BRIEFING

EPRS Ideas Paper

Towards a more resilient EU

European Parliament

EU competitiveness and global growth

SUMMARY

With rising tensions surrounding the multilateral and liberal trading order in recent years, and declining public support for globalisation, the coronavirus pandemic has hit the world economy hard. In the short term, the efforts of the European Union (EU) and its Member States, as well as many other jurisdictions, are focused on supporting a sustained and inclusive economic recovery and on protecting businesses, jobs and livelihoods. At the same time, policy-makers in Europe should seek to address medium- to long-term challenges to minimise long-term scarring and restore eroding competitiveness. Decisive action is needed to secure EU global leadership of environmental and digital transformation. This will include investing in research and innovation, implementing structural reforms, and completing the (digital) single market, while screening foreign investments more efficiently and leading more efficient global coordination. The EU must equip itself with the right toolbox to ensure efficiency and the ability to shape global long-term trends, and prevent or at least mitigate structural risks and threats.

Introduction

The coronavirus pandemic has hit the EU and other major economies severely. Both demand and supply sides of the world economy have been impacted significantly, with major disruptions. In response to this extraordinary shock, EU governments had to move quickly to put in place strict containment measures and implement wide-ranging economic and financial policies to prevent the collapse of the economy and to protect businesses, jobs and livelihoods.

The Organisation for Economic Co-operation and Development (OECD) forecasts the most severe global economic recession since the 1930s due to the pandemic crisis. The world's gross domestic product (GDP) is expected to contract by 6 % in 2020 in a single-hit scenario, or by 7.6 % if a second wave of infections with renewed lockdowns hits before the end of the year. For advanced economies, which have been hit harder in general, the picture is even worse, with a projected GDP fall of between 7.5 % and 9.3 % depending on the scenario envisaged. The Paris-based organisation stresses that, by 2021, real income per capita in the majority of OECD economies will be back to 2013 levels in a double-hit scenario and to 2016 levels in a single-hit scenario.

Either way, it will likely take several years before the world economy fully recovers, with lasting scars on investment, human capital – owing to fast-rising unemployment – and global trade. Potential output may decrease on a permanent basis as a result. In response to this shock, the implementation of key structural reforms is crucial to boost productivity and employment in an inclusive way.

This steep global economic downturn is unique. There was a broad-based aggregate demand and supply shock with a sudden and sharp drop due to lockdowns and social distancing. Households cut consumption and increased precautionary savings. Firms held investments back owing to falling consumption, supply disruptions and heightened uncertainty. Global trade also contracted substantially over the first half of the year, on account of subdued external demand for goods and services, plummeting travel and tourism activities and cross-border supply chain disruptions. The

Author: Stanislas de Finance

PE 652.060 – September 2020

EN

United Nations Conference on Trade and Development (UNCTAD) forecasts that global trade in merchandise will drop by 20 % this year. There is a growing risk that businesses will shift permanently away from established supply chains, reducing input from efficient but distant providers in favour of local ones in order to boost their resilience.[1]

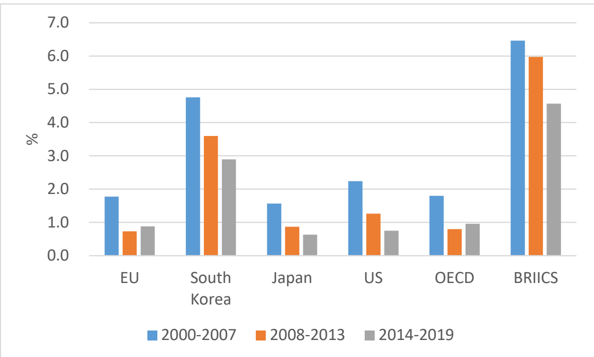
There is an urgent need for decisive action at EU level to improve the bloc's resilience and competitiveness. At the same time, stronger international coordination is required to address the pandemic crisis quickly and mitigate the global recession as much as possible so that it does not ultimately turn into an economic depression. Notable challenges include the sharing of knowledge, data, medical and financial resources, and the reduction of trade barriers, in particular concerning healthcare products.

