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Regime change? The European economy to 2030

by John Springford

"Europe will be forged in crises, and will be the sum of the solutions adopted for those crises." Five years before Jean Monnet wrote those words in 1976, Richard Nixon had suspended the convertibility of the US dollar into gold, bringing an end to the Bretton Woods system of fixed exchange rates. The breakdown of Bretton Woods led to currency instability in Western Europe, which in turn curbed trade and investment. Monnet was writing as the 1970s oil price shocks pushed up inflation. Europe's weakly contested goods and labour markets, which were still fairly closed to foreign competition, made Western Europe's economies slow to adjust to shocks.

The EU's current economic regime is the sum of the solutions adopted after the 1970s crises. The European Economic Community established the Exchange Rate Mechanism in 1979, which first reintroduced a managed exchange rate regime in Europe, and culminated in the single currency. The 1986 Single European Act sought to raise trade and investment through common rules and tougher enforcement, thereby making the European economy more efficient. After a decade of putting out the fires of the Great Recession of 2008-09, the euro crisis of 2010-12, and the migration crisis, which blew up in 2015, it is the right time to ask: what regime does the European economy need by 2030?

Europe's economy is finally recovering, with the EU as a whole now growing in line with pre-crisis rates. Investment has picked up strongly, raising hopes that a decade of disappointing productivity growth might finally be over. But, after the present bounceback, the European economy looks set to grow more slowly than it did before 2008 – thanks to an ageing society and the scars of the crisis.

Meanwhile, big economic changes are afoot. The next phase of globalisation, driven by digital technology, will see services become more tradable across borders. German technicians may soon be able to fix machinery in China remotely, using telerobotics, for example. Automation and artificial intelligence may help to drive up productivity growth but will also displace some workers. And if history is any guide, there will be two more recessions in the next decade – yet the eurozone still lacks the counter-cyclical tools needed to rapidly stabilise its economy.

The movement of people within the Union is lessening, but young, skilled workers migrating towards the core of the EU economy have implications both for economic convergence and for the sustainability of welfare states in the member-states they leave. Meanwhile, immigration into Europe looks set to continue at a high rate, and may accelerate: the bulge of young people in Africa and the Middle East is much larger than that of Latin America in the 1970s, 80s and 90s. The latter led to faster rates of immigration to the United States and contributed to the radicalisation of the Republican party.

All of these trends have implications for European growth as a whole; whether poorer countries can continue to catch up with richer ones; and whether the European project will survive politically. Unlike in the 1970s, solutions to the EU's current problems require the Union to get involved in distribution – of the costs and benefits of technological change; of the burden of adjustment to recessions; and of migrants from outside the EU between member-states.

Technological change – and continued offshoring – will make it harder for poorer EU countries to pursue an export-based industrial growth model. The proportion of European workers employed in industrial jobs has fallen, even though industrial output has risen. The EU will continue to use competition policy and create standards and regulations to try to stop digital monopolies from damaging consumer interests. But it could also do more to prevent most of the production of new digital technology from taking place in the US and China. More EU and national funds could be spent on science and the development and dissemination of new technologies across the economy, rather than on physical infrastructure and farm subsidies. EU funding should be awarded to the institutions and companies most able to use it effectively, which will probably be in richer member-states, raising questions about the industrial strategies that poorer member-states can pursue.

The eurozone has created so much tension since 2010 because the member-states had to decide who paid for the debts incurred in the run-up to 2008. Such distributional issues have historically been the preserve of nation-states, in which democratic politics could determine the winners and losers. The eurozone crisis led to bail-outs of both the European banking sector and the Greek state, and the European Central Bank has succeeded in lowering interest rates in southern Europe through the Outright Monetary Transactions programme (by which the ECB promised to buy the sovereign debt of a member-state on the brink of default) and quantitative easing (whereby the ECB buys up the sovereign debt of all member-states in exchange for newly created money). But debtors have not been allowed to default. Such heavy debt burdens are manageable now, but the ECB may not be able to keep sovereign borrowing costs down in future recessions. If the euro area countries cannot agree to a deposit insurance scheme and a meaningful resolution fund for banks in distress, member-states risk being dragged down by failed banks based in their jurisdiction. So far, Germany, the Netherlands, Austria and other countries have successfully stymied attempts to share the costs of recessions more evenly between creditors and debtors. The two recessions due between now and 2030 may force the issue.

The politics of ageing, slow-growing societies also tend to be dominated by distributional issues. This is a particular concern for countries such as Germany, Italy and some Central and Eastern European states, which have low birth rates or high rates of emigration. For poorer member-states, the continued loss of young skilled workers will slow their rate of convergence with rich ones.

