

1 The Continuing Evolution of Europe: Introduction and Overview

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The economic history of Europe is closely intertwined with the enlargement and deepening of the European Union. This body of institutions has evolved in rapid succession from the European Communities of the 1960s, a grouping of supranational institutions that fostered economic integration among a few Western European nations, into a new upper tier of government affecting the policies of twenty-seven member states in almost every sphere of government activities. Given this institutional setting, one might think that Europe is well prepared to face new challenges. This, however, is not the case. The financial crisis has resulted in a substantial increase in economic imbalances in Europe, necessitating the introduction of several “rescue packages” intended to stabilize financial markets in Europe, and convincing solutions to the crisis have not yet been found. At the same time, the global challenges faced by the European Union are mounting. Economic growth is relatively slow, presumably resulting from a lack of innovation, the promotion of national and European champions, labor market rigidities, the aging of the population, and overregulated markets. Finally, the European institutional framework seems inadequate to meet these challenges and often tends to hamper the implementation of new policies and reforms.

With regard to the diagnosis of these problems as well as to possible remedies, the CESifo Research Network, a leading network of economists in Europe and worldwide, recently launched a project to provide a forum for the exchange of relevant ideas. This book brings together overviews of the issues and in-depth analyses of key problems and possible solutions.

Rather than trying to cover all the politically relevant topics, our goal is to address key issues pertaining to the main economic challenges faced by the European Union: the financial instability, lack of growth,

costly welfare state, inadequate institutional framework, protection of national interests, and relationship between internal and external economic integration. The following pages provide a brief overview of the main issues the book covers.

The Financial Crisis: A Risk for the Euro Area

While individual countries are affected differently, the financial crisis has had and still has a substantial impact on public finances in Europe. Some countries, notably Greece, entered the crisis with a huge amount of public debt and now have trouble sustaining their fiscal policies because interest rates on their government bonds have increased substantially. The attempt of European countries to stabilize their economies during the sharp recession that followed the financial crisis also caused a large increase in public debt. The real threat to the financial stability of Europe and of the eurozone, in particular, however, comes from the fragility of the European banking sector. Not only did some national governments—Ireland, in particular—provide large support packages to their struggling banks, resulting in huge public deficits. Since the whole European banking sector is struggling with the aftermath of the global financial crisis, the increased risk of sovereign debt default in Europe triggered drastic actions, especially by the eurozone. The European Central Bank was forced to compromise key principles and to buy troubled government bonds.

The fiscal difficulties in the European Monetary Union reveal important deficiencies of European institutions. Currently, EU institutions are failing in three respects. The Stability and Growth Pact is not able to guarantee the stability of public finances. The Maastricht Treaty—apart from the no-bailout clause—did not provide for a crisis management mechanism. And the national boards of control are not in a position to guarantee the stability of the banking system.

To address these deficiencies and to propose effective measures, the European Union created a task force that recommended steps designed to strengthen budgetary discipline among the EU member states, improve economic-policy surveillance, and forestall and manage future financial crises in Europe. However, the instability of the European financial system has been left unaddressed by the so-called Van Rompuy Task Force.

In chapter 2 Paul de Grauwe and Frank Westermann focus on the financial markets, an area where regulation is crucial for stable

development. They begin with an account of recent developments in European financial markets, then home in on the market failures responsible for the financial crisis in Europe as well as in the United States. Two policy questions arise: What is an appropriate short-term response to the current financial crisis? And how can the financial sector be reformed to reduce its vulnerability to financial crises in the future? Two long-term policy options are considered: strengthening the Basel Treaty and returning to narrow banking—that is, to the Glass-Steagall Act approach. Finally, the European proposals for reform are discussed.

It seems fair to say that the financial crisis resulted from excessive risk taking in the banking sector. Several market failures are responsible for this excessive risk taking. From a microeconomic perspective, information asymmetries between shareholders, bank depositors and so on, and the bank management have been decisive. From a macroeconomic viewpoint, systemic risk can arise when either currency mismatch or maturity mismatch is present in the aggregate balance sheet of the banking system. And, finally, implicit bailout guarantees create moral hazard and excessive risk taking.

The financial crisis has triggered some of the largest government rescue operations in the history of several European countries. Central banks have performed massive liquidity infusions; governments have introduced state guarantees on interbank deposits and have recapitalized banks. The interventions have been successful, but will they bring the banking system back on track so that it can perform its function of credit creation?