In this context, the EU can play a strategic and active role in further shaping global long-term trends, if it equips itself with the right competitive toolbox. This paper presents a few ideas on key challenges that the EU needs to address if it is to enhance its competitiveness and cope with global powers such as the United States of America (USA) and China. Subsequently, it examines how increased global economic coordination could help kick-start the world economy.

Enhancing EU competitiveness

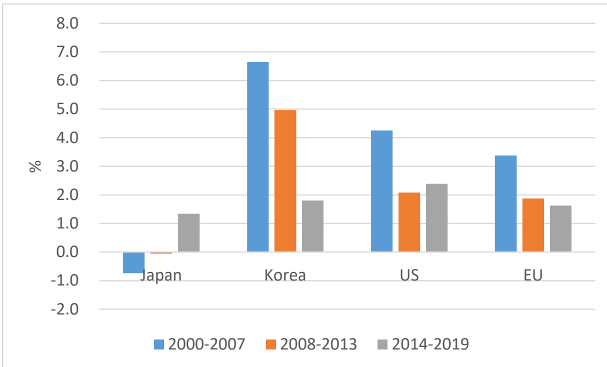
The debate on how to improve Europe's external competitiveness is a perennial one. Yet, a variety of statistics show that it has been eroding for a some time. By contrast, many Asian economies (barring Japan most notably) have outperformed and have been on average more competitive. Their productivity gains have generally been higher than in the EU and the US, while the export market shares of EU's largest economies have declined steadily over the past two decades (Figures 1 to 3). Admittedly, the higher rates of productivity growth recorded by emerging market economies are due in part to the relatively low starting levels for productivity and the catch-up effect, as they absorb technology and attract capital from wealthier nations.

Figure 1 – Labour productivity growth



Data source: OECD.

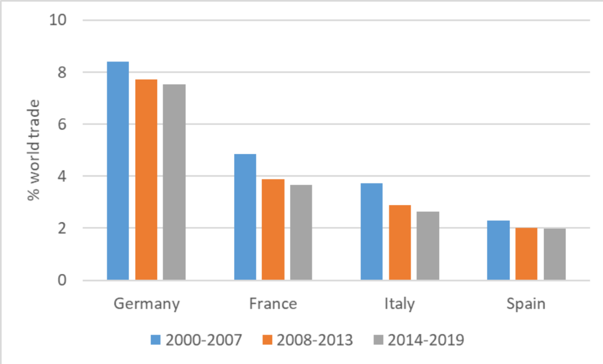
Figure 2 – Labour compensation growth



Data source: OECD.

NB: Labour productivity growth is the average growth rate of output per hour worked. For the BRIICS (Brazil, Russia, India, Indonesia, China and South Africa), it is the average growth of output per person employed.

Figure 3 – Export market shares



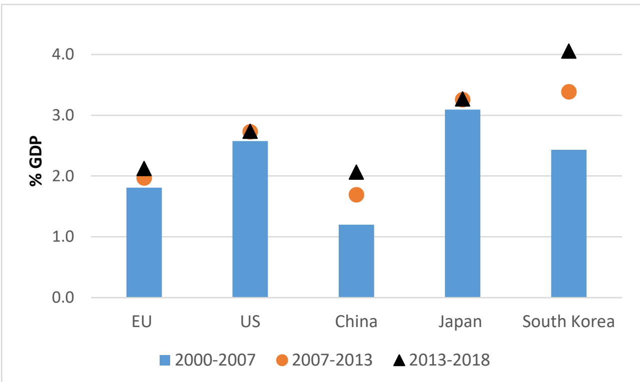
Data source: Eurostat.

In this context, the coronavirus crisis represents both a risk and an opportunity for the EU. In the short term, EU competitiveness is expected to fall, as it did in the period following the 2008 global financial crisis. However, if the EU can implement the right policies and incentives to enhance its external competitiveness, it could become a leader in areas of the future – namely in the digital and green transitions – and reverse the declining trend. For example, the EU could invest further in reducing CO_2 emissions, by supporting public goods such as renewable energy, resilient infrastructure and clean air. In this regard, the European Green Deal is a step in the right direction. It aims to make Europe climate-neutral by 2050, preserve biodiviersity and promote the circular economy, while ensuring EU's long-term competitiveness. The pandemic crisis has also revealed how important it is to invest in digital technologies and resilient infrastructure with a view to remaining productive.

