CENTRE FOR EUROPEAN REFORM
NEW IDEAS FOR A NEW EUROPE

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Choices for Europe

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Sluggish economic growth, high unemployment, ageing populations, climate change and security challenges on the borders of Europe have been some of the top priorities on the European agenda since the early 1990s. The EU has tried to tackle these issues, notably through its commitments to reduce greenhouse gases and its Lisbon strategy for economic growth. But the solutions offered have often fallen short, largely due to a lack of political resolve. European leaders have been reluctant to see through some of the difficult and costly policies required to ensure Europe's future security and growth.

The economic crisis that has enveloped the world will only make it more difficult for the EU to tackle many of these long-term challenges. European governments will find it harder to address the structural weaknesses of their economies in a period of recession. They also risk devoting less attention to non-economic challenges. The single market could even come under threat – support for greater state intervention is growing. If member-states start to support their economies at the expense of others, the benefits of the single market could be rolled back.

But the current turmoil also presents an opportunity for EU leadership. Voters will be looking for a positive vision amidst the crisis. European leaders should take advantage of this to put in place the difficult policies required to address not only the current recession but also the broader longer-term challenges.

This paper analyses the current main challenges for the EU; explores where Europe may be heading over the next ten years; and suggests policies which the EU should implement if it wants to meet its long-term commitment to a secure and prosperous Europe.[1] It will cover the key policy areas which the EU must tackle: the reform of the single market, the expansion of the eurozone, energy and climate change, migration and demographic change. It will also consider the EU's relations with its neighbours in the east and in the south – two regions which are likely to have a significant impact on the EU in the medium term. The present crisis does not have to – and should not – distract Europe from its long-term priorities.

[1] The paper is published ahead of a conference at the University of Birmingham's European Research Institute on the 'Future of Europe' that is taking place on May 14-15th 2009. It addresses the different policy areas which will be discussed at the conference.

Threat to the single market

There is plenty to worry those who see the single market as key to Europe's future prosperity. First, any hope that the impact of the financial crisis on the 'real economy' would be limited has ended. In the face of huge falls in industrial output this year and the prospect of several years of very weak economic growth, many European industrial firms will go bankrupt. Wage subsidies and short-time working, and all the other strategies currently being employed to cope with the collapse of demand, can only be sustained for so long. EU governments are under huge pressure to intervene to protect ailing companies. The way in which they do so will be crucial. The Commission will have a real fight on its hands to ensure that competition is not distorted. It should be strong enough to enforce the rules. But member-states will have to support the Commission over the next few years. They should also ensure that the next EU commissioners for competition and the internal market have the resolve to protect the integrity of the single market.

Second, the landscape of European banking has changed fundamentally over the past year and competition policy in this sector has effectively been suspended. A number of the biggest EU banks have been nationalised in all but name and governments have moved to provide public guarantees for bank loans. The shotgun marriage of Lloyds TSB with another high street British bank, Halifax Bank of Scotland (HBOS), has left the combined group controlling around a third of the entire UK market for consumer banking services. Governments elsewhere in the EU have also stepped in to recapitalise banks. The increase in potential government influence over the lending process will need to be reversed if serious distortions are to be avoided. There is a risk that pressure will be put on banks to maintain funding for national champions and to avoid lending to companies based in other EU states. Such politicised lending would undermine the efficient allocation of capital throughout the EU by protecting inefficient companies and reducing available funds for more competitive firms. Once the financial sector has stabilised and normal levels of financial intermediation have been restored, the Commission will have to get serious about ensuring that the EU does not retreat into such 'capital protectionism'.

Third, a further deepening of the single market can be ruled out. Crucially, faster action to liberalise and integrate service sectors across the EU now looks out of the question. It was hard enough to gain consensus in favour of radical moves to dismantle obstacles to the integration of service sectors before the crisis, but it will be impossible in the face of the backlash against liberalisation. This is bad news. Service sectors account for around two-thirds of economic activity across the EU. Service sector productivity has been extremely weak for a number of years now, holding back economic growth. More competition at both national and European level would do much to change this, and boost economic growth.

The lack of service sector integration will be particularly damaging for the eurozone. Countries that decide to forego exchange rate flexibility as a tool of economic adjustment need to ensure that their economies can be flexible in other ways. If countries such as Spain and Italy are to recover their competitiveness within the currency union, they will have to boost their productivity. This, in turn, requires more competition in service industries. The alternative route to greater competitiveness – wage cuts – would condemn their economies to stagnation. And such wage deflation might not be possible in any case, as Germany is heading for deflation. It will be extremely difficult to cut costs relative to Germany, if German costs are falling.

