Long-term global economic challenges and opportunities for Europe

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1 Introduction and summary

1.1 Building on the analysis set out in the Treasury's Pre-Budget Report paper *'Long-term Global Economic Challenges and Opportunities for the UK'*, this paper looks at the specific long-term global economic challenges facing Europe in the coming decade, and discusses how Europe can best respond to them. In this context, it also sets out how these challenges will inform the United Kingdom's Presidency of the European Union during the second half of 2005.

Global challenges and opportunities

1.2 The Pre-Budget Report paper noted that far-reaching and fundamental changes in technology, production and trading patterns are shifting the balance of global economic activity, and supporting the rise of fast-growing emerging economies, notably China and India. In particular, it discussed how the combination of rapid technological change and policy liberalisation is enabling increased specialisation, fragmentation and dispersal of economic activities across continents.

1.3 These trends present both opportunities and challenges for policy-makers in Europe. Rapid growth in emerging economies has the potential to boost global demand and provide new sources of wealth. However, these economies will also contribute to an increasingly competitive global market for goods, services and investment and the location of economic activities. The most successful economies will be those that are able to respond quickly to rapid technological and market changes, promote enterprise, productivity and innovation, and thus move up the value chain.

Europe's policymakers need to act

1.4 The opportunities and challenges posed by these global trends are increasingly recognised by Europe's leaders, Finance Ministers and Central Bank Governors. As noted by Europe's High-level Group chaired by Former Dutch Prime Minister Wim Kok[1] *'Competitor countries and regions are moving on… threatening Europe's position in the global economic league table.'* The Report[2] to the 2005 Spring European Council by Commission President Barroso also noted, *'The challenges we face are even more important in the face of … global competition'*. The President of the European Central Bank, Jean-Claude Trichet[3] stated, *'The world economy is transforming rapidly, external competition has become stronger, knowledge is easily transferable and the ability to adjust to changing economic circumstances is increasingly important. Many European countries have not been adapting…rapidly enough to face these challenges.'*

1.5 Europe's policy-makers have a critical role to play in equipping their economies to respond to these challenges, which demand concerted action to strengthen the key drivers of economic growth – employment and productivity. These challenges call for greater flexibility in product markets, labour markets and capital markets to ensure that Europe's businesses and individuals are equipped to adapt to economic change and take advantage of new opportunities when they arise. Structural reform, which promotes flexibility and fairness together, is the key to success in the modern global economy. There can be no security without change.

[1] *Facing the Challenge: The Lisbon Strategy for Growth and Employment'* Report from the High Level Group chaired by Wim Kok, November 2004.
[2] *'Working Together for Growth and Jobs:* A New Start for the Lisbon Strategy' Communication from President Barroso in agreement with Vice-President Verheugen to the Spring European Council, European Commission, February 2005.
[3] Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the European American Press Club, Paris, 14 January 2005.

I.6 So it is essential that Europe's policy-makers take the difficult long-term decisions to promote stability, flexibility and enterprise, high employment, openness and opportunity for all. In some areas leadership and responsibility are most effectively exercised at the EU level, for example with respect to multilateral action to promote free and fair trade. In other areas joint action at both Member State and EU level is essential for success. For example, national competition policies should be complemented by proactive enforcement of an effective EU-wide competition policy. However, in many areas, even though the challenges are global, policy action is most effectively exercised at Member State level. A clear example is tax, where globalisation demands not tax harmonisation but flexible and competitive tax systems.

Meeting the economic challenges in Europe: 1945-2005

Co-operation, trade and growth

I.7 The paper begins by looking at the development of the European economy since 1945, in order to set the current challenges in historical context. First, it looks at how Europe responded to successive challenges of the post-war period of reconstruction, entrenching stability and restoring economic growth. It discusses the cooperation amongst national governments and the development of European institutions, from the establishment of the European Coal and Steel Community (ECSC) and European Economic Community's (EEC) Common Market, towards the creation of the European Single Market and European Union. These initiatives reflected the belief that European economic cooperation was essential to promote lasting peace and prosperity.

I.8 For the first decades after the war, trade and investment flows in Europe rose, delivering strong growth and catch-up towards US standards of living. However, the external shocks and economic challenges of the 1970s led to a period in Europe of weak growth, rising unemployment, higher inflation and macroeconomic instability. Europe found renewed impetus in a new drive for internal reform, notably with the launch of the European Single Market in the 1980s, promoting closer European economic integration, trade and investment, and growth. In the 1990s, Europe rose to meet its greatest challenge since the Second World War with the unification of East and West Europe, expanding the continent's potential for growth.

Europe's economy has yet to meet its full potential

I.9 The second half of Chapter 2, however, looks at the significant economic challenges that Europe now faces in the new global economy. Despite the benefits from greater trade and investment within Europe, structural economic weaknesses have prevented Europe's economy from meeting its full potential. In particular, since the 1990s, and reversing the earlier post-war trend, the gap in living standards with the US has widened again, to around 30 per cent, due to Europe's inferior performance of both employment and productivity. Recognising the need for reform, Europe's leaders in Lisbon in March 2000 set the goal of making the EU the *'most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth and with more and better jobs and greater social cohesion'*[4]. However, since then Europe's performance – in terms of growth, employment and productivity – has not sufficiently improved. Moreover, recognising that Europe cannot act in isolation from global developments, and as noted by the High-Level Group chaired by Wim Kok, *'Even if every [Lisbon] target were to be hit on schedule, Europe would not be on safe ground.'*[5]

[4] Presidency Conclusions, Lisbon European Council, 23-24 March 2000, paragraph 5.