Investing further in research, development and innovation

EU spending in research and development (R&D) over the past two decades has increased marginally but remained short of the 3%-of-GDP target set at the beginning of the Lisbon strategy. By contrast, Chinese and South Korean spending increased significantly over the same period while American and Japanese expenditures remained stable, albeit at higher levels than in the EU, namely at about 2.75 % and 3.3 % of GDP respectively (Figure 4). Smaller high technology sectors and lower R&D intensity account to a large extent for this gap. In China, Japan, South Korea and the US, business R&D intensity is also much higher than in the EU and continues to be the main driver of R&D growth.

Figure 4 – Gross domestic expenditure on R&D



Data source: Eurostat.

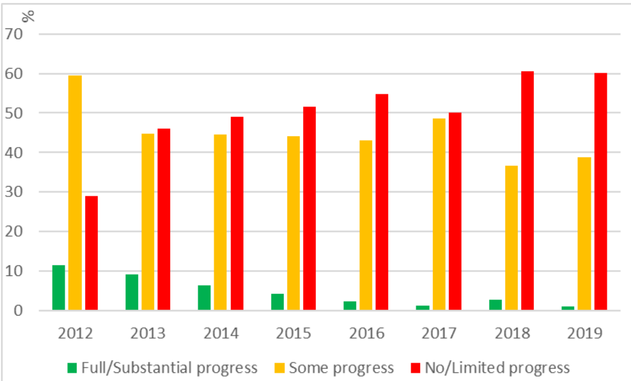
Recent efforts by the Commission – within the Strategic Forum for Important Projects of Common European Interest – to promote research and innovation in future technologies such as hydrogen and batteries will be key to helping the EU achieve global leadership and boost its competitiveness. Instruments and programmes such as InvestEU and Horizon Europe will also be crucial in this respect. Access to raw materials (e.g. rare earths) that have been under export control in China is critical. Likewise, there is an urgent need to step up efforts to develop a deeper capital markets union, given the limited progress recorded since 2015. This would provide new and diversified sources of funding for business, making Europe stronger, more resilient and dynamic. Improvements to the business environment are also necessary to attract and generate innovative and transformative companies. A series of recommendations outlined in the recent report by the high-level forum should be carefully explored by the Commission. All in all, this will also require strong coordination of EU and Member States' policies.

Incentivising better implementation of structural reform

The European Semester is a cycle for coordination of economic, fiscal and social policies in the EU – part of the EU's economic governance framework. Since 2011, the Commission has made country-specific recommendations (on the basis of Articles 121 and 148 of the Treaty on the Functioning of the European Union, TFEU) which provide guidance to Member States on economic, fiscal and structural policies, with a view to ultimately boosting sustainable economic growth and jobs while ensuring the soundness of Member States' public finances.

Implementation of these country-specific recommendations has been fairly poor and uneven across Member States and policy areas however, in spite of a relatively good economic environment in recent years. Indeed, since the first round in 2012, the annual implementation rate has followed a constant downward trajectory (with the exception of 2017). The share of recommendations fully or substantially implemented dropped from 11.6 % in 2012 to 1.1 % in 2019, while the share of recommendations with limited progress or no progress at all steadily increased from 29 % to 60.2 % over the same period. There were even some cases of reform roll-back. Nevertheless, the Commission acknowledges the multiannual dimension required for the implementation of the recommendations – in other words, the process takes time in many cases – and draws a less pessimistic overall picture compared to annual statistics.

Figure 5 – Implementation rate of country-specific recommendations per year (2012-2019)



Source: Economic Governance Support Unit, European Parliament.

