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Transcript

Chatham House Debate: Is a Two-Speed Europe Sustainable in the Long-term?

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Stephanie Flanders:

Welcome to this lunchtime meeting about the eurozone, which is not really very topical at all. It's not something we are all thinking about. It's one of these forgotten issues that Chatham House is keeping alive. I'm Stephanie Flanders, the BBC economics editor. I have been spending a lot of my life recently thinking about the future of the euro. Does it have one? What does it look like? Is it remotely consistent with decent economic growth which is obviously a key issue for the UK as well since half of our exports go to the EU.

We have a pretty good panel here to discuss them, but before I get on with that, can I just remind everybody and the speakers to turn off your mobile phones and anything else that might make rude noises. What we are going to do is we're going to have very brief opening remarks which will really be in response to a pointed question on my part and then open it up pretty quickly to questions and debate. I know there will be a lot of questions and this is obviously the topic on the top of the agenda. With us today, we have Stephen King who is the Group Chief Economist for HSBC and also the author of a recent book – I've now forgotten what it's called. It's why we should all be very afraid, but I can't remember the title.

Stephen King:

Losing Control.

Stephanie Flanders:

Losing Control, which I recommend to everybody. We have Paola Subacchi, from here, Research Director at Chatham House, in international economics. I'm afraid we don't have John Jungclaussen from Die Zeit here today because he's just fallen foul of strange goings on on the trains which I can't fathom, but anyway, they are insurmountable. But we do have Petros Fassoulas from the European Movement here in the UK. I think we've got quite a lot of perspective and I know some people in the audience were at the meeting with Wolfgang Schäuble yesterday and then perhaps if I can resurrect his voice occasionally to provide the German input which we won't have from Mr Jungclaussen at crucial moments.

Stephen, can I start with you? The title of this is: Is a two-speed Europe sustainable in the long term? Some people would say that the crisis has actually shown that it's difficult to sustain a two-speed Europe, either economically or politically, but there are others who would say we are still going to come out of this crisis with a two-speed Europe and there will be some kind of fudge at the political level to make that work. Just trying to step back a little bit from the next few days and the crucial events of the summit and everything else, where do you think economically the events of the last couple of years are going to leave the eurozone? And are we going to be looking at more of a two-speed Europe and is that sustainable?

Stephen King:

It all depends on whether the euro survives. I'm going to assume it does survive, but if it doesn't survive, then I think we would then face another great depression because we've seen over the last ten or 12 years, there's been a massive increase in financial entanglements across borders, across Europe. If you were to reintroduce national currencies, I think a lot of disentangling would take place and the process of disentanglement would lead to an extraordinary financial collapse threatening the same kind of run on banks that we saw with the first great depression back in the 1930s.

If it survives, it can only survive I think if there is an appropriate political process which deals with the relative interests of creditors and debtors within the eurozone because, at the moment, the process which we've seen has put almost all the burden of adjustment on all the debtors. Financial markets have taken the view that that is an impossible situation to be sustained. What we've seen over the course of the last months on countries who frankly haven't done anything particularly wrong fiscally finding themselves having higher and higher costs of borrowing.

The increase in costs of borrowing has meant that people have become more and more doubtful that the euro can survive so you have people buying lots of German bunds and selling Italian debt who then say, well, who are the holders of Italian debt these days and the answer is its maybe the French banks or other banks elsewhere in Europe so people start selling those particular institutions and, of course, as we've seen over the last few hours, people then start selling French government bonds because they believe that the French government will eventually have to nationalise some of its banks.

So this is a very, very unstable situation and I think it stems in part from this imbalance of interests between creditors and debtors. To put it simply, I think the creditors take the view that they behave well and the debtors have in some sense behaved badly. I'd like to argue to a degree against this. I think that there are two problems that come through. The first is that during the financial crisis, there was a collapse in incomes relative to expectations and, once that collapse had happened, it became much more difficult for the debtors under any scenario to repay the creditors.

The second difficulty goes back further. When the euro was first created, it was instrumental in creating a kind of imbalance within the eurozone which is the equivalent of the imbalance that we see say between China and the US. We had an ever-widening German current account surplus matched by widening current account deficits in other parts of the eurozone, particularly in the so-called peripheral nations.

The widening German current account surplus was partly a response to the fact that the Deutschemark no longer had to appreciate because the Deutschemark doesn't exist anymore. Exports went through the roof and that gave Germany a choice. Choice number one was to say exports are much higher, we'll therefore import more. We have stronger domestic demand. Everything is going to be absolutely fine. Choice number two was to say actually we don't want to import any more therefore we'll allow our exports to contribute to a wider and wider current account surplus.

I've heard some people saying, if only some countries could follow the German model. In other words, everyone should have a current account surplus, but that's a little tricky because, unless we are doing trade with Mars or Venus or something, that is simply impossible. So the point about this is that for every German account surplus, there has to be a current account deficit somewhere else. For every increase in German savings, there has to be an increase in borrowing somewhere and when you look at the way the eurozone behaved in the first few years, it's pretty clear, given movements in interests rates, that actually it was the northern European lenders who were driving the flow of capital rather than the southern European borrowers for the simple reason that southern European interest rates continuously fell over the first two years.