[5] Report from the High Level Group (2004), op. cit.

Global economic challenges for Europe

Six key global economic challenges for Europe

1.10 At each stage in its history Europe has come to recognise the need for change, adapting its policies and institutions in response to the challenges of the time. Europe now needs to rise to the challenges associated with the new global trends. The Treasury's Pre-Budget Report paper identified six key trends associated with this dramatic global change that will shape economic developments over the coming decade[6]. Building on this,[7] Chapter 3 discusses, from Europe's perspective, each of the six challenges and opportunities to which Member States and the EU as a whole will need to respond in order to achieve a strong economy and fair society in this new global environment:

- First, Europe needs to adapt to the changing balance of global economic activity, in which an increasing proportion of global output will be produced in the rising Asian economies and other rapidly growing emerging economies. By the end of this decade, China's economy might be larger than Germany's. Within a decade, it might overtake Japan to be the world's second largest economy. The EU and US will account for a steadily diminishing share of world output.

- Second, Europe needs to respond to the increasing integration of global economic activity, which is intensifying competition amongst producers and offering increasingly diverse sources and destinations of foreign direct investment (FDI). Europe is increasingly integrated in the global economy, not least due to enlargement and increased trade integration with Asia. It is already actively investing overseas, to a comparable degree to the US. However, the EU has been unable to benefit from inward FDI to the same degree as the US in recent years, missing out on associated benefits to productivity via its impact on skills, innovation and technology, and competition.

- Third, Europe needs to rise to the challenge of increasing tradability of goods and services and relocation of economic activities. Driven by further advances in technology, production processes are increasingly fragmented, enabling economic activities to become increasingly international, specialised and tradable. Estimates suggest that around 5 million services jobs from the US and Europe could be relocated abroad by 2015.

- Fourth, Europe must take advantage of the increasing rewards from innovation as both global competition and the speed of technological change increase. Compared to its developed economy competitors, Europe's performance with respect to innovation remains relatively poor and there is evidence that much of Europe's entrepreneurial potential remains untapped. Moreover, exports from the large emerging economies are increasingly moving up the value chain, and those countries are also stepping up their investment in research and development.

- Fifth, Europe's labour markets and welfare systems need to be able to cope with rapid technological and market changes. To realise the benefits that

[6] For a broader discussion of globalisation, see Wolf, M. (2004) *'Why Globalisation Works'*, Yale; Bhagwati, J. N. (2004), *'In Defence of Globalisation. Its Evolution and Contemporary Consequences'*, New York; Dicken, P. (2003). *'Global Shift, Reshaping the Global Economic Map in the 21st Century'*, London; Hutton, W. and Giddens, A. eds (2000), *'On the Edge: Living with Global Capitalism'*, London; Held, D. et al. (1999). *'Global Transformations: Politics, Economics and Culture'*.

[7] This paper also draws on a number of discussions on the global economy, including the '*Advancing Enterprise 2005*' conference held in London in February 2005, which brought together leading international thinkers to discuss enterprise in the context of the global economy; and DTI, '*Trade and Investment White Paper: Making Globalisation a force for good*', July 2004.

come from global integration, countries will require effective education and training systems to provide the higher skill levels, which underpin strong and flexible labour markets, economic growth and high employment, address inequalities and ensure social cohesion. Skill levels vary significantly between Member States and often lag behind other developed economies. Studies and outcomes both suggest that greater labour market flexibility tends to be associated with countries outside of continental Europe.

- Sixth, Europe needs to take a leading role in finding solutions to the increasing pressure placed on resources and the natural environment by the pace of global economic growth. In the absence of policy changes, global energy demand is projected to increase steadily over the next decade. While two thirds of the growth is likely to originate from developing countries, in particular China and India, the EU is also forecast to increase its demand for energy.

Policy challenges for Europe

I.II Chapter 4 discusses the policy challenges that Europe must meet over the next decade in responding to and shaping these global trends. It also discusses how the need to take account of these trends will inform the UK's Presidency of the EU in the second half of 2005. It argues that whereas in the past Europe has tended to focus on internal policy issues, most recently on the Single Market project, it must now build on the historic achievement of enlarging the Union from 15 to 25 Member States, and look outwards. The Government will aim, through the Presidency and beyond, to develop a consensus on the need for a more Global Europe: a Europe, which by becoming more outward-looking and embracing greater flexibility in labour, product and capital markets, delivers high employment for its citizens. At the same time a Global Europe must step up to its responsibilities to take action to reduce international poverty, advance fairer trade and support the drive to tackle climate change. Meeting the challenges of the global economy will require:

- a **stable macroeconomic environment** that promotes growth, investment and fiscal sustainability in the face of long-term demographic challenges and increased global flows;
- the **right climate for enterprise and innovation,** including support for research and development and intellectual property, and a new approach to regulation;
- a **dynamic and competitive Single Market** which reaches its full potential, allowing growth of high value added activities, including through more pro-active competition policy and reduction of distortive state aids which hinder change;
- **efforts to shape global trends and become more outward-looking,** taking a lead in multilateral trade liberalisation to deliver benefits for the developing world and Europe alike; strengthening economic co-operation with major partners such as the US; and playing a leading role in raising the resources needed to reduce international poverty and ensure globalisation can benefit all;
- **modern social policies, respecting Europe's historical commitment to matching enterprise with fairness,** including active and responsive welfare states, which equip people with necessary skills to respond flexibly to change, underpin high levels of economic growth and employment, and tackle inequalities and ensure social cohesion; and

- enhanced **environmental sustainability** through more efficient use of energy resources, while at the same time reducing environmental costs, particularly in the context of global climate change, with Europe playing a leading role in promoting market-based solutions.

