

Michael A Landesmann: Introductory remarks for the 'EU Scenarios' Panel at the wiiw MISEM 2017:

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Muddling Through – Economic Reform Stalemate – EC's White Paper – Multi-Speed?

A recent article by Timothy Garton Ash (FT, 19 March 2017) starts with a depressing picture of the current state of Europa (a mythical female figure in the classics):

"As she prepares for her 60th birthday party in Rome ..., **Europa** is in bad shape. A recent medical check-up revealed one hand about to be amputated (*gangreana brexitosa*), one foot terribly inflamed (*putinisma ukrainika*), a skin disease across many body parts compounded by a dangerous allergic reaction (*xenophobia populistica*), an ulcer eating away her stomach (*eurozonitis*), as well as *logorrhoea* and memory loss.

...When Europa was in her thirties, back in the hope-filled years after 1989, Ukrainians and Moldovans, Turks and Egyptians would turn their heads when this magnetically attractive woman walked into the room; now they take no notice. And to cap it all, her partner of many years has gone off his rocker (*egomania narcissistica trumpica*)."

When we discussed the preparation of the afternoon panel some months ago, we were guided very much by the spirit expressed in Garton Ash's quote and we thought of analysing possible scenarios of 'disintegration' of the EU and the EMU.

However, the mood – despite of yesterday's delivery of Teresa May's letter to Donald Tusk – has changed somewhat and we now find that it might be more useful to discuss the **most likely scenarios** – rather than focussing on 'disintegration scenarios'. We do want however to also consider the downsides of such 'most likely' scenarios.

To start off: I guess that the panel will agree that the most likely scenario – this has become an almost 'sure bet' over the past years - is:

'Muddling Through': to see this scenario as the most likely scenario is the legacy of the image of the EU/EZ as having dealt rather badly with the financial and economic crisis. This experience has led to strong doubts in the population that the EU/EZ is an effective instrument to deliver economic security and growth. On top of that the EU/EZ – given its focus on the 4 freedoms and the lack of a 'social pillar' – is seen as an organisation furthering market liberalisation/market integration (i.e. the European variant of 'globalisation') and does little to further a feeling of social security in the population. This perception has been exploited not only by populist parties, but – increasingly - also by politicians of the political centre.

The consequence of this is that in the medium-term – and in this period also falls the negotiation of the next Financial Framework i.e. the EU budget commitment for the period 2020-2027 – there will not be much 'deepening' (**'Economic Reform Stalemate'**). The fiscal room of the European Commission will be further tightened in these financial negotiations, given the loss of a significant 'net payer', the United Kingdom, and the unwillingness by the other net-payers to make up the shortfall. The need of the EU/EZ to undertake a major push towards building up important new pillars of policy, such as a significant 'stabilisation function', Eurobonds, a European Finance Minister, etc. will have to wait. The political mood is not supporting such major new initiatives. However, **incremental reforms** and a more efficient use of existing policy-structures in the areas of bank restructuring, Capital Markets Union, supports of labour/people mobility (recognition of degrees, pension portability etc.), the build-up of crisis-reaction structures (through the widened use of ESM resources; or the discussion of country bankruptcy procedures) will proceed. As will discussions – unlikely however much implementation - regarding elements of a **'Social Pillar'**, such as a joint unemployment insurance system, a PPP-adjusted minimum income, harmonisation of corporate

taxation, etc. However, **interest positions of countries are quite far apart** on many of these issues and depend partly on election outcomes. Existing programs regarding the 'social policy side' of the EU might be strengthened, such as joint sponsoring of youth unemployment and training programs, etc. But these initiatives and the resources devoted to them are limited.

There will, however, be an area in which EU coordination will be intensified: this is the area of **'Security and Foreign Affairs'**. A number of factors push in the direction of a 'deepening' in this area: (i) tensions with Russia over the Ukraine; (ii) the challenge of instability in Europe's neighbourhood: war in Syria; instability in the Middle East and Northern Africa more generally and linked with this the refugee and migration crisis; (iii) the recognition of better effectiveness of security cooperation in relation to the 'fight against terrorism' at the trans-European level, including cooperation with the U.K. even after Brexit; (iv) the greater ease to build up a European military arm once U.K. leaves, further strengthened by the pressures of the Trump administration that European Nato partners should increase their contributions.

