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Jean-Claude Juncker says there can be no respite in building a united Europe

The European Union can help to make trade more equitable, Benoît Cœuré believes

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David Briggs-Wilson: E david@hermes-aviation-consulting.com T +33 3 8331 0018

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The hour of European sovereignty

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A perpetual responsibility

At times, history moves forward only haltingly but it is always quick to pass us by. Such is the fate of a Commission with just a five-year mandate to make a real difference. This Commission is merely a chapter, a brief moment in the long history of the European Union.

But the time has not yet come to pass judgement on the Commission I have the honour of presiding over. This is why I will not present you with an overview of the last four years' achievements. Instead, I say to you that our efforts will continue unabated. We will keep working to render this imperfect Union that little bit more perfect with each passing day.

There is much still to be done. No self-congratulating, no boasting. Modesty and hard work: this is the attitude the Commission will continue to adopt. This is what is on our agenda for the months to come.

History can also show up, unannounced, in the life of nations and be slow to leave. Such was the fate of Europe's nations during the Great War starting in 1914. A war which took the sunny, optimistic and peaceful continent of the time by surprise. In 1913, Europeans expected to live a lasting peace. And yet, just a year later, a brutal war broke out amongst brothers, engulfing the continent.

I speak of these times not because I believe we are on the brink of another catastrophe. But because Europe is the guardian of peace. We should be thankful we live on a peaceful continent, made possible by the European Union.

So let us show the European Union a bit more respect. Let us stop dragging its name through the mud and start defending our communal way of life more. We should embrace the kind of patriotism that is used for good, and

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never against others. We should reject the kind of exaggerated nationalism that projects hate and destroys all in its path. The kind of nationalism that points the finger at others instead of searching for ways to better live together.

Living up to Europe's rallying cry – never again war – is our eternal duty, our perpetual responsibility. We must all remain vigilant.

The state of our Union in 2018: efforts that are bearing fruit

What is the State of the Union today, in 2018? Ten years after Lehman Brothers, Europe has largely turned the page

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Europe's Leaders meet in Sibiu, Romania on 9 May 2019. Sibiu is the moment we must offer all Europeans a strong perspective for the future

on an economic and financial crisis which came from outside but which cut deep at home. Europe's economy has now grown for 21 consecutive quarters.

Jobs have returned, with almost 12 million new jobs created since 2014. 12 million – that is more jobs than there are people in Belgium. Never have so many men and women – 239 million people – been in work in Europe. Youth unemployment is at 14.8%. This is still too high a figure but is the lowest it has been since the year 2000.

Investment is back, thanks notably to our European Fund for Strategic Investments, which some – less and less – still call the 'Juncker Fund'. A Fund that has triggered €335 billion worth of public and private investment. We are closing in on 400 billion.

And then there is Greece: after what can only be described as some very painful years, marked by unprecedented social hardship – though also by unprecedented solidarity – Greece successfully exited its programme and is now back on its own two feet. I applaud the people of Greece for their Herculean efforts. Efforts which other Europeans continue to underestimate. I have always fought for Greece, its dignity, its role in Europe, and its place inside the euro area. Of this I am proud.

Europe has also reaffirmed its position as a trade power. Our global trading position is the living proof of the need to share sovereignty. The European Union now has trade agreements with 70 countries around the world, covering 40% of the world's GDP. These agreements – so often contested but so unjustly – help us export Europe's high standards for food safety, workers' rights, the environment and consumer rights far beyond our borders.

When, amidst dangerous global tensions, I went to Beijing, Tokyo and Washington in the space of one week last July, I was able to speak, as President of the European Commission, on behalf of the world's biggest single market.

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On behalf of a Union accounting for a fifth of the world's economy. On behalf of a Union willing to stand up for its values and interests. I showed Europe to be an open continent. But not a naïve one.

The strength of a united Europe, both in principle and in practice, gave me the clout I needed to get tangible results for citizens and businesses alike. United, as a Union, Europe is a force to be reckoned with. In Washington, I spoke in Europe's name. For some, the agreement I struck with President Trump came as a surprise. But it should be no surprise that Europe succeeds when it speaks with one voice. When needed, Europe must act as one.

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A global responsibility

We proved this when relentlessly defending the Paris Agreement on climate change. We did this because, as Europeans, we want to leave a healthier planet behind for those that follow. I share our Energy Commissioner's conclusions when it comes to our targets for reducing CO_2 emissions by 2030. They are both scientifically accurate and politically indispensable.

This summer's droughts are a stark reminder – not only for farmers – of just how important that work is to safeguard the future for generations of Europeans. We cannot turn a blind eye to the challenge in front of our noses. We – Commission and Parliament – must look to the future. The world has not stopped turning. It is more volatile than ever. The external challenges facing our continent are multiplying by the day. There can therefore be not a moment's respite in our efforts to build a more united Europe.

Europe can export stability, as we have done with the successive enlargements of our Union. For me, these are and will remain success stories – for we were able to reconcile Europe's history and geography. But there is more to be done. We must find unity when it comes to the Western Balkans – once and for all. Should we not, our immediate neighbourhood will be shaped by others.

Take a look around. What is happening in Idlib in Syria now must be of deep and direct concern to us all. We cannot remain silent in face of this impending humanitarian disaster – which appears now all but inevitable. The conflict in Syria is a case in point for how the international order that served Europeans so well after the Second World War is being increasingly called into question.

In today's world, Europe can no longer be certain that words given yesterday can still be counted on today. That old alliances may not look the same tomorrow.

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The hour of European sovereignty

The world today needs a strong and united Europe. A Europe that works for peace, trade agreements and stable currency relations, even as some become more prone to trade and currency wars. I am not in favour of a selfish unilateralism that defies expectations and dashes hopes. I will always champion multilateralism.

If Europe were to unite all the political, economic and military might of its nations, its role in the world could be strengthened. We will always be a global payer but it is time we started being a global player too. This is why – despite great resistance at the time – I reignited the idea of a Europe of Defence as early as 2014. And this is why I will continue to work day and night over the next months to see the European Defence Fund and Permanent Structured Cooperation in Defence become fully operational.

Allow me to clarify one important point: we will not militarise the European Union. What we want is to become more autonomous and live up to our global responsibilities. Only a strong and united Europe can protect our citizens against threats internal and external – from terrorism to climate change. Only a strong and united Europe can protect jobs in an open, interconnected world. Only a strong and united Europe can master the challenges of global digitisation.

It is because of our single market – the largest in the world – that we can set standards for big data, artificial intelligence, and automation. And that we are able to uphold Europeans' values, rights and identities in doing so. But we can only do so if we stand united.

A strong and united Europe is what allows its member states to reach for the stars. It is our Galileo programme that is today keeping Europe in the space race. No single Member State could have put 26 satellites in orbit, for the benefit of 400 million users worldwide. No single member state could have done this alone. Galileo is a success in great part, if not entirely, thanks to Europe. No Europe, no Galileo. We should be proud.

The geopolitical situation makes this Europe's hour: the time for European sovereignty has come. It is time Europe took its destiny into its own hands. It is time Europe developed what I coined *'Weltpolitikfähigkeit'* – the capacity to play a role, as a Union, in shaping global affairs. Europe has to become a more sovereign actor in international relations. European sovereignty is born of member states' national sovereignty and does not replace it. Sharing sovereignty – when and where needed – makes each of our nation states stronger.

This belief that 'united we stand taller' is the very essence of what it means to be part of the European Union. European sovereignty can never be to the detriment of others. Europe is a continent of openness and tolerance. It will remain so.

Europe will never be a fortress, turning its back on the world or those suffering within it. Europe is not an island. It must and will champion multilateralism. The world we live in belongs to all and not a select few.

This is what is at stake when Europeans take to the polls in May next year. We will use the days before the European elections to prove to citizens that, acting as one, this Union is capable of delivering on expectations and on what

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we promised to achieve at the start of this mandate. By the elections, we must show that Europe can overcome differences between North and South, East and West, left and right. Europe is too small to let itself be divided in halves or quarters. We must show that together we can plant the seeds of a more sovereign Europe.

Delivering on our promises

Europeans taking to the polls in May 2019 will not care that the Commission made a proposal to make internet giants pay taxes where they create their profits – they want to see it happening for real. And they are right. Europeans taking to the polls in May 2019 will not care about the Commission's good intention to crack down on single-use plastics to protect our oceans against marine litter – they will want to see a European law in force that bans these plastics, which is what the Commission has proposed.

We all say in soap-box speeches that we want to be big on big things and small on small things. But there is no applause when EU law dictates that Europeans have to change the clocks twice a year. The Commission is today proposing to change this. Clock-changing must stop. Member states should themselves decide whether their citizens live in summer or winter time. It is a question of subsidiarity. I expect the Parliament and Council will share this view. We are out of time. This is why I am calling on all to work closely together over the next months, so that we can jointly deliver on what we have promised – before the European Parliament elections.

At the beginning of this mandate, we all collectively promised to deliver a more innovative Digital Single Market, a deeper Economic and Monetary Union, a Banking Union, a Capital Markets Union, a fairer Single Market, an Energy Union with a forward-looking climate policy, a comprehensive Migration Agenda, and a Security Union. And we – or at least most of us – agreed that Europe's social dimension should be given the Cinderella treatment no more, but should instead be geared towards the future.

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The Commission has put all the proposals and initiatives we announced in 2014 on the table. Half of these have already been agreed by Parliament and Council, 20% are on well on the way and 30% are still under discussion – difficult discussion at that.

I cannot accept that the blame for every failure – and there have been a few – is laid solely at the Commission's door. Our proposals are there for all to see. They need to be adopted and implemented. I will continue to resist all attempts to blame the Commission alone. There are scapegoats to be found in all three institutions – with the fewest in Commission and Parliament. Leadership is what is needed now. This is notably the case when it comes to completing our Security Union. Europeans rightly expect their Union to keep them safe.

This is why the Commission is proposing new rules to get terrorist content off the web within one hour – the critical window in which the greatest damage is done. And we are proposing to extend the tasks of the newly established European Public Prosecutor's Office to include the fight against terrorist offences. We need to be able to prosecute terrorists in a more coordinated way, across our Union. Terrorists know no borders. We cannot allow ourselves to become unwitting accomplices because of our inability to cooperate. In the same vein, we have also proposed measures to fight money laundering more effectively across our borders. We must protect our free and fair elections. This is why the Commission is proposing new rules to better protect our democratic processes from manipulation by third countries or private interests.

Leadership and a spirit of compromise are of course very much needed when it comes to migration. We have made more progress than is often acknowledged. Five of the seven Commission's proposals to reform our Common European Asylum System have been agreed. Our efforts to manage migration have borne fruit: arrivals have been drastically reduced – down 97% in the Eastern Mediterranean and 80% in the Central Mediterranean. EU operations have helped rescue over 690,000 people at sea since 2015.

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However, member states have not yet found the right balance between the responsibility each must assume on its own territory; and the solidarity all must show if we are to get back to a Schengen area without internal borders. I am and will remain strictly opposed to internal borders. Where borders have been reinstated, they must be removed. Failure to do so would amount to an unacceptable step back for the Europe of today and tomorrow.

The Commission and several Council presidencies have put numerous compromise solutions on the table. I call on the Council presidency to now make the decisive step to broker a sustainable solution on a balanced migration reform. We cannot continue to squabble to find ad-hoc solutions each time a new ship arrives. Temporary solidarity is not good enough. We need lasting solidarity – today and forever more.

We need more solidarity not for solidarity's sake but for the sake of efficiency. This is true in the case of our civil protection mechanism. When fires rage in one European country, all of Europe burns. The most striking images from this summer were not only those of the formidable fires but of the Swedish people greeting Polish firefighters coming to their aid – Europe at its best.

Turning back to migration: the Commission is today proposing to further strengthen the European Border and Coast Guard to better protect our external borders with an additional 10,000 European border guards by 2020. We are also proposing to further develop the European Asylum Agency to make sure that Member States get more European support in processing asylum seekers in line with the Geneva Convention. And we are proposing to accelerate the return of irregular migrants. The Commission is committed to supporting member states in doing so.

I would also like to remind member states again of the need to open legal pathways to the Union. I renew my call. We need skilled migrants. Commission proposals addressing this issue have been on the table for some time and must now be taken up.

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To speak of the future, one must speak of Africa – Europe's twin continent. Africa is the future: by 2050, Africa's population will number 2.5 billion. One in four people on earth will be African. We need to invest more in our relationship with the nations of this great and noble continent. And we have to stop seeing this relationship through the sole prism of development aid. Such an approach is beyond inadequate, humiliatingly so.

Africa does not need charity, it needs true and fair partnerships. And Europe needs this partnership just as much. In preparing my speech, I spoke to my African friends, notably Paul Kagame, the Chairperson of the African Union. We agreed that donor-recipient relations are a thing of the past. We agreed that reciprocal commitments are the way forward. We want to build a new partnership with Africa.

We are proposing a new Alliance for Sustainable Investment and Jobs between Europe and Africa. This Alliance – as we envision it – would help create up to 10 million jobs in Africa in the next 5 years alone. We want to create a framework that brings more private investment to Africa. We are not starting from scratch: our External Investment Plan, launched two years ago, will mobilise over €44 billion in both the public and private investment. Alone the projects already in the pipeline will unlock €24 billion.

We want to focus our investment where it matters the most. By 2020, the EU will have supported 35,000 African students and researchers with our Erasmus programme. By 2027, this figure should reach 105,000.

Trade between Africa and Europe is not insignificant. 36% of Africa's trade is with the European Union. This compares to 16% for China and 6% for the United States. But this is not enough. I believe we should develop the numerous European-African trade agreements into a continent-to-continent free trade agreement, as an economic partnership between equals.

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Another issue where I see a strong need for the Union for leadership is Brexit. I will not enter into the details of the negotiations, which are being masterfully handled by my friend Michel Barnier. He works on the basis of a unanimous position confirmed time and again by the 27 member states. However, allow me to recall three principles which should guide our work on Brexit in the months to come.

First of all, we respect the British decision to leave our Union, even though we continue to regret it deeply. But we also ask the British government to understand that someone who leaves the Union cannot be in the same privileged position as a member state. If you leave the Union, you are of course no longer part of our single market, and certainly not only in the parts of it you choose.

Secondly, the European Commission, this Parliament and all other 26 member states will always show loyalty and solidarity with Ireland when it comes to the Irish border. This is why we want to find a creative solution that prevents a hard border in Northern Ireland. But we will equally be very outspoken should the British government walk away from its responsibilities under the Good Friday Agreement. It is not the European Union, it is Brexit that risks making the border more visible in Northern Ireland.

Thirdly, after 29 March 2019, the United Kingdom will never be an ordinary third country for us. The United Kingdom will always be a very close neighbour and partner, in political, economic and security terms.

In the past months, whenever we needed unity in the Union, Britain was at our side, driven by the same values and principles as all other Europeans. This is why I welcome Prime Minister May's proposal to develop an ambitious new partnership for the future, after Brexit. We agree with the statement made in Chequers that the starting point for such a partnership should be a free trade area between the United Kingdom and the European Union.

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On the basis of these three principles, the Commission's negotiators stand ready to work day and night to reach a deal. We owe it to our citizens and our businesses to ensure the United Kingdom's withdrawal is orderly and that there is stability afterwards. It will not be the Commission that will stand in the way of this, I can assure you of that.

A strong perspective for the future

There is much work to be done before the European elections and before Europe's Leaders meet in Sibiu, Romania on 9 May 2019. Sibiu is the moment we must offer all Europeans a strong perspective for the future. Europeans deserve better than uncertainty and confused objectives. They deserve clarity of intent, not approximations or half-measures.

This is what is at stake on the road to Sibiu – a summit that will take place just six weeks after Brexit and two weeks before the European elections. By then we must have ratified the EU-Japan partnership agreement – for reasons as much economic as geopolitical. By then, we should also have brokered an agreement in principle on the EU budget after 2020.

If we want to give young Europeans the opportunity to make the most of our Erasmus programme – which we must – then we must decide on this aspect, amongst others, of the budget. If we want to give our researchers and start-ups more opportunities, and prevent funding gaps costing jobs, we have to decide before the elections. If we want to – without militarising the European Union – to increase defence spending by a factor of 20, we will need to decide quickly. If we want to increase our investment in Africa by 23%, we must decide quickly.

By next year, we should also address the international role of the euro. The euro is 20 years young and has already come a long way – despite its critics. It is now the second most used currency in the world with 60 countries linking

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their currencies to the euro in one way or another. But we must do more to allow our single currency to play its full role on the international scene.

Recent events have brought into sharp focus the need to deepen our Economic and Monetary Union and build deep and liquid capital markets. The Commission has made a series of proposals to do just that – most of which now await adoption by Parliament and Council.

But we can and must go further. It is absurd that Europe pays for 80% of its energy import bill – worth €300 billion a year – in US dollar when only roughly 2% of our energy imports come from the United States. It is absurd that European companies buy European planes in dollars instead of euro.

This is why, before the end of the year, the Commission will present initiatives to strengthen the international role of the euro. The euro must become the face and the instrument of a new, more sovereign Europe. For this, we must first put our own house in order by strengthening our Economic and Monetary Union, as we have already started to do. Without this, we will lack the means to strengthen the international of role of the euro. We must complete our Economic and Monetary Union to make Europe and the euro stronger.

Last but not least, by Sibiu I want to make visible progress in strengthening our foreign policy. We must improve our ability to speak with one voice when it comes to our foreign policy. It is not right that our Union silenced itself at the United Nations Human Rights Council when it came to condemning human rights abuses by China. And this because not all Member States could agree. It is not right that one member state was able to hold the renewal of our arms embargo on Belarus to ransom, or that sanctions on Venezuela were delayed for months when unanimity could not be reached.

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This is why the Commission is proposing to move to qualified majority voting in specific areas of our external relations. I repeat what I said last year on this matter. We should move to qualified majority voting not in all but in specific areas: human rights issues and civilian missions included. This is possible on the basis of the current Treaties and I believe the time has come to make use of this 'lost treasure' of the Lisbon Treaty. I also think we should be able to decide on certain tax matters by qualified majority.

I would like to say a few words about the increasingly worrying way in which we air our disagreements. Heated exchanges amongst governments and institutions are becoming more and more common. Harsh or hurtful words will not get Europe anywhere. The tone is not only worrying when it comes to political discourse. It is also true of the way some seek to shut down debate altogether by targeting media and journalists. Europe must always be a place where freedom of the press is sacrosanct. Too many of our journalists are intimidated, attacked, or even murdered. We must do more to protect our democracy and its agents – our journalists. In general, we must do more to revive the lost art of compromise. Compromise does not mean sacrificing our convictions or selling out on our values.

The Commission will resist all attacks on the rule of law. We continue to be very concerned by the developments in some of our member states. Article 7 must be applied whenever the rule of law is threatened. First Vice-President Timmermans is doing a remarkable but often lonely job of defending the rule of law. The whole Commission, and I personally, support him fully.

But we need to be very clear on one point: judgements from the Court of Justice must be respected and implemented. This is vital. The European Union is a community of law. Respecting the rule of law and abiding by Court decisions are not optional.

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Conclusion

I started this speech – my last State of the Union though surely not my last speech – by talking about history. I spoke of both the events that have marked this Commission's time in office and of history writ large, the History of Europe. We are all responsible for the Europe of today. And we must all take responsibility for the Europe of tomorrow. Such is history: parliaments and Commissions come and go, Europe is here to stay. But for Europe to become what it must, there are several lessons to be learnt.

Europe's Leaders meet in Sibiu, Romania on 9 May 2019. Sibiu is the moment we must offer all Europeans a strong perspective for the future. I want Europe to get off the side-lines of world affairs. Europe can no longer be a spectator or a mere commentator of international events. Europe must be an active player, an architect of tomorrow's world.

There is strong demand for Europe throughout the world. To meet such high demand, Europe will have to speak with one voice on the world stage. In the concert of nations, Europe's voice must ring clear in order to be heard. Federica Mogherini has made Europe's diplomacy more coherent. But let us not slide back into the incoherence of competing and parallel national diplomacies. Europe diplomacy must be con- ducted in the singular. Our solidarity must be all-embracing.

I want us to do more to bring together the East and West of Europe. It is time we put an end to the sorry spectacle of a divided Europe. Our continent and those who brought an end to the Cold War deserve better. I would like the European Union to take better care of its social dimension. Those that ignore the legitimate concerns of workers and small businesses undermine European unity. It is time we turned the good intentions that we proclaimed at the Gothenburg Social Summit into law.

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I would like next year's elections to be a landmark for European democracy. I would like to see the Spitzenkandidaten process – that small step forward for European democracy – repeated. For me, this process would be made all the more credible if we were to have transnational lists. I hope these will be in place by the next European elections in 2024 at the latest.

But above all, I would like us to reject unhealthy nationalism and embrace enlightened patriotism. We should never forget that the patriotism of the 21st Century is two-fold: both European and national, with one not excluding the other.

As the French philosophe Blaise Pascal said: I like things that go together. In order to stand on its own two feet, Europe must move forward as one. To love Europe, is to love its nations. To love your nation is to love Europe. Patriotism is a virtue. Unchecked nationalism is riddled with both poison and deceit. In short, we must remain true to ourselves.

The trees we plant today must provide shade for our great grandchildren whether they hail from East or West, from South or North. To give them all they need to grow and breathe easily. A few years ago, standing in this very same spot, I told you that Europe was the love of my life. I love Europe still and shall do so forever more. ■

Jean-Claude Juncker is President of the European Commission

This article is based on President Junker's State of the Union Address 2018, Strasbourg, 12 September 2018

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Europe and the euro 20 years on

We should consider the gains made as a result of having one market with one money, says Mario Draghi, outlining how the Single Market has benefited the people of Europe over the past 20 years

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In January 2019 we celebrate the 20th anniversary of the launch of the euro. The two decades in which the euro has existed have perhaps been exceptional. The first was the culmination of a 30-year upswing in the global financial cycle, while the second saw the worst economic and financial crisis since the 1930s. But, exceptional as they were, these two periods can teach us some useful lessons about what still needs to be done.

Monetary Union has succeeded in many ways, but it has not delivered the gains that were expected in all countries. This is partly the result of domestic policy choices and partly the result of Monetary Union being incomplete, which led to insufficient stabilisation during the crisis.

The way ahead, therefore, is to identify the changes that are necessary to make our Monetary Union work for the benefit of all member countries. We need to make these changes as soon as possible, but we also need to explain why they are important to the people of Europe.

The rationale for one market, one money

The Single Market is often seen simply as an expression of the globalisation process, which over time has even eliminated exchange rate flexibility. But the Single Market and globalisation are not the same thing.

Globalisation has led to higher overall welfare for all economies, and for emerging markets in particular. But it is now clear that the rules that accompanied this process were not sufficient to prevent it from causing severe distortions. Open markets have heightened economic insecurity for people exposed to intensified competition, and added to their sense of being 'left behind' in a world where the great wealth created has been concentrated in a few hands.

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From the outset, however, the Single Market was designed to reap the benefits of openness while also tempering its costs for the most vulnerable; to promote growth while protecting the people of Europe from the injustices of untrammelled free markets. This was undoubtedly also the vision of Jacques Delors, the architect of the Single Market.

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[The] European project is even more important today. It is only by continuing to make progress, freeing up individual energies but also fostering social equity, that we will save it through our democracies, with a unity of purpose

The Single Market was conceived during a period of weakness in the European economy. Annual growth had averaged just 2.2% from 1973 until 1985 in the 12 countries that would go on to form the euro area[1], down from 5.3% between 1960 and 1973. Growth potential had also fallen from about 5% per year at the beginning of the 1970s to around 2% per year by the beginning of the following decade.

The typical response of governments to low growth was to increase fiscal deficits. From 1973 to 1985, public deficits in the euro area 12 averaged 3.5% of GDP, while in Italy the average was 9% of GDP. Unemployment rose from 2.6% in 1973 to 9.2% in 1985 for the euro area 12. In Italy, it climbed from 5.9% to 8.2% over the same period.

But the EU had a powerful tool at its disposal to raise growth: the common market.

One reason that growth potential had decelerated was that intra-EU trade growth had stalled in the early 1970s, because the common market covered mainly intermediate goods where growth was already saturated. Trade in sectors with high R&D and skill content was restricted by non-tariff barriers, preventing productivity spillovers[2].

The Single Market offered a way to remove these barriers, reverse the decline in economic potential, and bring more people back into work. Yet the Single Market was never just about this. It also aimed to protect people from some of the costs of the changes that would inevitably arise. This, in turn, would create a more favourable political environment for advancing the process of European integration, following the setbacks of the 1970s.

Unlike the wider process of globalisation, the Single Market allowed Europe to impose its values on economic integration – to build a market that, to the extent possible, was free but just. Product rules could be used to protect consumers from lax standards in other countries, and protect producers from unfair competition. And production rules could be used to protect workers by putting a floor on 'social dumping' and upholding labour standards.

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This is why the launch of the Single Market agenda in the mid-1980s went hand in hand with a strengthening of common rule-making in the EU and of powers of judicial review. The opening of markets was accompanied by the creation of a strong European authority to safeguard fair competition; product standards became tighter, with the introduction of the geographical indication protections for specific foods, for example. And safeguards central to the European social model were progressively embedded in EU law, in areas where the EU had the power to act.

The Charter of Fundamental Rights has prevented a 'race to the bottom' in terms of workers' rights. Legislation was adopted to curtail unfair labour practices, such as the revision of the Posted Workers Directive this year. EU legislation also protects those in less secure employment.

One example is the Directive on part-time work in 1997, which sought equal treatment for part-time and fixed-term employees. Last year the EU institutions endorsed the European Pillar of Social Rights to support equal opportunities and access to the labour market, fair working conditions, social protection and inclusion.

EU legislation has not led to a complete harmonisation of labour protections across Europe. But it has meant that the gap in labour standards across countries has gradually narrowed, even as lower-income countries have joined the EU. Research finds a process of upward convergence in significant areas of social expenditure in the EU since 1980, although this has tailed off in recent years[3]. The same cannot be said at the international level.

But the Single Market required greater exchange rate stability than a free trade area, and this resulted in significant trade-offs for economic policy. These were well-articulated by Tommaso Padoa-Schioppa in his famous *"inconsistent quartet"*[4]. If European countries wanted to have the benefits of managed open trade, they could not simultaneously have capital mobility, independent monetary policy and fixed exchange rates.

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Governments initially responded to this conundrum by maintaining fixed exchange rates and introducing capital controls on short-term flows, which allowed a degree of monetary policy autonomy. But as financial integration deepened and capital controls were progressively eliminated during the 1980s, fixed exchange rates became unsustainable.

Due to the international financial storms raging at the time, the countries that had pegged their currencies to the Deutsche Mark (DM) within the European Monetary System (EMS) had to periodically decide either to maintain an independent monetary policy and devalue, or to maintain parity with the DM and lose any sovereignty over their monetary policy.

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Given the frequency with which policymakers had to make these decisions, some countries lost both the benefits of exchange-rate stability and their monetary policy independence. The social costs were high. This process came to an end with the ERM crisis in 1992-3, when it ceased to be credible for countries entering a recession to follow German interest rate rises. At the same time, devaluing repeatedly was becoming incompatible with the deep Single Market that countries were trying to build.

Indeed, the prevailing view on devaluations was captured well by Nobel laureate Robert Mundell, who developed his theory of optimal currency areas in the belief that, *"I could not see why countries that were in the process of forming a common market should saddle themselves with a new barrier to trade in the form of uncertainty about exchange rates"*[5]. Exchange rate flexibility would have undermined the Single Market in two ways.

First, it would have weakened incentives for firms to raise productivity, because they could have lifted competitiveness – if only temporarily – by devaluing rather than increasing output per head[6]. Yet Europe had witnessed time and again that such actions did not lead to lasting welfare gains.

From the launch of the EMS in 1979 to the ERM crisis in 1992, the Italian lira was devalued seven times against the DM, losing around half of its value cumulatively vis-à-vis the German currency. Yet average annual productivity growth[7] in Italy was lower than in the euro area 12 over this period, Italy's GDP growth rate was roughly the same as that of its European peers, and its unemployment rate went up by 1.3 percentage points. At the same time, consumer prices in Italy grew cumulatively by 223%, compared with 103% in the euro area 12[8].

Second, support for the Single Market would be undermined in the long run if firms that did invest in raising productivity could be deprived of some of the benefits by 'beggar-thy-neighbour' behaviour through competitive devaluations in other countries. Open markets would not have lasted.

Europe had experienced the problems created by exchange rate flexibility in the 1960s with the common agricultural market. Absent a single currency, the common agricultural policy was based on prices quoted in units of account. But successive currency crises, in particular a revaluation of the DM and a devaluation of the French franc in 1969, jeopardised trust in the market, as the farmers affected demanded compensation for their losses.

The issue was smoothed over by introducing monetary compensatory amounts to mitigate sudden changes in farm prices caused by abrupt adjustments in exchange rates. But the system proved difficult to implement and sustain as it was virtually impossible to avoid distortions of production and trade, which poisoned intra-Community relations[9].

So, faced with an 'inconsistent quartet' of policy choices, a single currency provided, at least in principle, a way to resolve them. It would allow countries to maintain stable exchange rates and therefore benefit from openness within the Single Market, while managing as far as possible its costs.

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Not all countries that had joined the Single Market also joined the euro, of course. Some countries, such as Denmark, pegged their exchange rates to the euro. For other countries, the Single Market represented the gateway to the euro. Five additional countries[10] joined the euro in its first decade and three more in its second, but other smaller economies have stayed out so far.

Finally, there is the United Kingdom, the only large economy inside the Single Market that chose to stay out of the euro area. The United Kingdom is a particular case, not only for political reasons but also for structural reasons, such as the relatively low exchange rate pass-through it had in the past[11].

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The benefits of one market, one money today

We should consider what gains have been made as a result of having one market with one money. With the euro protecting the Single Market, trade growth has increased, with intra-EU exports rising from 13% of EU GDP in 1992 to 20% today.

Intra-euro area trade has risen both in absolute terms and as a share of total trade with advanced economies[12], even as emerging market economies have entered the global market. Foreign direct investment (FDI) flows within Europe have also grown[13], with inflows from the rest of the EU to Italy increasing by 36% from 1992 to 2010[14].

Behind the growth of intra-EU trade lies perhaps an even more important development, which is the much closer intertwining of European economies through the deepening of value chains.

Since the start of the 2000s, supply chain linkages between countries within the EU have intensified at a faster pace and were more resilient during the crisis, compared with their supply chain linkages with countries outside the Single Market[15].

The removal of customs barriers as part of the Single Market agenda has facilitated multiple border crossings during the production process. Europe-wide standards have boosted intra-EU value chains by providing more certainty for firms about the quality of production in other countries and encouraging the fragmentation of the production process that is typical of value chains[16].

And the single currency has further enhanced the process by eliminating the costs of foreign exchange payments and settlements and of hedging exchange rate risk.

Participation in these value chains has brought gains for all countries, especially in terms of productivity spillovers. The imported inputs used in value chains generate a tangible boost to productivity[17].

And higher productivity in turn leads to higher wages. Integration within value chains is associated with an increase in hourly compensation for all skill groups[18].

Moreover, integrating into value chains has improved risk-sharing among European countries, since it has allowed the gains (and losses) of trade with the rest of the world to be more evenly spread. Within the EU, close to 20% of export-supported jobs are located in a country other than the one that exports the final product[19].

Around half a million Italian workers are involved in the production processes of companies located in other EU countries that export to the rest of the world[20]. Italian firms themselves participate strongly in global value chains and this is positively associated with labour productivity[21].

It is often this link to value chains that allows in particular the SMEs that are so typical of Italy's manufacturing sector to survive and grow. In a world that is increasingly dominated by scale, this permits Italy to retain one of its

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fundamental characteristics. Italy, through the Single Market and the single currency, is deeply integrated into the European production process.

The closer intertwining of European economies has had two significant effects on exchange rate relationships for euro area countries. First, the cost of not being able to devalue within Monetary Union has fallen.

ECB analysis finds that misalignments of real effective exchange rates are smaller – albeit more persistent – for euro area countries than those between advanced economies or countries linked by pegged exchange rates, and these misalignments have actually become smaller in the second decade of EMU relative to the first decade[22].

At the same time, value chains have blunted the short-run benefits of competitive devaluations[23]. Since exports contain a greater share of imports, any boost to external demand associated with a hypothetical devaluation is now offset by higher input costs from imported intermediates. As a result, participation in value chains has been found to reduce the responsiveness of export volumes to movements in the exchange rate[24].

So, any country hypothetically looking to devalue to regain competitiveness would have to do so to a much larger extent than was necessary in previous decades. And devaluations of such size would not only threaten the existence of the Single Market. They would also result in a substantial loss of welfare within the country carrying out the devaluation owing to the greater negative impact it would have via higher import prices.

And studies on non-EU countries suggest that the welfare loss would be greatest for the poorest in society, since poorer households tend to spend a larger share of their income on tradeable goods than richer households[25]. This is also typically the case in euro area countries.

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But does being outside the euro provide additional benefits in terms of monetary policy sovereignty? This is not so obvious. First, the single currency has actually allowed countries to regain monetary sovereignty compared with the fixed exchange rate regimes of the past.

Decision-making over monetary policy, which effectively belonged to Germany under the EMS, is now shared among all euro area countries. And the size of euro financial markets has made the euro area less vulnerable to US spillovers, even as global financial integration has accelerated.

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Second, it is worth noting that the supposed advantages of monetary sovereignty – such as the ability to engage in monetary financing of government spending – do not appear to be valued highly by countries that are members of the Single Market but not the euro.

Such countries have a weighted average public debt of 68% of GDP (44% of GDP if the United Kingdom is excluded), compared with 89% for countries that use the single currency.

In any case, as the history of Italy has shown, monetary financing of government debt did not lead to real long-term benefits[26]. In periods where debt monetisation was more common in Italy, such as in the 1970s, maintaining a growth rate similar to its European peers required repeated devaluations. Inflation reached unsustainable levels and hit the most vulnerable in society.

Convergence and divergence in the euro area

But if it is true that the supposed advantages associated with the freedom of being outside Monetary Union belong to a memory that has been obscured by time and the dramas of the recent crisis, it is also true that in some countries various benefits that were expected from EMU have not yet materialised.

It was not mistaken, and nor is it today, to expect higher growth and employment to emerge from the 'culture of stability' that Monetary Union would bring about. But it was inconceivable that joining Monetary Union alone would be sufficient to achieve this. We needed and continue to need much more.

To the founders of EMU, it was clear that establishing a well-functioning monetary union would be a long and gradual process. Historical experience suggested that opening markets could lead to differentiated gains, with some regions profiting more than others. This had been the experience of both Italy and Germany after unification in the 19th century[27].

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Several euro area countries have achieved significant convergence, particularly the Baltic countries, Slovakia and, to a lesser extent, Malta and Slovenia. In these countries, the gap between real GDP per capita and the euro area mean has been reduced by around one-third since 1999[28].

Others that also started far from the euro area average – such as Portugal and Greece – have on balance been unable to close the gap considerably.

But such divergences are not exclusive to the euro area. GDP per capita in the richest state in the United States is around twice that of the poorest state, which is roughly the same gap as in the euro area[29]. And the dispersion of growth rates across euro area countries has fallen considerably over time and, since 2014, has been comparable to the dispersion across US states.

So what has driven the different convergence trajectory of countries, and how much is it related to membership of the euro? Convergence can be thought of in two ways. The first is convergence of real GDP per capita levels. This is a long-term process which is driven by factors such as rates of FDI, productivity growth and institutional quality. Such

factors can be fostered by sharing a single currency, but they are not determined by it. Domestic policies, structural and institutional reforms, and contributions from EU structural funds are what play a crucial role here.

The second concept of convergence relates to *growth rates*, ie. how much business cycles across countries are synchronised, especially when major shocks hit. This is determined more by monetary union membership, since the design of a monetary union affects the capacity of countries to adjust and stabilise demand during recessions.

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In the case of Italy, we see both long-term and cyclical factors at play. Between 1990 and 1999 – that is, before the introduction of the euro – Italy already had the lowest cumulative per capita GDP growth of the original euro area members. From 1999 to 2008, it again had the lowest per capita GDP growth of all euro area members.

From 2008 to 2017, it recorded the second lowest cumulative growth, behind Greece. And, if we look further back, the growth we saw in the 1980s was borrowed from the future, having been based on debt that was left for future generations to bear.

So, low growth in Italy is a phenomenon that dates back a very long time before the euro. This is a supply-side problem, which is clear if one looks at regional performance. There is a correlation between GDP per capita in different Italian regions and some structural indicators, such as – just to take an example – the ease of doing business index compiled by the World Bank: the values for the poorer regions are generally lower than those of richer regions.

At the same time, the fact that Italy – and other countries – diverged further from the euro area average during the crisis highlights two important points. First, that structurally weaker countries are more vulnerable to economic slowdowns than others; and second, that our Monetary Union remains incomplete in some key respects.

There is a fair amount of evidence that countries that implemented decisive structural policies recovered faster from the crisis than others. In countries that made such changes, the labour market is now more responsive to growth[30], and the improved economic conditions have led to gains in employment[31]. But alongside structural policies, different layers of protection are necessary to ensure that countries can stabilise their economies during crises.

Without appropriate backstops at the euro area level, individual countries in a monetary union can be exposed to self-fulfilling dynamics in sovereign debt markets. Such overshooting can aggravate adverse debt dynamics in downturns, inducing procyclicality in national fiscal policies, as we saw in 2011-12.

Typically, sovereign borrowing costs should fall in a recession, but at that time economies representing one-third of euro area GDP saw their borrowing costs become positively correlated with risk aversion[32]. The result was a lack of stabilisation that harmed both growth and fiscal sustainability.

So it is the structurally weaker countries that most need EMU to have instruments to diversify the risk of crises and counteract their effect on the economy. I have talked before about how countries like Italy, which had been weakened by decades of low growth and had no fiscal space when the crisis began, saw a crisis of confidence in government debt turn into a credit crisis with major repercussions for employment and growth[33].

Deepening private risk-sharing through financial markets is one key element in preventing such events from recurring. In the United States, around 70% of shocks are mitigated and shared across the individual states through integrated financial markets, whereas in the euro area the share is only 25%[34]. It is therefore also in the interest of the weaker countries in the euro area to complete banking union and to proceed with the construction of a genuine capital market.

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But national budgets will never lose their function as the main stabilisation tool during crises. In the euro area, around 50% of an unemployment shock is absorbed through the automatic stabilisers in national public budgets, significantly more than in the United States[35]. The use of automatic stabilisers, however, depends on countries not being constrained by their debt level. So the necessary fiscal space will have to be created again so that budget interventions can be made in the event of a crisis.

Yet national fiscal policies also need a complement at the European level. We need an institutional architecture that gives all countries the necessary support to ensure that their economies are not exposed to procyclical market behaviour during downturns. This will only be possible if the support is temporary and does not constitute a permanent transfer between countries, which would result in a failure to put in place the necessary fiscal consolidation, let alone the fundamental structural reforms needed for a return to growth.

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Conclusion

It is not a technocratic desire to see convergence across countries and the smooth functioning of Monetary Union that has led me to frequently mention the importance of structural reforms in recent years. Each country has its own reform agenda, but such reforms are the only way to create the conditions for sustainable growth in wages, productivity and employment and to underpin our welfare state.

In large part these measures have to be undertaken at the national level, but they can be supported at the European level by the recent decisions to launch an instrument for convergence and competitiveness.

However, to tackle future cyclical crises, the two layers of protection against shocks – the diversification of risk through the private financial system on the one hand, and public countercyclical support through national budgets and the fiscal capacity of the EU budget on the other – need to interact in a complete and efficient manner.

The more progress we make in completing the banking union and capital markets union, the less urgent – although still necessary – it becomes to construct a fiscal capacity, which could at times serve to complement national stabilisers. Inaction on both fronts heightens the fragility of Monetary Union in times of great crisis and the divergence between countries increases.

It is clear that completing Monetary Union is the best way to prepare the transition to a form of union that is more complete. Monetary Union, a necessary consequence of the Single Market, has become an integral and defining aspect – with its symbols and its constraints – of the political project whose central aim is a Europe that is united in freedom, peace, democracy and prosperity.

It was an exceptional response – or to paraphrase Robert Kagan[36] an anti-historical response – to a century that had seen dictatorships, war and misery, and in that respect was not dissimilar to previous centuries. A unified Europe was part of that world order, itself the result of exceptional circumstances, which followed the Second World War.

The intervening years have confirmed the rationality of the choices made at the European and the global level. The challenges that have arisen have become ever more global in nature and need to be tackled together, not alone. And this is even more true for Europeans, both at the level of their individual nations and for the continent as a whole: rich but relatively small; strategically exposed, militarily weak.

Yet today, for many, the memories that inspired those choices seem distant and irrelevant, and the rationale behind them has been undermined by the misery created by the great financial crisis of the past decade. It does not matter that we are emerging from the crisis. Elsewhere in the world, the fascination with illiberal prescriptions and regimes is spreading; we are seeing little steps back in history.

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And this is why our European project is even more important today. It is only by continuing to make progress, freeing up individual energies but also fostering social equity, that we will save it through our democracies, with a unity of purpose. ■

Mario Draghi is President of the European Central Bank

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Endnotes

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7. Real GDP per hour worked.

8. Reference period is 1979-1991, excluding Italy.

9. European Commission (1980), "Reflections on the Common Agricultural Policy", Bulletin of the European Communities, Supplement 6/80.
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A new vision for trade

The Foundation for European Progressive Studies present a vision that can form the core of a new, forward-looking progressive model for trade and investment

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Over the last decades international trade has played an important role in promoting economic growth, job creation and better living standards at the global level. At the same time, international trade has been linked to a form of unregulated globalisation, causing uneven and unjust results for significant parts of our societies.

A key objective going forward must be forging a new consensus on trade and investment contingent on the principles of employment, broad-based prosperity, equality, transparency and sustainability. What follows presents a vision that can form the core of a new, forward-looking progressive model for trade and investment.

