Oxford Martin School

(Oxford University)

Political Economy of Financial Markets

(St. Antony's College)

Center of Capitalism and Society

(Columbia University)

Conference Report

Future of Europe: The Drivers of Change[1]

April 27, 2016

[1] This conference was hosted at the Oxford Martin School, in partnership with the European Studies Centre (ESC) at St Antony's College, which hosted the companion conference on the second day. The two-day conference was part of a series of events in celebration of the fortieth anniversary of the founding of the ESC.

Future of Europe: The Drivers of Change

Oxford, 27th April, 2016

This report draws on discussions at the conference on the "Future of Europe: the Drivers of Change", which was held in Oxford (at the Oxford Martin School) on 27th April, 2016, and was jointly organised by the Oxford Martin School (Oxford University), the programme on the Political Economy of Financial Markets (European Studies Centre, St. Antony's College, Oxford University), and the Center on Capitalism and Society (Columbia University, New York City).[2] This conference was the first of a two day conference in Oxford, and focussed on the longer term issues facing Europe.[3] The participants included academics and practitioners from Europe and the U.S.A., as well as from Oxford University itself. The report represents the organizers' interpretation of discussions at the workshop and does not purport to reflect the views of any of the participants (except where specified).

The conference was convened in the context of a number of increasingly evident adverse long term trends (demographic, geo-political and economic) in Europe. The conference's timing was meanwhile prompted by the immediacy of several acute and potentially fatal stresses for the European Union—the Eurozone meltdown, the surge in refugees, and the approach of the Brexit referendum. With the European Union's intensifying existential crisis the subject of the conference the next day at St. Antony's College, the conference on the first day at the Oxford Martin School was tasked with the broader questions bearing on Europe's long term future.

Europe and the World toward 2030

The conference was opened by **Ian Goldin** who questioned the validity of the Westphalian nation state as the model for international order in an increasingly globalized world, with the increasingly supra-national reach of financial flows and information technology and the blurring of borders by religious, cultural and/or economic linkages.[4] Globalization brings with it the potential of substantial rewards in terms of continued growth and rising standards of living, but it also introduces and intensifies a number of systemic risks. These risks include cascading financial meltdowns, which have proven hard to anticipate and prevent, pandemics made worse by the speed and convenience of international travel, as well as the power of individual fanatics or other mavericks to bring down key institutions and infrastructure by

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[2] The conference was convened by Ian Goldin (Director of the Martin School), Edmund Phelps (Director of the Center on Capitalism and Society), and David Vines (Acting Director of the programme on the Political Economy of Financial Markets), and co-organized with Adam Bennett (Deputy Director of the programme on the Political Economy of Financial Markets).

[3] The conference on the second day, April 28th, 2016, was held at St. Antony's College, and focussed on shorter term and more immediate issues affecting the European Union, through the eyes of four countries (Germany, Greece, Poland, and the United Kingdom). This conference is covered by a separate report.

[4] The Peace of Westphalia, which ended the Thirty Years War in 1648, is considered to have determined the international principles of (i) the sovereignty of states and the fundamental right of political self-determination; (ii) the legal equality between states; and (iii) the non-intervention of one state in the internal affairs of another.

hacking into the information technology that drives them. For some, these risks outweigh the benefits of globalization, leading to a view that the world of the past was better than the one that is now in prospect, and driving a return of extremism in politics, of xenophobia and a desire to reverse the trend to globalization—of which the debate about the impending EU referendum in the UK was but one example. What does this mean for Europe? Arguably, Europe—through the creation of the EU—has become the most integrated collection of nation states anywhere in the world, as well as being highly integrated externally. Europe is not immune to these regressive tendencies, but will it be able to overcome them? This is the key question facing us now.

