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The Future of Europe in the New Global Economy

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The economic and monetary turbulence we are experiencing today should not prevent us from reflecting either on the future of the global economy in the medium and longer term, or on Europe's place in a rapidly changing geopolitical situation. Let us overlook our momentary concerns so that we can sketch a bigger picture of the world that is taking shape and ponder the kind of reforms that would allow Europe to face the future with greater optimism.

To understand the geopolitical framework now taking shape, we need to begin by describing the broader trends shaping the development of the world's economy, then we need to situate Europe's place and prospects in that changing landscape. And lastly, we need to suggest a few more concrete paths for reform, and public policies capable of ensuring Europe's future in the new global economy.

1. The "big change" in the global economy

The global economy, which is the Europeans' reference environment, has undergone two major changes in the past 20 years; moreover, those changes are going to continue and, in all likelihood, to speed up over the coming decades.

1.1. The "big swing"

The first change involves a radical upheaval in economic masses and growth rates linked to the growing power of the emerging countries, some of which consider themselves to be still emerging while others feel that they have already emerged. Jean-Michel Severino[1] calls it the "big swing" [le "grand basculement"] and argues that it consists of both the masses themselves and of the speed at which those masses are shifting. There is no other instance in the entire history of mankind, of such massive economic development concentrated in so short a space of time.

China's output today accounts for over 8% of the world's economy (in current dollars) compared with less than 2% only 30 years ago. This increase is already having considerable economic, political and media repercussions, but twenty years from now China is likely going to be worth 20% of the global economy, and the consequences of that transition are going to be even more obvious.

[1] See Jean-Michel Severino & Olivier Ray, *Le grand basculement, la question sociale à l'échelle mondiale*, Odile Jacob, Paris, 2011.

The place that China occupies in this picture is of necessity unique because it is the largest and most important of the rapidly developing economic masses. India accounts for 3% of the global economy today and should account for 5% twenty years from now, thus it is a smaller and less rapidly developing mass. Africa accounts for 2% of the global economy today, while Latin America accounts for 4% to 5%. In twenty years' time, Africa should account for 3% of the global economy and Latin America's share should remain stable. Thus while these other economic masses are also shifting, they are not doing so to as great an extent.

The downswing in the West's economic power is the logical offset to the increasing economic weight carried by the emerging countries. If the trend observed over the past two decades continues, the weight Europe carries in the global economy is going to drop from 35% to 25% by 2030 and the weight carried by North America (the United States and Canada) is going to drop from 30% to 28%. The fact that North America is likely to hold out better is due, in the main, to a more favourable demographic situation than in Europe. This swing in relative weights is destined to continue, or even to speed up in China's case, while heightening the kind of turbulence we are already experiencing today.

1.2. The new configuration of international trade

The second major transformation that the world's economy has experienced in the past two decades is a deep change in the nature of the international division of labour, particularly in terms of stronger specialisation in the manufacturing apparatus of the various countries. This specialisation movement is rooted in the technological changes that have made the world a smaller place.

International trade has traditionally been restricted by the costs entailed by distance, particularly in connection with transportation and communications. That has led to a "preference for proximity", on which economists have dwelled upon for many years and which translates into a country choosing to trade first and foremost with its neighbours. The invention of the container and of the Internet has considerably reduced the obstacle of distance in the space of a mere few decades.

Thanks to the container, the cost of transporting a tonne of goods by sea has been slashed by fifty times in the space of a few years; while the Internet revolution has had an impact of the same magnitude in the sphere of communications. The power of today's computer tools combined with the possibility of real-time communication with the whole world has made it possible to set up logistics chains on a global scale spread out over different countries. These logistics chains, comprising a large number of distinct operations, would never have seen the light of day without a series of tools making it possible to handle complexity while at the same time regulating, monitoring, and remote-managing the work of all the suppliers and partners involved.

Fully 60% of Asian countries' international trade is concentrated in the Asia zone itself, the area which has witnessed the most in-depth integration of its production chains, with the manufacture of parts and semi-assembled units that are then mixed with components which themselves comprise elements from different countries, and the whole then ends up in China for assembly before being exported elsewhere. The underlying phenomenon, a process of fragmentation among different countries and types of labour, is effectively illustrated by the production chain of certain emblematic products.

Take the iPad, a part of which is assembled in Chengdu, in western China. Over 100,000 people work in a factory that only "manufactures" one part, namely the iPad's aluminium casing. The rest of the factory's activity consists in alternating assembly operations with technical testing. Logistics circuits are enormously complex and it takes eight hours to assemble the components of an iPad on account of the large number of quality controls required. The Chinese added value generated by this factory accounts for 5% of the iPad's purchase price, while the American added value of the same iPad, assembled in China and exported to the United States, is over 20 times higher.

Global manufacturing chains are constantly changing, in an ongoing movement involving the allocation and reallocation of labour and capital in response to the opportunities that businesses perceive, to a changing regulatory environment and to changes in trade barriers. The execution of these tasks, once performed in a given country by a given company and based on the use of an extensive labour force, can now be brutally shifted to another country and another company with different means of production.