Changing nature of trade agreements

The focus of trade agreements has moved away from trade liberalisation to covering a range of trade-related issues, like investment liberalisation and protection, and intellectual property rights, with important social, economic and environmental repercussions.

We need to acknowledge and tackle the issues arising under these new types of economic agreements, in particular in relation to unregulated capital flows and investments. We also need to redress the often opaque manner, in which these comprehensive trade and investment agreements have been negotiated, often designed to advance the interests of those in the top income brackets.

Europe as a leader for a progressive agenda

To address these challenges, we believe that the EU must use its economic weight to advance a progressive trade and investment policy at the multilateral and the bilateral level. To achieve this goal, we propose an agenda that reinforces the multilateral trading system while improving its fairness for the poorest and enhancing Europe's contribution to trade and development.

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Further, we propose to better integrate trade with labour and environment, and rethink investment and capital flows to advance sustainable development, as well as develop rules to govern the digital revolution and ensure the fairness of the intellectual property regime. To complement these elements of a new progressive vision of international trade governance, we propose the establishment of a new European fund to address the negative consequences of globalisation.

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... the EU must use its economic weight to advance a progressive trade and investment policy at the multilateral and the bilateral level

Multilateralism

We see the multilateral trading system as the preferred option for building international rules on trade. Multilateralism is fairer with a wide diversity of strong and weak, big and small economies. It is more efficient in providing a stable and predictable environment to a maximum number of operators. For these reasons we believe states should conclude the negotiations on the Doha Development Agenda.

They should rebalance the specific trade disciplines that govern the agricultural sector that is currently tilted in favour of developed countries. They should also strengthen WTO disciplines in areas such as subsidisation, conduct a review of the 'special and differential treatment' principle in order to adapt to present realities, and modernise the WTO framework in areas of growing importance.

The EU's role on trade and development

The EU has an important role to play in its bilateral economic relationships, especially with developing countries. As part of the post-Cotonou negotiations, the EU must expand unilateral trade preferences and preferential treatment to all low-and lower middle-income countries in Sub-Saharan Africa, in order to support the region prioritising its own regional integration.

This would allow for the creation of jobs, increased incomes, and ultimately, to reduce poverty and aid dependency. To achieve SDG 2 on ending hunger, we need to *"correct and prevent trade restrictions and distortions in world agriculture markets."* Accordingly, further reform of the EU Common Agricultural Policy (CAP) will help achieve SDG 2. Finally, the EU must live up its commitments regarding Official Development Aid (ODA) in accordance with SDG 17.2.

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Labour

All areas covered by trade and investment agreements impact employment and labour conditions. Trade policy must therefore play a vital role in encouraging and helping trade partners to implement ILO core labour standards. Parties must firmly commit to implementing core labour standards. Implementation and enforcement of core labour standards must be adapted to the partner country's level of development, and coupled with support.

Further, the comprehensive and effective involvement of social partners and civil society is essential for the successful execution of labour provisions in trade agreements. A progressive labour chapter should also provide a suitable framework for continuous and guided cooperation aimed at progressively advancing labour protection.

Finally, labour provisions should be complemented with traditional state-to-state dispute settlement as well as an innovative collective complaint procedure.

Environment

Trade and investment rules should not pose barriers to solving environmental challenges, such as climate change, biodiversity loss, and water scarcity. In the area of climate change, to avoid any potential regulatory chilling effect, states should clarify that strong, potentially disruptive, non-protectionist climate action is needed and is not prohibited under international trade and investment rules.

At the same time, trade rules should help discipline certain types of measures, such as fossil fuel subsidies. The design of climate measures with trade impacts, whether border carbon adjustments or other measures, must apply differential treatment and exemptions to exports from poor and middle-income countries whose CO_2 emissions per capita are low. Policy space for green industrial policies and green subsidies should be permitted, and agreements should be designed or adapted accordingly.

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Investment

Most comprehensive trade agreements today include chapters and provisions on investment. These chapters have focused on investment protection, investment liberalisation, and investor-state disputes settlement. The focus of these treaties should be reoriented to promoting quality investment that advances SDGs.

First, the treaties should guarantee the policy space needed to regulate incoming and operating investments. The EU should accordingly re-examine and adapt its approach to pre-establishment and market access rules and the prohibition of performance requirements.

Second, EU treaties should ensure that investment protection provisions do not limit the state's legitimate right to regulate. Moreover, they should also be rebalanced to include not only investment protection but also responsibilities for investors, including with respect to responsible global value chains.

The EU should continue leading on reforming investment-related dispute settlement and explore alternatives to investor-state dispute settlement. EU member states should proceed with terminating and redesigning the over 1000 outdated investment treaties of EU member states.

Capital flows

In light of the increasing evidence in favour of regulating excessive capital flows to respond to concerns about macro-economic instability and major economic costs that external capital flows and ensuing currency crises may create, countries should use capital flow management measures alongside other macroeconomic policies. Many trade and investment agreements prohibit such capital account regulations or lack the appropriate safeguards on capital account management. This erosion of policy space to implement such policies must be avoided.

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In future, neither the WTO, nor investment treaties and chapters in free trade agreements should contain provisions that limit an individual country's ability to freely manage its capital accounts and regulate capital flows.

If there are commitments to capital account liberalisation, appropriate and sufficient safeguards must be in place to allow countries to implement capital account regulations for prudential or balance of payments reasons, ideally on a permanent basis. Existing treaties should be promptly amended accordingly.

Digitalisation

Technological innovation is deeply interwoven in our globalised world. Fuelling cultural and economic exchanges, tech advancements spawned a global community, reaching the most remote regions of the world. Few economic or cultural realms lie outside the reach of technological innovation and some, like employment, grapple to reconcile old and new structures of social organisation.

Specific policies regarding digital trade, data flows, intellectual property rights, and net neutrality must embody and uphold democratic principles and a strong commitment to achieving the Sustainable Development Goals. This implies revising policies on data provisions, data localisation, research and development, national tax systems, the digital single market, and a reconsideration of investment screening mechanisms.

European Transformation Fund (ETF)

Ten years ago, the European Globalisation Adjustment Fund (EGF) was established to support victims of industrial transformation in Europe because of global economic changes. The EGF remains too modest in size and too narrow in focus given current needs. It must be redesigned both in terms of budget and scope.

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For the EGF to be effective, the EU must conduct sound and transparent impact assessments before concluding new trade and investment agreements. This analysis should be as accurate as possible and identify the consequences and changes on different economic sectors and on European regions.

The new Globalization Adjustment Fund, to be renamed as the 'European Transformation Fund' (ETF), must be designed to support the restoration of an ambitious industrial policy, one based on permanent, prospective analysis of economic and technological changes, including the effects of trade, allowing for the necessary strategic investments to prevent negative consequences of trade and investment treaties in Europe.

To conclude, the traditional approach, which argues that 'trade is good, but we need to work on the side effects,' is outdated. In today's changing world, 'business as usual' does not work. We believe that in such a new context between the faithful and unconditional promoters of free trade and the populist critiques defending protectionist and nationalist visions of the world, there is a critical political space for progressive forces to defend a regulated vision of globalisation, a vision which guarantees that global trade and investment benefit the many and not the few. ■

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ABOUT THE AUTHORS

Nathalie Bernasconi, Executive Director IISD Europe, Group Director, Economic Law & Policy, International Institute for Sustainable Development (IISD)
Carles Casajuana, SOLIDAR Board Member and former Spanish Ambassador
Stephany Griffith Jones, Professor, Columbia University, Financial Markets Program Director, Initiative for Policy Dialogue
Eveline Herfkens , Former Minister for Development Cooperation of the Netherlands
Pascal Lamy, former WTO Director General and former EU Commissioner for Trade

Bernd Lange, MEP, Chair of the European Parliament Committee on International Trade
Paul Magnette, Mayor of Charleroi and former Minister-President of Wallonia (Belgium)
Linda McAvan, MEP, Chair of the European Parliament Committee on Development
Alessia Mosca, MEP, Socialists and Democrats' coordinator in the European Parliament Committee on International Trade
Enrique Guerrero MEP, co-President of the Global Progressive Forum

The Foundation for European Progressive Studies, (FEPS) is the only progressive think tank at European level

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How far can trade policy go in promoting European values?

The EU can and should use trade agreements to promote European values but not at the expense of its economic interests, argues Luisa Santos

HERMES AVIATION
CONSULTING

The discussions around trade policy have seen the emergence of a new narrative. The focus was shifted from trade as a means to increase market access and promote EU companies' competitiveness to new aspects such as transparency, inclusiveness and the need to mitigate negative consequences of trade and globalisation.

A critical juncture for the EU's trade policy was the European Commission's *Trade for All* Strategy published in October 2015. It explicitly states that the EU's trade policy should *"not only project our interests, but also our values."* Since then, the debate on what objectives trade policy could and should seek has intensified within the European institutions and civil society.

This debate is in large fuelled by three interconnected perceptions:

1. Europe's traditional foreign policy tools, including development aid and multilateral diplomacy in forums like the United Nations and International Labour Organization (ILO) are perceived by some as not delivering sufficient results in a reasonable period of time in areas such as human rights, environmental protection or labour rights.

2. These instruments are seen as having failed to achieve their objectives (ie. compel third countries to alter their policies in the desired direction) due to insufficient incentives and weak avenues for enforcement.

3. As the world's largest common market, the EU wields considerable economic power and should use this leverage in its trade policy to achieve the above-mentioned goals that go beyond "traditional" market access objectives.

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This line of reasoning has led many civil society actors, members of the European Parliament, and some member states to call for an expanded list of foreign policy goals to be achieved through the EU's trade policy. Concretely, this means that the EU is asked to increase its list of demands vis-à-vis a given third country before a preferential trade agreement between the two parties can be signed. Examples of such demands include, but are not limited to, respect of the Paris climate accord, prior ratification of ILO conventions, implementation of human rights conventions and corporate social responsibility guidelines, and adoption of high environmental standards.

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The EU's free trade agreements can support goals such as improving labour, environmental and health standards, since higher standards abroad not only contribute to global sustainable development but also to a level playing field for European companies

In this view, the EU's trade policy is seen as capable of delivering on all of these value-driven foreign policy goals. However, this approach risks overloading the trade policy agenda. If the EU's demands prior to any free trade agreement (FTA) negotiations increase in both scope and intensity, two detrimental outcomes are more likely.

The first is that a potential negotiation partner could use the EU's non-trade related demands to extract larger economic concessions from the EU. The second is that such excessive demands could deter the third country in question from concluding any trade deal with the EU. In the latter case, the EU's trade policy risks becoming ineffective, projecting neither European economic interests nor European values.

For the European business community trade policy should remain focused on its core objectives that are opening markets and improving trade and investment conditions for companies. This is even more important now that we are facing a wave of protectionism and increased market barriers. The EU's free trade agreements can support goals such as improving labour, environmental and health standards, since higher standards abroad not only contribute to global sustainable development but also to a level playing field for European companies.

However, labour rights, environmental protection, climate change mitigation and gender equality should not be the primary goals of the EU's trade policy. Just as FTAs should not be seen as the primary instrument for delivering on these objectives. For instance, the EU cannot and should not duplicate and consequently undermine the work of the International Labour Organization. Similarly, we believe that EU trade policy should not duplicate but complement the work of the Conference of the Parties (COPs) on climate arrangements.

In an era of global supply chains, the economic growth is happening mostly in emergent markets. Many of them, like China, have already become leading trade powers. Europe cannot afford to be naïve and lead this battle on

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its own. The EU can and should use trade agreements to promote European values but not at the expense of its economic interests. ■

Luisa Santos is Director for International Relations at BusinessEurope

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The consequences of protectionism

Protectionism is the wrong solution to address concerns about the distributional effects of globalisation, says Benoît Cœuré, and the EU is the vehicle to make trade more equitable

HERMES AVIATION
CONSULTING

In the two decades before the financial crisis trade growth was a major contributor to higher living standards worldwide, with world imports growing at roughly twice the rate of output. The integration of many emerging economies into global trade, notably through participation in global value chains, boosted incomes and lifted millions of people out of poverty.

Since the crisis, however, trade has provided noticeably less support to economic growth. Trade growth has barely kept pace with output growth, and has even lagged behind it in a number of years. As a result, the current economic expansion in the euro area has been driven largely by domestic demand, supported by substantial monetary policy accommodation.

More recently, world trade has shown tentative signs of renewed vigour. Last year, world goods trade grew by more than 5%, the strongest rate for seven years, against less than 4% for world GDP. Yet, the nascent recovery in trade is at risk of being derailed by the introduction of impediments to global economic integration. There are signs that the anti-globalisation sentiment that has become more pervasive since the crisis has begun to be translated into actual policy measures.

Many commentators have expressed concerns that the tariffs recently announced by the US administration represent the first step towards a 'trade war', potentially leading to a broader reversal of globalisation. Retaliatory measures have already been announced by some economies.

These steps are taken despite the benefit of trade for aggregate welfare being one of the rare points of consensus for economists. In a recent poll in which economists were asked whether the announced tariffs would improve Americans' welfare, the respondents were split between disagree and strongly disagree[1].

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At the same time, the benefits of globalisation have not been spread evenly, neither across nor within countries, something that economists have not given sufficient consideration for a long time. While textbook economics suggests that lump sum transfers from the winners of trade can ensure that all are better off, such transfers – or adequate training and educational measures – have not happened in sufficient scale to compensate everyone. According to a separate survey, only 40% of people in the United States think globalisation is a force for good for the world[2].

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The European Union... represents the most progressive model we have for taking back control of globalisation by addressing people's concerns over open markets and fair competition – doubts that individual countries on their own cannot dispel

Protectionism is not the right answer to these challenges, however. It is unlikely to solve the distributional consequences of globalisation while it is certain to reduce aggregate global living standards. There are no winners in trade wars, just different degrees of losers.

But to defend openness by listing its aggregate benefits is no longer fully convincing. The question of the distribution of those benefits and the disruptive effects that come with them has to be answered. Economists and policymakers therefore have a responsibility to propose and design policies that help those not benefiting directly from globalisation. I have previously spoken about the need to make globalisation efficient, enduring and equitable[3].

Today I would like to share a central banker's perspective on potential structural changes to the current global trade regime – one where restrictions to trade are managed through multilateral agreements.

I would like to flag two main implications should impediments to the free movement of goods and services increase significantly. The first is the effects higher tariffs would have on growth and inflation in the near to medium term. There are a number of important channels to consider, including the direct impact of tariffs on prices and growth, changes to financial conditions and effects on expectations and confidence. The second main implication is the possible impact on long-run potential output growth, and how that may influence the conduct of monetary policy.

Implications for the short to medium term

Let me first look at the channels through which increases in tariffs may affect output and inflation in the short to medium term. For illustration, I will use the results of simulations carried out by ECB staff using both the ECB's global model and the IMF's multi-country model. As with all models, the uncertainties involved mean precise

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estimates from these scenarios should be treated with caution, but they are useful to explain the different channels at work.

To illustrate the potential effects of rising protectionism, I do not want to dwell on the specifics of the tariffs currently being discussed. This would miss the bigger picture. I rather want to consider a hypothetical scenario where the United States raises tariffs on all imports of goods by 10 percentage points, and its trading partners impose the equivalent on US exports.

According to our model simulations, such a scenario would have significant adverse effects on the global economy, including, and in particular, on the economy that raises tariffs in the first place. Specifically, real economic activity in the United States could be up to 2½% lower than in the baseline in the first year alone. The reasons are essentially threefold:

- First, if domestic and imported goods cannot be easily and readily substituted, higher import prices increase firms' production costs and reduce households' purchasing power. These effects weigh on consumption, investment and employment, resulting in a material overall negative impact on GDP.

- Second, in addition to the direct adverse price effects, the uncertainty about growth prospects is likely to cause consumers to delay expenditure and businesses to postpone investment[4]. Much will depend on how consumers and businesses react, but ECB simulations suggest that such uncertainty and confidence effects could account for around one-third of the overall effect in the first year. In addition, financial investors react to uncertainty by selling equities, reducing credit and demanding higher compensation for risk. This in turn reduces wealth, increases the cost of investing and further discourages demand.

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- And third, economic activity declines as US exports are hit by the tariffs abroad, which is only partially offset by lower imports.

In short, even though one may argue about the relative contributions of each of these channels, and the overall effect on economic activity, qualitatively the results are unambiguous: an economy imposing a tariff which is retaliated by other countries would clearly be worse off. Its living standards would fall and jobs would be lost.

The effects on other economies would primarily depend on their size, trade openness and how much they trade with the tariff-imposing country. Naturally, the economies that have the closest trade relations with that country would be the most negatively affected.

But the effects could also be material for those economies that, despite having a less direct exposure, are particularly integrated into global value chains. For example, one estimate puts the share of global value chain-related trade at more than half of exports from many South East Asian economies[5]. The erection of trade barriers threatens this integration, with potentially serious negative consequences for those countries and probably for the global economy as a whole. Only a few open economies with little exposure to the tariff-imposing country may gain as a result of increased competitiveness in third markets.

In other words, the overall scenario is clearly a net negative for the world economy as a whole. According to ECB staff simulations, world trade in goods could fall by up to 3% already in the first year after the change in tariffs and world GDP by up to 1%. Euro area GDP would also decline, but by less than in the US.

These developments would ultimately also weigh on prices and wages. Although import prices would likely rise as a result of the increase in tariffs – with the sign and scope depending on the exchange rate reaction as well as the

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choices made by foreign exporters about their profit margins – consumer price inflation and wage growth are likely to decelerate as the effects of lower aggregate demand and higher unemployment can be expected to prevail, both in the United States and globally.

Perceptions of a measurable deterioration in current trade relationships could therefore potentially dent the confidence and animal spirits that are currently driving the strong economic momentum – and that policymakers worldwide have succeeded in restoring after many years of actively counteracting the effects of the crisis.

The impact could be even worse if the deterioration in trade relationships would be compounded with a weakening of the international financial regulatory agreements that were reinforced in the wake of the global financial crisis and have made the global financial system safer[6].

These are not just theoretical considerations. While the effects of any tariffs on output and inflation may take time to materialise, falls in equity prices in response to the US announcement to impose a tariff on steel and aluminium, and prevailing uncertainty on the scope of any retaliatory measures, have already contributed to tighter financial conditions.

The S&P 500 index fell by more than 1% on the day of the US announcement of its intention to impose steel and aluminium tariffs. Equity market prices fell more markedly in countries with large current account surpluses. In Germany and Japan, for example, the major stock market indices were down by more than 4% on the day after the announcement. The US decision on 22 March of further tariffs on Chinese imports exacerbated market concerns, with the S&P 500 down by nearly 5% on the day after the announcement. Industrial sectors directly affected by the tariffs were amongst the biggest losers.

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Such movements appear more pronounced than would be consistent with the direct economic effects of the measures announced to date. They seem to anticipate the effects of retaliatory measures and price in some chance that the scenario I described earlier may occur. And by fuelling uncertainty among market participants, fears of a 'trade war' have added to the volatility already witnessed earlier this year in equity markets. None of this supports growth and employment.

Longer-term influences

Besides short-term cyclical factors arising from a potential transition to a more protectionist regime, there are likely to be longer-term effects on the economy too. Trade openness supports growth in productivity and hence the long-run potential output of our economies.

Competition from trade, and the benefits offered by larger markets, can encourage a more efficient allocation of labour and capital across sectors and across firms. This improved allocation supports innovation and hence productivity. This is why the EU Single Market is at the heart of the European integration process.

These effects are also borne out by the data. According to one estimate, EU GDP per capita would be as much as a fifth lower in the absence of the integration since 1950[7].

This is supported at the microeconomic level as well. Data collected by the Competitiveness Research Network confirms that European firms that export are more productive and pay higher wages than non-exporting firms in the same sector. Moreover, this is not simply because exporting firms are more productive in the first place, but also because firms become more productive through exporting. Firms in their first year of exporting post greater productivity gains than similar businesses that do not export[8].

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Barriers to trade would undermine this virtuous process and thereby cause both productivity and potential output to decline. The potential growth rate of advanced economies has already slowed over recent decades, reflecting a number of factors, including the ageing population[9], as well as declining productivity growth.

So to sum up, why does protectionism matter for central banks? First, because a 'trade war' scenario would add to global uncertainty at a time when some central banks have only just begun the process of unwinding the unconventional policy measures put in place following the global financial crisis. And second, because a further adverse structural shock to productivity may lead us to be more often constrained in the longer term by the effective lower bound on nominal interest rates and to increase the need to resort to unconventional policy measures.

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Conclusions

Greater global economic integration has boosted living standards worldwide and lifted millions out of poverty. Yet, its distributional impacts both across and within countries have not been adequately addressed, a fact that ultimately provides the political motivation for the protectionist moves we observe.

Winding back globalisation is the wrong solution to address these concerns. A retreat from openness will only fuel more inequality as import prices rise, goods become dearer and real incomes fall. It would deprive people of the undisputed economic advantages that trade and integration bring and thereby exacerbate economic hardship for the poorest in society. And it would breed distrust among nations, making for a more unstable international order.

The distributional and social effects of greater economic integration should rather be addressed by targeted policies that achieve fairer outcomes. This requires a strong political and institutional landscape which can ensure

that the geographical scope of policy action and political debates coincide with the scope of market integration. This is a landscape which in Europe is best provided by the European Union.

By allowing member states to recover some of the state functions that have been eroded by globalisation, the European Union is a vehicle that brings the benefits of economic openness to the greatest number of its citizens while protecting them against untrammelled global forces. It represents the most progressive model we have for taking back control of globalisation by addressing people's concerns over open markets and fair competition – doubts that individual countries on their own cannot dispel. ■

Benoît Cœuré is a Member of the Executive Board of the ECB

Endnotes

1. See University of Chicago, IGM Economic Experts Panel.

2. See World Economic Forum: https://www.weforum.org/agenda/2017/11/what-your-country-thinks-of-globalization

3. See Cœuré, B (2017), "Sustainable Globalisation: Lessons from Europe", Revue d'économie financière, 125, April.

4. See eg. Bloom, N (2009), "The impact of uncertainty shocks", Econometrica, 77(3): 623-685.

5. See WTO (2017), Global Value Chain Development Report 2017.

6. See Cœuré, B (2017), "The perils of isolation", speech at the Council of Foreign Relations, New York, 19 April.

7. See Badinger, H (2005), "Growth effects of economic integration: evidence from the EU Member States", Review of World Economics, 141(1): 50-78.

8. See ECB (2017), "Firm heterogeneity and competitiveness in the European Union", Economic Bulletin, Issue 2/2017.

9. See Nerlich, C and J Schroth (2018), "The economic impact of population ageing and pension reforms", Economic

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The international role of the euro

Konstantinos Efstathiou and Francesco Papadia assess whether the euro area should pursue a greater international role for the euro, as outlined by Jean-Claude Juncker, and how it might go about doing so

HERMES AVIATION
CONSULTING

European Commission president Jean-Claude Juncker raised, in his latest State of the Union address on September 12th, an issue that has been somewhat dormant over recent years: the international role of the euro. Indeed, he announced that the Commission would present plans *"to strengthen the international role of the euro"* before the end of the year.

This statement raises two important issues:

- Should indeed the euro area pursue a more important international role for its currency?
- What are the tools that the euro area could deploy to pursue this objective, if indeed it is deemed desirable?

Any plan about increasing the international role of the euro should start from the current situation: what is the actual international role of the euro, ie. its use outside the borders of the euro area, and how has it changed over the two decades of its existence?

One very important and very clear fact is that the euro is the second-most important currency in all possible international uses, whether in the private or in the official domain. The first-ranking currency by a good margin is the dollar, while other currencies cover minimal shares.

The ranking between the dollar and the euro has not changed in the last two decades, is very likely to remain unchanged in the foreseeable future, and can be seen as a continuation of the situation preceding the introduction of the euro – when the deutschmark and some other European currencies were internationally used. The shares of the dollar and the euro, however, have changed over time and what one has gained the other has lost.

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This is visible in all possible international uses of the two currencies by the private or the public sector, but is clearest in the role of the two currencies to denominate foreign currency bonds, as in Figure 1, ie. when a resident of one country uses a foreign currency to issue debt.

The shares of the two currencies are of course much more stable if one looks at stocks, for instance of international bonds or foreign reserves, instead of flows as in Figure 1. But the phenomenon is still visible.

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A larger international role of the euro could be promoted if the ECB would surpass its 'neutral' attitude towards it

Figure 1. Foreign–currency-denominated debt issuance by currency

70
60
50
40
30
20
10

30/03/2000 30/12/2000 30/09/2001 30/06/2002 30/03/2003 30/12/2003 30/09/2004 30/06/2005 30/03/2006 30/12/2006 30/09/2007 30/06/2008 30/03/2009 30/12/2009 30/09/2010 30/06/2011 30/03/2012 30/12/2012 30/09/2013 30/06/2014 30/03/2015 30/12/2015 30/09/2016 30/06/2017

EUR Other USD

Source: Decalogic via ECB (2018).
Note: the series are 4-quarter moving averages.

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Theoretical considerations as well as empirical regularities allow for the establishment of the most important factors determining the relative international role of different countries:

- Size of the country issuing the international currency
- Development of the underlying financial market
- Freedom of capital movements
- Political and military power of the issuing country
- Financial stability of the issuing country, relative to the stability of other countries
- A policy by the issuing country to assist, or deter, the international use of its currency

The first four factors are characterised by strong inertia and therefore cannot explain the changes in the international use of the currencies that have taken place over the years. The last two, instead, can move quite significantly over time. One very important case in this respect is that of the fluctuations in the international use of the euro that took place before, during and after the Great Recession.

This is documented in Figure 2, reporting the share of foreign-currency-denominated debt issuance in euros as well as the degree of euro area financial integration, as captured in the index calculated by the European Central Bank.

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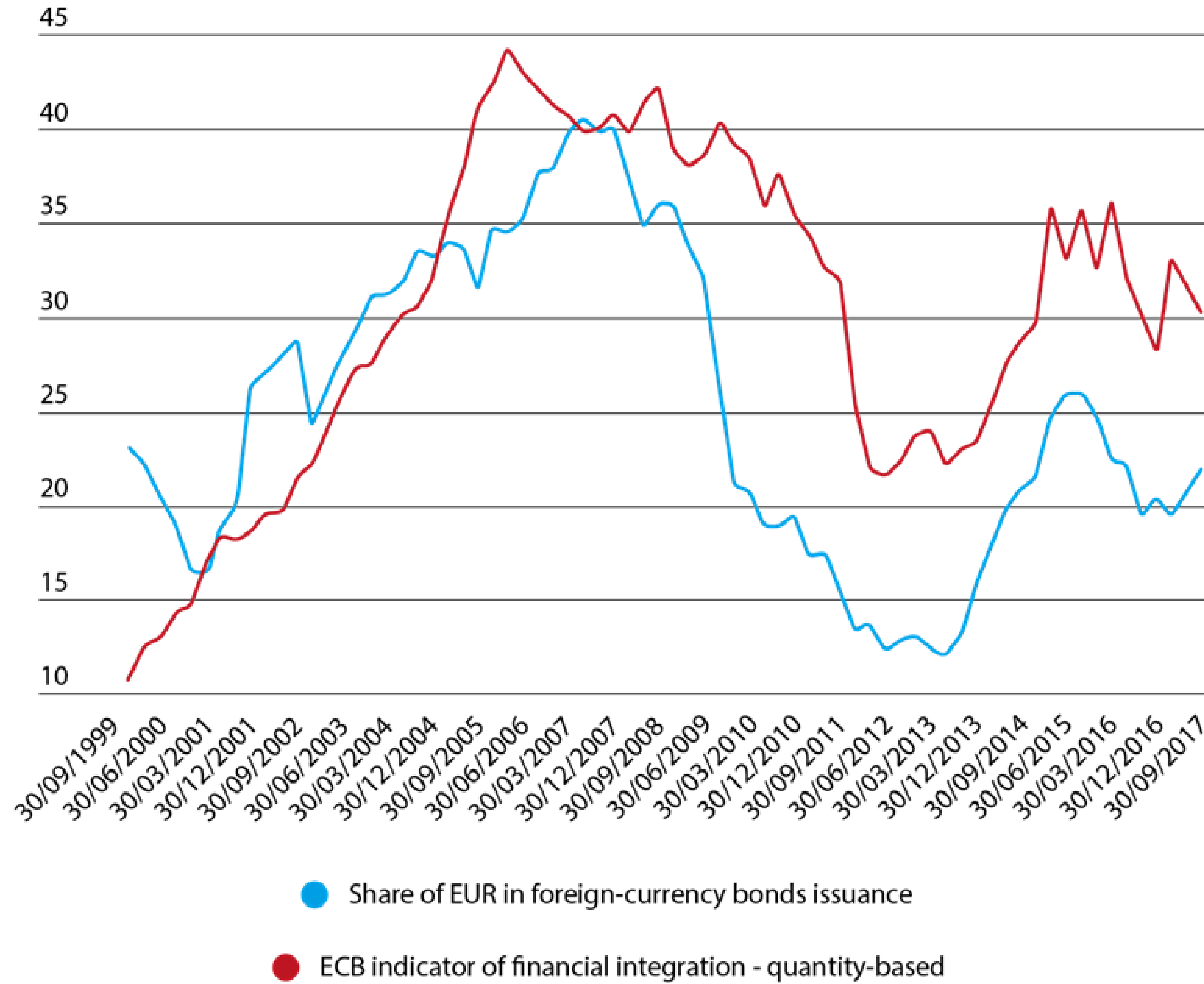
Figure 2. Foreign-currency-denominated debt issued in euro and index of financial integration



Source: Decalogic via ECB (2018) and ECB.
Notes: Share of EUR in bonds issuance is a 4-quarter moving average.

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Both series increased between the launch of the euro and the beginning of the Great Recession, decreased substantially in the course of that recession and started a recovery around 2012. This shows a high correlation between the international use of the euro and the stress in the euro area financial market (as measured by the changes in its integration).

Taking into account the evidence in Figure 1, the question about the desirability of a more important international role for the euro can be formulated more precisely: should euro area authorities pursue policies that would increase the share of the euro as an international currency?

One often-mentioned advantage of issuing an international currency, mostly elaborated with the example of the dollar in mind, takes the evocative name of 'exorbitant privilege'[1].

International seignorage is the first item under this general term, referring to the pecuniary advantage deriving from the use of zero-yielding banknotes by foreign entities and from the lower yield on external liabilities due to the international demand for the sovereign paper of the country issuing the international currency.

While seignorage was estimated at a non-negligible 1% for the US[2], the much lower circulation of euro banknotes outside the euro area – with respect to the foreign circulation of dollar banknotes – and the absence of federal euro bonds – covering the same role as Treasuries – make this advantage much less significant for the euro area. Also, the cheaper external borrowing allowed by the issuance of liabilities in one's own currency is less important for a jurisdiction, like the euro area, with large current account surpluses.

Another aspect, often mentioned for the US, is the 'denomination rents' that banks derive from the use of their 'home' currency in international finance. As for seignorage, the advantage for European banks to conduct

international business in their domestic currency is not as important as for US banks, since the former banks have significantly reduced their international activity during the financial crisis. In addition, for their international business, European banks use foreign currencies (in particular the dollar) more often than American banks.

Overall, the financial advantages stemming from the international use of the euro are quite limited. Analogously limited, however, are the disadvantages that could derive from such use for the conduct of monetary policy.

These disadvantages made the Bundesbank reluctant to allow the deutschmark to be used internationally and are likely to have led the ECB to its policy of *"neither hindering nor promoting the international use of the euro"*. But the much larger size of the euro area economy, with respect to that of Germany, and the emphasis of the ECB on interest rates rather than on monetary aggregates substantially attenuate the fear that external shocks may affect the conduct of monetary policy.

The most important benefit for Europe from a larger international role of the euro can be found in what one could call 'financial autonomy'. The influence over the EU, deriving from the extraterritorial reach of US rules, decisions and policies granted by the very extensive international role of the dollar, would be reduced if the euro had a wider international use.

This has become more relevant as the interests of the US appear more frequently different from those of Europe, as the case of Iran sanctions has recently shown. One could also link a wider international role for the euro to a multilateral set-up, in which the outsized role of any single currency would be reduced and competition between currencies would be enhanced.

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Given the desirability of increasing the international role of the euro, the second question asked at the beginning of this piece is relevant: *"What are the tools that the euro area could deploy to pursue this objective?"*

A larger international role of the euro could be promoted if the ECB would surpass its 'neutral' attitude towards it. This would carry an important message and could be linked to the repeated requests of the ECB to complete banking union and progress on capital market union.

A possible operational development would be if the ECB would show willingness to enter into a series of swaps with central banks of countries that are extensively using the euro, while maintaining under its control the drawings on the swaps, lest they affect monetary policy.

The experience during the Great Recession has indeed shown that international money markets can seize up and central bank intervention may be needed to repair broken market intermediation. The opening up of swaps from the Federal Reserve of the United States to a number of central banks, including prominently the ECB, was a decisive step in this respect. The less forthcoming policy of the ECB in granting swaps to non-euro central banks was consistent with its 'neutral' policy towards the international role of the euro.

More importantly, the reversal of the gains in the international role of the euro accumulated in the first decade of monetary union, which accompanied the onset of the Great Recession, shows that substantial progress critically depends on the general stability of the euro area and, specifically, on the smooth functioning of its financial system.

So, for instance, the completion of banking union, progress on capital market union, the surpassing of the shock that will inevitably be wrought by Brexit, and the creation of a common 'federal' bond – which would cover in the

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euro area the role that Treasuries play in the United States – are necessary steps to increase the international role of the euro.

In a broader perspective, progress also in the set-up of euro area economic policy, in its fiscal and structural components, would favour a larger international use of the euro. In a still broader perspective, the international use of the euro would be expanded if the EU would pursue a more united, and thus more effective, external and defence policy.

These policies would have effects well beyond the international use of the euro and, while in principle desirable, they are not easy to be achieved. The choice to embark on them depends on broader considerations than just enhancing the international role of the euro.

The right perspective is that the broader international role of the euro, and the 'financial autonomy' that this would bring, would be an additional advantage to be taken into account while pursuing the aforementioned, much broader, policies. ■

Konstantinos Efstathiou is an Affiliate Fellow and Francesco Papadia a Senior Fellow at Bruegel

Endnotes
1. See McCauley 2015 for a recent formulation.
2. Combining evidence from US Treasury, 2006 and Cohen, 2012

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A more stable EMU does not require a central fiscal capacity

Michel Heijdra, Tjalle Aarden, Jesper Hanson and Toep van Dijk argue that stronger financial market risk sharing and more effective use of fiscal stabilisers will mean no additional fiscal risk sharing

HERMES AVIATION
CONSULTING

A central fiscal capacity is a recurring topic in discussions on reform of the Economic and Monetary Union, but no consensus on the usefulness and necessity of a such a capacity has been reached. This column, part of the Vox debate on euro area reform, argues that the potential stability benefits of a central fiscal capacity can be achieved through stronger financial market risk sharing and more effective use of fiscal stabilisers, without any additional fiscal risk sharing.

The need for a central fiscal capacity is a recurring element in the discussion on reform of the Economic and Monetary Union (EMU). Bénassy-Quéré *et al*. (2018) argue that, as part of a package of measures to enhance risk sharing and risk reduction in the EMU, such a central fiscal capacity can provide much needed budgetary support if one or several member states experience a large economic shock. Others also argue that the EMU needs a central fiscal capacity (eg. European Commission 2018a, Berger *et al*. 2018).

However, there is no consensus about the usefulness and necessity of a central fiscal capacity, as the President of the Eurogroup recently reported (Centeno 2018). One objection is that in light of a high degree of convergence of euro area business cycles (ECB 2018), and negative side-effects through risks of moral hazard and permanent transfers across member states (Feld 2018, Beetsma *et al*.2018), the advantages of a central fiscal capacity are outweighed by its disadvantages.

Another objection, developed in the remainder of this column, is that the potential stability benefits of a central fiscal capacity can be achieved without any additional fiscal risk sharing: namely, through stronger financial market risk sharing and more effective use of fiscal stabilisers. Completing the Banking Union, building the Capital Markets Union, and ensuring the build-up of buffers in national budgets will deliver a more stable EMU, while the ESM already acts as lender of last resort.

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Strengthening financial channels is the most effective way to improve stabilisation

The argument for a central fiscal capacity in the euro area is often inspired by cross-state fiscal transfers in the US. However, capital markets in the US are much more important for shock absorption than fiscal transfers. Figure 1 shows that fiscal transfers across states absorb 9% of asymmetric shocks in the US, while capital markets (cross-border factor income and capital depreciation) absorb 48% and credit provision to the private sector absorbs another 17%.

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[T]he euro area should focus on completing Banking Union, developing a capital market union, and ensuring that its members have the fiscal space to use automatic stabilisers in a downturn

In the euro area, the contribution of capital and credit markets to absorption of asymmetric shocks is limited to 12%. Shock absorption through financial channels is therefore more than five times as small in the euro area compared to the US. Strengthening these financial channels is the most effective way to increase the resilience of the euro area (Buti *et al*. 2016).

The Banking Union will enhance shock absorption by credit markets. Credit provision to the private sector absorbs on average 17% of asymmetric shocks in the US versus a negligible contribution in the euro area (Figure 1). The limited contribution of credit markets in the euro area can be linked to pro-cyclical credit flows and the break-down of interbank lending during the euro area crisis. Completing the Banking Union will strengthen the ability of the banking sector to absorb shocks.

The stability and resilience of the banking sector can be increased further through adequate buffers for bail-in and measures to address non-performing loans. The Banking Union will be underpinned by fiscal risk sharing through the establishment of a common backstop to the Single Resolution Fund. Plans for further risk sharing through a European Deposit Insurance Scheme, which is linked to discussions on the regulatory treatment of sovereign exposures on bank balance sheets, would further sever the link between sovereigns and banks.

Building a Capital Markets Union will strengthen capital market shock absorption. Capital markets account for 48% of absorption of asymmetric shocks in the US, compared to only 12% in the euro area (Figure 1). Integrated capital markets contribute to risk sharing through cross-border asset holdings.

In addition, well-developed capital markets provide borrowers with alternative financing options if bank lending contracts during a crisis. Adrian *et al*. (2013) document such substitution from loans to bonds in the US between 2007 and 2009. Despite the relatively low degree of capital market integration, Cimadomo *et al*. (2018) show that

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cross-border equity and FDI holdings in the euro area were powerful shock absorbers during the sovereign debt crisis.

This is why the development of a Capital Markets Union, supporting cross-border equity and FDI flows, is a promising avenue for further risk sharing. It may take a long time to converge to US levels of capital market integration. However, narrowing only a quarter of the 36%-point gap with the US would already have a stabilisation effect that is similar to the full effect of fiscal transfers in the US.

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Automatic stabilisation at the national level can be powerful if sufficient buffers have been built

Fiscal policy can also provide stabilisation in the wake of a downturn. National fiscal policy in the euro area currently provides twice as much stabilisation compared to federal transfers in the US. Comparing the federal level in the US with the national level in the EU is relevant. In the US, fiscal stabilisation mainly takes place through the federal budget, while stabilisation through state and local level budgets is very limited (Follette and Lutz 2010).

In the euro area, anticyclical disbursements from the EU budget provide some indirect stabilisation, but national budgets are the most important channel for fiscal stabilisation. Alcidi and Thirion (2017) show that federal transfers in the US absorb around 10% of regional shocks, while national automatic stabilisers absorb 20% of country-specific shocks in the euro area. Looking at total stabilisation across levels of government, Dolls *et al*. (2015) find that fiscal stabilisation in the euro area absorbs roughly 47% of combined income and unemployment shocks, versus only 30% in the US.

While the degree of national automatic stabilisation in the euro area is much higher than in the US, the differences between member states are rather pronounced: the budgetary elasticity of member states varies from 0.3 to more than 0.6 (Figure 2). Member states with low budgetary elasticities have relatively more room to enhance the

stabilization properties of their budgetary frameworks, for example by better aligning domestic unemployment benefit systems to the economic cycle.

Ensuring a sufficient build-up of buffers along the cycle enables automatic stabilisation during a downturn. Doing so removes the need for pro-cyclical fiscal tightening. This is why the preventive arm of the Stability and Growth Pact (SGP) is centred around a country-specific Medium-Term Objective (MTO) for the structural budget balance. The MTOs are set to ensure sustainable debt levels and enough room to manoeuvre for automatic stabilisers, as they provide a safety margin against breaching the SGP's 3% nominal deficit limit (European Commission 2018b).

Figure 3 shows that countries at their MTO can absorb virtually all shocks with automatic stabilisers without breaking the 3% nominal deficit limit. The simulation in the figure is based on current budgetary elasticities and ex-post output gaps of the EA12 between 1965 and 2016. The results show that for countries at their MTO, automatic stabilisers can operate fully without breaking the 3% limit in 96% of all cases (98% if cases where financial assistance through the EFSF and ESM was provided are excluded).

Figure 3 shows these results for six member states. This simulation illustrates that buffers in national budgets can be a very effective shock absorber, and underline the importance of building-up fiscal buffers.

It should be noted that the output gap – which is used in the calculation of the structural balance to correct for business cycle developments – is a volatile indicator that is often revised ex post. Moreover, the budgetary elasticity can deviate in practice from the elasticity that follows from models, for example in the case of large cyclical fluctuations.

