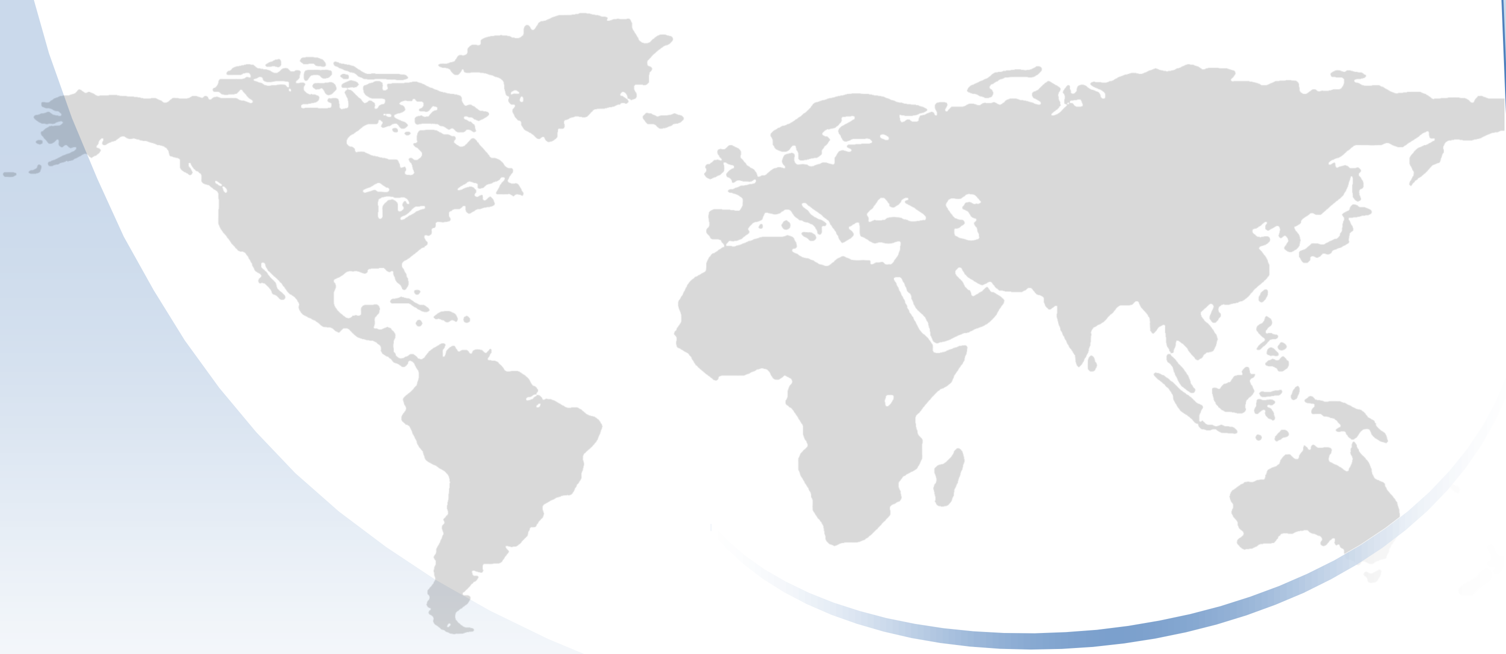
Luxembourg Institute for European and International Studies

EXECUTIVE SUMMARY

Conference on

Making Europe Work

14-15 July 2012
Palazzo Mundell, Santa Colomba (Siena, Italy)



Introduction

The Luxembourg Institute for European and International Studies (LIEIS) held a two-day conference on ‘Making Europe Work’ on 14 and 15 July 2012 at the Palazzo Mundell in Santa Colomba, near Siena, Italy. This meeting was the fifth in a series of conferences, which are part of a multi-year project on the EU jointly conceived by Robert Mundell, Professor of Economics at Columbia University and the 1999 Nobel Laureate in Economics, and Armand Clesse, Director of the LIEIS.

The first in this series took place in Schengen in 2006, while the second, third and fourth conferences were convened in Santa Colomba in 2007, 2008 and 2010. On the basis of the four conferences, the key ideas were summarised in a document entitled “The Santa Colomba Report”[1], which sets out 70 arguments and 45 policy proposals. This text brings together the main conclusions of the four conferences and seeks to make a significant contribution to current political discussions. As such, it is aimed at both decision- and policy-makers as well as academics and journalists.

The focus of the most recent conference was on the combined banking and sovereign debt crisis that has engulfed the eurozone and on how the EU as a whole can respond to its double deficit of democracy and legitimacy. In the course of six sessions, 28 participants from various European countries and North America debated these two key questions.

In his introductory remarks, Robert Mundell argued that the twin challenge for Europe is to make it solvent in the short term and to agree on a common vision in the medium and long term, whether a United States of Europe or a Europe of Nations (de Gaulle). On the first challenge, he said that the

[1] The full title is “The Santa Colomba Report: Alternative Ideas for the European Union”, available online at: http://www.ieis.lu/online/www/menu_vert/1152/220/221/content/349/433/113/ENG/The%20Santa%20Colomba%20Report%20with%20picture%20revised%20August%202011.pdf

wider origins of the financial and economic crisis can be traced to the end of the Bretton Woods system in 1971 when President Nixon abandoned the convertibility of the US Dollar to gold and abolished capital controls. Today the circumstances are very different but the current crisis raises questions about monetary arrangements and the future of the euro in the world economy. Within a monetary union, it is not real exchange rates that matter but rather fiscal divergence. Another specific issue is whether the European Central Bank (ECB) should limit itself to setting interest rates or whether it should support the bond market and, if so, whether this should be conditional on the fiscal stance of beneficiary countries. It seems that Chancellor Angela Merkel is opposed to any system of eurobonds without a concomitant transfer of authority—perhaps not quite a United States of Europe, but a federal great leap forward, R. Mundell said.

For his part, Armand Clesse suggested that the wording of the conference title 'Making Europe Work' is a little ambivalent, as it indicates that the objective is to make the European system function but also to create jobs, which is a major headache for the EU at a time of record unemployment, especially youth unemployment in the countries of the so-called periphery. Faced with the complex financial and economic problems, the participants would do well to be modest but one of the main goals of the conference is to bring some much-needed clarity. Crucially, the task is to develop long-term strategic thinking that is not being done elsewhere. In order to develop ideas about how to reform existing institutions and perhaps devise new ones, it makes sense to start with the question of what went wrong.

A. The short term: Managing and resolving the eurozone debt crisis

1. What went wrong economically?

Heiner Flassbeck started off the first session with the argument that retrospectively much went wrong and that the current crisis raises the question of what exactly a monetary union is. The first point to make is that historically political and monetary unions do not necessarily require each other. Secondly, the European Monetary Union (EMU) that was set up in 1999 is mainly a monetary union based on the goal of harmonising inflation targets across the member countries. In short, EMU means that sovereign countries give up their own inflation target. But this did not go according to plan. The 2% inflation target was only achieved on average. On the whole, Germany has had a lower rate and France was broadly in line with the 2% level. By contrast, the inflation rate of southern countries such as Greece, Spain and Italy was well above target—a trend that has been driven by unit labour costs. In short, the core objective of EMU has definitely gone wrong.

This evolution has led to a competitiveness gap of about 30% between Germany and the South, which is the key problem. Meanwhile the general focus is on fiscal policies as well as on debt and deficit levels. Politicians and other decision-makers like easy targets that they understand but this is not the main issue. As a result, they are administering the wrong kind of medicine. Similarly, moving to a political union is often portrayed as a solution but political union is not necessarily a proper response to the current crisis. Here it is instructive to draw a historical comparison. After reunification Germany faced a similar situation: a monetary union with the former GDR and a growing competitiveness gap between east and west. Nearly 25 years later, the East is still underperforming and the West pays €16–17 billion for 15 million people in the east every year. Nobody would want this for the whole of Europe because it is politically and socially unsustainable. Germany has had an economic policy which under normal circumstances would have led to currency appreciation but EMU has prevented this. However, to say that everyone should become 'more German' is nonsense, as it is impossible for all eurozone members to become simultaneously more competitive and run current account surpluses. Not every country can export its way out of the crisis—an error that economists describe as 'fallacy of composition', H. Flassbeck concluded.

R. Mundell contended that decisions about exchange rates are not purely economic but involve political reasons in order to achieve a consensus. Economically, there might have been a strong case to convert GDR marks into Deutschmarks at a rate of 3 to 1, but Chancellor Kohl decided on a 1:1 conversion. A 3:1 rate might have worked only in the circumstances of maintaining a separate East German state, which was unacceptable for a variety of reasons. On the issue of fiscal targets, the question is whether Italy and Belgium should have been denied membership in the eurozone because of their high debt to GDP ratio (around 120% in both cases). EMU in 1999 was a unique political moment and historic opportunity. If monetary union had not gone forward then, it might never have happened. In that case, one has to accept structural differences and should not wait until they disappear.

In his response, H. Flassbeck said that German monetary union was a case of 'money illusion'. People in Eastern Germany thought that with the D-Mark they would have the same living standard as their fellow Germans in the West. No politician explained to them that the loss of competitiveness due to soaring unit labour costs would entail high unemployment, despite lower wages in the East compared with the West. The modalities of monetary union were not good for anyone, except for some companies in the West who took over the East German economy. Of course politics is about seizing opportunities, but in the case of EMU there were many systematic problems: first, the limited role of the ECB to control inflation and secure price stability; second, the lack of inflation convergence after the creation of EMU in 1999, which led to the gap in competitiveness. Under the cover of a single interest rate and the absence of currency appreciation, Germany went for a 'beggar-thy-neighbour' policy that has resulted in such substantial imbalances.

Asked by Jan Zielonka about what was done at that time to reduce the competitiveness gap, H. Flassbeck responded that this problem was either ignored or denied. Nowadays, the euro area would need 10–15 years of steady wage rise in Germany while other countries would need to raise their productivity. However, at the moment Germany and other core countries are asking the periphery to cut wages, which is destroying their domestic economies by squeezing demand and exacerbating the slump. To break this vicious circle, the eurozone needs to make use of an 'institution' called the 'macroeconomic dialogue'. In principle, this dialogue includes the ECB, the European Commission, employers' associations, trade unions and member-states who would meet every six months to discuss key questions linked to wages, training and employment legislation. But this 'institution' was never taken seriously and it was ignored by the ECB, the Commission and national governments alike.

R. Mundell voiced his disagreement with H. Flassbeck's analysis. He wondered whether the eurozone crisis boils down to a macroeconomic problem of excessive spending or whether it amounts to a competitiveness problem between the core and the periphery. Based on the available evidence, excessive spending matters more than competitiveness. For example, on the eve of joining monetary union in 2002, Greece had to devalue by as much as 14%. Of course wage levels have risen in southern countries, but the question is whether this can be managed within EMU or indeed any other monetary union (e.g. wage differentials across the USA). The main problem really is macroeconomic, as demonstrated by Greece and Spain. It is true that German wage rates (about €35 an hour) are three times higher than Greek wage rates (about €14-15 an hour), but Greece is struggling much more with considerably lower wage rates in neighbouring Bulgaria (about €6 an hour).

In his intervention, Alfred Steinherr said that it is not possible to have the same growth of wages and prices across Europe. In the first ten years the eurozone saw a real appreciation in all the southern countries and a real depreciation in all the northern countries. *Contra* R. Mundell, he said that real exchanges between members of currency unions do matter because they are ultimately linked to current account deficits and surpluses. As a result, cutting wages in Greece cannot solve the problem, but one cannot continue with the iron cage of austerity. The right response is for the North to increase prices in order to redress the real exchange and to accept higher inflation across Europe. In other words, what the euro area needs is a series of mechanisms to correct the undershooting and overshooting of inflation and also the size of imbalances. It is true, as R. Mundell suggested, that there was a window of opportunity in 1999 to go ahead with monetary union but the question is at what cost. Indeed, the Maastricht Treaty was extremely weak, lacked important provisions and contained much irrelevant detail. But more than 10 years after the window of opportunity, would we not have been better off without the euro?

