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The future of European Integration

What are the centrifuge forces threatening it ?
What should be done about it ?

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Unfortunately, there is no better time to deal with this subject.

A large member state – the UK – has chosen, by the Brexit referendum in June 2016, to leave the Union.

Prior to that, the immigration issue has been exacerbated by the pressures coming from the Middle Eastern turmoil and by the fact that no "European position" on the matter could be expressed.

On the backdrop of mounting terrorism and Islamic radicalism, not to mention weak economic growth as well as high unemployment, public opinions in Europe are getting more and more eurosceptic. They are showing disenchantment with the EU as well as with national Governments. Extremist populistic parties are growing throughout Europe showing the magnitude of the lack of trust that affects the so called pro-european "elites".

These are some of the "centrifugal" forces at work.

We should not be surprised by such reactions.

In a way, Eurospecticism has always tended to have the upper hand.

We all know that Europe has been marred by lost opportunities, by a “democratic deficit”, by the excesses of Brussels bureaucracy, by the extreme heterogeneity of its member States, by the lack of a long term vision, by its inability to define a clear strategy and to carry it out …

All this reflects common perceptions, and, to some extent, reality. However those criticisms do not put in question, it seems to me, the essence of what Europe has achieved, in terms of its successes over the past sixty years. And they do not answer the question : what would happen to Europe and its members if it were to disintegrate ?

Let me try to approach these issues under two major headings :

- What are the policies that are lacking today and that would be required to make Europe more credible, in terms of achieving its own project ?

- What would be the “additional”, the “extra” elements that would allow Europe to become a “power” consistent with its fundamentals ?

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I – What is lacking today in Europe to achieve its basic intrinsic project ?

1- Better convergence in terms of economic policies

This has always been a fundamental – but often misconceived – issue. In a very diverse geographical framework with large productivity differentials as those that characterize the EU, there is a need to reach a sufficient level of homogeneity among member States in terms of economic performance and competitiveness. Such an imperative is all the more compelling for the members of the Euro-area which have given up, by definition, their freedom to devalue.

But, on this subject, we have to be clear. The EU has not been conceived nor established as an engine to equalize structural diversity among members States. Such a concept could have been the agreed path. But, in fact, that avenue has clearly been rejected from the very start.

The "no-bail out" rule is indeed at the root of the European architecture. The Union allows structural aid to help reduce major infrastructure discrepancies and therefore facilitate the catching up process of living standards throughout the continent. But such structural assistance is not intended to compensate – through permanent transfers of public money – persistent competitive weaknesses.

The consequence of the no bail-out concept is that each member State must make its own decisions – in terms of economic and structural reforms – in order to adjust its special conditions to a minimum level of “European consistency”.

In other words, in the case of fundamental disparities (in fiscal or structural policies), it is the duty of the member State that “deviates” from the common - “sounder” - path, to embark on corrective measures destined to redress its lack of competitiveness.

This looks obvious and even tautological.

But, in fact, it is the most confused notion and also the most difficult objective to achieve, as past experience has abundantly shown.

Indeed, the path towards convergence has been most uneven.

Paradoxically, the “peripheral” members of the Euro have been pretty poor performers in terms of convergence. From 2000 to 2010, their inflation, unit labor costs, and current account imbalances significantly deteriorated in relation to the performance of the “core” members of the monterary Union.

It is worth noting that while German unit labor costs had gone up by 0,4% per annum on average from 2001 to 2010, the corresponding figures are 3%for Greece, 2,7% for Spain and Italy (i.e. 7 times more !).

In this regard, competitiveness indicators have been telling :

Competitiveness indicators

From 1999 (1^{st}Q)	=	100 (common base)			
Germany was at	=	88.7	at end 2012	(gain : + 11.3 points)	from 1999 to 2012
Greece was at	=	103.7	“	(loss : - 3.7)	“
Spain was at	=	107.3	“	(loss : - 7.3)	“
Ireland was at	=	105.1	“	(loss : - 5.1)	“
Euro area average	=	92.9		(gain : + 7.1)	“

Source : ECB

Which means that, in relation to Germany, the “peripheral” countries had seen their competitiveness indicators fall by a range of 15 to 19 points over the period 1999 to 2012.

But financial markets were slow to react to these discrepancies.

Actually, they took almost ten years to sanction, through higher interest rate spreads, the magnitude of these gaps in economic performance.

The 2009-2010 Euro sovereign debt crisis eventually forced a number of Eurozone countries to start correcting their imbalances.

Did the European “system” ring the bell early enough? The answer is : “no”, in spite of the warnings given by the ECB. It was eventually the market signals that triggered overdue action. This does not speak in favour of EU’s governance.

Actually, to be frank, this 10 year long episode (2000-2010) casts an appalling light on the way the European States and Institutions dealt with the convergence of their economic policies and how much they disregarded the “minimum degree of consistency” that I was mentioning above as one of the main pillars of EU.

As far as the “new eastern” members are concerned, the process was much sounder : on most indicators of competitiveness these countries generally performed well and improved their fundamentals. Their business environment was, on the whole, friendlier. They thus benefited from significant capital inflows (notably from Germany and Nordic countries) not to mention EU funds, which facilitated their nominal and real integration to the EU.

