Chapter 6

Changing Economic Fortunes for Europeans: Implications for Foreign Policy

Maria Demertzis[1]

Seen from the perspective of the European Union (EU),[2] the world looks very different today than just one or two years ago. The U.S. election outcome has changed geopolitical dynamics and challenged what the EU considers its "natural alliance." At the same time, in combination with the UK's decision to leave the EU (Brexit) and the results of the 2017 French elections, it has brought new impetus to the debate on the EU's need to unite. As a result, EU member states are engaging in wide-ranging policy discussions on how to promote integration and improve the European Union's world standing.

And this all is taking place in the middle of what can only be seen as a mild and somewhat precarious economic recovery. The EU has experienced a very deep 10-year crisis, not only because of the force and intensity of the financial shock, but because of its lack of institutional resilience. Countries that were better prepared or had the tools to react quickly and decisively did so and recovered faster. But the EU as an institution lacked both the tools and the governance structure to react to events at the speed at which they unfolded.

Since its inception, with the signing of the Treaty of Rome in 1957, the European project of economic integration has moved in only in one direction, and that is deepening. When the UK voted in the summer of 2016 to leave, the EU received a very sobering message: European integration

---

[1] I thank Justine Feliu for helping collect all the necessary data and for allowing me to share her data on military expenditures.

[2] The European Union currently consists of 28 countries (including the UK). All EU countries, except Denmark and the UK, are required by the treaty to join the single currency—the euro—eventually (https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/who-can-join-and-when_en). At the moment only 19 countries have adopted the euro to form the euro area (EA). In terms of population, the EU is 510 million and the euro area is 340 million. The euro area economy represents about 70 percent of EU GDP; that share will increase when the UK leaves. The numbers that I will present will be either for individual countries or for the EA when I report on averages, as the EA is the relevant economic unit.

is neither inevitable, nor is it irreversible. This has had considerable impact on the European psyche. At the time, it was not at all clear what would follow. Populist, and mostly nationalist movements, in many countries had been arguing for less, or even “no Europe,” for some time. Was this the beginning of the end, or could the Brexit juggernaut be stopped?

The possibility that European integration could be reversed struck a sensitive cord. Many went back to rediscover the project’s *raison d’être* of peace following World War II: democracies whose economies are fused do not go to war with one another. At that time, it was important to promote integration by providing the right conditions for it to flourish. That process began when member states removed trade barriers, adopted common standards and agreed to a common set of rules when interacting with each other. This was done gradually over the span of almost 40 years—an illustration of both the enormity of the task and the strong commitment that countries had. In a second stage, countries that had achieved a certain level of economic convergence[3] adopted a common currency, the euro. This was seen as a way of removing the distortions that arise from currency volatility, thus allowing countries to reap the full benefits of free trade. Since the start of the financial crisis in 2008, important steps were made to unite the financial system by bringing the supervision of systemically-relevant banks together at the European level. This process is not complete, but it is very advanced.

Can the EU go an extra mile and actually build an economic federation? This would be the natural destination in this process of economic integration, as it would provide the means to collect, distribute and therefore manage the economy as one.

The EU is very far from what can be considered a single nation in organizational terms.[4] Despite common laws for many issues, national judiciary systems are still prevalent. National sovereignty is ensured by the power to tax and distribute at the country level. There is no significant federal equivalent, which implies that managing the macroeconomic system remains very much the job of member states. There is a system of coordinated monitoring at the EU level,[5] but it not an adequate substitute.

---

[3] To understand how convergence is evaluated, see https://ec.europa.eu/info/business-economy-euro/euro-area_en.

[4] I am not referring to cultural, historical or linguistic differences, which are crucial for the definition of a nation.

[5] Macroeconomic Imbalances Procedure, and the Fiscal Compact, https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/macroeconomic-imbalance-procedure_en.

This was made clear in the crisis years, when real time solutions were entirely national (e.g. saving banks). The EU, as an institution or as the collective voice of the member states, had neither the mandate nor the means to take over from national authorities.

Herein lie two inconsistencies.

First, as long as countries are economically interdependent, solutions at the national level will be incomplete. And in the EU, not only are countries interdependent, they also strive to develop very close links. From integrated value chains to a common currency and large financial flows, countries are part of one economic system and cannot insulate themselves from developments elsewhere. Defining at least some common objectives and harmonization of rules is becoming increasingly indispensable.

Second, while countries understand and acknowledge this incomplete nature of the EU architecture, they are not necessarily at the point of abandoning national sovereignty. This became very clear with the Brexit vote and with the surge of nationalism across the Union. The EU is therefore not at the level of being able to counteract shocks at the pace and with the commitment that countries at able to muster. At the same time, because integration is deep, national problems can quickly become continental problems.

It is in this context, of halfway architectural design, that the EU's economy needs to be assessed. In this chapter I describe the broad economic picture of the euro area and compare it to that of the United States. I argue that the differences, to the extent they exist, will be a manifestation of each entity's relative ability to act in real time to address economic shocks, particularly since 2008. That in itself is the result of the paradox explained above: all member states are affected by problems together, yet their power to act is not equally centralized.

I then describe the economic challenges the EU is battling. The financial crisis has left the EU with a number of financial and other legacy problems that now stand in the way of its ability to grow and prosper. In my view, the problems of indebtedness and unemployment (particularly for the young) are the two most important. I suggest ways to address them.

I then turn to the EU's external challenges, which have implications for its domestic and foreign economic policies. I discuss migration, the

call to rethink and possibly redesign defense expenditures, the EU's evolving alliances, and its role as defender of multilateralism. I conclude with some thoughts about going forward.