Disorderly migration across the external border of Schengen has led to rising support for nativist, anti-EU parties, largely because of distributional issues: Italy and Greece sought solidarity from other member-states, but Poland, Hungary, the Czech Republic and many others have taken in very few asylum-seekers from Greece and Italy. In the long-run, the pressure to co-ordinate member-states' migration and asylum regimes more closely is likely to increase. Migrants and refugees granted citizenship in one EU country have the right to move to others; and migration to the EU is likely to rise, not fall.

Over the next two years, the CER will be conducting a research programme on the European economy to 2030, which will be run from our new Berlin office. By focusing on the long-run trends that will shape the European economy, we hope to provide a strategy for European policy-makers, who have spent the last decade fighting crises. It seems likely that the EU will have to become less technocratic, and while the EU will continue to focus on efficiency, institutions and rules will be needed that allow it to distribute the costs and benefits of economic change in a way that national publics consider to be fair. That will not be an easy task, but we will try to offer some guidance.

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The EU's problem with May's plan for Brexit

by Charles Grant

Theresa May's scheme for the future UK-EU relationship has been attacked by both pro- and anti-EU Conservatives, which makes its passage through Parliament problematic. Yet the prime minister has proved resilient over the past two years and if any plan for Brexit can scrape through Parliament, it is likely to look something like hers. Whatever the views of British MPs, the scheme cannot work without the support of EU leaders. And their initial reaction, though polite, is negative.

May's white paper on Brexit would keep the UK de facto in the single market for goods and agricultural , as a rule-taker, and in something with the characteristics of a customs union. This would remove the need for border controls post-Brexit, thus protecting manufacturing supply chains and resolving the issue of the intra-Irish border. Service companies would have to cope with poorer access to EU markets, but May thinks the UK financial services industry is too big and important to be a rule-taker. May is probably right that her plan is the least-bad model for the UK economy that might work politically.

But the EU dislikes the idea of the British being in the single market for goods alone. It believes the four freedoms are indivisible: the UK cannot be in the market for goods without accepting free movement of people (as well as services and capital). It frets that if the bloc makes an exception for the UK, others – inside or outside the EU – will ask for special treatment, thereby undermining the institutional strength of the Union.

The European Commission emphasises that these days it is hard to disentangle goods and services, given that the latter contribute so much to the value of the former (consider the design, financing, marketing and servicing of a jet engine). And if the UK were free to undercut EU standards on services (say by regulating in such a way that business received cheaper credit) it could distort the level playing field for goods. This is not the strongest of arguments, given that the EU does not regulate many of the services involved in making goods. But it reflects the EU's great fear that the UK may undermine the level playing field by lowering standards on social, environmental, consumer and competition policies. The UK has promised not to do so but that is not good enough for the EU, which notes that the UK has not pledged to adopt any new standards that may emerge in these areas.

The EU worries that the UK is asking for something close to the Swiss model: Switzerland

Image: © European Union, 2018

is in the single market for goods but not services. The EU dislikes that model since the European Court of Justice (ECJ) cannot enforce its rulebook on the Swiss (who are resisting the EU's attempts to impose a new dispute settlement system that would involve the ECJ).

The Commission views May's plan for a 'facilitated customs arrangement' (FCA) – the complex, high-tech scheme for the UK to collect customs dues on behalf of the EU – as unworkable. It would have helped if she had spelt out her evident intention to stay in a customs union until the FCA works (if it ever does).

The Commission worries even more about the UK's proposals on governance. The white paper says the UK will "pay due regard to ECJ case law" for areas covered by the common rulebook, and that Parliament will normally update the rules as they change. But the Commission wants a more overt role for the ECJ and some involvement for itself in enforcement. It wants more automatic procedures for the UK to adopt additions to the rulebook. It does not like the British proposal for independent arbitration panels that would bind EU decision-making in certain areas. The white paper suggests that the EU should be able to fine the UK or suspend part of the agreement if it refuses to update a rule, but the EU regards that as insufficient to deter the British from deviating.

The line in Brussels – in the Commission and among many member-state representatives – is that given the UK's red lines (on the customs union, regulatory autonomy, the ECJ, payments to the budget and freedom of movement), the only possible deal is a Canada-style FTA, even if it is packaged into an association agreement, a format favoured by both the European Parliament and May. Is there a chance that national capitals could be open to a deeper relationship?

Some Central European leaders, fearing the geostrategic consequences of a Europe weakened by a hard Brexit, take a fairly benign view of the British plan. The Dutch say they have not yet made up their minds. Some Irish ministers sound positive, as do some Belgian politicians. Some continental companies, such as those making cars and aeroplanes, would like to keep the UK in the single market for goods. However, many European business lobbies take the line that the integrity of the single market matters more than a bit of lost trade with the UK.