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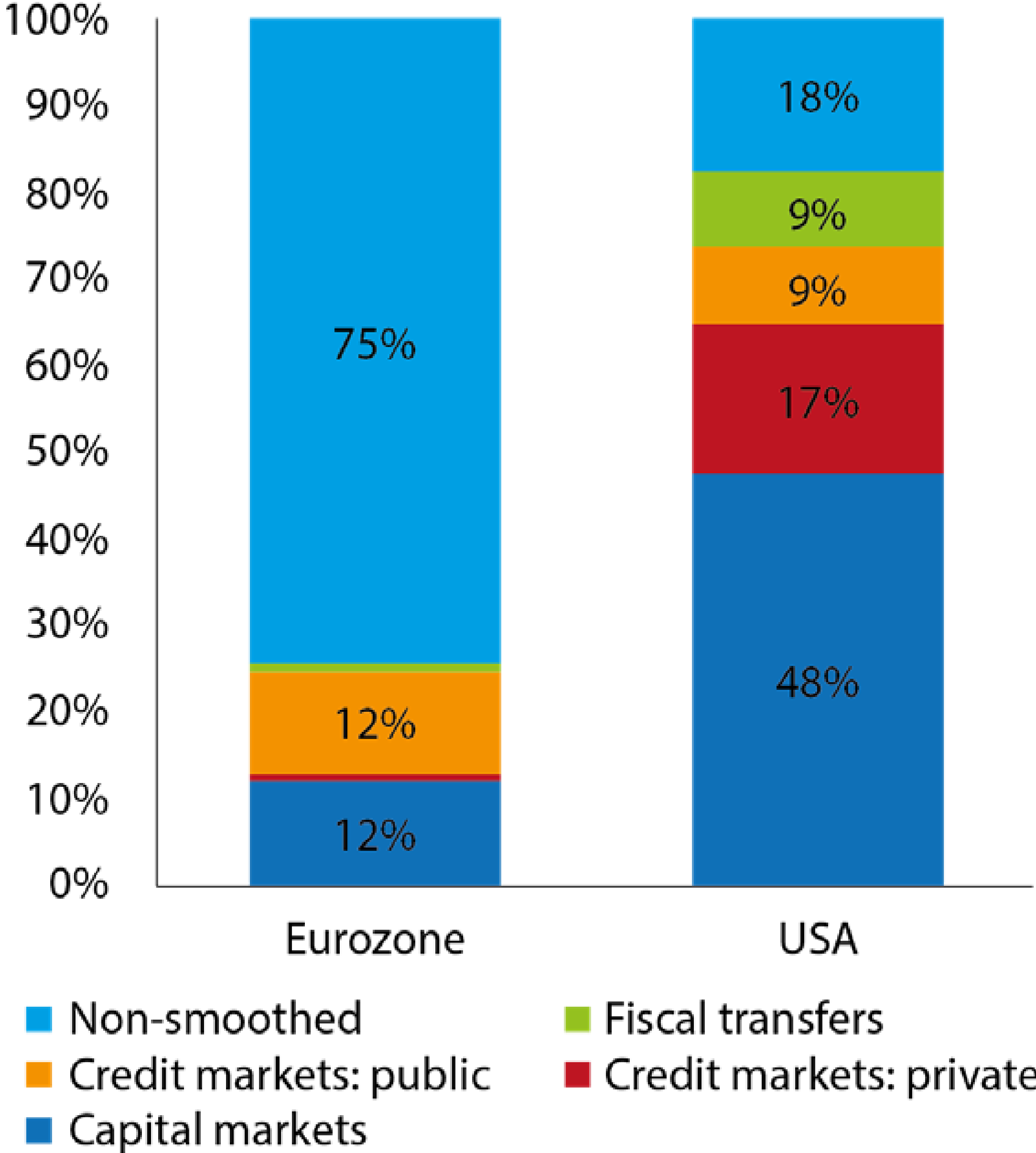
Figure 1. Channels of shock absorption (decomposition asymmetric shock absorption)



Source: Alcidi et al. (2017)

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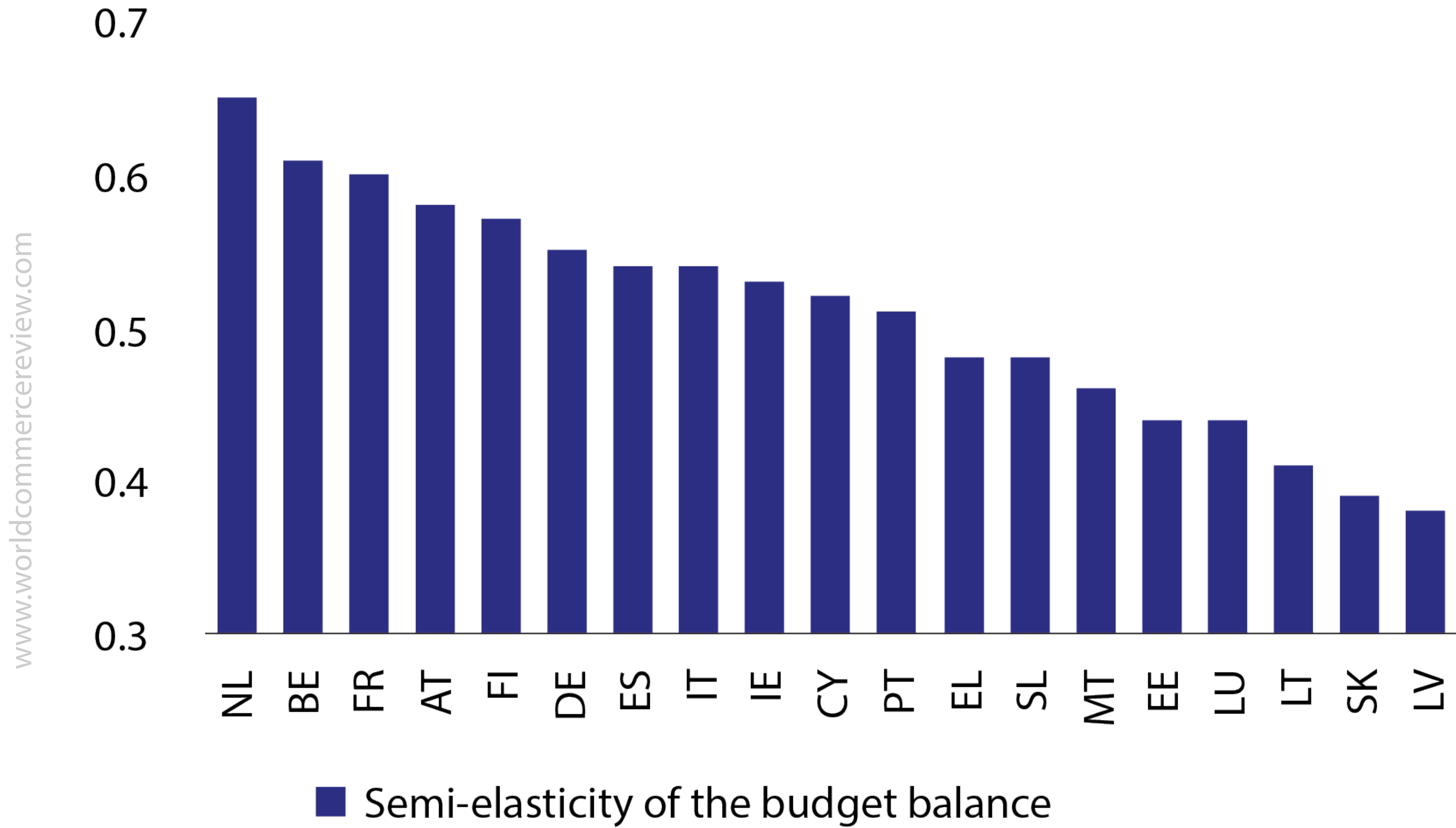
Figure 2. Automatic stabilisation across member states



Source: Mourre et al. (2014)

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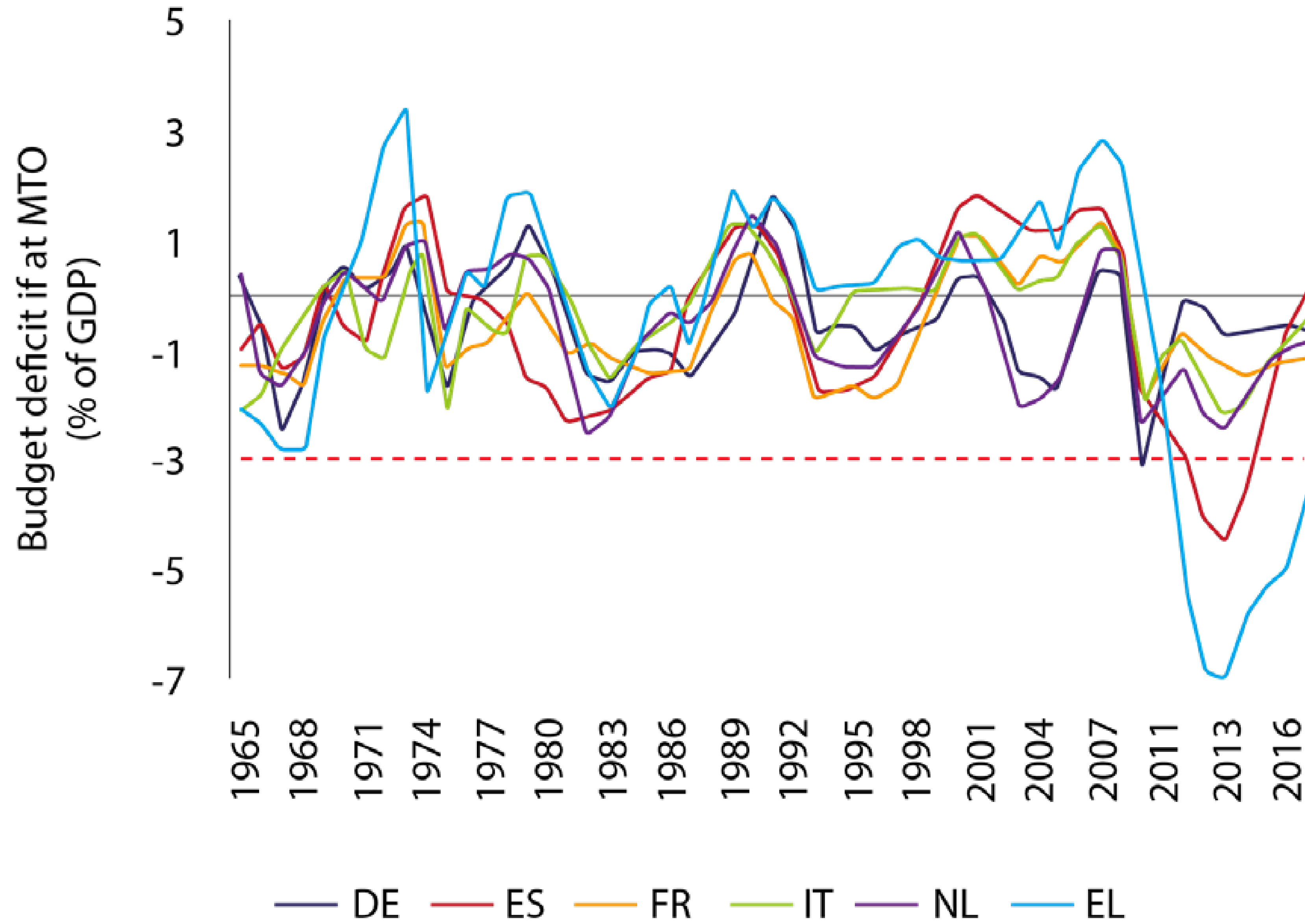
Figure 3. Shock absorption capacity if at MTO



Source: Ameco and Mourre et al. (2014).

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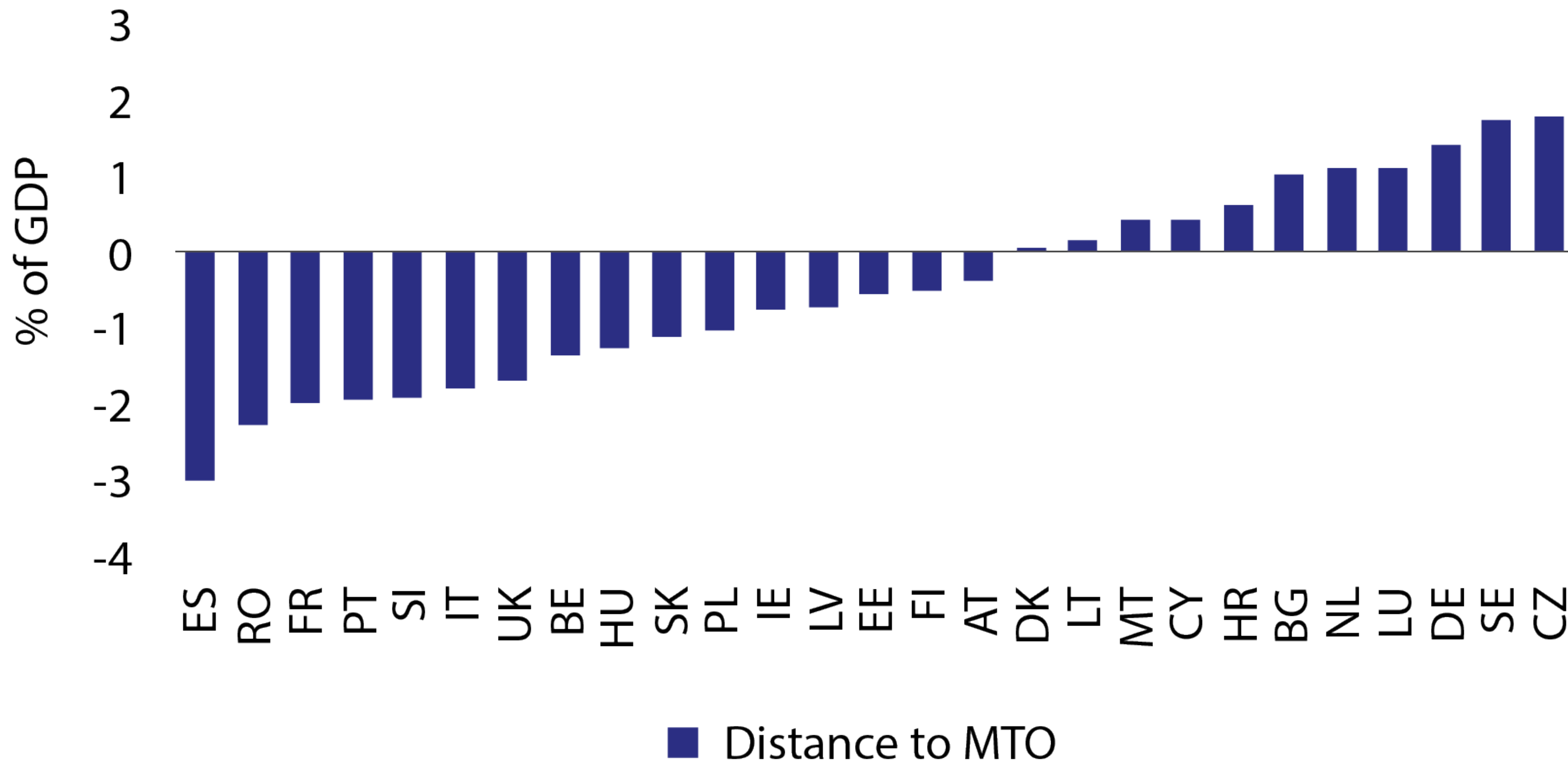
Figure 4. Distance to MTO in 2017



Source: Ameco.

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Different proposals have been made to give prominence to an expenditure rule as an operational target for national budgetary decision-making and fiscal surveillance (for instance, by Bénassy-Quéré *et al*. 2018, Darvas *et al*. 2018, the European Fiscal Board 2018, and the Dutch presidency in the first half of 2016, among others).

An expenditure rule combined with a debt target is more under the direct control of policy makers, although the design of such a framework would also require a balancing act in order to take account of the cycle. In the end, any framework must ensure that member states build sufficient buffers in good times, because this allows them to stabilise in bad times.

Over the past years, efforts have been taken in many member states to reduce their budget deficits, but a further effort is required as 12 euro area member states had not reached their MTO in 2017 (Figure 4). The low interest rate environment provides ample additional fiscal space to build these buffers in national budgets, and bolster the ability of national policies to stabilize the economy.

The cases of Ireland and Spain call for macro prudential policies and orderly bank resolution

Some argue that the cases of Spain and Ireland provide an example that even member states with a sound fiscal position can run into trouble (Dullien 2015, European Commission 2017). However, both Spain and Ireland were confronted with contingent liabilities stemming from a real estate boom and the banking sector. If anything, the cases of Ireland and Spain illustrate the importance of preventing the emergence and materialisation of contingent liabilities through policies to prevent macroeconomic imbalances and the establishment of the Banking Union.

The bursting of the real estate boom in Spain and Ireland had a permanent negative effect on fiscal revenues. The effect on government finances was significant due to a high sensitivity of tax revenues to declines in construction activity and asset prices (Lane 2012).

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The reduction in fiscal revenues was permanent, hence a fiscal capacity would not have alleviated the need for a structural budgetary adjustment. Instead, preventing the emergence of imbalances carries a high premium. The pre-crisis governance framework of the EU did not include preventive frameworks, such as the Macroeconomic Imbalances Procedure (MIP) and the macroprudential surveillance by the European Systemic Risk Board. The aim of the MIP is to detect the emergence of imbalances on the housing market in an early stage and could recommend corrective actions. In this light, it is important that the MIP is used to its full potential.

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Moreover, bail-outs of the domestic banking sector had an upward effect on government debt of up to 49% of GDP in Ireland, and further increased government debt through an indirect effect on sovereign bond yields. The principle of bail-in, which is a central element of the Banking Union, prescribes that instead of taxpayers, first private investors and then the privately filled Single Resolution Fund absorb losses in case of a bank resolution. This significantly lowers the risks for public finances.

As a last resort, the ESM provides funding, subject to conditionality to countries with liquidity needs

If member states can no longer stabilise their economy due to a loss of market access, the European Stability Mechanism (ESM) can act as a lender of last resort at the euro area level to provide financial assistance. Milano and Reichlin (2017) find that loans by the ESM and its predecessors stabilised no less than 55% of asymmetric shocks in the euro area between 2007 and 2014.

A downside of substantial financial support by the ESM is the effect on government debt levels in programme countries. In analogy to the bank resolution framework with loss-sharing through bail-in, a strengthened framework for orderly restructuring of unsustainable sovereign debt would enhance private loss-sharing in case of unsustainable debt levels and prevent a disproportionate adjustment due to debt overhang. This would also allow ESM programmes to focus less on fiscal adjustment and more on growth enhancing reforms.

To conclude, the euro area should focus on completing Banking Union, developing a capital market union, and ensuring that its members have the fiscal space to use automatic stabilisers in a downturn. Doing so would strengthen both financial and fiscal stabilization mechanisms and obviate the need for a central fiscal capacity. ■

Michel Heijdra is Director, Foreign Financial Affairs, at the Dutch Treasury, Tjalle Aarden is Deputy Head, European Affairs Division, at the Dutch Ministry of Social Affairs and Employment, Jesper Hanson is Advisor to the Executive Director of the Dutch-Belgian Constituency, IMF, and Toep van Dijk is a Policy Advisor at the European Affairs Division of the Dutch Minister of Finance

Authors' note: This column was prepared when all authors were employed at the Ministry of Finance of The Netherlands and represents the authors' views. A similar article was published in Economisch Statistische Berichten (Aarden et al. 2018).

Endnotes
1. However, with the establishment of the Banking Union, shock absorption on credit markets is strengthened through European supervision and a common rulebook that enhances the resilience of the European banking sector, and a resolution framework that ensures an efficient and orderly private sector loss-sharing in case of serious problems.
2. The structural deficit corrects the nominal budget for business cycle developments and the effects of temporary measures.
3. MTOs are defined instructural terms.
4. In Ameco, output gaps for the member states that adopted the euro after 2007 are not available from 1965 onwards.

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For Greece, we assume an MTO of 0.
5. Lane (2012) explains the permanent nature of the income reduction in Ireland and Spain: "In some countries (Ireland and Spain), the credit and housing booms directly generated extra tax revenues, since rising asset prices, high construction activity, and capital inflows boosted the take from capital gains taxes, asset transaction taxes and expenditure taxes. Faster-growing euro member countries also had inflation rates above the euro area average, which also boosted tax revenues through the non-indexation of many tax categories. Finally, low interest rates meant that debt servicing costs were below historical averages."

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The case for a central fiscal capacity in EMU

Marco Buti and Nicolas Carnot argue that whilst financial union and a euro area fiscal stabilisation are substitutes in normal times, they are complementary in bad times

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The debate continues over the needed ingredients for a stable Economic and Monetary Union. Some authors have argued that the completion of a financial union (banking union and capital markets union) together with sound national fiscal policies eliminate the need for common budgetary instruments.

The authors of this column beg to disagree and re-state the case for a central fiscal capacity. In essence, whilst financial union and a euro area fiscal stabilisation are substitutes in normal times, they are complementary in bad times.

Following the last crisis important governance steps have been taken to bolster the resilience of the European Economic and Monetary Union (EMU). The changes include putting in motion a banking union, establishing the European Stability Mechanism (ESM), and strengthening the surveillance framework. However, there is broad acceptance that current set up remains prone to shocks that could shake its functioning and even imperil its integrity. Further progress is therefore needed for a stable EMU (eg. Benassy Quéré *et al*. 2018).

In general the remaining 'problem' can be described as a lack of adjustment channels to large shocks, given the incomplete nature of the financial union and the absence of common fiscal instruments. Key ingredients to overcome these gaps are the completion of banking union and capital markets union (CMU) as well as the introduction of a stabilisation function. And, as argued in this column, a financial union is not a substitute to a stabilisation function – they are in fact complementary.

However, while the achievement of a full financial union is relatively consensual in principle, the value added of a central fiscal capacity is sometimes put in doubt (Heijdra *et al*. 2018, Feld 2018).

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Critics of the fiscal capacity make several points. They claim that: i) sizeable asymmetric shocks are infrequent; ii) private risk-sharing mechanisms, including as enhanced by the completion of banking union and CMU, could suffice to provide considerable shock absorption; iii) fiscal stabilisation can in any event rely on national budget stabilisers, provided that member states properly adhere to fiscal rules of the Stability and Growth Pact (SGP).

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Looking forward, the two priorities to deepen the EMU are the completion of the financial union as well as the introduction of targeted and effective common budgetary instruments. They complement and reinforce each other

Finally, critics claim that any common fiscal tool could only be an incentive to moral hazard and a door for non-legitimised permanent transfers. They conclude that the risks of a fiscal capacity outweigh its advantages.

We beg to disagree with this analysis. So too do the international organisations, which strongly favour the introduction of a fiscal capacity (eg. Lagarde 2018, Draghi 2018, OECD 2018).

In the rest of this column we take the points of the critics in turn. Hence, we examine three analytical questions:

> Q1: Is there evidence of large cyclical fluctuations in EMU, including country-specific components?
>
> Q2: Does private risk sharing via the completion of banking union and CMU eliminate the case for a central fiscal capacity?
>
> Q3: Do national automatic stabilisers within the SGP suffice to smooth the remaining shocks?
>
> Q4: Does a central fiscal capacity necessarily entail moral hazard and permanent transfers?

We finally recall, in conclusion, how together with other contributions, the Commission has proposed to move forward by tabling a balanced proposal.

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Q1: Is there evidence of large cyclical fluctuations in EMU, including country-specific components?

Business cycle fluctuations have remained sizeable since the inception of the euro. Interestingly, simple decompositions of the cycle suggest that output fluctuations comprise both a common component and country-

specific developments, with the two weighing about similar proportions. The average standard deviation of output gaps is about 3% of GDP (Figure 1), implying that output gaps bigger than that are not infrequent.

Moreover, when measured relative to the average of the zone, the average standard deviation of relative output gap is over 2% of GDP. National business cycles are imperfectly correlated and when they are, their amplitudes may considerably differ.

Cyclical fluctuations in EMU countries therefore reflect about as much a common component and country-specific fluctuations. This is confirmed by a more formal analysis relying on a principal component method, which finds that at most 60% of fluctuations can be ascribed to the common component, and thus, at least 40% is the result of idiosyncratic shocks or of the asymmetric transmission of common shocks (European Commission 2018). In addition, there is no empirical evidence of greater cyclical convergence over time. In other words, it is incorrect to consider that large asymmetric cyclical developments are irrelevant.

Overall, there remain significant asymmetric shocks, or at least asymmetric cyclical developments, across EMU countries, which by definition cannot be addressed by the single monetary policy. In fact, the monetary stance may contribute to cyclical differentials, as it is likely to be too supportive for countries in more favourable cyclical positions than the average and vice versa.

The presence of a relatively large common business cycle component also has implications. It justifies attention to the overall euro area fiscal stance, at least in circumstances such as the lower bound where the ECB may benefit from an aligned fiscal policy for counteracting large shocks, as happened during the early 2010s.

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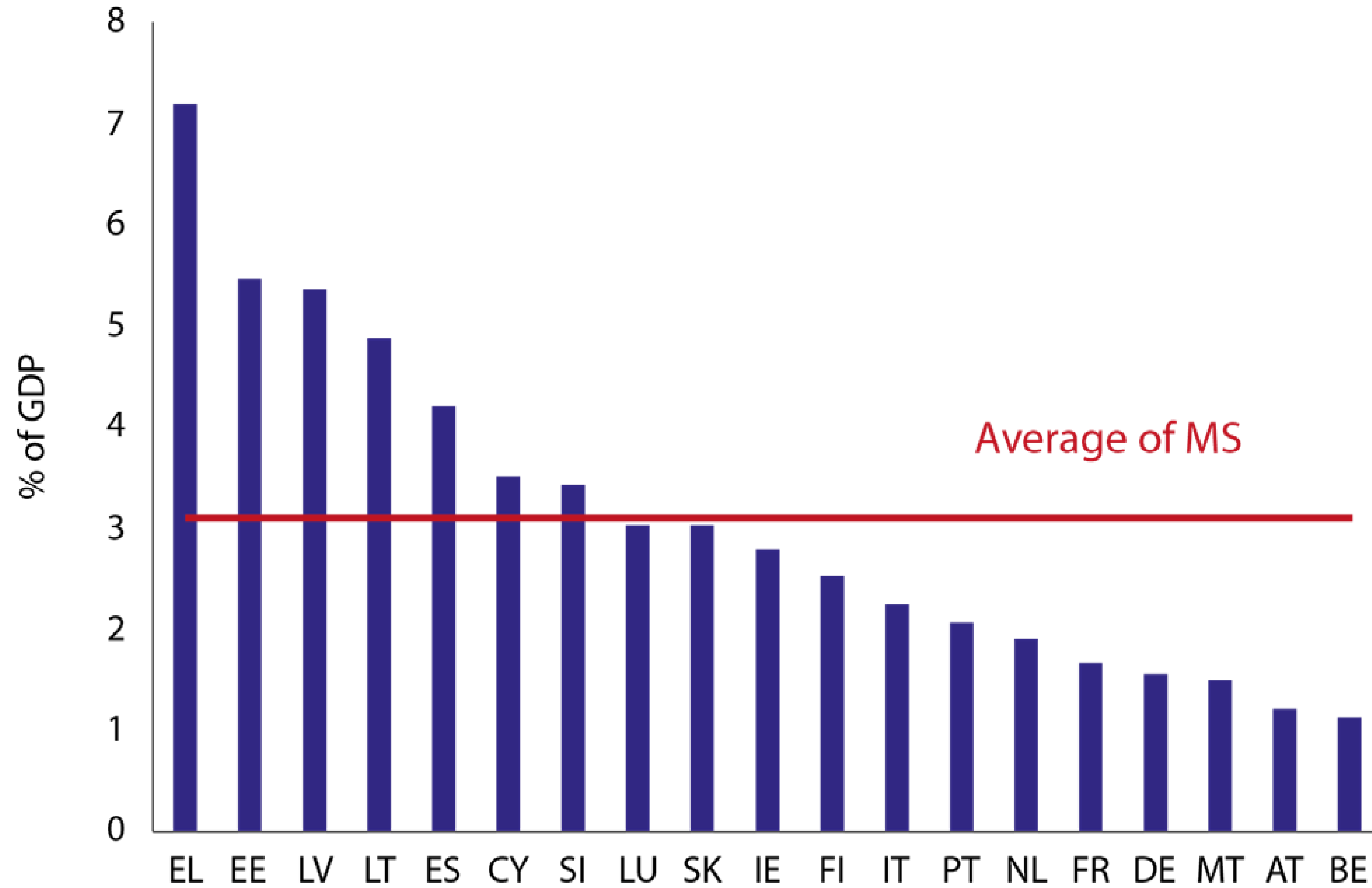
Figure 1. Standard deviations of output gaps, 2000-2017 (% of GDP)



Source: AMECO database, authors' calculations.

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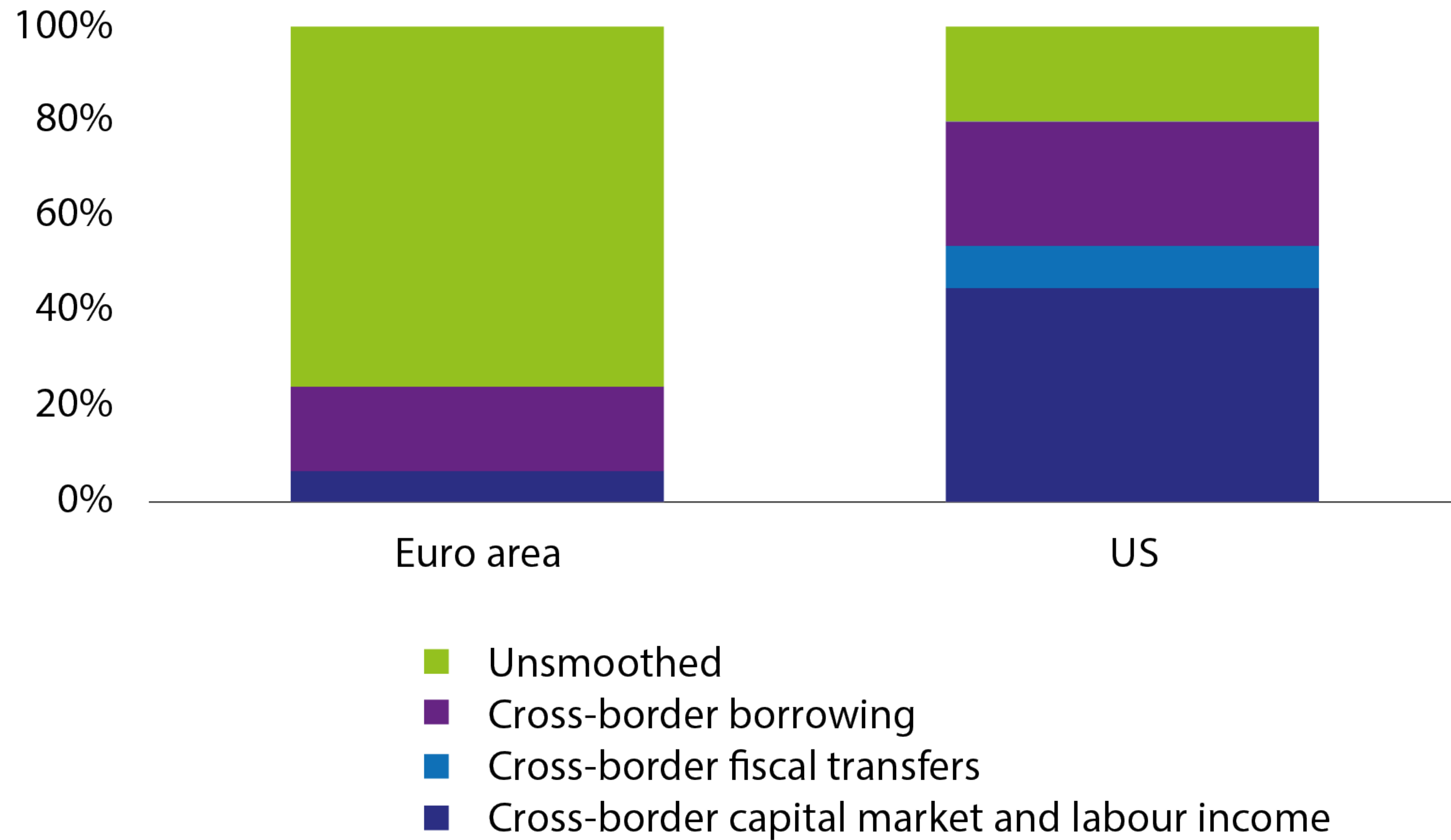
Figure 2. Cross-border risk sharing (% of output shocks)



Source: Buti et al. (2016).

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While this possibility was largely ignored at EMU inception, the experience has dramatically shown it to be relevant in the environment of the 2010s, and it is likely to remain relevant in the future. This means that conceptually, a common stabilisation capacity may not just be focused on asymmetric shocks, but may also usefully cater for large symmetric shocks, thereby also overcoming the limitations of coordinating the aggregate euro area fiscal stance from national fiscal policies.

Q2: Does private risk sharing via the completion of banking union and CMU eliminate the case for a central fiscal capacity?

Private risk sharing remains underdeveloped in the EU, as highlighted by comparisons with the situation in the US (Buti *et al*. 2016). Private risk sharing works by the combined effects of cross-border ownership of assets and labour compensation as well as credit markets (saving and borrowing).

In the euro area the effect of cross border factor incomes (capital and labour) has so far been to smooth a meagre 6% of asymmetric shocks, compared with over 40% in the US (Figure 2). The potential for improvement in this area is therefore large, and a well-functioning CMU would definitely contribute to this. The credit channel, which actually is better understood as consumption smoothing rather than risk sharing *stricto sensu* (Alcidi and Thirion 2016), is also more developed in the US.

Full financial integration is unlikely to be reached in the short or even medium term, as it requires deep structural changes. For instance, it will take time to diversify cross-border holdings, and a certain degree of home bias may persist even in the long term in the presence of asymmetric information.

This alone could be enough to justify a central fiscal capacity at least as long as the degree of financial integration remains limited. But more fundamentally, the question is whether a complete financial union can be seen as a

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substitute to a targeted fiscal capacity, or whether the two act as complements that strengthen each other, as is the case in the US.

The evidence suggests that financial and fiscal unions may substitute as shock absorbers in normal times but need each other in bad times. In other words, in times of acute market stress, the shock absorption function of the financial union will depend on the existence of a credible and effective central fiscal capacity.

Specifically, there is evidence that private markets behave pro-cyclically when left entirely on their own. In the case of EMU, cross-border financial flows increased somewhat in the run up to the crisis before collapsing afterwards.

In other words, the credit channel for smoothing shocks froze during the euro area crisis and actually worked in reverse (Furceri and Zdzienicka 2015). Private risk sharing is more effective when working in conjunction with public sector risk sharing. Some studies also point out that financial markets are not Pareto-efficient as private agents fail to hold the kinds of portfolios ensuring proper risk sharing in large shocks (Fahri and Werning 2017).

The pro-cyclicality may in part be explained by an inadequate structure of financial flows, such as the proportion of debt versus equity. And progress in financial supervision and more effective macroprudential policies should help. At the same time, it would be perilous to assume that financial booms and busts together with flights to safety and sudden stops are behind us in the euro area. Instead, the risk of a re-run of mechanisms similar to the ones experienced in the past crisis seem hardly negligible.

The experience in Europe and elsewhere suggests that these risks are attenuated with a public tool that acts as a catalyst for confidence (Kalemli-Ozcan *et al*. 2014). In this context, the existence of a fiscal risk-sharing tool can actually foster risk reduction by preventing excessive market volatility and full-blown financial crises.

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Moreover, moving to a genuine financial union will require a more comprehensive approach than implied by some authors, including Heijdra *et al*. (2018). The recent experience and discussions clearly indicate the difficulties in going ahead to complete the Banking Union as there is no agreement yet on even the technical elements which should allow political negotiations to start on a European Deposit Insurance Scheme.

The Banking Union needs to be completed with the backstop for the Single Resolution Fund and the European Deposit Insurance Scheme. The introduction of these forms of public risk sharing is crucial in order to make the system robust by strengthening financial stability, reducing pro-cyclicality, and maximising its capacity to smooth asymmetric shocks via private sector risk sharing.

While prudential and bail-in rules will help to contain and reduce risks and prevent them from having a fiscal impact, this does not eliminate the need for a public backstop. In this respect, an excessive focus on risk-reduction measures would, ironically, lead to increasing risks. For instance, there are good reasons to proceed very cautiously to avoid the risk of financial instability when considering any changes to the regulatory treatment of bank sovereign exposures.

Should such a proposal be contemplated, one would also need to consider a broader set of measures including a credible backstop to the SRF, the setting up of EDIS and the introduction of a suitable common European safe asset to take a central role in the financial system (Buti *et al*. 2017).

By reducing the risk of flight- to-safety and sudden stops in times of market stress, such a common safe asset would also reinforce the shock-absorbing role of the financial union through private sector channels.

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Q3: Do national fiscal stabilisers within the SGP suffice to smooth the remaining shocks?

Contrary to the US, the EMU does not have a large central budget which provides stabilisation as a 'by product' of its allocative and redistribution functions. At the same time, member states of the EMU have very large national budgets with significant stabilisation capacities.

The rules of the SGP, while primarily focused on ensuring fiscal discipline, have been crafted and evolved in a manner that aims at preserving stabilisation role of national fiscal policy. In principle, adherence to the balanced budget rule in structural terms, the medium-term objective (MTO), provides room for the automatic stabilisers to play out in ordinary cyclical situations without breaching the 3% reference value for excessive deficits. Preserving prudent fiscal positions including by constituting buffers in the good times is essential for this work.

Hence there is in general agreement that national automatic stabilisers should constitute the primary fiscal line of defence against demand shocks[1]. The disagreement is on the need for a central fiscal tool in addition to that. Here, we believe that the sceptics miss three points that tilt the case.

First, the frequency and magnitude of country-specific shocks is relatively large, as noted above. Admittedly, this is especially true for the more volatile economies of the euro area. The Baltic economies offer a good example. Second, the gyrations in the public finances triggered by exogenous shocks are often far stronger than as conventionally measured. The standard measurement of cyclical deficits based on the output gap relies on average values for fiscal elasticities (Mourre *et al*. 2014).

In practice, growth composition effects and residual technical factors imply that the sensitivity of the budget to economic shocks can be considerably greater. As an illustration, Figure 3 reports the distribution of tax windfalls and shortfalls that come in addition to conventionally measured cyclical deficits.

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In a downturn changes in headline balances will reflect variations in these windfalls and shortfalls together with the change in conventional cyclical balances. Putting these factors together, the evidence is that cyclical changes in headline fiscal balances typically exceed 3% of GDP every 10 years, and 5% of GDP every 20 years.

This goes beyond the protection offered by medium-term objectives, especially when the latter are met in good times by flattering temporary windfalls, as was the case in previous cycles.

Third, the legacy of high debts in some countries greatly complicates the use of stabilising national fiscal policies. Member states with high levels of debt are in an especially fragile position. When faced with a significant slowdown accompanied by large revenues shortfalls, they may very quickly come under the suspicion of markets, even when actually adhering to the agreed spending policies.

These countries may be facing an unpalatable choice between tightening policy at the wrong time to reassure markets and risking a self-fulfilling spiral of higher deficits and interest costs[2]. In those circumstances, an element of fiscal risk sharing can tip both policies and expectations towards a better equilibrium and prevent the materialisation of self-destructing austerity or a full-blown meltdown. This is not mutualisation but insurance for the benefit of the whole Union.

These considerations make the case for completing the economic architecture of EMU, including in particular a common fiscal capacity to top up the national automatic stabilisers in the event of large shocks. To be sure, the design of such an instrument needs to be well conceived in order to be timely and effective, while preserving against the risk of degenerating into a hidden transfer union. Several worthy proposals have been made in this respect (eg. Carnot *et al*. 2017, Arnold *et al*. 2018, Lenarcic and Korhonen 2018).

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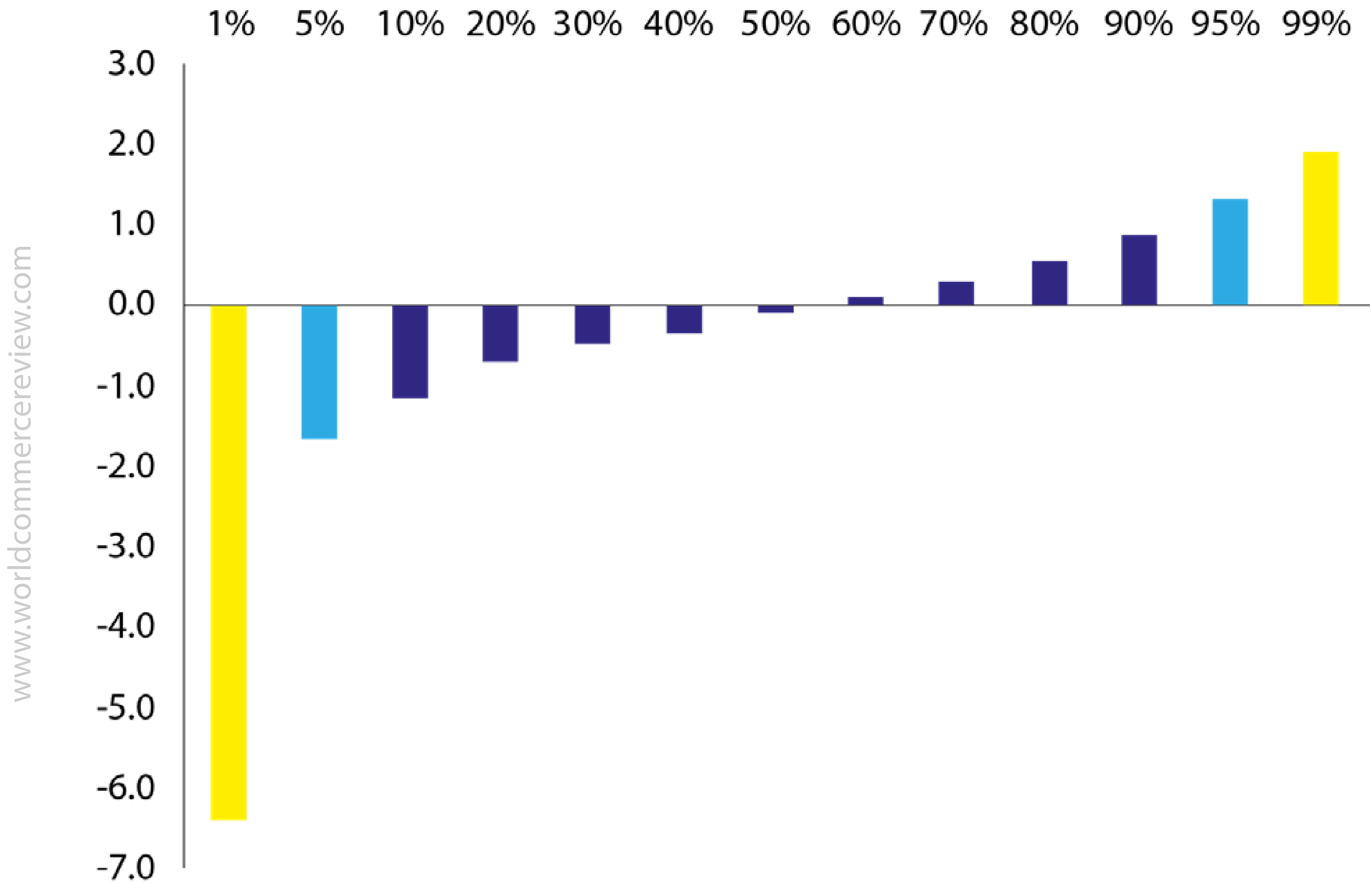
Figure 3. Distribution of tax revenues windfalls (+) and shortfalls (-) in euro area member states (% GDP)



Source: AMECO database, authors' calculations.