R. Mundell agreed that exchange rates matter a great deal but not in a monetary union. If one compares the eurozone with the US Dollar currency area that is characterised by varying price and wage levels, there are no competitiveness issues within the US economy. Nor do exchange rates matter between North and South Germany. However, the same does not hold for East and West Germany: in 1990 they mattered a great deal but their importance decreased over time. The ECB could not have done anything about depreciation in the North and appreciation in the South.

On the issue of whether 1999 was key, perhaps it would have been wiser to wait for Denmark to join or Italy to reduce its national debt from 120% GDP. However, the Maastricht Treaty came only two years after the Delors report in Spring 1989 that called for countries to give up their national currencies—a utopian project which hardly anyone at that time expected to become reality. Many European countries wanted to see Germany tied into a monetary union, which was the political glue in exchange for German reunification. Today it is most unlikely that Germany would sign something like the Maastricht Treaty. Seen from this perspective, the whole of Europe needed the date of 1999. As for crisis resolution, it is crucial that countries in the South put up their socks and adjust. Without structural reform, the fiscal imbalances will persist and continue to undermine the euro, R. Mundell said in conclusion of his remarks.

At this point in the discussion, H. Flassbeck made two brief factual remarks. First of all, there is strong evidence to suggest a relationship between real exchange rates and deviations in national current accounts, on the one hand, and the loss of market shares in the South to the North because of exchange rate differentials, on the other hand. Second, exchange rate differences in Europe and in the US cannot be compared with one another and therefore the same conclusions do not apply.

In her intervention, Iveta Radicova said that as prime minister of Slovakia, she participated in 19 irregular summit meetings of heads of state and government in the space of just 21 months—an indication that the crisis is deep, that governments are extremely nervous and that no-one has been satisfied with the outcome (neither markets nor citizens). The period 2009–2012 saw a total of 27 summits and informal meetings of the heads of state and government. While the origins of the turmoil are both financial and fiscal, the lack of political agreement has greatly exacerbated the situation. Broadly speaking, there were few structural differences between the various economic storms and recessions of 1975, 1982, 1991 and 2009–2010. But the current crisis is deeper, not so much in terms of absolute levels of budgetary deficits and public debt but first and foremost in relation to the cost of borrowing for a number of countries. More specifically, the US, the UK and Japan have a higher debt to GDP ratio but they have lower interest rates because of more confidence and trust in their political stability and their ability to service their debt. Portugal has lower levels of public debt than the US but today it lacks credibility because in the past Portuguese governments defaulted on national debt. So the problem is a combination of borrowing costs in the markets, the overall costs of debt servicing as well as confidence and trust in governments and banking system.

Since 2008, what has happened is (i) mispriced risk; (ii) macroeconomic misbehaviour over many years; (iii) weak prudential framework and supervision; (iv) missing structural reforms. One reason is a growing gap between political promises and economic reality. But there is also a close interaction of several factors. First of all, markets have become increasingly integrated beyond borders but supervision and regulation continue to take place at the national level. Second, the ECB was not allowed to be a lender of last resort but markets assumed a supranational safety net if things went wrong. Third, there was a widespread belief that economies and banking systems were too big or too complex to fail and that liabilities had implicit guarantees, which was not true. Fourth, eurozone average state debt stands at about 86% of GDP, household debt at about 66%, corporate debt at about 110% and so overall debt at about 250% (without the total liabilities of banks and other financial institutions). Thus, the only exit is to restore financial and fiscal order in each country. For example, since the onset of the crisis and the implementation of austerity Slovakia reduced the budget deficit from 8% to 4.8% in the space of 15 months, and the debt to GDP ratio has dropped to 43% while unemployment decreased by 1% and employment increased by 1.5%. All this occurred against the backdrop of the country having to use 13% of its GDP in order to recapitalise the banks in the late 1990s. This coupled with pressures on the welfare state, puts strains on social solidarity. Unless there is structural reform of health, pensions, education and finance, Europe will not survive—I. Radicova concluded.

Charles Maier returned to the links between political and economic union. He argued that political and economic processes of integration often diverge and that there is no good reason to expect an easy fit. Historically, in 1860–70 the USA decided to unify. The North imposed its conditions on the South but regional differences and disparities remained until the 1950s and arguably until today. Italy formed a unified state in 1872 but still has significant regional disparities. Put simply, if anyone wants a political union, they will have to pay for it. West Germany did so in the case of East Germany. However, it is equally true that there are two specific problems with monetary unions today. First of all, there has been an enormous increase of debt on a global scale since the 1980s (e.g. Mexico in 1994, South East Asia in 1997, Russia in 1998, Argentina in 2002, etc.). It is not so much the level of debt but rather the rate of change in the level of debt during peace times. Thirty years of leverage have left a toxic legacy, and a variety of eurozone countries have engaged in reckless borrowing, aided and abetted by certain banks. Second, regional disparities in the EU matter more than many acknowledge. It is not wage levels, it is a question of unit labour costs and capital equipment. Partly for this reason, the costs of austerity for the periphery are unbearable in the long term. If conditionality is imposed, it has to be imposed in a way that is pari passu, step-by-step. Economically and politically, nothing else has a chance of working because purely national solutions will not solve a supranational crisis, and a federal great leap forward lacks the necessary legitimacy.

According to Thomas Klau, economic, mono-causal explanations are doomed to fail. He identified three groups of factors that can account for the origins and evolution of the crisis. First of all, the eurozone has had flawed institutions and operates a little like a football team in which each player has a veto right vis-à-vis the referee and the captain is unable to impose any kind of unity, such that all players end up doing their own thing. Second, eurozone monetary policy has rested on flawed economic analyses: the ECB and other authorities have underestimated the impact of a massive lowering of interest rates in countries historically accustomed to high interest rates on consumer behaviour, wage setting and the housing market. Third, governments and regulators in Europe and elsewhere have made poor policy choices. This includes the catastrophic under-regulation of financial markets that have been transformed by technological change and driven to excess by a misguided ideology, which forced governments to increase both deficits and debt. At the same time, it should not be forgotten even with imperfect Maastricht instruments, Belgium and other euro countries managed to reduce their debt.

Since the collapse of the Bretton Woods system, every monetary and financial system has in some sense failed. What we now see is the failure of the latest attempt to construct or sustain a monetary union without a sufficient transfer of political power to a central, federal authority, as Robert Mundell has outlined in his text. There are thus two choices: either a centralised system with many powers of intervention or a less centralised system but with welfare transfers to the centre, leaving nations to manage the rest of their affairs more freely. Whatever scenario materialises, three assumptions can be made. First, the single market will not survive reversion to fluctuating exchange rates. Second, all attempts to limit fluctuations within margins or bands tend to fail. Third, if the single market collapses, then political integration collapses. The only solution is to construct a political order that functions and to do so the EU needs to get rid of the unanimity principle. The fiscal treaty, which is a nonsensical document, will enter into force even without every state having ratified it. That is the way forward, T. Klau concluded.

Dimitri Sotiropoulos said that the failure of structural reforms has led to the decision to cut the minimum wage. All previous measures were not effective in reforming the Greek economy, and no privatisation took place over the past two years. The problem is that consumer prices have remained excessively high for people on low wages. However, the short-term trigger for the crisis was the financial storm that broke loose in 2007–8. The long-term problem is that Europeans have never made a decision on what kind of Europe they want—deeper integration or a looser arrangement. Such protracted indecisiveness has a cost.

Philipp Thomas suggested that during the last decade bankers have been ripping off the banks employing them and that present governments have likewise been ripping off future generations by resorting to unconscionable levels of deficit financing. Besides financial recklessness by agents in the private sector pursuing their own agendas, the main problem was excessive spending by governments. Europe needs safeguards to force governments to put their finances onto a sounder footing, either by curtailing voting rights or by enshrining clauses establishing balanced budgets or by introducing constitutional limits on public expenditure to 25% of GDP.

In his remarks A. Steinherr said that it was not just by chance that spending became excessive. The state has effectively taken over the function of insuring against a number of risks but the financing is a growing problem because in a number of countries such as Greece, many members of the middle class and the upper class are not paying taxes and do not see themselves as part of the social contract. The eurozone needs much more than macroeconomic dialogue in monetary union. It needs robust institutions, otherwise the euro is like having a monetary union based on little more than arbitrariness. That is why it is necessary to establish provisions to leave such an arbitrary arrangement.

David Calleo argued that the best way to overcome the crisis is to bring about a gradual increase in the competitiveness of the periphery and a gradual decrease in the competitiveness of the core. In other words, either the eurozone needs other adjustment mechanisms (including price rises in Germany) or else it needs to be dissolved. In relation to debt, the one country that has been running deficits for nearly 40 years is the USA. It pays its debt in a very special way—simply by issuing more money. In the last 10–15 years the US Dollar has devalued, and at some point the market could turn against it. Seen from this perspective, the euro has made Europe much stronger in competition with other international and global currencies.

Joris Buyse divided his remarks into three: first, fiscal austerity vs. growth; second, monetary union; third, German competitiveness. On the first issue, he said that the current crisis is essentially a fiscal crisis. Up until a debt-to-GDP ratio of 70–80%, fiscal policy is effective, as Reinhart and Rogoff have argued in their acclaimed book.[2] Beyond that, countries enter a vicious circle. A number of eurozone countries exceeded this limit with the bailout of banks. Since then, we have in effect seen 'a creditors' strike', i.e. a refusal to lend to certain countries at reasonable rates. Now southern

[2] Carmen Reinhart and Kenneth Rogoff, *This Time is Different. Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009).

countries cannot borrow at reasonable rates without northern countries vouching for them, which is absolutely new. In this environment in which certain southern countries can no longer finance their deficits on their own, it makes no sense to speak about the need for expansive fiscal policy. In any case, what some call austerity is in reality nothing other than fiscal rectitude—a return to fiscal probity and a number of necessary structural adjustment measures (especially labour market reforms) which alone can generate growth. On the second issue, he suggested that there is no single country in the world which qualifies as an optimal currency area. Hence in most cases—and not only in the euro area—monetary policy would have to be regional in order to be optimal. Now that EMU has been created, there is no way backward: the costs of partial or total break-up would be immense, even in the case of a small country. To solve the current crisis, what is required is a fiscal union, a political union and a supervision union (or a banking union). However, while there is a strong case for federalism in Europe, a federal 'great leap forward' that fails to command popular support would, at this juncture, trigger an even greater nationalist backlash. Finally, on the third issue, he declared that arguments against German competitiveness are bizarre: why should a country like Germany take measures to lose its good state of health? Restoring fiscal rectitude and boosting productivity in the south makes much more sense.

Concluding the first session, R. Mundell argued that high and unsustainable budget deficits and public debt were responsible for the eurozone crisis. Euro members were not disciplined and there was no proper enforcement of discipline. The actual level of the debt is very important: with 40–50% of GDP it takes a long time to pay down, with 120% or 160% of GDP countries cannot go back to the markets. So the real cause of the crisis was a combination of soaring deficits and already high debt levels that led to national insolvency. On the Titanic people had a big party until they crashed into the iceberg. Europe in the 1960s had a social model with 25–30% of GDP worth of government spending and later the level rose to 40–50%. In principle, countries should not have a government spending level above 40%. Nowadays spending levels are so high that they are difficult to retrench. If you have a European minister of finance, he would not have leverage because he has only 3% of GDP, not like the US Secretary of Treasury who oversees a budget that represents 25% of GDP. Even in conditions of austerity, 40% are not really touched, so the problem is one of getting countries to cut down their level of spending and restoring their access to international money markets.