As to the future regulation of the banking system, strengthening the Basel Accords has the advantage of tackling the problem of the banks' insufficient equity at an international level, thereby preventing competition among national regulators. Currently, however, this approach has serious shortcomings. The possibility of using internal risk models and the variety of definitions of capital create important loopholes that prevent effective monitoring of the banks. That is why the current Basel approach must be rethought.

A policy option that would reduce the amount of risk taking would be a return to narrow banking. This would limit commercial banks' ability to accumulate high-risk assets on their balance sheets. Only they would be eligible for a government bailout, while all other financial institutions would not be. High-risk activities would be reserved for investment banks, which would be required to finance these activities

via funding in the capital markets. The opportunity to streamline regulations and supervision at the EU level has not yet been utilized. National authorities are still the main driving forces in the reform of bank regulation and supervision. This decentralized approach has important shortcomings, however. Regulatory arbitrage within the European Union remains in place.

Global Constraints

Getting public finances back into shape and overhauling financial market regulation and supervision should have top priority at the moment. But according to the European Commission's program "Europe 2020," Europe must also strengthen its economy for the future. The program calls on Europe to free up its growth potential. One element of the European Union's strategy is to remove obstacles in the internal market to increase mobility of people, services, and investments. Obstacles still exist. The European Commission's ambitious Service Directive may serve as an example. Launched with the aim of further reducing entry barriers to national markets, the governments' agreement that would have helped to open the markets for services was only passed in a less ambitious form by the European Parliament.

Whereas much attention in the debate about the construction of Europe is devoted to the challenges that arise from increased economic integration, Peter Egger and John Whalley in chapter 3 emphasize that European integration and growth are increasingly challenged by global constraints. Emerging economies such as those of China and India will not only play an increasingly large role in international trade but will also continue to attract huge amounts of foreign direct investment. Europe will therefore face growing external pressure toward improving the competitiveness of the European economy. Production in Europe will be subject to further internationalization and will display continued growth in international outsourcing, including countries outside the European Union, notably Asian countries. Growth in other parts of the world will tend to diminish Europe's role in important markets, not only in financial markets but also with regard to natural resources. Europe's diminished clout in the world economy also has implications for its potential to negotiate in important challenges such as environmental protection and global climate change. All this suggests that Europe cannot meet the challenges of the future by continu-

ing on the inward-looking integration path that has dominated its policies for the last fifty years.

Industrial Policy: The Role of National Champions

Another element of the “Europe 2020” growth strategy is investments in key sectors. Such investments are supposed to create growth and jobs in the future and bring a decisive competitive advantage. Christian Gollier and Ludger Woessmann in chapter 4 focus on industrial policy. Globalization has raised pressure on European governments to protect national firms from foreign takeovers, to promote national or European champions, and more generally to reinstall a strong industrial-policy agenda. In many political circles in Europe it is assumed that national champions assisted by the state are best for promoting employment and growth. In this chapter, the economic arguments for and against an industrial policy that favors the emergence of national or European champions are reviewed.

The beggar-thy-neighbor type arguments of the static model of imperfectly competitive markets are criticized because countries aim at capturing rents from other countries. In equilibrium each national government will inefficiently encourage national firms to become global champions and will end up in a prisoners’ dilemma situation. Every country would be better off with transnational coordination and supervision of champion-related policies. An “arms race” of national policies to promote their champions should be prevented.

Other arguments against champion-promoting policies are based on economic-policy considerations. There are many reasons to doubt that picking winners takes place efficiently. Politicians find it difficult to resist implementing inefficient actions that benefit well-established firms with political power if the costs are borne by a large group of more or less uninformed citizens. Furthermore, they are in favor of prestigious projects and face difficulties withdrawing support once it is given.

Finally, the infant-industry arguments of dynamic innovation models are not convincing either. In most cases the promotion of national champions seems less effective in creating innovation and growth than liberalizing policies that foster competition, especially since many of the “national champion” policies in EU countries are not about innovative sectors but about mature or declining sectors.

In concluding, Gollier and Woessmann note that all these arguments tend to suggest that European countries would be better off if their governments did not promote national champions.