Internal Challenges

The Current State of the Euro Area Economy

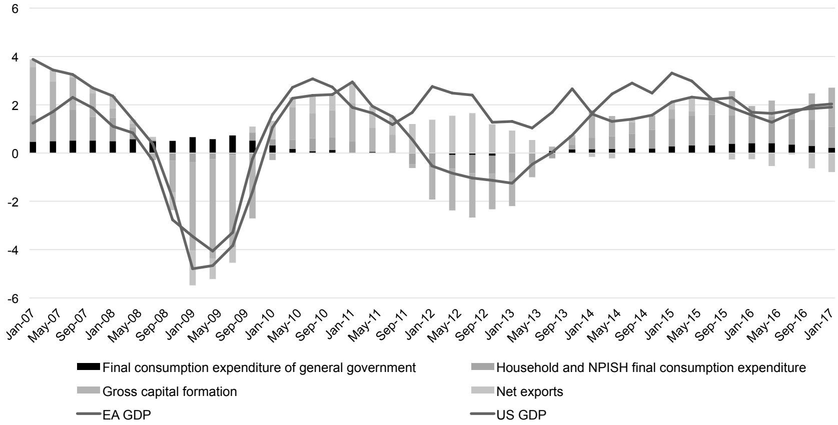
The euro area economy has been through was is now known as a double-dip since the start of the financial crisis in 2008. Figure 1 shows that while the first dip in growth in 2009 was very similar in the euro area and in the United States, their paths diverged during the subsequent four years. The United States managed to recover and sustain a more or less stable level of growth relatively early in the process. By contrast, the euro area faced a second contraction as investment collapsed, resulting in a four-year divergence in growth. Since late 2015 growth levels are again similar.

This second dip came to be known as the fiscal crisis, when the euro area faced a serious possibility of breaking up. Lack of sufficient coordinated action during the first banking crisis was the primary cause for the second crisis. Countries implemented strictly national efforts to save domestic banks, which exposed their fiscal capacity. Those that had healthier fiscal finances were in better position to pursue bank rescues. The point that was not sufficiently appreciated at the time was how weak fiscal finances in certain countries, even if these countries were small, could pose a serious threat to the euro area as a whole. Markets took the view that if countries share a common currency, they de facto also share fiscal positions. And if one country's fiscal position is in trouble, either others come to rescue it or the currency fails.

Failure to recognize this point, and then respond to it convincingly, prevented the euro area from sustaining the first recovery. Euro area member states were unwilling to admit the inexorable links that bound them together through the single currency, while EU institutions lacked the authority to respond.

It took three years before member states were prepared to acknowledge how close the euro has tied their economies together, and to put mechanisms in place to provide adequate responses.

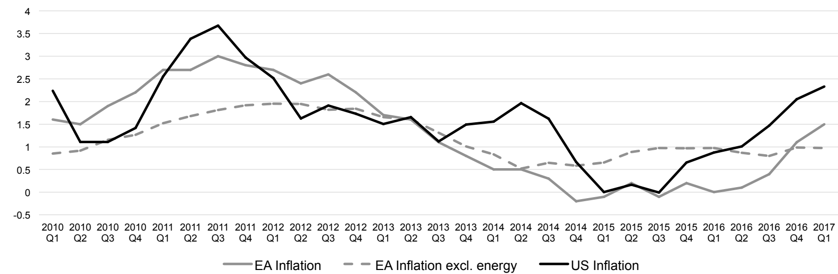
Figure 1: Real Growth in Gross Domestic Product (%) (and growth contribution, percentage points for euro area only)



Source: Eurostat, FRED (St. Louis Federal Reserve).

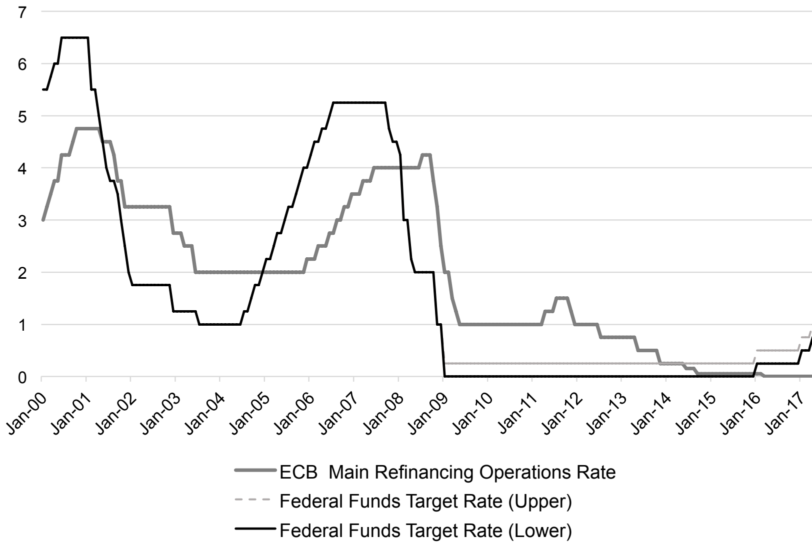
Since then, much has happened. But how convincing have such efforts been and are they enough? Initially, euro area growth was driven by domestic consumption. More recently, it has also been sparked by new investments. At the same time, the inflation rate, the main indicator of economic activity, remains persistency below what it ought to be (around 2 percent), in particular when looking at the core rate, which excludes volatile components (Figure 2).

Figure 2: Inflation and Core inflation (%), Euro Area and United States



Source: European Central Bank, FRED. Note: Core inflation is actual inflation that excludes energy prices.

Figure 3: The European Central Bank Main Refinancing Operations Rate (%)



Source: Bloomberg, European Central Bank.

Moreover, there is little that monetary policy can do to try and encourage growth. The interest rate is effectively at zero (known as the zero-lower-bound), so it cannot fall any further to promote investment.[6] The United States, in contrast, is once again in the position to use the interest rates to manage the economy (Figure 3).