2. What went wrong politically?

At the start of the second session, A. Clesse quoted from a recent article by Pascal Lamy: "The euro crisis shows that Europe's institutions of political integration do not correspond to the economic integration that has been built. This imbalance is not sustainable, and new forms of discipline, solidarity and legitimacy have to emerge. The euro crisis is actually three crises: one economic, one institutional and one of legitimacy. The economic component is the symptom: a dangerous combination of a lack of competitiveness, fiscal problems and shaky banks. The institutional component reflects the original sins in the design of the Monetary Union: Europe's insufficient central powers in supervision, resolution and risk-sharing that subsequent constitutional reforms have failed to address. Lastly, the euro is also plagued by a legitimacy crisis in which support for the common currency—and, more broadly, for the European project—is in decline."[3]

John Gillingham started off the debate by putting forward some ideas to stimulate the discussions rather than providing answers to the questions that concern Europe. In relation to R. Mundell's comments, we are dealing with something that reaches beyond the structures of the eurozone. The current turmoil is a more deep-seated crisis in an era of European history, which has to do with the sustainability of the much-vaunted European social models. In other words, the larger cause is a structural problem in the EU itself. The immediate problem is the disconnection of political from banking and other financial institutions and also the separation between national, political and supranational, regulatory mechanisms: since the ECB is not accountable to anyone at all, it is able to ride roughshod over national considerations. Jacques Delors himself admitted that EMU created a flawed institution (the ECB) but it was thought that Europe could over time build up countervailing political institutions. However, this assumption failed—as evinced by the rejection of the Constitutional Treaty in 2005.

At present it is one thing to talk about how to stimulate growth but it is far more important to talk about the inability of the institutions to deal with the crisis or to offer real solutions. Austerity destroys not just economies but also human lives: with 20–25% unemployment austerity does not just mean tightening your belt; in many countries it means to walk around without any belt at all. In short, the crisis is linked to the creation of the eurozone and the institutional inability to deal with the problems politically. Worryingly, there is a deep, growing divergence of views about the euro area and the EU. Two things are clear: first, it is not possible to solve the crisis with measures that should have been taken two years ago; second, there is no way out that is not costly, so all that is left is to engage in an exercise of damage control, written with capital letters. Finally, J. Gillingham said that national politicians are under heavy pressure from the public and that each country has to find its own way out of this terrible mess, which only national politicians can do. For now Europe lacks the effective mechanisms and political legitimacy.

In his short remarks, Herman van Gunsteren argued that there are three levels: first, he paraphrased Edison who is reported to have said something along the following lines: "I did not fail, but 10,000 things did not work. Only the ten thousandth and first thing worked." In the context of all the crisis summits of the eurozone, this seems particularly apposite. Second, it is true that 1989 was about seizing the political moment but now the pressing problem is who is going to make Europe work. In the core countries of the North, there is no talk about solidarity with other countries in the South. Third, the question of legitimacy can only be discussed in relation to the point that there is not as yet any European demos. Even if politicians can seize the moment, they are not rooted anymore in political cultures which they can take with them. What is missing is popular assent and support.

[3] Pascal Lamy, "Europe Needs a Legitimacy Compact" , *International Herald Tribune*, 9 July 2012, available online at: http://www.nytimes.com/2012/07/09/opinion/europe-needs-a-legitimacy-compact.html?_r=1&

Larry Siedentop agreed that the current turmoil in the euro area constitutes a very deep political crisis—the construction of Europe has neglected the political dimension. Liberal thinking during the years of competition with communism was affected by a misguided focus on economic determinism. The strategy of introducing federalism through the backdoor has not worked. Europe is suffering a crisis of representative government. There is an increasing risk, in terms of institutions, that national parliaments and the European Parliament (EP) will succeed in discrediting each other. The reason is that the increased powers of the EP are not offset by its enhanced authority. By contrast, national parliaments retain authority but have less and less power. That is a very dangerous dialectic which is gradually eroding the remaining popular support for European integration. This helps to account for the inability of successive EU ministerial meetings to come up with decisions that can command consent, which has to be a major concern. Similarly, the development on the political right seems indeterminate: there is now a great need to shape reactions, which combine bleak traditional nationalism with new—and arguably legitimate—doubts about the future of self-government and the failure of European politics to mobilise consent. In other words, Europe is in dire need of a political project that can influence debate and that can reconnect political classes to popular sentiment and opinion.

In his intervention, Mark Almond suggested that the current crisis is a deep ideological crisis, which consists in the absence of alternatives. It is not merely the case that the triumph of market economies and western democracy has not produced solutions to all the problems. What is worse is that there is now no coherent criticism of these historically contingent and by no means necessary or normative models. In Britain where people take constitutional government for granted, in the last few years the credibility of politicians, bankers and the press has been severely shaken by a series of scandals. The banking crisis and the corruption of bankers have discredited the market economy itself. Put simply, the hidden, self-regulating hand has been caught red-handed in the till! Or to paraphrase Bertolt Brecht, to rob a bank is a crime but not half as big a crime as to own one! That is why the term 'bankster' has become commonplace. So Europe and the rest of the West are undergoing an ideological crisis, which liberalism itself cannot solve. In the past the legitimacy of the EU and national governments has come from delivering economic prosperity to the many, not just the few. If that is challenged by the prospect of stagnation and the expectation of getting poorer for a majority, then there will be trouble. Indeed, the economic situation might be even worse than is generally supposed. For example, real rates of inflation are much higher than the average inflation level, so it is hard for many ordinary people to make ends meet. In terms of education, several countries like Britain are not only de-industrialised but also de-educated. Compared with Germany and Sweden, the British population lacks the sort of skills, knowledge and broad general education on which a prosperous economy and a vibrant society depend. In short, the crisis threatens the very existence and viability of the European social model. Paradoxically, the economic bubble of financial speculation may have burst, but this raises the question of how to mobilise people whose primary concerns are economic at a time when unemployment has once again reached record levels.

Luuk van Middelaar suggested that the creation of the euro was essentially for political motives. Even if economically it made sense, it would not have happened were it not for the end of the Cold War in 1989. Likewise, European leaders do not only try to save the euro for economic reasons but also for political reasons. For Chancellor Merkel to dissolve the euro is unthinkable but a transfer union is unacceptable. She will probably end up choosing the latter. But for now, one way of trying to get out of this dilemma is to propose a political union. Whatever the severe shortcoming of European decisions to date, it is true that politicians now know more than three years ago. Above all, they are keenly aware of the increasing interdependence—the fact that Greek deficits affect other countries and that Spanish debt levels matter, which is something that the public recognises too. At present, the political answer is more about managing interdependence than committing to some kind of federal great leap forward. However, what has recently changed is the tone of political discussions. In the highest circles, there are growing voices saying that Europe needs a systemic answer to the crisis. Put differently, there is now a sense among leaders of a long-term perspective to solve short-term problems. The trouble is that lenders who buy 10-year bonds ask where the eurozone will be in 10 years.

One vision for the future has been outlined by the presidents of the European Council, the Eurogroup, the Commission and the ECB. In June 2012, the so-called 'Gang of 4' published a report on how to create a genuine economic and monetary union.[4] The full report due to be published in December 2012 could mark a watershed, like the 1989 Delors report that inspired much of the Maastricht Treaty. But there is currently no agreement on the origins of the crisis and there are also unprecedented institutional tensions between the single market and the monetary union. Running a single currency is something completely different in terms of what it requires for legitimacy than running a single market because it touches upon the budgetary rights of national parliaments, which is historically and politically their main duty. This situation forces Europe to bind together national parliaments into a common framework. Here it is crucial to note that over the past 60 years, Europe has constructed itself not only according to the federal and transfer principle outside the nation-state but also in order to bring together national politicians into a binding common framework, which requires an awareness of being in the same boat. Ordinary people will not believe that the crisis will be solved by institutional engineering—a direct election of the EU President will not help to solve the Greek debt problem. So for all these and other reasons, the most likely scenario is one of ambitious 'muddling through', as L. van Middelaar concluded.

C. Maier said that he did not understand the *a priori* for saying that Europe cannot have a transfer union. Surely within developed countries there are transfers all the time (within the family, between regions, from the poor to the rich). This is as true for the US as it is within the EU, e.g. via CAP and cohesion and regional funds. Therefore, it is an illusion to think that if Greece leaves the euro, it will not need help—it is very much a case of either having a beggar inside the church or on the church steps, so to speak. Crucially, none of the current problems invalidate the principle of the euro. By analogy, the fact that the Titanic hit the iceberg does not mean that it was not a wonderful ship.

In his contribution, Jan-Werner Mueller argued that there was no real consensus on following the rules since the beginning of the monetary union, and there is no real consensus now on how to move ahead. If that is the case, then the euro area needs a coalition of the 'truly and deeply willing', as Thomas Klau has helpfully suggested. Nevertheless, there are three problems with this approach

[4] The short version of the report is entitled "Towards a Genuine Economic and Monetary Union" and was published on 26 June 2012, available online at: http://ec.europa.eu/economy_finance/focuson/crisis/documents/131201_en.pdf

that are peculiar to Europe and almost tragic because they at the same time reflect some of the great virtues of the European project. First of all, every rolling back of integration is seen as bad because it destroys the ideology of an ever-expanding, irreversible, eternal union. That is why the EU has practised buying off support through side payments such as cohesion funds. Second, Europe has repeatedly faked consensus: in the 1990s, it looked as if countries converged but once again today the idea of a political union hides fundamental differences. Third, the very virtue and ethos of European integration (viz. a peaceful resolution of disagreements through compromise and mutual accommodation) is in direct conflict with the idea of enforcing centrally determined rules. Besides the travails of the eurozone, there is also the extremely worrying tendency of two EU member-states moving towards illiberalism or even some kind of authoritarianism (i.e. Hungary and Romania). That is perhaps the first time that the Union has seen a clear reversal in terms of democratisation. In short, Europe has a problem with rule enforcement—plus the EU was supposed to facilitate democracy, now it looks to critics like an engine of post-democracy.

Christopher Coker remarked that sacrifice is a word the participants have not mentioned thus far. Mutual sacrifice is the only way of getting out of the economic and political crisis. The trouble is that the various European countries cannot ask their citizens to make sacrifices if there is a crisis of legitimacy, as Larry Siedentop identified. Since the conference is taking place in Italy, it is worth remembering what Mussolini said: 'we have created Italy but not Italians'. Arguably it is true that we have created Europe but not Europeans. Whatever Europe we are going to put together based on the current crisis resolution mechanisms, it is going to be just another structure that will lack legitimacy and will fail to mobilise citizens into making the necessary sacrifices. The two proposed solutions to the economic crisis are austerity and growth. Governments cannot push through austerity under a European diktat because of a lack of legitimacy to demand those sacrifices on the part of the citizens. Likewise, those who are calling for growth are unwilling to make the sacrifices to the welfare model. Strong growth requires a cut in the social model that is simply economically unsustainable. As Robert Cooper said, since the end of the Cold War Europeans need not be citizens, just consumers. Indeed, mass consumption seems to be the only ideology. As a graffiti in Paris during the celebrations of the bicentenary of the French Revolution suggested, in 1789 the subject becomes a citizen and in 1989 the citizen becomes a consumer.

Part of the European project was to dismantle the nation-state and to replace it with another kind of state, which has been variously described as a market-state or a transnational state. This substitute is characterised by three distinct features. First of all, it delinks the state from the nation, and the transnational state becomes a risk manager or just a manager. Second, it destroys the social contract between the state and the citizen and enters into different social contracts with different groups (whether ethnic or professional groups like bankers). As such, the citizenry as a whole lacks cohesion and identity. Third, it eliminates national myths and narratives. For example, British school children have not been taught history because the transnational state has a problem with history, as history requires national identities. So in short, Europe is suffering a crisis of social capital and a crisis of trust between citizens and the state, which is reflected by the fact that Latvia, Hungary and Romania are almost disqualifying themselves from being members of the club because their nominally liberal democracies are becoming illiberal and undemocratic. However, democracy is much more recent than is commonly supposed. In Britain, arguably the world's oldest popular democracy, universal suffrage was introduced as late as 1923. Crucially, democracy is a very fragile, new phenomenon, but the West continues to lecture Russia and China about democratic standards. At the same time, Europe's current policies are putting democracy at risk. New thinking and new forms of democracy are required, but Europe has not even started a proper debate about this task. The nation-state is the best model for democracy, not the polis or other small entities—as Rousseau suggested. Europe has a democracy and legitimacy deficit and the citizens recognise it, C. Coker concluded.