Jean-Luc Schneider explored the long term demographic and economic trends for the world over the next 35 years, as perceived by the OECD. While China has dominated the global economic consciousness for the past twenty five years as the "next big thing", the consequences of their ageing population—accelerated by the official one child policy—will begin to be felt in the coming decades.[5] China will therefore lead world GDP for only a comparatively short period during 2040-50, before potentially being overtaken by demographically more robust nations like India, Indonesia and Nigeria. Indeed, by 2060 the OECD expects China's growth rate (1.2 percent) to have fallen below that of mature economies like the USA (1.8 percent), and even Europe (at 1.3 percent). Adverse demographic trends are evident throughout the developed world, as a result of falling fertility rates, longer life expectancy, and the drying up of supplies of under-employed pools of workers. At the same time, growth in developing countries will slow down as the potential for catch up is gradually exhausted and total factor productivity growth converges on that observed in developed economies. By 2030, the share of global GDP (at least in purchasing power parity terms) accounted for by non-OECD countries could reach 50 percent, with implications for their clout in global decision making bodies like the WTO, but their contribution to global growth will start to shrink. During this period, the share of labour in the services sector in developing countries will increase, whereas mature economies—where the share of services is already high—could see a stabilization and even reversal of this trend as their comparative advantage in skilled labour (with high human capital) is eroded. Nevertheless, the gap between skill levels within countries will likely widen, giving rise to a further increase in the inequality of personal incomes. The higher growth rates in the developing world, albeit slowing, will also correlate with environmental damage and CO^2 emissions. However, the effect of this damage on global growth will not (at least through 2060) be very large, and this will likely delay substantive and effective agreement on limiting CO^2 emissions.

Wolfgang Munchau focused on one of the key drivers of globalization—the fall of the Berlin Wall and the collapse of the old East-West division of Europe that was the legacy of World

[5] China's one child policy was abruptly introduced over 1978-80, before the country began its transition to a capitalist economy and when population growth threatened to outstrip the communist system's capacity to deliver an adequate standard of living. The policy was only revoked in 2015, after many years of rapid economic growth under its revised capitalist system, by which time the policy had generated a sharp rise in the ratio of old to young that will soon result in a heavy dependency ratio and an increasing drag on growth going forward.

War II. The unification of Germany, and the vast €2 trillion resource transfer from West to East that facilitated it, created a new economic powerhouse at the heart of Europe, while communist economic systems were replaced by capitalist systems in the rest of Eastern Europe and in Russia itself. Despite this transformation of the East, however, political extremism—mainly on the right—and xenophobia has returned to haunt countries that were formerly behind the Iron Curtain. In part, this represents a counter-reaction to the "intrusion of the international over the national" evident across the EU and to the failure of globalization experiments like the Euro and European laissez faire policies regarding migration. There are two ways to respond these failures—one is to continue the process of integration (like Germany in 1989) and the other is to slow it down. Munchau considered the latter scenario to be more likely.

Andre Sapir looked first at the evolving relationship between the developed and developing world. He asked, on the presumption that the latter were able to overcome the inevitable political and economic challenges to maintaining their growth momentum, whether the developing world would be willing to cooperate with the developed world in the framework of the existing order of global governance—devised as it was mainly the British and Americans at the end of World War II. Or will there be tensions between the rising powers and the old ones, as there was in the last great phase of globalization in the run up to World War I when the key developing countries were Germany and Japan? Sapir then considered Europe's choices ahead—whether to deepen the transatlantic relationship with TTIP which is as much a political and security relationship as an economic one, or whether to take a more balanced international perspective of alliances. Either way, Sapir remained convinced that the EU would survive, in one form or another, and that there would be a single currency, though perhaps with different members and different rules.

