

PANEL DEBATE
How to Get Growth while Cutting Public Expenditure
Moderator: Nik Gowing

Rt Hon Dr Vince Cable MP

Thank you for inviting me, and it is a pleasure for me to be at the Königswinter Conference. It is sixty years since its inception, and this grouping has played an extremely important part in cementing friendship between Britain and Germany. It is especially good to be here with Herr Brüderle, and I am hoping to have private conversations with him afterwards about managing coalition politics. He also has a Ministry with a similar role to mine, and when we last discussed issues we had the same mantra, about growth-friendly deficit reduction in both countries.

More widely, the UK has a lot of common ground with Germany. We have odd disagreements, but a lot of common ground and, as we're finding in the Coalition, it is possible to have differences and still maintain a friendship.

Let's be clear, first of all, about how integrated our two countries are. After the United States, Germany is Britain's second biggest trade partner, and in recent years has been our second biggest inward investor; I think the current figures are that 3,000 German firms are invested in the UK and they employ 400,000 people, so a very substantial contribution. In the reverse direction, in Germany there are thousands of British firms employing 180,000 Germans.

In some ways our two countries are undoubtedly converging. The British are trying to become more of an export-oriented economy; I think the Germans, for their part, have adapted the concept of flexible labour markets with some difficulty and, as we have discovered here during the recent economic crisis, flexible labour markets were actually a rather helpful way of cushioning some of the impacts on unemployment. We both boast world-class science and research, although we still have a lot to learn from Germany. One of the concepts we are currently trying to develop in government is building on the ideas of the Fraunhofer centres, and seeing how we can adopt that approach to science and innovation in the UK, and develop it.

There is a lot of common ground also on EU trade policy. I think we would both consider ourselves to be free trading countries, with belief in open markets as being the best way to help our own countries, but also to help global economic welfare, and to reduce poverty. As a focus for discussion here there is a window of opportunity with the Doha talks in 2011, but it will be very difficult to make progress. I think there needs to be some clear signal at the G20 meeting about the way forward. Most of the problems at the moment are in the United States, but not exclusively, and if we are going to have a successful round there will have to be more concessions for the EU, particularly on agriculture. It will be useful to have a discussion about how feasible that is, and what are the prospects of proceeding through that multilateral route, where we have common ground.

In the meantime there are a lot of pressures to press ahead with bilateral arrangements. This is clearly sub-optimal, but it's one way of making progress, and after Korea the next step will probably be with the Mercosur countries, led by Brazil. I

was there a couple of weeks ago, and they made it very clear that they wanted to see real progress. There is an opportunity to have an agreement that would actually cover more than any other major country, including India, if that agreement were concluded. But they also make it clear what they want. They want better access for agriculture, in return for access to their markets for services, manufacturing and public procurement. The question is, is it feasible? Should we be going down that road?

On another subject, we believe in the UK that there needs to be more discipline on the EU budget, and we want to work together to have reform. The European budget and gross contributions are increasing at a time when member states are least able to afford it, and I have to say that, with big spending cuts in prospect in the UK, there will be real public anger if the EU budget and its contribution are not cut as well. I want to raise the question of how we can work together to get a smaller budget, and help this process to contribute to the fiscal consolidation that both our countries have to undertake – and indeed, how we can reform the budget to get it to focus on those areas where the EU does add genuine value.

I think it would be useful, too, through this forum to discuss issues where we may have a degree of difference. It is obviously helpful at a political level to be able to say that we're sharing the pain of fiscal consolidation, but economically there has to be some concern that all EU countries may now be exporting deflation to each other through collective fiscal tightening, and there is a case for a differentiated approach, depending on different circumstances, and recognising that there are structural imbalances which are reflected in the current account.

Given that there is a lack of flexibility in monetary and fiscal policy, and that's the nature of the disciplines of the Union, Europe urgently needs supply-side reforms to improve its growth; potential growth across the EU is forecast to recover to just 1.7% in 2014, so there is a question about what we do to accelerate this process, and how realistic is it to inject new sources of dynamism like opening up the Single Market, following through on the Monti proposals.

These are tricky issues, big questions, and there are others; we are hoping that we will receive good creative feedback from your sessions. I look forward myself to future meetings next year in Germany, and I very much look forward to being there.

Rainer Brüderle MdB

First of all, thank you for your work. The Königswinter Conferences are an ideal round table of British-German relations, an exchange of political ideas of great importance to our activities in Parliament. I hope very much that you can continue pursuing this effective and serious aim.

