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BRUEGEL

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Thank you very much for your invitation to discuss Europe in the global economy. The good thing about getting old is that you can look back and see how good concepts become realities. This is what I have seen with Bruegel under the able leadership of Jean and his team.

The epicentre of the global financial crisis that started in 2008 was not Europe. But Europe is the place where the crisis moved to in 2010. Since then, the key policy issue has been how the European Union could find its way out of the problems. What public policies should national governments and the EU implement? What reforms of the economic governance of the EU would promote the adoption of these policies?

I would like to put these questions in the broader context of the long-term forces shaping the global economy. My view is that a successful path of reform in Europe cannot be dissociated from the fast-pacing changes characterizing the current phase of globalization.

Long-term changes in the global economy

Shifts in comparative advantage

What forces are shaping the global economy? The first force is the rise of emerging economies. Developed economies' exports are expected to underperform in 2011 compared to the rest of the world. This would mark the 20th consecutive year that exports of developing economies have grown faster

than those of developed ones. The share of advanced economies in world trade stood at 55% in 2010, down from 75% in 1990.

Changes in the regulatory environment, technology, and transportation costs have opened new markets, altering trade patterns and forcing countries to adjust. The shift in comparative advantage that the world economy is facing today mirrors past experiences in the 19th and 20th centuries.

But what is unique about the current transformation is the fast pace at which change is taking place and the immense number of people involved. China and India today account for 11% of the world economy and according to some projections are likely to be more than the double in twenty years. These swings in economic weight have profound geopolitical consequences and can lead to political backlash, trade tensions or worse. Sometimes the international community has dealt with these pressures in a peaceful and successful way, others not. But the structural changes that were set in motion will hardly be reversed in the foreseeable future.

Internationalisation of production

The second force transforming the global economy is the international fragmentation of the production process, with technological innovations at the root of this structural transformation. Falling communication costs allow different manufacturing stages and the provision of specialized inputs to be performed in locations far from each other. The boundaries of production often cross multiple political borders.

Whereas in the past international trade mostly involved finished goods, today it is increasingly the case that "tasks" - those activities that add value to a good or service - are traded internationally. The import content of exports has grown from an average 20% twenty years ago to around 40% today.

This international fragmentation of production is caused by comparative advantage, but at the task level rather than at the final product. As for the traditional form of trade, the emergence of international production networks is good news. It is essentially equivalent to a technological breakthrough: it creates opportunities to improve firms' productivity by reallocating tasks where they can be performed more efficiently.

Seizing these opportunities does require adjustment for firms and workers. Public policies have an important role to play here. First, opportunities can be hard to get. Public action should focus on the competitiveness of firms; that is, on the conditions that promote the participation of firms in international markets. Second, adjustment is painful. Labor market reform, education and training programs should accompany and facilitate adjustment. Safety nets should be in place so that gains from new opportunities will be shared.

How is Europe responding to these changes?

Shifting our attention to Europe in the global economy, the picture is brighter than what is generally perceived. The EU share in world's exports has not changed much in the past ten years, hovering just below the 20% mark. A

performance definitely superior to that of other advanced economies like the United States and Japan, whose market shares have substantially shrunk. This suggests that European firms - or, at least, some of them - are taking advantage of the transformation in the global economy.

International production is a reality for many European firms. The European Union's total exports of parts and components were worth $850 billion in 2010, of which 60% was intra-EU trade. This indicates the importance of intra-European production networks.

The share of intermediate goods in EU trade with the rest of the world has been remarkably stable, but interesting new trends have emerged. North America's share fell sharply, from 29% to 22% on the import side between 2000 and 2010. On the other hand, EU imports of parts and components from China grew more strongly in the last 10 years than imports of goods overall, producing a sharp rise in the share of intermediates from 13% to 21%. Incidentally, this runs counter to the usual story that China imports high value components from more advanced trading partners and exports finished goods with limited value added and points to the rapid evolution of the trading relationship of the EU with China.

Aggregate trade statistics mask important variations in trade performance of European countries. Some of these differences obviously depend on country specific features. But as Bruegel's excellent report on the "Global operations of European firms" correctly points out: it is firms that are at the heart of European competitiveness. More than country-specific features, it is the characteristics of

firms that explain their success in international markets. Size, productivity, skill intensity of the workforce, ability to innovate, participation to international production networks and strong distribution networks are all features related to firms' export performance –particularly in emerging markets.

Why do these characteristics matter? Essentially, because they allow European firms to compete on quality rather than price. The exceptional export performance of German firms, 29% of which sell in distant markets in China and India, is rooted in the know-how of their workforce and the quality and innovation of their products –in a word, it lies in their non-price competitiveness. Other important characteristics, in particular salary levels and the broader regulatory infrastructure of labor markets, are not much dissimilar between Germany and other European countries such as France with inferior export performance.

Europe and the euro crisis

As these slow-moving and long-term changes in the global economy unfold, Europe is facing the more immediate challenge of the euro crisis. Why did the crisis come here? The immediate target of speculation was the solvency of some member countries of the euro area. But the ultimate target was - and still is - the Union itself, as markets doubt that the current European institutions have the instruments to manage and exit the crisis. Markets are right and wrong at the same time. They are right in seeing the limits and the contradictions of the current economic governance of the EU, but they are

mistaken in their belief that a solid post-Westphalian order in Europe cannot and will not be built.