Conclusion for the most likely medium-term scenario: 'muddling through' with incremental reforms; bigger initiatives in the area of Security and Foreign Affairs.

Will the medium-term **'Muddling Through' scenario lead to a disaster?**

I do not think so, as the most likely scenario is now one of a moderate economic recovery, with unemployment rates falling or stabilising and the debt legacy in the banking sector gradually being dealt with (Italy remaining the 'weakest link'). Also public debt will gradually be coming down and the biggest calamity of economic contraction of the Southern EU countries has come to an end. Further, it is likely that the 'election year' of 2017 will have reasonably positive outcomes (Dutch elections, French presidential elections, German elections). However, the medium-term will see no scope for new Treaties, so that reforms will have to take place under the existing Treaties. There will also be **no major push towards a next round of Enlargement** with rather negative consequences for stability in the Western Balkans. Also not enough resources will be made available for the **'Buffer region'** of Ukraine, Georgia, Moldova, Belarus, etc. But there might be further **bilateral agreements** with migration/refugee transit countries in Europe's neighbourhood.

There will be **back-sliding on integration** in some areas (such as on social security payments to EU citizens working in other EU countries; border controls in periods when countries are worried about 'losing control'; strengthening control on cross-border small firm activity, and others). We also witness the divergent paths that EU members take with respect to constitutional and 'European value' issues (Poland, Hungary). EU Treaties seem quite toothless in the light of these developments. It is a rather new phenomenon and we can no longer be confident that there is convergence towards a uniform 'EU value system'. Nonetheless, despite the developments we see in Hungary and Poland, EU membership will still act as a 'constraint' on political-economic developments both for members as well as for candidate countries. The case of Turkey serves as a warning for what happens when an accession perspective fully disappears. EU policy-makers have to be aware of this, especially with respect to potential developments in the Western Balkans. But also with respect to developments in non-candidate countries such as the Ukraine, Georgia, Moldova, even Belarus. We shall come back to this point later on.

Let us move to the big unresolved **'Long-term Issues' of EU/EMU/Wider European integration:**

(i) First: **Heterogeneity of EU/EZ members** will continue to be a long-term characteristic of the EU/EZ: this implies that growth rates will differ just as they differ across regions within countries. There will continue to be scope for 'structural/sustained current account disequilibria' and for centre-periphery developments at both country- and regional levels. Hence we cannot rely on

‘pervasive convergence’, although some significant convergence will continue to be a feature of the EU.

The issue of **chronic ‘external imbalances’** in the European Union, in the Eurozone and also in the Wider Europe is not resolved and this keeps the EZ but also associated countries highly vulnerable to shocks and open to severe interruptions of growth trajectories. Most of the ‘Northern’ EU/EZ member states are not willing to move towards a scheme of significant ‘pooling of risk’, common resolution of debt, or putting in place an arrangement that would lead to cross-Eurozone ‘automatic stabilizers’. The build-up of a significant fiscal stabilisation function at the EZ-level is unlikely.

However, the **other side of the coin** is that the experience of the stance by the ‘Northern’ EZ member states and of Germany in particular during the crisis, has changed expectations both in EU/EZ member countries and on financial markets. Although there were a number of rescue deals of Greece during its debt crisis, these were linked to very severe conditionalities that caused huge economic and social costs. Hence, the experience of ‘doing only the minimum at the last minute’ has shifted expectations in the direction of **taking the ‘no bail-out clause’ much more seriously** than before or during the crisis. It is therefore likely that this experience will shape expectations of policy-makers in the countries and on financial markets. In addition, one can imagine that the EZ will initiate proper procedures to deal with ‘bankruptcy’ of particular member countries (as mentioned above) and the gradual evolution of the ESM into a fully-fledged EMF (European Monetary Fund) is a real possibility. The misguided convergence pattern of interest rates across EU economies that we have seen before the crisis, will – most likely – be a thing of the past. The ECB will also - in this light - adjust its policy with regard to the assessment of assets that serve as securities for the provision of liquidity. This will go along with reforms in regulations that reduce the ‘home market bias’ in country’s portfolio investments which is one of the aims of the Capital Markets Union.

