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Challenges ahead for the European Union

It is a mild understatement that nowadays the EU is navigating in rough waters. Close to half of the member countries of the Euro area are in breach of their fiscal stability commitment – and some of them very substantially. Quite a few heads of government publicly criticise the ECB's monetary policy. Germany and France are determined to water down the Bolkenstein directive on the implementation of a genuine single market for services (which amount to about two-thirds of the EU's GDP), to which, incidentally, no major objections had been raised by the governments of the member states during the drafting stage. There is no agreement on the longer term EU budget. Only Ireland, the UK and Sweden accept the free movement of the residents of the ten countries which became members of the EU in May last year.

Most important, France and the Netherlands, resorting to a referendum, refused the ratification of the constitutional treaty – which had been accepted unanimously by the Heads of State or Government. It is on this last, largely unexpected event that I propose to share some thoughts with the readers of *Competitio* – keeping in mind, however, the other manifestations of a crisis situation as well.

Let me begin by bluntly stating that I do not believe a minute that all this foreshadows a fading away, let alone the implosion, of the EU, nor indeed of EMU. This is not the first crisis in the European integration process – remember the rejection of the European Defence Community initiative, France's "empty chair", or Mrs. Thatcher's "I want my money back". It will not be the last either. There are too many vested interests at stake which result from the exceptionally high degree of integration of our economies (and not only of our economies). They would surely prevent the realisation of a doomsday scenario. But there is a genuine risk that decision making within our very complex institutional arrangements will become more and more difficult. This would not affect necessarily the day-to-day management of our institutions, but could well paralyse badly needed new initiatives. It has become moreover reasonably clear that referendums organised in other member countries might well have also ended with a rejection (see the disappointingly unenthusiastic acceptance in Luxembourg). Hence the need for trying to understand what has led to the constitutional treaty debacle, or more generally to the European malaise.

It will take quite some time and a lot of humble analytical effort to fully grasp the sequence of causalities. One thing, however, is already quite sure: a number of

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influences have been at work. Here is a tentative list, which I submit to the reader, without suggesting an order of importance, which I ignore.

It was a bad idea, and an appalling political miscalculation, to submit such a complex proposal to a referendum. Referendums should be reserved to clear-cut issues that can be summed up in one single and simple sentence (are you for or against death penalty?). They should not be used for requesting approval of a massive legislative piece which contains some major, and great many technical proposals: what are you expected to say if you agree with some of them, but disagree with others? In a parliamentary democracy it belongs to the elected MPs to hammer out a decision, by making use of the appropriate committees. Great is the temptation for ordinary citizens to use the opportunity given to them by a referendum to voice their dislike of the incumbent government or head of state for reasons which are not even remotely connected with the issues raised by the referendum.

It is also possible to argue that no government took the trouble explaining in a few pages (a) that a substantial part of the draft treaty simply summed up in a coherent and consistent way the essential dispositions of the successive treaties which are now part of the "acquis communautaire" and which therefore were not up for discussion, and (b) that for the rest the new decisions going beyond technicalities – decisions which *are* of importance – numbered not more than four or five items. As a result, much of the dissatisfaction voiced by the citizens addressed issues that had already been decided. Not much was said about the rationale of the new proposals – which were intended precisely to respond to more deep-seated concerns, such as the inadequate transparency of the decision making process or, more broadly, the lack of democratic accountability.

I believe, however, that such manifestations of obvious mismanagement are far from providing a full explanation. The debate surrounding the draft constitutional treaty has also revealed a thorough dissatisfaction, or at least a genuine concern, about two major issues.

One is the perception that "Brussels wants to regulate far too much at the European level": that it interferes in matters which should be none of its business. The British press has been particularly vocal in this respect, carrying wild stories about draft directives, some of which were simply untrue. But it would be unwise to reduce such noises to the prevalence of an "Anglo-Saxon" conspiracy. The British media manifestly overdo it, but they are not alone. The perception is widespread. Does it correspond to reality? The answer is not an easy one. In one sense it does not. "Brussels" (by which is meant the Commission) cannot decide on what it would want to put into a directive. It can only submit a proposal to the two co-legislators, i.e. the Council and the European Parliament who than take the decision. Moreover, many of its proposals are made in response to the intense lobbying by member governments. As a result it is arguable that the responsibility for excessive Europe-wide regulations lies with the governments and/or the Parliament, which have the final say. But in practice this is not entirely true. The privilege granted to the Commission to be the only institution which can put on the table a draft directive is a considerable source of power. The Commission can flood the co-legislators with proposals, and unless both the member governments and the parliament enter at a very early stage in a game of give-and-take, they will find it hard to avoid being put into the unappealing position of either rejecting the whole proposal or accepting it with only minor alterations. Yet there is clearly a case for requesting that the

