systems, and was hence not a banking union as commonly understood. The eurozone was trying to break the sovereign-bank nexus on the cheap (through bail-ins), but needed to establish a big fiscal backstop too. There were also doubts over whether the deposit insurance would be effective while governments were still considered a risk. The eurozone also needed to encourage cross-border ownership of financial institutions: since the crisis, financial systems had shrunk and become more national in ownership and focus. If German banks owned Spanish ones, it would be easier to dilute the sovereign-bank loop, and open the way for more equitable burden-sharing. Some argued that the need for banks to generate inflated returns on equity was encouraging short-termism. Financial institutions needed incentives to provide financing to firms to make long-term investments.

Session 5: What can macroeconomic policies do to improve Europe's prospects?

European policy-makers turned their backs on fiscal stimulus in 2010. They have explicitly rejected Keynesian responses to the weakness of domestic demand, and implicitly rejected monetarist ones. Would more expansionary macroeconomic policies have an impact on Europe's growth prospects? Do debt levels and the structure of the eurozone, or even the existence of the euro itself, prevent the adoption of such policies?

The first panellist argued that the eurozone and the US had been in quite different institutional shape when they entered the crisis. In the US, monetary, fiscal and financial policies worked together, whereas the eurozone lacked the institutions necessary for such policy co-ordination. More investment was urgently needed, as this would simultaneously increase demand and tackle supply bottlenecks. He argued that peripheral countries were pushing through structural reforms, but that this was not being matched by the core, and in particular not by Germany. Policy-makers needed to be taken to the window and shown the abyss into which they were leading the eurozone economy. They needed to understand that without a grand bargain between eurozone governments, the single currency would collapse. Europe needed a monetary, fiscal and structural strategy, but they needed to be carried out together, not independently.

The second panellist argued that in order to solve the eurozone crisis, several obstacles needed to be removed or mitigated. Trust between countries had eroded during the crisis. There were big intellectual differences about the causes of the crisis and the way forward. Strikingly, even after seven years, there are still competing narratives of what caused the crisis. Countries also had differing interests (or, at least, perceptions of their interests) and the institutions needed to adjudicate between those interests were missing. The sequencing of policy responses had been mistaken, as some reforms had a negative short-term impact that needed to be compensated for but had not been. Fiscal relaxation, while desirable, needed to be complemented by a firm commitment to future prudence. He argued that there was not necessarily underinvestment in the eurozone as a whole, but rather in certain areas: in the public sector in Germany, and in the tradable sectors in France and Italy.

The third panellist focused on four issues regarding eurozone growth. First, the impact of demographics on growth was positive for much of the post-war period but was now turning negative. Germany and Italy, in particular, were on course to suffer sharply declining populations. As a result, Europe needed a growth model for negative demographics. Second, the ability of monetary policy to boost inflation was very weak. Demand was chronically weak despite very low interest rates. Lots of slack meant that the bargaining power of

labour was limited, and macroeconomic stimulus would not necessarily lead to more spending in some countries because of high debt levels. Third, it would be hard for the ECB to weaken the euro because it confronts an international environment in which other major central banks are far freer to engage in unorthodox policies. Fourth, monetary policy was more difficult to get right in a multi-country setting, because it was much harder to sequence monetary, fiscal and structural reforms in the optimal way. It was encouraging to see dialogue between France and Germany, but compromise was required by both sides.

The fourth panellist argued that attempting to reform labour and product markets in the middle of a depression was like relaying the roof when it is on fire. What is more, the fascination with structural reforms of labour markets as the key to growth was at best dubious since it is based upon a misleading account of Germany's economic turnaround in the mid-2000s. The so-called Hartz IV reforms had not led to Germany's growth spurt, and the country was not a model for other eurozone countries. Germany could only be Germany because everyone else was not Germany: an entire continent cannot competitively devalue when they are each other's major export markets. Austerity and structural reforms would not solve what was at root a banking sector crisis. The banks had to be deleveraged and the eurozone needed a co-ordinated fiscal stimulus.

The final panellist argued that flawed macroeconomic policies played a decisive role in perpetuating the crisis. The idea that contractionary fiscal policy was a prerequisite for economic growth had no basis in either theory or economic history. The impact on demand of the cuts in spending had far outweighed any positive impact on confidence. Germany was central to these policy failures: as the architect of flawed fiscal rules, as the inspiration for a central bank that consistently failed to meet its mandate and for domestic policies that had led to an enormous current account surplus. The eurozone was still not set up to deal with asymmetric shocks. Without a properly federal fiscal architecture, it would come apart.

Q&A: There was pessimism over the ability of the eurozone to agree on the necessary combination of monetary, fiscal and structural policies. For the eurozone to work, these three things would need to be undertaken simultaneously, but this was impossible due to the differences in financial and political cultures. Several participants argued that the Germans suffered from cognitive dissonance: a monetary union without a fiscal union was fundamentally flawed. Debt needed to be written down if such an institutionally-incomplete currency union was to survive. Germany should remember that it too was once a debtor country

and benefitted from debt relief. Regarding the fiscal pressure needed to induce structural reforms, there was disagreement, as anecdotal evidence could be presented for both sides of the argument. However, even if fiscal pressure was needed to force reforms, it was unclear that it is worth the damage done to the economies in the meantime. Finally, it was argued that the way in which current account surpluses were recycled was critically important; they needed to be invested productively and not inflate asset booms.

For some, the ECB's credibility was at stake because of its failure to take action despite expecting to miss its

inflation target two years hence. For others, democratic accountability demanded that governments should set the ECB's mandate rather than leaving this to the central bankers. Finally, it was argued that instead of trying to spur private-sector spending through asset purchases or interest rate changes, the ECB should hand consumers cash directly. Most economists agree that cash transfers from a central bank would stimulate demand, without creating inflationary threats. Indeed, given technological developments and globalisation, inflation pressures are set to remain weak for the foreseeable future.

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