EUROPEAN ECONOMICS

European integration

The next five years and the following decades

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In this series of twor articles, the authors argue that the European Union (EU) Parliamentary elections come at a time of major present and future challenges. In particular, Europe needs to manage far-reaching economic changes, such as technological disruption, demographic transition and climate change. Furthermore, the challenge of migration, growing distances with the US, the rise of China and Russian revisionism all underline the importance of close European coordination and integration in foreign policy, defence and security. In this context, the question that arises is: how will Europe face the next five years?

A challenging time

There seems to be a consensus that the coming years will be decisive for the EU; today more than ever the future looks both difficult and unpredictable. To approach this ambitious exercise, we need to provide a general description, which might be as follows. At

a time of change in the global order, almost unprecedented in previous decades, the main hegemonic power, the US, is reviewing its function in the world system and reducing its ties, so far in largely undefined ways, with the multilateral institutions that have defined the liberal institutional order. Furthermore, the US and its main rival appear to be more on a collision course than one of cooperation and, given this situation, Europe is questioning its role in the world. The economic situation is at the forefront of the debate, as Europe encapsulates many of the difficulties in facing the structural transformations affecting industrialised economies. Finally, rising political polarisation is frequently expressed as criticism of the European integration project. Does this ring a bell? Of course, you say, as it summarises, at least in part, some of the characteristics of the present.

Yet, this description in fact refers to the situation of the European Economic Community at the start of the 1970s. At that time, US withdrawal from multilateralism took the form of withdrawal from the Bretton Woods system and the gold standard in 1971. They were difficult times: the US was losing the Vietnam War and the country was debating how to deal with its problems, in which isolationism was a powerful temptation. The unnamed rival was of course the Soviet Union. We now know that it was a political giant with feet of clay, but it was not perceived as such at that time and in Europe the debate revolved around how to increase collaboration with the USSR and its partners without threatening the defence provided by the US. In economic terms, the underlying pressures were basically how to manage major changes in supply or, in other words, switch from industrialisation to a service economy. This became the highest priority when the oil crises hit in the following years. Finally, the confluence of significant polarisation and criticism of the European project was summarised at the time as ‘Eurosclerosis’. What would we have thought then about the immediate prospects for European integration? It is unlikely that we would have felt particularly optimistic.

Yet the following two decades saw some of the most important leaps in the history of European integration. Thus, the European Economic Community became the European Community, eventually called the European Union. A union of 9 members became the EU15 and it began to prepare for expansion to the east, leading to the current EU with 28 members. Economic integration, timidly achieved through the common market, became the much more complete internal market. And finally, the current Economic and Monetary Union (EMU) was forged. In short, the 1980s and 1990s were a veritable golden age for European integration.