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It is important to also stress that a stabilisation capacity would complement the fiscal rules framework and could actually contribute to strengthen it, by encouraging the build-up of fiscal buffers in good times and making it easier to implement rules of fiscal discipline (European Fiscal Board 2018). In due time, the fiscal rules framework could also be simplified and strengthened, for example by focusing on a debt anchor and a proper operational target.

Q4: Does a central fiscal capacity necessarily entail moral hazard and permanent transfers?
The design features are essential in this respect. The Commission proposal for a European Investment Stabilisation Function (European Commission 2018a), which was tabled last May, includes strong safeguards:

- First, the rules for activating support are targeted exclusively on large shocks of a cyclical nature. The triggering criterion relies on a 'double condition' on observed unemployment rates whereby unemployment must at the same time be historically high and strongly increasing (by over 1 percentage point). Moreover, payments are tied to changes in unemployment rates, precluding by construction indefinite support.

- Second, member states are eligible to support only if they have delivered effective action on recommendations under the corrective procedures of the SGP and of the Macroeconomic Imbalance Procedure.

- Third, the support takes the form of the provision of loans, possibly at concessional rates, but does not involve outright transfers. The provision of direct transfers could be more powerful in terms of stabilisation but admittedly would open more risks of permanent transfers. By definition loans would entail permanent transfers only under the extreme assumption of a default by a member state vis à vis the Union.

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Simulations using real time data over the past three decades confirm that the proposed mechanism would have been timely and would have potentially benefited all member states at a certain point. They show that the support would have been concentrated in the most severe downturns and would have extended to a maximum half of the area at peak points, that is, in 2009-10 and 1993-94 (Figure 4).

Conclusions

From the inception of the euro it has been asked whether the EMU set-up offered enough space for macroeconomic stabilisation. This question arises naturally as countries in a monetary union lose channels of adjustment to asymmetric shocks by giving up an own monetary policy and the possibility of nominal exchange rate changes.

The initial understanding at Maastricht was that this loss might be 'compensated' by a natural convergence of business cycles within the union. In addition, national fiscal policies remained available in order to absorb country-specific shocks.

However, the experience suggests that these assumptions were too optimistic. Even if they are partly synchronised, business cycles remain sizeable in EMU. They reflect both a common component and substantial idiosyncratic cyclical developments in member states. National fiscal stabilisers have functioned at times and in some countries, but have also exhibited serious limitations.

Market mechanisms have not been a reliable shock absorber either and the importance of financial markets was underestimated. Indeed, recent evidence shows that markets can have a pro-cyclical effect in times of stress if not complemented by a credible fiscal risk-sharing set up.

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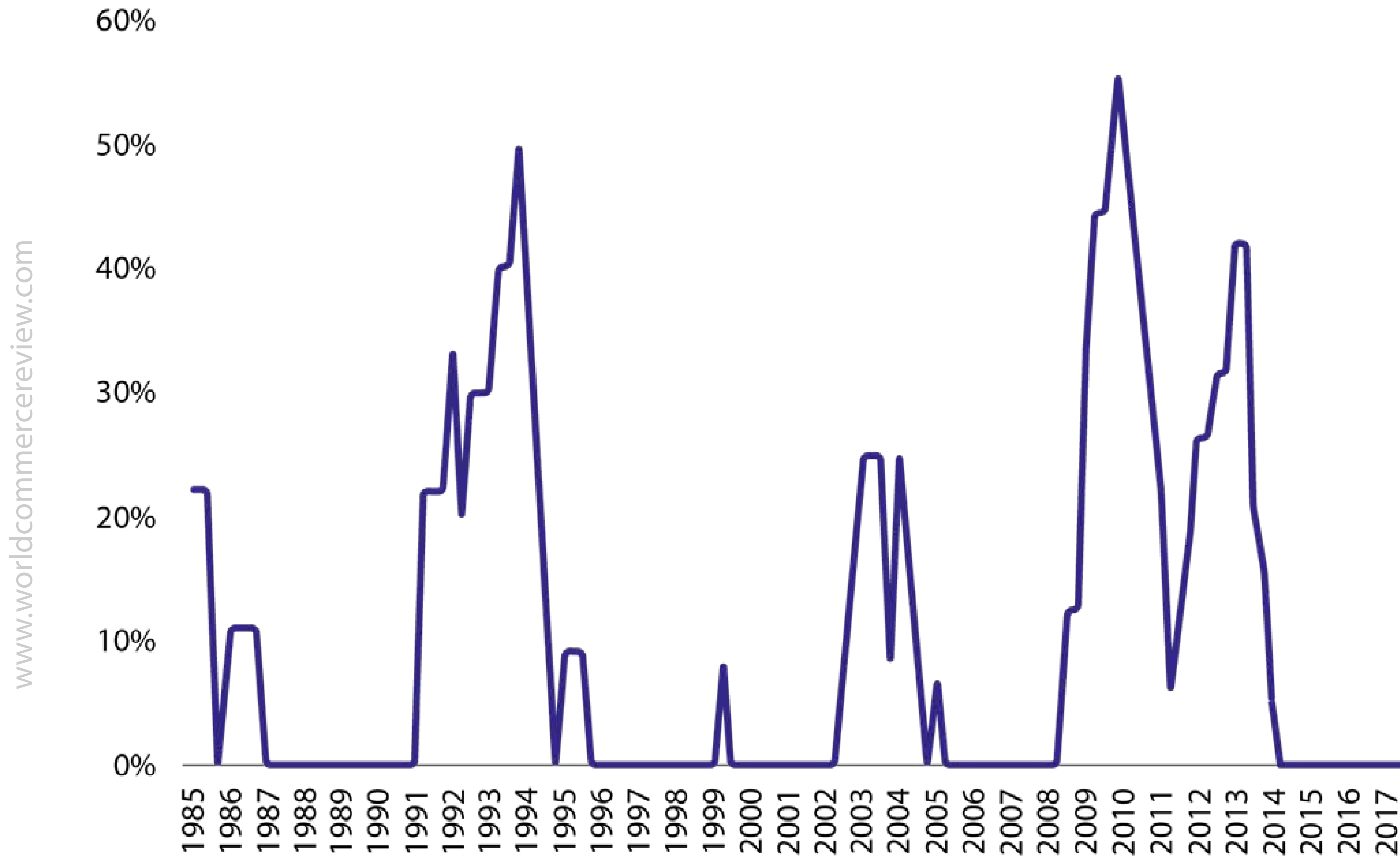
Figure 4. Share of euro area countries supported under the EISF proposal (%)



Source: European Commission (2018b)

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Looking forward, the two priorities to deepen the EMU are the completion of the financial union as well as the introduction of targeted and effective common budgetary instruments. They complement and reinforce each other.

The debate on the nature of further budgetary instruments is gradually gaining traction. Germany and France have recently proposed in the Meseberg declaration the setting up a euro area budget within the EU budget to support convergence, competitiveness, and stabilisation. Other ideas have also been evoked such as unemployment reinsurance funds. The Commission has proposed new tools as part of the next Multiannual Financial Framework for 2021-2027, including a Reform Support Programme to promote reforms for national resilience and a European Investment Stabilisation Function.

The latter has been designed to prevent any risk of mutualisation and to complement national fiscal stabilisers only in the event of large cyclical shocks. These various proposals from member states and the Commission are non-exclusive and might actually be combined. They should go hand in hand with further financial integration and a sound implementation of the fiscal rules. ■

Marco Buti is Director General, and Nicolas Carnot is an Adviser, at the DG Economic and Financial Affairs, European Commission

Authors' note: The views expressed in this column are those of the authors and should not necessarily be seen as reflecting the position of their institution. The authors thank Gabriele Giudice, José Leandro, Gilles Mourre and Lucio Pench for their comments.

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Endnotes
1. It may also be useful to enhance national automatic stabilisers (Buti and Gaspar 2015).
2. Note that while the SGP provides for escape clauses in exceptional circumstances, activating those would not fundamentally change the terms of this dilemma.

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The role of the European Union in fostering convergence

Benoît Cœuré focusses on the CESEE economies to explain how completion of EMU can accelerate convergence and foster cohesion in Europe

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I would like to focus precisely on three topics: growth, Europe and togetherness. I will argue that these three elements are needed to accomplish what the Treaty on European Union promises: economic and social cohesion[1]. I will focus on the economies of central, eastern and south-eastern Europe (CESEE), covering both those that are already part of the European Union (EU) and those that are EU candidate countries or potential candidates[2].

I will start with a brief review of the current state of convergence of CESEE economies, and then explain how three key European policy areas – the completion of the Single Market, the launch of a true capital markets union and the targeted use of EU funds – can help accelerate convergence and thereby also foster cohesion in Europe.

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The current state of convergence

CESEE economies have seen significant improvements in living standards over the past two decades, in both absolute and relative terms[3]. Since 2000, growth in real GDP per capita has averaged 3.8% in the region as a whole, compared with 1.4% for the EU28. As a result, we have seen these economies make measurable and welcome progress in catching up to the EU average[4].

But this catching-up process has been neither linear over time nor homogeneous across countries. You can see this in Figure 1.

Clearly, for most countries, convergence towards the EU28 average has practically stalled since the outbreak of the financial crisis in 2008 – this is the difference between the yellow dot and the upper end of the blue bar.

And before the crisis, convergence was noticeably faster in economies that were already part of the euro area. In many of these economies, relative living standards increased by half, from 40 to 50% of the EU average in 2000, to

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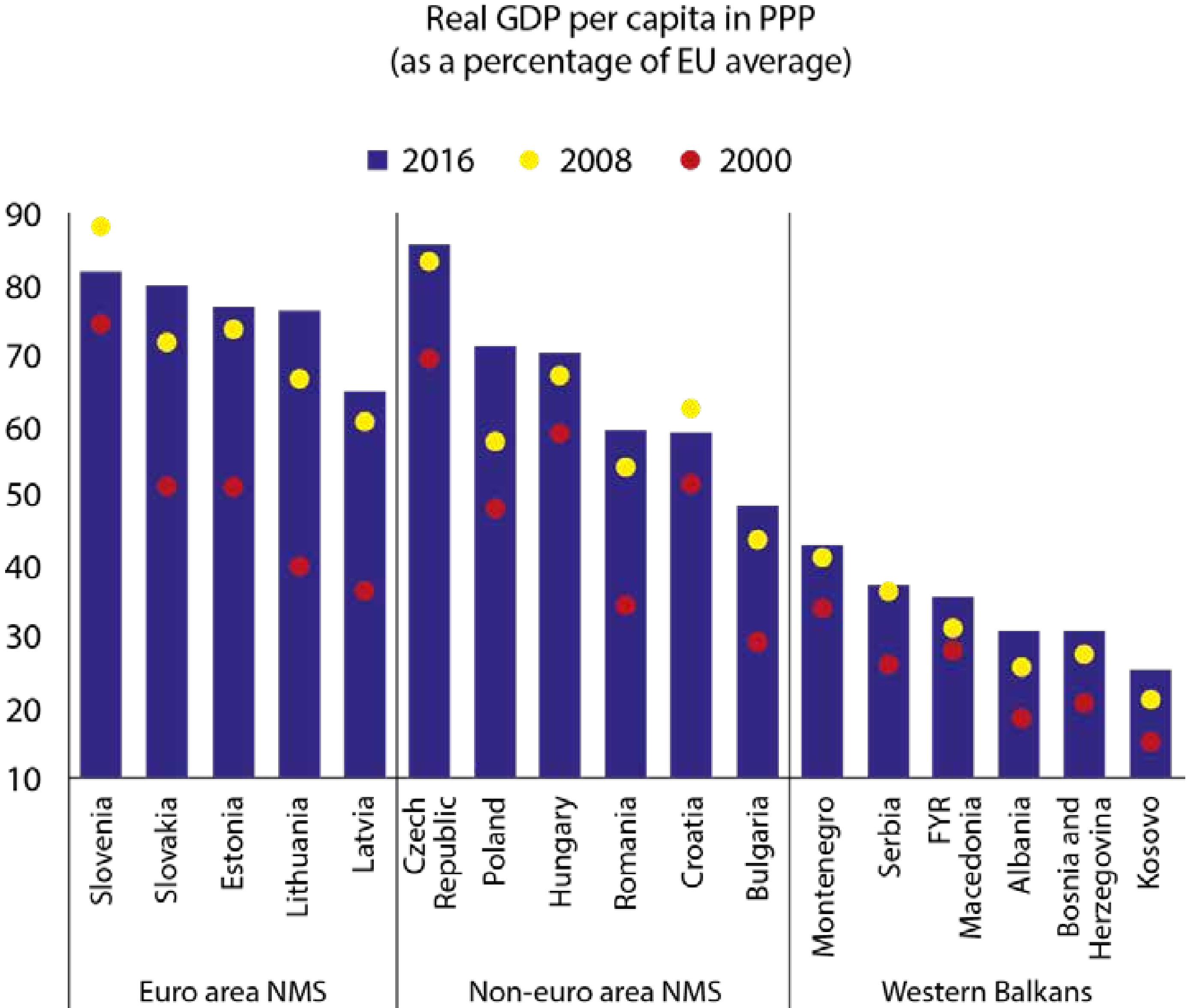
Figure 1. Uneven income convergence in CESEE countries



Sources: World Bank (World Development Indicators) and ECB calculations

around 70% in 2016. But the further one moves to the right on this figure, and contrary to what neoclassical growth theory would suggest, the less compelling strong convergence becomes.

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Achieving similar standards of living across our continent should speak to our highest aspirations. It is a recognition of history that economic prosperity, opportunity and peaceful societies are closely linked and mutually reinforcing

In the Western Balkans, for example, while relative income levels have increased, they have done so at a much slower pace. At current growth rates, fast convergence towards the EU28 average will remain illusory for many EU candidate countries or potential candidates.

These economies, and this you can see in Figure 2, would need much higher GDP growth rates than in previous years to even reach half of the EU28 average within the next 20 years or so, with the possible exception of Montenegro.

Clearly, this pace of convergence is disappointing. It implies that living standards in Europe will remain highly varied and uneven for a considerable period of time, even within the EU. And if there is no credible prospect of lower-income countries catching up soon, there is a risk that people living in those countries begin questioning the very benefits of membership of the EU or the currency union. Such doubts would be particularly worrisome in the unstable world we are currently living in.

We need the EU to remain a force for change, a source of growth and development and an anchor of stability. Action is therefore needed on two main fronts: first, to bring convergence in EU member states back onto its pre-crisis path and, second, to jump-start convergence in EU candidate countries and potential candidates.

To understand what needs to be done to tackle both challenges, it is useful to look at the drivers of growth and the factors that have recently been holding them back. You can see this in Figure 3.

What you can see here is that, since the crisis, growth in all CESEE economies has essentially slowed because of two main factors: a sharp drop in total factor productivity (TFP) growth and, to a lesser extent, in the contribution of capital to growth.

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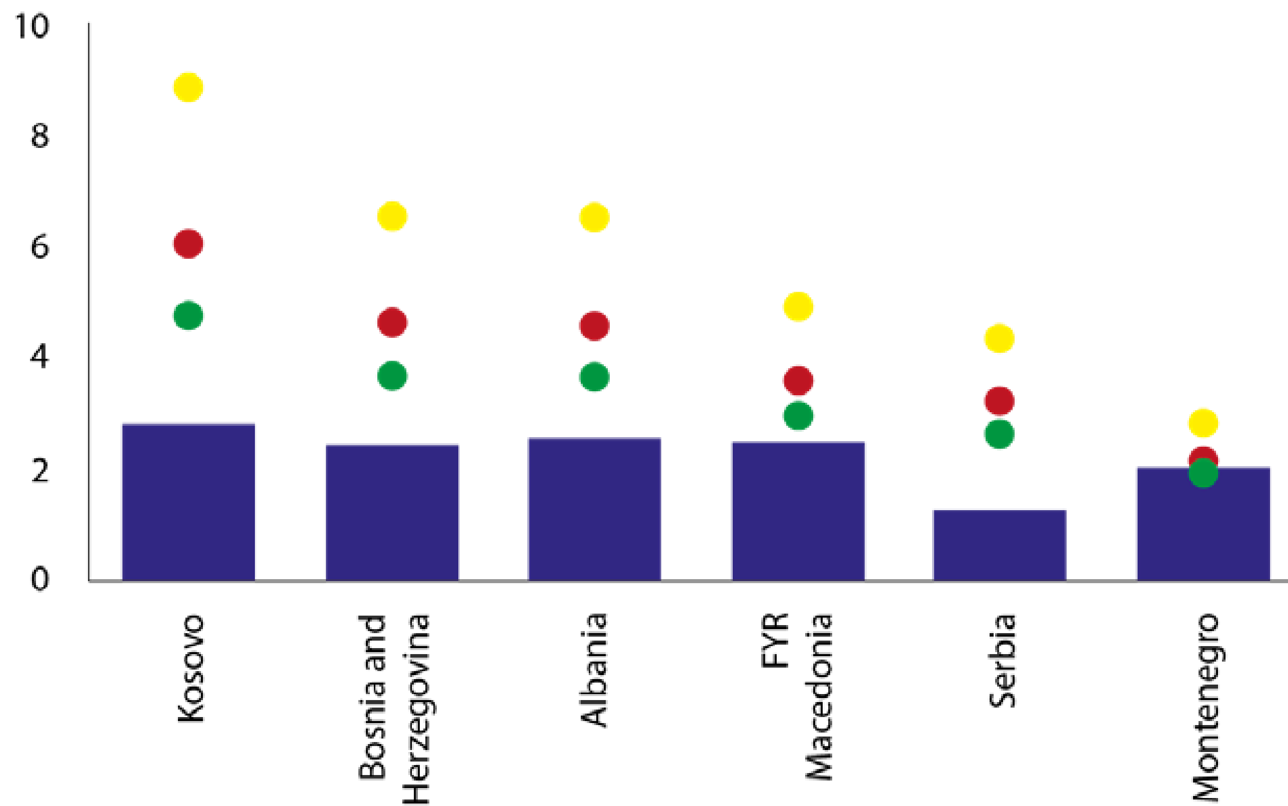
Figure 2. Stronger income growth required for faster convergence

Real GDP per required to achieve 50% of EU-28 average by 2025, 2030 or 2035
(annual growth rates)

Average2010-2016
2025
2030
2035



Sources: World Bank (WDI) and ECB calculations
Note: This assumes purchasing-power adjusted per capita GDP growth in the EU-28 of 1.2%, which is the average growth rate observed over 2010 to 2016.

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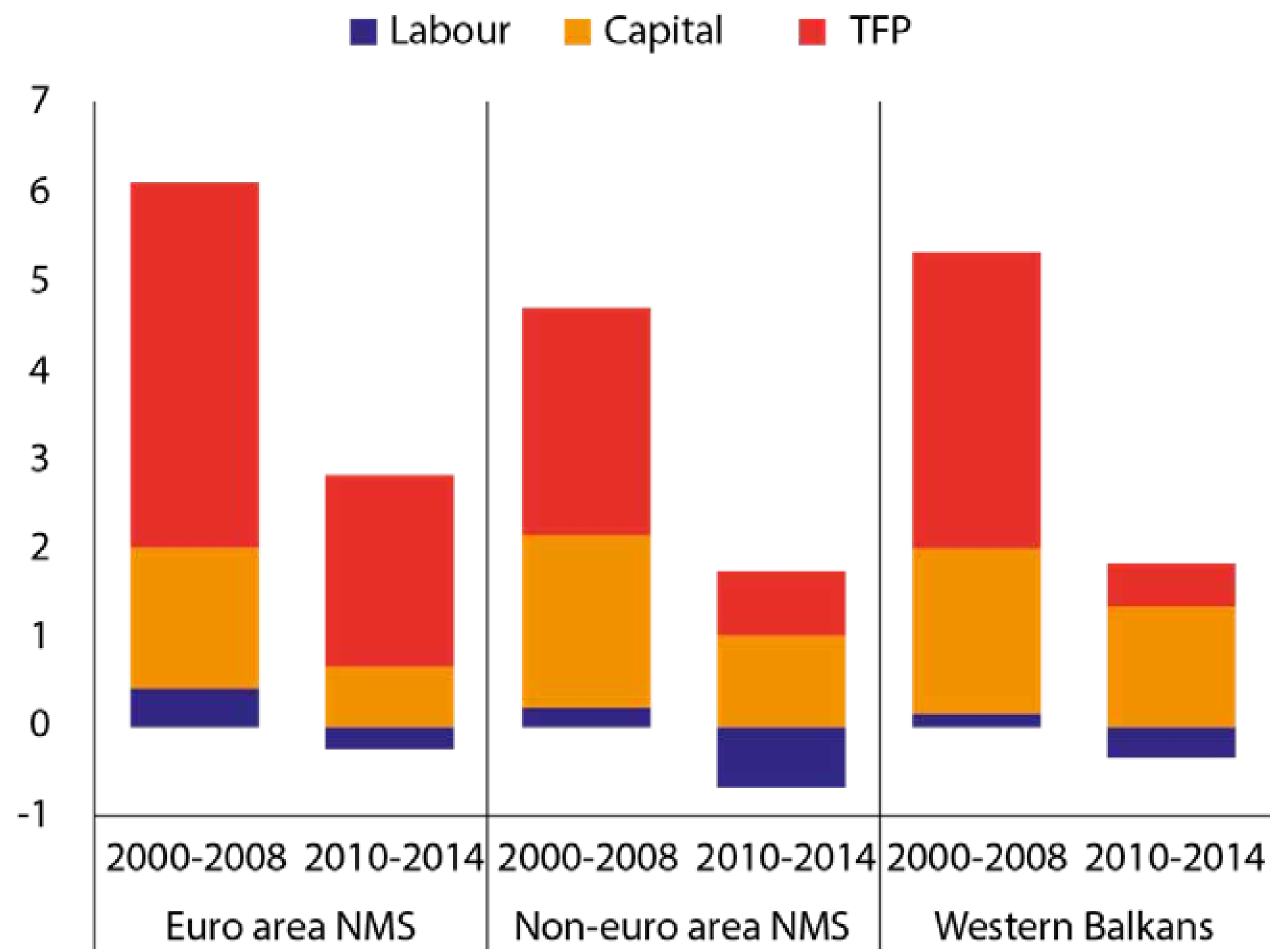
Figure 3. Growth slowdown mainly due to a fall in TFP growth



Sources: Penn World Table version 9 and ECB calculations.

Note: Labour share in Albania and Montenegro assumed to be equal to the average observed in FYR Macedonia, Bosnia and Herzegovina, Serbia and Croatia. Average hours worked in the Western Balkan countries assumed to be equal to the average in new EU member states. Calculations assume standard Cobb-Douglas production function.

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There are two things worth highlighting here. The first is that it is highly unusual that pre-crisis convergence largely reflected technological progress and innovation. During the transition phase, growth is typically based on capital and labour accumulation, and only later on TFP growth[5]. Or, to borrow the words of Paul Krugman, it is based first on perspiration and only later on inspiration[6].

The flipside is that these economies are now faced with a notable capital shortfall. The capital stock per person employed remains substantially below the EU28 average in almost all CESEE economies. You can see this in Figure 4 on the left-hand side.

In CESEE euro area member states, it also remains well below other emerging economies, such as South Korea, with similar per capita income levels. And, worse, investment rates have fallen further since the crisis in all CESEE economies. You can see this on the right-hand side.

The second fact worth highlighting is that the remarkable contribution of productivity to growth, both in the upswing and in the downturn, is likely to be an artefact of the growth model adopted by most CESEE economies. This growth model relies, by and large, on deep integration in global production chains.

You can see this clearly in Figure 5. CESEE economies are some of the world's most integrated. They are far more integrated in global value chains than their EU peers, for example. Sizeable foreign direct investment (FDI) inflows in the pre-crisis period – which you can see on the right-hand side – have promoted the role of CESEE economies in global production processes. These inflows accounted for around 6% of GDP in the run-up to the crisis. In the EU28 as a whole, FDI inflows accounted for just 3.4% of GDP over this period.

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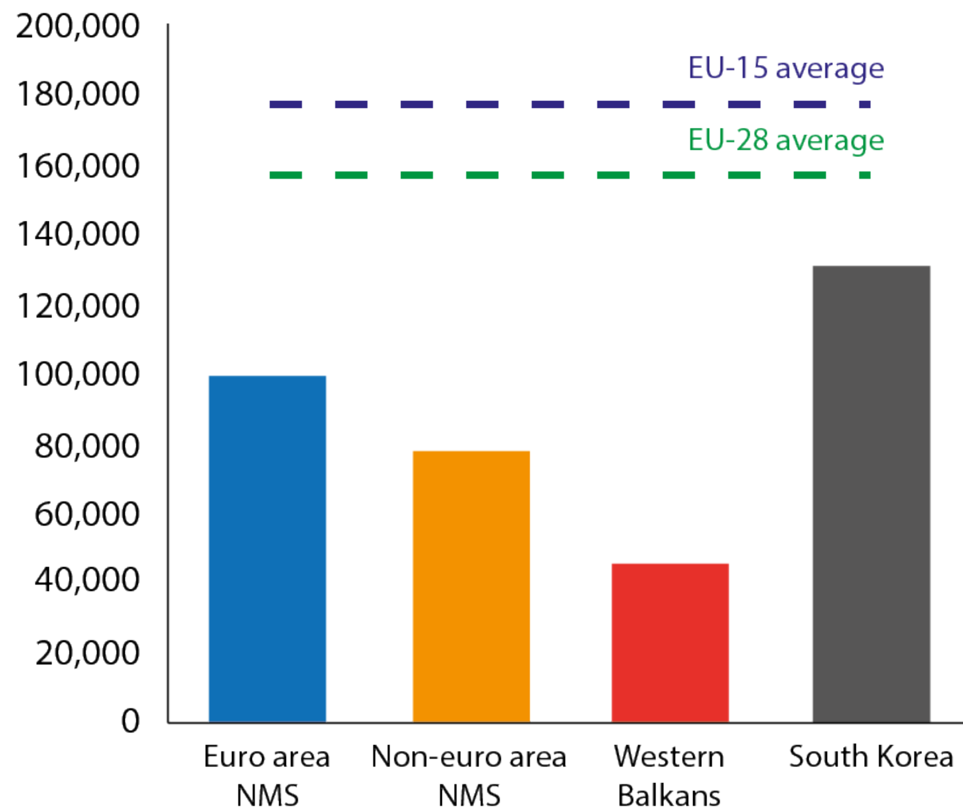
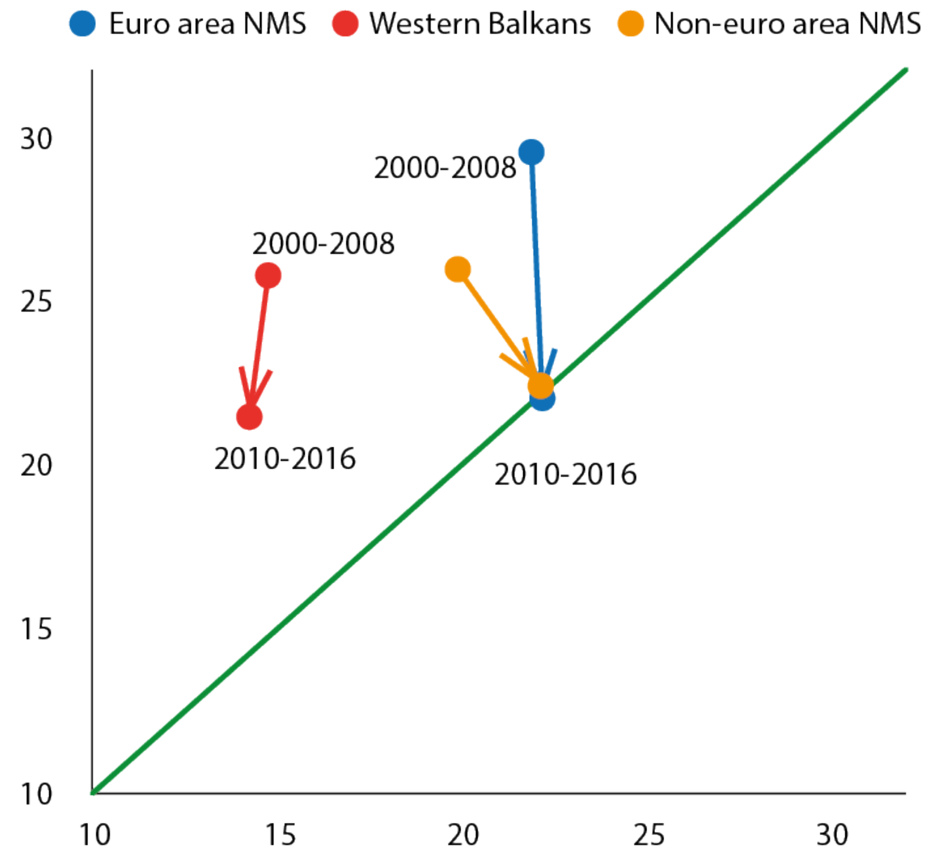
Figure 4. Capital stock remains comparatively low in CESEE economies

Per capita capital stock in CESEE economies in 2014 (in 2011 USD)



Sources: Penn World Table version 9, World Bank and ECB calculations.
Note: EU-15 refers to countries that joined the EU prior to 2004.

Average savings and investment ratios in 2000-2008 and 2010-2016 (x-axis: saving rate (as percentage of GDP); y-axis: investment rate (as a percentage of GDP))



Sources: IMF (World Economic Outlook) and ECB calculations.
Note: The 45-degree line is shown in green.

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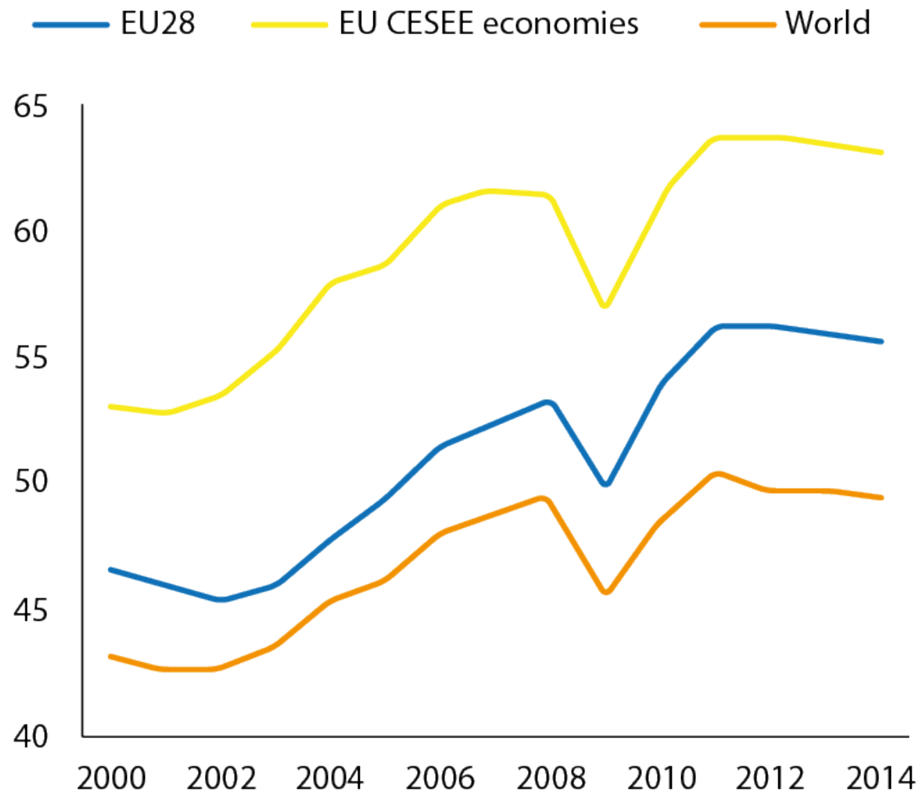
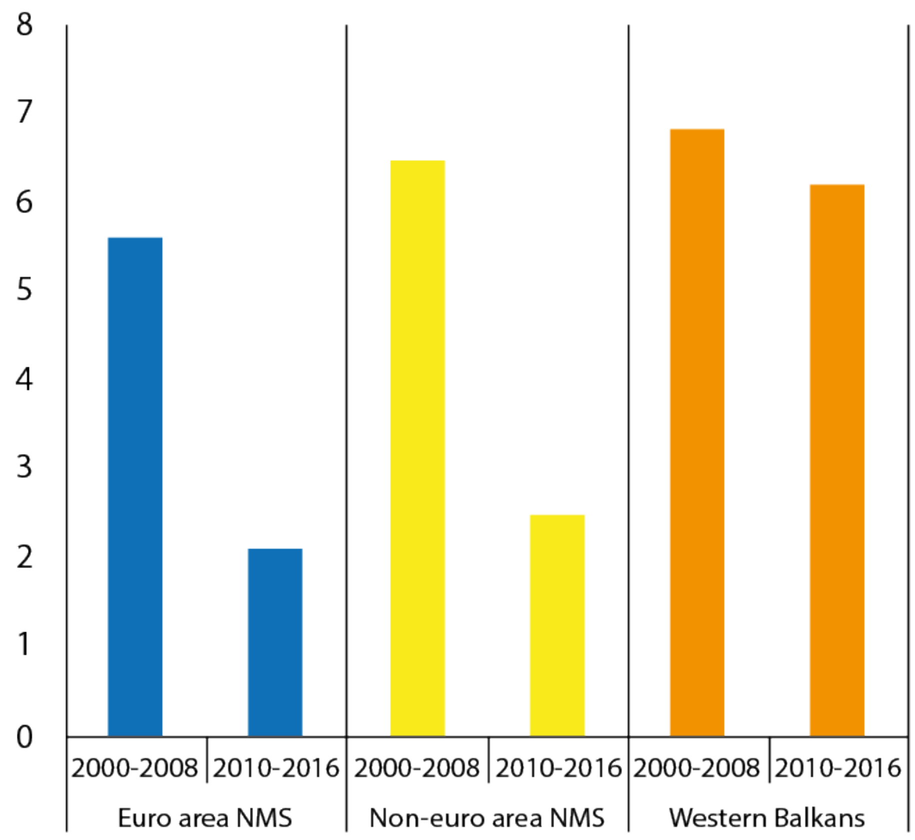
Figure 5. CESEE economies are some of the world's most integrated

GVC participation in 2000-2014
(share in gross exports of the sum of domestic value added in third country exports and foreign value added in own exports)



Sources: WIOD (2016) and ECB calculations.
Note: EU CESEE countries are Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

Average foreign direct investment inflows
(as a percentage of GDP)



Sources: Wiiw (FDI database) and ECB calculations.
Note: Data in gross terms. Simple averages of country-specific data for regional aggregates.

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The role of FDI in supporting TFP growth is well known[7]. By integrating local firms into global value chains, it facilitates the transfer of technology and expertise. The transfer of technology, moreover, does not stop at firms directly integrated into global value chains, but also extends to their domestic suppliers via local production networks[8]. Empirical evidence shows that, in the case of central and eastern European (CEE) economies, this transfer of technology has contributed to both strong TFP growth in the run-up to the crisis and to its more recent slowdown[9].

You can see this more clearly in Figure 6. There is a very close link between TFP growth in CEE economies and TFP growth in non-CEE EU countries. This link likely reflects the scale and scope of technology spillovers[10]. So, as FDI inflows decelerated and participation rates in global value chains levelled off, TFP growth in CESEE economies abated too.

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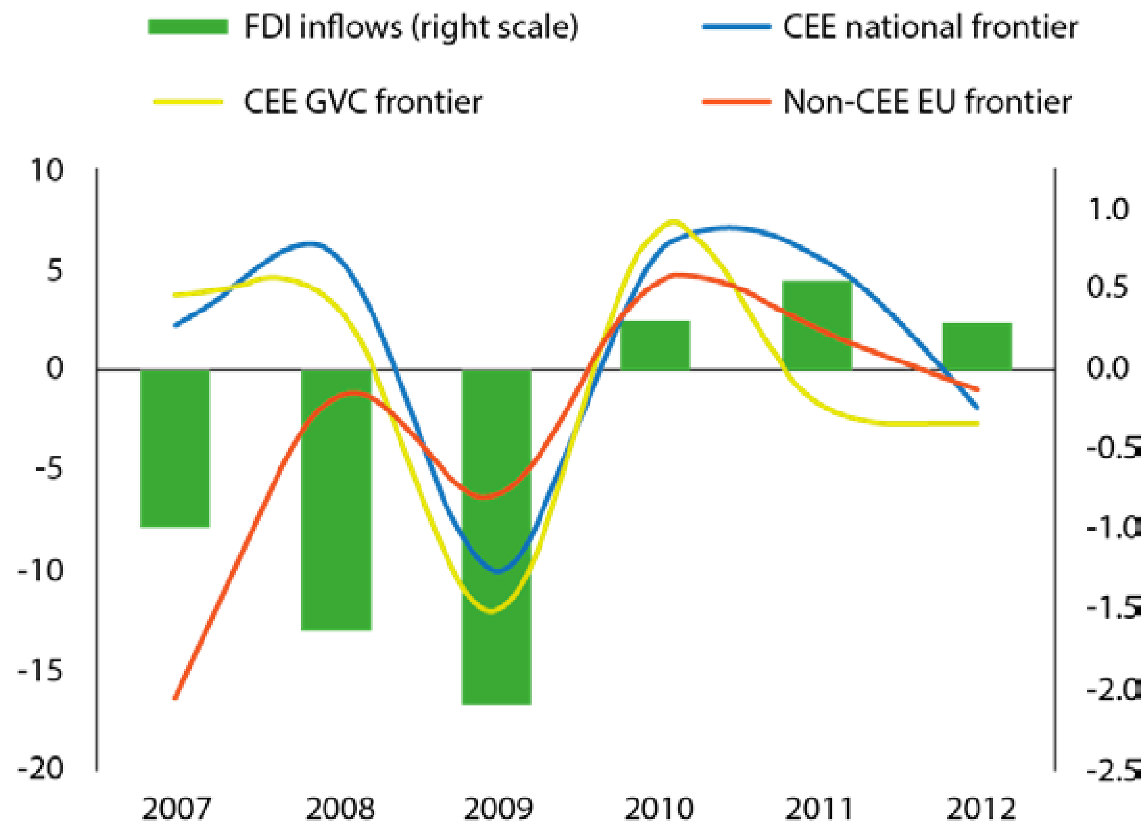
Global value chains as a source of TFP growth in the future

In sum, therefore, this diagnosis highlights two key facts: CESEE economies have a lack of capital, and a strong reliance on global production processes.

The easy answer, of course, is to brush away weakness in FDI inflows as a temporary phenomenon. After all, if the law of declining marginal returns on capital continues to hold, we should still expect capital to flow into catching-up economies, rebooting TFP growth.

I would be somewhat more cautious, however. It is true that weakness in trade and investment, worldwide, has been part of the collateral damage from the crisis. As we leave this legacy behind, headwinds should fade too. But the recent shift is also likely to reflect developments of a more structural nature – that is, the slowdown in global value chain formation may well persist[11].

Figure 6. Close link between TFP, GVCs and FDI developments



Sources: ECB staff calculations based on CompNet, WIOD (2016) and Vienna Institute for International Economic Studies (wiiw) (FDI database).
Note: CEE and non-CEE EU frontier represent firms in the 80th and 90th percentiles in terms of TFP in each country-sector-year. CEE GVC frontier is a weighted average of the most productive firms in non-CEE EU countries, with weights based on the share of imported intermediates of each CEE-sector pair from each non-CEE EU country-sector pair. The CEE countries are EE, HU, LV, PL, RO, SK, and SI. The non-CEE countries are AT, BE, DK, FI, FR, DE, IT, PT and ES. For FDI, the regional aggregate is obtained from the simple average of country-specific annual changes.

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There are three main reasons for this. First, natural disasters and increasing climate-related disruptions have led firms to rethink the length and design of their value chains to mitigate the risks of costly supply disruptions[12]. This is becoming increasingly visible and may still amplify as climate change takes its toll on our economies.

Second, in the past sizeable wage differentials for unskilled labour made the international fragmentation of production processes worthwhile. Some of these wage differentials have narrowed considerably as emerging economies have grown richer. In the EU CESEE economies, for example, real wages have increased by slightly more than 50% since 2000. In the EU28, real wages grew by 18% over the same period.