What I'd like to argue therefore is that any solution that comes through has to be a solution that involves not just the debtors, but also involves the creditors. If you instead impose all the pain on the debtors, the debtors will eventually default and you'll end up with a 1930s-type crisis. So the creditors themselves have a very big responsibility in the story.

Stephanie Flanders:

Well, I mentioned that the German finance minister was here yesterday. In fact, he was sitting right here and he said very explicitly that there was no symmetry between debtors and creditors. He would have disagreed with almost every word that you've just uttered.

Stephen King:

Good.

Stephanie Flanders:

And that the fact that debtors ought to be doing all these things had no implications for creditors at all because this was all about competitiveness and markets and Germany was just miraculously more competitive. But Paola, just turning to the weaker countries, if you like, when we are talking about a two-speed Europe, the countries that will now be probably growing more slowly than countries in the hard core. What's the perspective on this? Do you think it's sustainable? Do you see some of the same arguments that it is unfair that the burden of adjustment is only for and on the periphery countries?

Paola Subacchi:

Actually, I must declare, there is an interest here because Petros and I were ganging together because, despite the fact that we have both being living in this country for a long, I'm Italian. He's Greek. So you know, it's our fault.

Stephen King:

Would you like a loan, by the way?

Paola Subacchi:

Yeah, why not? I think the crisis has really highlighted the problems which actually predated the crisis. Again, we talk about the two-speed Europe. I don't particularly like this concept. I am a bit uncomfortable with this idea of the European periphery. What is periphery and how we define it? The geographical concept, again, is the centre, is the central part of Europe, where Germany sits. But it's also a broader concept and involves a lot of structural differences as well as problems which have built up throughout the years.

So right now, if I had to define why I see these two-speed Europe or how I can define the periphery although I know it is a very fuzzy picture, I just think in terms of high debt and deficit. Again, no country at the moment has a good fiscal position so now we are talking about very high debt and deficit. We talk about high inflation, low growth and current account deficit or surplus. The exercise we did here is to plot the current level of inflation and growth and try to single out the problematic countries and the picture gives the picture of the periphery if you will because these are the countries.

The problematic countries are actually the countries that sit at the end of Europe geographically. So we have Greece which, at the moment, has high inflation and deep negative growth. We have Ireland with effectively negative inflation, so a deflationary position, with slightly negative growth. We have Spain which actually sits on the chart with almost zero growth and around two percent inflation. And then we have the virtuous countries which are – guess – Germany, Slovakia and Finland with good growth and low inflation, so an ideal position.

So this is very much the picture now and is a picture which actually has a long history. The crisis has somehow crystallized the problems which were there, but the problems predated the euro-area, the establishment of the European Monetary Union and some of the countries with problematic fiscal positions – Greece, Italy – they couldn't really sort out their position. Now they find themselves really on the brink. Problems with growth, again the inability of some of these countries to understand what needs to be done inside a monetary union which has a fixed exchange rate system. So back to the 1930s, effectively it's like having this straight jacket where you have to operate with different policies because you can't depreciate your currency, so again Greece, Italy and generally the periphery of Europe used to get a boost of competitiveness through the valuation. That is not possible anymore.

Again, we have some really problematic – clear evidence here of how much, for example, the labour costs, the nominal unit labour costs in Greece have grown over the last 20 years. Again, we are not talking about the last two years which could be somehow problematic because we look at the picture under stress and a lot of pressure, but we are looking over 20 years. So Greece always had a very uncompetitive liberal market for a lot of reasons, followed by – guess – Portugal, Spain, Italy, Ireland. So again, in some way, the problems crystallize with the crisis, but there was that before.

Another thing is the crisis created another sort of divided line in this periphery of Europe so we have classic cases of [inaudible] a deep, embedded fiscal problems – again, Greece and Italy. So basically, you have an effect… you have problems in the public sector which spill over on the private sector. It's the case of Greece now. And, on the other hand, you have problems in the private sector, like the banking system, which spill over into the public sector like Ireland and somehow Portugal and Spain. So we have this sort of two poles which converge into one crisis and for which we probably need to think of different solutions for the medium and long term.

Stephanie Flanders:

Thanks very much. I want to pick you up on a few things that you said, but we also ought to bring in Petros. I know that you are Greek, but we don't have you here as a Greek. We have you here as chairman of the European Movement in the UK. So I'm wondering how – if looking on from Britain, and you must have been interested to see that, for example, George Osborne now is such a convert to the case of fiscal union and closer integration in the eurozone. How do you think a two-speed Europe – whatever direction we think the eurozone is going in – how does that leave Britain? How is Britain's economic interest going to be affected?

Petros Fassoulas:

I've had this conversation with a lot of Greeks since I moved to this country and, not too long ago, somebody said that it's not rare for people to miss buses, but it's very rare for people to set out to miss a bus. I think the relationship between the UK and the EU bears that characteristic especially in the current environment. It is indeed very interesting that Mr Osborne and Mr Cameron are big supporters of the idea of fiscal union as long as they have to stay out and usually that sentence is finished with an acceptance of the fact that what goes on in the eurozone affects our economy, the value of assets in [inaudible] massively.

At the same time, they are prepared to relegate themselves into a second class citizen who even though it has the option of having a seat around the table, chooses to stay outside of the room while people make decisions that affect us on our behalf and without us. Unfortunately this is the situation where we find ourselves now.