Since the market wake-up call of 2010 and the deep sovereign debt crisis that it triggered, significant adjustment has taken place in countries like Greece, Ireland, Spain, Portugal and, to some extent, Italy.

Labour markets are being reformed in the South (from a level of (over) protection rated 3 by the OECD in 2008 to 2,6 in 2013). Fiscal imbalances are being gradually repaired, current account balances are almost all now in positive terrain, and competitiveness indicators are improving.

The case of Spain is rather remarkable : growth has resumed to more than 3% in 2015-2016, investment has picked up (5% on average) and exports are booming (+ 5,4%).

Here I should mention France which has only modestly started to deal with labour mobility and fiscal and retirement issues.

So, in sum, the convergence story of the EMU has been a failure during its first ten years (2000 to 2010), failure that is now being repaired at a high cost. The "Eastern" part of the story is much more rewarding.

Now let us look at growth.

2- A return to growth ?

We know that the EU performance has been lackluster in this regard over the last seven years :

GDP growth (annualized)

	1998-2007	*2010-2016*
Euro area	+ 2,4%	+ 0,9%
US	+ 3%	+ 2,1%

There has been a slight rebound in 2015-2016 (+ 1,5%) but this is still fragile and is based more on consumption than on exports and investment.

This poor performance is in part the reflection of "secular" trends (ageing population, structural reduction of productivity gains …). But it is also a "European made" problem. The outburst of the Eurocrisis in 2010 was followed by several years of recession (2012-2013) that heavily affected countries like Portugal, Greece, Spain.

Europe is striving to catch up and to heal the specific wounds that have accumulated as a result of ten years of divergences.

And average unemployment in the Eurozone has been hovering around 9% of the labor force with strong deviations from country to country (for example, unemployment in Spain reached 19%).

The question is : is it realistic to expect a significant increase in growth above the 1,5% average that is observed now ?

I believe that such an expansion would necessitate a few important preconditions.

a) Fiscal adjustment : the weight of public debt and the size of Governments are hindering growth.

In spite of the recent fiscal adjustment that I have alluded to above (and that has, on the whole, reduced government spending to pre-crisis levels in the periphery), levels of spending are generally too high in many countries and debt sustainability is far from being established.

Therefore, I believe that, for the sake of higher growth and increased private capital inflows, public spending must be further reduced in a number of countries.

This is all the more indispensable that the aging trends are pushing up pension imbalances and social protection spending.

b) I would add a number of structural remedies to low growth :

- Reduction of administrative barriers on new business at entry ;

- Elimination of too many thresholds on size of different categories of enterprises (SMEs) ;

- Boosting labor market mobility and training policies ;

- Increasing initiatives to provide equity to enterprises instead of encouraging debt.

As long as Europe will not bite those bullets, I am afraid that - except for countries like Germany that have ingrained a culture of “mittelstand”, of high quality industrial products and social cohesiveness - growth will be sluggish and unemployment will remain high.

When we look at the “capital market Union” project, we should be mindful not to add new layers of regulation to capital movements.

We need a Union open to capital inflows as well as to outflows, a Union where investors are eager to work, participate and make transactions. We do not need a Union that will focus on more regulation imposing additional constraints on investors.

If you look at Europe from a macro-perspective, the paradigm that I would favor is the following :

- Each country should see to it that the “minimum convergence” is in place, even if this entails constraints on revenues ;

- Then, “surplus” countries (in the North) could be keener to export capital and to take advantage of the “catching up space” offered by those Southern countries as long as they are no more seen as the source of imminent financial crisis (because of unsustainable debt profiles).

Then we could reach a “normal” functioning of financial markets in Europe, where “excess capital” can move in a sounder way to countries in need of investment. This pattern is the one that works in countries like the US as well as in the Eastern part of the Union, but not in the South. In the South, the huge capital inflows that took place before the 2010 crisis were mainly bank to bank lending. Differences on yields favored those purely financial movements that were immediately reversed when the crisis came. [1]

Against the description above, I often hear the “austerity” argument : « How can you ask more fiscal austerity from people who are unemployed and are at pains to make ends meet ? »

The answer is that as long as productivity increases in the South are lagging those in the North (which is the case) there is no way to insulate and “protect” their revenues and wages. Actually, the only way out (barring a devaluation that would make people even poorer) is to accept wage moderation and to focus on more structural reforms. One could add that the “austerity” measures of the past years have only reduced government spending to pre-crisis levels in the Eurozone periphery. So the excesses of the “divergence frenzy” have been corrected but not more.

The measures and orientations suggested above do not call for any Treaty change. They could be decided immediately by number of States. They are straight-forward and easy to understand even if they entail political differences of views.

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[1] *Total lending by banks in the core Eurozone countries increased by 1,5 Trillion Euros from 2000-2009 (+ 340% increase !). See “Europe’s growth model in crisis” in “The Search for Europe” 2016 BBVA.*

In a way, this is the demonstration that the lack of convergence and the obstacles to higher and sounder growth are more the result of weak national policies than the manifestation of an EU institutional deficiency.