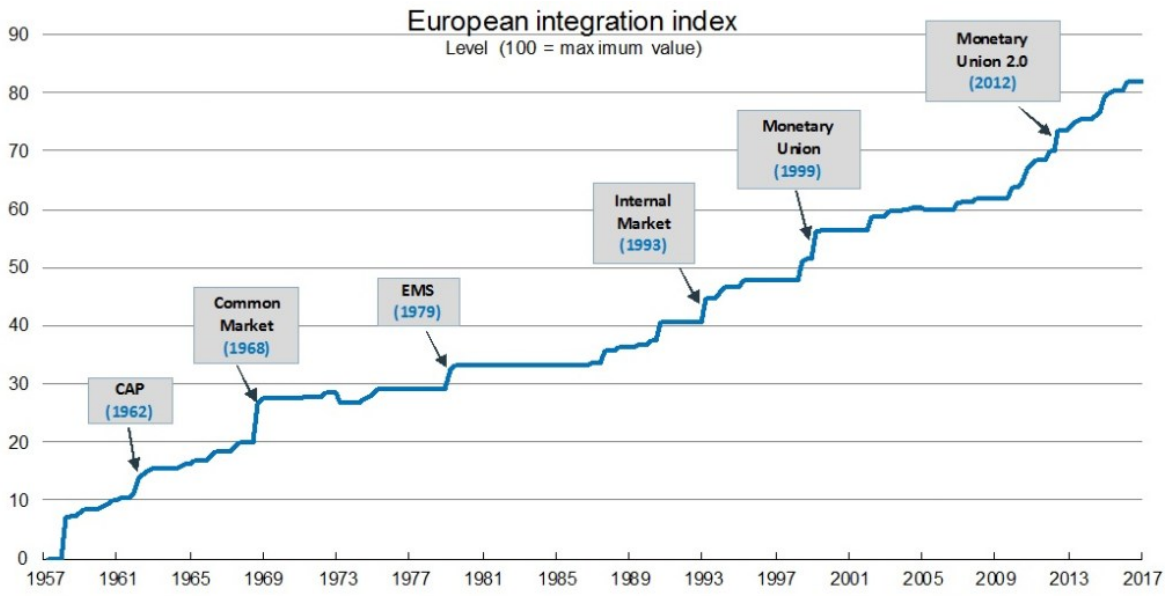
The lessons of the past

Leading the reader into comparing the current situation with that of five decades ago is more powerful than the apparent conclusion that excessive pessimism in the past was a poor predictor for subsequent events. If we accept this statement, the point argued here is that the factors acting at that time could be similar to some of the elements we see today. To make full use of this short exercise in comparison, we will start by describing what we understand by European integration. Although integration is a multidimensional process and, thus, difficult to reduce to a single measure, the essence of the European experience

may be summed up using an indicator of EU country integration. As shown in the graph, the trend in the European project has been towards greater integration (there have been no retreats), sometimes speeding up when major leaps forward were made. What factors explain this dynamic?

First of all, there is a mechanism at work that we might term endogenous or ‘functionalist’. Through this mechanism, integration that begins in relatively technical areas, such as steel, coal or trade, expands into other complementary fields, such as regulatory harmonisation or freedom of movement for productive factors. The second key factor is changes in the configuration of the world order. Thus, the bipolarity that arose after the Second World War (1945) gave way to unipolarity following the fall of the Berlin Wall (1989) and the current incipient multipolarity. These changes in the system of world governance, although infrequent, have in the past led the EU to develop new competencies as a global actor. The third factor that in the past led to progress in European integration is the existence of economic changes that demand a capacity for structural reform. Such changes can be deep and long lasting, such as the switch to the service economy that transformed the productive structure of European economies in the 1970-80s, or more specific, such as the double recession of 2008-2009 and 2012-2013. Faced with these economic transformations, European integration has played a role on two different levels. Firstly, experience shows that often the political toll of implementing required reforms is easier to swallow internally when explained as the demands of a supranational institution. Secondly, and undoubtedly more importantly, many structural changes require public policy responses that can only be optimised at the supranational level.

We are now ready to analyse the two ‘golden decades’ of European integration. As the graph shows, the need to ensure the survival of the new-born common market of 1968 after the supply-side shocks in the 1970s and abandonment of fixed exchange rates led to a first attempt at monetary integration, the European Monetary System, whose stability in some periods was punctuated with volatility in others. Such dysfunction created the need for a more complete monetary integration, the current EMU. Furthermore, during the complicated decade of the 1980s, European economies simultaneously faced a dramatic change in the productive model (the so-called ‘industrial restructuring’ was not damaging to Spain at that time) in the previously mentioned context of the oil crisis and the onset of the complex situation of stagflation. This highlighted the need for a leap forward in economic integration and the transformation of the common market into the current internal market. The internal market required an unprecedented drive to liberalisation while definitively lessening the threat of competitive devaluations, in turn making the EMU an unavoidable complementary step.



Note: The index is a measure of integration of EU countries which considers new area of European coordination: common market, internal market, supranational institutions, economic union, financial union, fiscal union, monetary policy coordination, monetary union and democratic legitimacy.
Source: CaixaBank Research, based on data from Dorrucci, E. et al. (2015). "The Four Unions 'PIE' on the Monetary Union 'CHERRY': A New Index of European Institutional Integration". ECB Occasional Paper, No. 160.

The situation today is (probably) no different

Fins aquí l'exercici de comparativa històrica. Si acceptem que hem estat capaços d'explicar de forma raonable el passat, què podem dir del futur? Tal com es desprèn de l'inici d'aquest article, la premissa bàsica és que tornem a trobar-nos amb factors que en el passat han comportat salts endavant en el procés de la integració europea.

So much for historical comparison. If this is a reasonable explanation for the past, what may we say about the future? As suggested at the start of this article, the basic premise is that once again we are facing factors that in the past have led to leaps in the European integration process.