Innovation in Europe – Facts, Causes and Consequences

The second session of the day was devoted to the subject of innovation, and more particularly to the apparent decline of innovation in continental Europe. **Edmund Phelps** and his team from New York presented a raft of facts and figures in support of his thesis that, while the pace of indigenous innovation has gone up and down in all countries since the great surge in the 45 years prior to World War I, it has recovered since the 1970s in the USA and the UK, but declined in Germany, France and Italy—which were once amongst the most innovative countries in the world. While Europe could still generate respectable growth rates by importing innovation and ideas from abroad, the lag involved meant that their level of GDP per capita would always be behind that of the countries that were the innovation originators. Such a strategy reflected an unwillingness to take risks and would, moreover, fail if there were to be a slowdown in innovation in the originating countries. Phelps' thesis is that the relative absence of an innovative and entrepreneurial spirit, possibly traceable to cultural and institutional variables, had damaging economic and social consequences. In addition to lower relative wages and lower returns on capital and thereby on savings, a lack of innovation impacted adversely on non-pecuniary rewards to work. The sense of "prospering", of reaping hoped for rewards from enterprise, of experiencing "personal growth" from using ingenuity and knowledge to solve problems, and of "flourishing" depended, in Phelps' view, on more than just doing a job and earning a wage, but on the exercise of "human agency" in taking the initiative and exploring new paths. Phelps believes that it is this loss of dynamism, rather than the slow wage growth, that explains why Italy and France are at the bottom of the usual tables on job satisfaction. What is needed is more engaging careers—a return to "modern life" itself.[6]

Capital markets, ageing and pensions

The discussion on capital markets, ageing and pensions explored the consequences of the potentially explosive combination of four adverse developments for the provision of pensions: adverse demographic trends with rising dependency ratios, (ii) growing pension liabilities, and increasing numbers of pension schemes in deficit, (iii) falling returns in capital markets – especially in those assets such as gilts and other government bonds that pensions funds invest in to match maturities between assets and liabilities, and (iv) regulatory constraints (actual or prospective) following Solvency II and Basel III that could inhibit pension funds and life insurance companies from diversifying into higher yielding equities and other long term (but less liquid) investments. To some extent, these problems are global, but they are especially acute in Europe, because investment yields are particularly low, dependency ratios are high, and a large share of pension liabilities fall in the public sector. **Christian Thimann** followed up on these themes, and pointed out that the dilemma of unfunded, or underfunded, pension schemes is made worse by the fact that price inflation for the types of goods and services future pensioners will require – in particular in healthcare – is running much higher than the very low overall headline inflation figures suggest. Given the very low returns available (partly as a result of policy-induced zero or near zero long term interest rates), this means that the real returns available for pension provision are negative. Thimann called for a more long term orientation to financial planning, including considering moving away from mark-to-market accounting for earmarked long term savings products and performance measures. **Ashok Gupta** expressed frustration that regulation and solvency requirements have pushed UK institutions, over many years, out of equities into bonds, so reducing yield and removing any natural inflation hedge. Indeed, regulation of life and pension businesses in the UK have prompted them to hold much larger pools of liquidity than the long- term nature of liabilities would require. He noted how the share of investment by British corporate pension schemes in equities had fallen steadily from about 80 percent in the mid-1990s to under 40 percent by 2014, with most of the difference being made up by bond purchases. The collective pension deficits of the top 350 UK listed companies have doubled from around £50 billion in 2014 to £100 billion in 2016. Without the prospect for superior returns in the future, pension funds will have to either raise contributions, or reduce benefits, or both. **John Muellbauer** focussed on the effects of Quantitative Easing (QE). While this policy was helpful in the early stages of the recession in the USA, mainly by engineering a recovery in house prices and thereby supporting consumer spending, it has not been effective in Canada, Germany, France and Japan, where the mechanism of equity withdrawal is not available. It has also made pension

[6] See link for the full text of Edmund Phelps' speech.

provision harder for companies which must either dip into their profits, cut benefits or increase contributions—none of which helps to stimulate demand. **Colin Mayer** stressed the need to get the balance of regulation right. Recent regulatory reform has had the effect of encouraging both pension funds and life insurance companies to move away from equities and into "low risk" assets like index-linked bonds with a view to better match their long term assets and liabilities in a low-risk manner. The shift out of equities has also resulted in the decline in the share of UK equities owned by UK pension funds and insurance companies being offset by foreign investors (who now own 40 percent of UK equities compared with only 15 percent in the mid-1990s) and other institutions like hedge funds which have a short term investment horizon. Neither of these developments is comforting or conducive to good governance.