Many have criticized the EU's response to the crisis, but let me start by stressing what has been achieved. First, Europe has so far successfully rejected the dangerous temptation of reversing the integrationist path.

Some call for a break-up of the euro area. They argue that the single currency is the problem; a return to flexible exchange rates the solution. This option will only throw Europe in a deeper crisis. As Tommaso Padoa-Schioppa taught us almost thirty years ago, free trade, free capital movements, fixed exchange rates, and autonomous national monetary policies form an "inconsistent quartet". A break-up of the euro area will, over time, erode the single market. I will let you imagine what this would mean for European firms that find in this quasi-domestic space the initial area to produce, grow and reinforce their competitiveness.

Others advocate a return to European protectionism. Europe, the argument goes, will find its way out of the crisis by redirecting domestic demand towards a domestic production that has experienced unfair competition from its trading partners. This reasoning is based on an erroneous premise and a false hope. The first is that Europe has porous trade borders. This is plainly wrong, as trade policies in Europe are not very different from trading partners with a comparable level of development. The false hope is that European protectionism will not be matched by the erection of similar barriers elsewhere.

This strategy will only foreclose profitable opportunities for European firms in rapidly expanding emerging markets.

While rejecting these temptations, the EU has also managed to move from initial *ad hoc* emergency measures to structural corrections. The "fiscal compact" treaty signed at the end of January has many limitations, but also much to commend. The institutional framework of the Economic and Monetary Union suffered several original sins. One was that member governments did not accept thorough monitoring of their fiscal policies by the European Commission. Another was the lack of clear enforcement mechanisms in the case of fiscal misbehavior. The treaty is a step forward in increasing the fiscal discipline of the members of the monetary union.

Critics, however, have argued that the current approach is too narrow and will ultimately fail. They make the compelling argument that the austerity measures embedded in the treaty will trigger a vicious circle, lowering growth and worsening fiscal conditions. One bailout package will necessarily follow the other, "firewalls" will continue to be deemed insufficient and the euro crisis will remain in the front page of international media. In the process, uncertainty will damage the competitiveness of European firms, pain and resentment towards the EU will rise, particularly in affected countries. Trust in the European project will be at risk.

Ending the crisis: A growth plan for Europe

To exit the crisis Europe needs a common growth plan. The goal of this plan should be to allow Europe to find its full place in the evolving global economy. But growth is also the essential ingredient to keep European solidarity. Not because of some sort of altruistic dream, but because it is redistribution that anchors the marriage between national and mutual interest which is at the heart of the European project.

This means, first and foremost that the EU should adopt those policy and institutional reforms that will improve the ability of European firms to compete in global markets.

Much of the current debate in Europe is focusing on the need for a fiscal union with own resources, including direct EU taxes, project bonds, euro bonds. You, at Bruegel, have been very vocal on this point, which I fully share. The new treaty itself, with its stringent rules on national fiscal policies, will create a demand for an extended EU budget. But what should the priorities of the common fiscal policy be?

I can see three broad target areas for the EU budget that relate to the conditions that underpin the competitiveness of European firms.

- First, invest in common infrastructure, particularly in the energy sector, that weighs heavily on manufacturing costs and affects price competitiveness.

- Second, promote R&D policies, education and innovation systems, which are at the core of non-price competitiveness.

- Third, assist countries in adapting their production structures, social security systems, and labor markets to the new challenges created by globalization and the internationalization of the production process. This has to be done "the European way", the "Sozialmarktwirtschaft way", which recognises that strong social protection systems have a proven track record in improving competitiveness.

Beyond fiscal policy, completion of the internal market should be the other priority. Services are indispensable for the smooth functioning of cross-border production processes. European firms still live in a fragmented services market. This puts them at an obvious disadvantage compared to their competitors in the US and, increasingly, in China that are embedded in a continental-wide services market. In a nutshell, what Europe needs is a "Stability, Growth and Competitiveness Pact".

Let me conclude with a word on the institutional reform of the EU. A growth plan can be translated into action only if the EU is a real policy actor. This means four things.

- First, return to the Community method and re-establish the central role of the Commission. Directorates or other forms of inter-governmental bargaining are unlikely to properly respond to the trans-national interests created by European production networks and are too easily captured by local special interests. We have to accept a reality: the credibility of the EU in the world scene is directly correlated to the Community method both positively and negatively.

- Second, the EU's powers should be limited but effective. The growth strategy of the EU, the Lisbon Agenda, relied excessively on the concept of the Union and its Commission as a coordinator of national policies. We should recognize that this political model, based on inter-governmentalism and peer pressure - the so-called "open method of coordination", has failed to enhance growth.

- Third, the increased EU's power should be matched by stronger democratic legitimacy. Notre Europe circulated a policy note back in 1998 with the suggestive title “From the single currency to the single ballot-box”. Start by linking the choice of Commission president to the results of European elections, with each political grouping proposing a candidate during the campaign.

- Fourth, institutional reforms cannot wait. Some of these steps do not require amendments of the treaties, others do. The European Union today has a variable geometry. If no broader agreement can be found, further institutional progress will have to move on through forms of enhanced co-operation as we saw with the negotiation of the new treaty.

Conclusions

If Europe wants to exit the current crisis, it has to restore economic growth by finding its full place in the global economy. This requires two complementary reforms. First, the EU needs to become a real policy actor, with independent fiscal resources. Second, the EU's public policies should focus on improving the competitiveness of European firms in global markets. These changes demand a leap forward in the process of political integration, not for a distant future but *hic et nunc*.