Embracing a Global Europe

1.12 Only by embracing a Global Europe – reforming, flexible, outward-looking and competitive – will the EU and its Member States respond to the new challenges of globalisation, delivering sustainable growth and opportunity for all in this period of far-reaching economic change. Building a European consensus to take the right long-term decisions in this context will be a central objective of the UK's Presidency of the EU.

2 Meeting The Economic Challenges in Europe: 1945-2005

INTRODUCTION

2.1 This chapter sets the development of the European economy in its historical context, looking at Europe's response to the global economic challenges of the past. It describes how, at each stage in its history, Europe has come to recognise the need for change, and has adapted its policies and institutions in response to international economic developments.

2.2 It begins by describing how Europe rose to the challenge of post-war reconstruction, through cooperation among national governments and the creation of new European institutions. These initiatives answered a political imperative to strengthen regional economic ties as a guarantee of lasting peace and prosperity. They also succeeded in providing a base for strong economic recovery, enabling Europe to realise substantial welfare gains and catch up with US living standards.

2.3 The external shocks and economic challenges of the 1970s led to a period in Europe of weak growth, rising unemployment, higher inflation and macroeconomic instability. The chapter goes on to discuss how Europe responded to these challenges with a new commitment to reform, in particular with the launch of the Single Market programme. It then describes how the continuing process of European enlargement has further sustained economic growth and integration in Europe following the end of the Cold War.

2.4 However, as the chapter sets out, Europe has not yet realised the full benefits of the Single Market. Moreover, Europe's focus has been primarily on internal integration: inward-looking and protectionist policies may have limited its ability to benefit from wider international ties.

2.5 The second half of the chapter focuses on recent economic developments in the EU. It looks at Europe's growth, labour market and productivity performance, and notes how continued structural weaknesses are hindering Europe's ability to succeed in a period of intense global competition. Just as Europe has responded to the global economic challenges of the twentieth century, so it now needs to take urgent action to ensure that it maintains a leading role in the new global economy.

HISTORICAL BACKGROUND TO EUROPEAN INTEGRATION

Europe's role in nineteenth century globalisation

2.6 For centuries, Europe has played a significant role in the process of global economic integration. European countries were at the forefront of the technological advances of the Industrial Revolution. As these new techniques were applied in the nineteenth century to international transport and communications, European nations - alongside the United States – were a driving force behind the growth in international trade, forging new global product, capital and labour markets[1].

[1] The themes are explored further in *'Long-term global economic challenges and opportunities for the UK'*, HM Treasury December 2004 – drawing on Landes, D. (1998) *'The Wealth and Poverty of Nations'*, London; Maddison, A. (1982) *'Phases of Capitalist Development'*, Oxford; Maddison, A (2001) *'The World Economy: a Millennial Perspective'*, OECD, Paris; and DeLong, B. *'Slouching Towards Utopia: The Economic History of the Twentieth Century'*, http://www.j-bradford-delong.net/.

2.7 A network of bilateral trade treaties, beginning in 1860 with the Cobden-Chevalier Treaty between Britain and France, helped countries to take advantage of improved transport links and supported an increase in world trade (defined by the ratio of world exports to GDP) from 10 per cent of GDP in 1870 to 17 per cent in 1900 and 21 per cent in 1913[2]. From 1866, new transatlantic telegraph links dramatically reduced communication times, leading to rapid integration of transatlantic financial markets. Finally, this was a period of high labour mobility, with up to 10 per cent of the world's population migrating from one continent to another between 1870 and 1925, far higher than today's rates[3].