How to get growth while cutting public expenditure – that is the theme on which I am to speak. The question assumes a contradiction between cuts in public expenditure and fostering of growth. Let me say right away that I do not see any such contradiction. After all, the money which a state spends doesn't grow on trees, nor can the state simply print it. There are good reasons for our growth. The United Kingdom and the Eurozone have independent central banks. The taxpayers

first have to earn the money which the state spends, either this generation of taxpayers - or else the state borrows money, and leaves it to future generations to pay off the debt. We are all well aware of this in Germany, and as my dear colleague just explained you are no less aware of it here in Britain.

For the first time in many years the Liberal Democrats are in office in London, which fills me and the entire Liberal family with pride and joy. Liberals are guarantors of reason and a sense of proportion in government. Mr Cable, Britain and Europe are most fortunate that you are pursuing your Liberal-style economic policy in Britain. It is no surprise that the UK has a sensible economic policy.

Britain has produced great economists and philosophers: Adam Smith, John Stuart Mill, John Locke, Thomas Malthus and others. When it comes to today's topics, two great British economists are particularly important, David Ricardo and John Maynard Keynes. From Ricardo we have learned that today's debts are tomorrow's taxes. The public sector deficit cannot keep rising for ever, and the public knows it. They know, sooner or later, they will have to pay for the debts taken on by the state. Economists call this Ricardian equivalence. So there is more to economics than Keynes. In fact, academics argue about how great the "Keynsian multiplier" effect of additional, debt-financed government spending actually is. The less confidence the public has in the stability of public sector finance, the smaller the effect. It shows that the state can intervene, and sometimes it has to intervene, perhaps to stabilise a crisis situation. But it is equally true that government spending needs to be reined in again during an upturn.

We are now seeing a recovery. The economy is slowly picking up again in the UK, as you have just explained, while things are happening slightly more quickly in Germany. Leading economic research institutes have increased their growth forecasts for Germany in recent weeks. The GDP may expand by more than $2\frac{1}{2}\%$ this year, the European Commission's forecast is 3.4, and - something that is particularly important for me - our upturn in Germany is an "employment upturn". Seasonally adjusted employment has nearly reached its required pre-crisis level again. Unemployment has fallen, and is down near to the 3 million mark. Even during the crisis, many international observers were envious of Germany's job miracle.

In contrast to almost all the other OECD countries, there was virtually no rise in unemployment at all; despite a severe drop in orders and turnover, companies held on to their staff. Working together with staff representatives, they responded responsibly with flexible structures. After all, it is important to take precautions, not only for a rainy day but even for fine weather. Firms are well aware just how dependent we are on a highly skilled workforce. They are now reaping the benefits of their foresight. It is accomplished by their hard-working staff who generate our growth and prosperity. The upturn we are now experiencing is their upturn.

But it is only fair to say that the Government does have a part to play as well. It is our job to ensure sound public finances, and scope for future growth. This is exactly what the Conservative/Liberal governments in the UK and Germany are doing. In Germany we have responded vigorously to the crisis with stimulus packages and acts of growth acceleration. At that time we had a Keynes situation. The German Government provided individuals and businesses with permanent tax relief,

amounting to roughly 24 billion euros per year, as of 1st January this year. Now, with the upturn, we are changing, away from a crisis response and towards a strengthening of the long-term forces for growth.

In fact, that's what Keynes recommended, but sometimes people have only read the first chapter and not his whole work. We need to go back to the right balance between state and market. Because of the global economic and financial crisis, the balance shifted strongly towards the state, due to many rescues of banks, companies and even entire economies. That cannot be a permanent situation. In an upturn, public sector programmes need to be scaled back. Exit from the crisis measures is a question of credibility, and credibility is something very precious. If nothing else, we should at least have learned from the financial crisis that, if people have no trust in the ability of governments to cope with the situations, they won't spend their money, they won't invest; if they don't invest or spend their money we have no growth, no jobs and no upturn.

At the moment, Germany has public sector debt coming up to 80% of GDP. Our schedule is to reduce this step by step, first with a budget cut of about 12 billion euros, our intention being by 2016 to come down to new borrowing of less than 0.35%. It is easier to turn budgets up, and harder to turn them down, but we have to do it. If you like, it can be called a non-Keynes effect; the people need to trust that the state is able to cut back, to do the same as every person does. If I haven't enough money, I have to save, and I have to set a time-table for long-range plans to spend money, say buying a car two years later, and the state has to do exactly the same.