Future of Europe – roundtable discussion

The conference concluded with a roundtable discussion. **Peter Jungen** stressed that despite the global economic pessimism, there are reasons to be optimistic about the world economy, and used a prescient quote from John Maynard Keynes to illustrate how earlier episodes of pessimism have been confounded by subsequent events.[7] Jungen reminded the audience that global economic growth from the birth of Christ to 1800 was negligible compared to what is being experienced even now, and that one billion have been added to the labour force since the fall of the Berlin Wall. If there is a problem, it is in Europe, which is suffering from a self-inflicted crisis—the Euro and the debt crisis. More fundamentally, Europe is not doing enough to stimulate innovation and entrepreneurship. The Lisbon agenda of 2000, which staked out the ten-year objective of making Europe the most dynamic knowledge–based region in the world, has clearly not been achieved—possibly because it never once mentioned the word "entrepreneur" as the key driver of innovation. In the succeeding plan "Europe 2020" (another ten-year plan), there is a (single) reference to entrepreneur, and this with regard to giving the entrepreneur a second chance in the event of failure. The dearth of start-ups in Europe is notable even in Germany, which sits 100 out of 160 countries in the World Banks index of "ease of starting a business". This is a reflection of the European intolerance of failure. It is also a reflection of the European social welfare dependency culture, which is the highest in the world. Jungen concluded that there are no guarantees that civilizations will still stay great (as the Arab world has discovered), or that they will become great (as Europe did in the latter half of the second millennium)), or that they will resume a position of greatness once lost (as China has done). **Juan Sola** warned the European project against the dangers of "corporatism" and populism", drawing on the experience of South America. Sola cited the Common Agricultural Policy as an example of corporatism at work, being a system that subsidized agriculture and

[7] "We are suffering just now from a bad attack of economic pessimism. It is common to hear people say that the epoch of enormous economic progress which characterised the nineteenth century is over; that the rapid improvement in the standard of life is now going to slow down –at any rate in Great Britain; that a decline in prosperity is more likely than an improvement in the decade which lies ahead of us. I believe that this is a wildly mistaken interpretation of what is happening to us. We are suffering, not from the rheumatics of old age, but from the growing-pains of over-rapid changes, from the painfulness of readjustment between one economic period and another. The increase of technical efficiency has been taking place faster than we can deal with the problem of labour absorption; the improvement in the standard of life has been a little too quick.", opening lines from "Economic Possibilities of our Grandchildren" in *Essays in Persuasion*, John Maynard Keynes (1931).