Stephanie Flanders:

But I think that wouldn't be their first choice. I think it's just the crisis that's shown we have to make that choice.

Petros Fassoulas:

Indeed, but they have been given the option of joining into the decision-making structures that they are put in place to reform the eurozone, to make sure that these problems don't repeat themselves. The Euro+ Pact, for example, is open to non-eurozone countries and the UK has chosen to remain outside of it. So the crisis in in effect giving opportunity to several people within the government but beyond, also in the Conservative Party, to push towards a different kind of relationship with Europe that will eventually lead into a marginalization of the UK within the European Union and that, according to the admission of the prime minister, is probably not a good idea.

Stephanie Flanders:

I'm interested, listening to what Paola was saying, I mean, there is a view that says, one conclusion of all the debates we've been having since this crisis began could be that a large euro, which is not obviously the original idea, but one that… lots of countries that you can start thinking about as core and periphery, there's always going to be a two-speed Europe just as a matter of economics. It's just that you want countries to be swapping in terms of which ones are going slowly and which ones are going fast.

So I've heard economists say, look, Germany was very uncompetitive at the start. A lot of the core European countries were uncompetitive. They had slow growth, very slow consumption growth. We all said Germany was the sick man of Europe and, at that time, the periphery countries were growing rapidly and now the balance has shifted and that's what you would expect. Now, they are uncompetitive. They grow more slowly to sort themselves out while the core does better for a while and that's the kind of yin and yang you should have in a broad currency union.

I mean, Stephen, is there an argument that says given that we don't want to unpick this now, regardless of whether or not we might think a broad euro wasn't such a great deal now, you know that boat has sailed and the way this works is precisely to have a sort of back and forth, quite uncomfortable period of two speeds.

Stephen King:

It may be although I think there are some difficulties with how you adjust from how we are currently. Going back to your comments about labour costs – that's something that's really a fundamental issue. Clearly, labour costs have got out of control in parts of the so-called periphery. But these countries in southern Europe and elsewhere, if those countries are going to regain competitiveness, their labour costs have to fall relative to countries elsewhere within Europe. The way you've done this in the past, the euro would have been three, fours in nominal exchange rates. The lira or the peseta, whatever, they would have fallen and that's when the adjustment in relative labour costs in common currencies.

At the moment, the only way you can really get that adjustment coming through is by having differential inflation rates. In other words, that the inflation rates in countries like Italy and Spain and Greece would have to be suddenly lower than the eurozone average to enable them to get that competitive improvement. This is a tricky issue because let's say the easy bee has an inflation target of 1.9 percent and peripheral nations – and let's include Italy in this to make sure that they are big enough so to speak – have to achieve an inflation rate which improves their competiveness by say a half percent or zero. Well, if they are at a half or zero and the average is 1.9 then it must follow that countries like Germany would have to have inflation rates well above two and the question is whether Germany would be prepared to accept that its part of the adjustment mechanism will be to have an inflation rate that is significantly higher than the average.

What I often hear is when countries say we want the average to be 1.9 for the eurozone as a whole, we want our number also to be at 1.9. I'd like to argue that those two are actually inconsistent. If you want to have a situation where the eurozone as a whole is delivering the right kind of price stability, you have to accept differences in inflation rates across different countries. If Germany is not prepared to cap inflation higher than 1.9 and demands of the peripheral nations to improve their competitiveness, you will end up, over a number of years, with European inflation on average being well below target and that will condemn Europe to a period of very, very difficult and anemic growth.

Stephanie Flanders:

Paola, do you agree with that? Because there is an argument when you talk about the labour costs. Ireland, those same charts that you talk about, Ireland did have a very deteriorating competitiveness. It's achieved enormous amounts in the last couple of years. It's sort of done what it's supposed to do and seems to be getting some benefit from it. It had quite a high growth rate in the second quarter of this year relative to other countries. Is there a way, do you think this adjustment can happen? Stephen is suggesting it can't.

Paola Subacchi:

Well, I think the issue is a bit broader and again, of course, there is – why we want country in some way to have, to convert to some points and why do we want to have as little differential as possible is because this impacts on policies because otherwise, we are in a situation where countries are so different in their fundamentals, then the common policy which is a monetary policy is totally out of synch. That was the problem somehow . . .

Stephanie Flanders:

Do you think in ten years time that they will have converged either by having all slow growth as Stephen has suggested?

Paola Subacchi:

It is a very difficult proposition in the sense that of course we can improve growth. I mean, there are some regional differences and some regional differences which are not only an issue of good policies but also the kind of endowment that a country can have. Take an example: Italy used to be very productive north and effectively the price sells in the same country. Again, despite all the effort to bring the south to the same level as the north, it never works out. That’s some proof of some sticky points there. There are improvements that can be done to reduce this gap, but possibly perhaps is very difficult to reach the same level and that is the problem inside the euro-area, within the Eurozone.