The legal underpinnings of the single market appear robust. But over the next few years, there will be real reasons for concern. The steady progress in reducing state-aid has been halted and is likely to be put into reverse. The partial renationalisation of bank lending is inimical to the emergence of a single capital market. And progress towards deepening the single market in services has ground to a halt. All this bodes ill for Europe's growth prospects and the stability of the eurozone. All EU governments profess to be committed to upholding the single market. The next couple of years will determine the strength of that commitment. Member-states will have to respect the Commission's right to enforce the rules, otherwise the single market could indeed come under threat.

The eurozone

The financial crisis has highlighted the benefits of membership of the euro area economies. Small member-states, especially those with big banking sectors such as Ireland, would have had an even more torrid time were it not for their membership of the single currency. If national currencies had been retained, a number of smaller member-states would almost certainly have suffered severe foreign exchange crises on top of everything else. The euro has insulated its members from this kind of volatility and also allowed fiscally weak member-states to borrow more cheaply than would have been the case had they not been members of the single currency.

Various Central and Eastern European countries have announced that they want to bring forward their timetables for joining, and popular opinion in Denmark and Sweden is turning in favour of signing up to the single currency. Denmark's status as half in and half out of the eurozone (the country is a member of the exchange rate mechanism) forced it to raise interest rates in a recession, despite its economy being far better placed to weather the economic downturn than most members of the eurozone. Some observers have even suggested that the British government's mismanagement of the UK economy and the steep fall in the value of sterling could help overcome the British public's hostility to euro membership.

Over the next few years, the EU should welcome new member-states into the eurozone, but only when these countries are ready. The only obstacle to Denmark or Sweden adopting the euro is domestic opposition in both countries. They would have few problems meeting the criteria for entry and as stable and competitive economies would be welcomed with open arms. The Central and Eastern member-states face bigger obstacles. There is little doubt that accelerated entry into the eurozone would lessen the short-term uncertainties facing the new member-states. The risk of currency crises brought on by large current-account deficits or weak banking sectors would be negated. But the long-term benefits for these economies of joining now rather than in a few years time are less clear. The new EU member-states need to ensure that they do not repeat the mistakes of the southern European members of the eurozone: Greece, Italy, Portugal and Spain. Since joining the single currency, these economies have experienced a huge loss of competitiveness because wages have grown faster than productivity. They are now at risk of hard-to-finance current account deficits and stagnation unless they can regain this lost competitiveness. Many of the existing members of the eurozone will oppose the membership of the Central and Eastern European countries until it is clearer that the latter can flourish in the currency union. Consequently, it is unlikely that the criteria for joining will be watered down in order to facilitate entry, and it would be unwise to do so.

The steep devaluation of sterling has led to renewed speculation that Britain might overcome its hostility to joining the single currency. Such speculation is almost certainly unfounded, especially as the eurosceptic Conservative Party is on course to win the next general election in 2010. Even leaving aside the domestic political obstacles to the UK joining, there are some other formidable obstacles. First, existing member-states would not allow the UK to join with sterling at its current level, as this would give British firms an unfair competitive advantage within the eurozone. Second, Britain's public finances are now so weak that it will be many years before the country meets the Maastricht criteria (even if these were interpreted flexibly).

Energy and climate change

European governments have rightly recognised climate change as one of their top policy priorities. The EU, which is responsible for only 13 per cent of the world's CO_2 emissions, cannot tackle climate change alone. But there are moral imperatives on the developed world to lead, both through example and in partnership with the developing world. So, over the next decade , the EU should strive to be a leader in the post-carbon economy – an economy in which the full cost of carbon will be taken into account in economic transactions.

The EU has a range of measures which it can use to change the behaviour of business and consumers. These include taxation, EU support for research into new market-leading technologies, and subsidies which encourage a shift in transport from road to rail.

The EU and the rest of the world produce more cars than there is a market for. Over the next decade, the motor industry will face growing pressures to shrink and restructure. European governments must manage this change so that Europe's car industry survives and prospers on a sustainable path. To assist this process, the EU should lower the ceiling for emissions allowed for new cars from the current target of 95 g/km. And throughout the recession, state-aid should only be given to motor manufacturers in order to develop greener models.

In addition, as part of its efforts to reduce greenhouse gas emissions and bolster sustainable competitiveness, the EU should also require that all existing buildings must conform to minimum insulation and energy-saving requirements by 2015. Legislation will be needed to push reluctant owners into making the necessary and costly improvements. The 2002 EU energy performance of buildings directive made some progress in this field, but its scope should be extended to existing buildings that are not undergoing major renovation.