restricted competition, enraged other countries, and even brought divisions within the European Union. Populists (who can be nationalist, leftist or rightist) offer a vision of social identity in terms of "enemies", where nations, classes or the "common good" are opposed, for example, by race, immigrants, foreigners, refugees, or free trade. Populist leaders "awaken" the people to these dangers. Pluralism and economic dynamism are impossible in corporatist and populist societies. Associated with these features is the idea that politics is a "struggle" against, for example, individual greed, or transnational bureaucracies. This leads to a resistance to competition, which (it is believed) breeds egotism, arrogance and inequality. Corporatism, by contrast, is posited as favouring stability and social equality. The corporate society is represented by the triangular relationship between companies, trade unions and the state. Sola concluded by confiding the South America wishes the European Union well, and that it might one day copy the experiment. He cited the philosopher Ortega y Gasset who predicted that Europe would only unite (in the wake of the First World War) when China invades Russia or the "Islamic Magma" begins to move.[8] In the meantime, Sola urged Europe to accept uncertainty, competition and the possibility of a new renaissance, and reject corporatism and the inevitable slide into stagnation and authoritarianism. **Saskia Sassen** began her presentation by observing how Germany, while declining as steeply as other European countries in the wake of the global crisis, has since recovered all the lost ground and this, she felt, owed a lot to the nature of Germany's specialist manufacturing sector, especially in machine tools. Nevertheless, she was impressed by the damage that the crisis has done to what she called the "economic logic" that prevailed before the crisis. She noted the high level of residential foreclosures, both in the USA and in Europe, the disturbing trend of trading in so called "dark pools", especially in the USA. Was there any reason for optimism? Perhaps the crisis will stimulate a new wave of innovation, related in part to the migration of highly educated economic and political refugees. Finally, **Paul Seabright** returned to the subject of the unification of Germany as an example of globalization, but drew a more negative conclusion about the effect of unification on the concept of "worthwhile work" in the East, which disappeared with the rise in unemployment in the East and its welfare dependency on transfers from the West. Seabright argued that the debate on globalization needed to look more closely at the role of firms, as opposed to nation states. He claimed that firms are doing an increasingly poor job of providing workers with the idea that their lives have meaning through their work. Seabright pointed to the need for a narrative, like the Odyssey, which could supply a challenge, a journey, and a homecoming. Firms needed to provide this sense of a "quest" for their workers. Instead, the narrative that people seek for their lives is all too often supplied by nationalism. Seabright also noted that divergent narratives played an important part in explaining why the Greek debt crisis was seen as pitting irresponsible Greeks against stern Germans in a way that threatened the viability of the Euro, whereas the Californian debt crisis had given rise to no such group stereotyping and had never been considered to threaten the viability of the dollar."

[8] José Ortega y Gasset was a Spanish liberal philosopher, and essayist. He worked during the first half of the 20th century, while Spain oscillated between monarchy, republicanism, and dictatorship.

Speakers and discussants

- **Professor Saifedean Ammous**, Assistant Professor of Economics, Lebanese American University
- **Professor Eric Bartelsman**, Director, Tinbergen Institute; Professor of Economics, Vrije University, Amsterdam
- **Adam Bennett**, Deputy Director of the Political Economy of Financial Markets, St Antony's College, University of Oxford
- **Professor Raicho Bojilov**, Assistant Professor of Economics, École Polytechnique in Paris
- **Professor Ian Goldin**, Director, Oxford Martin School; Professor of Globalisation and Development, University of Oxford
- **David P. Goldman**, Contributor, Asia Times
- **Ashok Gupta**, Defined Benefit Taskforce, Pensions and Lifetime Savings Association
- **Peter Jungen**, Chairman, Peter Jungen Holding GmBH
- **Professor Colin Mayer**, Peter Moores Professor of Management Studies, Said Business School, University of Oxford
- **Professor John Muellbauer**, Deputy Director, Economic Modelling, Institute for New Economic Thinking at the Oxford Martin School, University of Oxford
- **Wolfgang Munchau**, Associate Editor of the Financial Times
- **Professor Kalypso Nicolaïdis**, Professor of International Relations, Director of the Centre for International Studies, Faculty Fellow, St Antony's College, University of Oxford
- **Professor Edmund Phelps**, winner of the 2006 Nobel Prize in Economics; Director of the Center on Capitalism and Society at Columbia University
- **Professor Richard Robb**, Professor of Professional Practice in International Finance, School of International and Public Affairs, Columbia University
- **Professor André Sapir**, Senior Fellow at Bruegel, Professor of Economics at Université Libre de Bruxelles
- **Professor Saskia Sassen**, Robert S. Lynd Professor of Sociology and Member, The Committee on Global Thought, Columbia University
- **Jean-Luc Schneider**, Deputy Director, Economics Department, OECD
- **Professor Paul Seabright**, Director of the Institute for Advanced Study, Toulouse School of Economics
- **Professor Juan Sola**, Director of the Centre of Law and Economics, University of Buenos Aires
- **Dr Christian Thimann**, Group Head of Strategy, AXA
- **Professor David Vines**, Acting Director, Political Economy of Financial Markets Programme; Professor of Economics, University of Oxford
- **Professor Gylfi Zoega**, Professor of Economics, University of Iceland and Birkbeck College, University of London