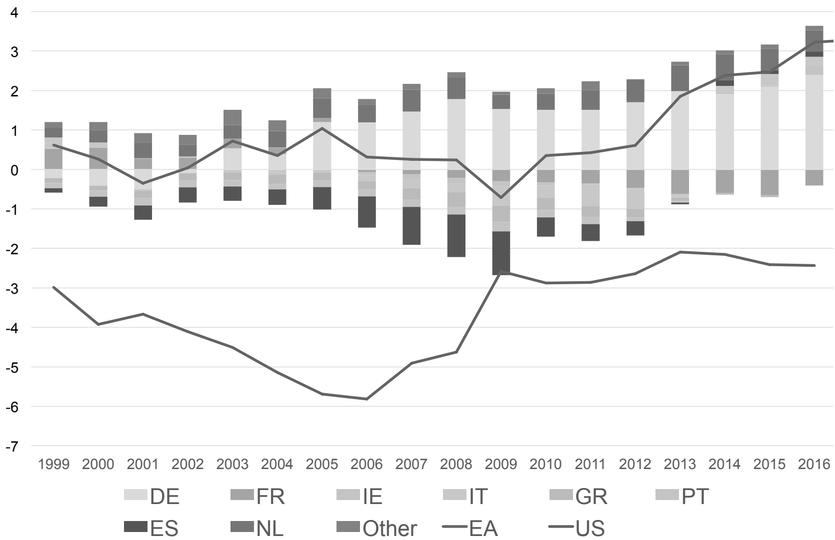
At the same time, with the exception of France, all countries in the euro area are now net capital exporters. Figure 4 shows that the euro area itself exports capital of over 3 percent of its own GDP. With recovery being nascent and precarious, the fact that capital does not stay home does not reflect confidence in domestic conditions.

There is one area where the EU on the whole has managed to maintain consistency, and that is with regard to income inequality. Figure 5 compares the EU (28 countries) to the United States. Not only does the EU have a

---

[6] Admittedly more is done in the form of "unconventional" measures. But the "conventional" part of monetary policy, i.e., the ability to use the interest rate, is effectively now incapacitated.

Figure 4: Current Account as % of GDP: Euro Area (and country contributions) and United States



Source: Ameco, European Commission and FRED.

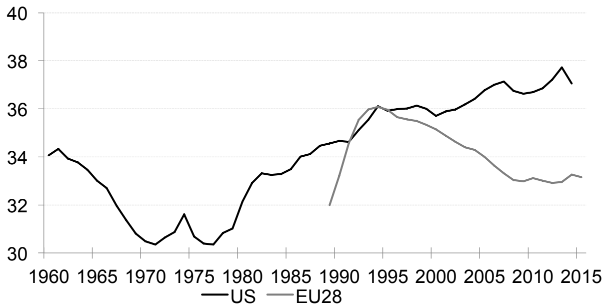
much lower level of income inequality than the United States, it has also been able to prevent a deterioration, despite weak economic conditions over the past 10 years.

On the whole, the EU economy is only just beginning to enter a convincing recovery. This is in contrast to the United States, which recovered much faster after the financial crisis. Whether Europe manages to sustain this recovery depends crucially on how it handles important legacy problems. I turn to this next.

Economic Legacy Problems

In the context of a low-growth, low inflation environment, the main problems to overcome in the EU are excessive debt (both private and public) and unemployment, in particular amongst the young. Both these are the results of a prolonged crisis period and are affecting the EU's ability to grow and be productive.

Figure 5: Gini Coefficient of Net* Income Inequality: Comparing the EU with the United States, 1960-2014



*After taxes and transfers. Source: Zsolt Darvas and Guntram Wolff, "An Anatomy of Inclusive Growth in Europe," Bruegel Blueprint series, 26, 2016, http://bruegel.org/2016/10/an-anatomy-of-inclusive-growth-in-europe/.
Note: A Gini index of zero represents perfect equality (i.e., incomes are perfectly evenly distributed) and a Gini index of 100 indicates perfect inequality (all incomes are owned by one person). I thank Zsolt Darvas and Guntram Wolff for kindly allowing me to use their data.

Excessive Debt

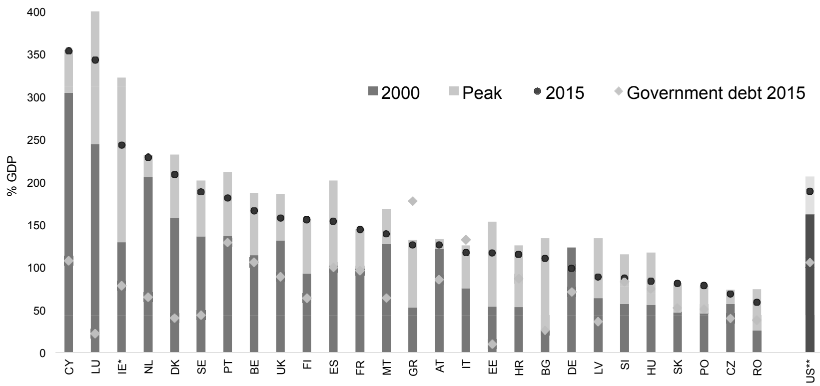
Debt has become more important for the functioning of modern economies over the last 20 to 30 years. More and more people and firms use debt to finance growth. The procedures followed to resolve debts when borrowers default, however, have not adapted to match the increased prevalence of debt.[7] As a result, the inability to resolve debts as they become unproductive has led to the accumulation of high stocks of debt. Figure 6 shows that levels of private debt (not fiscal debt) remain high, and possibly too high. The EU is not different in this respect from the United States, where average debt levels are comparable.

The exact level at which indebtedness distorts growth remains unclear. The European Commission's Macroeconomic Imbalance Procedure uses a threshold of 113 percent of GDP as a signal for deeper investigation of private indebtedness. Others have identified lower threshold levels (between 85-90 percent of GDP[8] or below 100 percent of GDP[9]), so

---

7 World Bank, "Report on the Treatment of the Insolvency of Natural Persons, Insolvency and Creditor/Debtor Regimes Task Force" (2011).
8 S.G Cecchetti, M. S. Mohanty and F. Zampolli, "The real effects of debt," BIS Working-Paper No. 352 (2011).
9 J-L Arcand, E. Berkes and U. Panizza, "Too Much Finance?"IMF Working Paper, No. 161, June 2011.

Figure 6: Private Sector Debt+, % of GDP



Notes: +Households and non-financial corporates. *Private debt data for Ireland are based on central bank statistics (CCB indicators), which are based on national bank credit data, thereby excluding debt of foreign affiliates. **Private debt data for U.S. are based on World Development Indicators and GG debt on Fred statistics.
Sources: Eurostat, Irish National Central Bank Statistics, World Development Indicators, FRED.