The EU should also substantially increase funding for railways. New high-speed rail lines, of the sort that have been built in Western Europe, should be significantly expanded. Better and faster rail travel would reduce the incentive to use short-haul flights, cars and road hauliers.

In addition the Commission should encourage member-states to provide extensive networks of cycle lanes both within and between towns. Improved cycle lanes would be an eye-catching measure which would have substantial popular appeal.

Migration and demographic change

Europe's ageing population and declining birth rate have caused concern across the EU for years. The demographic 'time bomb' could have serious financial implications for welfare systems and harm Europe's competitiveness. But the challenge of demographic change is not insurmountable and over the next few years both the EU and national governments can introduce a series of measures to help mitigate its impact.

Firstly, the EU must ensure it fully exploits its skills base. A mobile labour force across Europe will allow skills to move to where they are most needed and increase competitiveness. So far, however, the full free movement of workers within the EU has remained a politicised debate. And the economic crisis is only increasing public anxieties towards migrant workers. Member-states must make clear to their citizens that migrants will be necessary and beneficial to their long term well-being. The EU should also introduce a series of measures to help its labour force become more mobile. It should promote the mutual recognition of qualifications and skills, and support the development of language skills, in-post training and career progression.

To tackle the demographic challenge, Europeans will also need to work more and for a longer share of their lives. The working time directive needs to be made more flexible for Europe to remain competitive.[2] And European governments will have to increase the target retirement age to 70 by 2020.

[2] The working time directive limits the maximum length of a working week to 48 hours in 7 days with a minimum rest period of 11 hours in each 24.

Relations with neighbours in the east

The EU's eastern neighbours – Russia, Ukraine, Belarus and Moldova – are a source of concern to its member-states. They are very poor in comparison with the EU. The per capita GDP of Ukraine, Belarus and Moldova is less than 10 per cent of the EU average. Moreover, the EU's eastern neighbours are being severely affected by the global economic crisis. The World Bank predicts that Ukraine's GDP will decline by 4.5 per cent in 2009. Belarus was obliged to borrow $2.5 billion from the IMF in 2008. The Russia economy is also projected to contract sharply.

The four successor states of the Soviet Union are far from being stable democracies. Lukashenko's Belarus is an authoritarian regime. The Russian government's notion of 'sovereign democracy' differs greatly from the EU norm. Ukraine and Moldova have taken steps in the right direction. But they also have suffered setbacks. Ukraine's government has been paralysed for a year, while in April 2009 Moldova's parliament was burnt down by protesters accusing the government of rigging elections.

The political and economic vulnerability of the EU's neighbours creates considerable problems for the EU. The east is a source of organised crime and outward migration. The poverty is partly to blame for the slow economic development of the eastern fringes of the EU. Much of Europe's gas supply flows through the region. Moreover, populist governments could reignite the region's various frozen conflicts.

The EU can do various things to promote stability in its eastern neighbourhood. Firstly it needs to form a united position towards Russia. Whilst the Union should criticise Russia when it is in the wrong, it should not pointlessly antagonise Moscow either. The Russian and European economies are deeply intertwined, and Russia is a necessary partner to tackle most global challenges (such as the Iranian nuclear programme). So when possible, the EU should strive to build a constructive relationship with Moscow. In addition, in order to strengthen mutual links, the EU should boost person-to-person contacts with Russia. It should encourage more student exchanges, supply more scholarships for Russian students in European universities and increase training programmes for Russian civil servants.

The EU should set out the conditions under which a membership perspective could be offered to Ukraine, Moldova and even Belarus. The eastern partners would be looking at a distant membership perspective. But the move would nevertheless provide an important boost to the reform agenda in all three states. In the meantime, they will receive many of the benefits of membership along the way, such as integration into the single market through comprehensive free trade agreements, as envisaged in the Eastern Partnership (the free trade agreements potentially apply to Georgia, Armenia and Azerbaijan in addition to the three eastern neighbours). The EU should be stricter in its assessment of reforms than it was during the 2004 and 2007 enlargements and it should ensure that the eastern neighbours fulfil the required conditions prior to accession. This might help to overcome the opposition to further enlargement within several member-states.

Finally, the EU should significantly increase the amount of financial assistance it gives to its eastern neighbours, despite the pressures to reduce development budgets due to the economic crisis. The Eastern Partnership is offering €600 million in the period to 2013, but this will not be enough in light of the magnitude of the challenges. The EU should also concentrate its efforts on improving the quality of governance. Funding should be targeted at helping to build an independent and effective judiciary that has the resources to ensure that its decisions are enforced. Assistance is also needed to improve the quality and independence of the civil service. Unless these twin pillars of a democratic society are erected, any future reforms are likely to founder.