William Pfaff said that the conference had so far been talking about monetary and economic questions as if they could be solved by themselves. It seems that in Europe and in the USA, the debt crisis is like an Old Testament plague that we do not comprehend or choose not to comprehend. Ultimately, all this was the result of a swindle in high finance. Contemporary societies are victims of what happened in financial circles. Some criminal banks have been diverted from traditional practices and have ended up swindling their clients. Since 1945, Europe has been constructed on two different sets of foundations: one has been the belief that European integration will be simple because Europe has nearly 4,000 years of shared history. In short, there is an underestimation of nationalisms, which is surprising given how much nationalism is linked to conflicts throughout the nineteenth century and the two world wars in the twentieth century. The other foundation has been the belief in a largely theoretical model of building a continental union that is greater than the sum of its parts. But monetary union was built without the necessary institutions to guarantee the currency. While it is true that the EU is guilty of institutional deficiency and political overreach, it is not too late to correct mistakes in the construction of Europe.

I. Radicova said that eleven governments have fallen in the last 20 months but this is not part of the normal alternation between governing and opposition parties. On the contrary, nationalistic extremists have either taken power or play a pivotal role in propping up governments, for example in the Netherlands or in Romania where the position of the president is weak in comparison to that of the prime minister. From today's perspective, the chance of introducing eurobonds is zero because it will lead to a separation of the eurozone from the rest of the EU. Many member-states will never agree to this and then new structures will need to be set up. The logic of 'take-it-or-leave-it' will lead to a core Europe in a four-speed EU. I. Radicova concluded her remarks by briefly outlining four possible scenarios:

(i) muddling through

(ii) a total collapse of the EU

(iii) a core group of states without the rest

(iv) real European unification with a proper fiscal and monetary union for all.

At the end of the second session, R. Mundell said that Europe is not in such a bad situation. It certainly faces fundamental problems that will be hard to work on, but Europe will ultimately succeed. He recalled his work in 1969 on optimal currency areas and in 1970 on a European currency, envisaging at that time that countries would keep their currencies and that there would be a central currency. When in 1989 the above-mentioned Delors report proposed a plan for a single currency, it seemed utterly unrealistic. Only the end of the Cold War changed all that. Delors' argument was that if you have a single currency, it is more irrevocable than maintaining national currencies. This has proven true: even Greece does not want to get out of the euro. Once the goal is set and you get away from the idea of countries leaving, then you make it work. It is like a war situation: the budgetary measures would have to be taken, the enemies would be at the gates and the big decisions would be made. All this requires conditionality to keep up the pressure on profligate governments. On competitiveness, there has been a real appreciation of rich northern vis-à-vis poor southern countries, which is to be expected with real wage growth. In the absence of labour mobility, capital mobility makes a big difference: there is substantial influx of capital because of higher rates of return in Southern countries. For example, 650,000 housing units were built in Spain between 2003–2010, which was more than in Germany, France and UK combined. Linked to this is a real wage appreciation in poorer southern countries that has added to the deterioration of their competitive position.

B. The medium term: Transforming the institutions

3. The limits of current institutions

R. Mundell introduced the third session by calling for alternative ways of enforcing rules of government spending and new ways in which central authorities can monitor structural adjustments in exchange for bail-outs. What this will require is a shift of transfer of some political authority or sovereignty to a central state. Italy is already making such a de facto transfer of powers. Interestingly, the Italian Prime Minister Mario Monti recently described this to R. Mundell as a sharing of sovereignty rather than a surrendering of national powers to an unaccountable centre in Brussels.

In his short presentation, J. Zielonka said that in future historians will ask why this financial failure was transformed into a political and institutional failure. Some people believe that German banks have something to do with the problem. Arguably, more Europe is only possible with more 'Europes': a fiscal union would mean leaving some out who do not want to join and kicking out some who would like to be part of it. Thus, integration now means the integration of 17 member-states or 17 minus. This is at odds with functionalist theories, which suggested that mutual interdependence would be the engine of integration of all. Paradoxically, now the reverse logic is true: monetary integration has produced financial and fiscal interdependence, and more political integration is necessary to save Europe from the effects of interdependence caused by monetary integration. It is unclear whether Franco–German policies have been right or wrong, economically or ethically but markets have rejected them and so have national electorates. With so many governments failing and falling over the last few months, populists like Berlusconi will soon suggest that democracy has been suspended by the EU and that countries need to fight back. Here it is useful to heed the so-called 'bicycle theory' put forward by the late Ralf Dahrendorf: "you don't fall off if you keep your feet on the ground."

In his intervention, Serge Allegrezza made four points. First of all, we do not do justice to the European project. Launching monetary union was part of the post-1989 political momentum and it was historically right to seize the opportunity despite the fact that the economic criteria of an optimum currency area were not fulfilled. EMU was the continuation of the Monnet method whereby economic cooperation will produce institutions and convergence will continue. When the euro celebrated its first birthday in 2003 (one year after the formal beginning and the start of the circulation of both notes and coins), nobody paid attention to current account imbalances and other indicators of divergence. At that time, governments were only interested in paying lip service to the criteria on public finance set out in the Maastricht Treaty and in the Stability and Growth Pact. Against this backdrop, the eurozone needs a system of monitoring rules that goes far beyond what is on the table in relation to public finance. Second, on the issue of interdependence, it is interesting to note that this concept was already mentioned in the Maastricht treaty: member-states should consider the common economy as a kind of public good and thus take coordination seriously. Third, the European social model is an essential part of how Europe's economy and society operate. Cutting expenditure does not eliminate the problem because if governments want to reduce public spending, they shift it to the citizens who need to be able to afford it. Europe requires a health care system and a pension system. Without such systems Europe would have something like US conditions and deep divisions over Obamacare and similar reforms. Finally, the 'beggar-thy-neighbour' policy worked quite well, but if every country does this, it is not sustainable. It is merely a recipe for small, open economies who have the opportunity to engage in 'free-riding'.

According to Adriaan Schout, the issue of fiscal rules and the monitoring of such rules is part of the answer, but only a small fraction of an overarching solution. The key task for the eurozone and the EU as a whole is how to devise a system of economic governance within the Union's multi-governance arrangements. In terms of institutions and public administrations, the EU has been skirting the issue—not least because there are dysfunctional institutions at the member-state level while at the same time the eurozone has sought to build a currency union with some failing, perhaps even failed, states such as Greece. What the euro area needs is a more accurate and reliable statistical office, an economic planning office and institutions that facilitate social change such as trade unions. The deeper integration that German Chancellor Angela Merkel and the German Finance Minister Wolfgang Schäuble are proposing will not work if national authorities are not strong enough. It will also hit the barrier of popular referenda with similar outcomes as in 2005. Before discussing further integration, the first level of analysis is that of member-states. Currently it is the case that many problems stem from national public administration and governance (e.g. national planning). If some of these are resolved, then this is key to the future of the euro area and could also help provide legitimacy for coordination among member-states at the supranational level.

H. Flassbeck said that he is strictly opposed to enforcement rules. Take Spain, in the midst of a protracted recession, with the economy contracting by 6% in 2011 and by at least 2% in 2012. To announce that the government will cut €56 billion in 2013–14 is totally crazy because in a situation where both consumers and investors are deeply worried, this will fuel capital flight, raise the country's borrowing costs and push it further towards insolvency. It will not work, just as it did not work in Greece. Experience for this from the last 30 years of IMF-imposed policies indicates that austerity conditionality was always wrong, except when there was external stimulus like a significant currency devaluation. Instead of cutting too far too fast, it is crucial to put an end to austerity and have a stimulus from surplus countries (i.e. an external surplus). Linked to this is the point that competitiveness is relative and that not everyone can improve all the time. What can and must improve across the euro area is productivity. In relation to Germany's financial flows, the fact is that the net saving of German households represents about 10% of GDP. In a few years private sector net saving will probably amount to 2–3% of GDP. If Germany is a net saver, then who is a debtor if not Southern countries any longer? As already indicated, everyone can be more productive but not more competitive at the same time.

Against H. Flassbeck's arguments, A. Steinherr contended that Germany has one of the lowest investment rates in Europe, so one way of solving excessive saving ('invested abroad') would be to invest surpluses at home. But crucially, German banks have claims on Southern Europe of about €150 to 200 billion and the German Bundesbank about €1,000 billion. The reason is that the internal payments system of the euro area lets both deficit and surplus countries get away with such unsustainable imbalances. It is therefore wrong only to blame the banks; this is also a political failure. In terms of competitiveness, Greece is just above Yemen and just behind Papua New Guinea in one of the latest global rankings. By contrast, countries such as Slovakia have changed in order to attract investors. People do not want to invest in Greece because of corruption (including tax evasion) and because the public sector is dysfunctional.

In relation to R. Mundell's point about confidence in governments (and public debts of 30–40%), one should look at what governments do when they accumulate their debt, whether it is 40% or 80%. What matters is whether it is spent on investment (e.g. infrastructure, education, etc.) or just wasted. Yet more top-down legal obligations create bad blood and require central enforcement. The EU has shown that its capacity to enforce a treaty just does not (as yet) exist. The various signatories have not been serious and properly committed. Virtually all the Maastricht rules have been disregarded: the 'no-bailout' clause, the deficit limit, the debt limit, etc. What could be done is for national governments to negotiate credit lines with the European centre. A genuine commitment must not only be a commitment by the lender but also by the borrower. Only countries with such credit lines would receive help in an emergency. The rest would have to fight for themselves. That's the only credible way to combine discipline with solidarity, according to A. Steinherr.

Here R. Mundell injected that the bulk of the treaties has remained in place and that no nations have created their own currency, while free trade has been maintained and the single market been extended. Europe has enforced the treaties very extensively, with the exception of the fiscal provisions enshrined in the Stability and Growth Pact.

J. Gillingham made four comments. First of all, European integration is not a spontaneous process but rather a three-level game of interdependence: the EU level, the national level and the international level are in play and periodically end up in positions in which constructive compromises can (or cannot) be reached. Mono-level analyses or explanations fail to capture this dynamic. Second, J. Buyse claimed that a breakup was not really on the table—what are the costs and benefits of preserving or dissolving the euro? The latter is likely to be very high in the short-run (about five years), but the former risks a Japan-style stagnation in the long-run (perhaps as long as 20 years). Third, he agreed with Steinherr that investment is important but what kind of incentives does it give to German and Dutch savers if their savings are invested elsewhere (especially countries led by comedians, e.g. Italy, or with dysfunctional patent and other systems like Greece)? So what can be done? First, the debt burden is such that everybody will be burned—whether debtors or savers, including the Germans who are owed about €1 trillion. Second, the question is how much people will suffer from technical settlements and liquidations, etc. Third, a fall-out among the eurozone members is not a remote possibility but rather an imminent prospect.

A. Schout followed up on some of these marks by saying that to stay in the euro is very costly but to quit will also be very costly. What institutional reforms do countries need? If Greece exited the eurozone, it would still have to overhaul its economy and administrative system. Countries cannot avoid the institutional questions at different levels. Asked by J. Zielonka about who should do the institutional reforms, A. Schout answered that the questions of who pays and who oversees institutional changes largely overlap and that reform and solidarity have to go hand in hand.

At this point in the discussions, Adrian Lyttelton took the floor and argued that macro-solutions of austerity have been disastrous for countries already in recession. At the same time, the survival of the euro requires more mechanisms of surveillance and enforcement. In some very important sense, the eurozone will have to be more, not less, intrusive. Crucially, stronger regulation of banking and finance would be popular: how to explain to people that they have to pay taxes (maybe for the first time in the case of young people who join the active population) while the financial system is behaving in the same way as before? In relation to the specific problem of tax evasion, what about a European tax inspectorate, including in countries such as Italy and Greece? Apparently, some commentators have recently quipped that "Italians used to be in favour of tax evasion. Nowadays they are opposed to it, except their own!". If that is true, it constitutes already some sort of progress. The Italian case shows how a failure to maintain some of the basic rules of democracy and the rule of law has serious economic consequences. Threats to the independence of the magistrates, a dysfunctional civil justice system, the monopoly position of Berlusconi in the media, and the conflicts of interest between public office and private interest all created a climate of uncertainty which discouraged both domestic and foreign investment.