Commission start consulting all stake holders *before* it begins drafting a directive. For the major problem for any federal organisation is to decide whether there is any need at all for EU-wide legislation; and a lot of time and effort could be spared if this was done before undertaking the considerable effort of drafting a full-blown directive. It is only recently that the Commission has genuinely accepted the idea of an initial cost/benefit analysis of any new legislative initiative – and I may assume (perhaps immodestly) that the work done by the Committee of Wise Men on the Regulation of European Securities Markets, which I had the pleasure to chair, played a constructive role in this respect. But this is a very recent development, the importance of which has not yet had time to sink into public perception.

The second source of concern is somewhat related to the first – there should be areas left out of the European integration process – but it focuses on a very specific area: cultural identity. Its strength has been revealed by the popular reactions to the potential accession of Turkey to the EU. It has to do with the widely shared apprehension that globalisation represents a genuine danger for all those who want to preserve their cultural identity; and there are many who fear that European integration is somehow part-and-parcel of globalisation and therefore enhances the danger of losing our cultural identity. I have often argued, and I still believe, that, on the contrary, in a "globalising" world a well-managed EU constitutes the best protection against the loss of our cultural identity. As a result of our history, we share common values (which are nicely summed up in the preamble of the draft constitutional treaty), but one of these values, which has developed at the cost of bitter experiences, is precisely the acceptance and the respect of specific national cultural identities, of which the language is the undoubtedly the core component. There is no dominant country or cultural powerhouse inside the EU which could put this respect at risk; but if we had to defend our identity individually at the world scene, all of us would end up as losers. But would this argument remain convincing if Turkey were to join the EU as full member?

Now let me turn to what I consider (perhaps as a result of my professional bias) to be the most powerful factor contributing to the European malaise: a basic discontent with the performance of the European economy – and by "European" I mean Euro area. So I am talking about the twelve countries of the "old" Europe. Here we have to face up to *reality*, rather than to a more or less well founded perception. The rate of growth of the European economy has been over the past eight years dismal: GDP has been growing at a rate below that of potential output – which itself expanded only slowly. As a result, unemployment has got stuck around 9% of the labour force and there are abundant excess capacities. What has gone wrong, and what can be done about it?

The starting point is to compare our situation with that of the United States, which is enviable by our mediocre standards. But this has not always been the case. During the 1970s and 80s, and even until the mid 90s, Europe performed far better than the US: this applied to the rate of growth of global GDP, to that of GDP per head, and also to that of labour productivity (i.e. of GDP per hour worked). By 1995 this led to a situation where European GDP per head of population came close to that of the same figure for the US; and to the extent that it was still lower, the explanation could be found in the fact that fewer Europeans worked fewer hours than their American counterparts, rather than in any dysfunction of our economy. In fact, the level of productivity was higher in some European countries than in the US: for instance in France and in Belgium. Looking at this situation, it was fashionable to say that lagging behind the US in terms of GDP per head was a matter of social choice (we valued more than the Americans having long holidays and shorter working weeks) It was *not* the result of a poorly functioning economy.

By now this explanation lost whatever validity it might have had ten years ago. Sometime in the mid-1990s a radical change occurred in the relative positions of the two areas. Until then labour productivity grew in the United States by around 1% per annum, while the comparable figure for Europe was 2.5%. This is what was at the heart of our catching-up process. Over the past ten years, however, the respective positions have been radically reversed: the rate of growth of productivity in the United States shot up to around 3% (and do not forget: this period included a recession, during which productivity used to decline in the past), while that of Europe slowed down to a miserable 1 to 1.2 %. The result has been a significant deceleration in the rate of expansion of European *potential* output, which suggests that we should try to find explanations for the US success on the supply side, and remedies for Europe also on the supply side.