This way, you have no contradiction between budget cutting and getting growth. It is two sides of one method, and two attempts we have to make, and I have the feeling that you are on the same path as we are. The first step is hard, the next is even harder, but finally we will have success.

Discussion

The free discussion which followed moved between the subjects of Growth and the Budget Deficit.

The first major item for discussion was the Euro. Charles Grant pointed out that neither speaker had mentioned it, and that the Euro crisis was tarnishing Europe's reputation in countries like China and India. He observed that in Germany public opinion was generally hostile to the Euro, though the business and political elites understood that it was good for Germany. He therefore asked why German politicians had not done more to explain the benefits of the Euro to the German people. Rainer Brüderle enlarged on the reasons for the crisis, such as lack of a common political coordination, a lack of competitiveness in some countries, and the weakening, by France and Germany, of the criteria for membership. Vince Cable said that Britain had been affected by the crisis even though not a member; ten years ago he had been a strong advocate of membership, and Britain had derived benefits from having a flexible exchange rate, but these were short-term. Andreas Busch thought that Germany had had more disadvantages than advantages from membership over the first five years, due to losing relative

advantages, but started to profit from it after, in 2005, embarking on a painful course of reforming the labour market. Since the onset of the financial crisis, however, the Euro had been a definite advantage for Germany due to precluding a revaluation as would have occurred under the Deutschmark.

On the subject of Growth, there was a detailed discussion, with particular focus on the German position. Derek Scott pointed out that Germany had been very uncompetitive after unification, and the reason its competitiveness had improved was that the European Central Bank had kept interest rates low for Germany, which has led to high rates of inflation and credit bubbles in several countries in the periphery of EMU. Even despite this, Germany was not able to consolidate its budget deficit, so it was unrealistic to expect countries like Greece to improve their competitiveness by deflating their economies when Germany couldn't. Rainer Brüderle replied that it was true that after unification Germany had had a problem with debt, because they were confronted by a new situation, with two completely different systems coming together overnight. But if you had a common central bank you had a common interest rate, which limited the ability to control your budget. As far as Greece was concerned, it was their decision to join the Euro, and if you joined a club you had to obey the rules – a point he emphasised more than once. Ulrike Guérot said this sounded as though other countries were being told they must do what the Germans did, without the recognition that other countries were very different from Germany.

Alastair Darling agreed that the German government's policy of supporting East Germany made absolute common sense. However, he thought Germany was reluctant to recognise that there was bound to be a problem if one set of countries was doing very well while another was taking deflationary action; if you were part of a single currency, even without a political and economic union to back it up, it had certain consequences. Rainer Stinner pointed out that, even after twenty years, there were dramatic differences in the income levels of East and West Germany.

Iain Begg asked what the optimal size of the state was to promote growth, and within that optimum which headings of expenditure should be promoted, and which reduced. To this Vince Cable replied that the British government's aim was to reduce the structural component of the budget deficit over a relatively short period of time, and it was not helpful to have a general definition of the overall level of spending.

On the rate of the deficit reduction, Alastair Darling wondered whether it was axiomatic that if you cut back public expenditure the private sector would step up and take its place. Vince Cable did not think it necessarily happened automatically; you needed a combination of macroeconomic policy, which included expansionary monetary policy, and intervention at a micro level in various ways. He did not see a fundamental difference of philosophy on the cuts, only disagreement on pace.

The final word on growth went to Alastair Darling, who lamented the lack of a common agenda between Britain and Germany; in all the European meetings he had attended there had been much talk about the reforms needed on the Lisbon agenda, but nothing had happened. There must be a common agenda, whether on the Common Agricultural Policy or on changes needed to be made on rigidities

in the labour market, otherwise Europe's growth would be sclerotic. This was a theme touched on by Ludger Kühnhardt with reference to budget cutting. He thought this was the time to consider pooling resources, and a European tax, a view greeted with some pessimism by Vince Cable; different governments had tried, he said, but the British found the European budget unproductive, focusing too much on agriculture rather than things like research and development.