D. Calleo returned to the relationship between the national state and the federal state. The viability of future solutions depends on the equilibrium. Without a kind of a shared, mutual identity, a monetary and a political union are ultimately unsustainable. What do you say to Greece, for example? If it is told to decrease wages in order to compete with low-wage countries like China, what do you expect Greek people to think of the EU? Europe is witnessing growing nationalism and radicalism in part because it is losing the global economic competition with China.

C. Maier proposed to reverse Keynes' famous dictum: in the short run we fear we might be dead, whereas in the long run we know what needs to be done. He agreed with H. Flassbeck that in the short run, the heavily indebted countries in the periphery should not have to lower their wages across the board (perhaps only at the sectoral level) but rather implement structural reforms (such as tackling youth unemployment, the retirement age, the licensing system, rent-seeking behaviour, etc.). In other words, the key question in the short run is how to reform the public sector. The existing framework has promoted virtuous behaviour, at least on the part of some countries and sectors. Already in the 1920s and 1940–50s, a number of governments faced the choice of taking money out of savings or reducing employment in order to adjust to new macroeconomic conditions. 'Amputating' savings seemed then and seems now the more desirable option. One possibility is to have credit amplification and a sliding scale on conditionality and fiscal adjustments at the right moment of the economic cycle. But what about the long term? Rules about deficits have been violated all the time, including by the French and the Germans themselves in the early 2000s. What Europe requires is some sort of political deliberation, not just good public administrators. Finally, this is ultimately a crisis of representation that needs to be addressed as such, by making representation meaningful. In short, one can argue in favour of more Europe without however endorsing a technocratic deliberation. Pressed by J. Zielonka about whether he means rule enforcement or rule observance, C. Maier responded that it is primarily a matter of rule negotiation.

According to M. Almond, the discussions raise the issue of moral legitimacy and the internalisation of rules. Proper incentives for paying tax require a common social purpose. Historically, there used to be consequences for those breaking the rules. For example, the French Third Republic saw lots of scandals and people went to prison, as they did in the 1930s in the US and Britain. However, today there does not seem to be any sense of personal responsibility on the part of bankers. Moreover, the amount that was demanded of German taxpayers to bail out their banks was much smaller than in countries like Spain or Britain. In Scandinavia, there are viable social contracts which no longer hold in Britain or inside the eurozone. The new phenomenon that Europe is struggling with is something like consequence-free risk-taking. Thatcherites and social-democrats have both failed but the 'barbarians' have yet to arrive. In short, there is a 'window of opportunity', even if the political left has been discredited. Compared with the Cold War, the absence of a dangerous external threat is a problem. Now the threat is inside and the fact that there is no consensus on either values or policies does not bode well for the future.

In his remarks, L. van Middelaar sought to bridge the debate between economists and political scientists. First of all, it is too simple to reduce the current position to austerity or to blame the crisis on economic illiteracy. Spain is reducing public expenditure because only in that case will they get €30 billion from the EU for the direct re-capitalisation of their banks. Moreover, it is politically and economically difficult for the German government to explain to its citizens why they give money to Spanish banks without getting anything in return. In other words, conditionality is needed in order to have legitimacy on the part of the lender. In this sense, some of the arguments put forward by H. Flassbeck are too easy. Second, Maastricht has not delivered the stability it was supposed to offer. Action has been taken both in terms of fire-brigades and crisis management and also in terms of policing and prevention, but much more needs to be done in order to secure the long-term future of the eurozone.

Concluding the third session, R. Mundell said that the question about the consequences of a euro breakup is a very difficult one because it is counterfactual. Therefore, it is best to delve into history and ask what would have happened had there not been a revolution or similar watershed moments.

Milton Friedman once jokingly remarked to R. Mundell that without the American Revolution, the USA would today own Britain! Around 1810, there could have been a rapprochement between Napoleon and Britain to attack the USA, demolish it and share the booty; what if? Even without foreign intervention, the USA itself could have split into three: south, east and west. To reverse a monetary union that has existed for thirteen years would be akin to undoing history. This would not be a zero-sum game; it would have negative consequences. If the dissolution of the euro area led to a breakup of the EU, there could be three groups: first, a Germanic group, including the Anglophone group; second, a Latin group headed by France but ultimately dominated by Germany; third, a Slavic group dominated by Russia. Therefore, NATO is the biggest factor in our lifetime because it is the condition *sine qua non* for European political and economic integration—the only glue that holds Europe together.

4. Possible institutions for the future

A. Clesse briefly introduced the fourth session. He wondered whether there is unwavering support for the euro and said that such a belief raises critical, vital questions about elites, peoples, hidden interests and implicit premises. Many praise the EU at 50, but what is the Union about? How ambitious can Europeans be? Can institutions revive the EU? Are we not seeing an integration and enlargement fatigue? Giandomenico Majone, the Italian scholar of the EU, thought that it would already have 30–32 member-states today. Crucially, what is the Union's *ethos, demos* and *telos*? These are the vital questions, as Joseph J. Weiler remarked already a decade ago.

D. Sotiropoulos said that unwavering support for the euro and solidarity must go hand in hand if Europe is to preserve its institutions and build a union for the future. He cited the case of Greece, which has made some progress since it started receiving aid from its fellow euro members but insufficiently so. The country has reduced the budget deficit from 15% to 9% in one year. In the past it has demonstrated its capacity to meet great expectations, e.g. the Olympic Games in 2004 and a transition to democracy in the 1970s. But building institutions cannot be done by the Greeks alone, and Greece is not the only corrupt country. High-level corruption is true for many countries, including those inside the EU and the eurozone. Low-level corruption is particularly bad in the case of Greece, namely among customs officials and tax officials. The ordinary Greek population would be happy to receive support from the EU with this low-level corruption. More generally, all discussions about the Union's future institutional set-up should focus on the following four challenges:

(i) how to streamline the economy

(ii) how to restore political legitimacy

(iii) how to rebuild governance

(iv) how to improve institutions in every single member-state that has deep-seated problems

This triggered a short discussion on Greece and the wider ramifications for the eurozone. J. Gillingham agreed that the problems which beset Greece really are structural: a small country with a small population is struggling to compete with neighbouring countries and the legacy of many years of mismanagement by successive administration. In this context, it is hard to see how the problems of Greece can be solved without some form of currency devaluation. How else can any Greek government enforce the necessary reforms? By contrast with permanent austerity, Iceland opted for devaluation and capital controls. J. Buyse contended that the Greek deficit reduction from 15% to 9% may be a progress but that it is still unsustainable and as such constitutes the single biggest problem—profligacy rather than rectitude.

J.-W. Mueller intervened to say that presumably everyone is opposed to corruption and tax evasion and that good institutions are better than bad institutions. However, the Greek crisis is about something deeper, namely the social contract. In the case of Greece, it has been shaped by the legacy of dictatorship and the transition to democracy but it is now being affected by European integration. If in Europe countries are dealing with a renegotiation of the fundamental relationship between citizens and the state, one question is about who can conduct such a renegotiation and another question is which process would be legitimate to bring this about.

In his response, Jacek Zakowski argued that the EU was created on the basis of certain values of European society after the Second World War. He wondered why so many today do not want to ask what our values are. Ronald Inglehart's World Values survey suggests that many contemporary societies are more materialistic and more individualistic. If this is true, then what does it mean for the EU? Are people willing to pay for others, i.e. are they prepared to practice the principle of solidarity? If the EU does not even try to answer this question, then it means that the Union may act even worse than the Chinese politburo. When expectations change, political and policy responses must change. Since expectations and values have changed profoundly compared with ten years ago, the political elites must rise to this challenge. Europe must go back to the principle democracy, otherwise the Union will collapse. Politicians continue to insist on imposing rules from the top, but this approach has manifestly failed. The task for both national and European elites is to try to find European values and sources of identity now and to work out how they shape the European economy. If individual (and national?) selfishness characterises contemporary societies, then it will be more difficult in future to impose taxes in Europe than it was 20 years ago. In short, the challenge for the EU and its member-states is to define a new social basis of the European project.

On some of these issues I. Radicova made five points. First of all, she suggested that the basis is trust—trust in institutions and in national governments as well as trust in supranational institutions. Second, in relation to European identity and especially in multicultural countries or societies, it is exceedingly hard to define what it is to be European. Arguably, we could say who is American, but not yet who is European. Third, how can we build new values and identities when financial markets, debt, consumer behaviour, prices, etc. shape civic life much more so than ever before? In other words, we have changed citizens into consumers (as C. Coker has argued) and we only speak the language of economics. Fourth, the seventeen members of the euro are not able to find a common language on harmonisation of taxation because of a lack of mutual trust. How can it be possible that Cyprus gets help from the EU, on the one hand, and that it has a vast shadow economy based on attracting foreign capital, on the other hand? Fifth and finally, many countries decided to invest in Greece because of vast military expenditure linked to NATO membership. In that context, how can the eurozone ask successive governments to cut spending? Without common institutions based on more than economic interest, neither the euro area nor the EU survive and prosper.

L. Siedentop wondered what Europe might want to achieve by reforming European institutions. At the very least, the objective has to be to entrench the rule of law. One of the obstacles to that is comparison: Rousseau famously said that the vice of civilised man is to compare. Arguably Rousseau was wrong because this is also the virtue of civilised man. But the process of comparison can also generate many difficulties. Take the UK: one of the major sources of irritation is that the common rules governing the single market have not been respected (e.g. in relation to taking over firms or on matters of free and fair competition). This erodes any popular support that there might be for Europe. In other words, even something as uncontroversial as the rule of law is controversial in the case of the EU and well-intended efforts to reform its institutions.

M. Almond drew attention to the counterproductive and even perverse effects of current policies. For example, part of the austerity-imposed structural reforms is to reduce both state expenditure and corruption. However, cutting the salaries of policemen, judges and border guards in Greece, Bulgaria and Romania has made corruption even worse, which in turn exacerbates the fiscal problem and this leads to more corruption, etc. The iron cage of austerity has set in train not just the vicious circle of debt deflation but also the dangerous dynamic of shrinking the state and increasing criminality. For his part, H. van Gunsteren said that to avoid a socialist or a European utopia, it is important to look at the historical actors and forces that can take key decisions and implement them. The Council of Ministers has disintegrated as a credible actor who could take decisions.

Concluding the fourth session, R. Mundell argued that Europe has always been an aspiration, perhaps something like 40% hope and 60% reality. Thus the question is how to make the EU more of a reality. First of all, fiscal union does not exist so far; there is a monetary authority (ECB) but no fiscal authority. The benefits of introducing eurobonds and eurobills would be tremendous. This is not as far-fetched as it might sound. With the benefit of NATO, Europe does not have to worry about substantial expenditure in the area of security and defence. Nor is the current system particular desirable: instead of eurobonds, every country has its own bonds, but 17 countries are nevertheless part of a single currency. The diversity that the euro area gets is in relation to credit default risk, which is not a very good kind of differentiation. It is not the same to have all the different national bills and bonds or instead to have common ones. If one compared the situation to the USA, one would realise that US bills and bonds provide the federal government with substantial gains from seigniorage (i.e. difference between the value of money and the cost to produce it). That is because 5–6 trillion of the 11 trillion worth of foreign currency reserves worldwide are denominated in US dollars. Europe is way behind this.