A number of ministries in national capitals think the line set by the Commission, the Chancellery and the Elysée on Brexit is too tough. Thus Horst Seehofer, Germany's interior minister, has complained that the Commission's attempt to keep the UK at arm's length on security co-operation could endanger public safety. But the way the EU has organised itself appears to make such views peripheral. The national officials in Brussels with whom the Commission deals tend to be generalists working for prime ministers rather than specialists from particular ministries. So far there is little evidence of member-states seeking to soften the Commission's line on Brexit.

Some EU officials see no need to reject May's plan formally; their priority is to get the UK to sign the withdrawal treaty, and they hope that a vague and sketchy political declaration on the future relationship – attached to the treaty – will suffice. But Britain's Parliament will not accept a withdrawal agreement that includes the Commission's 'Irish backstop' – leaving Northern Ireland in a regulatory union with the EU, if no other solution to the Irish border is found – without a declaration describing a plausible way of avoiding the backstop.

Ireland remains the most difficult issue in the Brexit negotiations. The EU cannot accept a land border in Ireland and the UK will not accept a sea border between the two islands. French officials suggest the latter would be more palatable for the British if the UK stayed in a customs union; there would still need to be checks for compliance with single market rules but these could be less obtrusive and strict than at other EU frontiers. But many British politicians would still see that as a threat to the UK's constitutional integrity. The strongest argument for May's plan is that it would ensure no hard border in Ireland or the Irish Sea.

Faced with the prospect of a no-deal Brexit, the EU might show some flexibility. But May would have to make concessions. She would need to commit to a customs union until some high-tech alternative became viable, a stringent mechanism for following new EU rules and a significant role for the ECJ. She has indicated flexibility on all three points. But she would find it harder to cede on payments to the EU and free movement of labour (both of which Norway and Switzerland accept as the price for market access). May's dilemma is that the paler her red lines become, the greater the risk that Conservative MPs will vote against her.

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Dead or alive? A UK-US trade deal

by Sam Lowe and Beth Oppenheim

In his infamous interview with *The Sun*, US President Donald Trump warned that Theresa May's Chequers plan would "kill" a trade deal with the US. He later backtracked, but the president was right the first time.

May's proposal involves regulatory alignment with the EU on goods. Some EU rules conflict with America's, making a trade deal with the US very difficult to conclude. However, it remains overwhelmingly in the UK's economic interest to prioritise a close economic relationship with the EU over any potential trade deal with the US.

The government's recent white paper commits the UK to follow the EU's rulebook on goods and food. Additionally, it would see the UK remain in a de facto customs union with the EU until new systems could be agreed. These systems would allow the UK to apply its own tariffs at the border, alongside the EU's, depending on the final destination of an imported good. The prime minister hopes that such a partnership would obviate the need for additional infrastructure and checks at the EU-UK border (including the Irish land border), and secure British manufacturers' position in pan-European supply chains.

But minimising trade barriers with the EU will come at a cost. The EU's approach to goods standardisation and food and plant hygiene (SPS) has been frequently criticised by the US, most recently in its 2018 report on foreign trade barriers. The EU's single standard model for goods is accused of unfairly discriminating against US and internationally recognised alternative product standards. European SPS rules effectively shut out American products like beef, chicken and pork, due to restrictions on the use of growth hormones and anti-microbial washes.

The EU's SPS regime is particularly strict. If a country does not apply EU rules both domestically and in relation to third country imports, all of its exports of products of animal origin to the EU must enter through a veterinary border inspection post, where up to 50 per cent of containers are subject to physical inspections. If the UK were to accommodate American demands, the EU would be required to implement new checks on food imports from the UK, causing serious disruption for British suppliers currently selling, for example, Angus beef into the EU.

Furthermore, the US remains unconvinced that the EU will accept the UK's 'facilitated customs arrangement', viewing it as a stalking horse for a permanent customs union, which would leave the UK unable to unilaterally lower its goods tariffs as part of a transatlantic trade agreement.

The UK faces a harsh dilemma. If it chooses to accommodate American demands as part of a transatlantic trade agreement, it will face a hard border with the EU and potentially on the island of Ireland, and disruption to trade.