We need to converge in order to have the same policies which can achieve the same results, but at the same time, it becomes very difficult to control the speed of economic growth and other fundamentals. Again, the [inaudible] was talking about before – and unfortunately we can’t project it here because we are under strict instructions and we can’t obviously in a meeting like this – but it shows very clearly that Greece has a problem which requires some kind of intervention. Ireland has problems which required completely different intervention. So how we can adjust this? And somehow one of the big issues behind this crisis is the inappropriate level of interest rates that some countries experience by being part of the monetary union because the interest rates were effectively determined on the basis of the average inflation, wage force, more or less close to Germany…

Stephanie Flanders:

But then we are getting back to this point. We may all agree that a very broad single currency area with very different fundamentals was not such a great idea it turns out, but I'm not so sure that that gives us where to go and if we think that a dissolution would actually mean another 1930s depression, we do have to start from here.

Paola Subacchi:

I agree with Stephen. The dissolution would probably bring that kind of scenario, but there are other ways. One is fiscal transfer, something that is not…

Stephen King:

That's easier to do between north and south Italy than it is to do between Germany and Greece.

Paola Subacchi:

We know that.

Stephen King:

In a relative sense, it's easier, I think.

Stephanie Flanders:

Sorry, I think we might – Petros, do you mind if we have a couple of questions because we might get something more specific for you?

Question 1:

I would like to pursue with Petros the question of the outs which is actually what I thought two-speed was going to be about, although I do think two-speed *inside* the eurozone is also very interesting. My question for Petros is whether the single market can survive a situation in which there are outs, but there are ins which are doing things like some element of tax harmonization, possibly Wolfgang Schäuble's favoured financial transactions tax, a common corporate tax base – other measures that the 17 might agree, but the out countries do not apply. How easy will it be for the single market to survive in that situation? The Commission is there. The Court of Justice is there. But there is going to be some pressure from the ins not to suffer from what they might see as unfair competition, particularly unfair tax competition from all the outs, the most obvious one of course is Britain.

Petros Fassoulas:

Well, that's a fair point and we already see a situation where a member of the single markets has been allowing its currency to devalue itself against the euro in an effort to gain a competitive advantage. It hasn't worked like that and as we see, a result of that devaluation has been increasing inflation rates in the UK, but I completely agree with you. You cannot have a single market where part of it has a common currency and the other doesn't.

The disadvantages of being actually outside are quite big and already a lot of countries are feeling uncomfortable – countries like Sweden and Poland – with a degree of [inaudible] to influence what's going on in the eurozone. For that reason, together with many others, they would pursue slowly, slowly an effort to join the eurozone so they can be part of the decision making process so they can affect the market. Eventually, the question will be how many will be left out of the eurozone in the market of their own and what would be the effect for those countries standing entirely on their own when the eurozone single markets have finally come together in one.

Stephanie Flanders:

It's very interesting you say that because a lot of people would say that's going from not having control over events in the eurozone to not having control over events in your own country.

Petros Fassoulas:

Well, I think you can influence events in your own country when you are sitting around the table that makes decisions that affects those events.

Stephanie Flanders:

The Greeks might feel a bit differently about that. Stephen?

Stephen King:

I just want to ask you a question about your position on the UK. I guess you are saying that the Ambassador of the UK [inaudible] refer to being in rather than out [inaudible] of the euro. My question is not a Euro-skeptic question – I suspect you are beginning to think I am a Euro-skeptic, but I promise you I'm not. My question is this: Do you think the euro itself would easily have survived had the UK been a member and the UK had gone through its own financial crisis over the last couple of years? How would Europe have coped in the events of the huge financial crisis that we went through?

You talk about that fact that the exchange rate fell and this was anti-competitive in some sense but oddly these were sort of pressure valves that were relieved in the UK that allowed an easier adjustment than otherwise would have taken place. I'm just wondering are the members of the euro secretly relieved that the UK didn't join?

Petros Fassoulas:

You are going to have to ask them, but for what it's worth, I have the feeling that what brought the financial crisis and the credit crunch in this country might have been averted if the UK was part of the eurozone.

Stephen King:

That's a very strong statement.

Stephanie Flanders:

How? The interest rates would have been lower if anything so we could have had more imbalances growing up internally...

Petros Fassoulas:

But the asset bubble in the UK wasn't the only problem. It was a matter of legislation as well. Perhaps the financial service sector would have been differently oversighted if we had put in place the conditions, the structures to oversee the financial sector across borders the way we failed to do, unfortunately, because we didn't have European regulators.

Stephanie Flanders:

Do you think – just as a matter of interest – what do you think is the answer to Stephen King's question? Do you think the eurozone would have survived if the UK had, in fact, joined the eurozone? Who thinks? Do you think they would have survived? Hands up. Do you think the eurozone would have had an even worse crisis had the UK been inside the euro or would there eventually…So do you think yes? Hands up if you do think they would have had a worse crisis with the UK in. And put your hands up if you think it would have been better or manageable for the eurozone to have the UK in and we probably should have joined? Well, very brave people. Well done. Getting together in the spirit of the times.

Questions 2:

I grew up in the 1930s. Where I lived, there was very considerable unemployment and poverty. But in the south of the country, under the same government, there was a comparatively prosperous way of life. If the European single currency is to survive, do we not need at least an EU economic government which can harmonize the decisions, the financial and economic decisions taken in the member states?

If this is the case, do we not also need to have a political element so that it is not simply the matter of the experts taking decisions and that therefore a move towards an EU government, however limited its potential is, however limited its function is, is the long term answer to the euro crisis.

Stephanie Flanders:

You think that would start with the eurozone countries? Or you think it would start with the EU?