Apart from the issue of the current crisis, R. Mundell said that he had been arguing for eurobonds and eurobills in order to make the euro a better reserve currency. This could even be done by the private sector. The former French Minister of Finance Edmond Alphandéry has also talked about such a bundling together by banks. However, there is an important argument that the transaction costs for the private sector might be too high, so it would probably have to be done by governments and the ECB. That is why there is such a great need to put in place the European Stability Mechanism (ESM). A lot of people are worried about holding so many assets in US dollars. For the USA itself, dollar-denominated American assets are default free assets (thanks to the Fed). The same would be true for euro-denominated European assets if they were backed by the ECB. Indeed, it is very unlikely to see a repeat of what happened in the late 1970s when the US devaluated the dollar by half.

On its key policy objective of maintaining price stability, the ECB has been a little bit sluggish in the face of serious deflation risks. In 2008, the rate of inflation stood at almost 3% and subsequently it tumbled to nearly 0%. In other words, inflation was way below the target of 2%. Since then there has been practically no risk of inflation faced with the double dynamic of debt deleveraging and deflation. Since Mario Draghi took over the helm of the ECB in late 2011, its direction has been very different compared with what it was under his predecessor Jean-Claude Trichet. First, Draghi has provided monetary expansion worth approximately €1 trillion since taking office. Second, he has put in place the ECB's Outright Monetary Transactions (OMT) programme, which would stabilise sovereigns by buying up national bonds when the market-based monetary transmissions mechanisms are broken and bond spreads overstate the underlying fiscal positions. Beyond these steps, there are other instruments to solve the crisis, *inter alia*, immediately buying up Italian and Spanish debt or issuing ECB debt (e.g. €300 billion). There is nothing in the treaties to prevent the ECB from doing that because its mission is to secure price stability, so the risk of deflation justifies such a proactive stance. However, the question is how to make such a transfer of authority so that the ECB can issue bonds; what kinds of rules should be imposed on national spending? Across the EU, the gap between total government spending and total revenue is 2.5% of GDP, which is large but can be overcome by close cooperation among member-states.

C. The long term: Where is Europe going and how long will it take to get there?

5. Possible political projects for the EU

At the outset of the fifth session, A. Clesse summarised the debates up until this point as follows: the participants have talked about what went wrong, who is to blame, some of the challenges Europe has not yet thought through and how much can be saved. How ambitious will the Europeans be? Can institutions revitalise the EU project? The Union is still a reflection of a certain *état d'esprit*—a technocratic approach without the interference of 'high politics' that should later lead to spill-over effects and further integration. Jean Monnet's idea of a High Authority has been with us ever since. On this basis A. Clesse raised a number of questions. First of all, can the balance of power between institutions be reduced to a zero-sum game or could there be a 'win-win' situation? Second, linked to this is the issue of the future role of the European Commission as one of the key elements, as changing one institution will inevitably affect the others. Third, is it desirable and/or feasible to give more power to all the supranational institutions or only to some? At this juncture he referred to Gerhard Schröder's proposals: first, the EC must be further developed into a European government; second, the Council must be transformed in an upper chamber (akin to the *Bundesrat*); third, the powers of the European Parliament must be increased: candidates should be chosen from pan-European party lists, with top candidates from the lists vying to become the President of the Commission who would be elected by the EP. A. Clesse then opened the floor for debate.

In his presentation, T. Klau put forward a case for a federalist future. He began by taking a step back and saying that the current crisis has brought to an end a useful conceit—the idea that Europe is a viable model *sui generis*—more than an international organisation but less than a federal state or entity. The *sui generis* argument was very useful because it enabled fruitful compromises between keen advocates of federalism and those who oppose a federation because they think that a federal solution is unachievable or undesirable, or both at once. The Commission was an embodiment of the *sui generis* argument: more than just a secretariat, but less than a political body in the classical sense of reflecting a political majority based on elections. More recently this has somewhat changed, as the Commission President is in some sense the representative of a specific 'political colour' (within the European Council) and the whole Commission is confirmed by a majority of the EP that is itself structured according to the traditional political spectrum of left, right and centre.

However, the crisis has brought this useful conceit to an end because it just is not good enough. Neither citizens nor markets believe that it is good enough. We are seeing some kind of 'investors' strike'—i.e. no confidence that the *sui generis* arrangement is sufficient to make the euro last. Ironically, evidence for this withdrawal of confidence is that all the meetings have been unable to stop the crisis, perhaps averting a meltdown but not putting a halt to the dangerous dynamic that has engulfed both the eurozone and the EU as a whole. Meanwhile the official approach still gambles on the continuation of the *sui generis* model that rests on de-politicised rules and sanctions, which simply has not worked. Now the idea is to escalate this approach, i.e. adopt and enforce more far-reaching rules and more dramatic sanctions that cover a much wider range of macroeconomic policies and behaviour. But this, coupled with reinforced supranational coordination, will fail like its predecessors, e.g. the Stability and Growth Pact in its first and second incarnations. The reason is that the 17 national governments and parliaments operate in very different institutional and political contexts and constraints.

Here it is reasonable to make two basic assumptions. First of all, evidence of the last two years shows in a very clear fashion that the current model of governance is not good enough to sail the eurozone through such a storm because it relies on a consensus among the 17 or even the 27 heads of state and government. Second, a much more severe crisis will lead to the unravelling of the entire edifice, unless major changes are made—including such fundamental decisions as abandoning the unanimity requirement. Seen in this light, the eurozone will either disintegrate or lead to a new settlement that will effectively amount to something like a federation. Perhaps this will take the form of 'federalism light'—as Emma Bonino has helpfully suggested—a non-intrusive kind of federalism. Robert Mundell himself has said that Europe faces a choice between two kinds of federalism: either one that would permanently transfer actual, financial 'fire power' to the central level, including the welfare state; or another that would not have that kind of permanent power but would establish the right to have supranational control and intrusion – an apparently more decentralised concept than a permanent transfer of power to the centre. We are currently moving towards the latter, which is ironic because in reality it obeys a far more centralising logic than the former that allocates power and grants national components (or sub-regional components) a far greater degree of autonomy to administer their affairs.

At this juncture two rival scenarios seem more plausible than most others. Either Europe continues to muddle through. The leaders will be just doing enough to stop the euro from disintegrating in the coming six weeks but that will not solve the crisis. Economically, things will get worse (Greece, Spain, Italy and then spreading to the core). Over time, the economic reality will become so dire that it would precipitate a dramatic weekend—with eurozone leaders creating new powers and institutions, but not with all eurozone members agreeing. Or else, there is a more orderly scenario: as the German Finance Minister Wolfgang Schäuble reminded everyone in his Charlemagne speech, the fiscal pact has a clause saying that it has to be integrated into the EU treaties within five years (i.e. within the Hollande mandate). That itself will create a discussion about treaty changes. The scope of change caused by reinforced steering mechanisms and by the integration of the fiscal treaty will become so apparent that conjointly they will trigger a much wider debate, not just about economic governance but about political government. If and when such a debate happens, the Germans will push for a dynamic where this goes hand-in-hand with a politicisation of the European system; including the direct election of the Commission President (as suggested by the governing CDU).

Personally, T. Klau said that he would prefer an electoral college, so that the smaller member-states and their citizens do not drop out of the equation altogether. However, it is clear that politicisation is indispensable because it alone can create the popular assent for the new powers of intrusion transferred to the centre that are needed to make the euro work. People need to be in a position to vote politicians into and out of power. The tragedy is that the citizens seem to understand better than most decision-makers that the euro binds us together more than any other aspect of Europe (i.e. the interdependence that many participants have already mentioned). Therefore, joint policies are necessary, but there are no elections that give people influence over those who make vital decisions, T. Klau concluded.

L. van Middelaar began his presentation by emphasising that he was speaking not as a member of Herman van Rompuy's cabinet but in his personal capacity as author (in particular of *The passage to Europe: How a Continent became a Union*, Yale University Press, 2013). He referred to the report by the so-called 'Gang of 4' on the banking and fiscal union, a working document that is saying little on institutions (no more than 5 lines): something like "strengthening the democratic legitimacy and accountability", which recognises the problem but does not offer any answers. One question that emerges is whether a political union is a goal in itself or a necessary corollary of the banking and the fiscal union. Even on this key question there is disagreement. For Germany it is partly tactical, as it concerns the relationship between money and power (help and oversight; authority and legitimacy). Berlin first wants to be clear about the money and oversight before it commits itself to anything else. Of course, it is easier for German politicians to think in terms of federalism because their country is a federal state and because it remains the biggest power in both the EU and the eurozone. For their part, the French insist on democratic legitimacy to accompany the steps taken towards banking and fiscal union, otherwise they are uncomfortable about signing up.

In terms of the fiscal side, much has been done but a more systemic answer is needed. Intrusion or intrusiveness is key: the experience of interdependence has brought home the recognition that measures in one country can influence another country or even many other countries. Therefore the centre needs to have the power to correct potential damage. The question is whether the centre should also have the power to repeal the budgets of countries that do not endanger others and that do not ask for help. Personally, L. van Middelaar thinks no: the centre should only have powers over those countries that put others in danger. One way of characterising such an arrangement might be to describe it as an 'emergency federalism' (*fédéralisme d'exception*, in the words of J.-C. Trichet), i.e. central powers only when needed to save the system as a whole. By contrast, the notion of a non-intrusive 'federalism light' (Emma Bonino) seems to be little more than political spin.

On the idea of a central budget, he said that maybe there is a macro-economic rationale such as absorbing external shocks but he would generally caution against it for reasons of political legitimacy. So far the EP only has a say over a budget that represents about 1% of EU-wide GDP. The perspective of Europe as a taxman will hardly increase legitimacy and popular support. This also applies to European integration in more fundamental ways. Periodically, people have claimed that Europe faces moments when it has to move forward or faces the prospect of disintegration. But when one takes a step back, it is clear that this has never happened. On the whole, the European system is strong; it has transformed itself and developed by binding national states together rather than merely transferring power to the supranational centre. Take executive power: most assessments are teleological, predicting that ever-greater power will accrue to the Commission. But historically this is not what has happened. First of all, the Commission has administrative functions, and its executive power is limited. Second, EU Foreign and Finance Ministers have executive power with a permanent chairman who can set the agenda, but this does not apply to other ministerial councils that have more legislative than executive power. Third, the European Council has developed into a collective executive and a crisis manager; how can this be changed into some kind of European Senate (akin to the *Bundesrat*)? It is the executive, not the legislature. Moreover, the seventeen eurozone members have a parliament standing behind each of them and need parliamentary support to act.

So certain steps should be taken, but only those needed in the current crisis, not more than that. The crisis should not be hijacked for some power grab that confirms people's worst fears about European integration. Put differently, politicians, citizens and commentators should keep some confidence in the plasticity of the current system. Europe is not about to become a federal super-state but instead it is finding creative ways of binding states together, not in a zero-sum game but in mutually beneficial ways. All parts are getting stronger because the power of the centre is shared among several Community institutions and all the member-states, L. van Middelaar concluded.

In his response, J. Zielonka said that he never talks about federations because everybody means something else—whether Schuman and Spinelli in the past or Verhofstadt and Bonino at present.

What we do know is that we cannot run the EU only in terms of 'output legitimacy' (i.e. efficiency). Especially in a crisis like the current one, such an approach will not work. There is also 'input legitimacy', i.e. how to legitimise certain economic policies that make sense. In nation states, 'input legitimacy' is via parliaments but this system is in crisis at the national level (with party membership in freefall, public trust in politics at a historic low, etc.). How does anyone expect that the EU will perform better on this? The EU is even further away from 'input legitimacy' than it is from 'output legitimacy'. Europe has tended to respond in three ways. First of all, the EU has always tried to improve its democratic and legitimacy deficit by treaties, with a certain record of implementation and policy outcome. Second, the European Parliament has always got more powers with every new treaty but this has not necessarily been accompanied by gains in legitimacy. Third, numerous popular referenda have proved to be an hour of populists, as evinced by successive Irish votes.