Many of the recommendations issued deal with structural policies that aim to stimulate competitiveness and innovation, enhance Member States' competition in product markets and improve the business environment. For example, Germany has been recommended to strengthen competition in business services and regulated professions since 2012, but limited progress has been made. In 2019, the Commission concluded that 'progress has been particularly weak in addressing competition and regulatory frameworks, as well as in addressing recommendations related to state-owned enterprises and in broadening tax bases'. Nevertheless, undertaking such productivity-enhancing reforms at national level would surely help boost GDP in the EU by as much as 0.7 % up to 2023, through stronger and fairer competition within the EU.[2]

Incentivising national authorities to step up their efforts and do more to implement these recommendations while safeguarding national ownership of reforms is not an easy task. Formal infringement proceedings against Member States for neglecting to transpose and implement EU directives – such as the Services Directive that aims to reduce legal and administrative barriers to providers and recipients of services – is an instrument with limited effect.[3]

Providing Member States with financial incentives might help overcome widespread 'reform fatigue', especially in the above-mentioned areas identified by the Commission. In practice, that would help offset the immediate negative effects of some unpopular, albeit necessary, reforms by compensating the losers and mitigating the political costs in the short term. However, financial support entails moral hazard, as national authorities may postpone reforms until they are eligible for financial support. It may also prove to be inefficient, with taxpayers bearing the burden, and generating potential windfall gains for reforms that would have been implemented anyway.[4]

To overcome these drawbacks, experts have suggested that financial incentives should be offered in tranches (paid after the achievement of each major milestone). They should take into account the potential positive spill-over effects across Member States, the continuous implementation of the reform package and the achievement of convergence targets. It would also be essential to identify where the implementation of reforms creates a high level of European added value and reward structural policies that enhance the efficiency of the single market and boost Member States' competitiveness.

The recent agreement at European Council level on a Resilience and Recovery Facility worth €672.5 billion is a step in the right direction. Member States will be incentivised to implement major reforms and investments as part of their national recovery and resilience plans – to be assessed by the Commission – over the next three years, in areas such as competitiveness, productivity, employment, education and so on. After satisfactory fulfilment of the milestones and targets, grants and loans will be paid out to Member States in instalments.

Completing the single market

The pandemic crisis has exposed weaknesses in the EU single market and severely impacted its functioning, as Member States decided to impose measures hampering the free movement of goods, services and people. In response, the Commission addressed export bans and issued border management guidance to keep essential goods available, in particular to ensure access to products such as face masks, medical supplies and food.

The economic potential of the cross-border provision of services remains untapped despite several initiatives since the 2006 Services Directive. In 2015, the European Commission estimated that the average economic value added of the Services Directive between 2012 and 2014 was +0.1 % of GDP over a period of five to ten years, while a gain of between + 0.8 % and +1.8 % could have been expected. The market remains fragmented and there are still unduly restrictive regulations on services trade.[5] Greater efforts to remove these remaining barriers, together with strengthened transposition, implementation and enforcement of EU legislation could boost the EU's competitiveness.

As part of these renewed efforts, the Commission recently published a communication on the single market barriers and another communication on a long-term action plan for better implementation and enforcement of single market rules.

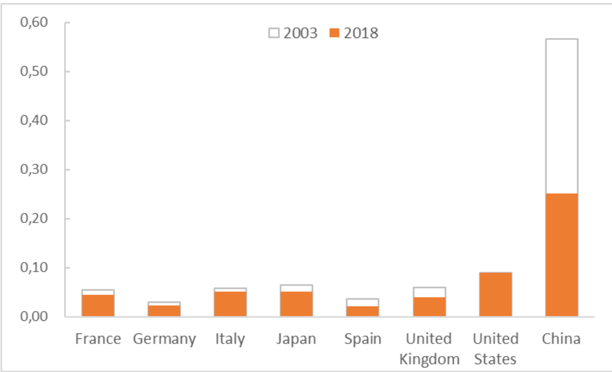
At the same time, it is essential to complete the digital single market. This will help firms to compete on an equal footing, and develop and boost their productivity and competitiveness by further investing in and using digital technologies. Legislation adopted during the last legislature (e.g. on the portability of online content, on the free flow of non-personal data and the copyright directive) is welcome. Nevertheless, additional steps including the update of legal and regulatory frameworks in the digital arena and greater coordination of data regulations across Member States are still required. Reinforcing EU's digital sovereignty is also crucial to ensure control over data, over capacity for innovation, and over ability to shape and enforce legislation in the digital environment.