Question 2 (continued):

I think it's important that the eurozone countries make a start particularly in relation to economic government, but it's equally important that all member states should have not only a say in establishing an EU government, but in addition, that they should contribute their ideas as to what form that political structure would take.

Stephanie Flanders:

Paola, what do you think? This is something that many people would say that one conclusion of the past year or two has been that there is a political imperative here, not just an economic imperative.

Paola Subacchi:

Frankly, I have a serious view on this and I still believe that it is possible to improve what we got in terms of governance of the EU area which sounds like a big concert and is very fuzzy as well. But there was a mechanism which we failed to apply properly to actually…the crisis didn't explode over night. It wasn't a tsunami. It was something which could have been monitored. It was a build-up of imbalances throughout the years. So obviously there was a big failure of surveillance there. So there are other things that can be improved.

If I remember, if I picked up correctly what the German finance minister yesterday said, I think when the whole process of easing the currency was discussed. There was actually on the cards also the possibility to have a political union, eventually to move to a political Europe. That was then. I don't think now it would be possible. And if it certainly is not possible to somehow bring in some kind of a more fiscal Europe or political Europe from the backdoor it is something which has, as you said, to be approved by the citizens of Europe because one thing is to decide – and again, in many respects, there is a gap between what the leaders of the European countries thinks and do and what the people want to do.

So I think certainly we need to reconnect to close this gap. And then, I don't know. Things have changed and maybe now we live in a different Europe from the one 30, actually 40 years ago when the whole project of a single currency was I believe started to take shape apparently the Werner Report was a key part in this process. I think we live in a different world. So, and obviously, if the eurozone, the euro will survive – and I believe it will survive even in this – I think it will be a different Europe so we cannot go back to where we were before in 2011 and even before 2008.

Stephanie Flanders:

That is interesting because a lot of people feel – you are almost certainly right on the politics, that we feel politically quite far from that kind of solidarity and integration. And yet, economically, it seems like the case is much stronger now. In fact, it may be a necessary part of solving the crisis to move closer together. I mean, Petros, do you agree with Paola? There is now, and there has to be, an economic impetus anyway to have more political integration?

Petros Fassoulas:

I do agree that we live in a different kind of Europe from 30 or 40 years ago. Most of the people have realized the degree to which our economies, our financial service sectors, our banking sectors are integrated and that makes stronger the case for closer cooperation at the economic governors level [inaudible]. Whether it will be politics or economics, necessity or design that brings it about, I have a feeling it will be a mix of all those. There is a strong need obviously to address the problems you have now and a lot of the proposals on the table for the medium and long term at least imply a degree of fiscal integration that wouldn't perhaps have been possible about a year ago.

But at the same time, I do think that there is a political will within the leaders to do whatever is necessary and that implies engaging in political integration at this moment.

Question 3:

There seems to be a common assumption that, were the euro to break up, there would be a depression and I don't see why that should be the case. If you are dealing with trade, a break up into two or more currencies would allow the peripheral countries, in fact all of the countries, to readjust to appropriate levels for trading purposes. The problem which Stephen referred to was entanglement of debt across borders. Bearing in mind that such a break up would be managed, why cannot the cross-border debt be denominated [inaudible] a resurrected ECU – which of course is an average basket of the various currencies which make up the union which would at least push out the problem to be handled on an adjusted basis as it went along?

Question 4:

First, just to comment – I must say that I'm American. I'm also French, but speaking from my American side, it seems to me that what Europe is going through today is very similar to what America went through after it was founded because, during the first 50 years, more or less, we couldn't make up our minds whether we wanted to be a confederation or whether we wanted to have a union. Virginia was issuing its own currency. It was chaos and the economy was in shambles. It seems to me until we brought ourselves together and realized that we had to have economic and political union.

I think that the fundamental problem in Europe today is that people want the benefits, but they don't want to give up the power. That is simply, in my opinion, going to have to happen. You talk about are we going to have to have an economic union. I think it's absolutely indispensible and I think this crisis proves that you cannot have 27 countries going off in different directions and expected to come out well. And I think even more so today because, if you go back to the beginning of the 1800s, it seems to me the world was far less complicated. Maybe that kind of chaos could be tolerated more, but today it's virtually impossible.

My question really is along the lines of what was just asked. I have a hard time understanding why Greece can't withdraw without the whole world collapsing.

Question Five:

We had a chat over lunch and part of the question has been asked, but I'd just like to supplement that. I'm a Dutch economist who was rather skeptical at the start of all this when the treaty was signed in Rome, I'm afraid, in the 1960s because of the divergence of the membership. We were trying to run before we could walk, establishing the euro when we did in 1999. Having got here now, having sacrificed the instrument of currency adjustment, the instrument of monetary adjustment – the Central Bank in Frankfurt – now trying to get to the third instrument which is obviously necessary to correct this mess – a fiscal union – which will be ages away before you get all that through the 17 parliaments.

Indeed the point is, the question is back to the original title which was a very good one – I believe it is something like would a two-tier Europe be sustainable. That implies that it is feasible and I think it is feasible. It is very disruptive. Terribly disruptive, but we have to return in a crisis. I don't think that Europe will fall apart. It will be difficult but under the circumstances we just have to give up something that we tried to build too quickly and start again and I don't see why the pain cannot be absorbed before we can try again with the fiscal union which as I say will take too long to fix the current problems.