Given all the shortcoming of these three responses, it is possible to draw two conclusions. First, all solutions would need certain rearrangements, new powers—including powers over money (to a large degree). This is true even if citizens care not just about money but also about ethical issues. Second, creditor nations are scared that debtor nations will take their money and run. Each time France asks for more German leadership, Paris is effectively asking for more German money. For their part, debtor nations are afraid that they will be condemned to the periphery. None of this takes sufficient account of Europe's citizens. To have consumers is not enough. Europe needs more production. In conclusion, there seem to be two scenarios. Either Europe makes the leap to a state, which would severely curtail national sovereignty. But are the Germans prepared to do this and abandon parliamentary sovereignty? Or else, Europe travels along a gradual road with a new parliamentary chamber, direct election of the Commission President and so on. But does the EU and the eurozone have time for this? Are citizens interested in institutional engineering? That discussion has not even started.

L. Siedentop said that he agreed almost entirely with J. Zielonka. However, it is important to be careful about some terms. The first notion is that of federalism. Originally, federalism was designed to limit centralisation, not to promote it. In part, rival conceptions of federal settlements explain the differences in French and German views on political union. The second notion is that of Europe's 'democratic deficit'. Yet every system of representative government is in 'deficit' compared with the rigorous standards of democracy and representation. This is not the same as a crisis of legitimacy, which concerns the lack of hold over opinion or public trust and in turn involves three factors: (i) the intelligibility of a system; (ii) the ability to mobilise consent; (iii) the ability to interest and even to entertain citizens. The EU's crisis of legitimacy predates the eurozone turmoil and has been developing for at least twenty years, since the acceleration of integration following the fall of Communism and German reunification.

So what can be done? The clearest weakness of the European system is the premature direct election to the EP, which has broken the link between national political classes and the European project, giving national political classes and parliaments an excuse to get involved less than they should do and might otherwise have done. In an ideal world, Europe would start again; but in the present situation, it could and should create a second chamber, containing elements of the original notion of a European parliament, which is to bind national political classes to the European project.

The objection that we already have an incipient second chamber in the form of the European Council seems to ignore what the Council actually does, which is to relate the European project to national executives but not to national parliaments and political classes in the way that is needed. So in conclusion, L. Siedentop declared to be on L. van Middelaar's side in the larger debate: Europe's future is likely to be some outcome between a confederation and a federation, but even to foresee a single coherent outcome is not possible at this point.

Similarly, D. Calleo agreed with previous speakers. His point was that the confederal model is more interesting than people give it credit for. In some sense, the federal model is a radical simplification of politics, which stand up very well to clear and distinct standards and criteria. By contrast, the confederal model is highly complex and reflects highly complex reality—with hybrid institutions, overlapping jurisdictions, multiple membership and multi-level governance. Clearly, the confederal model applies much better to the EU. At the same time, sovereigns sometimes need a kind of Congress of Vienna platform to face common problems and be obliged to find solutions. In short, Europe combines features of confederal settlements with the remnants of the nation-state and the need for some form of balance of power.

6. Final reflections and outlook

J. Gillingham recalled that in the 19th century, before the civil war, the US federal budget was similar to the EU budget today—no more than 3% of GDP. This alone suggests that a polity can take quite radical turns depending on unforeseen events. In relation to the current crisis, perhaps Europe should learn from the experience of the 1924 Dawes Plan (which marked the attempt to resolve the post-1918 reparations problem). For example, such an approach could involve limited deficits, wage increases and outside enforcement in the sense of financial power (a reformed model for Wall Street). R. Mundell has put forward some key financial reforms that have to be at the heart of the solution. Other possibilities include creating a basket of sovereign securities (e.g. bundling secondary mortgage paper, but in the past this gave rise to credit default swaps, which is why they involve unacceptable transaction costs, as R. Mundell said). Unless the ECB can give guarantees, it is hard to see how to make such an instrument marketable. The issuance of fiat money by ECB was not explicitly forbidden by the treaties, but is it consistent with the spirit of the agreements?

C. Maier commented on two key issues. First of all, R. Mundell's ideas on finance are important and feasible, but J. Gillingham's questions are right. All hinges on the ECB and the banking union. The eurozone has to get over the deficits, but that is precisely the short-term conundrum. Second, L. van Middelaar spoke about binding together nations, but who is doing the binding if it is not some kind of representational assembly? Many do not seem to like parliaments anymore. We are scared stiff of referenda and we do not trust the public, but we have to involve citizens. If you want to incorporate responsibility, you have to allow for the effective exercise of responsibility. Maybe Europe just does not want to have anything to do with popular sovereignty in this project.

J.-W. Mueller called for more precision on legitimacy. The concept always oscillates between the normative and the empirical. Everyone assumes that the EU is illegitimate because it is unpopular.

But while that may be empirically accurate, it is not necessarily warranted in normative terms. One should always say 'legitimate for what'—there is no such thing as legitimacy in the abstract. *Contra* J. Zielonka, it is a mistake to say that we used to think about 'output legitimacy' and that now we need to think about 'input legitimacy'. It is crucial first to think what legitimacy is for before asking how to justify it. One ought to remember that, for instance, Thomas Hobbes did not sit around speculating whether the Leviathan will turn out to be popular or entertaining or whether it creates feelings for the state (legitimating the authority of the centre in those terms). On the contrary, Hobbes said first what legitimacy is for and then thought about corresponding institutional structures.

The only real justification for changes European elites seem to have available at the moment seems to be: the markets made us do it. Investors no longer believe in the *sui generis* model, and therefore something new is required (as T. Klau correctly diagnosed), but is that good enough in terms of public justification? Furthermore, on a more historical note: it is wrong to oppose European elites who are undemocratic to national democratic system and parliaments. After 1945, continental Europe took a turn away from parliamentary sovereignty. In some sense, it took a Madisonian turn—with the exception of the UK. The single most successful institution of post-1945 Europe has been the constitutional court, all about constraining parliamentary sovereignty. This is for good historical reasons, because left to their own devices, parliaments, or so post-war elites assumed, have in the past transferred their powers to figures such as Hitler and Pétain. In short, the contrast between a pure democratic ideal at the national level and the idea of a European illegitimate, undemocratic regime is wrong, J.-W. Mueller concluded.

A. Schout argued that Europe's first task is to manage interdependence. The EU cannot have centralisation without decentralisation or vice-versa. If it did one without the other, it would surely fail. Crucially, the eurozone needs to look at the national systems if it wants to make economic governance work. The Commission alone cannot oversee it all from the centre. Other mechanisms are needed which are variously more supranational or more intergovernmental. In short, a systemic perspective is required, not simply a federal or a confederal approach.

In his intervention, Gerhard Michael Ambrosi spoke about eurobonds and eurobills. One of the reasons why this idea has not taken off might be that it involves a de-nationalisation which the member states dislike. In the context of open market policy, these instruments presumably will be under the direct control of the ECB. If that is so, the national central banks might fear that they will lose importance. Eurobonds trading might generate a tendency of financial market transactions to shift to the seat of the ECB and that Frankfurt therefore will become a more favoured financial market place. Historically, there was indeed the tendency that the geographical location of financial markets followed the location of the Central Bank as was the case in Germany when in 1957 the "Bank deutscher Länder" in Hamburg was replaced by the "Bundesbank" in Frankfurt. Introducing eurobonds could be considered as being prone to enhance the position of Frankfurt as a financial market place because it is the seat of the ECB.

G.M. Ambrosi commented further on the tendency to re-nationalise political and economic decisions—a development noted by several contributors here. He suggested that these phenomena should not always be taken at face value. Their underlying cause might well be not so much national fervour in the wider public of the countries concerned but local discontentment with the way in which regional interests are safeguarded. Cases in point are the movements towards devolution in Scotland, Catalonian 'independentism', or the appalling failure of regional development in Greece. He recalled his idea of 'Governance by NUTS' (*Nomenclature d'Unités Territoriales Statistiques*). EUROSTAT's sub-national statistical units are the basis for much of European expenditure on regional policy and this suggests to seek for possibilities of more regional decision-taking and more budgetary control along the lines of the NUTS. He recalled further that since the Treaty of Maastricht the guiding principle of decision-making in the EU is 'subsidiarity'. But this means not only that the higher authority should be passive and refrain from doing 'too much'. 'Subsidiarity' means also that the higher authority should actively enable the lower units to organize their own affairs. If this principle is taken seriously, it would mean that the EU assumes a more direct and a more enabling approach towards the sub-national administrative units. Ambrosi claimed that there is considerable regional demand for this type of new governance. It should lead to a more efficient planning and control of European regional policy. In his view the main issue of future debates about European governance should not be the relation between the EU and the nation states, but the issue of how to find new structures for Europe's regions so that they can become more direct beneficiaries of 'subsidiarity' in an enabling sense.

<u>Ryan Connelly</u> reacted to T. Klau's arguments in favour of de-politicised solutions. He argued that resolving the crisis can take one of two shapes: either by politicising the system or by altering the rules and sanctions, and legitimacy changes depending on the approach. If the former, then European institutions become totally different actors and they need to be legitimate in the eyes of national institutions and national citizens. If the latter, then we are essentially dealing with foreign policy where the source of legitimacy remains the nation-state and legitimacy is not permanently transferred to supranational institutions. So when one considers the federal 'great leap forward' or in other words how to politicise Europe, this option does not seem to be on the table, for a number of reasons: first, there are no credible rules and norms that can constrain and discipline, as evinced by the eurozone experience. This was supposed to be an irrevocable institution in the eyes of international investors. Second, for the EU as a whole to become an irrevocable federal entity, Europe would need one of three models: either need a permanent transfer union (from richer to poor countries, including during severe crises), which is not on offer politically. Or else, it would need an irrevocable federal structure by 'course of capacity' (i.e. a US civil war model), which is not on the horizon. Or else, a convergence of national identities in such a way as to bind together nation -states. So even if Europe were to politicise Community institutions such as the ECB or others, there is no reason for investors to believe that countries will not pull out.

<u>A. Steinherr</u> made two points in relation to R. Mundell's earlier comments. First, it is true that central banks cannot go bankrupt. But what happens to confidence in the currency if all the assets are wiped out, for whatever catastrophic reasons. If that were to happen, the ECB might not be bankrupt, but surely confidence would be gone and investors would simply pull out. So central banks need a latitude of action but it needs to operate within rules and constraints. Here <u>R. Mundell</u> interjected that the only real risk is that of inflation, which is not the case. The question of assets is

a non-issue for central banks whose assets are either backed by taxpayers or by gold reserves or indeed both at once. Second, A. Steinherr said that the idea of putting together a package of bonds from different markets is not new, as Europe has experience with the ECU market. But there are problems of transaction costs, the need for government guarantees and the credit rating of such packages. Third and finally, on the question of political arrangements, it is interesting to note that as long as the common rules are respected, there would be no crisis. Now Europe has to accept that it needs to find new rules because the Maastricht convergence criteria were broken practically from the outset.

L. van Middelaar commented briefly on the question of what binds states together, if not a central state or fixed rules. The answer is that they bind each other together, through peer pressure around the table, market pressure, the Commission reminding people of their earlier commitments, etc. So this system is very different from a Congress of Vienna type scenario, either federation or a very loose association. Instead, the current structure is much tighter—not just a club of states but rather a club of member-states. There is absolutely no guarantee that decision-making in a federal state would be working smoothly. For example, the supranational, Community method that led to the strengthening of the Stability and Growth Pact took two years. By contrast, inter-governmental decisions in moments of crisis work much quicker: e.g. the decision in July 2011 to put more money into the rescue fund, which was taken by 17 governments, ratified by their parliaments and in place by November 2011.

D. Sotiropoulos argued that the EU and the eurozone need a host of new institutions, including a robust statistical office and a central Commission with real power, etc. To survive in the 21st century we cannot continue with a step-by-step integration towards a loose confederal model. Rather, we need a proper European federation and a European public sphere. European citizens have been alienated from the current structure.