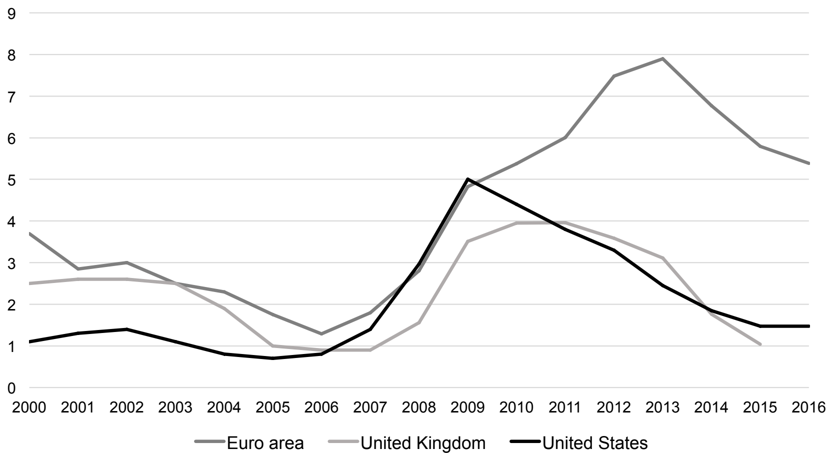
therefore caution is important when attempting to categorize a level of private debt as excessive.

Irrespective of the exact threshold, at a level of an unweighted average of almost 150 percent of GDP, debt in the EU is considered excessive. And we can recognize two ways in which excessive debt has detrimental effects on the economy.

The first affects the supply of credit. Excessive debts are typically non-performing. When creditors have a significant level of Non-Performing Loans (NPLs) on their balance sheet, they do not issue new credit, thus putting a cap on the credit supplied to the economy. And as member states rely heavily on banks to finance growth (by contrast to the United States, which relies more or less equally on banks and capital markets) they find themselves in a position of insufficient credit creation. This is particularly true for new credit to firms (as opposed to households), therefore preventing new investment.

While a number of countries have made progress in removing NPLs from bank balance sheets, others clearly have not. Here we also see a startling difference with the United States, which achieved a much lower peak level to begin with and reduced NPL levels almost in real time. In the

Figure 7: Progress with Resolving Non-Performing Loans (NPLs): Bank NPLs to Total Gross Loans (%)



Source: World Development Indicators, IMF

euro area, by contrast, the resolution of NPLs reached a much worse level and did not begin to improve until early 2014.

Excessive debt also suppresses the demand for new credit. This second effect, known as the debt overhang, has been less prominent in the European discussion. Debt overhang is a situation in which high debt levels act as a disincentive to new investment.[10] This effect is difficult to measure directly, but can be identified in different ways. Companies that are highly leveraged find it difficult to take advantage of an improvement in demand, and may even continue to de-lever as a recovery takes hold.[11] It is estimated that the debt overhang in the EU explains about a third of the decline in investment observed during the crisis.[12] It is likely that the number of firms originally affected by this distortion is significant, making it a systemic obstacle to recovery.

---

[10] S. C. Myers, "Determinants of Corporate Borrowing," *Journal of Financial Economics*, 5 (2) (1977), pp 147–175.

[11] International Monetary Fund, "A Strategy for Europe's NPLs," IMF Staff Discussion Note, 15/09 2015.

[12] S. K. Ozcan, L. Laeven and D. Moreno, "Debt Overhang in Europe: Evidence from Firm-Bank-Sovereign Linkages," paper presented at the 21st Dubrovnik Economic Conference, 2015.

A significant obstacle to this adjustment has been the EU's anemic growth and almost zero inflation, at least until recently. As the real value of debt is not adjusting, it is the nominal value of debt that needs to do so. In principle, there are two alternative paths to such an adjustment and they both need to happen.

The first is deleveraging, as debtors put aside resources to repay existing debt. This, however, depresses growth and investment as lenders rebuild liquidity in the absence of a more comprehensive improvement in the debt situation. European Commission estimates point to a permanent reduction in GDP of almost one percentage point for every ten-percentage point reduction in the private debt ratio.[13] Repaying back debts in order to reduce them to levels that are deemed sustainable is going to cost a lot in terms of growth.

The second is re-structuring and/or write-downs. This form of adjustment would involve wide-ranging modification of loan terms to recognize the value loss relative to the original terms in credit contracts, and to share this value loss between creditors and equity holders. European countries on the whole have much less of a culture of write-downs, and as a consequence have developed little skills on how to allow markets to work them through. The issue is slowly becoming part of the tools to be used, but it is protracted.[14] Also, it is important to recognize that this process cannot happen to the detriment of the health of banks, given the efforts made in past years to restore credibility in the sector. If restructuring were to happen, it would have to follow banks' capacity to absorb losses very closely. This inevitably adds an extra layer of complication that prevents the swift solution to the problem of indebtedness in the EU.

Unemployment: Divergences Among Countries and Generations

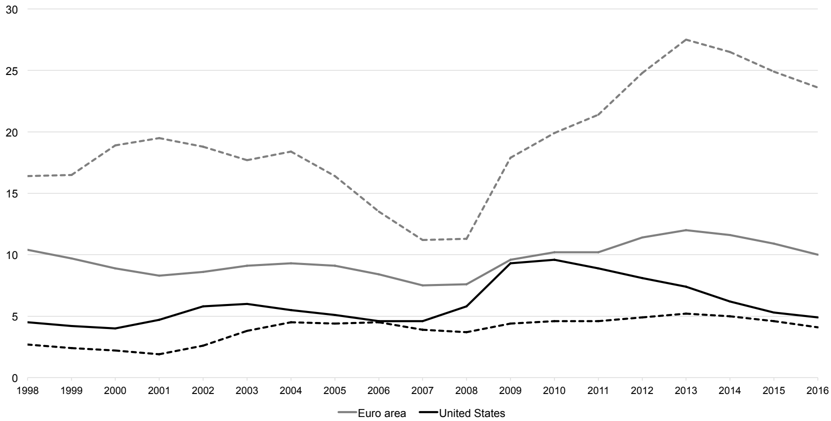
Traditionally, the level of unemployment in European countries have always been higher than that in the United States. This discrepancy continues to hold, with the exception of a few years prior to the crisis when the United States saw a distinct increase in the level of unemployment.