Stephanie Flanders:

Stephen, do you want to respond to this idea that you are wrong? That there wouldn't be a great depression after all. It would all be kind of a bit messy, but we would all come out alright from it in the end.

Stephen King:

Well, of course, being an economist, it is an occupational hazard to be wrong all the time. So I apologize in advance for what I may have already said, but my observation is this. Go back to the 1930s. There's now a commonly accepted view that the decisions by countries separately to exit from the gold standard was absolutely material in the subsequent recovery. That's why for example the UK's depression was relatively modest compared with the depressions that the US or maybe France went through during the 1930s because by exiting they got their own marginal independence and everything worked fine. So if you apply the same logic to where we are today, you would say that depression wouldn't happen. Actually, breaking up Europe would be the solution to avoiding the depression rather than the cause of a depression.

But I think there is a fundamental difference. Again, I could be wrong on this, but the fundamental difference I think is this: that globalization [inaudible] peaked before the First World War, particularly in terms of cross-border holding of capital. The First World War destroyed all of that and in the interwar period, there were simply no cross-border holdings of capital of any significance other than the transfers by governments. And so the whole process of interconnections of entanglements just wasn't there. Therefore, although countries came off the gold standard, that did not lead to sudden doubts about the evaluation, the revaluation, the devaluation of a whole series of different assets. What I'm getting at is, because the euro has been absolutely crucial in creating a massive increase in cross-border holdings, the process of disentanglement is fundamentally different than what was the case back then.

I'd also note that I think there is a legal uncertainty. I accept that your proposal for having a sort of legacy ECU or something to value these currencies, these assets is a reasonable proposal, but I do think that there will be all sorts of legal questions about whether someone who is French who bought a Spanish bond and thought they were buying it in euros and discovers that actually a Spanish bond is worth, well, is it worth euros? Is it worth ECUs? Is it worth pesetas? Is it worth francs? Who knows what it's worth? And, of course, the other big issue here is, if you assume that the creation of separate currencies gave the opportunity for countries like say Italy or Spain then to devalue, even if your asset was worth something ECU, as a consequence of the devaluation, the ability of the Spanish to repay the asset holder would be seriously reduced. So I think there are a series of difficulties with your proposal. But again, I could be wrong.

Stephanie Flanders:

Petros, what do you think of this comparison with America in its earlier days -- I mean I have had very senior American politicians say to me, you know the lesson in this is if you are going to have your own currency, maybe you should check to see whether you are one country yet. I thought this was probably not one he would be sharing with his colleagues at the G20 finance ministers meeting.

But do you think there is a parallel there or do you think that this is just a bumpy road. I get the impression from what you were saying before that, yes, this will be the way that European integration has always gone. You bump along. You overreach. You go back a bit, but in the end, you're even further than where you were.

Petros Fassoulas:

I definitely share the sentiment. Of course, I would, wouldn't I? But there is an element of anxiety. We keep forgetting the eurozone as a project has been around for ten years without counting the years of preparation. The infrastructure, the architecture is perhaps incomplete, but not to the degree to disqualify completely the benefits that it had brought. The process of redesigning the architecture is I think capable of guaranteeing its long term survival as long as we keep in mind we still have those benefits.

Reference is often made to the 1930s and we keep forgetting that what exaggerated the crisis – and I think that was alluded to a little bit – was the process of competitive devaluation and protectionism that took hold in the world, something that didn't happen in Europe after the crisis in 2008 and the year since then exactly because we have a single currency, exactly because we have a single market.

Those two fundamental factors remain the reason why we have this single currency. It's a matter of investing politically and economically and fiscally to making sure it has a future and it has a successful future.

Question 6:

I work for a large private equity fund and I'm a partner in a social enterprise called Generation to Generation. Could I ask the panel to analyse the long term stability of the eurozone through the lens of the, I suppose, global economic power shift eastwards – the rise of the BRICs. Earlier in the year it was Cameron following the status of China that triumphantly announced a multi-billion dollar bilateral trade deal, but I think that's still small change relative to the Germany-China bilateral trade relationship which boasts exports multiple times that and some equity analysts estimate that it's increasing by up to ten percent a year.

So I guess going back to the title of the debate, could it be the case that the slow lane is occupied by those countries which fail to adopt the new global financial paradigm and the fast lane will be dominated by those export-driven countries such as Germany who power exports to the rising economies. And just one side note: I'd ask the panel to comment on the declining bilateral trade relationship between France and Germany because many people would argue that has always been one of the very foundations of the eurozone project.

Question 7:

There seems to be a consensus emerging that this thing can't break up, but there seems to be a parallel consensus that this thing can't work. Now something has to happen. I would quite like the panel's views as to how the scenario works out in the next three to six months. What actually is going to happen? There seems to be a belief now that of course Greece will default. It has to. Surely Greece cannot in the current circumstances repay its debts. It would be interesting to hear Stephen here – and I think we are under the Chatham House rule…

Stephanie Flanders:

No, we are on the record. No, it just occurred to me as a journalist that I should have made this point right at the start. It is on the record.