The standard objection to this assertion is that it misses the visible fact of a shortfall of demand, too, in the case of Europe. Given our high unemployment, this is an acceptable counter-argument; and I share the view that we *do* need a faster expanding domestic demand. But how to achieve this? I do not think that we would be well advised to resort to the use of the two traditional macro-policy instruments – monetary and fiscal policy. The monetary policy of the European Central Bank has not been merely accommodating; it has been clearly stimulating. At 2% its key interest rate is not only low in absolute terms, or by historical standards. It is, in fact, slightly negative in real terms. Money supply broadly defined – M3 – has been growing at an average of around 7% over the past five years. This has resulted in a sizeable liquidity overhang. Its further growth would perhaps not raise the rate of inflation as measured by consumer price indices, at least not in the short term, but it runs the risk of entertaining asset price bubbles, in particular real estate bubbles, which have the nasty habit of a sorrow ending. Fiscal policy has been, to say the least, accommodating, and further significant expansion of public debt, as per cent of GDP would cost us a lot in the longer run – not to mention that it could become counterproductive by pushing up the saving rates of European households. Our citizens know quite well that someone will have to pay in the future for any current fiscal profligacy.

The upshot of all this is that the use of the two traditional macro-policy tools for stimulating domestic demand is unlikely to yield sizeable and lasting results, but would surely pile up trouble for the future. So what to do? The short answer is: try to have an influence on investment and consumption by other means. As regards *investment*, two objectives should be pursued simultaneously. First, to entertain an "investment-friendly" climate across the full range of the enterprise sector, but with a special attention towards small and medium-sized firms, which as a group are the only ones likely to create jobs (this has been clearly the case in the United States). The core concern in this field (in addition to the obvious need to significantly reduce the administrative, fiscal and regulatory impediments which hinder entrepreneurial initiatives) is to encourage risk-taking, which means in plain language increasing the rewards in case of success in comparison with the penalties in case of failure. The second objective is to raise not only the level of, but also the return on, investment – this is what economists call, in their user-unfriendly jargon, the "reverse of the incremental capital-output ratio". Here the obvious tool is the generalised use of information technology which, after a very long time-lag, has now begun to yield unquestionable results: this is also a lesson to be drawn from the US experience. As regards *consumption*, the key word is "confidence", or rather the lack of it. Many of our European citizens are worried about their future – and therefore save quite a lot – because on the one hand they are fully aware that the European social models (there are several of them, but all are based on social solidarity) badly need repair, but on the other hand they either do not see the beginning of a genuine reform process, or they fear its outcome. The bulk of the reforms will have to be conceived, agreed upon and implemented within national borders – but their success in relieving anxieties and therefore restoring consumer confidence could much gain by agreeing on broad principles at the European level, and even more important, by eliminating those major differences in national approaches which would be liable to lead to conflicts in areas of common interest.

To cut a long story short, such supply-side measures would have a stimulating impact on demand. At the same time we need also "supply-side" or "structural" measures to raise the rate of growth of labour productivity to levels that would allow an acceleration in the rate of expansion of European *potential* output. It seems to me that two major factors have been responsible for allowing the United States to achieve simultaneously a significant increase in the rate of growth of labour productivity and large-scale net job creation. One has been the traditionally high degree of labour mobility, which implied both job destruction and job creation, but with the second exceeding the first. The other factor has been the generalised deregulation of business activities, affecting to a very large extent the services sector.

If we want to emulate the US example (which I believe we should), we encounter a major challenge: how to preserve our tradition of social solidarity which seems to clash with the requirement of labour mobility or, to put it bluntly, with the freedom to "hire and fire"? For there should be no doubt about the fact that in this respect our traditions are radically different from those prevailing in the United States; and I believe that despite all our intra-European diversity regarding our "social models", there is a shared attachment in all European countries to some kind of social solidarity. I regard the respect of this solidarity as a core component of our European identity.

The crux of the matter is that the acceptance of a strong social safety net cannot mean in a world of accelerating structural changes that everyone has the right to keep his or her actual employment. But then it *should* mean that he or she has the right to expect receiving effective help for finding a new job. The implications of such a commitment are manifold, and costly. It does involve receiving adequate unemployment compensation; it means large-scale re-training facilities; it also means financial assistance for enhancing geographical mobility; and most of all re-shaping our educational systems with a view of improving the adjustment capabilities of those entering the labour force. It also implies that impediments for hiring should be removed – most important, the major disincentive for hiring which results from the scandalous discrepancy between net employment income and the cost of employment to the firm. Quite a challenge ahead.