Improving the screening of foreign investments

The EU has one of the most open investment regimes in the world. Attracting foreign investment is important when it comes to driving economic growth, boosting competitiveness and creating jobs. Nevertheless, foreign investments can be a cause of concern, as they are sometimes harmful to the domestic economy, as in the case of purchases by foreign firms of EU strategic assets and technologies.

With the pandemic crisis weakening the EU economy temporarily, many European companies are more vulnerable and could end up exposed to foreign takeovers. For that reason, Europe must defend its economic interests, in particular those that are essential to its security, in a similar way to global powers such as the US or China. Restrictions on foreign investment are higher in the world's two biggest economic powers.[6] Competition distortions due to a third country failing to comply with market rules, or subsidising outward investment, should also be addressed, as foreign investors – directly or indirectly controlled by a state – may target acquisitions in some specific strategic sectors, e.g. critical infrastructures or services. Additionally, foreign investment can undermine the effectiveness of foreign policy-making through direct or indirect interference, especially as decisions in this area are taken by unanimity at EU level. Moving to qualified majority voting in the Council would help in this regard.

Figure 6 – OECD Foreign Direct Investment Regulatory Restrictiveness Index



Open = 0; Closed = 1

Source: OECD.

The EU has recently begun to react to this situation by adopting a regulation establishing a legal framework for the screening of FDI inflows into the EU. The Commission also published guidelines in March 2020. These initiatives lack teeth, however, as the EU legislation merely creates a framework for cooperation and information-sharing among Member States and the Commission, and for raising concerns relating to specific foreign investments. Banning or restricting foreign investment for security reasons is still a national prerogative. As a result, foreign investment that is blocked in one Member State may be authorised in another, owing to different assessments of national security threats. For example, the German parliament recently adopted an update of the Foreign Trade and Payments Act, as part of Germany's new industrial strategy, to strengthen its scrutiny and potentially block investment from non-EU entities seeking to acquire a stake of 10 % or more in any Germany businesses in the area of robotics, artificial intelligence, semiconductors, biotech or quantum technology. The example of the introduction of 5G technology further illustrates the problem of multiple views on potential risks across the EU. However, there is a risk that it could undermine the EU if rival economies were to implement retaliatory measures or if innovative businesses decided to base their research facilities outside EU Member States.

The EU must think strategically about enhancing its framework for screening foreign investment, all the more so as investors have access to the single market and potential security risks could affect several Member States or the whole EU. A common approach and common procedures could be agreed in this regard, including granting the Commission the right to recommend that the Council prohibit foreign investment that could threaten the EU's security or strategic interests. Should the Council decide – by a qualified majority – to block or restrict a specific foreign investment, the EU could set up a special investment instrument to offset this effect.

Enhancing international coordination

The global economic downturn and the coronavirus crisis may well expose vulnerabilities in emerging-market economies, which could in turn reinforce the global recession through contagion and negative spill-overs given the overall interconnectedness in the world economy.

High indebtedness in emerging-market economies could jeopardise the global economic recovery and that of the EU, an open and export-oriented economy. Some of these vulnerable countries are important trading partners, including China (first in terms of total EU trade) and Brazil (13th), while Mexico (11th) and Turkey (sixth) notably have a substantial share of loans and debt securities of non-bank borrowers, denominated in foreign currency, notably in US dollars. This could raise serious challenges if the local currency depreciates. In addition, there is a sizeable number of non-performing loans in major economies such as Turkey and India, which could also pose future problems for the financial sector. In general, central banks in emerging-market economies conduct a more constrained accommodative policy, owing to high public debt and inflationary pressures to manage, which are fuelled by currency depreciation.