Question 7 (continued):

But once Greece has defaulted and all our political leaders say one down, but no more, I mean will HSBC just be piling into Portuguese bonds on the basis that under no circumstances there is any chance of another euro state being allowed to default. How is it going to pan out?

Stephanie Flanders:

This is why the second part of all of the conversations for the summit is always you allow this for Greece and then you have to do X – fill in the blank here – to protect other countries to quarantine.

Question 8:

I regret that the word accountability has been kept out of this discussion. The great difference between Europe now and America after its founding is that people demand that the economic policy makers be made accountable to them. A lot has been said about the benefits that countries receive from the euro, but I think if one was a Greek, one might say, well, I'm not clear what these benefits are because I am being asked to undergo an austerity program which will really break one and if one could do the rational thing and devalue one's currency, austerity – although not painless – would be a much easier thing to achieve. Greeks may say we don't elect our government to be responsible to international institutions but to be responsible to us and that was the issue raised in the 1920s in Britain and other countries with the gold standard and I suppose it was also the issue raised in Britain when we were in the ERM.

So it seems to me that the euro institutions will only work and the fiscal eurozone will only work if you have institutions that are actually accountable to the public. But then you face the problem that the span and divergences of culture are simply too large to secure accountable institutions, certainly in a group of 17. Perhaps even in a smaller group, but certainly in a group of 17. The political reaction we are seeing is a reaction from the radical right as we saw also in the 1920s and 1930s, of political parties who were saying particularly when the Euro-skeptic position isn't represented in parliament which it is in Britain, but in other countries, part of the radical right are gaining strength because of this phenomenon of lack of accountability, lack of national accountability.

A lot has been said about the 1930s. Now, when the minority Labour government of 1931 was asked what would happen if Britain left the gold standard, the chancellor of the exchequer, Phillip Snowden, threw up his arms and said the deluge. Now, when we were actually pushed out of the gold standard, one of the former Labour ministers said no one told us we could do that.

Question 9:

Coming back to the position of the United Kingdom and just to answer one bit of the question that was raised about what would have happened if the UK had been in the euro. I don't really know how it would have panned out as regards to the eurozone crisis, but what I am absolutely certain of that if we had been in the euro, we would have had an even bigger boom and bust, very much in line with what happened in Spain and Ireland and it's just as well we weren't.

Coming on to the UK's position. Of course, what most people in the UK, and in a [inaudible] sort of way, really want from their relationship with Europe has always been a free trade area with none of these dodgy political integration overtones and that, of course, given the very strong integrationist drive which we've always underestimated in continental Europe, has never been what's available.

But I was wondering whether an outcome of this for the UK was that if something much more like that would actually become available and given the underlying divergence of attitudes whether it would be a good idea to trade a certain amount of influence on European policy for that kind of outcome.

Stephanie Flanders:

You've raised an interesting question and I hesitate – I'm not sure everyone liked the first one, but I'm going to try again. Who disagrees with the previous speaker and agrees with the current chancellor that it is now – regardless of what might have been the case in the past – in the current situation in the British national interest that there be a more closely integrated, more like a fiscal union form of eurozone? Who agrees with the chancellor that it is now in our national interest?

Question 9 (continued):

But one without us.

Stephanie Flanders:

One without us being able to influence. There are definite downsides. But I thought – but then the suggestion of your question is that we should be trying to get the opposite. That we should be trying to get a more loose integration…

Question 9 (continued):

They can get on and form their fiscal union and whatever they like. We can become more detached and have a purely trade relationship. And given that they are under pressure, maybe we could manage to negotiate something like this [inaudible].

Stephanie Flanders:

Who believes that the end result of this – a fiscal union for the eurozone will be bad ultimately for the UK because we will be further and further away from decision making that affects us, which is more or less Petros' position.

That's interesting. I thought more people might be on that side. So to round up some of those questions – I think we had two variants of the 'we can't break up, but it also doesn't seem to be able to work' question because we also have the 'it will break up without accountability, but there is no way really to get accountability' so that seems to be a similar kind of question. Are they damned if they do, damned if they don't, Stephen? Is there actually a way out of this?

Stephen King:

Yes. I have the answer.

Stephanie Flanders:

Quick.

Stephen King:

I'm not going to tell you. Just one observation first of all about the US. We've heard a lot about how the US solved its problems, but I think if I recall, it solved its problems through a civil war and I'm not suggesting – I'm not advocating that Europe should go down the same route. So there are other ways of solving problems other than having a civil war. Secondly, the solution.

This is what I think it has to look like: First of all, and this is a fairly familiar refrain at the EFSF has to be expanded dramatically. The amount of money in the kitty currently is far too low.

Stephanie Flanders:

That's the bail out?

Stephen King:

The bail out, yes. The second thing that needs to happen is the funding of the EFSF has to be very visible, very transparent and probably eventually will have to come from the European Central Bank which I suspect will cause all sorts of problems within the eurozone, in particular in northern Europe, but this is no more than the equivalent on what the Federal Reserve did in 2009 by expanding its balance sheet, buying a huge chunk of GSEs – Fannie Mae and Freddie Mac paper – and it helped to stabilize things against a background of continuous speculation that was actually forcing a complete meltdown. So you need to have that kind of support – big support. Then you need…

Stephanie Flanders:

And that will stop HSBC madly selling – not that you ever talk about . . .