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But let us venture now in a more hypothetical and hazardous field : how could the EU play a more decisive role internationally ?

II – What would be the "additional" elements that would allow Europe to become a "power" consistent with its fundamental strengths?

1- Let us first give a quick view of the international importance of Europe.

Demographically, the EU is shrinking. The ratio of people aged 60 and more is increasing worldwide : from 19% in 1996 to 31% in 2030. But the ratio is moving faster in the EU. Therefore the percentage of the European working age population in the world will continue to diminish (estimates are that the present proportion of 11,5% of working Europeans will be falling to 6,4% in 2050).

This means a weakening of Europe's influence in the world.

In 2004, emerging countries accounted for 46% of world GDP compared to 54% produced by developed nations. Today they represent nearly 60% and within ten years the emerging markets may account for 75% of world GDP.

If we take into account the relatively weak economic growth and productivity gains in Europe, we can understand why the EU represents today only 11,4% of the world economy (US : 16%). This trend is getting worse and in 2050, not a single European country will be able to justify its presence in the G7 on the basis of GDP.

So, the fundamental question is : what is our ambition for Europe ? Are we resigned to see it getting marginalized in the community of nations or do we feel it is important to integrate it more so it can become one of the first actors in a world whose center of gravity if drifting eastwards.

2 – <u>If Europe wanted to live up to such a challenge a few "extra" decisions towards more integration would be called for. Let me just sketch a few of them.</u>

- *Security and immigration policies*

Member States would have to design a common policy. That policy, in my view, should not impose immigration quotas or measures of the like. Some members have already too many problems with their own labor force to be caught in an "immigration policy" of net inflows.

But it should allow some other countries, like Germany[2], whose fertility rate is one of the lowest in the world and is beginning to see its workforce dramatically reduce, - which is threatening the economy - , to organize its own policies on immigration.

Instead of protecting “Schengen”, the Union would focus on protecting its borders on the basis of a strict - but not necessarily uniform - selective immigration policy (on the model of the US or Canada) in order to eliminate illegal movements. That imperative would have to prevail – for the time being – over openness and freedom of movements.

- *Foreign policy and defense*

If Europe wants to become a significant world “player” (while it is merely today a “follower”) it should raise the issue of a common foreign and defense policy (for external objectives). This is a subject fraught with difficulties, objections and past failures. But, it could make sense in a world of enormous security tensions, of mounting external powers and where the continuous US “shield” becomes more problematic. The EU cannot remain on the sidelines as a mere spectator when rapid changes are affecting its own population.

- *A somewhat larger budget*

In order to carry out common defense policies (that would go beyond the simple addition of present national forces and budgets), some increase in the present EU budget could be

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[2] *Germany’s population is estimated to fall from 81 Million inhabitants today to 65-70 Millions in 2050 (70 Millions would need a net immigration inflow of 200 000 a year).*

warranted. This should be very carefully limited, and certainly not conceived as a “general mutualization or transfer effort”. But a slight and well justified increase could present some advantages.

- *A common “convergency” ministry*

The performance has been so dismal in this field, that a further step towards integration might help. If there were to be a sort of “Convergency Authority” it should have the power to act :

- To impose economic corrections when they are blatantly needed (peer pressure has shown its inefficiency) ;

- To dispose of a minimum of “dry powder” to manage the conditionality process with a modicum of flexibility that would provide more credibility.

- *A political setting that would be anchored in the populations themselves.*

People would have to be comfortable with the above ambitions and feel able to share them.

In order to achieve such democratic ownership of the vision, it might be a good idea to elect European Parliament members directly from the people on a global continental basis (not country by country) and, perhaps, to elect its President by direct popular vote on a programme turned to the future.

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For such an ambition to be clearly conceived and proposed to the people Europe would require more leadership. And if democracy were enhanced, we could dream of a situation where each member State – big or small, rich or poor – could find in the new system : respect, collective discipline and a sense of security, in the face of present shocks and tensions.

Could the above ambition be carried out by a simple coordination between nations (Etats-Nations) and therefore not involve supra-national powers ?

This might be more attractive to "nationalistic" circles. But it seems difficult to achieve the goals sketched above without some form of extra integration. The route of coordination between States is cumbersome and majorities are difficult to emerge. The danger, in this type of system, is that large members may have too large a say which could result in blocking decisions.

Therefore, some form of additional integration seems called for even if its probability today looks remote.

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I will finish by stressing the present paradoxical situation. We are told by nationalistic groups that the Union has failed. But an objective analysis shows that it is governments – more than the EU institutions - that have been the major culprits in the lack of policy convergence and in slow growth. Is it therefore obvious to re-transfer powers to national governments that have displayed so much inefficiency? the danger is to further weaken the embryo of "collective discipline" provided by the EU and to go back to old fashioned habits and demagogy. Some extremist parties are asking for the right to "peaceful devaluations". But they do not recognize that, in a globalized and competitive world, devaluations are a recipe for trade retaliations and for the impoverishment of people.

The present model of integrated Europe – albeit limited - that we still enjoy may well be the fundamental bulwark to protect us from further decline.

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