All in all, these developments will impose constraints on countries to which extent ‘chronic current account disequilibria’ can be sustained and this in turn will and has already affected policy-making at the national levels.

(ii) **A-synchronicity of economic integration and political processes**

Second point regarding unresolved longer-run issues: There is a **discrepancy between sectoral economic interest articulation that often drive the policy agenda in the EU and the dynamics of political processes**. Let me explain: If we look at the evolution of many of the EC/EU integration initiatives (the early formation of the Coal&Steel Community, various free trade deals up to the Single Market initiative and even the EMU, but also the day-to-day work of many DGs), they are driven by sectoral interest groups which push towards advancing their agenda (at times integrationist, at times protectionist, but – on balance – more integrationist). However, the full implications of these initiatives beyond the sectoral (economic) impact reveal themselves only at a later stage (e.g. free mobility of labour affecting social sensitivities at the regional and country levels; trade deals as well as regulations/deregulations affecting the situation of local producers and consumers, etc.). It is only when certain **thresholds of sensitivities are crossed**, that political responses to these local/regional social impacts start to unfold, often leading to a backlash. Hence one can speak of a **typical pattern**: sectoral economic interest often drive the integration policy agenda, and then **social and political responses react with a lag** once sensitivities of their impact have crossed certain thresholds.

What follows from this? Policy-makers in the Community have to think about reform initiatives much more carefully **in a ‘general equilibrium way’** i.e. beyond the sectoral impact, be concerned with all the direct and indirect effects these might have at the social and regional levels. Even if the initial

stages of such policy initiatives do not yet show severe social impacts and do not yet cause political responses. As we know from our textbooks, it is the '**normative job**' of **policy-makers** to take account of 'indirect' (i.e. 'general equilibrium') effects and of 'externalities'. Policies with regard to deeper cross-country integration measures are no exception to such a 'normative duty'. This is particularly true at the EU level, where the popular attention and the Parliamentary scrutiny is much less developed than at the national level.

Greater attention *ex ante* to this 'normative job' would assist to counteract the pendulum swings in public opinion that often accompany moves towards further European integration (similar issues arose with regard to FTAs at the international levels, such as TTIP).

(iii) Finally, let me turn to the various **proposals with regard to 'Differentiated Integration'**:

These get currently articulated under different names such as 'multi-speed', 'forging-ahead', (see also Scenario 3 in the Commission's recent White Paper named 'Those who want to do more').

Janis Emmanouilides from the European Policy Centre (EPC) in a recent paper ('The **future of a more differentiated E(M)U** – necessities, options, choices'; *Istituto Affari Internazionali*, Feb. 2017) discusses various scenarios of a differentiated EU/EMU; He states: "*From a purely functional perspective, differentiation is a strategic necessity if the EU wants to remain effective and cope with current and future challenges*". Emmanouilides (Ibid, p.3)

The scenario of a more differentiated E(M)U seems to be the scenario favoured at the recent Rome Meeting by important EU leaders when they celebrated the 60th Anniversary of the EC/EU.

Emmanouilides distinguishes different forms of differentiated integration: (i) functional-pragmatic differentiation within the EMU/EU frameworks (ii) within or outside the Union's Treaties.

In the paper, Emmanouilides comes out forcefully in favour of a '**Forging Ahead**' scenario by groups of economies. There are important differences between a 'Forging Ahead' scenario (based on inter-governmental initiatives by sub-groups of EU economies making use of 'enhanced cooperation statute of the Lisbon Treaty) and the more familiar phrase of a '**Multi-Speed Europe**' (which congeals rules and policy initiatives through agreements within a Treaty). However, although the differences between these different forms of differentiated integration are important, I would like to point to certain dangers that affect each of these.