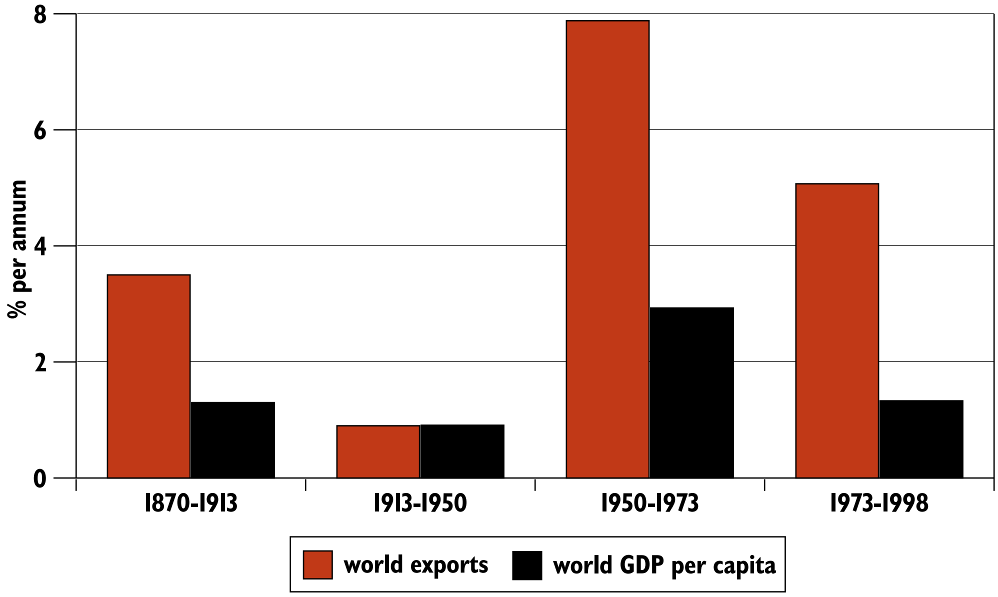
2.8 The period after the outbreak of the First World War saw a sharp reversal in this expansion of international trade and integration of the world economy. Following the war, the decline in trade was exacerbated by the absence of a stable international payments system, and by the introduction during the 1930s of protectionist policies such as tariffs, import quotas and foreign exchange restrictions. By the end of the Second World War, many of the gains of the nineteenth century had been lost: global trade flows had collapsed and the volume of trade in Western Europe was lower in 1950 than it had been in 1913[4].

RECONSTRUCTION AFTER 1945

New drive for international economic cooperation

2.9 The challenge of reconstruction was keenly felt in Europe, in the wake of the economic devastation wrought by the Second World War. However, all Western Governments saw the importance of opening up markets, not only as a means of rebuilding trade and investment links, but also as a political imperative to guard against future conflicts. The trauma that resulted from the breakdown of political and economic relations in Europe over the 1930s and 40s fuelled a new commitment to economic cooperation at both international and European levels.

Chart 2.1: World export and GDP per capita growth



Source: Maddison (2001).

[2] Figures taken from Estevadeordal, A., Taylor, A. M. and Frantz, B. (2002) '*The Rise and Fall of World Trade, 1870-1939*', NBER, Cambridge, Mass., 2002.

[3] Chiswick, B. and Hatton, T. (2003) '*International Migration and the Integration of Labour Markets*' in Bordo, M., Taylor, A. and Williamson, J. (2003) '*Globalisation in Historical Perspective*', Chicago; DeLong, op. cit.

[4] O'Rourke K, '*Europe and the Causes of Globalization, 1790 to 2000*' in Kierzkowski H (2004), '*Europe and Globalization*' 2004. See also HM Treasury and DTI (2004) '*Trade and the Global Economy*' May 2004.

IMF, World Bank and GATT established

2.10 At the international level, the Bretton Woods conference of 1944 established new institutions whose explicit aim was to promote lasting multilateral economic cooperation between nations[5]: the International Monetary Fund (IMF) to promote a stable monetary system as a basis for multilateral trade, and the World Bank (founded as the International Bank for Reconstruction and Development) to help restore economic activity in the devastated countries of Europe and Asia. In 1947, 23 countries established the General Agreement on Tariffs and Trade (GATT), as a framework for progressive mutual reductions in tariffs. These initiatives delivered rapid benefits: as trade barriers fell, both global trade and income per capita increased, and the strong growth of both exports and output between 1950 and 1973 stands in marked contrast to the weak performance of both in the first half of the century.

Marshall Plan & OECD

2.11 European countries were also working to build regional economic ties and provide the stability needed for economic recovery. In the immediate aftermath of war, the pursuit of closer economic cooperation amongst recipient countries was a condition of US aid to Europe under the Marshall plan. This led to the establishment of the Organisation for European Economic Cooperation (later the OECD) in 1948, which both managed US aid and did much to further trade between member countries in the 1940s and 1950s – for example by helping to establish payments schemes.

European Coal and Steel Community

2.12 A group of West European countries then sought even closer integration of European markets as a source of growth and prosperity for their own economies, and to promote political stability through economic co-operation.[6] In 1951, they established the European Coal and Steel Community (ECSC), with the intention of creating a free trade area and common market in the key sectors of European economies. The ECSC made swift progress in abolishing customs tariffs and quotas, and reducing non-tariff barriers to trade – accompanied by rapidly increasing output and trade between the member countries.

2.13 These initiatives answered the needs of the time, providing stability to rebuild Europe's infrastructure and promote economic growth from a very low base. They also show how, from the beginning, the impetus for European economic integration has come from broader global developments.

ECONOMIC GROWTH AND COOPERATION

Launch of Common Market

2.14 The creation of the European Economic Community (EEC), in 1958, began the formation of a broader common market based around four fundamental freedoms: free movement within the EEC of goods, services, people and capital. It launched a customs union (completed in 1968) in which tariffs and other explicit restrictions were eliminated on trade between member countries, and a common external tariff applied to trade with third countries. It prohibited practices that would distort or prevent competition between Member States. To support these policies, it also established Europe's institutional structure, using the "Community method" of decision making to agree the rules needed for the common market to function smoothly.