And, third, the increased use of robots and artificial intelligence has the potential to turn global value chains on their head and cause firms to reconsider offshoring practices[13].

The second and third factors may be the most pressing ones. Put simply, if robots can deliver the same output more cheaply, more efficiently and closer to the consumer, then firms may have fewer reasons to spread production across countries.

By some estimates, the average price of industrial robots has declined by about 40% over the past ten years and is projected to fall considerably further[14]. A survey by the Boston Consulting Group revealed that more than 70% of senior manufacturing executives in the United States think that robotics can improve the economics of local production[15].

The implication is that, to the extent that growing automation and narrowing wage differentials make the outsourcing of production processes less profitable, policymakers in CESEE economies, and in emerging market economies more generally, will need to think about developing other growth models.

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To reboot TFP growth and deepen capital accumulation they will need to stimulate domestic investment spending and help new, innovative industries to grow and develop. Only in this way will convergence towards the EU28 average accelerate.

These should be joint efforts, however, which brings me to the second part of my remarks. Europe can and should help, in three main ways. First, by providing the market that makes the development of new industries profitable. Second, by channelling funds to sectors and countries where capital can be used most productively. And, third, by providing direct financial assistance to foster convergence and support national reform efforts.

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Reaping the benefits of the Single Market

Let me take each of these points in turn, starting with the market dimension. The EU's Single Market can be a valuable source of competitive advantage for firms located in CESEE economies, in particular when competing with other economies at similar stages of development.

It is the largest market in the world, offering the benefits of enormous economies of scale, and has helped establish product and safety standards that are used worldwide. There is compelling evidence that the Single Market has had a positive impact on exports, investment, innovation and productivity[16].

To exploit its full potential, and to accelerate convergence, two things need to be done. First, member states need to strengthen its enforcement so that Single Market initiatives translate into concrete and positive effects on the ground.

A key ingredient for this is efficient administration at all levels of government. Indeed, a lack of real convergence in income levels is, more often than not, the result of a lack of convergence in institutional quality[17]. You can see this

in Figure 7 – a figure that makes a compelling point, notwithstanding the usual caveat on the two-way causality between institutional quality and income levels[18]. Most CESEE economies are still in the lower left-hand corner, meaning there remains a significant gap in overall institutional quality compared with the average level observed in the EU as a whole.

Some EU member states have recently renewed their interest in the process leading to participation in the exchange rate mechanism (ERM II) and the adoption of the euro. This could become a fundamental catalyst for institutional reforms in the years to come.

Second, the scope of the Single Market must be broadened. For the EU, this means expanding its reach into industries that are prime drivers of innovation and catalysts for future growth.

This is particularly relevant for CESEE economies. As you can see in Figure 8, most of these countries are still classified as modest or moderate innovators. There have been some notable improvements in certain countries over time, but in others the process of gradually catching up with their EU peers appears to have stalled, or even to have backtracked, in recent years.

The first priority is therefore to complete the Single Market for services, which already account for two-thirds of global GDP and employment, and represent many of the potential growth sectors in the age of digitalisation and automation.

Research by the ESCB's Competitive Research Network (CompNet) shows, for example, that many firms in the EU services sector are far behind the productivity frontier, particularly in CESEE economies[19]. Reallocating capital and labour to more productive firms would help boost overall competitiveness and support employment.

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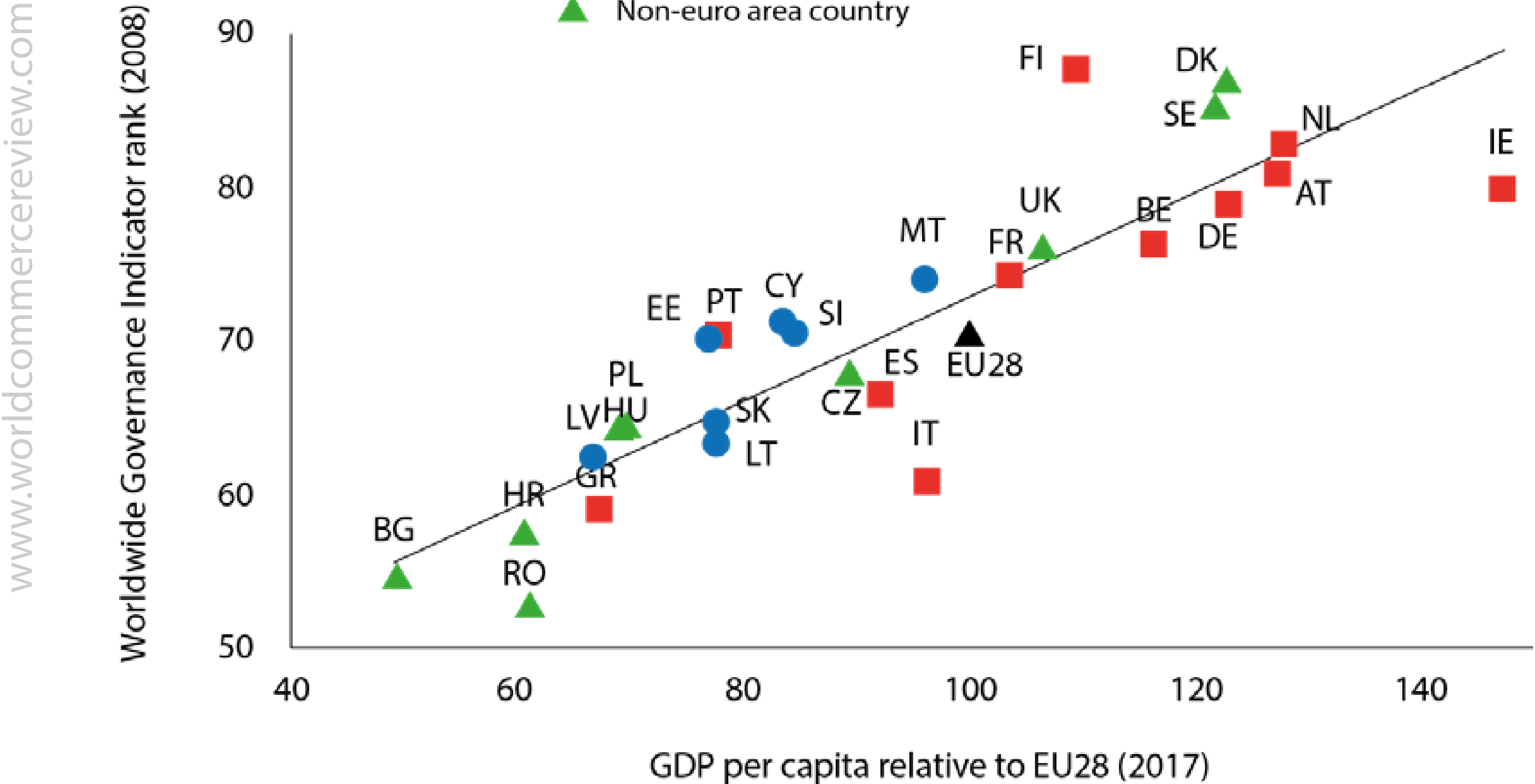
Figure 7. A significant gap in institutional quality remains



Sources: Eurostat and World Bank.
Note: The Worldwide Governance Indicator is the composite rank of average positions in six broad institutional dimensions. Luxembourg is excluded because GDP per capita computations are distorted by eg. the high number of cross-border workers.

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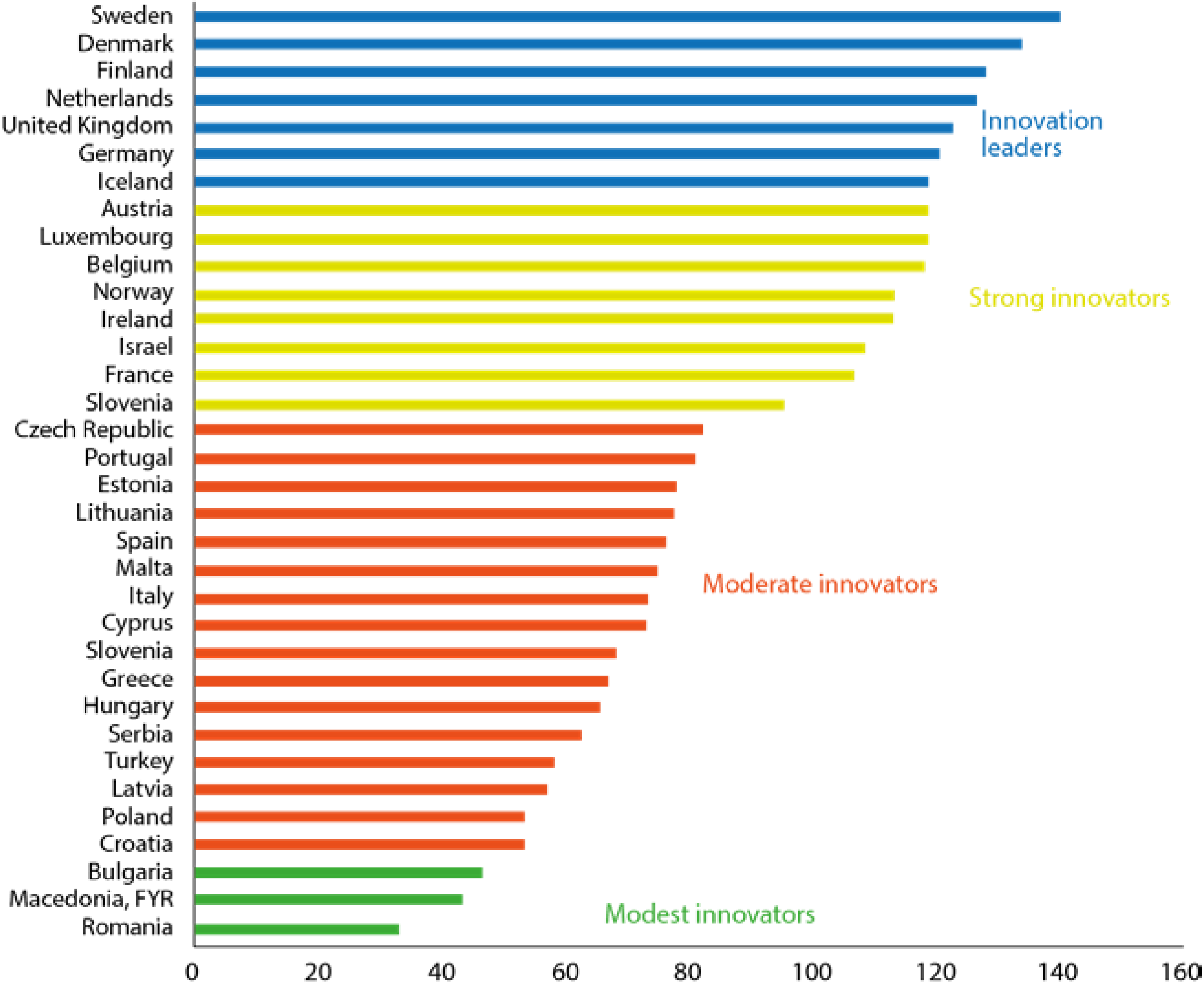
Figure 8. Most CESEE economies only modest or moderate innovators



Sources: European Commission (European Innovation Scoreboard).
Note: Data are available only for some CESEE economies.

A second, and more direct, avenue is to increase efforts to build a 'European data economy,' or a digital single market, as also advocated by the European Commission in its communication in November[20]. Digitalisation offers a particularly promising opportunity for catching-up economies to leapfrog more advanced economies and adopt new technologies faster than them, thereby mitigating the risk of being hurt by reshoring and premature deindustrialisation.

Convergence and the role of the capital markets union

The second key area where Europe can help – which is close to the heart of this conference – is by channelling funds to where they can be used most productively.

There is compelling evidence of the importance of finance for technological innovation and, ultimately, long-run growth rates[21]. Differences in the quality of financial intermediation across countries have been found to have significant implications for economic growth[22].

In particular, research is increasingly challenging the view that bank and market-based finance tend to support economic development and living standards in similar ways.

Evidence is growing globally that large banking systems are associated with more systemic risk and lower economic growth, in particular as countries grow richer[23]. In addition, recent work by ECB staff highlights that, during the euro area sovereign debt crisis, capital misallocation increased substantially among firms that were more reliant on bank finance[24].

Other research suggests that deeper equity markets are more effective in promoting innovation and productivity and, hence, in bringing economies closer to the technological frontier[25]. Recent ECB research, for example, suggests

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that if an EU member state were to increase its ratio of stock market capitalisation to bank credit from the 25th to the 75th percentile, the average growth rate of its most high-tech industry could be expected to increase by 3.1 percentage points, everything else being equal[26]. None of this is to say that banks will become redundant. They will continue to play their key social role of pooling savings and engaging in maturity and risk transformation.

But recent findings are increasingly reflected in the ongoing policy discussion. The European push towards a capital markets union, for example, reflects not only the need for increased cross-border risk-sharing in a currency union, but also the hope that deeper and better-integrated equity markets will support innovation and productivity growth in the European Union[27].

This also includes making new innovative financial technologies available to firms and ensuring they are as safe as conventional technologies. Europe is spearheading this process. Europe's Payment Services Directive (PSD2), for example, has been revised to introduce more competition in financial intermediation by requiring banks to share account information with new contenders.

China, of course, is a prime example of new financial technologies supporting growth in the transition towards higher income levels. Although EU data requirements are more stringent – for good reason – there is considerable scope for such technologies, if used prudently, to also foster growth and convergence in the EU.

On Figure 9 you can see that in Europe more generally, and in most CESEE economies in particular, these technologies have not yet gained much traction. In other words, progress towards a true capital markets union can both support the funding of investments, thereby helping overcome the current lack of capital accumulation, and, at the same time, foster the use and distribution of new financial technologies that may themselves become a source of growth[28].

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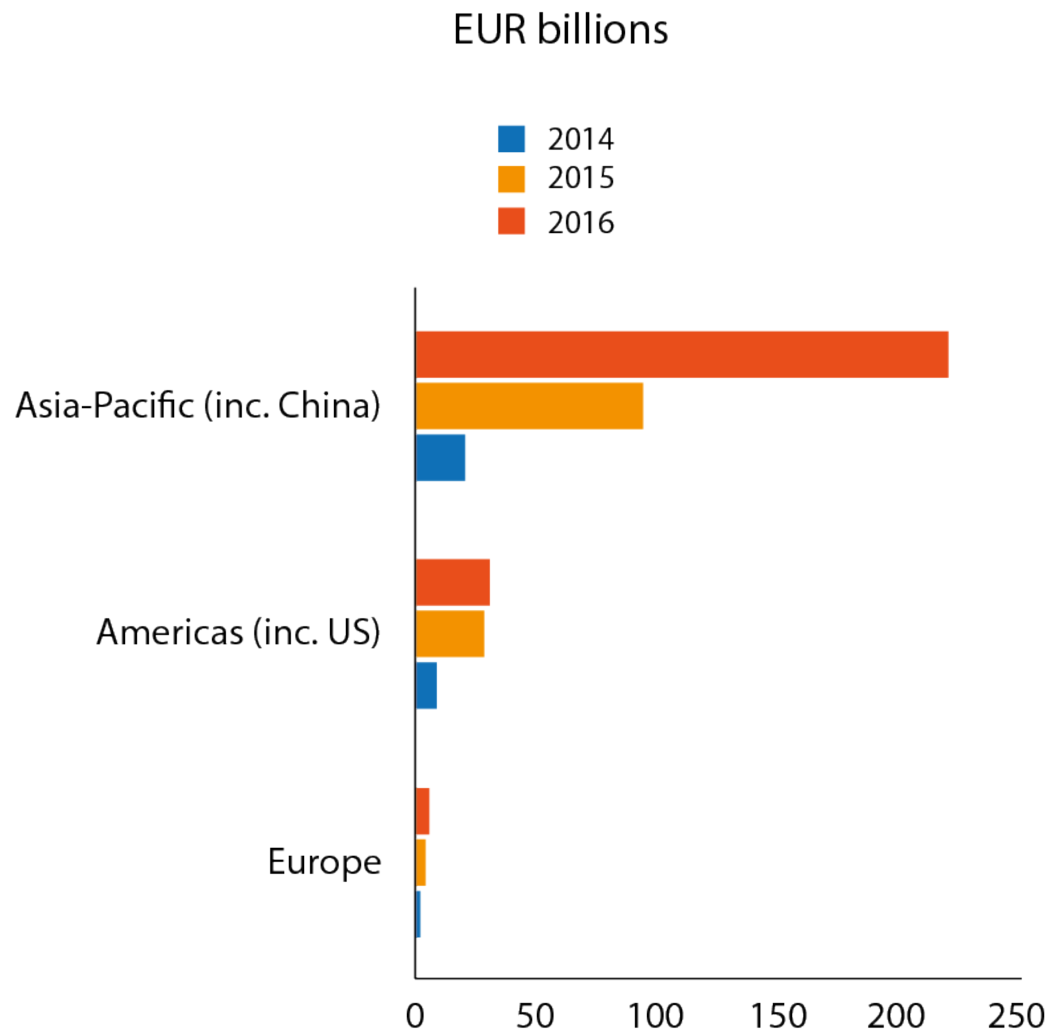
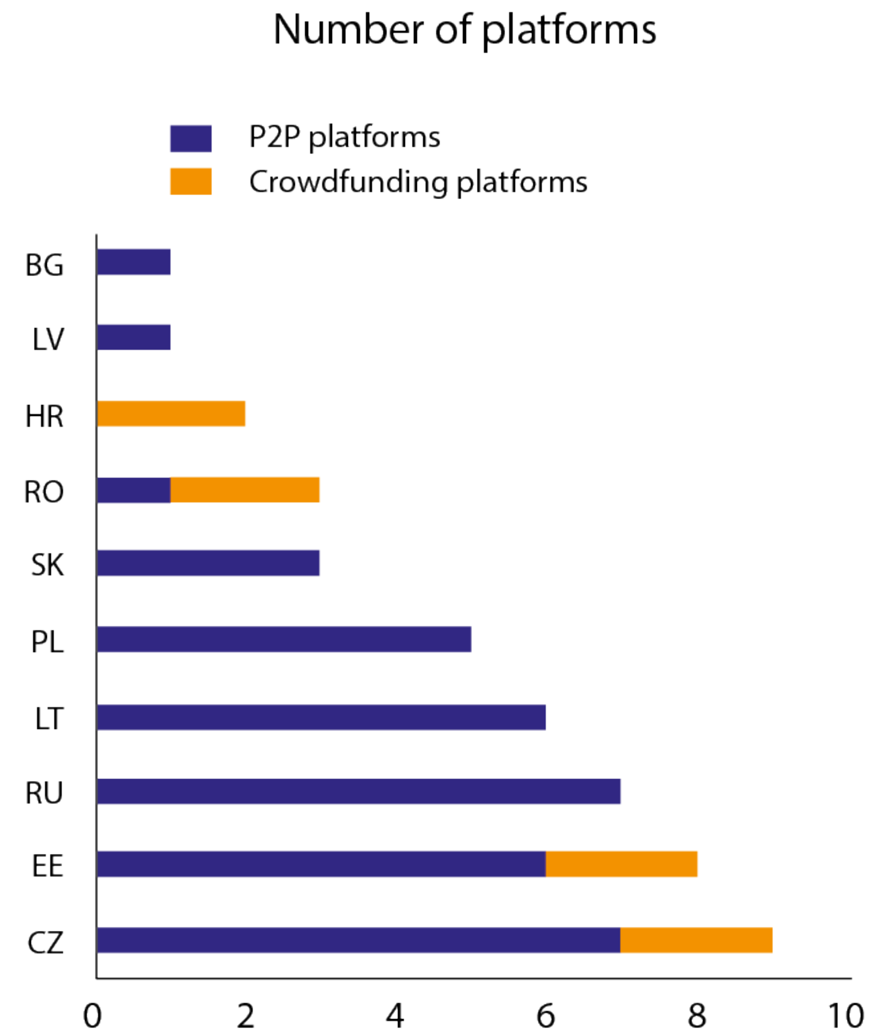
Figure 9. New financial technologies have not yet found much traction in Europe





Source: Expanding Horizons – the 3rd European Alternative Finance Industry Report, reports by the Cambridge Centre for Alternative Finance (2016).
Note: Data are based on information gathered from 344 crowdfunding, P2P lending and other alternative finance intermediaries across 45 countries in Europe.

Source: FinTechs and their emergence in banking services in CESEE (Stern, 2017).

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Using EU funds to foster convergence

The third area where Europe can help is arguably the most contentious one. It relates to transfers between member states to foster convergence in the EU.

Such transfers are already happening, of course. Cohesion policy, designed to reduce structural disparities among regions and member states, was the second largest item in the EU's 2014-20 budget. Over this period, and this you can see on the left-hand side of Figure 10, the cumulated available funds for CESEE countries range from 8 to 21% of average annual GDP, with the allocation of resources linked to prevailing income levels. In other words, these funds are not negligible.

One problem, however, is that not all countries are equally successful in accessing them. One reason for this is linked to the importance of institutional quality, which I mentioned earlier. You can see this on the chart on the right-hand side, which suggests there is a positive correlation between institutional quality and a country's ability to effectively absorb available transfers and secure new funding opportunities.

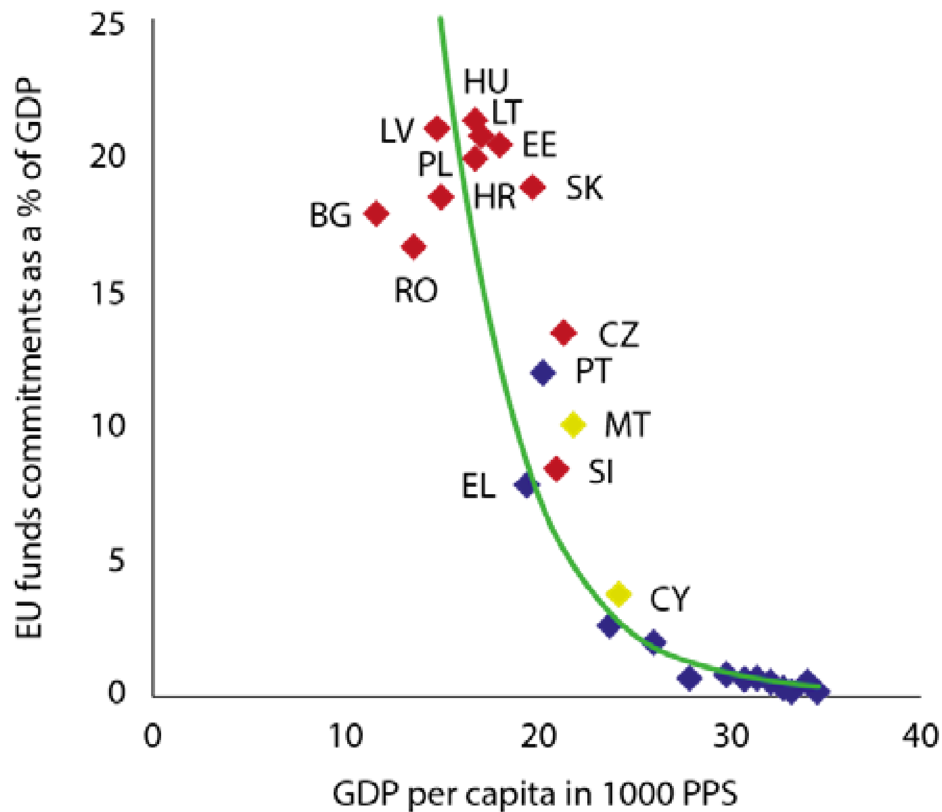
Such patterns are even more visible when considering EU funding opportunities for social policies, education and training[29]. Under the European Fund for Strategic Investments plan, for example, CESEE economies have only been able to attract less than 5% of total funding allocated to social infrastructure projects.

This means two things. First, we need to strengthen the ability of receiving economies to access and absorb funds. This should be part of the broader effort to improve institutional quality.

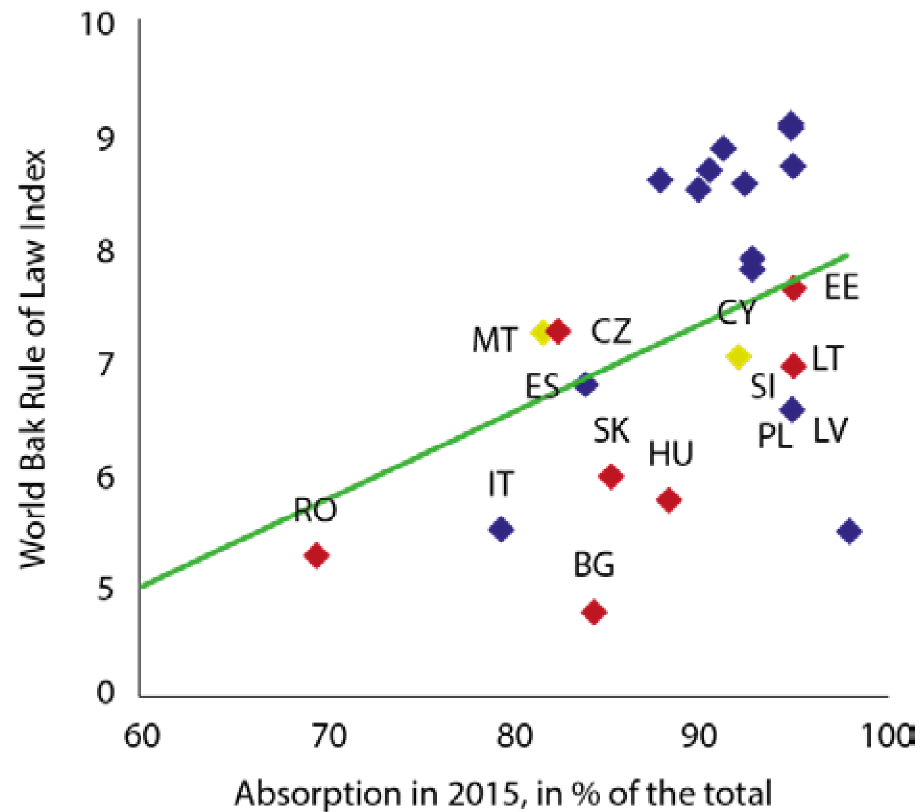
Second, EU allocation rules should be made as simple as possible. The European Commission has already made several important suggestions in this respect, with a single rulebook planned to cover several EU funds, less red

Figure 10. Cohesion funds sizable but not all countries equally successful in accessing them

EU funds for Cohesion and GDP per capita
(% of GDP, thousand PPS)



Absorption rate of EU funds for Cohesion and Rule of Law
(index, % of total allocations)



Sources: European Commission, AMECI, and ECB calculations.
Note: Data for the 2014-2020 programming period; red diamonds refer to the EU11, blue diamonds for the EU15. For nominal and per capita GDP, 2010-2013 average is used. Data for ERDF, CF, and ESF. Luxembourg is not shown.

Sources: World Bank, European Commission, and ECB calculations.
Note: Data for the 2007-2013 programming period. The institutional quality index for 2015 is rescaled between 0 and 10, indicating low and high institutional quality, respectively. Data for ERDF, CF and ESF. Croatia is not shown.

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tape and lighter control procedures for businesses and entrepreneurs benefiting from EU support[30]. Such initiatives are essential if we want people and companies to take full advantage of the opportunities that the EU provides.

Conclusion

Achieving similar standards of living across our continent should speak to our highest aspirations. It is a recognition of history that economic prosperity, opportunity and peaceful societies are closely linked and mutually reinforcing. The prospect that relative income levels in Europe, without further action, will remain unacceptably large for the foreseeable future is therefore a warning sign. It should urge policymakers to think in new ways about how convergence can be accelerated, and what role Europe itself should play in this process.

I have highlighted that we must begin by acknowledging that convergence requires joint efforts and responsibility. It requires member states to translate EU initiatives and recommendations into concrete and positive effects on the ground, and candidate countries and potential candidates to achieve institutional excellence as early as possible in the transition process. Convergence must be built on strong institutions. And adhering to standards, EU standards, is a powerful vehicle for growth.

Accelerating convergence also requires the EU, and the euro area in particular, to help underwrite this process. This includes completing the Single Market, building a new digital market and being serious about developing a true capital markets union. Transition economies need both the market and the capital to nurture and feed domestic growth initiatives. ■

Benoît Cœuré is a Member of the Executive Board of the ECB

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Endnotes

1. Article 3 of the Treaty on European Union states that "[The Union] shall promote economic, social and territorial cohesion, and solidarity among member states."

2. EU members comprise Bulgaria, the Czech Republic, Estonia, Croatia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia. EU candidate countries or potential candidates comprise Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Montenegro and Serbia (also referred to here as the "Western Balkans"). Kosovo is also included subject to data availability (without prejudice to positions on status, in line with United Nations Security Council Resolution 1244 and the International Court of Justice's opinion on Kosovo's declaration of independence).

3. See also Nowotny, E, D Ritzberger-Grünwald and H Schuberth (2018), "Structural Reforms for Growth and Cohesion – Lessons and Challenges for CESEE Countries and a Modern Europe", Edward Elgar Publishing.

4. See Zuk et al. (2018), "Real convergence in central, eastern and south-eastern Europe", ECB Economic Bulletin Article, Issue 3.

5. See, for example, European Bank for Reconstruction and Development (2017), Transition Report 2017-18, November.

6. See Krugman, P (1994), "The Myth of Asia's Miracle", Foreign Affairs, November/December.

7. See, for example, Girma, S (2005), "Absorptive capacity and productivity spillovers from FDI: a threshold regression analysis", Oxford Bulletin of Economics and Statistics, 67(3), pp. 281-306; Amann, E and S Virmani (2014), "Foreign direct investment and reverse technology spillovers: The effect on total factor productivity", OECD Journal: Economic Studies, Vol. 2014/1; Alfaro, L, S Kalemli-Ozcan and S Sayek (2009), "FDI, productivity and financial development", World Economy, 32(1), pp. 111-135; Kimura, F and K Kiyota (2006), "Exports, FDI, and productivity: Dynamic evidence from Japanese firms", Review of World Economics, 142(4), pp. 695-719; and Arratibel, O, F Heinz, R Martin, M Przybyla, L Rawdanowicz, R Serafini and T Zumer (2007), "Determinants of growth in the central and eastern European EU Member States – a production function approach", ECB Occasional Paper No 61.

8. See, for example, Kee, HL (2015), "Local intermediate inputs and the shared supplier spillovers of foreign direct investment", Journal of Development Economics, Vol. 112, pp. 56-71.

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9. See, for example, Bas, M and V Strauss-Kahn (2014), "Does importing more inputs raise exports? Firm-level evidence from France", Review of World Economics, Vol. 150(2), pp. 241-275; and Bustos, P (2011), "Trade Liberalization, Exports, and Technology Upgrading: Evidence on the Impact of MERCOSUR on Argentinian Firms", American Economic Review, Vol. 101, No 1, pp. 304-340.
10. See Chiacchio, F, K Gradeva and P Lopez-Garcia (2018), "The post-crisis TFP growth slowdown in CEE countries: exploring the role of Global Value Chains", ECB Working Paper No 2143. This research also suggests that sectoral TFP growth in CEE countries depends roughly equally on technology creation at the global value chain frontier and on the ability of national firms to absorb the new technology.
11. See Cœuré, B (2018), "Trade as an engine of growth: Prospects and lessons for Europe", speech at the NBRM High Level International Conference on Monetary Policy and Asset Management, Skopje, 16 February.
12. See also Cœuré, B (2018), "Monetary policy and climate change", speech at a conference on "Scaling up Green Finance: The Role of Central Banks", organised by the Network for Greening the Financial System, the Deutsche Bundesbank and the Council on Economic Policies, Berlin, 8 November.
13. See also United Nations Conference on Trade and Development (2016), "Robots and Industrialization in Developing Countries", Policy Brief No 50.
14. See, for example, Sirkin, H, M Zinser and J Rose (2015), "How Robots Will Redefine Competitiveness", Boston Consulting Group, September.
15. See Boston Consulting Group (2015), "Made in America, Again: Fourth Annual Survey of U.S.-Based Manufacturing Executives", December.
16. See, for example, Monteagudo et al. (2012), "The economic impact of the Services Directive: A first assessment following implementation", European Commission Economic Papers No 456; Blind, K, A Mangelsdorf, C Niebel and F Ramel (2018), "Standards in the global value chains of the European Single Market", Review of International Political Economy, Vol. 25(1), pp. 28-48; and Pelkmans, J and A Renda (2014), "Does EU regulation hinder or stimulate innovation?", CEPS Special Report No 96.

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17. See Cœuré, B (2017), "Convergence matters for monetary policy", speech at the Competitiveness Research Network (CompNet) conference on "Innovation, firm size, productivity and imbalances in the age of de-globalization" in Brussels, 30 June.
18. See Acemoglu, D, S Johnson and J Robinson (2001), "The Colonial Origins of Comparative Development: An Empirical Investigation", American Economic Review, Vol. 91, No. 5, pp. 1369-1401.
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21. See Levine, R (2005), "Finance and Growth: Theory and Evidence", in Aghion, P and SN Durlauf (eds.), Handbook of Economic Growth, pp. 865-934, Elsevier, Amsterdam.
22. See Boyd, JH and BD Smith (1992), "Intermediation and the equilibrium allocation of investment capital: Implications for economic development", Journal of Monetary Economics, Vol. 30(3), pp. 409-432.
23. See Langfield, S and M Pagano (2016), "Bank bias in Europe: effects on systemic risk and growth", Economic Policy, Vol. 31(85), pp. 51-106; and Demirgüç-Kunt, A, E Feyen and R Levine (2013), "The evolving importance of banks and securities markets", World Bank Economic Review, Vol. 27(3), pp. 476-490.
24. See Bartelsman, E, P Lopez-Garcia and G Presidente (2017), "Factor reallocation in Europe", ECB, mimeo.
25. See Hsu, P, X Tian and Y Xu (2014), "Financial development and innovation: Cross-country evidence", Journal of Financial Economics, Vol. 112(1), pp. 116-135.
26. See ECB (2018), "Financial development, financial structure and growth: evidence from Europe", Financial integration in Europe, May. Moreover, higher growth in value added has been found to be driven by faster growth in labour productivity than in capital accumulation, supporting the idea that equity markets play an important role in the financing of innovation and TFP growth.
27. See ECB (2015), Building a Capital Markets Union – Eurosystem contribution to the European Commission's Green Paper; and ECB (2017), ECB contribution to the European Commission's consultation on Capital Markets Union mid-term

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review 2017.

28. See also Stern, C (2017), "Fintechs and their emergence in banking services in CESEE", Focus on European Economic Integration, Oesterreichische Nationalbank, Issue Q3/17, pp. 42-58.

29. Here most of the EU funds are allocated via tenders and competitive calls, not via pre-allocated grants on the basis of quotas at member state level.

30. See European Commission (2018), "EU budget: Regional Development and Cohesion Policy beyond 2020", press release, 29 May.

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This article is based on a speech delivered at the Conference on European Economic Integration (CEEI), Vienna, 26 November 2018

Retooling Europe's economy

European firms are investing too little compared to global competitors. Debora Revoltella calls for a 'retooling' of the European economy

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Europe is at risk of falling behind its global competitors. In a period of radical technological transformation, European firms are investing too little, with a gap both in tangible and intangible investment compared to the US. This article calls for a 'retooling' of Europe's economy in relation to skills, innovation finance, the business environment, infrastructure, and deepening the Single Market.

Over the last year, we have seen a notable re-emergence of concerns with regard to the medium- and long-term economic outlook. In its latest forecast, the IMF (2018) draws attention to *"powerful structural headwinds acting on potential growth"* that have only temporarily been offset by cyclical factors. Likewise, the European Commission (2018) projects moderate economic growth that faces significant downside risks, despite supportive financing conditions.

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A range of structural factors explains Europe's relatively low rate of productivity growth and overall potential growth. Well-known and relatively well-studied is the enduring gap between the EU and the US in R&D investment (Van Ark *et al*. 2008, Moncada-释Paternò-Castello *et al*. 2010, Cincera and Veugelers 2014) and other intangibles (Haskel and Westlake 2017). Recent work has also examined the role of the diffusion of innovation between and within countries (Andrews *et al*. 2015, Cirera and Maloney 2017), while Gopinath *et al*. (2017) and Restuccia and Rogerson (2017) discuss causes and costs of capital misallocation. But there are also many factors to be considered, such as skills constraints (Cedefop 2018), market size, and the recent, less well-known divergence in the investment rates in machinery and equipment between the EU and the US.

The *EIB Investment Report 2018/2019* (EIB 2018) provides a comprehensive analysis of investment and investment finance in Europe. Building on the latest findings of a unique annual survey of 12,500 firms across Europe[1], it analyses structural and cyclical factors influencing investment in various assets classes, opening a window on some of the weaknesses of the EU economy, the likely cost of inaction, and what a 'retooling' should entail.

After a strong investment recovery, headwinds are strengthening, and structural challenges remain

Investment has been clearly recovering in Europe, on the ground of supportive monetary policy and financing conditions. The intensity of investment in the EU, relative to GDP, is now close to its long-term average level. Its recovery has been driven by investment in machinery and equipment and intangibles, with investment in dwellings and structures now also picking up. Monetary and financial conditions have supported this recovery: the cost of borrowing for businesses is still historically low, and the share of firms in the *EIB Investment Survey* (EIBIS) that name access to finance as a major impediment to investment is low and declining at 17%.

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Europe's economy still lacks the 'tools' to meet the urgent challenges of the future: remaining globally competitive in the face of rapid innovation and digitalisation, achieving sustainability, and creating an inclusive and cohesive society

However, headwinds are strengthening, adding to long-lasting concerns about low potential growth. EIBIS asks firms to assess the relevance of different factors in influencing investment activities. The net share of firms considering the general economic climate as supportive for investment has declined relative to 2017, while the net share of firms considering political and regulatory conditions as negative for investment has substantially increased. This is an early indication of changing sentiment, with Brexit, rising social tensions, political polarisation, and increasing economic risk contributing to rising uncertainty.

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Structural weaknesses in the EU economy

In a period of disruptive technological transformation, Europe's recovery has actually been relatively weak, at least in relation to the US experience. Since the crisis, a gap has opened up in investment in machinery and equipment. While some of this effect is related to the shale boom in the US, it also raises questions about whether the EU will be able to keep up in terms of technological transformation, with widespread adoption of new technologies.

This gap in tangible investment is even more worrisome when viewed in combination with the well-known gap in investment in intangibles. European firms still fail to see the need to invest in different forms of intangibles to internalise complementarities across different forms of investment. R&D is not the only important form of intangible investment. Investment in software, skills, and organisational transformation are all becoming essential elements in the new digital world, both in the manufacturing and the service sectors.

At the forefront of the innovation process, the EU also shows a concerning lack of dynamism. Based on EIBIS data, we can categorise firms according to whether they do not innovate, just adopt innovations, conduct R&D, or are 'leading innovators' who are both doing R&D and introducing globally new products. What we see is that the EU, compared to the US, has more firms that do not innovate at all or that only adopt innovations. Where Europe is

really lagging behind is in terms of leading innovators, particularly among young firms. This is a symptom of a more static system, where fewer young firms succeed in displacing older rivals.

When we look at the top firms globally for R&D expenditure, what we see is not only the dramatic rise of China but also a relative lack of dynamism in Europe, with fewer new entrants since 2011 among the top firms, compared to the US. This is also accompanied by the much lower presence of European firms in high-tech sectors.

One of the constraints facing innovation and technological transformation in Europe is finance. The European financial sector is largely bank-based, with banks being relatively unsuited to financing innovation and intangible investments. While the cost of debt now stands at around 400 basis points below its pre-Global Crisis level, the cost of equity has not fallen to such an extent. The equity risk premium remains elevated and the spread between equity and debt is still larger than before the crisis. Private equity, venture capital and listed equity funding all lag behind the US and advanced Asian countries on several fronts, leaving European firms more dependent on bank lending and weakening resilience to financial shocks.

The effects of this are visible in EIBIS data. When we compare innovating with non-innovating firms, we see that the innovators show better performance and financial health, yet are significantly more likely to be financially constrained. Their dissatisfaction with the collateral requirements for bank credit is also particularly marked, as you would expect for firms investing in intangibles such as intellectual property.