From a technocratic point-of-view the scenario of a differentiated EU/EMU (whether in the form of 'forging ahead' or 'multi-speed Europe') is attractive: countries can voluntarily decide in which initiative to participate; a sub-group can develop its set of functional rules and this arrangement can overcome stalemates whereby particular countries or groups of countries can block moves towards further integration. However, multi-speed/differentiated Europe has two fundamental problems: (i) it can **cement heterogeneity** across European economies and social systems and (ii) it can generate very fundamental **problems of political legitimacy** for the EU as a whole. On a practical level it can generate an institutional 'spaghetti bowl' of full/part/no participation in circles which might generate great complexity in political processes and present a very unwieldy picture to the European population. It can lead to a feeling of 1st, 2nd, 3rd class citizens of a 'United Europe'.

On the issue of cementing heterogeneity and the likelihood of which 'clubs' are going to be formed: it is likely that clubs are going to be formed by members that are more similar. And this is despite theory suggesting that e.g. the biggest gains of organising an insurance is to cover as wide a range of members which might be open to differentiated idiosyncratic shocks. I would conjecture that the political dynamic will likely go in the direction of a 'Differentiated Integration' scenario which favours '**clubs**' being formed by members that are rather similar. This would particularly be true for anything

to do with 'risk pooling', i.e. in any area where the impression exists that there are 'chronic asymmetries' across economies and that could lead to having to shoulder part of the debt of another country. Hence moving along the path towards differentiated integration, forging ahead etc. has the danger of **cementing heterogeneity within the European Union**, reducing the scope of risk sharing and reducing horizontal aspects of political participation.

Nonetheless, we agree in line with most observers that the EU will continue to move on a path of differentiation and hence it is important to choose a path that is most conducive to keep 'coherence', a feeling of 'openness' and avoid a congealment of membership in different circles of club membership. Let me leave it to the panel to discuss how this could be achieved.

But the issue of differentiation is not only relevant with regard to the EU or the EMU but even more obviously in relation to the '**Wider Europe**' (i.e. the European continent as a whole) and also with regard to Europe's relationship to its **non-European Neighbourhood**:

For the Vienna Institute it was always important to think about 'European integration' beyond the EU, beyond future 'Enlargements/accessions' and even beyond Europe's borders. It is our view that the longer-term successful stabilisation of European integration has to include a plan that provides for social, economic and political development beyond membership of the EU. There have to be substitutes to full membership that provide sufficient 'meat' so as to help stabilise the social and political situation in the Balkans, the Ukraine, Georgia, Moldova, etc.

Looking forward, it is likely that to utilise potentialities for growth for the countries **within the EU**, greater resources and much more attention will have to be devoted over the coming decade to: the '**candidate**' region (where candidacy in the waiting room seems to have become a position with indeterminate time lines), the countries 'in the **buffer zone**' **between the EU and Russia**, also to the relationship with Russia and, last but not least, to **Europe's neighbourhood**, specifically the Middle East and Africa. Instability in all these regions has the potential to spill-over into the EU and into Europe and can only be countered by a strategic, long-term thinking about development processes in these differentiated sets of countries together with substantial investments into relationships with these countries.

If there are **reduced expectations** in the medium-term regarding deepening and widening of the EU, then the positions of countries outside the EU should be seen as **less 'transitory'**. Consequently, these less transitory positions have to be made sufficiently comfortable so as not to tip these countries into social and economic chaos and into political regression.

Concern for carefully designing EU's relationships with its candidates, its other European neighbours and its non-European neighbours should and – I expect will - get much higher priority over the coming years. Furthermore: just as the 'Forging Ahead' strategy inside the EU has to be open-ended avoid insurmountable barriers for 'late joiners', the **Europe of 'concentric circles'** should also be designed with **appropriate incentive structures and supports** to allow countries to move – in due time – across the boundaries of these circles.

Thus, coming back to Garton Ash:

When we look ahead, let us make sure that with a careful attention to a healthy diet, a positive outlook and a respectful regard for her neighbours, **Europa** will again be an attractive and admired lady in her 70s and 80s.