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Europe and Globalization: Some Reflections about the Main Challenges

Globalization generates opportunities and challenges. This applies to all regions and countries including Europe. The idiosyncratic European dimension lies in the global poor record of the EU and the euro zone as far as growth and employment are concerned.

The purpose of this contribution is to highlight the main goals and policies which could improve the net outcome of globalization for European countries.

The Relevant Goals

Increasing Potential and Actual Growth

Europe has to deliver more growth and employment in order to post a better economic and social record and also to get more political support from the public opinion in the member countries. Growth is a pre-requisite: with a 1% growth, distribution effects are close to a zero-sum game, whilst a 3% growth could generate even from the viewpoint of redistribution "win-win" solutions.

Potential growth in the euro zone is currently estimated to be about 2% per year, to be compared to 3.5% for the United States. Therefore in 2006 actual growth in the euro zone will come back to potential growth, filling the output gap which was significant in 2005.

The main challenge for Europe and the euro zone in particular is to increase potential and actual growth possibly to 3%. This is not a short-term goal and does not rely mainly on Keynesian demand policies. It is a medium- and long-run objective which involves at least three main aspects:

(i) Demography. In all countries, with some leads and lags, the demographic component of potential growth is going to evolve in the wrong direction due to the combination of ageing population (being in itself a favorable evolution) and low fertility rates. Long-term forecast (up to 2025–2030) of European potential growth are quite disturbing. In order to face both economic and social challenges, the EU will have to set up

the first elements of a common immigration policy (including its Euromed component). Today we are far from such a qualitative step.

(ii) The quantity of work. In many EU countries it will be crucial to offset the negative demographic trend by increasing the rate of participation of the labor force for both men and women, delaying the age of retirement (see Germany), allowing more flexible labor organization (see the willingness in France to circumvent the original rigidity of the 35-hour week), etc.

(iii) Productivity gains. In the recent period many EU countries have been posting some acceleration in labor productivity gains. Nevertheless there is still a productivity growth gap vis-à-vis the United States mainly due to the low pace of R&D, innovation and investment in information and communication technologies in many European countries. In order to boost productivity gains EU countries have also to improve the quality and the competitiveness of their education and academic system.

Many theoretical arguments but also empirical evidence illustrate the fact that we cannot decouple structural policies (such as employment policy, innovation policy …) from macroeconomic policies. When potential growth in Europe is at 3% (instead of 2%), the role of the policy mix will be, through budgetary and tax measures, the ECB monetary policy, … to reduce the standard deviation of the output gap. Given the bequest of the past and the role of hysteresis effects in the labor market, a sustained 3% growth is necessary – but not sufficient – to reduce structural unemployment and the NAIRU at least in the major euro zone (Germany, France, Italy) but also in many other European countries.

The Search for New Comparative Advantages

Globalization and the rise of large emerging countries (China, India, Brazil, etc.) lead the most advanced countries to find new Ricardian comparative advantages. Europe cannot count on wages and prices deflation to cope with the tough competition from low-cost and in some cases (e.g., China) undervalued currency countries. Wage deflation would be the worst solution for Europe, from both the economic and political viewpoint. Innovation – both product and process innovation – rather than deflation. Speaking today in Vienna, may I assert that under the present circumstances it is more relevant to be Schumpeterian than Keynesian, Monetarist … In effect Schumpeter was the most prominent economist to capture and underline the supply-side factors (R&D, innovation, profitability …) which jointly condition potential growth and international specialization.

Process innovations are decisive but we must not underestimate the role of product innovations. For example the future of the textile industry in Italy, France but also in Morocco, Tunisia … facing tough competitive pressures from China and India lies in their capacity to accelerate high-quality product innovation and to keep some reputational advantages issued from trade-marks.