[5] See Boughton, J.M. (2004): '*The IMF and the Force of History: Ten Events and Ten Ideas That Have Shaped the Institution*', IMF Working Paper (May, 2004); James, H. '*International Monetary Cooperation Since Bretton Woods*', Oxford, 1996.

[6] The founding members of the ECSC and EEC were Belgium, France, West Germany, Italy, Luxembourg and the Netherlands.

2.15 In 1960, shortly after the foundation of the EEC, other European countries, including the UK, signed the European Free Trade Agreement (EFTA)[7]. EFTA aimed firstly to create a free trade area between its membership (completed in 1966) and, secondly, to conclude free trade agreements with non-EFTA countries, including (in 1977) the EC. The creation of the EEC and EFTA reduced trade barriers further within Europe during the 1960s, most notably on trade in industrial products, providing European producers with easier access to each other's markets and leading to the formation of a free trade area encompassing all of Western Europe.

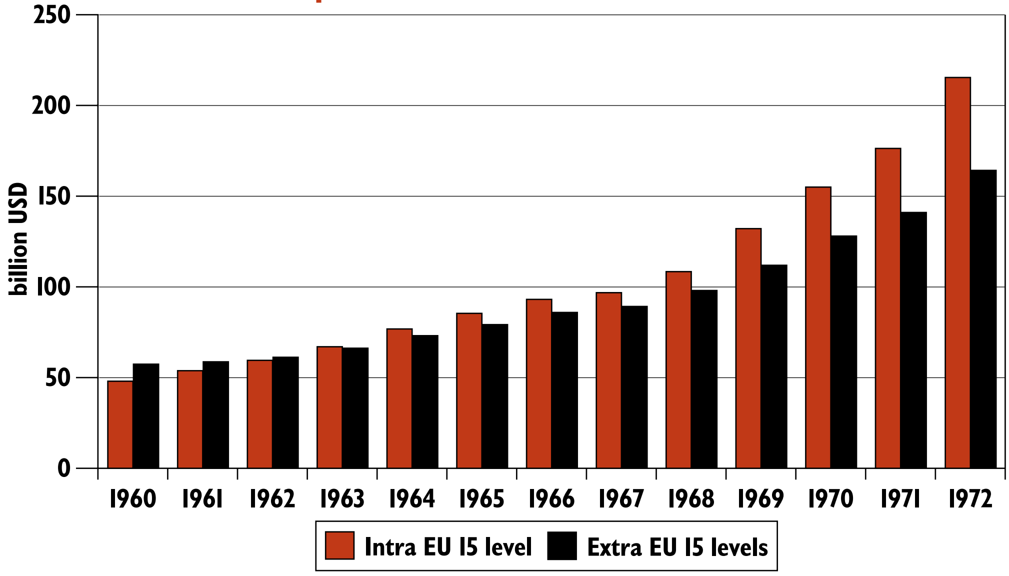
Recovery of trade and growth

2.16 These initiatives succeeded in providing a base for strong economic recovery, ushering in the "Golden Age" of European growth. During the period 1950-73, Western European trade expanded by over 8 per cent per annum, with exports as a share of GDP rising from 9.4 per cent to 20.9 per cent of GDP. During the same period, GDP per capita grew by 4.1 percent per annum, compared to an average of just 2.4 per cent in the US, Canada, Australia and New Zealand.

Strong intra-European trade

2.17 Trade in this period was characterised by a significant expansion in intra-European trade. While total EC trade grew roughly in line with world trade in the post war catch-up phase, between 1960-72, trade volumes between the now EU 15 Member States expanded by around 350 per cent, compared with a 185 per cent increase in their trade with external third countries[8].

Chart 2.2: Comparison of intra and extra EU-15 trade, 1960-72



Source: OECD.

2.18 Developments in France and Germany, the major contributors to European growth in this period, demonstrate this trend: both countries were increasingly focussed on strengthening their trade links with other Member States. In France, where strict import quotas and tariffs had applied throughout the 1950s, the share of exports to former colonies fell from 38 per cent to 14 per cent between 1958 and 1968, and the share going to OECD countries rose from 47 per cent to 70 per cent[9].

[7] EFTA's founding members were Austria, Denmark, Great Britain, Norway, Portugal, Sweden, and Switzerland. Iceland joined in 1970, Finland in 1986, and Liechtenstein in 1991. EFTA's current members are Iceland, Liechtenstein, Norway, and Switzerland.

[8] Trade figures sourced from OECD.

[9] Sicsic and Wyplosz, '*France, 1945-92*' in Crafts and Toniolo (Eds) '*Economic Growth in Europe since 1945*' Cambridge, 1996.

2.19 This dominance of intra-European trade growth reflects the fact that the ECSC and EEC were initially designed to strengthen economic relations within Europe, rather than to open up trade links with the rest of the world. In the ECSC, cooperation focussed on cross-national intervention to serve the interests of its members' dominant industries. And the EEC's founders, although their aim was to remove barriers and reap the benefits of expanded markets, also sought protection and special treatment for certain aspects of their economies. The removal of restrictions on internal trade was accompanied by the establishment of a common external tariff, and the adoption of a Common Agricultural Policy protecting farming interests. The prohibition of practices that would distort or prevent competition between Member States was accompanied by provisions allowing state aids to finance transport projects or to fund "obligations inherent in the concept of public service".