This led Heather Grabbe to suggest that, rather than talking of cutting the budget, there should be a positive agenda for using it better, and with this in mind proposed that the CAP be changed from a Common Agricultural Policy to a Climate Adaptation Policy, directed towards a low carbon economy. Again, Vince Cable was not encouraging; although Britain and Germany knew they had to move towards a low carbon future, and the Germans were doing better in renewable energy than the British, the EU approach to research did not give him cause to hope. He cited the example of the International Thermonuclear Experimental Reactor (ITER), to which Britain was contributing a large amount of money, and which he had discovered was not likely to produce a prototype for at least thirty years.

Matthew Baldwin, though as he said less brave than Heather Grabbe on the subject, was struck by how the British debate on the budget always began with the "quantum" rather than the "what". If one was going to have a fundamentally improved European budget, one must start with what the money was going to be spent on. Apart from R and D, he would like to suggest energy interconnections, since the energy infrastructure in Europe was insufficient.

Among other topics, exports were discussed, with Dr Karl-Ernst Brauner, in reply to a question from Lucy Neville-Rolfe, saying that Germany was doing very well, because they were 5% better interconnected with the growth markets of China, India and South America than the rest of Europe. Antje Hermenau however pointed out that, while Germany was indeed successful at the moment, and this success might continue, it could be over in two years. Will Straw raised the question of the British cap on non-EU immigration, as likely to hamper recovery, to which Vince Cable responded that, while he was a member of a cabinet which had collective responsibility, on behalf of business he would continue to argue in favour of flexibility. Points made by Quentin Peel included, first, the hope that the services sector in Germany could be more liberalised, and also a wish for greater responsibility in Britain about the sterling exchange rate, as a 25 to 30% devaluation in sterling had been destabilising for the rest of Europe, with Ireland particularly badly hit.

When the discussion closed, delegates had already a great deal of material to bring to their groups, the last mentioned being Alastair Darling's hope that the next 24 hours could focus on subjects like the need for internal change in Europe, rather than events in British politics, however entertaining they might be.

REPORT ON GROUP 1

John Plender

It is an extraordinarily difficult challenge, as a rapporteur at Königswinter, to try to bring together the disparate strands of conversation that one listens to and participates in. At least in my session on the subject of "Can democracies deliver and how do we secure economic recovery?" we could agree on something very fundamental at the outset, that democracies will have to deliver because, although to a degree there has been a debate around the world about models of capitalism, and different ways of doing things, I don't think anybody is suggesting that China offers a viable user-friendly alternative to our democratic way of doing things, still less North Korea.

We kicked off by considering the causes of the crisis, as a necessary requirement to discussing policy responses. This is difficult, because if you think about this financial crisis, and compare it with previous ones through history, it is hard to think of any one which has had such a huge variety of underlying causes – it is a very unusual crisis in that way. What I can say about our discussion on causes is that among the most fundamental things we emphasised, even if we didn't entirely agree on them, was that global imbalances were extremely important, and there was a sense that, whatever your view about the causes, something is not working properly about the way capital flows operate in the global system. Also, monetary policy has been dysfunctional, and the central bankers have fallen short in their conduct of that policy, which is a fundamental problem that needs to be addressed.

What we tried to do was to get the gathering to sign up for five propositions, and we managed to achieve this with a surprising lack of dissent.

First, in addressing issues of debt in the system, we were able to agree that economic growth was crucial, but we were concerned where demand was going to come from to drive the European economy as fiscal stimulus was withdrawn, being unconvinced that the private sector yet had the confidence to pick up the baton from the public sector. We believed that the prospect was for a very unbalanced European recovery, with Southern Europe being required to make a huge adjustment without the help of devaluation, so that the deflationary pressures would be very hard for their systems to bear. Against the background of a fundamental lack of competitiveness in much of Southern Europe, we felt that on current policies debt reconstruction was probably unavoidable.

On our second proposition, we felt that there was huge uncertainty about the effectiveness of policy in this recovery. On the monetary front we obviously have minimal flexibility with the interest rates weapon, so we are more dependent on unconventional measures such as quantitative easing, and I think most of us felt very unconfident about how that worked, and whether it could deliver in current circumstances, and even what it would deliver. We also felt that the scope for policy mistakes at this juncture was uncomfortably large. If you look at fiscal policy, clearly on both quantum and timing there are some unattractive precedents, Japan in the 1990s and the US in the 1930s, which warn us of just how badly things can go wrong if the judgements are not good.

On the specifics of tax and spending cuts, the one thing that we all agreed on was that we were very concerned that too much of the cutting was falling on the investment side of the equation, and not enough on current spending, which meant that we were not looking after the future as we should. On the supply side of the European economy, we felt that there were major market rigidities going unaddressed – it is very much an agenda that has gone onto the back burner, partly as a result of the crisis but also arguably because inertia set in long before.