Skills present another constraint: 77% of European firms consider the limited availability of staff with appropriate skills to be an impediment to investment. This skills gap reflects a structural process of adjustment to changing technology and skill requirements, exacerbated by a tight labour market in many EU countries and migration in Central and Eastern Europe. At the firm level, it is the more innovative firms that more often report limited skills

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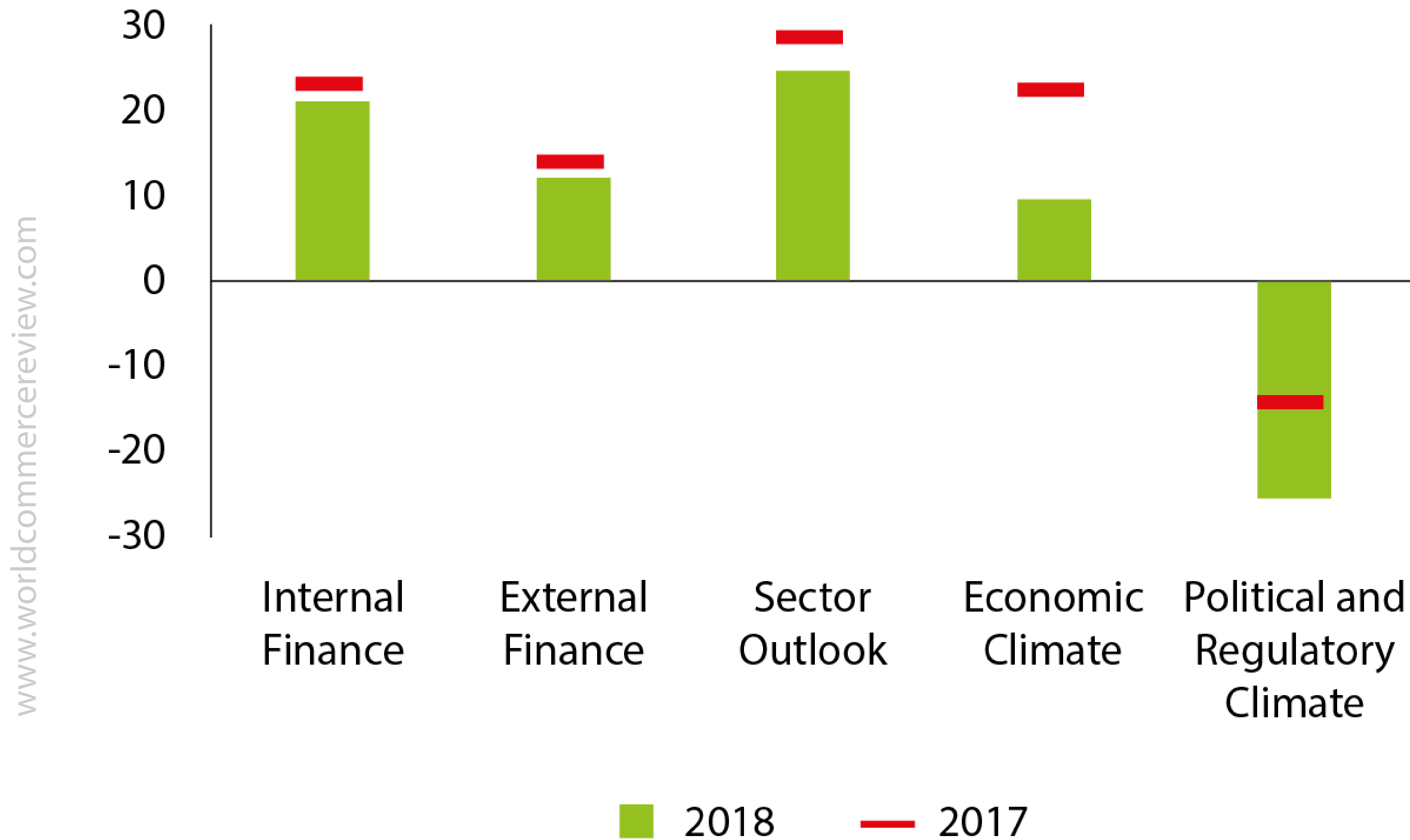
Figure 1. Headwinds are strengthening (firms considering each factor supportive, minus firms considering it negative)



Source: EIBIS 2018.

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Figure 2. Investment gap, EU vs US (machinery & equipment and intangibles, % of GDP)

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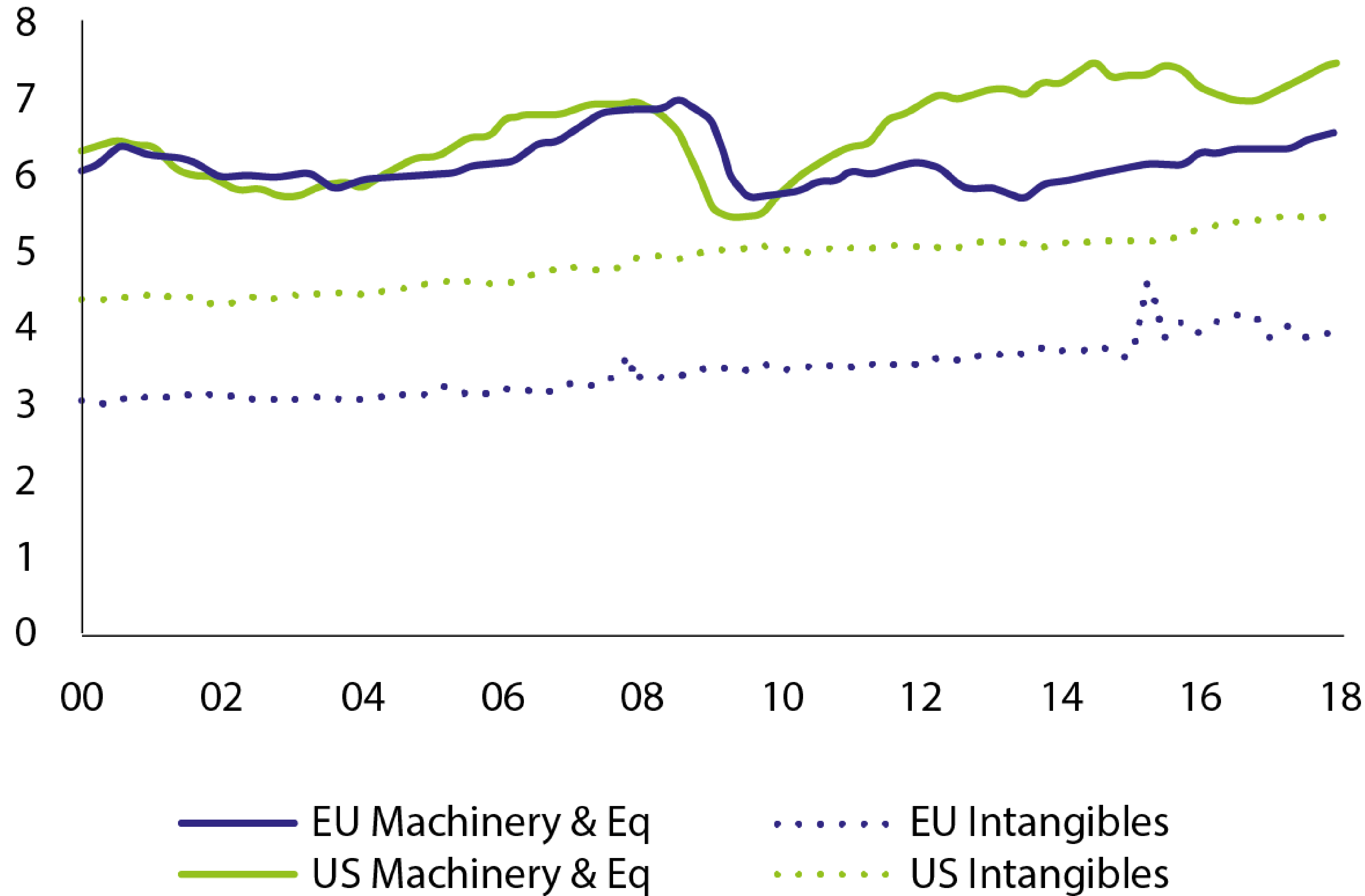
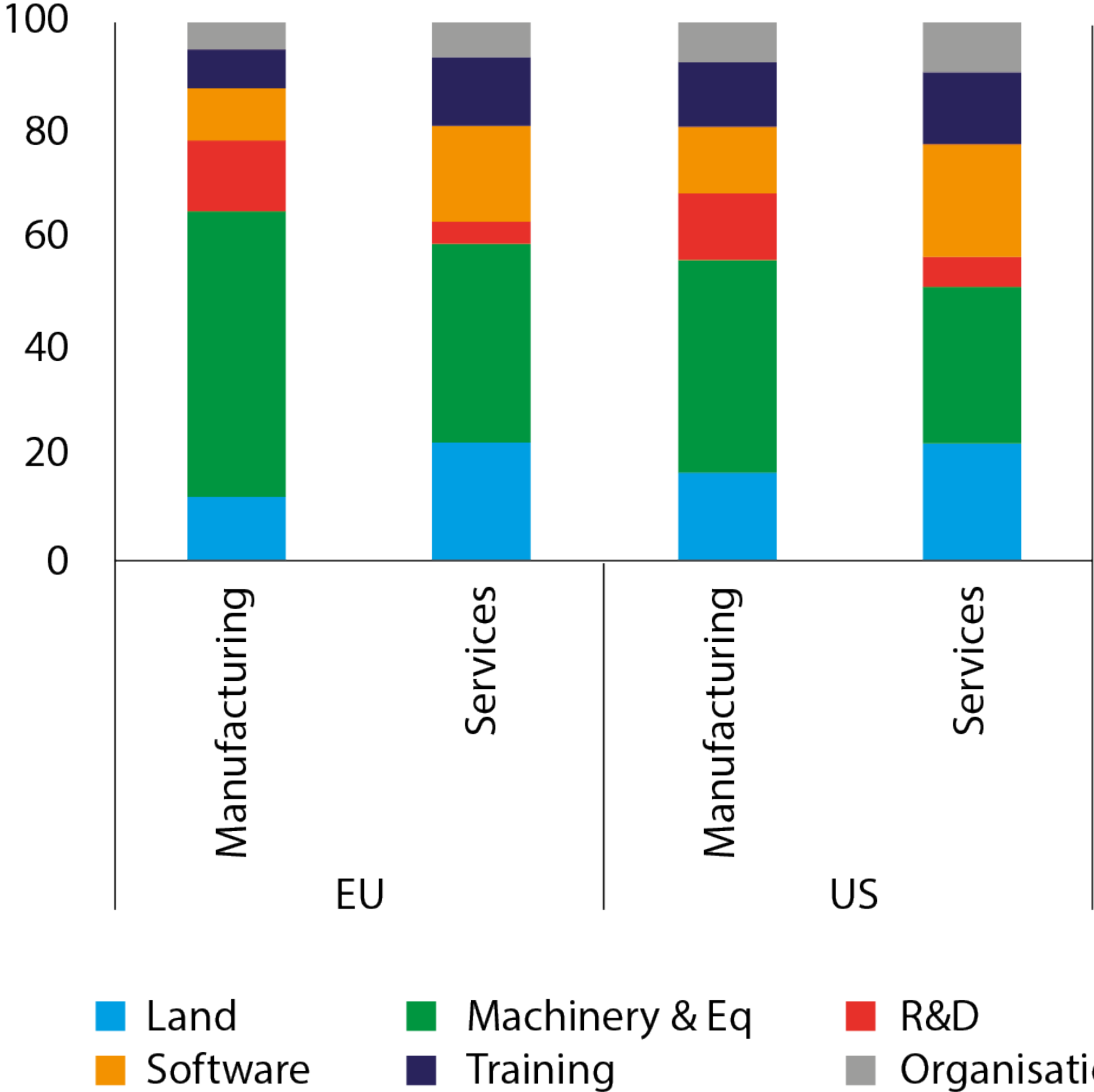


Source: Ameco.

Figure 3. European firms invest less in intangibles (% of total firm investment)



Source: EIBIS 2018.

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Figure 4. Europe has less leading innovators (innovation profiles by age of the firm, %)

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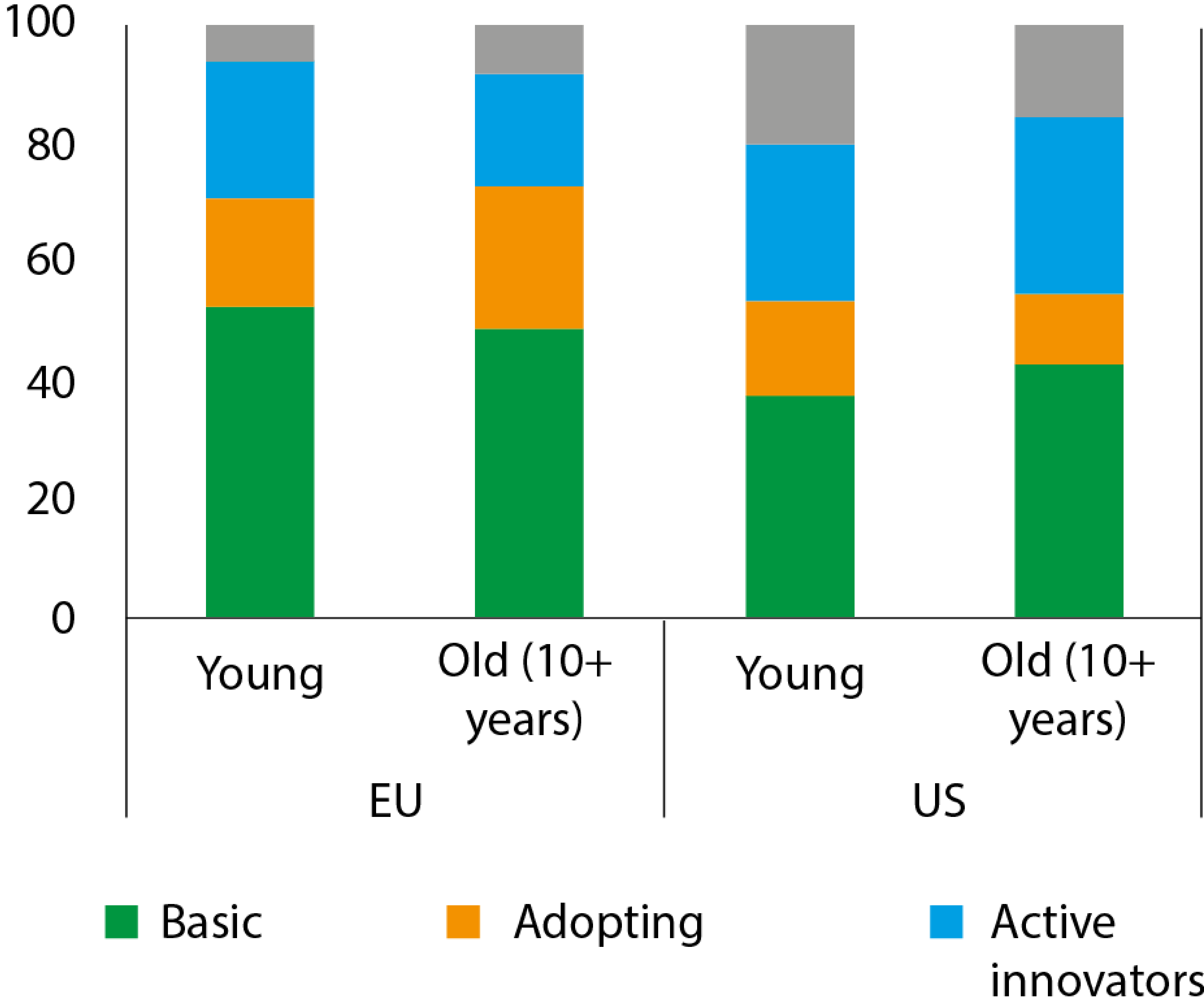
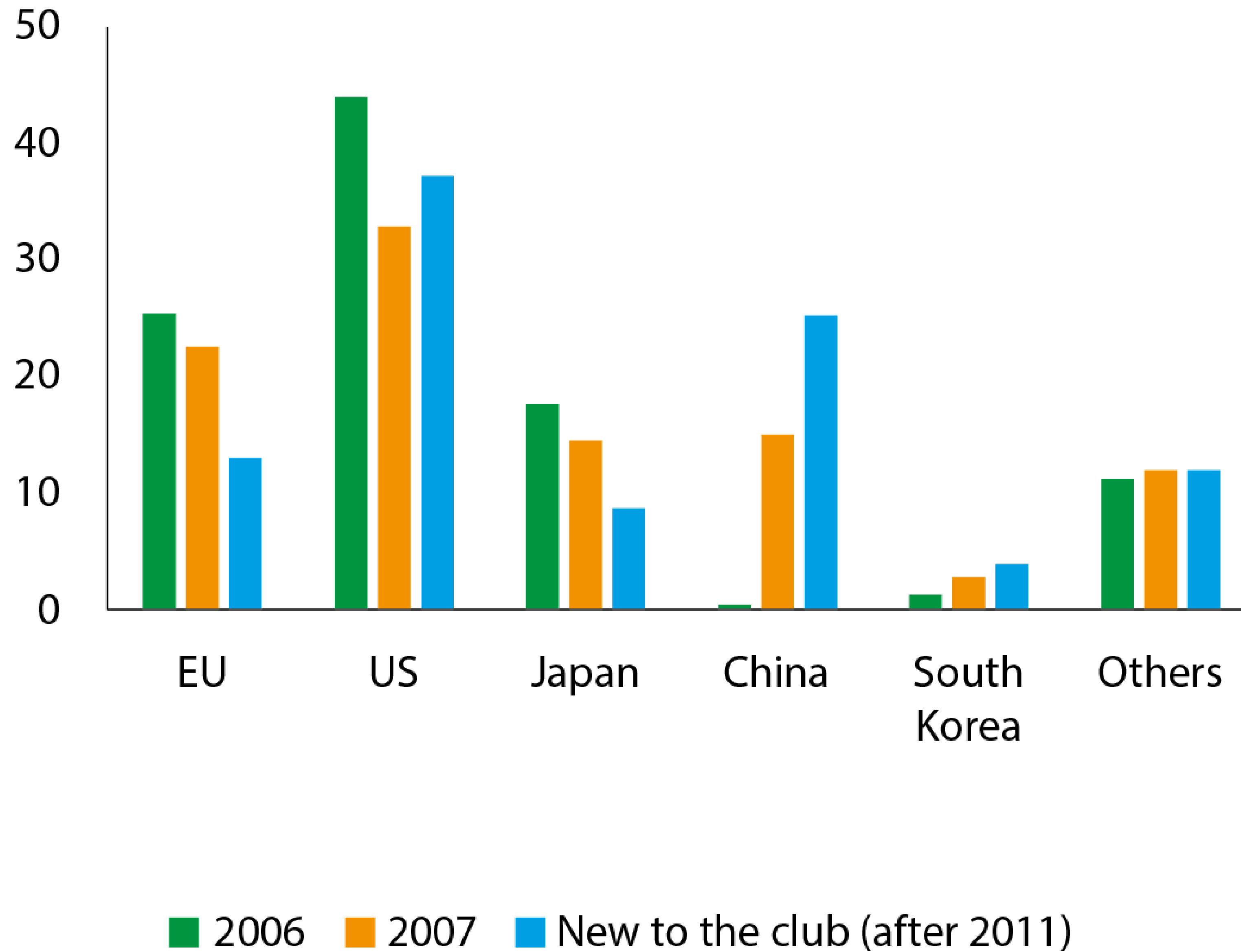


Source: EIBIS 2018.
Note: Innovation profiles are defined based on firms' spending on R&D and firms' introduction of products and processes new to the firm, country or world.

Figure 5. Europe has fewer 'new' global leaders (share of top 2,500 R&D global spenders, %)



Source: EU Industrial R&D Investment Scoreboard.
Note: % firms in the top 2,500 R&D global spenders in 2006 and 2017, and % of new entrants to this group after 2011.

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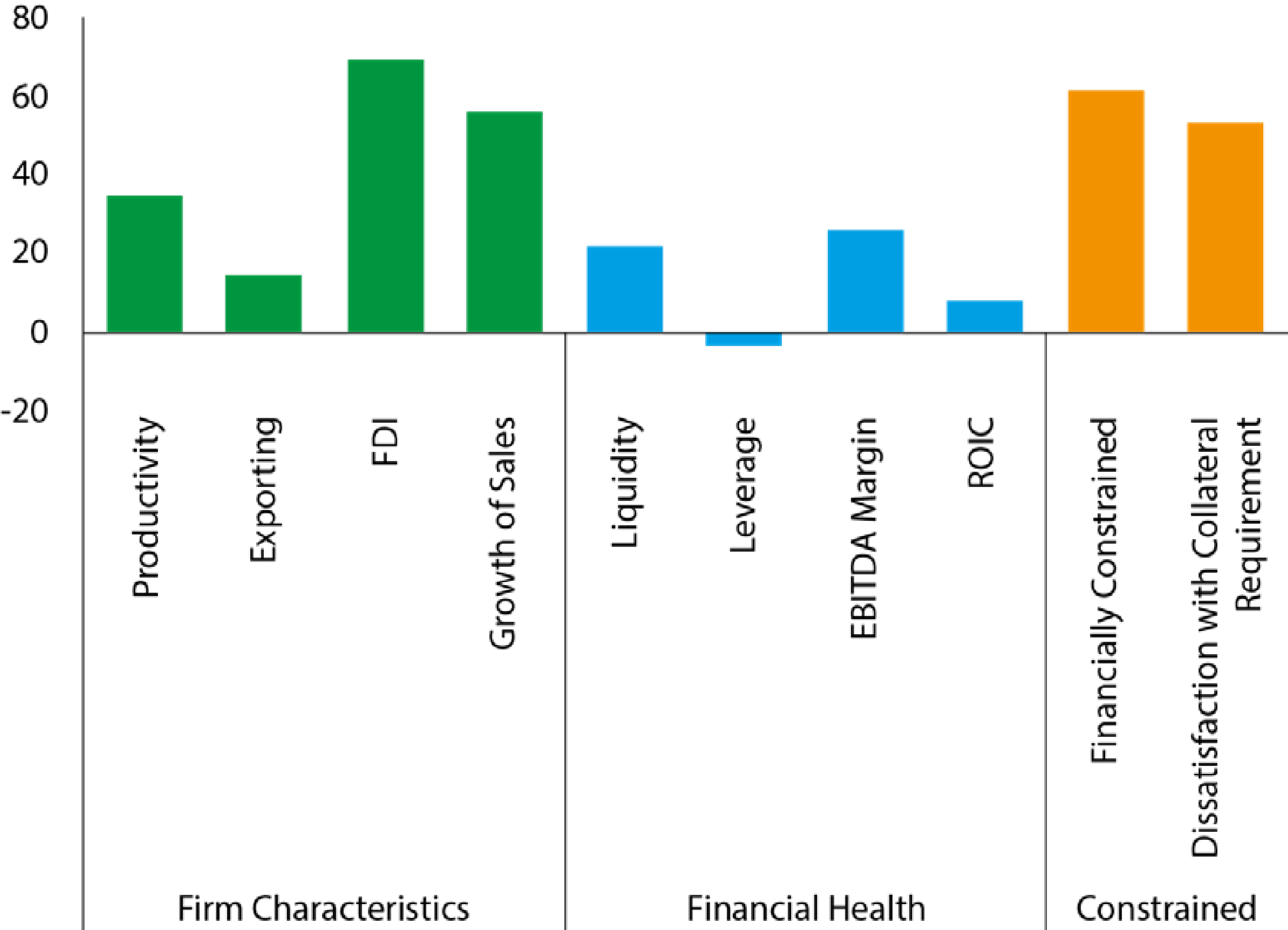
Figure 6. Difference between innovating and non-innovating firms (% deviation from non-innovators, defined as non-patenting firms)



Source: EIBIS 2018.

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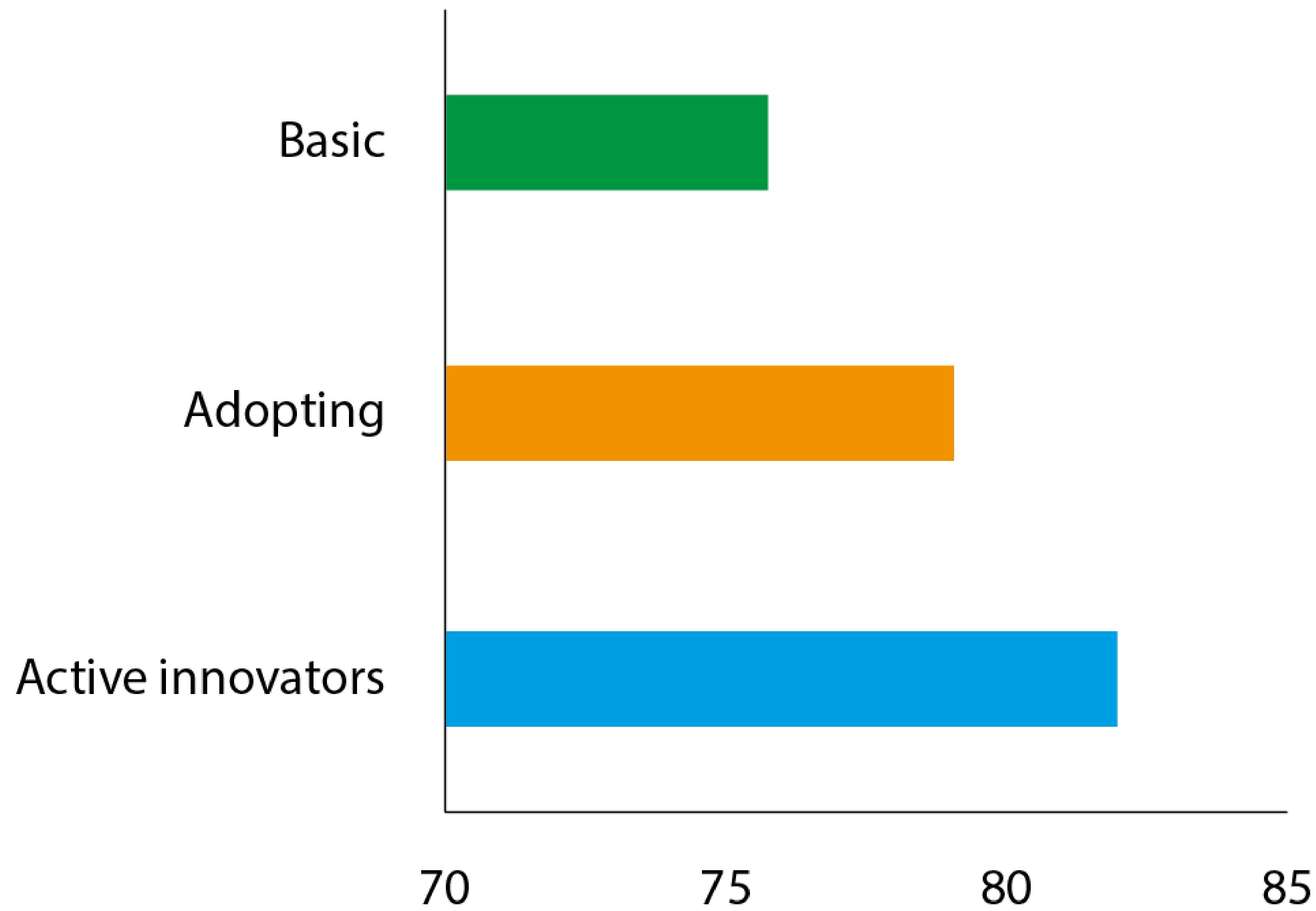
Figure 7. Lack of skills, by firms' innovation profile (firms that consider lack of staff with the right skills an impediment to investment, %)



Source: EIBIS 2018.

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Figure 8. Infrastructure investment remains low (investment in infrastructure, % of GDP)

2.5
2.0
1.5
1.0
0.5
0

05 06 07 08 09 10 11 12 13 14 15 16 17*

Non-PPP Project
PPP
Corporate
Government

Source: EIB Infrastructure database.
*Note: * Provisional estimate.*

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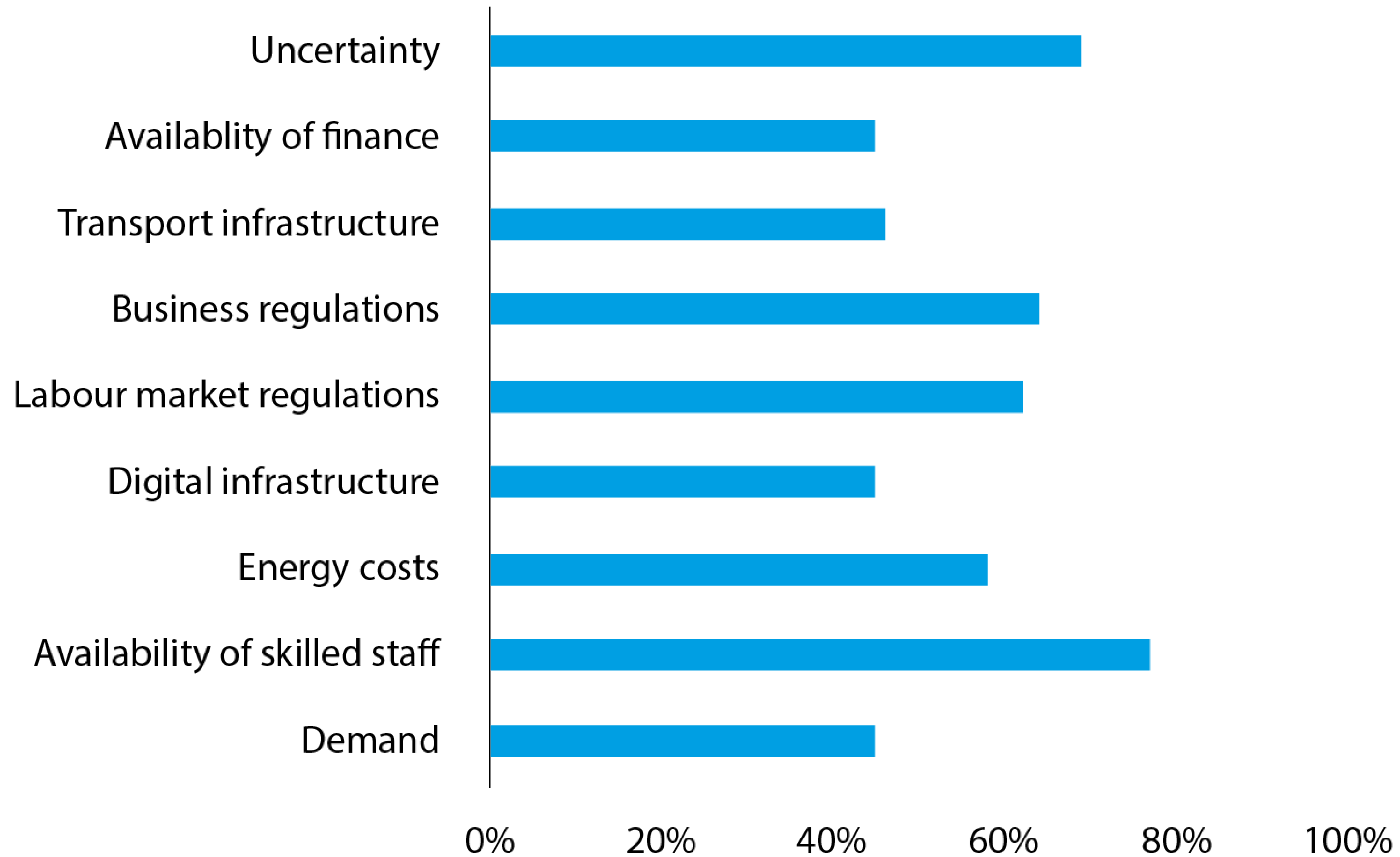
Figure 9. Long term barriers to investment (% firms reporting impediment to investment)



Source: EIBIS 2018.

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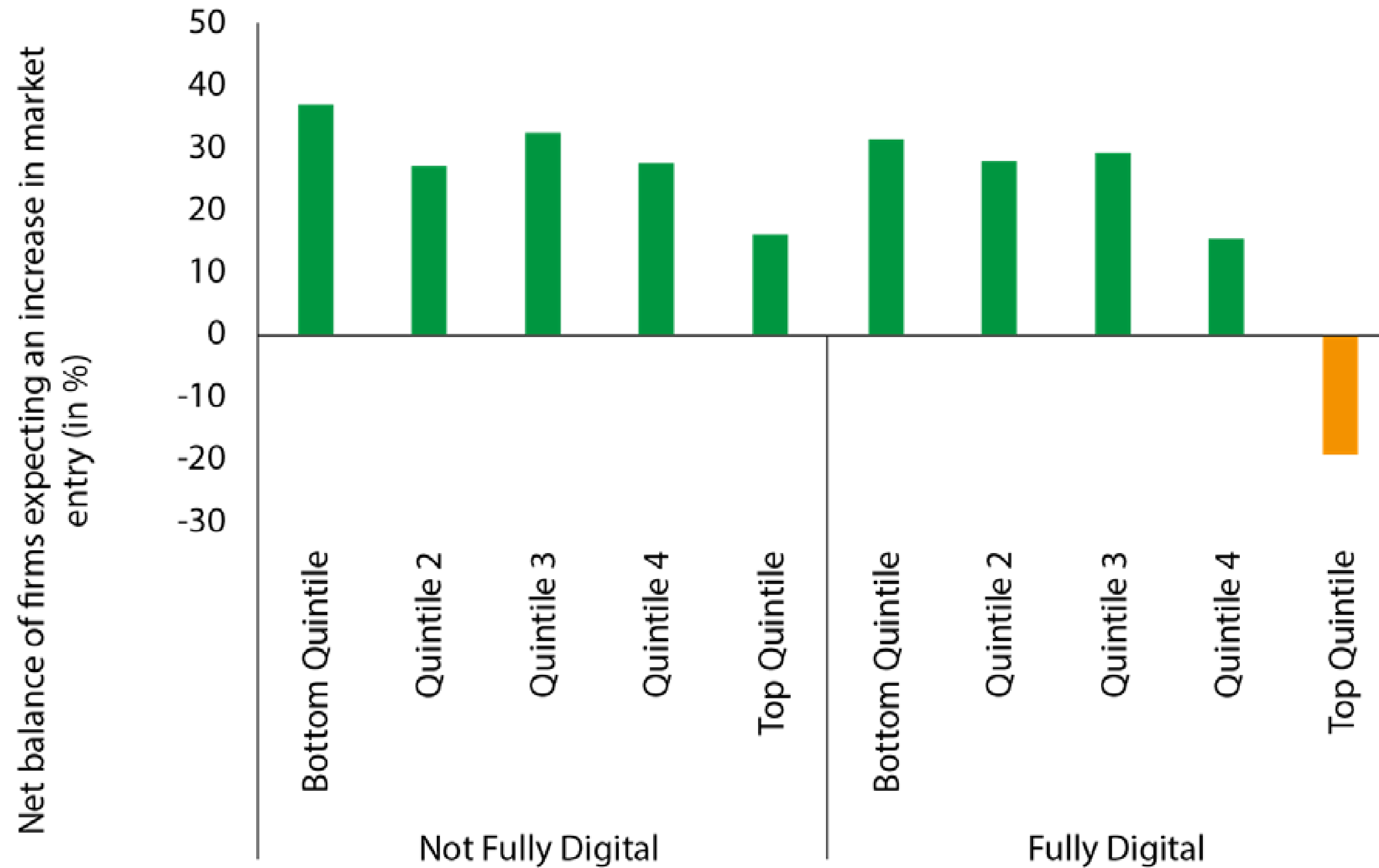
Figure 10. Will digitalisation increase competition? (expectations by productivity quintiles for fully and not-fully digital firms)



Source: EIBIS Digital and Skills Survey 2018.
Note: Firms are grouped by quintile in terms of total factor productivity. The graph shows the percentage of firms that expect digitalisation to increase competition minus those that expect competition to decrease (net value).

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availability as a constraint. Seventy-one percent of EU firms invest in training, but only 21% consider that their recent investment in training has been sufficient. This may partially reflect the difficulty firms face in internalising benefits from training, pointing to the importance of public action in this area.

Quality infrastructure is another vital economic enabler, but investment in infrastructure in the EU is lagging the recovery. At 1.7% of GDP, it now stands at about 75% of its pre-Financial Crisis level and shows only little sign of an upturn. This does not appear to be a response to need saturation: the fall in investment is not correlated with infrastructure quality and one in three large municipalities in Europe say that infrastructure investment is still below needs.

Instead, it reflects a shift in public investment away from infrastructure during the crisis. Along with a retrenchment of the public sector, the capabilities to generate projects has been declining. Finance is not the only gap. Planning capacity is poor as well as project generation capacity. A new narrative is needed, as well as clearer incentives for the private and public sector to cooperate.

In addressing these weaknesses, the institutional framework will be key. Forty-three percent of municipalities regard technical capacity for planning and project generation as a major obstacle. Difficulties in properly structuring public-private partnerships mean that incentives for private sector operators are unclear.

We also see that firms are three times more likely to innovate and nine times more likely to introduce a patent in regions that score well on indicators of institutional quality. Meanwhile, firms consider both business and labour market regulations to be significant impediments to investment.

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In the face of disruptive digital technologies and a global race for technological leadership, the cost of inaction is high

Our EIBIS survey module on digitalisation and skills, covering 1,700 firms in the EU and the US, is a first direct comparison of achievement in digitalisation in the EU and the US. The results of the survey suggest that firms that adopt digital technologies tend to be more productive, invest more, and engage more in innovation activities. They also credit the adoption of digital technologies with increased sales: 50% more firms in manufacturing and over 60% more in services believe that their sales would have been lower, had they not adopted digital technologies.

More worryingly, digitalisation appears to be creating winner-takes-all dynamics. On the one hand, digitalisation is associated with higher markups, suggesting a lack of competition. On the other, the most productive digitalised firms stand out in expecting, on balance, that digitalisation will lead to a decrease in the competition they face. These dynamics suggest that late adoption of digital technologies could have disproportionate and long-lasting effects on competitiveness.

In the context of the growing relevance of disruptive technologies, there is a cost of inaction. Thus far, in the manufacturing sector, European firms have kept pace with their US counterparts in terms of digital adoption, but in the service sector, EU firms are lagging. Moreover, when one looks at the most advanced forms of digitalisation (internet of things, big data, and software development), the digital gap between Europe and the US is more evident.

We need to retool Europe's economy

Europe's economy still lacks the 'tools' to meet the urgent challenges of the future: remaining globally competitive in the face of rapid innovation and digitalisation, achieving sustainability, and creating an inclusive and cohesive society. This requires a response at all levels, and not least at the European level. European cooperation is needed

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to facilitate the allocation of European savings towards the most productive use, overcoming investors' home bias. This means advancing financial integration through the CMU and Banking Union. It also means making full use of EU instruments such as the EIB and the EU budget.

Our analysis also points to key areas for attention:

- Encouraging a dynamic, innovative business environment through improving regulatory conditions for firm growth, and market entry and exit, and through addressing the 'equity gap' and 'growth stage trap', on the demand and supply sides.

- Committing to market efficiency through further deepening the single market, particularly for services (crucial for digitalisation incentives), and through creating the conditions for a true European digital market.

- Unblocking critical investment in infrastructure and innovation through better infrastructure governance, complementing finance with technical capacity, and through support to innovation and adoption of new technologies, focusing on all intangibles, not only R&D, and considering the complementarities between asset classes and private/public investment.

- Working together to close the skills gap, an issue that provides an opportunity for win-win policies that address both competitiveness and social inclusion, and where there is potential for more coordinated action at the EU level.

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Retooling Europe must be socially and environmentally sustainable, taking into account the impacts of automation on jobs and demand for skills, issues of cybersecurity and data governance, and, not least, the need for a step-change in investment in climate change mitigation. ■

Debora Revoltella is the Chief Economist and Director of the Economics Department of the European Investment Bank

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Endnotes
1. The EIB Investment Survey (EIBIS). Further information and survey data can be accessed at: www.eib.org/eibis.

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Testing the resilience of Europe's inclusive growth model

Globalisation is placing the European social model under strain. Jacques Bughin and Christopher Pissarides argue that lack of action could make Europe even more vulnerable

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Europe's social contracts to protect their citizens from socioeconomic risks are based on an inclusive growth model characterised by a more egalitarian view of revenue generation and distribution. But this model is under strain, with various global placing upward pressure on inequality that could intensify. This column suggests that keeping the essence of Europe's current inclusive growth model does not preclude it from adapting its current social contracts to protect its citizens, whatever the disruptions that lie ahead.

Europe has many flavours of social contracts depending on the degree to which individual countries protect their citizens from socioeconomic risks, how much they redistribute revenue generated, and which citizens are entitled to benefit from those contracts.

Within this diversity, however, Europe's social contracts have a common backbone – they are based on a long-established inclusive growth model characterised by a more egalitarian view of revenue generation and distribution (Esping-Andersen 1999).

European cracks

Europe's social progress had been remarkable (Fehder *et al*. 2017, Benabou 2000). However, in recent years, the economic crisis has put significant strain on this model, especially for the Mediterranean cluster. Countries in that cluster have been the most hit by the crisis and in response have cut social spending, among others, leading to increased inequality with many citizens still fearing that worse is to come.

More broadly speaking, the median income growth in Europe has been trailing beyond its long-term trend, and many citizens are expressing those fears by voting for non-mainstream political parties and voicing their reluctance to accept more migration. Trust in institutions (both own-country and EU, for member states' citizens) has also been declining in one-third of European countries (Algan *et al*. 2017, Foster and Frieden 2017), see Figure 1.

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Evidently, social contracts in the EU have been tested in every recent decade – by the oil shock in the 1970s, the growth of world trade and rising competition from Asian economies in the 1980s, and the information and communications technology bubble at the turn of the 21st century. During these periods, inequality rose, but then, as growth returned, settled back again.

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Keeping the essence of its current inclusive growth model does not preclude Europe adapting its current social contracts in order to enable a fast and more effective transition

A new ball game?

But this time may be different. New McKinsey Global Institute research suggests that the upward pressure on inequality could – this time structurally – intensify as the result of the interaction of six global trends that are coming of age at the same time.

The six trends are ageing demographics; digital technology, automation, and artificial intelligence (AI); increased global competition and migration; climate change and pollution; and shifting geopolitics.

The ultimate impact of these megatrends on inclusive growth will depend on how actively European policymakers respond to them, either to seize positive opportunities or to mitigate potential negative effects.

Unlikely, but theoretically possible, is a 'denial' scenario in which the EU and European countries do not respond to the megatrends (and roll back current policies such as increases in the retirement age). The result would be prolonged secular stagnation (Gordon 2015), rising inequality, and growth in welfare costs that outstrip gross income growth.

Our simulation suggests that the strength of the headwinds induced by the megatrends could be sufficiently large to reduce baseline income growth from an average of 1.6% per year to 0.3% (an 85% drop), not accounting for the likely depressive effect of rising inequality on income growth.