What are these factors? First of all, possibly the most striking element is the change in political polarity, a transition toward a clearly asymmetric multi-polar world: the US will undoubtedly remain the hegemonic power for some time, but the rise of China and the activism of many mid-level powers, such as Russia and India, is a long way from the so-called 'unipolar moment' of the 1990s. We said earlier that in a similar context in the past, Europe gradually accepted its role as a global actor, falteringly at times, with little conviction at others, but unavoidable in the end. It may well now follow an equally uncertain path. A second element that appears to be repeating itself consists of the long-term dynamics affecting the economy. If previously this was the switch to the service economy, this time it is technological disruption produced by digitalisation, demographic transition and climate change. The natural response to all three should involve a transnational dimension, which the EU already provides and will continue to do so

(obviously, with differences in each area). Finally, a third recurring element is the endogenous development of integration itself: in certain areas, the effect of overflow, or complementarity, is not yet complete and will continue to produce further advances.

Do these three factors mean we are at the gates of a new stage of intense European integration? It all depends on how we define ‘gates’. If it means we are already crossing the threshold, then definitely not, but it may be the case if we take a broader time scale. Obviously, the key lies in new elements that distinguish the current situation from the past. By far the most important such element is the heterogeneity of preferences: alongside the public perception, there is growing empirical evidence that political preferences in many fields are more polarised than in the past. [1] As is to be expected, this polarisation is also expressed in the demand for European integration, and is particularly intense in areas where more progress in European integration needs to be made. Why might such polarisation significantly affect the dynamics of European integration? It is often argued that the political expression of this polarisation could alter the normal operation of community institutions. Without ignoring the obvious, this points to something more profound. Remember that one of the key factors for steady progress in European integration is the functionalist mechanism, i.e. factors that spread from one, generally technical, area of integration to another complementary one. Thus, the common market became the internal market and then the EMU. The key to this process is the confluence of two realities in these areas: economies of scale in the area in question and (relatively) similar preferences among the actors. By contrast, in many areas where this new stage in European integration needs to materialise, often of a far more political nature, the latter element becomes diluted, as preferences on such issues are more heterogeneous, due to the diversity in societies, cultures and identities. This has always been the case, but if one also adds the increased polarisation in recent years, the panorama becomes more complicated. Nevertheless, this does not mean that progress towards integration cannot be made.

Arrival in the EU agenda

Which of these effects will prevail in the medium term? To provide a diagnosis as detailed as possible, we focus on certain areas we consider central to the EU and where we believe there will be new developments in the medium term. In each, we have attempted to offer a balance of what can be expected in the next five years.

Economic and Monetary Union 2.1: margin for functionalist manoeuvre

Monetary integration is an area where the so-called ‘functionalist overflow’ still has room to advance. The clearest example of this is the commitment to the full European banking union, a project that would decisively complement the institutional design of the EMU. Specifically, after establishing single supervision and resolution mechanisms and after agreeing on the Eurozone Rescue Fund (ESM) acting as a lender of last resort (backstop) for the Single Resolution Fund, we may expect progress in the political debate over the next

five years and the third and final pillar of banking union to be given the green light: the single European Deposit Insurance Scheme (EDIS). The aim of EDIS is to guarantee a banking system under equal conditions and help separate sovereign risk from banking risk, an essential step towards reducing the vulnerability of national deposit insurance systems to large local shocks. In this context, the most delicate issue will be the extent to which the political will of individual countries permits a truly ambitious agreement on EDIS that ensures full risk sharing. Furthermore, following the functionalist logic, the Eurogroup continues to work on the embryonic countercyclical stabilisation mechanism for the eurozone. Although its funding might be limited and come with demanding conditions (thereby distancing it from the operation of automatic stabilisers in member countries), it could be the seed for a future fiscal policy for the eurozone as a whole.

Taxation: preferences for harmonisation among citizens, rather than political decision-makers

In accordance with citizens' demands, changes in business models (due to changing technology) and tax collection requirements in individual states, more harmonised taxation, especially with regard to company tax, is an area in which qualitative change may be about to occur. However, here there is a confluence of two different problems. First of all, there is a striking heterogeneity of preferences among different countries. Secondly, in terms of institutional operation, such heterogeneity significantly hinders progress in this area, given that decision-making requires unanimity. The failure of the relatively modest proposal for a digital tax is a clear example of the power of veto. To overcome these barriers, the European Commission aims to introduce a qualified majority system, firstly on issues where there is most consensus, such as tax fraud and evasion, to extend it later to other areas, such as defining new taxable actions. This is an area in which there is likely to be progress and public debate will help drive further, longer-term ambitions.

Schengen, immigration and internal security: the polarising issue par excellence

The migration crisis of 2015 and the persistent terrorist threat has led to de facto questioning of both Schengen (in 2015-2016 border controls were reintroduced in 9 of the 26 countries in the area and are still in place in 6 of them) and the Europeanisation of external border controls. Furthermore, piecemeal measures have been taken that seek to reduce the entry of unauthorised immigrants. Finally, with regard to internal security, the EU has adopted a variety of measures in the last few years, such as registering passenger names, tougher regulations for the arms trade and strengthening the fight against terrorist funding.