Proposition three concerned European governments, and more specifically fiscal Europe, where we couldn't see much scope in the short term for progress, after the failure of the Stability and Growth Pact. The game, people argued, ought to be about developing clever forms of reprimand – we wanted to avoid using the word sanctions – but it was clear that national interests and perceptions at the moment stood in the way of developing a really convincing set of rules for us to do that. Our suspicion was that we were unlikely to end up with much more than token gestures in terms of taking fiscal Europe forward.

Proposition four concerned banking. We recognised that there was a fundamental contradiction in the way people felt about the response to what the bankers had done to us and to the global economy. On the one hand, everybody wants the bankers to submit to tough capital requirements, to make it harder for them to have another shot at blowing up the world economy, but everyone also wants them to lend more to support economic recovery. You can't have both – they are fundamentally incompatible. However, I think we recognised that Basel 3 did at least offer some kind of compromise on that contradiction, with its very stretched time-table.

We also felt that there was in a way a fundamental problem for our democracy in addressing this kind of financial crisis, because the sheer complexity of so much of what had gone wrong in the system, particularly to do with the nature of the financial instruments that the banking system had been producing, was such that most politicians and members of the public simply did not understand what had been going on. What we do understand is that they have been hit very hard in their pockets, and they want blood from the bankers, and because of the contradiction I have mentioned it is very hard for them to have that quite as they would like it, which poses questions of legitimacy about the way our democratic process works.

There was a sense around the table that there had not been outstanding leadership, whether at a global, a regional or a national level, in the kind of response that had been delivered to this crisis, and this is a worry that I would raise. We started with a very good response from the G20, but it looks as though this has been substantially dissipated as the shock has moved further away from us, and particularly if you look at events this week, with the Japanese currency moves, we are very much into a *sauve qui peut* world of competitive devaluation, with a question within Europe about whether people's perception of national interests isn't much narrower than it would have been some time ago. At the national level, I think we all recognised that there were huge political challenges. It is very difficult to go about the job of fiscal adjustment, and of public spending cuts. On the other hand, there are things you can look at in terms of policy responses on the cutting side, for example like extending retirement ages, which we know has got to happen; but when you look at what is happening now it is very, very timid. Looking at the obvious case, France,

and what has happened there over the past few weeks, they are talking about a rise from 60 to 62 years, when maybe what they should be talking about is 65, 67 or even 70.

Those were the things we thought we could all sign up for. I am afraid we were very conscious that it was a rather negative set of statements, but we also felt that they were realistic.

REPORT ON GROUP 2

Dr Ulrike Guérot

I have a very difficult task in reporting on five hours of very intensive discussion, and I have been told that I should tell the truth, only the truth, but not the whole truth! The whole truth is that we didn't find many answers, but we tried to square the circles, and to pose a couple of very good questions. In essence, we concluded that, after breaking it up into all the topics we discussed, if it were only possible to achieve a higher degree of political will within the EU, the Union could at least live up a bit more to its potential – though that is an idea I have been hearing for twenty years or so!

We started off with energy. There was quite a lot of agreement round the table that this is the topic of the decade to come. It would be important to design a united European energy policy and one could build a new narrative for Europe out of this; it is a necessity for Europe to think of a common energy market; and of course under the conditions of the current climate policy the promotion of renewable energy is required. We agreed that this must be done Europe-wide, because only with Europe-wide grids allocating hydroelectric power, wind power, solar power and others on a cross-national basis, would one be able to cover 80% of the EU with renewable energy. We also agreed that a truly European energy market should be largely market driven. There should be no dreaming of handing over competences in European energy policy to the European Commission (which was clearly said to be unrealistic); however, if one lets companies work on the grids and lets them make a 'European Green Deal' project, perhaps this could be a uniting project for the coming decades.

Also with relation to climate policy, it was suggested that in Europe we might be currently ignoring that China and the US had learned their lessons of Copenhagen; that they are actually catching up with renewable technologies, and that the EU should speed up its energy and climate policies, also by engaging in a redistribution of the EU budget (with financial review to come) and to shift more money into these policy areas. Concerning the latter, there was agreement, but when we discussed whether Europe would be able to concentrate on such European projects, we finally ended up in a discussion about the Euro. There was much concern whether Europe might be so busy with navel-gazing and its own domestic problems (especially the Euro crisis) that it would not be able to deal with far-reaching projects such as energy in an appropriate way.