The Relevant Policies

The Necessary Revival of the Lisbon Strategy

In 2000 the Lisbon European summit rightly pointed out a strategy to boost growth and employment. Quantitative targets have been selected including the overall R&D ratio (3% of GPD by 2010) and employment ratios. As well documented by the Wim Kok report and several other studies the Lisbon strategy has been until now a great disillusion. Why such a failure? Several factors have interfered: the "free rider" strategy, each member country counting on positive externalities generated by the other countries initiatives; the prevalence of myopic attitudes from public decision-makers, a structural hindrance which is aggravated by the political cycle; the lack of clarity and pedagogy about Lisbon.

However the Lisbon agenda is still the relevant one for the present and the future to boost potential growth and to improve international specialization of the enlarged EU zone. A true revival of the Lisbon strategy implies to fulfill several conditions. I cite here some of them.

1. Strengthening the SMEs is one of the priorities. The implementation of the Small Business Act (SBA) and the Small Business Administration since 1953 has been instrumental in the United States to boost R&D and innovation in those firms. Since a national SBA is not compatible with the Single Market we have to adopt it at the European level and to make it effective despite some reluctance from several WTO partners. More SMEs must benefit directly from public orders instead of being only sub-contractors of large firms.
2. Tax incentives could help private firms to reach the combined Lisbon-Barcelona target (the overall minimum R&D 3% ratio must be equal to 1% for public R&D plus 2% for private R&D). Given the necessity for many euro zone countries to reduce their public sector deficit and debt, the appeal to these tax incentives means some redeployment in the tax system and a greater control on public expenditures.
3. The debate is still open concerning the optimal competition policy in Europe. On the one hand it is important to keep protecting the European consumers. On the other hand, given the pace of consolidation elsewhere (in the United States, Japan, China …), Brussels must not veto further concentration in many sectors (industry, banking …).
4. The search for more competitive universities is crucial. If we want to get European Harvard, MIT, Stanford …, we better reach some critical size for our universities and count on economies of scale. Therefore the main competition is not between the Sorbonne in Paris and the University of Bonn,

or between Bocconi in Milan and Pompeu Fabra in Barcelona. It has to do with our collective capacity to implement an effective and credible intra-European partnership in order to catch-up vis-à-vis the best US universities and to cope with the upcoming academic and research competition coming from China, India …
5. The financing of the Lisbon agenda is very often presented as the main constraint and hindrance for its implementation. Most of the financing must come from national sources which is fully consistent with the fact that the subsidiary principle applies to most of the items which are involved. There is no trade-off between the Lisbon agenda and the respect of

the stability and growth pact provided that public expenditures are better controlled. However the EU must generate a leverage effect. Here I have in mind two aspects. First, the European Investment Bank must borrow more on capital markets and allocate the extra-financing to the implementation of the Lisbon goals. Private savings is abundant in Europe; it could be more and better invested in R&D, innovation, etc. There is much potential for a rapid growth of private equity financing but also the financing of large-scale infrastructures. This new role for the EIB has recently been endorsed by the European authorities. Now it is the right time to start to deliver. Second, the debate concerning the EU budget must remain open. Would it be a real problem for the European governance if this budget were passing from 1% to 1.5% of the EU GDP and if the increase were entirely due to the financing of some of the Lisbon goals? I know that in 2005 Tony Blair emphasized the trade-off between the financing of the CAP and the financing of Lisbon. I do not underestimate the necessity to accelerate the reform of the CAP but in this matter we have to be pragmatic and cooperative rather than ideological and conflictual.

What to Think of the New Social Paradigm?

Ten years ago, the Dutch social model was fashionable because it gave the means to remove or at least moderate the dualism in the labor market by creating some solidarity between the "insiders" and the "outsiders." Nowadays the Danish social model is the new paradigm, combining labor market flexibility with a relatively high degree of social security for the individual. According to André Sapir[1], the "Nordic" model is currently the only one to combine both equity and efficiency. It provides generous unemployment benefits against relatively low employment protection legislation (i.e. high flexibility). The budgetary cost of such a system has also to be taken into account.