In contrast, if Europe scales up current policies on, for instance, ageing, actively enables the diffusion of digital and AI technologies, and invests in the circular economy (Ellen MacArthur Foundation and McKinsey Center for Business and the Environment 2015) – a 'deliver' scenario – it could achieve more solid per capita income growth of 1.9% a

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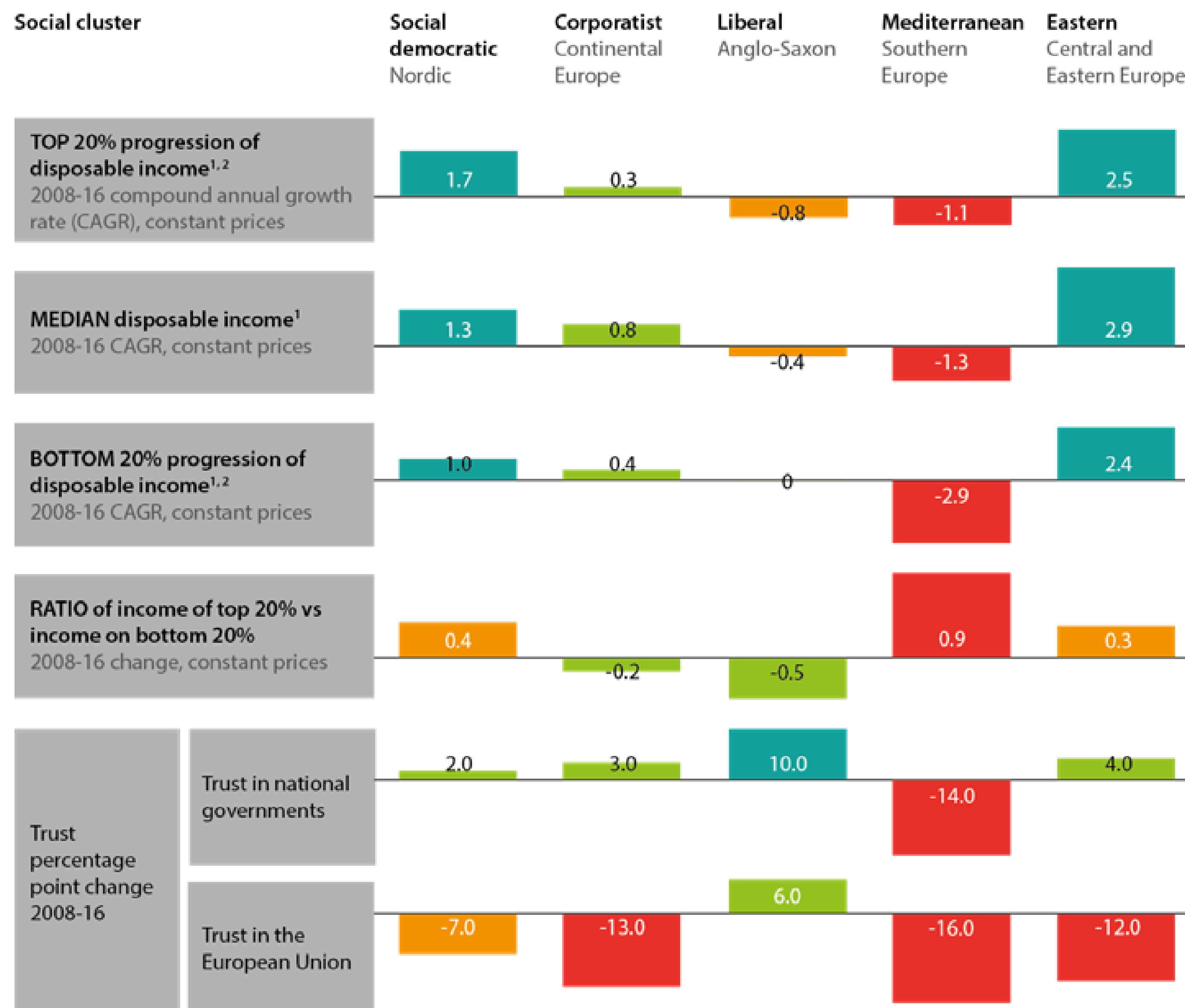
Figure 1. Social clusters' performance has diverged in Europe since the crisis, with the Mediterranean cluster appearing worst off



Sources: World Bank Development Indicators; OECD; Eurostat; Eurobarometer; McKinsey Global Institute analysis

1. Estimates of disposable income are based on the current average tax rate of the income tax bracket, which has been corrected for inflation using the Harmonised Index of Consumer Prices.

2. Estimated change over time in the median income of the quintile.

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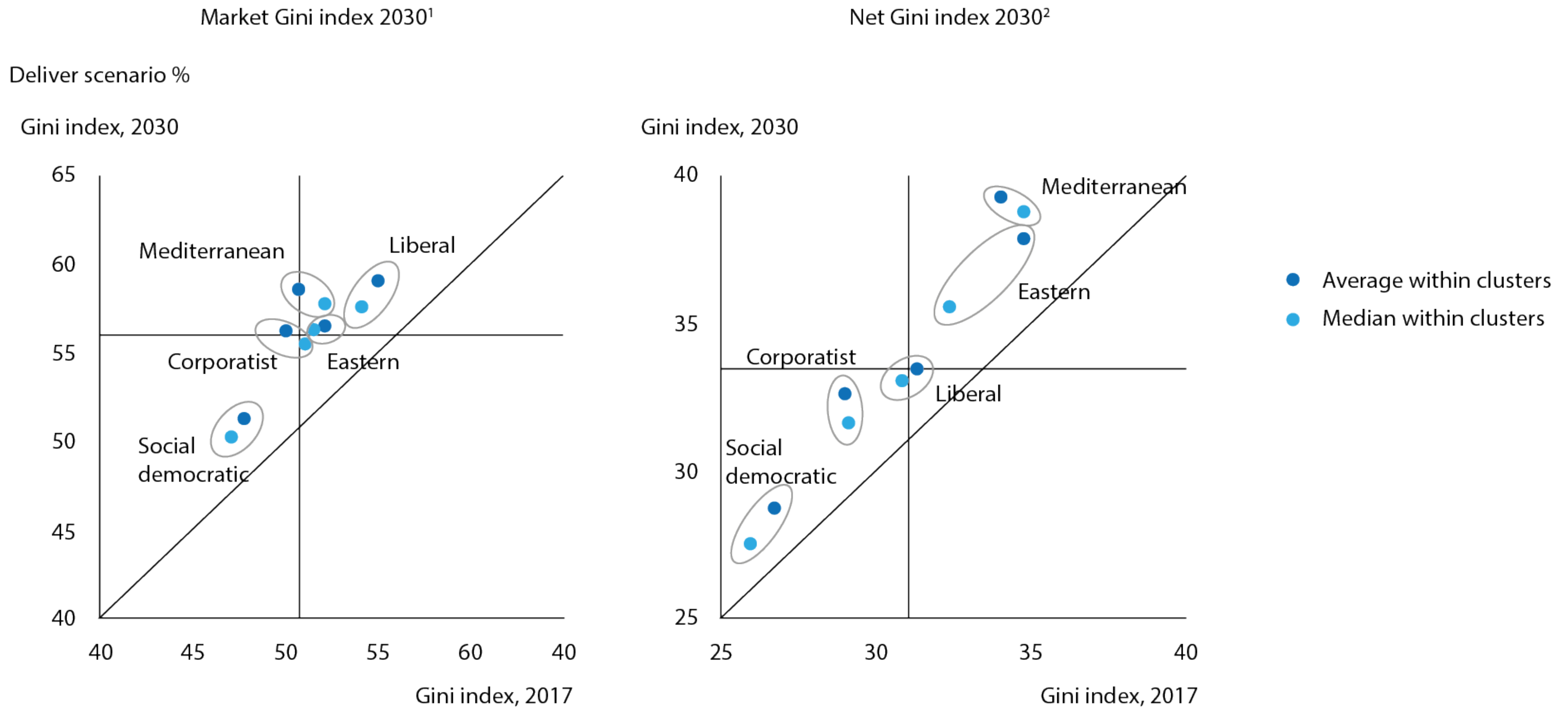
Figure 2. Social divergence may spread within the EU28 even in a 'deliver' scenario



Sources: World Bank; Eurostat; McKinsey Global Institute analysis
1. Before taxes and transfers; GNI Index on wage income only.
2. After taxes and transfers.

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year, producing an additional €9,000 of per capita gross income that could fund additional public social spending to help citizens, whatever the disruptions that lie ahead.

However, even if Europe delivers necessary policies, rising inequality appears to be inevitable because of concomitant forces at work. For instance, digital technology and AI will put pressure on the wages of those doing routine jobs and pay premiums to the higher-skilled, while the deployment of the circular economy could potentially hit some sectors (including manufacturing) more than others.

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Alongside rising inequality among citizens within EU member states, more social divergence may develop among European countries. Europe's 'social democratic' cluster of countries, which includes Nordic economies, has fared relatively well.

These economies have experienced the highest GDP growth in the EU, leading to real positive growth in per capita income and a slight increase in inequality due to superior income growth in the top decile; there has been improved social progress and rising institutional trust (see Figure 2).

In stark contrast (and as highlighted in Figure 1), the 'Mediterranean' cluster of Southern Europe has still not fully digested the impact of the 2007/8 crisis. All income deciles and quintiles have lost between 1% and 3% a year of disposable income per capita with the lowest-income households experiencing the largest losses.

Poverty and relative income inequality have increased. Among the most affected economies, median disposable incomes declined by as much as 5% a year in Greece over this period, and by about 1% per year in Italy and Spain.

Even in McKinsey Global Institute's 'deliver' scenario, Southern Europe will continue to be challenged by its demographics, and, if it does not catch up with the rest of Europe on digital and AI capabilities, have lower potential to benefit from technology.

Our estimate suggests that the cluster of Mediterranean countries may generate less than 1.5% of per capita income growth, compared with more than 2% in the other European clusters. Moreover, Southern Europe could experience double the increase in inequality as the north (see Figure 2).

With such challenges ahead, it may be tempting to resist change or alternatively to give up on the essence of the social contracts in Europe. This, however, may be a strategic mistake and backfire. Inequality may, in fact, boost entrepreneurship (Grigoli *et al*. 2016, Aghion 2003).

Furthermore, in the 'deliver' scenario, a large part of inequality is due to transformational change in the way we work (Acemoglu and Restrepo 2018), in the way we rethink pollution and climate externalities, and in the way we must adapt the pay-as-you-go model of pensions, for instance.

These challenges need to be met no matter what, and the best – and vital – form of action is investing in skills, developing new models of workforce participation, and innovating. Only by doing so can Europe achieve inclusive growth in the medium term (Atkinson 2015).

Keeping the essence of its current inclusive growth model does not preclude Europe adapting its current social contracts in order to enable a fast and more effective transition. During a previous societal revolution, countries financed a new model of education, mandating citizens to go to high school, for instance, and launched the first model of union-firm industrial relations.

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In the new green and digital revolution, Europe will need to embed lifelong learning in the workplace, experiment more with the gig economy, and enforce new behavioural models with respect to limiting pollution and overuse of natural resources.

Some of the elements that need to be put in place may require strong political mandates, which could be very difficult in an era of low trust in politicians and institutions. But lack of action could leave the European inclusive growth model even more vulnerable.

Challenging times – politically and economically – lie ahead. However, history has taught us that nations emerge from uncertain societal transitions by taking rapid action, engaging in fresh thinking, experimenting with new models of social contracts, and using social protection as an insurance against failure. ■

Jacques Bughin is a Senior Partner at McKinsey and Director at the McKinsey Global Institute, and Christopher Pissarides is Regius Professor of Economics at the LSE

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EU budget implications of a no-deal Brexit

A no-deal Brexit would mean the UK's contributions to the EU budget fall to zero. Zsolt Darvas calculates the estimated budget shortfall and how the burden would fall across different member states

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The United Kingdom's financial contribution to the liabilities of the European Union – the so-called 'exit fee' – is, in my view, a less important aspect of Brexit. The amounts at stake are small relative to GDP both for the EU and the UK, and there are many more important issues that could also have larger direct budgetary impacts than the exit fee.

For example, I regard the future trade, services and immigration partnerships – which will affect economic growth and thereby direct budget revenues – as more important matters than the exit fee. Similarly, non-economic issues like security and defence cooperation, visa-free travel, aviation cooperation, nuclear safety and food safety are also crucial aspects of Brexit.

Yet it can be useful to quantify the exit fee, because the likelihood of a no-deal Brexit has increased and in such a case the UK might not contribute to the EU budget at all starting from March 30th 2019. Thereby, EU member states should stand ready to fill the eventual gap rather soon.

In this post I focus on the current multi-annual financial framework (MFF) in order to assess the near-term (2019 and 2020) necessary extra contribution to the EU budget in case of zero UK contribution after Brexit. After making certain assumptions and simplifications (see the end of the post), I find that in an extreme scenario – in which the UK will not contribute at all after 29 March 2019, and EU spending in the UK fully stops that day – the total Brexit hole in the EU budget for March 30th 2019-December 31st 2020 could amount to about €16.5 billion, or 0.066% of EU27 gross national income (GNI).

This figure relates to the extra transfer needed by members states to the EU budget, yet an offsetting factor is the 20% of customs duties on imports from the UK retained by member states, which could amount to €0.8 billion in the same period (80% of customs duty revenues go to the EU budget and 20% is retained by the member states).

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Thereby, the extra direct financial burden on the public budgets of the 27 members states would be €15.7 billion, or 0.062% of GNI.

This estimation can be considered as an upper limit for the Brexit hole for the following main reasons:

- Even in the absence of a comprehensive withdrawal treaty, the UK might contribute to the EU budget because, for example, the UK might recognise its financial liabilities towards the EU, or it might wish to show its goodwill in the hope of a better agreement later. If so, the financing gap in the EU budget could be smaller (even if EU spending in the UK would also not stop overnight).

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... the extra direct financial burden on the public budgets of the 27 members states would be €15.7 billion, or 0.062% of GNI

- I assume that 100% of the MFF payment ceiling will be spent in EU27, but actual spending is typically slightly lower than the ceiling (even though some carry-overs used to be spent in later years). If so, the needed national contribution will be smaller.

- I consider a low estimate for the customs-duty revenues arising from EU27 imports from the UK, by assuming the same average tariff rate as the current average tariff rate on imports from non-EU countries. But non-EU countries include developing countries, which typically face preferential tariff rates. Imports from non-EU countries also include a large amount of raw materials, which have zero or very low tariff rates.

  Thereby, the average tariff rate on imports from the UK could be considerably higher than what I consider in the calculations. (Note that customs-duty revenues from imports from the UK is not a transfer from the UK, but a duty primarily paid by EU27 companies and households. Yet this will be a revenue in the EU budget.)

- I do not wish to estimate the fall of EU imports from the UK as a result of the distraction caused by a no-deal Brexit, including the introduction of the customs duties. But for illustrative purposes the calculation assumes a 20% fall in the volume imports. If imports fell less, higher customs duties would be collected on imports from the UK.

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Even considering my upper-limit estimate of €16.5 billion for the extra contribution to the EU budget in 2019-2020, no new legislation is needed to cover this financing gap. The overall own-resources ceiling of the current 2014-2020 MFF is 1.22% of GNI, which represents the maximum amount of its own resources that the EU may raise.

See a simplified table of the MFF here, which shows the three types of MFF ceilings: payments, commitments, own resources. Some explanations are available here. The payment ceiling is 0.96% of GNI. The difference between the

overall own-resources ceiling and the payment ceiling *"provide room for manoeuver in case of unforeseen needs and emergencies".*

This margin, 0.26% of GNI, is much larger than the financing gap, 0.066% of GNI, caused by a no-deal Brexit. This gap would therefore be filled by larger contributions from the 27 EU member states. Figure 1 shows the distribution of this amount across countries based on their GNI, along with the nationally-retained 20% of the extra customs duty revenue from imports from the UK.

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Assumptions for the 2014-17 calculations:

- All 2014-17 data, except values in italics in Table 1, are calculated on the basis of actual data from DG Budget;

- It is not possible to determine the share of the UK in 'further' expenditures (line 1.3 of Table 1). 'Further' expenditure is the sum of expenditures in non-EU countries (€8.6 billion in 2017), earmarked expenditure (€11.1 billion in 2017) and other (€6.1 billion in 2017).

  Other expenditure is expenditure allocated to beneficiaries whose countries cannot be determined (covering groups of countries or paid to international organisations). Earmarked expenditures relate to revenue earmarked for a specific purpose, such as income from foundations, subsidies, gifts and bequests, including the earmarked revenue specific to each institution.

  To guesstimate the UK's share in these expenditures (line 1.3.1), I do not consider non-EU expenditure and the global and administration components of other and earmarked expenditures. For the rest I assume that the UK's share is the same as the UK's share in EU28 expenditures of the same expenditure heading.

Figure 1. Distribution of the March 30th 2019-December 31st 2020 no-deal Brexit EU budget financing gap between EU27 countries, and the offsetting nationally-retained extra customs duty revenue from imports from the UK (€ millions)

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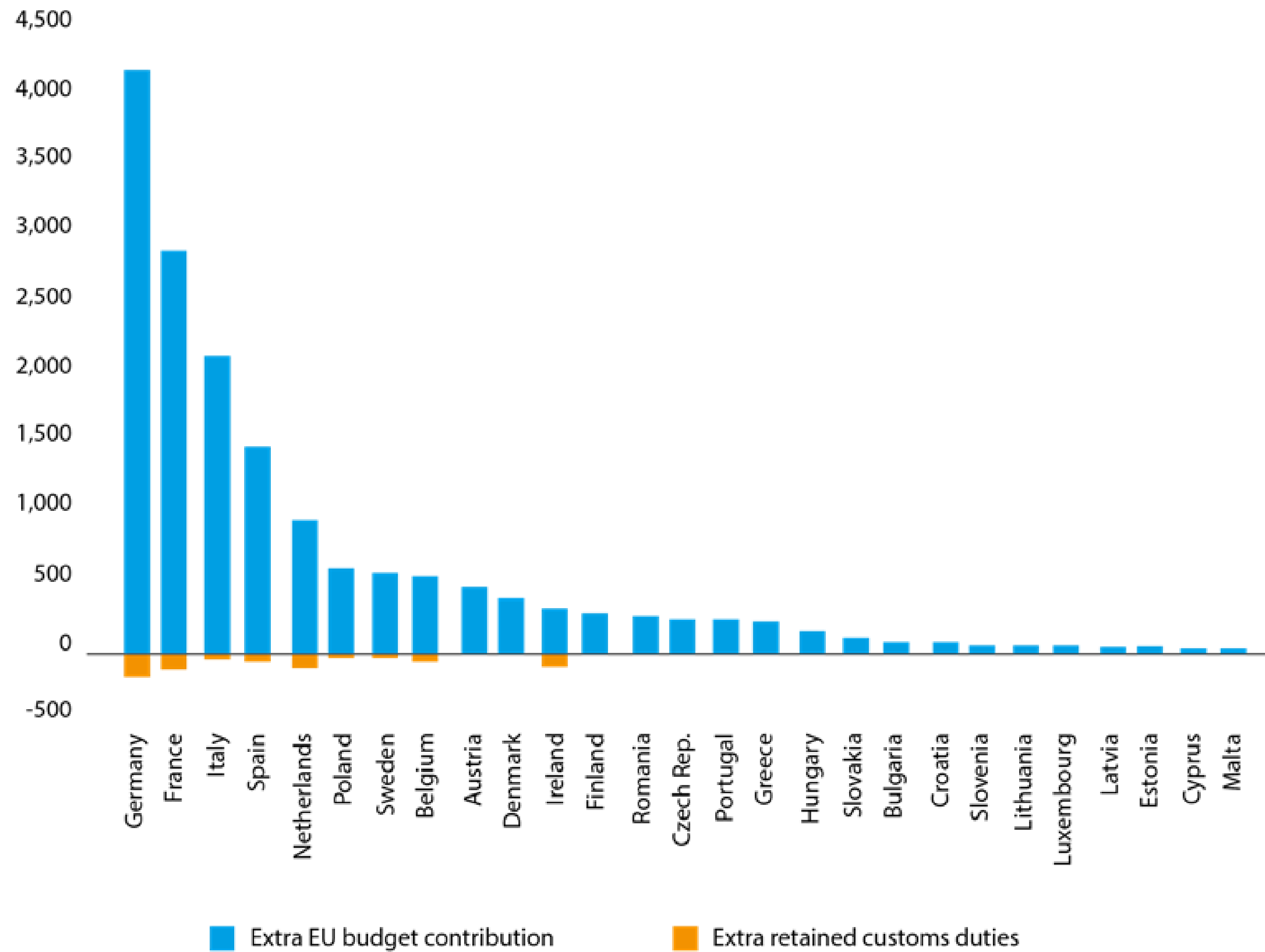

Note: The blue bars correspond to 0.066% of each country's GNI in the period of March 30th 2019-December 31st 2020, and represent the extra amount that member states would have to transfer to the EU budget in the no-deal Brexit scenario I consider. The orange bars with negatives show by how much the 20% of hypothetical customs-duty revenues (which are retained by the member states) would reduce the next public-sector burden. Various assumptions for the calculations are described in the text.

Table 1. Actual EU budget for 2014-2017 and my projections for 2018-2020 (€ billions)

		Actual					Projections		
		2014	2015	2016	2017		2018	2019	2020
[A] Scenario of continued UK's EU membership or the transition period along the agreed deal									
1	Total expenditure	142.5	145.2	136.4	137.4		*154.6*	*166.7*	*172.2*
	of which:								
1.1	in EU27	121.6	122.7	110.8	105.3		*126.7*	*136.7*	*141.2*
1.2	in UK	7.0	7.5	7.1	6.3		*7.7*	*8.3*	*8.5*
1.3	further [non-EU, earmarked and other]	13.9	15.1	18.5	25.8		*20.2*	*21.8*	*22.5*
1.3.1	*guesstimated UK part of 'further'*	0.2	0.2	0.4	0.7		*0.4*	*0.5*	*0.5*
2	Total revenue	143.9	146.0	144.1	139.0		*154.6*	*166.7*	*172.2*
	of which:								
2.1	EU27 VAT & GNI-based contributions [including rebates]	103.9	99.2	99.3	84.4		*109.5*	*121.4*	*125.9*
2.2	UK VAT & GNI-based contributions [including rebates]	11.7	18.2	12.8	10.6		*13.7*	*15.2*	*15.8*
2.3	EU27 customs	14.5	16.6	16.9	17.3		*17.6*	*18.0*	*18.3*
2.4	UK customs	2.9	3.4	3.2	3.2		*3.2*	*3.2*	*3.2*
2.5	Surplus from previous year	1.0	1.4	10.6	6.4		*1.6*	*0.0*	*0.0*
2.6	Other revenue	10.0	7.3	1.3	17.2		*8.9*	*8.9*	*8.9*
2.6.1	*guesstimated other revenue from the UK*	*1.6*	*1.3*	*0.2*	*2.6*		*1.3*	*1.3*	*1.3*

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3=2-1	EU28 Balance	1.4	0.8	7.7	1.6		*0.0*	*0.0*	*0.0*
4=2.2+2.4+2.6.6-1.2-1.3.1	*Estimated UK net contribution*	*8.9*	*15.2*	*8.7*	*9.3*		*10.2*	*11.0*	*11.3*
5=3-4	*EU27 Balance [excluding the UK]*	*-7.5*	*-14.4*	*-1.0*	*-7.6*		*-10.2*	*-11.0*	*-11.3*
[B] Hypothetical custom duty revenues from UK imports in case of a no-deal Brexit, if:									
6	*no change in imports due to no-deal Brexit							*2.8*	*2.9*
	80% going to EU budget							*2.2*	*2.3*
	20% retained by member states							*0.6*	*0.6*
	*20% reduction in imports							*2.2*	*2.3*
	80% going to EU budget							*1.8*	*1.8*
	20% retained by member states							*0.4*	*0.5*

Note: Non-italics 2014-17 numbers are based on DG Budget data, while the 2018-2020 values for total expenditure are the updated current price MFF payment ceilings. Values in italics include my assumptions and estimations – see the various assumptions for the calculations in the text. The hypothetical customs duties from UK imports in lines 6 and 7 relate to full year even in 2019 in order to be consistent with other numbers in the 2019 column, which all refer to the full year of 2019. But when quantifying the possible EU budget and national revenues from such duties, I consider only the 30 March – 31 December period in 2019.

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- It is not possible to determine the share of the UK in 'other' revenues (line 2.6 of the table). 'Other revenues' include income from third countries for participating in EU programmes, competition fines, taxes paid by EU staff, interest on late payments, and so on. Most likely, competition fines play a big role in the annual fluctuations of this revenue.

  For example, in 2017 there was an unusually large 'other revenue' amounting to €17.2 billion, which resulted in much lower VAT- and GNI-based revenue collection from member states in 2017 than in earlier years (lines 2.1 and 2.2). The estimated 'other revenue' from the UK simply assumes that the share of the UK in these revenues is the same as the UK's share in EU28 GNI (line 2.6.1).

Assumptions for the 2018-2020 projections under the scenario of the UK's continued EU membership or the transition period along the agreed deal (lines 1-5 of Table 1):

- EU spending in the UK in 2018-2020 is assumed to be the same proportion of total EU spending as it was on average in 2014-2017;
- Actual EU budget payments will be 100% of the payment ceilings in 2018-2020;
- 'Assigned revenues' will not reduce the GNI-based contributions (*"Assigned revenues"* finance specific items of expenditure which are not subject to the MFF's ceiling for payments);
- 'Other revenues' will be €8.9 billion annually in 2018-2020 (average value for 2014-17);

- 'Other revenues' from the UK relative to total 'other revenues' is proportional to the ratio of UK GNI to EU28 GNI;

- Annual customs revenues from non-EU countries will grow in 2018-2020 as in 2017;

- The EU budget will close with zero overall balance;

- VAT- and GNI-based contributions result as residual;

- For 2018-2020, I use the European Commission's November 2018 forecast for GNI;

- I assume that the UK's share in the EU28 VAT- and GNI-based contribution will remain the same 11.1% in 2018-2020 as it was in 2017 (this share, which is lower than the UK's share in GNI (14.9%), reflects the UK rebate, which itself varies across the years);

Assumptions for the 30 March 2019 – 31 December 2020 projections under the scenario of no-deal Brexit:

- No UK contribution to the EU budget starting from March 30th 2019, while the January 1st-March 29th contribution is proportional to the number of days;

- No EU spending in the UK starting from March 30th 2019, while the January 1st-March 29th EU spending in the UK is proportional to the number of days;

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- Starting from March 30th 2019, EU27 imports from the UK will be subject to customs duties. I assume that the average tariff rate will be the same as the current average tariff rate on imports from non-EU countries. Note that this assumption underestimates the customs duty revenues from imports form the UK, because of the preferential tariff rates applied to import from developing countries and the zero or very low tariff rates applied to raw materials;

- Line 6 of the table shows the customs duty revenue estimate if import volumes do not change, while line 7 shows the estimate if EU27 imports from the UK declines by 20% – in the overall calculation mentioned earlier I used values corresponding to the 20% reduction for illustrative purposes;

- The total March 30th 2019-December 31st 2020 impact is calculated from the EU27 balance (line 5 of Table 1): 0.7589 times the 2019 values, plus the 2020 values.

Assumptions for the calculation about the cross-country distribution of the Brexit financing gap:

- The €16.5 billion, March 30th 2019-December 31st 2020 gap is to be distributed among the member states according to their GNI;

- The corrections mechanisms (*"rebates on rebates"*) are not considered in this calculation;

- Member states retain 20% of customs-duty revenues: the orange bars show the estimates using the assumptions discussed above, considering the 2017 distribution of imports from the UK across the 27 member states.

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See our tutorial for the main EU budget concepts and our detailed methodology to calculate the exit fee in our 2017 working paper. ■

Zsolt Darvas is a Senior Fellow at Bruegel

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The EU's pivot to Asia

ASEAN SINGAPORE 2018 RESILIENT AND INNOVATIVE

Fraser Cameron considers the unforeseen consequences of global uncertainty, and how the EU has seized the opportunity in deepening EU-Asia relations

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One of the unforeseen consequences of the increasing global uncertainty, largely due to President Trump's unpredictable behaviour, is a deepening of EU-Asia relations. President Obama's 'pivot to Asia' which involved several trips to the region and receiving ASEAN leaders at an unprecedented summit in California, was ditched by President Trump as soon as he took office.

His first action in the White House was to withdraw from the Trans-Pacific Partnership (TPP) trade deal and call into question the usefulness of America's security alliances in Asia. These actions plus his attacks on international institutions caused consternation around Asia, from Australia to Japan, and led many countries to reach out to the EU as a predictable and staunch supporter of a rules-based world order.

The EU has been quick to seize the opportunity signing free trade agreements (FTAs) with several Asian countries, reviving the idea of an EU-ASEAN bloc to bloc deal, and also increasing its political and security engagement with the region.

In July, Presidents Tusk and Juncker had successful summits in China and Japan. In August, Federica Mogherini, the EU's energetic, foreign policy chief, spent ten days in the region cementing ties with a range of partners. Trade commissioner, Cecilia Malmström, has also been very active in Asia promoting closer trade ties. Several other EU commissioners as well as ministers from member states have also visited the region highlighting the growing EU engagement with the Asia-Pacific region.

EU-Asia relations will be further deepened at the biannual Asia-Europe meeting (ASEM) in Brussels in October. Although largely a talk feast, it provides a unique forum for over fifty European and Asian leaders to discuss global issues. ASEM also provides an opportunity for many side meetings. For example, there will be an EU-Korea summit involving President Moon before ASEM begins.

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Asia rising

The growing importance of Asia for the EU is easy to understand. It is home to two-thirds of the world's population. It has been the driver of global growth for the past two decades. It is now the EU's biggest trade partner, with some €1.5 trillion in two-way trade in 2017 and over €800 billion of European FDI going to Asia in 2016. There is also an increasingly large amount of Asian FDI coming to the EU. All projections show that these figures are likely to increase in coming years.

Furthermore, it is quite clear that most global problems, from climate change to migration, cannot be resolved without Asia's input. It is also true that there are many unresolved security issues in Asia, from the Korean peninsula,

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Just as the EU is paying more attention to Asia for political, economic and security reasons, there is a reciprocal growing Asian interest in strengthening ties with the EU which is now viewed as a stable and predictable actor

through the South China Sea to Kashmir. But most observers are impressed at the ability of Asian countries to live with these unresolved disputes and carry on promoting business ties. For example, despite poor political relations between China and Japan, and China and Taiwan, all three are closely linked via just-in-time supply chains.

Just as the EU is paying more attention to Asia for political, economic and security reasons, there is a reciprocal growing Asian interest in strengthening ties with the EU which is now viewed as a stable and predictable actor, compared to the uncertainty that characterises the United States under Trump.

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The constant refrain from all Asian leaders in recent months is that they do not wish to see the current rules-based international system destroyed. Hedging is now the name of the game. Asian leaders can no longer rely exclusively on Uncle Sam and they do not wish to fall under the Chinese steamroller. There is thus a new enthusiasm for the EU as the principal defender of a rules-based order.

EU-Japan FTA

This enthusiasm was most marked by the July agreement on an EU-Japan FTA. Prime Minister Abe, despite his multiple golf rounds with Trump, concluded that it might not be sensible to place all his eggs in the American basket and it was time to deepen relations with the largest trade bloc in the world. The economic and trade agreement was complemented by a wide-ranging political agreement that should lead to closer cooperation in foreign and security policy.

The FTA (known as the EU-Japan Economic Partnership Agreement) is the biggest free trade agreement in the past two decades and creates significant new opportunities for selling European goods and services to the fourth richest economy in the world with 127 million citizens.

According to the EU, the deal should lead to a 13% increase in exports to Japan with the food sector, textiles, chemicals, machinery, cars and business services likely to benefit most. EU companies could save up to €1 billion a year on customs duties compared to what they are required to pay today upon exports to Japan. EU companies will also benefit from higher standards for example on motor vehicles, on food and on wine additives.

Particularly interesting are the provisions for trade in services, currently worth €28 billion to EU firms, including advanced provisions on movement of people for business purposes. The EPA also covers sustainable development, core labour standards, natural resource management, environmental protection and dispute settlement mechanisms. Both sides also agreed to recognise each other's data protection systems as 'equivalent', which will allow data to flow freely between the EU and Japan, creating the world's largest area of free flow of data.

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EU-China

China and Europe trade on average over €1 billion a day. Given that China is the EU's biggest source of imports and its second-biggest export market, there are inevitably some disputes. On the EU side, there are concerns about a lack of transparency, industrial policies and non-tariff measures that discriminate against foreign companies, strong government intervention in the economy, resulting in a dominant position of state-owned firms, unequal access to subsidies and cheap financing, and poor protection and enforcement of intellectual property rights. On the Chinese side, there are complaints that the EU has reneged on a promise to grant China market economy status and its growing protectionism.

Although the EU and China have signed impressive documents outlining their mutual desire to deepen their strategic partnership, relations had stagnated in the past couple of years over the above trade disputes. The July summit was significant in that both sides were able to agree a lengthy statement, something that they could not achieve in the two previous EU-China summits.

Trade issues were still central at the summit but both sides sought to emphasise areas of cooperation rather than divergence. Leaders expressed support for the rules-based multilateral trading system and agreed to set up a working group on reform of the WTO.

Both sides also agreed an exchange of market access offers that should give an impetus to the negotiations for a bilateral investment agreement. China confirmed its commitment to acceding to the WTO government procurement agreement (GPA).

There were also other positive outcomes at the summit including MoUs on the circular economy and an emissions trading system plus an oceans' partnership covering fisheries and marine pollution. Finally, both sides discussed connectivity – taking stock of progress in the EU-China connectivity platform – and exchanged views on the digital economy, including how to avoid introducing market access barriers through their respective cybersecurity regulations.

Remarkably, the EU and China are more on the same page when it comes to Iran, climate change and preserving the UN system than with the US. President Xi, who has recently cemented his power base in China, also views the EU as a solid anchor in an uncertain world. There are of course areas of dispute such as human rights between Brussels and Beijing and it remains to be seen how China's highly ambitious Belt and Road Initiative can be linked to the EU's forthcoming policy on enhancing connectivity between Europe and Asia.

EU-Korea

Korea was the first Asian country to sign an FTA with the EU in 2012. Since then EU exports of goods to Korea increased almost 60% and exports of services increased nearly 50% over the same period, turning trade deficits

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into surpluses. Two-way FDI also saw a 50% increase in the past five years. Businesses in Korea and Europe have expressed satisfaction with the FTA although there are calls for some adjustments in some sectors.

The EU and Korea also have a political and a security agreement allowing for close cooperation in foreign policy. Ahead of the planned October EU-Korea summit, Mogherini visited Seoul in August for talks with her opposite number. The visit demonstrated the EU's support for the tricky negotiations to denuclearise the Korean peninsula. The EU has been a strong defender of the UN sanctions policy against North Korea. Apart from the DPRK, Brussels and Seoul increasingly agree on major foreign policy issues and Mogherini was able to explore opportunities for further cooperation during her visit.

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EU-India

India is currently the fastest growing economy in the world and a strategic partner for the EU, representing a sizable and dynamic market of 1.25 billion people. But the negotiations for an FTA, launched over a decade ago, have proved difficult. Sticking points include improved market access for some goods and services, government procurement, geographical indications, sound investment protection rules, and sustainable development.

The EU is India's number one trading partner while India is the EU's 9th trading partner, sandwiched between Korea and Canada. The value of EU exports to India is much smaller than with China. Exports grew from just €24 billion in 2006 to €38 billion in 2016. Indian exports to the EU were of a similar scale. But export of services to India has almost tripled in the past five years and FDI doubled. There has also been a sizeable increase in Indian FDI to Europe. Both sides recognise that there is vast potential to increase trade but the EU remains disappointed at the unwillingness of India to open its market while India criticises the EU for its restrictive visa policies.

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ASEAN

The EU is a strong supporter of the ten-nation association of south-east Asian nations (ASEAN) provided considerable financial support and technical assistance. ASEAN is handicapped by its small budget and secretariat plus its insistence on unanimity for all decisions.

Some have questioned its lack of leadership, a role that used to be played by Indonesia. There are also many internal problems that affect relations with the EU. For example, the drug war in the Philippines, the treatment of the Rohingya in Myanmar, and one party or military rule in a number of ASEAN countries.

There have been numerous action plans to try and boost EU-ASEAN relations that celebrated their 40th anniversary in 2017. The EU is keen to upgrade relations to a strategic partnership but it has proved difficult to agree a response from the ASEAN side.

There are currently negotiations for an open skies agreement which would further boost the booming tourism trade between the EU and SE Asia. There is also renewed talk of an EU-ASEAN free trade agreement but given the disparate size of the economies between ASEAN members this will be a difficult undertaking.

Despite its many internal problems, the EU is keen to promote the centrality of ASEAN, with its commitment to multilateralism, international rules and its culture of consultation and inclusiveness. It believes that its own experiences in resolving disputes could be useful in reducing tensions in the South China Sea and elsewhere.

Australia/New Zealand

Australia and New Zealand have also moved to deepen their relations with the EU. In July both countries opened

negotiations for an FTA with expectations for a swift deal, possibly before the end of the mandate of the Juncker Commission. The biggest problem area will be agriculture, given the efficiency of farmers in both Pacific countries.

Mogherini also visited Australia and New Zealand in July, describing them as 'like-minded supporters of the rules-based, multilateral system'. Given the unpredictability in Washington, Canberra and Wellington are also engaged in a major debate about their future security. They too view the EU as a stable partner in a turbulent world.

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An increased security role

In May, EU foreign ministers agreed to enhance the EU's security cooperation with Asia though intensified consultations, capacity building, training programmes and joint exercises. The EU is already working with ASEAN on sensitive issues of maritime security, cyber security and the prevention of violent extremism.

Now the plan is to expand on this soft security agenda to cover conflict resolution and peacekeeping (the EU has already engaged successfully in Aceh, Indonesia), counter terrorism, police and coastguard training, combatting illegal fishing, military to military contacts, and anti-piracy (a number of Asian partners have already participated in the EU-led Operation Atalanta in the Red Sea).

Upping the EU role in Asia will not be easy. The Asian security landscape is shaped by a large number of factors: strategic competition between the big powers; historical grievances; ethnic and religious tensions; governance failures; competition for resources, territory and influence, all compounded by expanding defence spending and capabilities, including nuclear capable states.

This volatile mix explains the EU's vital interest in supporting overall stability in Asia and advancing a rules-based approach to promote effective security structures. On the Asian side, it is the current occupant of the White House

that is driving Asians towards a closer relationship with the EU. It is a relationship that could shape the future of the world. ■

Fraser Cameron is Director of the EU-Asia Centre

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Between a rock and a hard place

European companies are squeezed between US sanctions and the new EU blocking statute. Matthew Oresman and Henrietta Worthington discuss

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The US recently re-imposed sweeping sanctions against Iran over the objection of the EU and various European governments. In response, the EU issued a new 'blocking statute' to counter these sanctions and provide some level of relief to European companies. However, European companies are now caught in the crossfire as this patchwork has created a host of complex options and processes for those who are still involved in Iranian-related transactions, even indirectly or unintentionally. European companies are very much caught between a rock and a hard place.

US sanctions

For European companies, 'the rock' is the very real possibility of being sanctioned themselves or incurring other penalties for breaching US sanctions. The US has confirmed that it intends to make life difficult for anybody doing business in Iran.

The US completed the 'snap back' of its rigorous sanctions regime on 5 November, along with the announcement of a large number of new Specially Designated Persons and Blocked Nationals (SDN) designations. Secretary of State, Mike Pompeo, has stressed the importance of the re-imposed sanctions, stating that they are *"an important part of our efforts to push back against Iranian malign activity"* and that *"the United States is going to enforce these sanctions."*

The impact of US primary and secondary sanctions is far reaching. For example, primary sanctions can apply to any person transacting in US dollars, even from outside the US, because virtually all dollar denominated transactions pass through the US financial system in some way, even if just for a moment when they are 'cleared.' Secondary sanctions can be applied to companies even when there is no US jurisdictional contact; secondary sanctions apply to a number of specific categories of activities, including participating in Iran's energy sector and engaging in transactions with Iranian SDNs.

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The Office of Foreign Assets Control (OFAC) has shown its willingness to impose significant penalties on companies violating US sanctions. In 2015, the US Treasury fined BNP Paribas almost $9 billion for sanctions infringements in respect of Sudan, Cuba and Iran. Penalties of about $1.3 billion have just been announced for Société Générale for the same, and there are many other examples.

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There is increasing pressure on the EU to come up with a workable solution, with Iran threatening to scrap what remains of the nuclear deal unless the EU can offer sufficient economic protection

EU Blocking Statute

The EU's Blocking Statute is the 'hard place,' as it aims to counter the effect of the re-imposed US sanctions. The EU has stressed its commitment to the Iran nuclear deal, and its amended legislation is testament to its intention to keep the deal alive.

The statute takes a three-pronged approach in its attempt to protect EU businesses. Firstly, it forbids EU companies from complying with US sanctions, unless they have a specific authorisation to do so. EU operators may apply for approvals in circumstances where *"non-compliance [with US sanctions] would seriously damage their interests or those of the Community."*

The EU has tried to put some weight behind this exception by publishing, for the first time, the mechanics for making an application. This could be indicative of the EU's intention to enforce any breaches which have not been specifically authorised. However, there are also queries as to the robustness of this provision, given the difficulties in proving that any withdrawal from Iran was due to US sanctions, rather than a legitimate business decision.

Secondly, the Statute nullifies any foreign court judgements based on US Iranian sanctions, including court rulings and arbitration awards.

Finally, it allows companies to recover damages incurred because of the US sanctions from the person who caused them. Exactly who will be the defendant in each case will depend on the specifics of the case, the kind of damage caused, the person or entity causing it, possible shared responsibility, etc. The language is vague enough to allow for the possibility that claims could be brought against the US by an injured company under this provision.

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To further reinforce its commitment to the Blocking Statute, the EU also published guidance to help companies navigate its terms. EU operators are also required to inform the European Commission where their interests are affected by US sanctions on Iran.

However, whether the regulations really offer significant protection in practice remains to be seen. Member states are responsible for enforcing the regulations, which will lead to inconsistencies in implementation across the bloc.