2.20 So the creation of the common market was accompanied in some respects by increased external barriers and the introduction of protectionist policies, such as the CAP, with a legacy of persistent difficulties. Gains in regional integration (trade creation) may have been made, to some extent, at the expense of broader international ties (trade diversion). Nonetheless, strong growth in the major European economies, accompanied by broad economic stability and rising living standards, demonstrates the success of the EEC model at this period and in particular the gains to be made by liberalising product markets.

TOWARDS THE SINGLE MARKET

2.21 In 1973, the EU's membership expanded to include the UK, Ireland and Denmark in the first of a continuing series of enlargements – supporting the trend of rising intra EU trade that continued, albeit at a slower rate than in the previous decade, throughout the 1970s. Intra-EU trade grew by 160 per cent between 1973 and 1983[10].

Global economic instability

2.22 However, against a backdrop of rising oil prices and global economic downturn, Europe's convergence with US living standards - and its combination of growth, stability and social cohesion – was proving difficult to sustain. From 1974-1985, EU15 GDP growth averaged only 2 per cent, and GDP per capita averaged 1.7 percent. Average inflation rose to 11 per cent, and unemployment rose from less than 3 per cent in 1974 to 10 per cent in 1985. This combination put pressure on EU15 public expenditure: between 1970 and 1985, social transfers rose by six percentage points and subsidies by one percentage point, while public investment fell by one percentage point[11].

Launch of the Single Market

2.23 In this climate of instability, European leaders recognised the need to respond to new, global economic challenges. Spurred by a feeling that Europe was falling behind the US and Japan in developing new technologies, they determined to reenergise the process of economic integration. This resolve led to the launch of the Single Market Programme in the 1980s, further reducing the impediments to cross-border trade within the EU and seeking deeper integration of European markets to boost economic performance. The programme's aim was to complete an internal market providing for genuinely free movement of goods, persons, services and capital.

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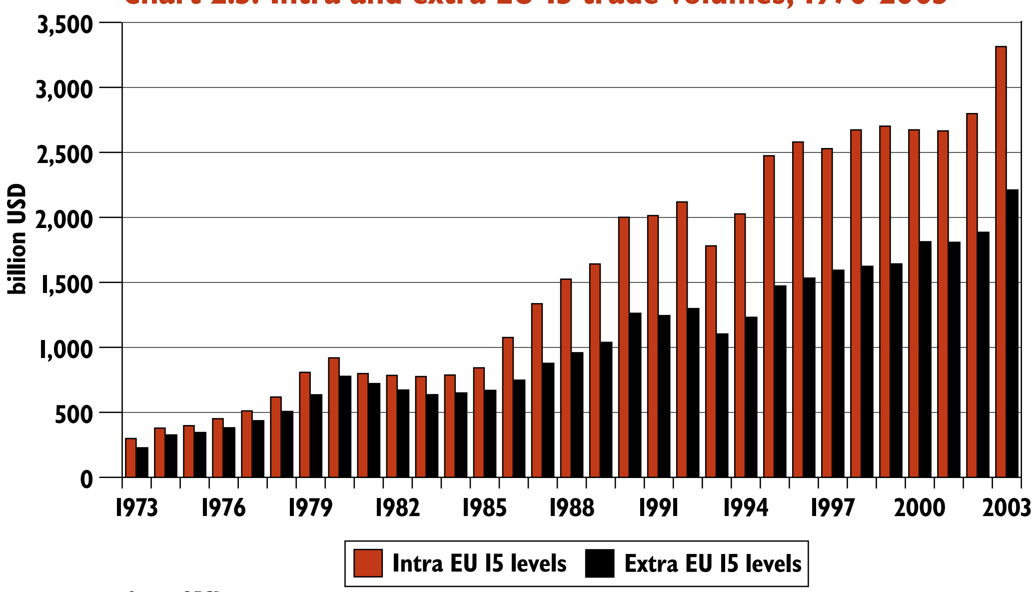
[10] Source: OECD

[11] Sapir, A. et al. (2003): Ch. 7 *'Is the European Model Sustainable?'* in '*The Sapir Report – An Agenda for a Growing Europe*', Oxford, 2003.

2.24 The Single European Act in 1986 set out a strict timetable for completing the Single Market. It also extended qualified majority voting to facilitate decisions on Single Market legislation. These provisions were reinforced by the 1992 Treaty of Maastricht, which set out the framework for Economic and Monetary Union. As the EU's activities have expanded into new areas, so Member States have also evolved new methods of policy coordination - such as the framework of Broad Economic Policy Guidelines – in order to meet common objectives while respecting national competences. Following the enlargement of the EU from 15 to 25 Member States, the Treaty establishing a Constitution for the European Union was signed in October 2004[12].

2.25 The evolving Single Market in the 1980s and 1990s cut barriers to trade and investment in Europe. By removing tariffs and non-tariff barriers, it helped trade in goods and services amongst the EU15 Member States (intra-EU15 trade) rise by about 40 per cent in the decade following its launch in 1992. Intra-EU15 trade in goods and services now accounts for over 40 per cent of Member States' total GDP, bringing significant economic benefits.

Chart 2.3: Intra and extra EU-15 trade volumes, 1970-2003



Source: OECD.

