CHALLENGE EUROPE

Challenges and new beginnings: Priorities for the EU's new leadership

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Solidarity and cohesion

Pawel Swieboda

In the past five years, the concept of solidarity has quietly lost much of its traction in the public discourse in Europe. Widely used at the time of the creation of the single market, the emergence of the common currency and during the EU's big bang enlargement of 2004-2007, it has recently become a more confused organising principle. The European system has been affected by growing levels of distrust, which has much to do with the way in which the euro zone crisis was tackled. In spite of massive resources having been mobilised to support countries in need, mutual accusations and discord have become ever more present in the EU's policy-making process.

As a result, many observers and analysts have given up on the promise of restoring convergence in the European Union. Ashoka Mody for one, has argued in favour of accepting a "*de facto* decentralisation in Europe" making it more robust, rather than seeking a federal arrangement at any cost.[1] His basic assumption is that overcoming structural differences between the Member States and the differences in governance cultures will be impossible. Europe should accept this situation and manage its diversity, rather than continue to seek uniformity.

However, questioning the rationale for economic convergence in Europe can pose a major risk to the sustainability of the European project. It can blow a hole in the meticulous effort to restore legitimacy of the European Union in the face of massive pressures of fragmentation. What is more, it can also weaken growth prospects in the EU at large. As the continent struggles through the aftermath of the deepest recession since the 1930s, it is becoming broadly accepted that weakness in one quarter of the European Union affects the performance elsewhere. Even in Northern Europe, "the recovery has been much slower and less powerful than after previous downturns", leading analysts dwell on the likelihood of the "new normal" of lower growth.[2]

Cohesion was, from the beginning, part of a larger bargain by means of which some Member States received compensation for benefiting less from some European policies. One of the first instruments of cohesion policy, the European Regional Development Fund, which was introduced in mid-1970s, compensated the UK for not being in the position to draw benefits from the Common Agricultural Policy. At the time of the formation of the single market, the reason for compensation changed and a more redistributive logic was accepted: the deepening of European integration was to be accompanied by measures supporting those members with lower ability to withstand competitive pressures. The objective of reducing disparities between regions with different levels of development has been for long enshrined in the Treaties. The introduction of the euro also carried cohesion policy implications, granting weaker countries the benefit of lower interest rates and better access to capital. As we have seen later, what seemed to be a bargain at the time, in this case, turned out to be a curse.

Subsequent reforms of cohesion policy, starting in the late 1980s have focused on the efficiency of spending and success of investment projects as the major criterion. Although

much criticism has been voiced with respect to the resistance of the EU budget to change, cohesion policy itself has been undergoing significant modernisation towards broader acceptance of its role in incentivising economic activity, rather than providing a blank cheque for investments. In the context of the economic and financial crisis, the case for elements of redistribution at the EU level has only been strengthened by the unquestionable benefits, which the stronger countries have drawn from the single currency.

However, as the World Bank stated in its flagship "Golden Growth" report[3], the convergence machine in Europe had been broken from the early 2000s onwards when the inflow of investment in Southern Europe was diverted to unproductive use. The scale of the damage done by the lack of vigilance on the part of the recipient countries has been enormous, not only in the social texture but also in economic prospects. In Spain, new loans for small and medium sized businesses (non-financial) have decreased nearly 70% between the end of 2007 and the first quarter of 2013.[4] This contrasts with an increase of nearly 30% between the beginning of 2003 and the end of 2007. The prerogative of solidarity requires recognising that there are always two sides to each investment decision – just as some sectors of the Southern European economy had a sponge-like ability to attract funds, creating financial bubbles, investment decisions were backed up at the other side of the equation by Northern European banks.

In the meantime, Central Europe has largely continued improving its economic performance and catching up with the European median. Most countries of the region have exceeded the aggregate EU-27 level of growth, although performance has differed sharply among them. Poland and Slovakia have done best with their 2013 growth 49% above the 2004 level. They were followed by Lithuania (38%), Romania (37%) and Bulgaria (34%). Some have done less well with Slovenia's economy growing only by 14% and Hungary's by 9%.[5]

The 2004-2008 boom years in Central Europe can be justifiably attributed to the EU dividend. Lower business risk, higher attractiveness for investors and financial credibility, reducing barriers in the flow of capital all contributed to the catch-up dynamic. Investments and exports have interchangeably been the main contributors to growth in the region. Foreign direct investments have been particularly important, given Central Europe's low saving rate. They have led to rise in productivity and technology transfers. In some of the younger Member States, EU funds constituted over 90% of public investment in the course of the crisis, underlining the importance of transfers in maintaining growth dynamic.

Productivity improvements have been significant, although not allowing yet for bridging the gap to the EU average levels. When it comes to labour productivity, Poland is at 72% of the EU average (up from 60% in 2003) while Slovakia is the regional leader with 81% (up from 64% in 2003). Trade has been a big growth engine in Central Europe with Poland's exports rising 220% in the years 2004-2013 and imports by 160%. Slovakia has become the most open economy with exports amounting to 97% of GDP in 2013.[6] EU membership has led the region to anchor its enterprises in the global supply chains. As the IMF observed, the spill-over of German domestic demand to Central Europe remains relatively small while much of the bilateral trade between Germany and the region is in intermediate goods.[7]

All this is a success story. However, more recently, Central Europe's advances have stalled and its rates of growth have converged downwards towards the median for EU-27. There are two paradigms to explain the region's slowing growth. One draws on the approach presented in the European Bank for Reconstruction and Development (EBRD) "Stuck in transition" report[8], which puts the blame on the slowing momentum of reform. Another builds on the approach of the World Economic Forum, which speaks about the need for transition from the efficiency-driven to the innovation-driven model of growth. Given that most countries in the region have not yet made that transition, one of the EU's objectives in the next institutional cycle ought to be to incentivise and assist in the process.