Relations with neighbours in the south

By Clara Marina O'Donnell

The proximity of the Mediterranean makes its stability and prosperity of crucial importance to the EU. Yet the EU's neighbours along the coast of North Africa and in the Middle East are prone to conflict and instability. Most countries along the Mediterranean rim suffer from poor economic development. Many are run by authoritarian regimes and several, including Egypt, are increasingly fragile. Some countries, such as Lebanon, have been suffering from political instability and civil wars for decades. In addition many countries in the region are in conflict with each other. The Arab-Israeli conflict is the most intractable dispute, but serious tensions also exist between Lebanon and Syria and between Morocco and Algeria.

The current state of affairs across the Mediterranean poses several challenges for the EU, and these are likely to get worse over the next decade unless new policies are put in place. The low levels of economic development create important migration flows towards Europe. The EU relies on several frail authoritarian governments for a substantial amount of its energy supplies and to help control Islamist terrorists. Some of the regional conflicts, in particular the Arab-Israeli dispute, feed resentment towards Europe from Muslims across the world, and even from Muslims within Europe. And the current economic crisis is only exacerbating poverty levels and increasing the vulnerability of fragile governments.

The EU has been working with the region for many years. Through the Barcelona Process, the European Neighbourhood Policy, and most recently the Union for the Mediterranean, the EU has tried to encourage regional co-operation and domestic reforms, in exchange for deeper relations with the EU, including closer trade links. But the Mediterranean has not been a consistent priority on the EU's agenda and its efforts have yielded very limited results. Democratic reforms and economic development have not materialised, and the various conflicts inside the region remain unresolved.

Two main challenges have hampered EU efforts in the Mediterranean. First, the benefits that the EU can offer Mediterranean governments are limited, so the EU has little leverage to encourage reforms. The EU's most effective incentive, membership, is not an option, and with the exception of Morocco, most countries are not interested in joining. The EU's leverage is further reduced by its reluctance to offer things which are attractive to the region's governments, such as greater access to the EU's labour markets. Second, the EU is trying to encourage co-operation across a region riddled with conflicts. The different tensions, in particular those emanating from the Arab-Israeli dispute, obstruct most efforts to foster co-operation.

In order to have a bigger impact on the Mediterranean, the EU must offer its partners some of the things they care about – such as greater financial assistance and simpler visa requirements. Even then, the EU should lower its expectations and acknowledge that it is dealing with partners which analyse the costs and benefits of reform differently to the East Europeans.

The EU should also increase its diplomatic efforts to engage in the various conflicts across the region, from Lebanon to the Western Sahara. The EU has been trying to play a role in solving these different conflicts, in particular the Arab-Israeli conflict. But if the EU wants to play the role of neutral arbiter, as is often required in the region, it must adopt a more comprehensive stance towards engaging local players. Currently, the EU refuses to engage with the Palestinian group, Hamas, and some EU countries would like to block engagement with the Lebanese group, Hezbollah. Hamas and Hezbollah are not attractive partners, but the different conflicts cannot be solved without them. The EU should encourage the US, Israel and others in the region to engage with these groups, and be ready to do the same.

Conclusions

The global economic crisis will create some difficult times for the EU over the years ahead. It will put strains on the internal market and the eurozone. It also risks diverting attention away from Europe's pressing non-economic long-term challenges such as climate change and foreign policy.

The single market will be the area most affected by the economic crisis. The pace of reforms is likely to slow down in certain areas, in particular progress towards liberalising services. Instead of deepening the single market, for the next few years the EU is likely to have to focus its attention on preserving the gains made so far.

But the EU should not let the economic crisis affect its policy objectives in other areas. It should not, for example, allow countries in Central and Eastern Europe to join the eurozone prematurely. The EU should continue to pursue, and strengthen, its policies to address climate change and promote stability in its neighbourhood. Despite the economic crisis, the EU should introduce strict measures on car emissions and develop the European high-speed rail network amongst its efforts to curb carbon emissions. It should also deepen its relations with its neighbours to the east and south through enhanced trade relations and aid. And once the worst of the economic crisis is past, the EU should redeploy its efforts to deepen the single market.

Europe in 2020 can be a prosperous and secure area. It also has the potential to serve as a model for others in how to develop sustainable economic growth. But the EU will only be able to ensure its long-term wellbeing if it finds the political will to introduce the necessary reforms.

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