Expansion of capital flows

2.26 Despite the steady recovery of trade flows over the post-war period, global capital flows had remained well below their nineteenth century peaks. But as Europe progressed towards the Single Market, the dismantling of capital controls led to a massive expansion of FDI. As a world average, the stock of foreign direct investment (FDI) had reached over 9 per cent of world GDP in 1913, but this figure was finally exceeded in the 1990s, reaching 10 per cent in 1995 and 23 per cent in 2003[13].

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[12] See Foreign and Commonwealth Office (2005), '*Treaty Establishing a Constitution for Europe: Commentary*', London, 2005.

[13] Source: UNCTAD

2.27 As with the expansion of product markets in the 1950s, so Europe took a leading role in the new global expansion of capital markets. The Single Market provided a good climate for FDI, and Europe's economic development became as much about investment as about trade. Total European FDI flows grew over twenty fold between 1970 and 1990, compared to a seventeen fold increase in the world and a nine times increase by the US; and the EU became the most important destination for US overseas investment. Even more than with trade flows, though, a high proportion of EU FDI relates to transactions between Member States. In 2003, 66 per cent of inward EU 15 FDI came from other EU 15 Member States, with 66 per cent of the EU 15's outward FDI also directed at other EU 15 members[14].

2.28 The Single Market, in bringing greater openness to trade and investment, has delivered benefits in terms of growth and productivity, realised gradually through the 1990s. According to a recent report, EU GDP in 2002 was 1.8 per cent higher (£110 billion) than it would have been without the Single Market; and over the last ten years, the Single Market has boosted EU15 GDP by approximately £588 billion – equivalent to £3800 for every UK household over the period[15]. However, subsequent chapters will explain that Member States must still go further if they are to realise the full benefits of deepening the Single Market[16].

2.29 The Single Market was also accompanied by further action in the social field. Rising unemployment in the 1970s and 80s had refocused attention on the importance of social welfare, and this was eventually reflected in the incorporation of the social chapter into the Treaty at Maastricht. However, in pursuing its social objectives the EU has not always struck the right balance between fairness and competitiveness. Looking forward, as Chapter 4 will argue, building active and responsive welfare states, which equip people with the skills they need, provide security for the vulnerable, while maintaining incentives to work and save, is critical if Europe's Single Market is to continue to deliver benefits to its citizens.

Economic and Monetary Union

2.30 Following the launch of the single currency under Economic and Monetary Union (EMU) in 1999, twelve Member States of the European Union have replaced their national currencies with the euro. The key implications for countries of the euro area are: nominal exchange rates between them are fixed irrevocably at the entry rate; there is a single official short-term interest rate which is set for the euro area as a whole by the European Central Bank (ECB); and fiscal policy remains the responsibility of Member States subject to the requirement to avoid excessive deficits and comply fully with the terms of the Stability and Growth Pact (SGP).

2.31 As the detailed assessment[17] published by the Government in June 2003 noted, the potential benefits of a successful single currency within a single European market include lower transaction costs, less exchange rate volatility, and more incentives for cross-border trade[18] and investment. There is evidence that, with the euro, trade within the euro area has increased. However, as the assessment set out, sustainable and durable convergence and sufficient flexibility are essential preconditions for successful membership of EMU.

[14] Source: Eurostat.

[15] *'The Internal Market - Ten Years Without Frontiers'*, European Commission, 2003.

[16] Economic gains from the Single Market to date are below those predicted in the 1988 Cecchini Report, which noted that completing the Single Market would raise GDP by $4^1/_2$ per cent of EC GDP and create 1.8 million new jobs.

[17] See HM Treasury (2003) '*UK Membership of the Single Currency, An Assessment of the Five Economic Tests*', June 2003.

[18] See, for example, HM Treasury (2003) '*EMU and Trade*', EMU study, June 2003.