Stephen King:

Well, we are not under Chatham House rule so therefore I can't possibly answer that question. But I'm not responsible for these kinds of decisions anyway…

Stephanie Flanders:

The likes of HSBC would believe that, would they?

Stephen King: I think if it's sufficiently sizeable and it effectively creates clear two-way risk in markets, then it will have a useful impact. Then one of the key issues with the 'why don't we let Greece just go' is the fact that there's not a sufficient firewall to protect other countries. So if you have this massive increase, then you've got the chance of having a successful firewall.

Then you need accountability, political legitimacy, and my suggestion would be this: You propose and you have European leaders supporting the creation of what we might loosely describe as a fiscal club, a very low level kind of fiscal union. In this fiscal club, you have countries who mostly are free to set tax rates, [inaudible] rates whatever they want to do. They can have surpluses, deficits, whatever they want.

But if they get to the point where they can no longer access capital markets to fund themselves, they can turn to their European partners and say please can we have some funds and the European partners can say, yes, you can at a reasonably fair interest rate, not the penal rates that we've seen over the course of the last two or three years. But the penalty is that during the bailout phase, that country loses its fiscal sovereignty all together [inaudible] at Brussels.

In other words, you establish a contingent principle of new European taxation without representation will hopefully appeal to some of the Americans in the audience. You then have a time table and you say, we are going to come up with this plan by say 2016, 2017 and you are going to allow countries to choose whether to opt into this plan or opt out of it. If they opt in, then the euro survives and everyone is happy and it's got political accountability. If countries individually chose to opt out, they will basically reveal themselves to be countries not prepared to accept the insurance policy implicitly offered by the fiscal club and they would then be faced, presumably, by the significantly higher borrowing costs forevermore that has been the case up until now.

So there is a penalty for being out. There is a political cost of being in. At least it is a way of clarifying the situation. If you have European leaders say something along these lines fairly soon, this is what we are planning to do, than it actually makes it much clearer what is going to take place in Europe in the years ahead as opposed to the complete fudge that we see currently.

Stephanie Flanders:

Have you sent that solution to the appropriate chancelleries of Europe? Sent first class in time for the summit?

Stephen King:

It's there already.

Stephanie Flanders:

Well, now we have a solution, but we have just a bit of housekeeping with the other questions. Paola, can I ask you this question about the bricks? The slow speed, the slow lane for Europe – Is that going to be the countries that don't adapt, don't build up the connections with the bricks? Prada is doing very well in China these days.

Paola Subbachi:

Yes, they are doing very well. Apparently, they had a successful IPO. I think this is a bit… it's true that there might be differences here, but again I think the most important point here within the context if this shift is whether small countries – whether or not they are successful – can survive in a world which is becoming dominated by these players. Again, I wonder if monetary consolidation, currency consolidation, which is actually the essence of the euro project, makes sense in the 21st century different balance of economic power. In other words, is it better to be on your own as a small country and try to fight your battle against giants or be protected in what it is right now – a dysfunctional union – but still a union which still carries some weight? Because there is still a lot of respect for Europe in the relevant part of the world and particularly in Asia. So I think that is to me a critical plan.

Going back to a plan I agree with Stephen that we need a safety net. I think a solution would be a G20 solution which implies and involves also the Greeks and other countries, non-European countries in the G20. I think it would be a solution that would include some kind of safety net and also some plan for growth again with a substantial difference and responsibility and action from the so-called surplus countries. Once we have this plan in action, in place then Greece can default because at that point we should have all the firewalls necessary to protect the other critical countries in Europe and generally the worst economy. So this is the best case scenario.

Stephanie Flanders:

Petros, I'm going to let you have the last word, a very brief word obviously which is not always what happens in the UK in these discussions. On this question of accountability, Stephen engages with it with his solution, but there has been this fundamental disconnect. It's not just that it's hard to get the accountability, but once you've got it you've got an institution which cannot respond to events and markets because it responds so quickly. So although we don't think it's been very accountable, people in the markets think it's too accountable because of the endless markets and endless summits before they can agree to anything. How do you think – can that issue be resolved? What is the future for the accountability because that does seem to be a hole in this, in preventing a response to the crisis, but also reducing the legitimacy of the whole process.

Petros Fassoulas:

We have to decide whether we want a democracy of the people or a democracy of the market. There has been indeed a disconnect between the two over the current crisis. The unfortunate thing – and I don't want to blame the markets exclusively for what's going on – is that we don’t have the structures in place to inspire confidence in the markets. That's why they have been trying to force the hand of politicians to exactly deliver those results.

But I totally echo the point about accountability. There is a lot of discussion of fiscal economic political union without consideration of the same process – how we connect with our citizens in the process, how we make a fiscal union accountable to national parliaments and the European Parliament, how much power we give to supernatural institutions and how much we leave to the member states and these are the elements of the debate that have to be discussed alongside everything else. Me as a pro-European, I'm keen to make sure that whatever we put in place is as democratically accountable as possible.

Stephanie Flanders:

Thank you very much. Thank you very much to all of you. I think what we’ve ascertained is that a two-speed Europe may or may not be sustainable, but we’ve got a lot of other questions we have to answer first like is any kind of eurozone sustainable in the next few years? But thank you for all your great comments and please join me in thanking all of the speakers.