Looking at both Southern and Central Europe, it is clear that the post-crisis solidarity and cohesion agenda must focus on restarting the convergence process. No other priority is more important for winning back citizens trust and ensuring renewed legitimacy for the European project. Importantly, reinstating the pivotal role of convergence is not only an issue with relevance for the more vulnerable Member States but is profoundly in the interest of the stronger countries as well. It is both the question of restoring aggregate demand as well as avoiding the transmission of individual countries' instabilities. The EU cannot afford to be a patchwork of growth areas intermittent with countries and regions on the trajectory of failure.

There will have to be several components of this 'growth for convergence' agenda. The basic one will have to do with overcoming the legacy of the past and restoring the level-playing field in the European Union. Much of the effort at the reconstruction of the euro zone belongs to this category. A genuine commitment to the convergence agenda would require completing the Economic and Monetary Union with a robust fiscal pillar, including the joint issuance of debt and elements of a "transfer union". However, reduction in the cost of debt, which this would entail, or a mechanism for orderly restructuring of debt, which still does not exist in the euro zone, would not be effective without restoring growth.

Beyond issues of re-footing the EMU, the new convergence bargain will need to span across both demand and supply sides of the equation. On the demand side, stronger economies will need to play a more pronounced role, given their surplus savings, while on the supply side, more will be expected of the vulnerable countries. There will also need to be a powerful EU dimension to enable the scaling up of opportunities through advancement of the single market.

In the former basket, increasing investment in order to raise aggregate demand is the most pressing task. It is the collapse of public investment in the weaker countries that has contributed to the depth of the recession. There are three possible ways to proceed. One would be to create a dedicated investment fund, aiming to serve the interests of the strategy for growth by pulling the available resources through a loan-based vehicle.[9] Another possibility is the one to which the new President of the European Commission, Jean-Claude Juncker, has committed himself. This means greater efforts at leveraging private investment through the more flexible use of the EU budget and European Investment Bank (EIB) lending. In Jean-Claude Juncker's view, this can mobilise up to 300 billion euro additional public and private investment in the real economy over the next three years.[10] A further increase in the EIB's capital "should be considered" for this end.

The third method would be to encourage more domestic investment by incorporating a range of EU-level incentives. This may include exclusion of national co-funding of EU-financed investments from the fiscal indicators of the Stability and Growth Pact as well as the extension of the EU fiscal framework with an asymmetric "golden rule" to protect public investment in times of difficulty, while limiting adverse incentives in good times.[11] In parallel, improving the range of financial instruments, which are available to the Member States and enterprises, is vital. This means increased use of the new private-public partnership instruments, including project bonds, and greater use of loans or guarantees.

A workable and flexible financial infrastructure to allow firms to gain finance and investment must be an essential component of the new convergence agenda. The most vulnerable countries have appealed for a long time to the European Central Bank (ECB) to engage in non-standard reflationary policy and restart credit to small and medium sized enterprises (SMEs). They would benefit enormously from increasing the flow of non-bank finance, including by more equity funding, venture capital and corporate bond issuance. Peer-to-peer lending could significantly improve the funding environment for start-ups. As Hugo Dixon points out, an initiative to create a "capital markets union" could "kill two birds with one stone: it would help the euro zone finance jobs and growth, while giving the UK another strong reason to stay in the EU".[12]

Investment needs to increase not only in the periphery but also at the centre. In Germany, low investment has meant low productivity growth and a vicious cycle of continued dependence on low wages and outsourcing of the production to Central and Eastern Europe.[13] Therefore Germany should change its approach to investment not only to help overcome the wider EU imbalances but also for the sake of its own growth model.

The prerequisite for increasing the flow of investment lies in improving the supply side environment and competitiveness in the vulnerable countries. Progress needs to be achieved across the whole range of component areas of competitiveness, including not only labour market reforms but also efficiency of the institutions, quality and extent of infrastructure, good macroeconomic environment, maturity of financial markets or sophistication of the business models. Better investment environment also involves improving absorption capacity, including earlier involvement of the European Commission and the EIB in the preparation of projects.

The other side of the bargain has to do with improving macroeconomic performance and completing structural reforms in vulnerable countries. Efforts need to be undertaken to work out an optimal policy matrix, which combines the objectives of fiscal consolidation with those of growth and equity. As the OECD suggests, "well-designed consolidation packages can avoid severe adverse side effects on growth, equity and current-account imbalances".[14] In spite of major efforts, which have been undertaken in the past few years, there is still an enormous scope for improvement. Spain, for example, is ranked 136th in the World Bank's "Doing Business" report when it comes to starting a new business. Being an entrepreneur in Spain "continues to be more expensive than in other European countries" with the different levels of administration requiring different authorisations for starting a business and licensing goods and services.[15]

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Prior to the crisis, much of the EU's economic policy, including the use of cohesion funds, was geared increasingly towards addressing the EU's strategic challenges of globalisation, demography and technological change. Although the "Europe 2020 Strategy" will need to be significantly revised to take into account the fallout from the crisis, the focus on long-term readiness to meet societal and global challenges will need to be retained.

This means that the EU's agenda for solidarity and cohesion will become more complex and more nuanced. It will need to be better anchored in the societies' understanding of the commonality of their interests. In the future, solidarity in the EU will need to be more tailor-made and better adapted to the specific requirements of countries at different stage of economic development. It will also need to be more of a two-way street with clear mutual advantages. Its ratio of success will be measured by how decisively and how effectively it re-launches the convergence process in the EU.

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