For many EU countries posting a too rigid labor market and a high NAIRU, the "Nordic" model could be very attractive in the medium and long-run. The transition from a "Continental" system (low efficiency, high equity) or a "Mediterranean" system (low efficiency and equity) to the "Nordic" model generates transition costs (which are economic, social, psychological …) and distribution effects between the losers and the winners. Both effects must be considered and very often a high rate of time discount, reflecting a high degree of myopia of public and private decision-makers, combined with the political cost of the transition creates a *de facto*

[1] *Sapir, A. 2005. Globalisation and the Reform of European Social Models. Bruegel Policy Brief. November.*

preference for the status quo. The social contest in France about the draft CPE ("contrat première embauche") in March-April 2006 offers a good illustration of the transition cost and collective preferences for the status quo.

The J-curve impact of many structural reforms is sufficiently well documented: the costs for now and the short term, the benefits for the medium and long term. As regards the reform of the labor market, more pedagogy concerning the goals and the means of the reform but also some compensation schemes in favor of the losers could improve the cost-benefit outlook and enhance the support from the public opinion. From this viewpoint, the timing, sequencing and intertemporal consistency of structural reforms are crucial. Another lesson to be drawn from the recent OECD literature is that the deregulation of the labor market and the deregulation of the goods markets are not separable. They must be fully integrated with each other.

Implementing the Single Market

Regarding the Single Market in Europe there is still a significant gap between the goals and the reality. The lack of fair competition and/or harmonization, the obstacles to a real "level playing field" in many sectors (including the most integrated sectors like banking and financial services) could jeopardize the very notion of a Single Market. In the short run, several issues are going to test the effectiveness and the credibility of the internal market exercise.

1. The implementation of the new version of the services directive is going to be essential for the reality and credibility of the "level playing field" goal. The transition from the home to the host country rule was necessary; it is not sufficient. As regards services (which amount to 70% of GDP in most EU countries), the Single Market has to deliver from now.
2. What is the optimal balance between the two ways for more tax convergence – the market (tax competition) and the political process at the European level (tax harmonization)? The issue is always there, not too often explicited. However the unanimity principle which remains the rule for tax issues means that the probability of any significant harmonization measure is very low for the EU-25, still lower for a larger EU. Therefore we must acknowledge that the Commission is right and realistic when it focuses the intra-EU tax negotiation on the very definition of tax bases (for corporate income tax …) rather than on the convergence of tax average and marginal rates.
3. The outcome of the "battle of the stock exchanges" is still unknown. Concerning the future of Euronext and Deutsche Börse, we do not know yet which scenario is going to prevail and whether transatlantic links (with the NYSE, or the NASDAQ for the LSE) are conducive or an obstacle to further European capital markets integration. Nevertheless we are sure of two arguments: 1) Given the importance of economies of scale in financial markets, the Single Market and the euro will continue to push in the direction of more financial inte-

gration. The transition to a single stock exchange in Europe is not purely hypothetical provided that the UK be in the euro zone (still a remote perspective!) and this stock exchange functions as a very decentralized network (or "club") of the major financial centers in Europe. 2) In light of the US experience, we could assert that the competitiveness of firms in Europe is going to be positively correlated to the competitiveness and the degree of liquidity of European capital markets.

The Context: The Need for European Economic and Political Governance

The opportunities and benefits generated by globalization are much higher than its costs. In order to get the maximum from globalization, the EU and the euro zone in particular must improve their economic and political governance systems which are significantly lagging behind the degree of economic, financial and monetary integration. Several aspects have to be improved : the proper implementation of the new version of the stability and growth pact, the transparency and the accountability of the ECB, the dialogue between the ECB and the Eurogroup, the deliberative power to be given to the Eurogroup, the proper working of the Single Market, etc.

The draft constitution is dead. We better acknowledge it, since in both economic and political terms Europe has no time to lose. For the next couple of years, I would advocate a bottom-up approach rather than the classical top-down one. Namely, the tense energy configuration and the environmental objectives and constraints give an opportunity for Europe to rebound from concrete challenges and to get more support from the public opinion. Despite the fact that I am French, I am and want to stay pragmatic …