With respect to the Euro crisis, I think the fault lines of our discussion were pretty much the same as those in yesterday afternoon's discussion. There was a lot of concern that the southern countries of the EU had lost competitiveness, and could not gain it

back under current conditions; they cannot devalue, there is no inflation, they cannot exit the Euro, so basically they have no chance to recover. This will probably put huge pressure on the EU, especially on the Euro. The question in our discussion then was, whether Germany was aware of that fact, and whether Germany would converge, and whether indeed it could converge under its domestic political and economic conditions. The problem is foremost a recognition problem: the German economy is now performing well again, Germany has a return of competitiveness, and it is once again export champion, but what the German domestic discussion ignores is that Germany may be performing well but that its performance is on the back of the others. So how could one organise a discussion about European aggregated competitiveness and convergence, and how can one prepare Germany for this discussion? We had fierce discussions about whether Germany could change the export driven growth model, and we all came up with the conclusion that it probably could not. This is a tragedy, because it means that the current problem of economic imbalances within the EU is going to continue.

We also talked about what had been achieved so far under the Van Rompuy group, and it was agreed that on the fiscal side, meaning the preventive and the corrective branch of the Stability and Growth Pact, we probably are going to see some progress; i.e. we will see progress on the so-called 'European semester', on increasing the capacity of the Commission to sanction deficit sinners without a unanimity decision of the Council, and so on.

Hence, there was discussion about the 'moral hazard problem' within the Euro zone, which remains unsolved. Seen from a German perspective, you either need to take the 125 'Bail-out clause' of the Maastricht Treaty seriously or not. The real policy imperative is that we need to get the EFSF permanent, because for the moment it is only temporary and ends in 2013. The question is whether we get it permanent under the current conditions, or whether we get it permanent and change it. The 'moral hazard' problem is that you have countries with social systems that they cannot afford. Therefore the EU would become a transfer union at the moment the EFSF becomes permanent in its current structure, because it ultimately states that all stand for one, whatever happens. I guess the negotiation situation is that Germany recognises that the Euro zone or the EU at large probably needs to get the EFSF permanent, but it wants a structure for the EFSF containing a 'structured or orderly default' mechanism; this would maintain Article 125 of the Maastricht Treaty (bail-out) as valid in principle and keep the problem of 'moral hazard' restricted; while other countries would prefer to get the EFSF permanent under the current conditions, which Germany will probably not accept and also probably could not accept because of its Constitutional Court.

So we ended by discussing the legal situation, which seems to be the 'quadrature' of the circle. Europe needs to come up with a solution for the EFSF that is acceptable to the Germans, negotiable in Brussels, and doable with Karlsruhe for constitutional reasons. Most Germans in the room considered that, if you want to change the EFSF to get it both permanent and with a 'structured default' mechanism, a change in the treaties is unavoidable. One would need a treaty change for the German proposals in the Van Rompuy group as well, i.e. to suspend voting rights in the EU Council for deficit sinners or to cut back cohesion funds. We basically found no solution to this question, but at least we agreed on the analysis of the crisis.

From there, we moved to neighbourhood policies, and with respect to enlargement policies we went through the Balkans, Turkey, the Ukraine and the Eastern partnership. On the Balkans we were more or less sure that the EU would proceed to membership, but more slowly than it was thought before. However, in some ten years' time there was a decent chance of getting the Balkan countries hooked on the European accession path.

On Turkey we had a more intense discussion, because the fault lines of the discussion were more complex. Basically, it turned on whether the EU had already 'lost' Turkey, and whether we were fooling ourselves into the dream that Turkey would fully join the EU; or whether Turkey is already looking elsewhere, especially to its own East with the ambition to become a regional power. Only 30% of Turks want to join the EU today; Turkey wants to be a real player in the region, and the EU has failed so far to offer a clear perspective for Turkey. One sort of 'quick fix' solution was that the EU should offer Turkey something like a full-membership deal, but do it quickly and under certain special provisions that would accommodate the 'real' problems the EU has, indeed, with Turkey's accession. For example, as Turkey has a population of 90 million Muslims, it would become the largest member state of the EU, and it would also acquire the largest number of weighted votes in the EU Council and the largest number of seats in the European Parliament. On the other hand, many people in the room were against this solution, saying Turkey and the EU were on two different trajectories already. Europe had already missed the momentum; the most likely scenario would be that accession negotiations would get stuck next year on Cyprus and the Ankara Protocol. The overall assessment in the room was that the EU would be going nowhere with these negotiations (other than keeping them alive for the sake of keeping them alive, and being ultimately able to pass the mistake for their failure to the Turks), if it waited too long with the promise of membership.