---

[13] P. Pontuch, "Private sector deleveraging: where do we stand?" Quarterly report on the euro area, European Commission, 2014.

[14] Maria Demertzis and Alexander Lehmann, "Tackling Europe's crisis legacy: a comprehensive strategy for bad loans and debt restructuring," Bruegel Policy Contribution No. 11, April 21, 2017, http://bruegel.org/wp-content/uploads/2017/04/PC-11-2017-2004.pdf.

Figure 8: Unemployment as Percentage of the Total Active Population, Euro Area and United States



Source: Ameco, European Commission. Notes: dashed lines represent the minimum (best performer) and maximum (worst performer) at any point in time, not shared by the same country across the whole period.

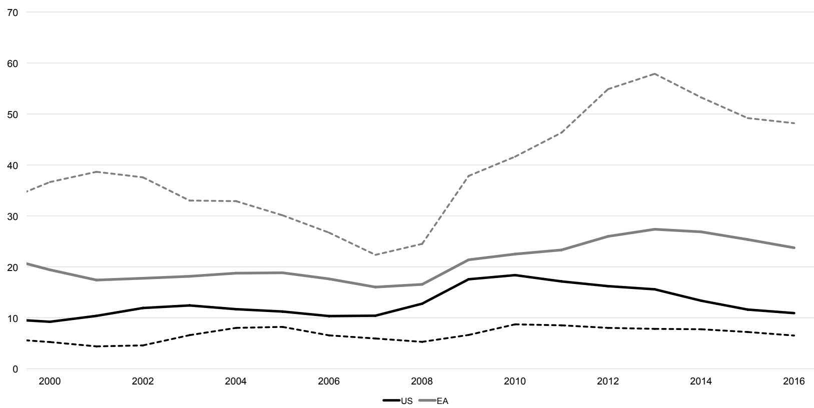
Currently, the actual level of unemployment in the euro area as a whole is comparable to historical levels.

Where the problem of unemployment in the euro area has deteriorated is that we now observe divergence between countries as well as in certain segments of the population. Figure 8 shows the two-unemployment series for the euro area and the United States, but also shows the range of unemployment levels between countries in the euro area. The main message is that while the early years of monetary union (from 1999 to 2008) saw a slow but visible convergence, since then that process has reversed, with a sustained divergence between countries now prevailing.

The problem is particularly visible when it comes to young people. One in four young people in the euro area is now unemployed; in some areas one in two are unemployed (figure 9). This is particularly true in areas that have systems that benefit incumbents over new entrants, and where there is no culture of vocational training to smooth integration into labor markets.

This can lead to both important social problems in real time, but it also implies that as their skills depreciate, the young will have difficulties inte-

Figure 9: Youth Unemployment as Percentage of the Total Active Population, Euro Area and United States



Source: FRED; World Bank, World Development Indicators. Note: Youth unemployment refers to the share of the labor force ages 15-24 without work but available for and seeking employment (modeled ILO estimate). Notes: dashed lines represent the minimum (best performer) and maximum (worst performer) at any point in time, not shared by the same country across the whole period.

grating in the labor market in years to come. It is difficult to predict the intergenerational effects implied, but the scale of the problem has now made it a number one policy priority.[15]

Important differences between the United States and the euro area account for these differences. Labor mobility has always been greater in the United States than typically in EU member states. 30 percent of Americans reside in a state other than the one they were born. This is true for only 2.8 percent in the EU.[16] Language and cultural factors account for this difference, but the fact remains that labor mobility cannot be counted upon to provide a solution when certain regions are affected by economic disturbances. Similarly, generous welfare systems in the form of long-lasting unemployment benefits also generate disincentives for job-seeking.

The need for labor market reforms is similar across all European countries, albeit with different degrees of urgency. French President Macron has made this his top priority in the reform agenda that he has set in

---

[15] For the European Commission's strategy put in place to help tackle it, see http://ec.europa.eu/social/main.jsp?catId=1036.

[16] https://www.economist.com/blogs/economist-explains/2015/08/economist-explains.

France. Other countries need to push for ways of increasing the flexibility of the labor market and ensuring access for all. Countries' ability to handle this, in particular as it concerns the young, will determine how well the EU will provide sustainable development in the future. It remains the most urgent problem to tackle, as it has implications not only for the economy but also for social cohesion.

External Challenges

Beyond its own economic legacy problems, there are a number of challenges that are affecting the EU's foreign economic policy. Without claiming to be exclusive, I will discuss the surge of recent economic migration waves, the revival of the issue of the need to coordinate defense expenses and finally the EU's economic alliances and how they might be challenged.

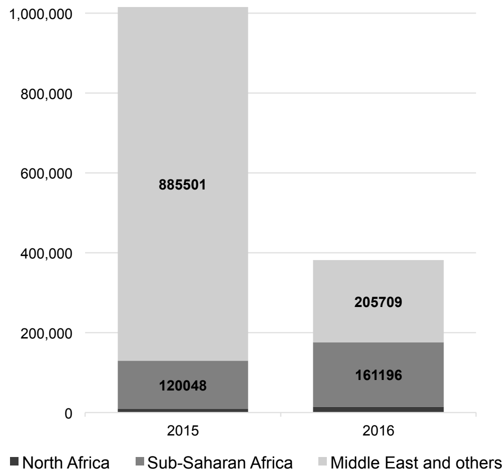
Economic Migration

Migration waves into the EU have increased steadily and significantly particularly since 2012. This has raised a number of questions, including whether such levels of population shifts can be sustained, and whether and how migrants can be integrated successfully. A significant number of these people, particularly in 2015 and 2016, were effectively refugees from Syria escaping war. Figure 10 shows that the bulk of people arriving into the EU in these years originated from the Middle East region, and therefore were not economic migrants.