In this context, the International Monetary Fund (IMF) had granted 17 billion SDR (US$24 billion) in emergency financial assistance to over 60 countries by the end of May, while it had received more than 100 requests. It had also approved immediate debt relief for 25 developing countries under its Catastrophe Containment and Relief Trust (CCRT). Nonetheless, this extraordinary assistance is not expected to be enough to address economic challenges in the event of a prolonged global economic recession and pandemic.[7]

The EU should also seek to push for more effective coordination at G20 level to address global crises. Yet, the crisis has taken place at a time when multilateralism is challenged by some global powers, which have attempted to use international organisations 'for competition rather than cooperation'.[8]

Instead, major world economies should deliver a coordinated and synchronised fiscal stimulus to boost the global recovery and prevent long-lasting economic scars. In addition, major central banks should coordinate further – as they did during the Great Financial Crisis – and continue implementing an accommodative monetary policy, with a view to ensuring the improvement of financial conditions in the real economy and to restoring confidence. Central banks' instruments include, for example, the easing of swap lines in a coordinated way. Such decisive monetary policy actions would support a sustained global economic recovery. In addition, there is a need for global cooperation concerning the regulatory response in order to safeguard financial stability. Major regulators across the globe should coordinate their responses appropriately, by seeking to maintain the soundness of the banking system while preserving sustained economic activity. Lastly, the world's biggest powers should cooperate and agree on the OECD framework to address tax avoidance and tax evasion more efficiently. That would help governments raise income, which is vital if they are to implement their stimulus strategies.

International trade as an engine for growth

International trade has taken a severe hit with the pandemic crisis, while it had already been damaged in recent years owing to escalating trade tensions generated in particular by the Trump administration in the US. The pandemic crisis has revealed the vulnerability of local production when it relies to a large extent on outsourced inputs from distant providers in order to secure efficiency gains. The long and complex global value chains that had built up were shattered with the emergence of the coronavirus crisis and the sudden border closures. The propagation of this global supply chain shock has been amplified by the fact that many companies have been reliant on non-diversified sources of inputs – for example, components supplied by China – leading to significant disruptions.

Shortening global value chains in order to reduce risks and enhance resilience to future shocks would, however, generate efficiency losses. Reshoring some activities would impact adversely on economies of scale and the specialisation gained by firms in recent decades. Overall, global competiveness would also be hit adversely.

In addition, heightened trade policy uncertainty resulting from prolonged trade tensions and the eroding rules-based trading system as embodied in the World Trade Organization (WTO) have been a drag on global trade, investment and economic growth. Greater cooperation and coordination at global level through the relevant forums, and organisations such as the G20, would help foster recovery. It is important to improve the current global policy environment so that it supports free flows of trade and investment as a post-crisis engine for growth. The impact of stimulus packages implemented by governments across the world will be greater, including on trade, if there is strengthened and inclusive global coordination within a multilateral framework in place.

In this context, the EU should take a leadership role concerning the reform of the rules-based framework, so that it is fair, predictable and open, with a view ultimately to guaranteeing a level playing field and benefiting all businesses and consumers. At the same time, the EU should think strategically, address foreign takeovers in strategic sectors and defend its economic interests.

Leading more efficient global coordination in economic and financial affairs

The EU could strengthen its influence in the decision-making of international economic and financial organisations and forums such as the IMF, which are increasingly important to address global economic issues. The EU (and the euro area) has lacked unified representation in such organisations and forums for some time, whereas each EU Member State has its own seat in the IMF, scattered over sometimes geographically distant constituencies. As a result, the weight of the euro area is reduced. For this reason, in 2015, the European Commission tabled a proposal for a Council decision under Article 138 TFEU, laying down measures with a view to gradually establishing unified representation in the IMF. In a similar vein, also in 2015, the Commission presented a communication on a roadmap towards more consistent external representation of the euro area in international forums, including the G7, the G20, the Financial Stability Board, the OECD, the World Bank and the Asian Infrastructure Investment Bank. Other global standard-setters such as the Basel Committee for Bank Supervision should also have been included.

However, the proposal has been blocked in Council for several years. Many Member States consider that their national interests are best served within the framework of the current governance structure, and consider that the current form of representation enables them to defend their own, specific interests more effectively and achieve their goals.

According to the Commission's 2015 communication, following through on the proposal would 'allow the EU to play a more active role in international organisations and fora and shape effectively the future of the financial global architecture'. It would also help the EU to counterbalance the influence of other global economic powers, including the United States and to a lesser extent China, more effectively in economic and financial affairs. At the onset of a post-coronavirus period with potentially significant changes in global governance afoot, adoption of this proposal could make a difference.