The UK will attempt to square the circle. The white paper talks about gaining the flexibility to negotiate with third countries on issues such as mutual recognition of conformity assessment, which would allow a US-based certification body, for example, to confirm that a product produced in the US can be sold in the UK. The UK's Department for International Trade has also had an internal discussion on a carve-out in Switzerland's agreement with the EU, which allows the Swiss to import labelled hormone-grown beef from around the world on the condition that it is not forwarded to the EU market. However, the US is not interested in negotiating new agreements on mutual recognition of conformity assessment and the EU is unlikely to grant the UK the same flexibility as the Swiss. Even if it did, British farmers would be less sanguine about facing potential competition from cheaper US beef than the heavily protected Swiss agricultural sector.

The promise of a UK-US trade agreement has political value, but no economic rationale. It suits May to avoid acknowledging that the Chequers plan is incompatible with a US trade deal. Her Cabinet is split, and she cannot afford to incense hard-line Brexiteers, who view a US trade deal as the big prize of Brexit. The British government's most optimistic estimate is that a UK-US trade agreement would boost the economy by just 0.3 per cent. But the type of Brexit needed to realise the gains of such a trade deal would leave the UK's economy 4.8-7.8 per cent smaller than if it had remained inside the EU, according to the government's own analysis.

It is unclear whether the EU-27 will accept May's proposal, or whether it will survive the domestic political backlash. Dissent is currently raging through Parliament, and May has already been forced to make concessions to the hard-right of her party on the Customs Bill vote. But the prime minister was right to prioritise existing economic ties with the EU over much smaller future potential gains with the US. When caught in a tug of war between two regulatory superpowers, better the devil you know.

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CER in the press

The New York Times
15th July 2018
Ian Bond, a former British diplomat in Moscow who is now director for foreign policy at the **CER** said, "Putin versus Trump is not an equal contest" because of the Russian leader's vastly superior knowledge of policy detail, his mastery of geopolitics and his past as a KGB officer schooled in the arts of persuasion, flattery and subterfuge.

The Times
12th July 2018
Sam Lowe of the **CER** said: "If the UK remains bound by the EU's approach to plant and animal health it will remain unable to address many of the concerns laid out by India, potentially making a far-reaching free trade agreement more difficult."

The Financial Times
24th June 2018
The prime minister is edging towards something that looks much like a single market in industrial goods, to counter the need for regulatory checks at the Irish border – or any of Britain's ports – after Brexit. "It is a proposal under current consideration," says Charles Grant of the **CER**.

The Times
23rd June 2018
The economy is 2 per cent smaller than it would have been had Britain not voted for Brexit, a leading think-tank has claimed. John Springford of the **CER** said that the performance of the economy, compared with what it would have been if the 2016 referendum had gone the other way, was significant.

The Financial Times
19th June 2018
Camino Mortera-Martinez of the **CER** says that Britain is unlikely to retain direct access to Schengen's main law enforcement database, the Schengen Information System. Instead, "the UK could ask Europol or a friendly EU or Schengen country to run searches on its behalf, as the US and Canada do".

The Telegraph
14th June 2018
As Charles Grant, director of the **CER** points out, the single market was virtually a British invention, enlargement was championed by the UK, we essentially wrote the EU's competition and state aid rules, and the current wave of European free trade agreements was a largely British-driven phenomenon.

The Financial Times
12th June 2018
"When MPs vote on Tuesday they should stick to their guns and pass the Lords amendment. It gives them an opportunity to transform parliament from a bystander into an active player in the Brexit talks," wrote Agata Gostynska-Jakubowska of the **CER.**

The Economist
7th June 2018
More worrying, says Sophia Besch of the **CER**, are the implications of going it alone [in satellite navigation] for wider defence co-operation. In January 2017 Theresa May was criticised when she hinted that Britain's future defence relations with Europe might be affected by the terms of any Brexit deal.

Recent events

Camille Grand

29 June
CER/Kreab breakfast on 'The 2018 NATO summit', Brussels
With Camille Grand

22 June
CER/KAS conference on 'Plugging in the British: Completing the circuit'
London
Speakers included: Rosa Balfour, Yvette Cooper, Simon Fraser, Paul Johnston, Claude Moraes, Peter Storr and Nick Westcott

Claude Moraes and Yvette Cooper

Hugo Dixon and John Kerr

20 June
Lunch on 'Is Brexit inevitable?'
London
With Hugo Dixon, Charles Grant and John Kerr

14 June
Breakfast on 'Business and Brexit', London
With Carolyn Fairbairn

Carolyn Fairbairn

Zhang Ming

7 June
CER/Kreab breakfast on 'What can China and the EU do to save globalisation?', Brussels
With Zhang Ming

6 June
Bingham Centre/CER/ Middlesex University roundtable on 'Enhancing the rule of law in the EU', Brussels
Speakers included: Emmanuel Crabit, Sandro Gozi, Zuzanna Rudzińska-Bluszcz and Judith Sargentini

Sandro Gozi

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