However, the issue of economic migrants, particularly from Africa, is an older story. What has changed is the increase of irregular arrivals, mostly by boat under very life-threatening circumstances. These numbers have been increasing since 2010, as shown in Figure 11. The European policy establishment has become more interested in Africa because of a fear that ever-increasing migration inflows are unpopular with the public. But this irregular migration is still only a fraction of total immigration, which is actually fairly stable at around 500,000 per year.

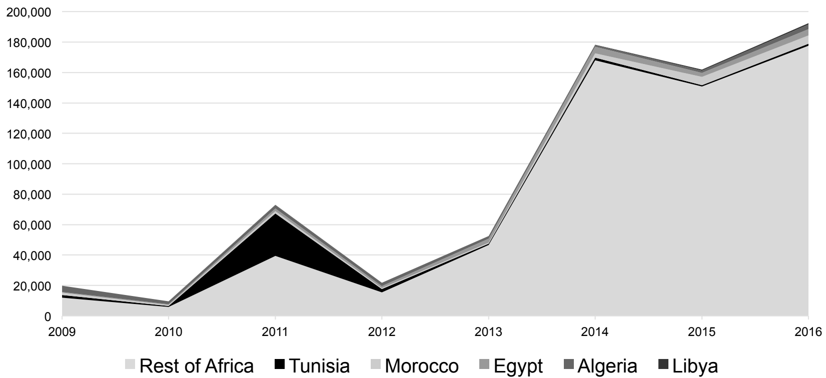
Figure 11 shows that African migrants coming to the EU are primarily from sub-Saharan Africa. At the moment, annual migration from Africa to the EU only represents 0.1 percent of the EU population. But the numbers will likely increase in the future, as the population of Africa is expected to more than double by 2050, reaching 2.5 billion. The demographic pressures are the strongest in sub-Saharan Africa, where fertility rates are

Figure 10: Arrivals into the EU by Country Groups (persons)



Source: UNHCR.

Figure 11: Detection of Irregular Border-Crossing from Africa (persons)



Source: Frontex.

exceptionally high at 5 children per woman and where the average annual income per person is below $3,500 in purchasing power parity terms. For these reasons, emigration from Africa will continue, and Europe will remain an attractive destination.[17]

Naturally, income differences between Africa and the EU are an important reason behind such population movements. There is no doubt that economic development in sub-Saharan Africa is a critical objective in the fight against poverty. EU countries individually, collectively and through multilateral institutions, like the European Investment Bank, will need to step up their involvement on the continent. But development aid can only go that far, as development and migration do not always go hand in hand. In fact, in very poor countries emigration often increases with rising GDP per capita. This happens because at first, development simply provides the means to escape poverty. Empirically, studies find that starting from low levels of income development will not stop people leaving. Only when levels of income rise to above $7,000-9,000 in purchasing power parity per year does emigration begin to fall.[18] Out of 47 sub-Saharan countries, only seven are currently above the $9,000 GDP-per-capita level, and 39 have a GDP below $7,000 per capita. Under reasonable assumptions, 35 countries are expected to still be below that level in 2030. Meanwhile, the population of these countries will have reached 1.05 billion.

Low economic development in the countries of origins, combined with projected demographics, leads us to conclude that many will seek to leave the African continent. Northern African countries that have higher levels of income as well as lower rates of population growth can act as destinations themselves, and therefore buffers for the EU. The fact remains, however, that the EU will remain a popular destination. European countries will necessarily have to find ways to help the origin countries develop, and help migrants integrate at home.

Defense Expenditures

Important geopolitical challenges, ranging from irregular immigration to tensions with Russia, have prompted the EU to think harder about pro-

---

[17] Uri Dadush, Maria Demertzis and Guntram Wolff, "Europe's role in North Africa: development, investment and migration," Bruegel Policy Contribution No. 10, 2017, http://bruegel.org/wp-content/uploads/2017/04/PC-10-2017.pdf.

[18] Michael, Clemens, "Does development reduce migration?" *International Handbook on Migration and Economic Development*, pp. 152-185 (2014), https://www.cgdev.org/sites/default/files/does-development-reduce-migration_final_0.pdf.

tecting its outside borders. This has given rise to discussions on coordinating defense and security, issues that the EU had previously left almost exclusively to member states, even though defense and security is one of the few issues where most European citizens agree that the EU can play a constructive role.[19]

In June 2017 the EU Council agreed to launch a European Defense Fund,[20] the purpose of which is to "coordinate, supplement and amplify national investments in defence research, in the development of prototypes and in the acquisition of defence equipment and technology." The European defense fund would aim to generate a total investment in defense capability of €5 billion per year.

At the same time, there has been increasing criticism coming from the United States on inadequate defense spending. President Trump directly criticized NATO members for not honoring their budgetary commitments. Only 5 members (including the United States) actually meet NATO's defense spending target of 2 percent of GDP (Figure 12).

Feliu argues that Donald Trump's statements effectively acts as a threat (and is perceived as such) of removing the security guarantee that the United States had always offered European countries through NATO.[21] If European countries that are NATO members wanted to meet the 2 percent of GDP target, they would have to collectively spend an additional $96 billion annually.