Potential initiatives

	Project	Likely lead actor	What should be done?	
1	Boost investment in research, development and innovation (R,D&I)	EU institutions and Member States	• Promote investments in R,D&I in order to reach the 3 %-of-GDP target • Improve the business environment • Remove barriers to investments	
2	Implement the European Green Deal and reduce CO_2 emissions	EU institutions and Member States	• Invest in green technologies • Support industry to innovate and sustainable finance • Phase out regressive fuel subsidies that increase carbon emissions	
3	Complete the capital markets union	EU institutions and Member States	• Implement measures in the 17 clusters recommended in the June 2020 report by the high level forum in order to remove the biggest obstacles in the EU's capital markets	
4	Improve the business environment	Commission and Member States	• Reduce the regulatory burden, improve market access and access to financing • Support digitalisation and the green transformation of businesses, for instance through tax incentives	
5	Incentivise the implementation of structural reforms	European Commission, Parliament and Council	• Provide Member States with financial incentives – while limiting moral hazard – so that they implement productivity, enhancing reforms and investments in line with challenges identified under the European Semester • Adopt the Resilience and Recovery Facility	
6	Implement structural reforms	Member States	• Implement reforms in line with challenges identified under the European Semester	
7	Complete the single market	Commission and Member States	• Remove barriers hampering the free movement of goods and services	
8	Complete the digital single market	EU institutions and Member States	• Update the legal and regulatory frameworks and financial instruments • Develop, invest in and deploy cutting-edge technologies • Reinforce cybersecurity	
9	Consistently screen foreign investments in a strategic way	Commission and Member States	• Enhance the EU framework to screen foreign investments more efficiently and more consistently	
10	Enhance international cooperation	G20 members	• Deliver a coordinated and synchronised fiscal stimulus • Remove barriers to trade introduced in recent years	
11	Rescue developing economies	IMF and G20 members	• Continue granting financial assistance and debt relief to developing economies in need	

			• Stand ready to do more in the event of a prolonged recession and pandemic	
12	Fight tax avoidance and tax evasion to boost fiscal revenue	OECD members	• Agree on a framework to address tax avoidance and tax evasion more effectively	
13	Further coordinate central banks' action	Central banks	• Coordinate action to safeguard international financial stability	
14	Promote fair trade as a growth engine	EU	• Lead reform of the rules-based trading framework so that it is fair, predictable and open	
15	Progressively unify EU and euro area representation in the IMF and other global fora	Council	• Adopt the Commission's 2015 initiative	

REFERENCES

de Finance S., Fair competition within the EU and globally, EPRS, European Parliament, January 2020.

European Investment Bank, Restoring EU competitiveness, 2016.

Gaub F. Global Trends to 2030: Challenges and Choices for Europe, ESPAS, April 2019.

Leonard M. and Shapiro J., Empowering EU Member States with Strategic Sovereignty, European Council on Foreign Relations, June 2019.

OECD, Economic Outlook, Volume 2020, Issue 1, June 2020.

ENDNOTES

1 OECD, Economic Outlook, Volume 2020, Issue 1, June 2020.

2 OECD, Building a stronger and more integrated Europe, 2018.

3 Court of Auditors, Has the Commission ensured effective implementation of the Services Directive?, 2016.

4 M. Dolls et al., 'Incentivising structural reforms in Europe? A blueprint for the European Commission's Reform Support Programme', *Intereconomics*, Vol. 54, 2019.

5 International Monetary Fund, Euro area policies: Article IV Consultations, July 2019.

6 The OECD's Foreign Direct Investment (FDI) Index gauges the restrictiveness of a country's FDI rules by looking at the four main types of restrictions on FDI: foreign equity limitations, screening or approval mechanisms, restrictions on the employment of foreigners as key personnel, and operational restrictions.

7 A. Dworking , How to repair multilateralism after covid-19, May 2020.

8 *Ibid.*

DISCLAIMER AND COPYRIGHT

eprs@ep.europa.eu (contact)

www.eprs.ep.parl.union.eu (intranet)

www.europarl.europa.eu/thinktank (internet)

http://epthinktank.eu (blog)