However, the effects of these measures have failed to convey the sensation that the EU is safer than 10 years ago, while feeding, not always directly, political polarisation. A further complication is the fact that migratory pressure in the south has not lessened in recent years, as the demographics of sub-Saharan Africa and factors affecting these flows will tend to generate greater movements of people. Thus there is a striking contradiction between a

largely short-term, defensive approach and long-term dynamics. Probably more time is needed for citizens to adopt a broader view of the movement of people within the EU and from outside the Union, possibly longer than the next five years.

European defence: differences in the means and possibly in the ends

Defence is a central area in which tensions for the EU as a global actor, arising from changes in the international order, are particularly notable. Factors such as the US's reassessment of its role in defending the Old Continent, the rise of China and Russian revisionism are likely to run for some time, highlighting the need for the EU to adjust to the previously mentioned asymmetric multipolarity. In this issue, we are at the start of a profound debate, which essentially hangs on two major decisions: progressing towards an instrument that could give rise to a future European army, and redefining the role of European countries in NATO. Regarding the former decision, there is an abundance of political declarations, but few specific measures. Thus, both Germany and France have stressed the need for a European army, but without explaining what type of army they have in mind: one that is answerable to European institutions and defends the territory of the members states (an army of Europe) or a military force under the control of participant states (an army of the Europeans). The most likely option in this area of integration is stronger cooperation in security and defence (including cyber defence), which is voluntary and organised on a case-by-case basis. The EU could supplement national efforts, but its participation in the most demanding operations would be limited and EU/NATO cooperation would be conducted under the current structure and format. Anything more ambitious in the next five years is probably premature. However, once again, it could establish the foundations for more wide-reaching changes in the longer term.

Dealing with China: between taking a hard line and pragmatism

China has now made it clear that it represents the greatest change in the global institutional order. This is a dynamic game, in which the EU, China and the US are redefining their underlying strategies and Europe's response is probably a taste of what we will see in the coming years. To continue our main thread, a single response from the EU would require the benefits of such a response to outweigh the cost of divergent national positions which, in turn, reflect the heterogeneity of internal economic situations. What we have seen so far suggests that the benefits are not obvious to member states, as a bilateral response between different countries, or blocs of countries, and China has prevailed in at least two crucial areas: reciprocity in opening up markets (which is even more important if the US 'closes' its market and Chinese trade is diverted to Europe) and the balance between attracting direct foreign investment from China and protecting sensitive sectors and technologies. As with defence, it is only now that an initial European approach to the issue is being outlined, suggesting a period of political discussion rather than decision-making.

The prelude to a major change?

Let us return to the key questions in this article: Over the next five years, will we see a leap forward in the European integration process? The short answer is that this period is not long enough for changes in the international order and the effects of the triple transition in technology, climate and demographics to produce radical changes in EU's current inertias. It is also too short a time scale to assess whether, in the immediate future, the benefits of integration will be overwhelmed by the costs of heterogeneity. Nevertheless, over the next five years we may begin to discern the necessary conditions for an as yet poorly defined acceleration in European integration. This is as least one conclusion that can be drawn from the review of prospects in different areas where change might be expected over the medium term. Historically, Europe has tended to show its least proactive faceimmediately before meeting challenges in an unexpectedly ambitious way. This might be the case now, although, obviously, we will not know until we are well into the next decade.

Conclusions

In conclusion, in economic terms, the eurozone will maintain modest growth at a lower rate than in the previous expansion cycle. This is because the economy will be affected by a number of structural factors (low productivity, ageing population and imbalances in the labour markets) which limit its capacity for medium-term growth.

In political and institutional terms, we believe that a single (European) legislature is not long enough for radical changes to occur in the EU's current inertias. However, we believe there is a favourable basis for new leaps forward in European integration. In particular, pressures arising from external defence, relations with China and migratory flows will help establish the necessary political foundations for joint decision-making. Furthermore, we can expect the eurozone to progress toward completing its institutional framework, especially in the area of the banking union.

Series: Europe facing the mirror

Economic and Institutional Perspectives

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1 — See, for instance, Gentzkow, M. 2016. Polarization in 2016. Toulouse Network for Information Technology Whitepaper. And Rodrik, D. 2018. Populism and the Economics of Globalization. Journal of International Business Policy, 1-22.



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