It is not at all clear that EU countries are responsive to such calls. Coordinating defense spending via the new fund is a way to exploit economies of scale and reduce inefficiencies. But there is no clear appetite to expand spending, and certainly not of the scale that would be required. And there are even arguments that challenge the appropriateness of increasing military spending at all. Andrew Moravcsik, for example, argues that "demands for … defense spending rests on an outdated conception of world power."[22]

---

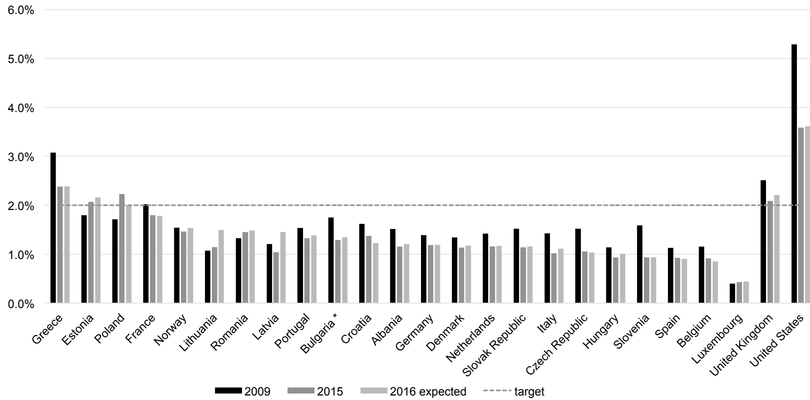
[19] In an April 2017 Eurobarometer survey, 68 percent of those polled would like the EU to do more on security and defense policy. Indicatively, 57 percent of responders thought their country's membership of the EU was a good thing. Results here: http://www.europarl.europa.eu/pdf/eurobarometre/2017/2019ee/two_years_until_ee2019_synthesis_en.pdf.

[20] See communication announcement here: http://europa.eu/rapid/press-release_IP-17-1508_en.htm.

[21] Justine Feliu, "Trump, NATO and European defence spending," Bruegel Blog post, November 15, 2016, http://bruegel.org/2016/11/trump-nato-and-european-defence-spending/.

[22] Andrew Moravcsik, "Europe pays its fair share whatever Donald Trump says," *Financial*

Figure 12: Defense Expenditures as Percentage of GDP (based on 2010 prices)



* Data do not include pensions, ** based on 2010 prices
Source: Justine Feliu, "Trump, NATO and European defence spending," Bruegel Blog post, November 15, 2016, http://bruegel.org/2016/11/trump-nato-and-european-defence-spending/. Bruegel calculations based on time series computed by NATO. See press release on defense expenditures: http://bru.gl/2fcxLKJ.

He continues by saying that Europeans have other non-military ways of exerting global influence, namely by pursuing diplomatic routes and enhancing economic ties. He refers to German Chancellor Angela Merkel, who believes that engaging in trade, providing developing aid and promoting multilateral institutions, such as development banks, are more effective ways of safeguarding national security.

Be that as it may, the emergence of new global powers and the clear change in the global role that the Trump administration wants the United States to play in defense, trade and spreading of cultural values are forcing the EU to rethink its own position.

Redefining Allies

The last issue to discuss is how a change of world powers is also affecting the EU's global stance. An important trend, which began a couple of decades ago, saw advanced economies diminishing in relative economic

---

Times, May 26 2017, https://www.ft.com/content/b50b456e-41ed-11e7-82b6-896b95f30f58.

power. This trend became evident around 2010, when advanced countries started to account for less than half of global GDP in purchasing power terms.[23] As advanced economies saw their shares in global trade and income decline, they resorted to a more protectionist approach when engaging with other countries.

This trend is very visible in the United States currently, but it is not new. It emerged during the Clinton administration (1993–2001), when the question of "what's in it for us?" first arose in terms of "regaining competitiveness." However, the Trump administration does not just aim to reduce the U.S. role as an anchor of the global multilateral system, it has openly challenged it, either by threatening to withdraw from it unilaterally or by imposing protectionist measures, such as high tariffs. The underlying rationale of "what's in it for us?" is well captured by President Trump's "America first" rhetoric.

In the meantime, China's position in the world has strengthened during the last quarter century. President Xi Jinping's speech in Davos in January 2017 was indeed that of the leader of a global power calling for an open global economic system.[24]

Where does that leave the EU? To answer the question, it is important to understand the EU's current economic ties. Figures 13 and 14 show the bilateral trade and investment between a number of countries. For the EU27, the United States is the number one partner for both exports ($495.5 billion) and imports ($463.5 billion). With regards to China, the EU27 exports $190.4 billion and imports $394.9 billion. For the EU27 the UK remains a very important trading partner, even before China (exports to: $445.5 billion, imports from: $348.5 billion). For the United States, China is the number one partner, certainly with regards to its imports ($517 billion), although the EU is the first destination for U.S. exports ($463.5 billion).

When it comes to foreign direct investments, the ties between the EU and the United States are also very strong. Figure 14 shows that 44 percent of U.S. foreign direct investment comes from the EU27 ($1.38 trillion),

[23] Maria Demertzis, Andre Sapir and Guntram Wolff, "Europe in a new world Order," Bruegel Policy Brief, Issue 2, February 2017, http://bruegel.org/wp-content/uploads/2017/02/Bruegel_Policy_Brief-2017_02-170217_final.pdf.

[24] For the text, see https://www.weforum.org/agenda/2017/01/full-text-of-xi-jinping-keynote-at-the-world-economic-forum.

Figure 13: Bilateral Imports (Goods and services) in 2015, Selected Partners ($ billions)

	Into:	US	EU27	UK	China*	Japan	Canada
From	US		463.5	96.6	150.5	126.3	285.2
	EU27	495.5		445.5	190.4	88	35.1
	UK	108.5	348.5		18.9	19.1	12.9
	China	517	394.9	64.7		172.4	53.4
	Japan	166	88.1	14.5	143.1		13.5
	Canada	331.1	31.1	13.5	26.3	11.3	0
	World	2784.3	2828.1	845.2	1681.7	817.7	529.5

Source: Bruegel based on UN Comtrade data (available here: https://comtrade.un.org/data/). Note: *China numbers for goods only. Data for goods, bilateral trade on import statistics, which are considered more accurate given the custom system in place to collect tariff revenues. Data for services: Bruegel based on ITC Trade Map and OECD Statistics on International Trade in Services by partner country. Both sources follow the Extended Balance of Payments Services Classification (EBOPS 2010).

Note: data on EU27 are estimated by subtracting UK imports from all the bilateral import flows of EU28. In particular, EU27 (EU without the UK) total imports are equal to (EU28 total imports - UK total imports from ExtraEU28 + EU27 imports from UK).

and 31 percent of the EU27's foreign direct investment comes from the United States ($2.16 trillion).