With respect to EU policies towards Ukraine and towards the other countries of the Eastern neighbourhood and the Eastern partnership, the group could analyse the situation but not move it further to concrete solutions. It was thought that the EU should not cause Ukraine to be pulled between East and West, but accept that the Eastern partnership policy could not and should not be a substitute for EU enlargement. We also agreed that the enlargement policies of the last decade, especially NATO enlargement, were distorting the relationship that Europe needed with Russia. We tried to look at the problem from the Russian side, and thought it was fair to say that the Russians had been promised no further enlargement, especially of NATO, but Europe had broken all these promises. For this reason the EU now has a problem with Russia, and needs to be sensitive to the Russian perceptions.

We spoke a lot about the apparent dysfunctional parts of the European security architecture. We made the point that there was economic gravitation towards a G2 between the American/Chinese side ('Chimerica') and towards 'Eurasia' on the Russian/European side. However, the whole European rhetoric would still be focusing on a European security architecture, which is NATO-driven. The group agreed that it was very difficult to push European countries towards a more assertive Europe security policy, despite the fact that Europe definitely needs a different relationship with Russia than the US would like to see or is able to allow. The policy question behind this is to what extent Europe is 'allowed' and ready to answer to the Medvedev proposals of 2008.

We further discussed whether NATO membership for Russia was a possible solution, to bring Russia closer to the West in a Euro-Atlantic setting, and many of the group actually thought it would be good for Europe to get the Russians into NATO. It would ultimately mean a sort of 'collective security' with Russia, and the running joke in this discussion was that, since we Europeans no longer believe in NATO anyway, we should take the Russians on board to contain the United States. The joke did at least emphasise the sort of dysfunctional direction in which the European architecture is going at the moment.

We finally asked what Europe needed in terms of security policy. We achieved only minor results in this discussion, but with a little bit of hope on the horizon. In essence, we said that the EU was not performing too badly in small missions, such as Kosovo or the Congo, but it did not tackle the big military issues and security problems rightly, such as the question of a European army merging military capacities and capabilities. We talked a bit about whether or not the financial crisis and the consequent budget constraints would provide the pressure that Europe needs to go for common European structures, especially in terms of military capabilities. We had some hope here, though I was bemused that in London you could so often use the term 'European Army' without being removed from the room immediately! We ended by saying that Europe currently and under the current conditions seems pretty unable to do what it should, but that it might be able to move a lot with a little more political will. This, however, is not a new feature of the EU, but more the EU's usual pattern. So hope for European progress is still around!

REPORT ON GROUP 3 ***Philip Stephens***

We had a rather small subject to deal with, 'Decline and fall, is the West losing its influence?' I can't do justice to the richness and erudition of a discussion which ranged across, among other things, the influence of the Scottish Enlightenment on the framing of the American Constitution, the immutability or otherwise of Koranic teachings, and the impact on the Atlantic alliance of trade in chlorinated chicken – just to be clear, that's 'chlorinated' not 'Coronation' chicken.

As any journalist would, I am going to begin at the end, with our conclusion. It seems to me that power, rather like beauty, lies in the eye of the beholder; seen from Beijing, Moscow, even Washington, Europe doesn't look terribly powerful at the moment, nor especially beautiful. The sense I took from our discussions was that Europe will struggle very hard to reclaim its power, but it could do rather more to improve, and indeed to show off, its looks.

Returning to the beginning, we started in rather upbeat mood, as the sun streamed into our meeting room. We decided at the outset that the rise of the East was not something that we should be mourning, but rather should be recognising as the triumph of the West. China, India and others were pulling hundreds of millions of people out of poverty, and they were doing so within frameworks and parameters of a global system which we in the West had designed. So we should be celebrating, we should be rejoicing; we should climb out from beneath the bedcovers and proclaim our own victory.