It is no longer a matter of trading in goods and services but of trading in tasks, which enter the production process of an end product or service. International trade theory these days talks about "trade in tasks". This underlying transformation has numerous and very obvious consequences because it rests on industrial location, transfer and relocation, which give businesses the leverage they need to improve their efficiency.

To understand where the efficiency in this new configuration of international trade comes from, we have only to refer to a simplified Ricardo-Schumpeter model. From David Ricardo we take the increased manufacturing efficiency that he argues is to be gained from an increasing international division of labour, while from Joseph Schumpeter we take his theory based on the uninterrupted cycle of the destruction and creation of manufacturing systems, the least efficient making way for the more productive, which then employ the labour and capital thus freed up.

This movement is speeding up at the global level and it is triggering an increase in growth and employment at international level. But the division of employment and the changes affecting it are by no means uniform. Social and economic fabrics cannot develop at the same pace and they take considerable time to adapt to the changes to which they are subjected. Hence the deindustrialisation process that is hitting certain traditional labour pools, triggering dramatic social shocks in certain regions. Hence also the painful social insecurity in job markets where the previous model had been stable for a long time, in other words in the developed countries[2].

In this new configuration of international trade, commercial issues broadly transcend the mere issue of trade imbalances. And in any case, bilateral trade imbalances are becoming meaningless when China's exports to the United States contain almost 50% of Chinese added value while US exports to China contain 80% to 90% of American added value. It is an economic non-sense to continue to calculate bilateral trade balances the way we do today. What we need to monitor is the effective added value in each country, not the overall value of goods and services imported and exported.

Naturally, China is in a surplus situation and the United States is in deficit. That is a macro-economic problem whose causes are well-known: excessive consumer restraint in the former case and insufficient savings in the latter. Yet politicians focus on the two countries' bilateral trade relations, which makes very little sense these days as we can see from the example of the manufacture of iPads.

That is why we have to stop measuring international trade flows using a gauge that increases a product's overall value each time that product crosses a border. We need to calculate trade in the same way as we calculate gross domestic product (GDP), in other words by adding together the value added flows. An approach of this kind would also allow us to conduct a meaningful analysis of the impact of trade on employment, a crucial policy issue in today's world.

[2] British university lecturer Guy Standing likens the "precariat" of the 21st century to the proletariat of the 19th.

2. The impact of these changes on Europe

To explore the situation and prospects for Europe in this global economy in the grip of change and development, we first have to put paid to two clichés that too often foul the debate and prevent it from making any progress.

The first cliché argues that Europe is a victim of this new international division of labour. All the available figures show us that that view is mistaken. In the change in production methods that we have witnessed over the past twenty years and more, Europe is coming out of things far better than either the United States or Japan. Europe's market share of international trade has remained more or less stable throughout this period, hovering around the 20% mark, while the United States' and Japan's market shares have shrunk substantively. The EU's foreign trade surplus in the industrial sphere has trebled over 10 years, hitting somewhere in the region of 200 billion euro.

But as we have seen, that same period has witnessed major progress on the part of the emerging countries, with China heading the list. The countries of Europe, Germany in particular, are especially well placed to benefit from their comparative advantages at a time when the emerging countries have to import considerable quantities of manufacturing technologies and goods. So we can hardly call Europe a victim; indeed so far it has rather profited from the globalisation process.

The second cliché: Europe is naive in that it allows itself to be taken advantage of and overtaken by its trading partners, and the porous nature of its borders is said to be the most obvious demonstration of this state of mind.

In point of fact, these statements cannot withstand even the most modest analysis of the facts and figures. Europe's borders are neither more nor less porous than those of comparable developed countries. This applies to traditional trade barriers, customs duty and quotas, but also to such commercial protection measures as anti-dumping rules and countervailing duties, or to technical quality, food safety and environmental safeguard standards. Europe is no more naive than its trading partners that enjoy a comparable level of development.

Europe's problem, its weak growth and its crippling unemployment are thus not simply linked to international trade but to different factors, and thus we should not be seeking solutions to that problem in a fallback commercial policy built on increasing the number of obstacles to trade.

The prices of European products have tended to become increasingly less competitive over the past few years. Salary levels are sometimes mentioned as being one of the causes for this, but there is absolutely no point in comparing hourly wages without relating them to the productivity of the working hour. Where competitiveness is concerned, the fact that a European worker earns far more than his Chinese counterpart is of little consequence so long as that higher hourly wage level is reflected in greater efficiency and greater productivity. Thus when we look at salaries, we have to set them against worker productivity. Having said that, it is glaringly obvious that Europe's hourly productivity is currently being eroded, particularly by comparison with the United States. The euro's high rate of exchange against the dollar in recent years has also had a far from negligible impact on European products' loss of competitiveness in the world's market places.