In short, the economic relations established between the EU and the United States imply a natural alliance. And if the Transatlantic Trade and Investment Partnership (TTIP) were to be pursued, this economic alliance could be enhanced by offering greater choices, reducing prices and generating jobs and growth.[25]

Nevertheless, despite these very clear ties with the United States, the EU has a strong economic and political interest in preserving the multilateral trading system. Openness, measured as exports in terms of a country's GDP, is far greater in the EU (43.8 percent) than in China (22.1 percent) or the United States (12.6 percent). The rules-based system allows all players, including the weaker ones, to trade with each other based on high and comparable standards that have to be followed by all. Protectionism would reduce EU and global welfare, hurt global growth and could mean lower standards and unfair competition. In particular, in

[25] See an independent study for the effects on the EU: http://www.trade-sia.com/ttip/.

Figure 14: FDI Stocks 2015 ($ billions)

	To:	US	EU27	UK	China*	Japan	Canada
From	US	.	2156.3	433	116.6	51.6	280
	EU27	1382.3	.	679.9	257.9	58.4	150
	UK	484	1248.6	.	42.3	13.2	24.8
	China*	25.9	97.1	20.6	.	8.4	26.7
	Japan	411	115.3	67.7	180.7	.	15.9
	Canada	269	214.3	34.4	15.8	1.2	.
	World	3130	6863.6	1550	2580	171	555

Source: CDIS (Coordinated Direct Investment Survey), IMF. *(including Hong Kong)

the EU with its strong trade relationships around the world, many jobs could be at stake.

But can the EU protect the continuation of the multilateral system alone or in coordination with China, as it had done with the United States in the past? This is not a trivial question because the EU and Chinese economic systems are much more dissimilar than the EU and American economic systems. Nevertheless, in certain areas, such as support for the WTO, EU-China collaboration should be relatively straightforward. The EU should also seek other partners for collaboration in support of the WTO.

Overall, there is a very clear economic link between the EU and the United States that could come under threat if the latter were to take unilateral protectionist trade measures. This would be damaging to international welfare, and the EU would be pressed to react strongly and decisively to such measures. The underlying guiding principle needs to be to defend multilateral trading systems that have helped increase welfare across the world. At the same time, collaboration with others to this end is equally important.

Conclusions

The financial crisis has left a different economic and political trail in the EU and the euro area than it has in the United States. Although its member states are deeply integrated economically, the euro area lacks a

governance set-up that would allow it to respond to problems as they arise. In economic terms, this means that responses to the financial crisis and its aftermath late came too late and remain incomplete. Excessive debt, and high unemployment particularly among the young, continue to prevent growth from picking up convincingly.

There are, of course, differences in economic development among euro area countries. Arguably, such differences can be larger than among states in the United States. This would then make it difficult to identify appropriate economic responses at the macrolevel of the euro area itself. One size cannot easily fit all.

While there is some truth to this argument, it should also not be overstated. Differences in taxation and legal systems are an important source of heterogeneity. But there is also a very large accumulated body of European Union law, known as the *acquis communautaire*, that has established common standards across all countries. This in turn has allowed the creation of a Single Market, a common currency, and a banking union, and will promote a digital single market in the future.

Moreover, economic heterogeneity is also substantial in the United States; indeed, there is no clear evidence that the United States is an optimal currency area. However, where there is an important difference is that the United States is an economic federation, which next to a single currency, enables authorities to tax and redistribute at the federal level and thus smooth economic shocks across the states. Despite also having a single currency, the euro area does not have that power, and thus countries are left to fend for themselves when shocks arise. Building an economic federation would be the right step to take to strengthen the EU's architecture. This is not a short- or even medium-term possibility, however, and many doubt whether this is even a long-term possibility. In the meantime, the euro area copes with its multi-level, half-way architecture.

Despite these challenges, most countries in the EU have one important strength: they have always maintained relatively low levels of income inequality, certainly in comparison with the United States. As the benefits of open economies were shared more evenly, citizens found it easier to accept and endorse the benefits of globalization. As a result, there has on the whole been support in EU member states for closer cooperation between nations, neighboring as well as further afield. In contrast, in the United States, and to some extent also the UK, the benefits of globalization accrued only to a few. These societies became distinctively more polarized,

giving rise to deep discontent. And this, in my view, has left a different political trail, manifested in the ability of many EU countries to contain populist voices.

Apart from its own internal problems, the EU faces a number of outside pressures. The refugee and migration crises have raised the issue of protecting external borders. At the same time, discussions on the need to increase and coordinate defense has also raised an issue that had laid dormant for decades. Here again, the extent to which there can be progress depends crucially on the EU's ability to coordinate swiftly and effectively.

Last but not least, the emergence of China as a global player and the increasing withdrawal of the United States from global leadership is creating a tri-polar system of world powers. As a staunch supporter of multilateralism, the EU is having to reconsider its position and how to best protect its interests. On the hand it needs to maintain what has always been the most natural of alliances with the United States, despite having to deal with a series of increasingly contentious issues. On the other hand, it is having to deepen alliances with China, despite very significant differences of views, in particularly when it comes to the role of the state in the market place. And since the emergence of a tri-polar global system does not automatically lead to multilateralism, the EU will have to invest in building broad alliances across the world.

There is no doubt that international economic relations are currently shifting and that partnerships need to evolve. This is also true for the EU-U.S. relationship. It is important to maintain and promote economic ties between the two, as they rest on a similar and established economic approach. Nevertheless, it is also important to strengthen ties with new countries as they enter the global economic system, and there is no reason why this will be antagonistic to EU-U.S. relations. At the core of its approach, the EU aims to strengthen the multilateral system and promote access for all. A concerted EU-U.S. effort could go a long way in achieving that.

In the end, the EU's ability to promote economic development at the global level rests on the future of its own integration. European integration, in turn, depends crucially on the responses Europeans provide to both internal as well as external challenges. Important problems and populist pressures remain. It is vital that Europe avoid the trap of isolationism, but far from guaranteed that it will do so.