Historically, there has been a serious lack of EU member state enforcement for breaches of blocking regulations. Only Austria has ever brought charges under the Blocking Statute and the case never even advanced to a prosecution. This is in stark contract to OFAC's eagerness to enforce US sanctions breaches.

A huge question mark remains as to whether a member state would sanction one of its prized corporate assets for complying with US laws in order to avoid high fines in the US. However, this is distinctly possible, particularly considering the current transatlantic trade tensions.

The House of Commons European Scrutiny Committee released their comments on the Blocking Statute, acknowledging that *"it puts EU and UK companies in the position of having to choose between risking enforcement measures at home (if they choose to comply with the American sanctions) or in the US (if they abide by the Blocking Statute and ignore the US legislation."* However, no guidance has been given on either side as to how companies should navigate these conflicting rules.

Other initiatives

Whilst the EU, and in particular Germany, France and the UK, have stressed their commitment to the Joint

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Comprehensive Plan of Action (JCPOA), the US is holding all the cards. In July, Mike Pompeo and Steven Mnuchin formally rejected an appeal from E3 ministers requesting various exemptions to the re-imposed US sanctions.

The second wave of US sanctions – targeted at Iran's oil, financial services and shipping industries – provided no clarity or reassurances to EU companies.

Along with the completion of the 'snap back' came the announcement that SWIFT (the international financial messaging system) would comply with US sanctions. Secretary of State Mike Pompeo also highlighted the strict US position on enforcement against financial transfer messaging platform providers.

Heiko Maas, the German Foreign Minister, has indicated that Europe, like China and Russia, could look to create its own euro-based SWIFT system. However, the Chancellor, Angela Merkel, has warned against undermining the transparency of SWIFT, which helps to weed out financial crime – further provoking fears that Iranian transactions will move underground.

This has forced the EU back to the drawing board to develop financial messaging that is 'outside of US influence'. The most promising suggestion was for the EU to establish a 'Special Purpose Vehicle' (SPV) to process Iran-related payments, but this initiative looks to have collapsed.

In theory, this SPV would have sat outside the international banking system with the aim of protecting EU companies from the reach of US sanctions. It would work as a kind of clearing house, offsetting Iranian exports against purchases of EU goods whilst avoiding any actual banking transactions.

EU diplomat, Federica Mogherini, told the UN general assembly that the SPV would *"allow European countries to trade with Iran in accordance with EU law and could be open to other partners in the world."*

However, the idea has hit multiple hurdles, with no EU country willing to host the SPV. European companies also appear not to be buying into the idea and are instead bowing to the fear of consequence for breaching US sanctions.

A further blow came with Austria's confirmed refusal to host the SPV, prompting questions as to its feasibility. The EU was aiming to have the SPV up and running by the end of November, looking to Luxembourg to step up to the challenge, but this is looking increasingly unlikely.

Despite all good intentions, Europe will be heavily constrained in its ability to uphold its commitment to the Iran deal unless it is able to find a *"financially independent sovereign channel"* to move funds to, and from, Iran. With the commercial banks off the table, EU members are considering using their own central banks to handle Iranian transactions.

The gamble here is that the US wouldn't dare to sanction an ally's central bank. However, US pressure groups are already proposing that the US sanction individual central bankers if the banks themselves are off limits. Once again, it appears the central banks are afraid of being cut off from the all-dominant US financial market. No bank, as yet, has shown a willingness to take that risk. The European Investment Bank's board was quick to refuse any involvement.

In yet another show of US determination to cause the collapse of the Iran deal, it has offered its assistance to American allies importing Iranian oil to find alternative sources. National security adviser, John R Bolton, confirmed

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that the US *"[does] not intend to allow our sanctions to be evaded by Europe or anyone else."*

Even the waivers granted by the US come tinged with their commitment to cripple the Iranian economy. The pre-JCPOA system on Iranian oil exports has been reinstated and exemptions have been granted to eight countries on the condition that they commit to reducing their purchases. They must also use escrow accounts designed to keep hard currency out of the hands of the Iranian regime.

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How are companies reacting?

The Blocking Statute is of particular relevance to EU subsidiaries of US companies. It does not apply to EU branches of US companies, or US subsidiaries of EU companies, which are only subject to US law. However, the long reach of US sanctions will leave EU operators with activities in Iran vulnerable.

Probably the best marker of the EU's success in countering the US's aggressive Iranian standpoint is the response of European multinationals to the re-imposed US sanctions.

Almost without exception to date, businesses caught by both the EU and US regimes are choosing to step away from the Iranian market. Companies including Total, Maersk, Eni, Boeing, and Peugeot were quick to confirm that they would exit their Iran activities.

BP also announced that it would be suspending a joint venture with an Iranian partner, stating that *"BP always complies with applicable sanctions. We cannot defy the United States."*

However, EU operators should be aware of the risks of cancelling planned activity in the absence of an authorisation, particularly if member states show the political commitment to apply the Blocking Statute strictly.

Whether such a cancellation is based on true economic considerations, or because of concerns related to US sanctions, may not be an easy analysis to demonstrate to EU regulators; obtaining authorisation therefore may offer a safer approach.

The EU has started looking to its SMEs to lead the charge on activities in Iran. Smaller companies with limited or no operations in the US have the opportunity to grow their Iranian businesses – provided the SPV, or other payment channel, can be secured.

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Meanwhile, US diplomats have been working with exactly these companies to help them find new markets and business opportunities outside of Iran. US representatives from the Commerce Department have been holding seminars in the EU devoting time and resources to thwart any attempt for the SMEs to bring economic benefits to Iran.

SMEs may take the view that they are too small to be targeted by the US for sanctions breaches. However, they should be wary given all recent US rhetoric: they may not slip under the radar if the US wants to make an example of them.

What next?

US sanctions already appear to be taking their toll: Iranian oil exports are on the decline and its currency is plummeting. There is increasing pressure on the EU to come up with a workable solution, with Iran threatening to scrap what remains of the nuclear deal unless the EU can offer sufficient economic protection.

Whilst companies run the gauntlet between the conflicting regimes, the question remains as to which one they should obey. It is evident that businesses perceive the risk of falling foul of US sanctions to be a greater threat than

the protection offered by the EU – and until the EU proves otherwise, they are probably right. The good news is that the Blocking Statute allows EU companies seeking to comply with US sanctions a process to obtain authorisation and avoid being crushed by the conflicting laws. ■

Matthew Oresman is a Partner, and Henrietta Worthington a Senior Associate, at Pillsbury Winthrop Shaw Pittman LLP

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On populists, immigration and welfare

Niek Kok examines the rise of 'right-wing' populism in Europe, and finds that their policies match those of the social democrats of the mid-twentieth century

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In her book *For a Left Populism* (2018), the political philosopher Chantal Mouffe argued for a 'left-wing populism' to counter the rising support for right-wing populists. Mouffe has observed that what makes most current European populist parties right-wing is their xenophobic character.

She refers to parties such as the Danish People's Party (DPP), the Sweden Democrats (SD), the Dutch Party for Freedom (PVV) and the Freedom Party of Austria (FPÖ). These parties present immigrants as a threat to the identity of what they claim to be 'the people'.

Indeed, most European populists (admittedly, an analytically often ill-defined category) share a preference for restrictionist immigration policies. But most of them also start to make political arguments in line with welfare statism and, though to a lesser extent, trade protectionism. All of these policy preferences were a part of traditional social democratic thought from the 1930s to the 1970s onwards.

Undoubtedly, the populist emphasis is on anti-immigration whereas traditional social democracy puts the accent on the welfare state. Still, comparing the views on the welfare state and immigration of the 'right-wing' populist of today with the traditional social democrat yields interesting parallels.

I argue that this begs the question if it makes sense at all to label the aforementioned political parties *right-wing* – and if they are, in a sense, not simply best compared to traditional working class parties that advocated welfare statism and, as a result, welfare protectionism.

What the populist says

Populists have been said to distinguish an 'us, the pure people' from a 'them, the corrupt elites'. They present themselves as leaders embodying 'the people's true interests'. Political analysts find that this discursive strategy is

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used by most European populists such as the Dutchman Geert Wilders or the Swede Jimmie Åkesson – as well as by President Donald Trump, who is sometimes deemed a populist as well.

Interestingly, these three politicians share similar views on immigration, but also adopt similar welfare chauvinistic views. Åkesson, for instance, presents politics as a dichotomous choice between mass immigration and welfare. In his view, you cannot have both. Trump repeatedly called for renegotiated trade deals and a reduction in immigration as a way to promote working-class economic security. And Wilders reportedly opposed attempts by

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Chantal Mouffe has called for a left-wing populism. But in a way, the supposedly right-wing populists are already quite leftish

the Dutch government to slash funding for health care and other welfare state programs after *"his criticism of Islam and immigration turned out to do very well with less educated voters"*.

Many contemporary populists lament the idea of immigrants coming to the 'fully laid table' of the welfare state and grieve that *"people who have not contributed throughout a lifetime with their labour, taxes and socially useful activities are allowed to enjoy common benefits as free riders"*.

It remains unclear whether populist parties adopt a protectionist approach to welfare to attract working class voters or whether they adopted this approach only after attracting the vote of the working class. What is clear, however, is that populist parties are increasingly attracting support from voters who, speaking for European politics at least, traditionally supported social democratic politics.

As Mouffe has argued, so called populists like Åkesson, Trump and Wilders are deemed right-wing because they favour strict immigration policies. I would argue that this is a rather limited view. Contemporary anti-immigration parties are using the welfare state as an argument *for* restrictionism.

The traditional European left also favoured anti-immigration policies to protect the welfare state. This is because of a conceptual congruence between the welfare state, a strict immigration policy and even trade protectionism. The history of social democratic ideas shows that these policies are likely to go hand-in-hand.

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Traditional social democrats and the anti-immigration cause

Looking at the history of welfare statist ideas in Europe, we find very strong *ideological congruence* between support for the welfare state and restrictionist immigration policies. The reason for this is that a restrictionist immigration policy conceptually follows from the idea of the welfare state.

In a much-cited article, the political scientist Gary Freeman noted that national welfare states *"are compelled by their logic to be closed systems that seek to insulate themselves from external pressures and that restrict rights and benefits to members"*. The welfare state presupposes a bounded group of people that distribute welfare amongst themselves – and not with outsiders.

This 'logic of the welfare state' stems from the idea that only those individuals who have contributed to its system may temporarily fall back on its benefits in times of unemployment or, for instance, for old age pensions. William Beveridge (1879-1963), a British economist and member of the Liberal Party, best known for his report *Social Insurance and Allied Services* (1942) which outlined the contours for the British welfare state, wrote that there is no absolute right to welfare benefits.

Citizens only have a right to welfare benefits in virtue of the contributions they have made to the welfare state. In other words, the solidarity of welfare programs exist for those who have contributed. Foreigners, as well as anyone who does not contribute, can thus not be said to have a right to welfare benefits – they can acquire it only until after they have made contributions.

Beveridge already foresaw that exclusive rights to welfare benefits in one country would be problematic in a world in which people could freely move from one country to another. What would happen to acquired, individual social rights as soon as individuals would move to another country?

Beveridge proposed that, in due time, different countries should arrange possibilities for transfers of individual rights to welfare from one country to the other, *"enabling men on migration to avoid forfeiting security and allowing them to carry with them some of the rights that they have acquired in their former country,"* Beveridge wrote.

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The receiving country could, or so seems to have been Beveridge's assumption, not be expected to provide welfare for newcomers who had never contributed. One could only have a right to as much as one had contributed at home.

At the end of the 1940s, several British Labour politicians already foresaw the problem mass immigration could pose to social and economic security. On the 22nd of June 1948, they wrote a letter to Prime Minister Attlee, suggesting "*that the British Government should, like foreign countries, the dominions and even some of the colonies, by legislation if necessary, control immigration in the political, social, economic and fiscal interests of our people*".

These politicians thus called for a restrictionist immigration policy to prevent mass immigration in the future. Back then, their argument was not all too controversial. But when in 2007 Labour minister Margaret Hodge had the very same insight and argued that giving council housing to newly arrived immigrants undermined Beveridge's idea that welfare should reward individuals who paid into the system, she was heavily criticized for using the language of the 'far-right'.

Hodge's argument was, however, an argument congruent with traditional social democratic ideas. Mid-twentieth century European social democrats realized that citizens would only *want to* contribute if there was solidarity amongst them. And solidarity is more easily achieved in a homogenous society: one in which citizens feel like they are all part of the same family.

Concerns about immigration by the traditional Swedish and Dutch left

The Swedish ideologist and economist Gunnar Myrdal (1898-1987) expressed this exact notion. He explicitly linked welfare rights with nationalism and the 'commonness' of the people. Myrdal was acutely aware that the welfare state in Western countries is, as he wrote, by necessity, *protectionist* and *nationalistic*.

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"The peoples in those countries have achieved economic welfare at home – economic progress and a substantial increase in liberty and equality of opportunity for all within their boundaries – at the expense of indulging in nationalistic economic policies". Myrdal moreover attested that the supporters of the welfare state are naturally of *"the inclination to take defensive action against the repercussions of the international crises in order to preserve stability and welfare at home"*.

All in all, a welfare state flourishes through the people's homogeneity and economic stability. The successive Swedish social democratic prime ministers Per Albin Hansson (1936-1946) and Tage Erlander (1946-1969) based their welfare state ideology on these ideas (Myrdal served as minister for commerce between 1945 and 1947 under both prime ministers).

Hansson introduced the famous Swedish notion of *folkhemmet*, which expresses the welfare state as a home for the people. Welfare statism required the Swedes to view each other as a single, large family. Hansson argued that the basis of the Swedish welfare state was the commonality and mutuality of its people. The idea of *folkhemmet* led his government to adopt strict immigration policies and assimilatory integration policies, as ethnic differences collided with the social democratic interest in building up a welfare state.

Folkhemmet excluded non-Swedes on both biological and cultural grounds. Hansson's successor, Erlander, continued his policies. In 1965, he compared Sweden to the United States, observing that *"We Swedes live in an infinitely happier condition. The population of our country is homogenous, not only in regards to race but also in many other aspects".*

The same ideological congruence between welfare statism and restrictionist immigration policies can be said to have been part of the Dutch social democratic ideology in the 1950s. From 1948 until 1958, the social democrat

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Willem Drees was the Dutch prime minister. In this role and as minister for Social Affairs, he became known for having laid the foundations for the Dutch welfare state.

Drees, too, was aware of the danger of mass immigration to Dutch social and economic security. At one point, he even advocated a proactive emigration policy, as in his eyes the Netherlands started to become too full. He held these views throughout his lifetime.

In 1977, when Drees had long left politics, the Dutch newspaper *De Telegraaf* reported that Drees had strongly criticized the immigration policies of the later social democratic cabinet of prime minister Den Uyl, which had allowed the free settlements of many Surinamese, Turkish and Moroccan immigrants in the Netherlands.

Recalling the image of Drees' leadership is rather fitting in the context of *folkhemmet* and populism: paralleling the populist idea of a leader representing the people's interests and the *folkhemmet* idea of the people as a family, Drees was nicknamed Father Drees. Deeming a political leader to be a fatherly figure attests to a rather deep bond between him and his supporters – and it fits neatly into the analytical framework of populism proposed by many present-day political scientists.

Conclusion

In the 1970s, traditional social democratic views on immigration started to shift. New social democratic leaders such as Olof Palme in Sweden and Joop den Uyl in the Netherlands started to approve of multiculturalist policies and allowed for more foreign influx in their respective countries. But the parallel of their predecessors with contemporary so-called populists remain – and on top of that, their predecessors and contemporary populists appear to have the same voting base.

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"[S]ocial democratic parties have in most countries identified themselves more or less exclusively with the middle classes, and that they have stopped representing the interests of the popular sectors – whose demands are considered archaic or retrograde," Chantal Mouffe writes. Much of the support for the traditional left has shifted toward what is called the 'far right'.

But besides the ideological congruence between welfare statism and restrictionist immigration, the observation that many left-wing voters now vote for 'far-right' parties begs the question: why should we so explicitly associate populists like Jimmie Åkesson and Geert Wilders with the right-wing?

In many respects, these politicians advocate the same ideas as the social democrats of the mid-twentieth century – except for a more explicit anti-immigration emphasis. Chantal Mouffe has called for a left-wing populism. But in a way, the supposedly right-wing populists are already quite leftish. ■

Niek Kok is a researcher at the Telders Foundation (TeldersStichting)

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How Europe could yet take the lead in the global EV development race

The electrification of vehicles has become a key trend in the automotive sector. Simone Tagliapietra and Reinhilde Veugelers consider how Europe might best attempt to catch and overtake other countries in the development race

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The automotive sector is important for the EU economy. Accounting for 4% of EU GDP, it employs 8 million people and ranks among the main EU sectors in terms of exports and research and development (R&D). And because of its long supply chain, the sector has a significant multiplier effect on the EU economy.

The automotive sector is currently at the centre of a global transformation, driven by four key trends: electrification, autonomous driving, sharing, and connected cars. While each of these interconnected trends is already visible in daily life, their full deployment is not yet guaranteed, nor is the speed of take-up.

The electrification of vehicles has become a key trend in the automotive sector, driven by clean energy and climate-change concerns and policy interventions – such as support for zero-emission vehicles and carbon taxes – intended to reduce greenhouse gas emissions. We can expect EVs to proliferate in the future. On the technology side, improvements are quickly reducing electric-vehicle (EV) production costs, in particular by reducing battery costs. On the policy side, to meet commitments assumed under the Paris Agreement, more governments are increasing their support for zero-emission vehicles, banning dirty vehicles and supporting the deployment of EVs and their charging infrastructure.

In a recent Policy Contribution we investigated the position of the European automotive industry in a scenario in which electrification substantially progresses. In this blog post we summarise the results of our study, which are – surprisingly – encouraging for Europe.

Electric vehicles in Europe: the demand side

Data on registrations of electric vehicles reveals that the global EV market remains, to date, still a small part of the overall car market. In all major countries, EVs in 2017 had shares well below 5% of total vehicle registrations. But it

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is growing rapidly. This growth is particularly manifesting itself in China. As a consequence, the major market for electric vehicles is nowadays in China.

While the EU (with 23%) and the US (with 48%) dominated the worldwide EV market in 2013, by 2017 China had a clear lead, with 48% of global EV registration, leaving far behind the US (with 16%) and the EU28 (with 15%). Within the EU, Germany and the UK increased their shares of the global EV market, while France and early-adopter the Netherlands experienced declines between 2013 and 2017 (Figure 1).

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Electric vehicles in Europe: the supply side

China is also the source of another crucial trend in global EV manufacturing: over the last few years, it has rapidly established itself as the global leader, leaving Europe and other regions behind. While Japanese and US firms were

The gap in policy ambition between Europe and China is huge

Figure 1. Share of new EV registrations of country in world new EV registrations

2013 2017

60%
50%
40%
30%
20%
10%
0%

EU Norway Germany* UK France Netherlands China USA Japan

Source: Bruegel based on national statistics.

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Figure 2a. EV production by vehicle manufacturer

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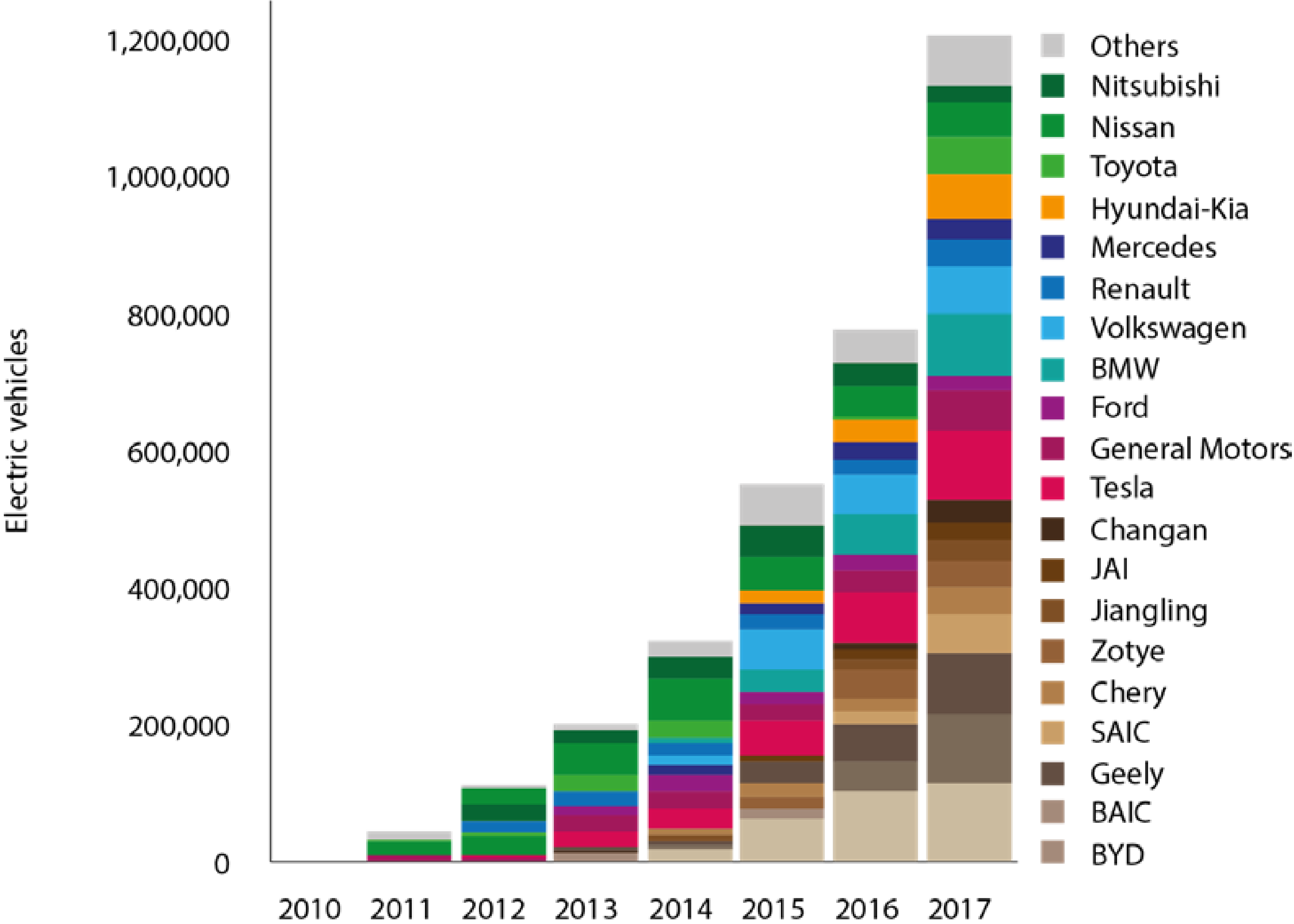
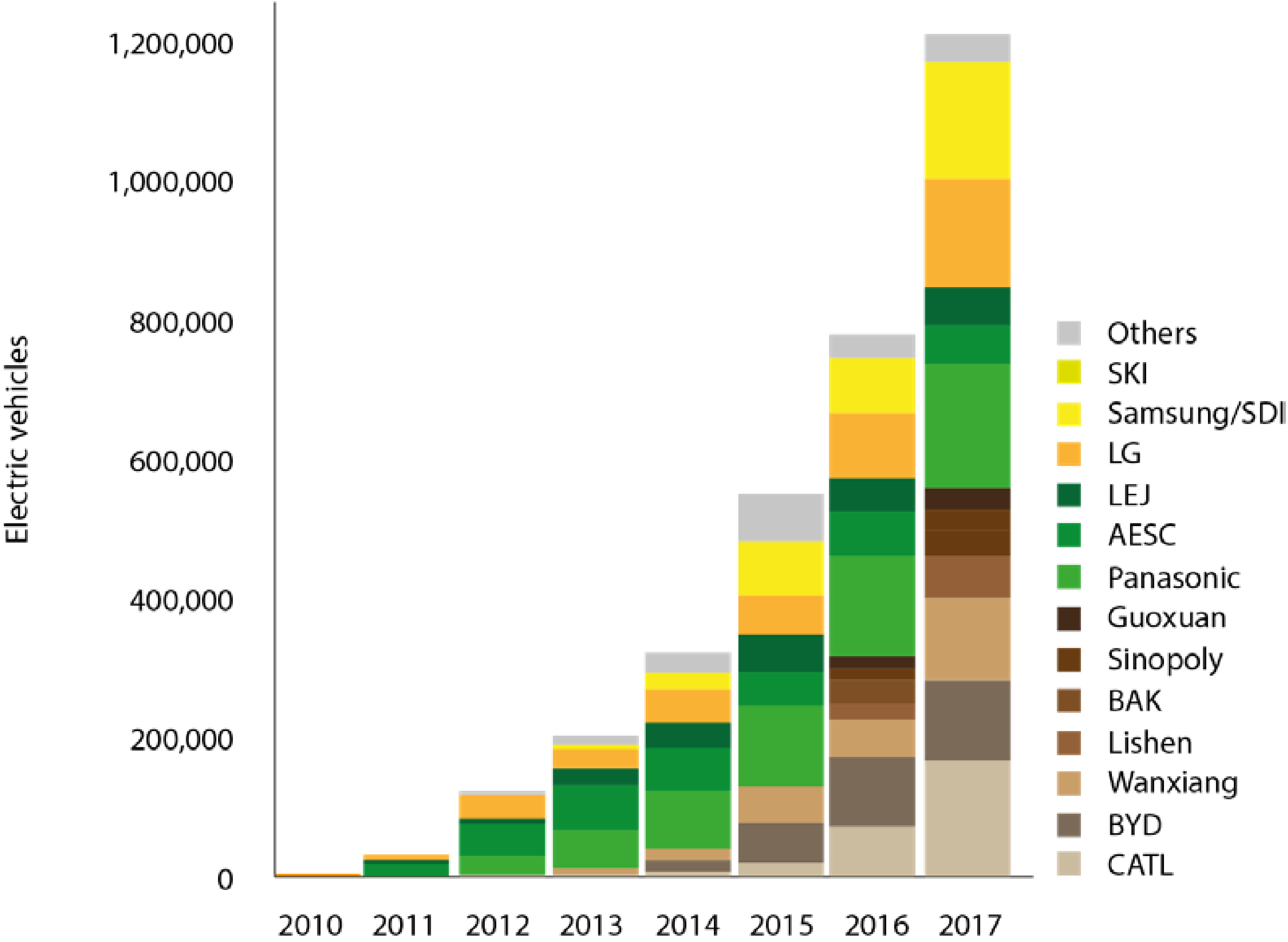


Source: International Council on Clean Transport (2018).

Figure 2b. EV production by battery manufacturer



Source: International Council on Clean Transport (2018).

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early movers, nowadays the largest EV manufacturers are new Chinese firms (Figure 2a). From the early movers, only US's Tesla is currently a leading manufacturer in the global EV market. EU firms entered late, and are only recently starting their catching up, especially the Germans.

In global EV battery manufacturing (Figure 2b), which is a crucial part of the EV value chain, China's leadership is even more evident. The first mover, Japan, was rapidly surpassed by China between 2014 and 2017, as Chinese companies proliferated and grew rapidly along with Korean firms. There are no EU or US firms among the world's major battery producers.

This impressive rise of China in EV manufacturing has been driven by the country's strong industrial policy in the field (eg. generous fiscal subsidies for EV manufacturers, based on the EV's driving range per charge, to foster innovation; requirements for international carmakers to manufacture EVs in China in order to access the market; strong financial incentives for EV purchasers; extensive charging infrastructure deployment).

EU and the technology development in EVs

The EU was not a first mover neither in EV technology development, as patent data show. The Internal Combustion Engine (ICE) technology has traditionally been the major power train technology for cars. The EU dominated the ICE technology until 2008. EV technology patenting activity, while mostly flat until 2005, kick-started globally in 2005. In the EU it began to grow only in 2009 (Figure 3).

The dominance of ICE technology in EU automotive patents before 2009 has since been changed to a more balanced position across all power-train technologies – electric, hybrid, hydrogen and ICE. For instance, the number of EU EV patents grew from 124 in 2008 to more than 250 per year for each year between 2011-2016.

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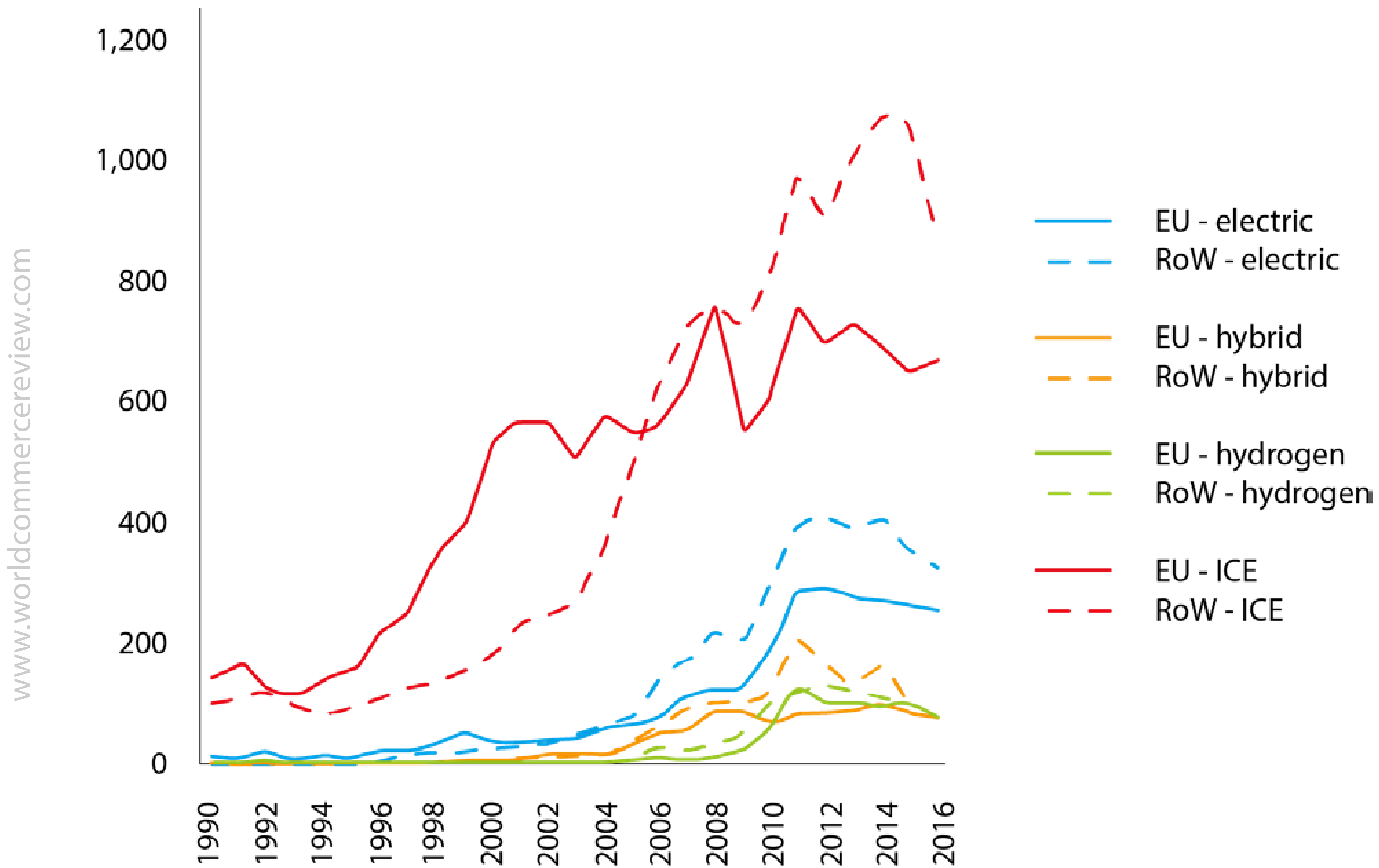
Figure 3. EU vs. rest of the world in major power-train technology patents



Source: Bruegel based on EPO Patstat, April 2018 edition.

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How European automotive firms tackle the EV challenge

Which EU automotive firms are driving the EV trends? Although they were not the first movers on EVs, European automotive firms have now all become as buoyant on the EV market as their global counterparts. All have announced new EV models and ambitious annual EV sales targets to be achieved in the near future.

But as most of the investment in EVs are still very recent and/or attached to announced plans, hard evidence of actual committed investment by EU firms in EV manufacturing is not widely available.

In order to assess the commitment of EU firms to EV technology, we turn to patent statistics to assess how active EU automotive firms have been in developing EV technology compared to their international competitors and compared to their activities in improving the incumbent ICE technology.

We focus on the automotive and parts firms who are the largest R&D spending firms in the world, as recorded by the EC-JRC Scoreboard. This handful of large firms account for the overwhelming majority of patenting activities in this sector. Patenting by South Korea's automotive sector is dominated by Hyundai; in the US it is General Motors and Ford. The EU and Japan, although they have big players such as Volkswagen and Toyota, show a more distributed structure of patenting activity with several major players involved. In all cases, all of the major players are established incumbents, with very few new entrants, Tesla and Chinese companies being the exception.

There are major differences between the patenting activities of different companies (Figure 4). Chinese companies exhibit an overall still very low level of patenting. Among the EU assembly companies, Renault, BMW and Volkswagen have the highest shares of electric power-train technology patents, while also having large shares of ICE patents.

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Overall, these EU assembly companies exhibit relatively balanced patenting activity. This contrasts with EU automotive parts companies, which exhibit a much greater degree of specialisation when it comes to power-train technologies. Some companies, such as Mahle and Rheinmetall, are active only in ICE technology patenting.

Other car parts companies have higher shares of non-ICE patenting, though with low absolute numbers. The balanced patenting activity is also true for the Japanese and US incumbent automotive assemblers.

Conclusions and policy recommendations

The transition to zero-emission transport and the development clean power-train technologies as alternatives to the ICE, among which the EV technology is the most powerful, needs to be supported by a more ambitious and broader policy agenda both at the EU and at member-state level. It is not too late for Europe to lead the global EV race, but it has to step up if it wants to remain at the frontier of automotive technology.

It is for the EU automotive industry to face and ideally drive the global EV revolution and to take up pivotal positions in the EV value chain. As EU companies were not among the EV first-movers, they will have to invest more ambitiously in new EV technologies, while more quickly reducing their exposure to the incumbent ICE technology.

Too many important companies, especially car-parts manufacturers, are still predominantly or even exclusively focused on ICE technologies. The EU particularly lacks strong players that can capture the value from batteries for EVs.

European firms have the capacity to continue their global leadership of the automotive sector as the next generation of automotive technologies is phased in. European car and car parts manufacturers can rely on a large internal market, a long experience and a strong brand-name in automotive manufacturing.

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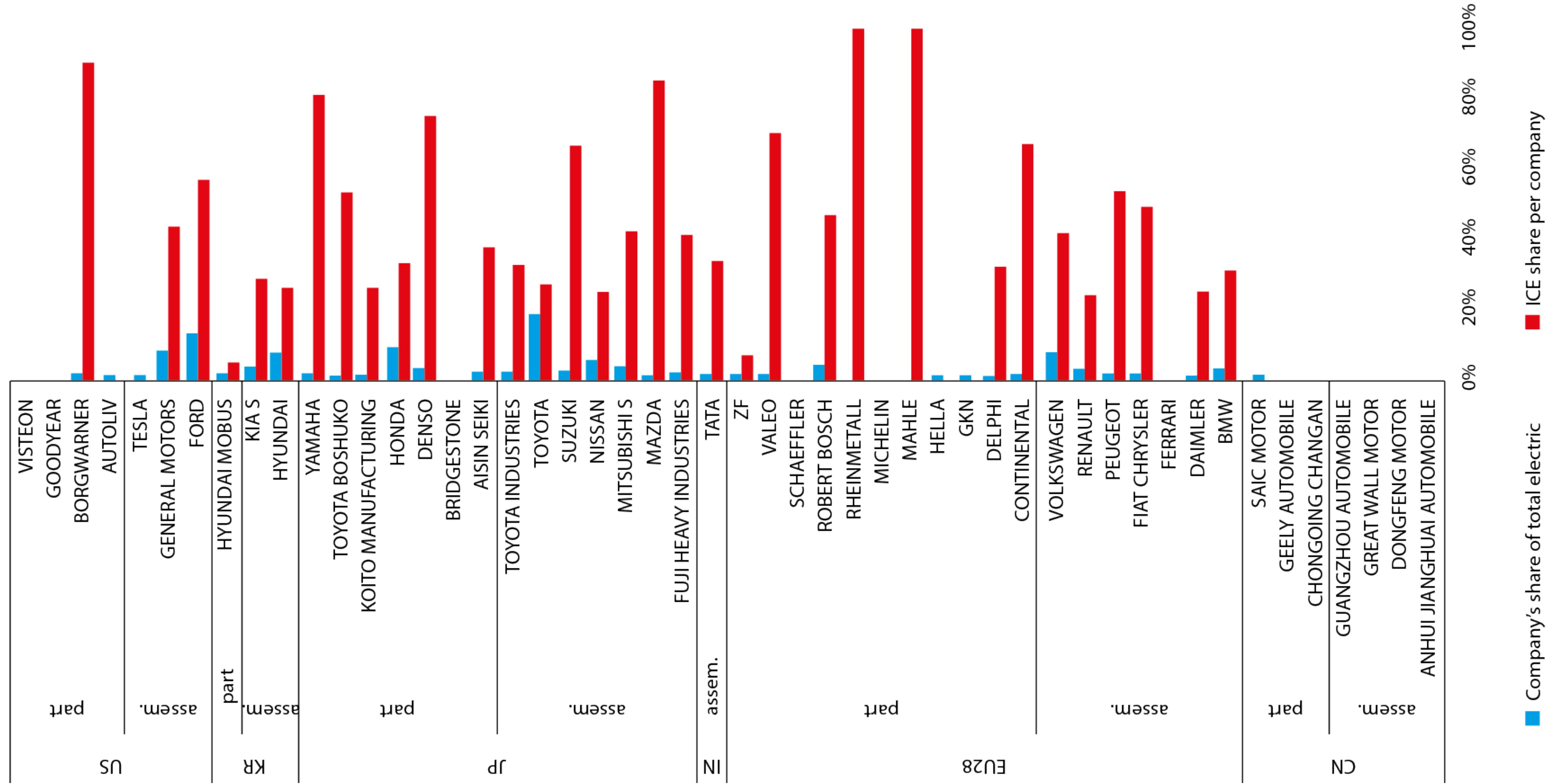
Figure 4. Patenting structure of the top 50 R&D spending automotive companies (2012-14)



Source: Bruegel on JRC Scoreboard 2016.

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They also have the technological expertise from a portfolio of R&D projects and patents that is diversified across various power-train technologies. But in order to realise the potential from this capacity, and to face global and particularly Chinese competition, European firms will have to be more ambitious.

To warrant more ambitious investment in EVs by EU automotive companies, the proper framework conditions should be in place. Both the EU and EU member states are increasingly discussing and putting in place policies to support the deployment of EVs. However, best-practice examples of EV policies from Norway and China illustrate that piecemeal interventions will not work. What is needed is a broad policy framework, combining a multitude of demand- and supply-side instruments in an ambitious long-term clean transport policy mix.

First and foremost, there needs to be EU demand for EVs. Subsidies, taxation and public procurement favouring clean rather than dirty technologies should be used to stimulate EU demand for clean technologies in general, including EVs. Without an EU internal market for EVs, EU companies might be developing their ambitious investments in other world regions, most notably China.

On the supply side, the policy menu includes public R&D support for the next generation of clean technologies, including support for investment in the latest and next-generation clean technologies, and support for the conversion of dirty technologies into clean.

Policymakers can also favour clean technologies that include EVs by establishing efficiency standards. Last but not least, a full range of policies can be implemented to bolster infrastructure deployment: a non-exhaustive list includes urban planning, public transport, charging stations and accessibility improvements.

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The gap in policy ambition between Europe and China is huge. The Chinese EV policy mix includes strong commitments to an electric future and coercive measures for carmakers. Europe cannot follow China in the adoption of centrally-planned industrial policy measures.

However, Europe can and should do more to stimulate the transformation of its automotive industry through a more ambitious combination of supply and demand-stimulating policy measures. At the EU level, this includes particularly:

1) Targeting EU R&D funds to trigger frontier clean technologies

The EU can improve its transport research and innovation funding. In particular, it should carefully allocate this money, targeting areas in which it can truly have leverage on private investment.

Transport-related research and innovation funding should notably focus on next-generation early-phase technologies and should focus across the value chain, including for next-generation batteries, such as solid-state batteries.

2) Rethinking transport taxation

Taxation is a key policy tool to switch demand to cleaner transport, fostering road transport decarbonisation. European countries still have very different transport taxation regimes.

The EU should promote a new discussion among EU countries on the future of transport taxation, as is being done in the field of digital taxation. A harmonisation of mobility taxation throughout Europe would lead to less fragmentation and more certainty for business, thus increasing the incentives to invest in production of clean (electric) vehicles in Europe.

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3) Bans on dirty cars: cleaning-up the air

Since 2017, a series of countries and cities across Europe have introduced bans on diesel and petrol cars. These plans are mainly driven by a political commitment to reduce air pollution, and are based on the expectation that the shift already under way towards clean vehicles will continue to gather pace over the coming years.

These plans are also meant to provide a strong signal to the EU automotive industry, encouraging it to innovate and become a global player in clean vehicles. The EU should ensure that these plans should be more coordinated and ambitious.

4) EU support for member states' transition towards clean transport

To encourage its member states and cities to clean-up their transport systems, the EU should support the transition costs associated with this transformation.

An 'EU Clean Transport Fund' could be established to provide dedicated financial support to countries and cities committed to a transformation to decarbonise transport. For instance, this fund could allow cities to bid for EU money to support measures such as the deployment of alternative fuels infrastructure or to support the retraining of automotive workers to enable them to switch from dirty to clean technology production technologies. ■

Simone Tagliapietra and Reinhilde Veugelers are Research Fellows at Bruegel

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