H. Flassbeck said that he was getting impatient with abstract debates among political scientists because they delink political questions from economics and miss several key questions. First of all, how to change the German model? As long as there are no answers, the rest will not matter very much at all. He said that hardly anybody is willing to identify the elephant in the china store but instead engages in fixing the broken cups. If Germany does not fundamentally alter its economic model, the other countries have no chance to survive economically. Concerning interest rates, he insisted that in the first eight years of the euro identical nominal interest rates indicated the belief of the markets in the survival of the currency union. With a huge divergence in interest rates the markets have lost that belief. Disciplining countries to bring down their public budget deficits and debt levels is the wrong medicine and divergent interest rates make things worse. New instruments are needed to reduce the interest rate differentials between core and periphery countries, whether through eurobonds or ECB intervention. However, in Germany this is called 'interest rate socialism' and is rejected by the government because it tries to punish profligate countries. Without answers to these core economic questions, questions about centralisation (a single EU/eurozone Finance Minister) and de-centralisation (regions and localities) make little sense in his view.

R. Mundell contended that the eurozone suffered from a deep delusion during the early years: at that time Italy with 120 % of debt to GDP had the same interest rate as Germany or Luxembourg, which was unrealistic. Nominally identical rates were indeed some form of interest rate socialism. Before the formation of EMU, when interest rates were at 12% there was inflation-cum-devaluation risk. Here H. Flassbeck interjected that until the crisis broke out, markets did not put discipline on states for their debt because there was no default risk. Now there is a default risk, which is not a question of government deficits but rather a question of external imbalances.

A. Steinherr added a rejoinder to this discussion by saying that the 'no-bailout clause' enshrined in the Maastricht Treaty was not credible from the beginning. Retrospectively, this explains why very few people anticipated the consequences of the convergence of interest rates. At that time, this was an opportunity for Southern countries to borrow at historically low rates. The fiscal recklessness that developed then would have blown up anyway in the future. The global financial crisis was merely the detonator—an accelerator but not the cause of the sovereign debt disaster. So there are two options: either have the same interest rate and all sorts of rules to enforce discipline or else accept differences in risk premium. However, G.M. Ambrosi rejected the claim that interest rates are a disciplining device. For some member-states common interest rates do not reduce the costs of borrowing whereas for others they do. In short, it is futile to suggest that interest rates can discipline countries because they can increase local price levels and thus be detrimental for regional competitiveness.

R. Mundell made two remarks. First of all, on G.M. Ambrosi's comment about the role of Frankfurt and the money markets as an important factor, he said that it is also something else, namely the degree of centralisation that results from monetary union. Indeed, it is this side-effect which has deterred countries like Sweden from joining: the government in Stockholm seemed to agree with the principle of a common currency but not with EMU and all that would go along with it. Europe has a history of shifting powers to the centre, e.g. the Risorgimento that marginalised Naples and other cities in favour of Rome. In the case of EMU, the problem is not whether Frankfurt or Brussels is the capital but the effects of centralisation.

Second, against the argument that Europe needs diversity and does not want a federal state, he said that this is to assume people want to keep nations, like the confederacy in North America. However, just as the US put in place a federal system, so too Europe can agree on an arrangement. It is true that a higher degree of centralisation is possible in the US than in other countries because of cultural homogeneity but this ignores all the differences and disagreements between red and blue states. At the same time, the US federal model separates federal debts from state debts, for which these states are responsible. Paradoxically, Europe has undermined the independence of national states by lax fiscal rules. Can Europe go back to the freedom of subsidiarity and national sovereignty? If not, then the alternative is a transfer to central authority, a diminution of national power and the adoption of eurobonds.

J. Buyse remarked that under the Maastricht Treaty there was a prohibition for the ECB to buy national bonds on the primary market. While the Treaty allowed the ECB to buy bonds on the secondary market, the (potential) scope of such bond buying had raised concerns in some Northern countries. A consensus on a new framework was needed and rules on deficits would have to be respected.

C. Coker shifted the discussions towards the international environment in which Europe operates. After all, the outside world is very much part of the scenery. The question that this perspective raises is that of the irrelevance of Europe as a player in a world where power has been restructured and institutions like the IMF, the World Bank and the UN are being reformed. He made four points: first of all, Europe is going through the largest demilitarisation period in its history. Britain is becoming a third-rate military power in the next ten years and has lost any respect in the eyes of the USA because of the defeat in Basra and in Afghanistan. *Contra* W. Pfaff, it is the case that Britain and France as military powers are gone. Second, what about the model that Europe has tried to export—a civilian power (Solana, 2002) with an underpinning of military power. However, without the military power, the civilian power becomes unsustainable and frankly laughable in the eyes of the rest of the world.

Third, the moral high ground that the US and Europe might have had in the 1990s is lost. The EU is seen to be failing and it is seen as having no future. Even if the EU overcomes the current crisis, it is hardly seen as a model for others or as a global power. Take the Cotonou process, a trilateral process whereby the EU tries to introduce better economic and commercial standards in Africa, including Chinese companies. Africans and Chinese are not listening. This is a terrible indictment, given that Africa will be a key continent and Europe will not in any way shape it. Finally, we are not entering a multilateral world but a multipolar world. China and Russia are important for Europe, but they do not take the EU seriously at all. Russia wants good relations with Germany but not with Brussels. China is merely interested in Europe as a market and sells more goods to Germany than the rest of the EU combined. This sort of bipolarity (Russia-Germany and China-Germany) is dangerous for an independent Europe. Look at the Copenhagen conference on climate change: the US and China simply kicked Europe out of the room, C. Coker concluded.

T. Klau made three points. First of all, a transfer union is cheaper than disintegration. The EU has been a transfer union from the beginning. Now it needs to tell the citizens of Europe that disintegration is more expensive than transfers. Second, he agreed with H. Flassbeck's argument that the debate on Germany needs to shift away from sanctions towards solidarity. However, this will have to take place in Germany itself. If there was an elected European President, then that would help create legitimacy, but at present it seems a distant prospect. Third, he pleaded for people to stop calling the EU an elite project, which has been the result of a top-down technocratic conspiracy. Yes, it is true that big business and trade unions backed European integration, but so did all the major political parties and most member-states. If we do not rely on parties, we risk playing into the hands of extremist parties like the FN.

Concluding the final session, R. Mundell observed that there is no consensus at the moment and that any such consensus could be interrupted by new events. A. Clesse pleaded for new thinking that focuses not only on more or less integration but also to consider different types of integration.

Concluding remarks

The conference focused on three aspects of the current crisis. First, what went wrong—economically and politically? Second, what are the limits of the present institutional set-up and which alternative arrangements are available to the eurozone and the EU as a whole? Third, what logic of integration and cooperation will prevail amid the unprecedented divergence and the real risk of eurozone or EU breakup?

There can be little doubt that the eurozone turmoil is neither just a financial crisis or a sovereign debt crisis but instead the result of an unsustainable economic model characterised by booms and bubbles as well as busts and bailouts. The mutual interdependence of governments and banks has led to a near deadly embrace from which neither can easily escape. Politically and economically, the eurozone and the EU have failed to prevent a bureaucratic centralisation of power and a concentration of financial wealth. That has exacerbated not just the 'democratic deficit' but also and above all the lack of legitimacy.

In terms of the future, the risk is that the EU will combine some of the worst aspects of a federal super-state and a single free market dominated by finance. One alternative is to build a commonwealth of Europe, as R. Mundell has suggested—a looser form of federalism with a clearer division of labour between Community institutions and member-states.

Like the previous four editions, the conference was very rich in ideas. This, coupled with the Santa Colomba report, provides a very valuable contribution to the ongoing debate about how to make Europe work.

Dr Adrian Pabst
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November 2012

Programme

Saturday, 14 July 2012

Welcome remarks by Robert Mundell and Armand Clesse

A. The short term: Managing and resolving the eurozone debt crisis

09.15-10.45 **Session 1:** Towards unifying the Eurozone/EU banking system; EU/Eurozone public debt; eurobonds and eurobills and the international monetary system; new controls on national deficits and government spending; the welfare state issue.

10.45-11.15 Coffee break

11.15-13.00 **Session 2:** Shift/transfer/sharing of sovereignty between European states and central authority; a European Ministry of Finance (Trichet)? a European Fiscal Authority? Would a European Ministry of Finance take over some national functions like social welfare? The EU/ EMU problem and UK.

13.00-14.30 Lunch at the Palazzo Mundell

B. The medium term: Transforming the institutions

14.30-16.00 **Session 3:** The executive power. Can the Commission be divided into a civil service and an executive power? Could the roles of the President of the Commission and the President of the Council be combined? How should the president be appointed/elected? Should the commissioners be cabinet members appointed by the president?

16.00-16.30 Coffee break

16.30-18.00 **Session 4:** The legislative power. Should there be two legislatures, one representing the people and one representing the nation-states? Could the Council be turned into a senate with nation-states having equal number of senators? Or should senators reflect to some extent the size (by population) of the state?

Sunday, 15 July 2012

C. The long term: Where is Europe going and how long will it take to get there?

09.00-10.45 **Session 5:** The incentives/needs for change. Is the goal to have Europe as a power centre to achieve/regain superpower status? Europe in the world economy/community. The boundaries of Europe: are they definitive? Europe and NATO. Europe and Russia. The energy issue.

10.45-11.15 Coffee break

11.15-13.00 **Session 6:** Proposals for reform

13.00-14.30 Lunch at the Palazzo Mundell

List of Participants

Allegrezza, Serge, Director, Central Service for Statistics and Economic Studies (STATEC), Luxembourg Ministry of the Economy and Foreign Trade, Luxembourg

Almond, Mark, Visiting Associate Professor, Department of International Relations, Bilkent University, Ankara

Ambrosi, Gerhard Michael, Professor emeritus, Jean Monnet Center of Excellence for European Studies, University of Trier

Buyse, Joris, Head of External Relations and Communication, Central Bank of Luxembourg

Calleo, David, Dean Acheson Professor, Director of the European Studies Program, Paul H. Nitze School of Advanced International Studies, Johns Hopkins University, Washington

Clesse, Armand, Director, Luxembourg Institute for European and International Studies

Coker, Christopher, Professor, Department of international Relations, London School of Economics and Political Science

Connelly, Ryan, PhD candidate, Paul H. Nitze School of Advanced International Studies, Johns Hopkins University, Washington

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Frentz, Jean-Marie, Associate Research Fellow, Luxembourg Institute for European and International Studies

Gillingham, John, Professor, Department of History, University of Missouri - St. Louis

van Gunsteren, Herman, Professor of Political Theory and Legal Philosophy, Leiden

Klau, Thomas, Head of the Paris Office and Senior Policy Fellow, European Council on Foreign Relations, Paris

von Leipzig, Wolf, Journalist, Luxemburger Wort, Luxembourg

Lyttelton, Adrian, Senior Adjunct Professor of European Studies, Paul H. Nitze School of Advanced International Studies, Johns Hopkins University, Bologna

Maier, Charles, Leverett Saltonstall Professor of History, Harvard University

van Middelaar, Luuk, Member of the Cabinet of President Herman Van Rompuy, European Council, Brussels

Mueller, Jan-Werner, Professor of Politics, Princeton University

Mundell, Robert, University Professor of Economics, Columbia University, New York

Pfaff, William, Author and Syndicated Newspaper Columnist, Paris

Radicova, Iveta, former Prime Minister of Slovakia; Professor of Sociology, Comenius University, Bratislava

Schout, Adriaan, Deputy Director Research Europe, Clingendael Institute, The Hague

Siedentop, Larry, Emeritus Fellow of Political Thought; Emeritus Fellow of Keble College, University of Oxford

Sotiropoulos, Dimitri, Associate Professor, Dept. of Political Science and Public Administration, University of Athens

Steinherr, Alfred, Professor of Economics, University of Bolzano; Honorary Chief Economist EIB, Luxembourg; Academic Director, Sacred Heart University, Luxembourg

Thomas, Philipp, Managing Director, Aequi-Libria Associates, Luxembourg

Zakowski, Jacek, Journalist, Columnist for the weekly Polityka, Contributor to the daily Gazeta Wyborcza, Warsaw

Zielonka, Jan, Professor of European Politics, St Antony's College, University of Oxford

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