In parallel with price competitiveness, Europe's (and especially Germany's) comparative advantage stems largely from its "non-price competitiveness". This type of competitiveness comprises all of those characteristics that cause a product to stand out positively among its competitors, regardless of price. In particular, it comprises know-how, quality and innovation, which allow a company to sell the same products as its competitors but at twice the price. This explains the performance of the German manufacturing system — and that performance, incidentally, is on a par with the average figure for the Community, according to the most recent figures.

The countries of Central and Eastern Europe have made enormous progress in terms of price competitiveness; yet while they have now overtaken even the Germans, they perform less well than them in the field of "non-price competitiveness". Other countries, on the other hand, have fallen below the average, performing less well in the sphere of price competitiveness like Italy, or less well in the sphere of "non-price competitiveness" like France.

The difference between France and Germany in terms of comparative advantage on the international trade scene does not lie in price competitiveness, because salaries and productivity are the same in both countries. The Germans, on the other hand, enjoy a very clear comparative advantage in the field of "non-price competitiveness", in other words, in terms of the range of products that they manufacture and export. The level of specialisation that sets France apart from Germany does not lie in pure product but in the range of products offered. "Up-markets" products are sold at a higher price and guarantee higher profit margins. Their quality attracts consumer loyalty and confidence, and this, to some extent, shields manufacturers from having to worry about fluctuating global prices and competitor attacks.

In view of this situation, if we bear in mind the Europeans' market positioning, know-how and economic tradition, we have to admit that comparative advantage is going to depend on price competitiveness but also to a large extent on "non-price competitiveness". Thus the problem of Europe finding its place in the new global economy boils down to a European "domestic" issue. The external environment is not negative; on the contrary, it is rather positive.

3. What reforms for Europe's future?

Europe enjoys comparative advantages that ought to allow it to find its full place in the global economy. If we accept the idea that an improvement in its integration into international trade depends first and foremost on its internal policies, then we need to go back to the basic problem, which is a problem of excessively weak economic growth in Europe. That was true before the crisis, when the European Union's potential for growth hovered around the 2% to 2.5% mark, but since the start of the crisis that potential for growth has decreased by half.

On a global scale, Europe is an island of prosperity and well-being thanks to a welfare system which is of unquestioned quality, yet whose sustainability depends on significant growth both in the economy and in the population. However, Europe has a problem in both of those spheres. A well-known solution to its demographic problem would involve falling back on immigration, but it is difficult to envisage such a solution being adopted in the short term on account of the positions espoused by Europe's political forces on the issue. It would also be opportune to make it easier for people to reconcile their personal and professional lives, and to remove obstacles standing in the way of an increase in the birth rate, which has dropped to critical levels in European countries where the generational turnover is no longer guaranteed — although there are a few exceptions, and one of them is France.

Where potential for growth is concerned, the crisis has highlighted difficulties incurred through the problem of excessive indebtment. The only way to keep the social security system going without significant demographic growth is by increasing the economic growth rate. Yet it is difficult to impart a fresh boost to the growth of an economy whose potential for such growth has been damaged by the crisis and which is having to cope with a heavy indebtment burden. Yet therein lies the whole issue: it is a matter of boosting potential for growth by 1 or 1.5 percentage points in order to be able to continue funding the European welfare system and to check the indebtment that has built up to date.

The reforms required to achieve this goal and to make the best of Europe's comparative advantages are long-term reforms primarily regarding its education, training and innovation system. It is in that sphere that the difference between countries and continents is going to be seen. A population's level of education is the single variable that best evinces differences in economic growth and success worldwide over the past forty or fifty years. But public education and innovation policies can have an impact only in the medium and longer terms. So in view of that, how can we stimulate growth in the short term? It is a matter of devising measures whose impact can be felt at once.

We may find an answer to that question on the labour market, yet we have to combine fiscal and budgetary measures in order not to reduce productive public expenditure, which has a driving effect on the economy, and to avoid any rise in manufacturing costs so that we can protect our price competitiveness.

And finally, monetary policy can also serve as a short-term lever for action. According to the Bruegel think tank, there is a way of managing the inflation differential within Europe intelligently so as to restore part of the competitiveness that is missing in the south. Inflation at 2.5% to 3.0% in northern Europe, coupled with lower inflation — at say 1.0% — in southern Europe would gradually allow countries that cannot devalue their currency to recover, to some extent at least, the price competitiveness they lack.

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We are not telling fairy stories here: the economic stagnation affecting Europe today — and from which it must emerge on top and as rapidly as possible — is not caused by international competition as devastating as Europe's trade policy is allegedly weak or naive.

Europe's dearth of price competitiveness and of "non-price competitiveness" must be the target of future public policies, which will give Europe the means to benefit from the comparative advantages that it should have. Education, training and innovation policies, the meticulous management of intra-Community inflation, and greater fluidity in the labour market are the pillars of a courageous reform equal to Europe's legitimate ambitions in an increasingly competitive world.