Reforming the European Welfare State

A third element of the European growth strategy consists of reforms of rigid labor markets and ineffective social protection. Martin Werding and Kai A. Konrad in chapter 5 analyze labor market regulations and public transfers, which are often perceived as having adverse effects on growth performance and as impeding adjustments to new challenges in the era of globalization. Although they acknowledge that the European welfare state is confronted with problems and needs to be reformed, they see basic merits in its potential for improving efficiency as well as for promoting an equitable distribution of income and opportunities. There is, however, a need for reforms so that the welfare state can continue to play a positive role in the future.

Three major sets of issues are identified as deserving special attention with regard to reforms: labor market performance and labor market policy, the impact of an aging population on social protection schemes, and the opportunities and risks involved in extended international migration. As to the first, strategies for increasing employment should rest on two pillars. On the one hand, countries should increase the attractiveness of capital investment. On the other hand, labor market policy should be geared toward activating the unemployed. Elements of flexibility in the utilization of labor should be combined with elements of worker security and complemented by a continuous activation of the unemployed, with in-work benefits and workfare measures as the most prominent instruments.

The aging of the population is considered a threat to the long-term sustainability of public pension schemes, public health funds, and public finances in general. An appropriate balance must be sought between burdens imposed on the old and the young. In recent years, many European countries have made considerable progress in reforming their unfunded systems for old-age provision, mostly by reducing benefit levels that will take effect over the next two to three decades. Similar problems involved in healthcare systems are largely unresolved. With respect to old-age provision, partial funding through higher precautionary savings of younger cohorts forms an important

part of many reform strategies. The same approach should probably be extended to the health sector.

With respect to designing migration policies in a European context, migration inside the European Union has to be distinguished from migration from outside. Within the current EU-27, the principle of free mobility of workers and their families will be applied without further restrictions starting in 2014 at the latest. Whereas fears regarding the impact of migration on labor markets in such a free-mobility regime are misguided, the impact on social protection systems can be truly harmful. Migration can result in an international “race to the bottom” of social protection. Coordination of social policy at the EU level may need to be considered. New approaches may also be needed to actively manage the immigration of non-EU citizens and to shape the size and structure of future immigrant networks.

Reforming Institutions and the Public Sector

The performance of the European Union has been particularly poor with regard to reforms of European institutions. Initiatives to introduce a basic constitutional framework that would improve decision making in Europe and at the same time increase the role of the parliament have been stalled by several referenda, and the success of current attempts to rescue the main provisions of the agreements is still in doubt.

In chapter 6 Massimo Bordignon, Thiess Buettner, and Frederick van der Ploeg turn their attention to the role of the institutional framework in hampering or fostering the implementation of new policies. The chapter starts with a discussion of decision making in the European Parliament and other key EU institutions, highlighting voting, budgeting, and the implementation of European legislation as national law. While the European institutions can be credited with important achievements—in particular, with regard to the integration of the markets in Europe—progress in the quality of integration has slowed down considerably. Further reforms are needed to enhance innovation and growth in Europe; however, there are substantial problems with the key institutions and in the balance of power between them that explain why reforming European policies has proved so difficult.

Bordignon, Buettner, and Van der Ploeg argue that a thorough reform of European institutions is a precondition for a reassignment of responsibilities between supranational, national, and local governments in Europe. Such a reform process is not only necessary from the viewpoint

of standard prescriptions of an abstract theory of fiscal federalism but is also demanded by European citizens, as the analysis of survey data suggests. The tensions between European politics and the demands of the European people are reflected in a growing anti-European sentiment. Dismissing suggestions to transform Europe into a full-blown federal state, the authors argue that a reasonable strategy to reconnect European policies and Europe's citizenry would be to revitalize European politics and to empower the European Parliament—for instance, by giving it the right to elect the president of the Commission.

What conclusions can be drawn from the analyses presented in this book? Key findings include the following. A solution to the financial crises requires not only budgetary discipline but, above all, effective regulation of the banking system. In addition, a strategy for increasing the European Union's growth potential needs to be implemented. Such a strategy should take global considerations into account. A purely inward-oriented integration process is not a substitute for global integration. Europe's international competitiveness requires a competitive internal environment without the promotion of national champions. Reforms of rigid labor markets and of social welfare systems would also influence competitiveness and growth positively. Despite recent institutional changes, reforms of the decision-making processes of key European institutions and a reassignment of responsibilities between supranational, national, and local governments remain of the utmost importance. These reforms are crucial for ensuring that Europe continues to evolve into a model for international cooperation and serves as an anchor of stability, democracy, and peace in the world.