Sadly, this moment in the sun didn't last too long. A German colleague broke the reverie. What if Europe, he remarked, and indeed the West, had an economic system that had failed, a system of morals and ethics that had failed, and a military system that had failed? Even some of the pessimists among us thought that rather harsh. One made an interesting point, that we tend sometimes to impose on the present the historical templates of the past, particularly those of the Great Power competition of the nineteenth century. China, the participant said, did not want to impose its values, or indeed its reign, on the West in the way that we Europeans had done on the rest of the world during the nineteenth century. It was enough, he suggested, in the twenty-first century, to be beautiful in order to be powerful. 'Beautiful' in this context is of course the power of attraction, the normative power, which has actually served Europe rather well for fifty years.

The trouble one or two others noticed, however, was that there had been one or two blemishes on this beauty. We talked quite a lot about the weakness of the Euro, the economic troubles that Europe had faced over the past year, and it seemed to some at least that this put a big question mark over whether the European model was one that others in the world would still want to emulate. To take that further, during the 1990s the West had imposed the Washington Consensus on the countries of Asia, particularly after the Asian crisis; the Washington Consensus now lies in ruins.

Some others thought that we were also losing confidence in our values. It was one thing to be realistic about how much we could preach universal values to the countries that took a rather different view of their societies, but if we lost confidence in our core beliefs, then that would show through and reflect on our normative strength in the world.

Nor did some of us see Europe demonstrating much cohesion in relationships with its neighbours. I had the temerity to suggest that, before we got to grand policy initiatives with the rising powers like China and India, Europe could show its seriousness by adopting a common energy policy, as discussed in Group 2, as the foundation for a strategy towards Russia. Someone in Brussels had told me a week or so ago that strategic dialogues with Russia and others were marvellous things because they obviated the need to have a strategy towards these countries. I think everyone in the group agreed that it would be rather good if we had systems of interconnections, and a policy towards Russia that would ensure the security of gas and energy for the whole of Europe. But someone piped up that we had been trying that for twenty-five years and it had not worked. So there was questioning of why we kept banging our head against the wall.

There were similar discussions – and our Chairman was quite passionate on the subject - about the need for Europe to get its act together on defence, to share capabilities and responsibilities. I thought for a moment that here the group was really going to cohere, but then someone pointed out that a Franco-German helicopter project had been in the making for twenty or thirty years and had yet to fly, so we moved on.

We were told that this normative power still exists; we learned that across the globe, in Beijing, in Delhi, Jakarta, Johannesburg, leaders and elites sit up till midnight, glued to the BBC. This is real normative power. The fact that we were told this story by the

representative of the BBC did nothing to dent our confidence in its veracity! But, more seriously, what could Europe do?

After lunch we talked about a range of areas where we could use our economic and soft power to set agendas in the world. We talked, for example, about the free trade agreements that Europe was signing with countries across the world; we talked about R & D and innovation; we talked at some length about education and the power that that can give us – I think on the British side at least there was a certain pride that British educational institutions attracted very large numbers of overseas students, and indeed that some of these institutions were now setting up in the world.

We were getting towards what was to be done, and our Chairman posed the choice between a grand strategy, one of courage and vision, and one of small incremental steps. Emotionally, most of us went for the grand strategy, but realistically we settled for small incremental steps. This took us on, finally, to the discussion that always looms over such gatherings, the transatlantic relationship. I'd like to say that we cracked this one, that we came up with a project, an analysis that would demonstrate how Europe and the United States could finally get their act together. Sadly we didn't; we agreed basically that Europe was slipping into the peripheral vision of the US administration, as Obama talks of what he calls the Pacific Century. We agreed that the US view of Europe was becoming more transactional; the emotional ties that had bound us together after the war were weakening. However, we did say that Europe now had to come up with some ideas, something to offer the Americans in terms of substance, particularly now that the US/EU summit has been revived for Lisbon, alongside the NATO summit. What three things should the EU offer to the Americans that demonstrated to Obama that we were serious actors? That was work in progress, but I am sure we will find them.

What I really took from a rich discussion – and there was a lot there, but it is quite difficult with such a big subject to pull things together – was the recognition that Europe and the West's interest does lie in the preservation of the global system established in 1945, not the preservation as is, but the adaptation and if necessary expansion of it, and that some time soon Europe and the US are going to have to bite the bullet and do the most difficult thing in foreign policy, to cede power in order to remain reasonably powerful. We didn't think the West was in terminal decline, but we identified the need to look seriously at reform of global institutions, and to give up some of our own power in those institutions, to make sure that, as relative economic and political weight shifts in the world, the values and the interests of Europe and the West are preserved, and that, if we don't remain powerful in a conventional sense, we keep some of our looks into middle and old age.