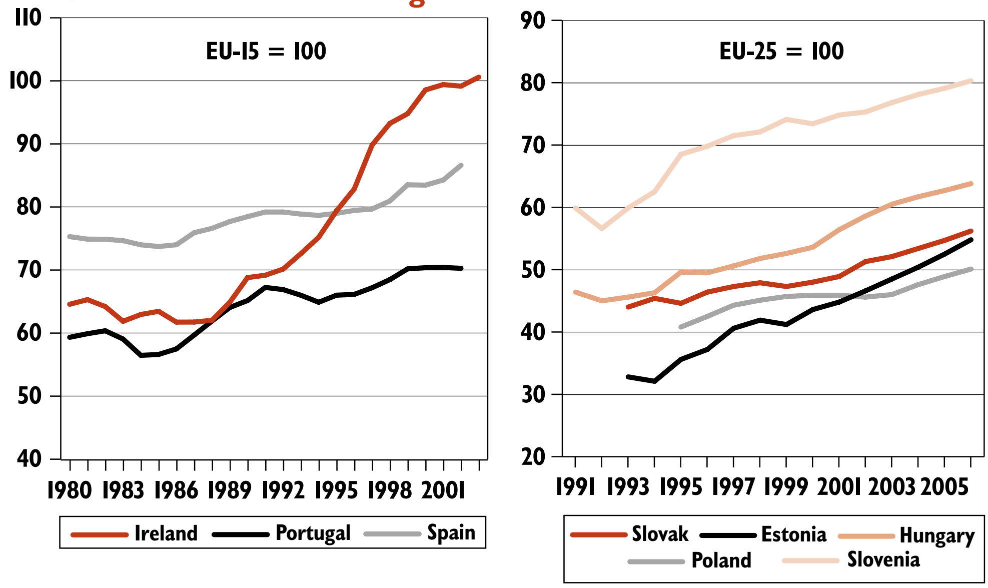
ENLARGEMENT

2.32 The fall of communism presented the EU with the greatest political and economic challenges it had faced since the end of the Second World War. Europe again responded to these challenges: since 1992, the main driver of European economic integration has been progress towards the accession of the ten New Member States, accompanied by economic liberalisation that widened, rather than deepened, the Single Market. The success of enlargement shows the EU's ability to adapt its institutions and policies to the needs of the day, and has proved an effective stimulus to economic growth.

Benefits of enlargement

2.33 Countries joining the EU at an earlier date, such as Spain (in 1986) and Ireland (in 1973) had already showed the gains that could be made by harnessing sound economic policies to the opportunities of the common market. In Spain, trade was growing at an annual rate of around 8 per cent in 1984-85, but accelerated to around 42 per cent in 1986[19]. Economic convergence was delayed in Ireland, but by the late 1980s, structural reforms to stabilise public finances and increase competitiveness had taken effect; and, as chart 2.4 below shows, Ireland was well-placed to take advantage of the expansion in FDI flows following the introduction of the Single Market[20].

Chart 2.4: Income convergence



Note: GDP per capita in current purchasing power terms, for Ireland GNP per capita in purchasing power terms is used.

Source: Annual National Accounts for OECD countries, OECD 2004; Structural Indicators, EC 2004; and CSO Ireland 2005.

– to the new members

2.34 Enlargement to include the ten new Member States of Central and Eastern Europe has been a much more ambitious undertaking, but one that is also proving successful. Following dramatic liberalisation in the early 1990s, average growth in the new Member States has outstripped the EU15 level since the mid-1990s (averaging 4.1 per cent in 1996-2000, as against 2.7 percent in the EU15). Several of these economies have recorded growth rates above 4 per cent over the past five years, highlighting the scope in the longer term for the new Member States to catch up with existing members.

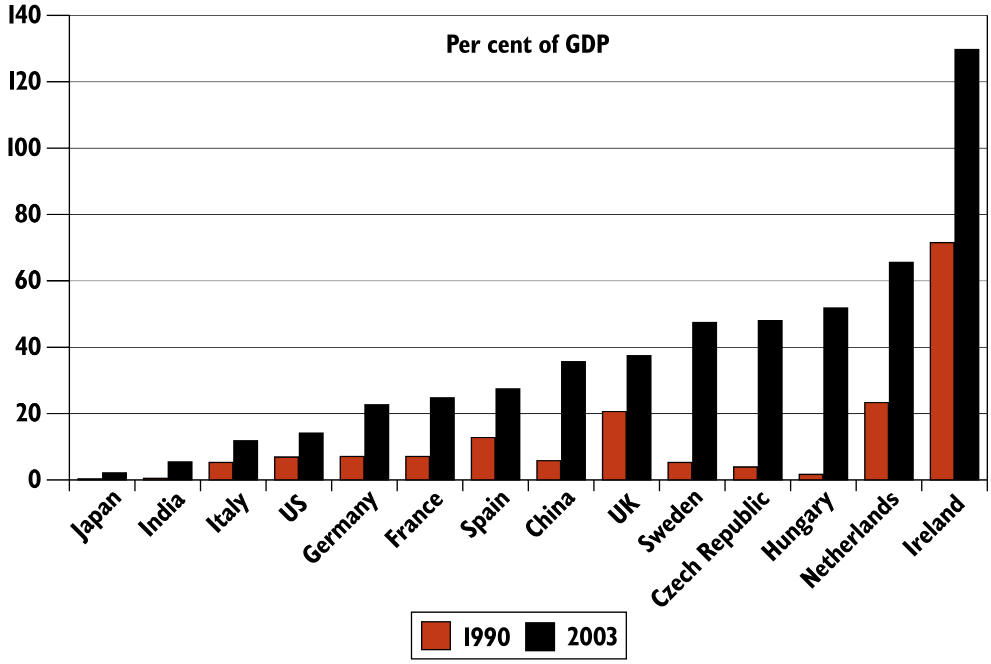
[19] Source: OECD. See also discussion in Ch. 2 of *'Trade and the Global Economy'*, HM Treasury 2004, drawing on Prados de la Escosura and Sanz (1996)

[20] Barry F, (2004) *'Economic Policy, Income Convergence and Structural Change in the EU Periphery'*, Ch 9 of Kierzkowski H, *'Europe and Globalization'* 2004.

– and to the EU as a whole

2.35 This growth has also proved to be a new source of dynamism for existing EU Member States: between 1993 and 2003, the EU's trade with the New Member States grew by 275 per cent. As discussed in Chapter 3, this means that the process of enlargement, over the course of the 1990s, has been the most significant recent source of extra-EU15 trade growth. Chart 2.5 illustrates how some of the new Member States have also benefited from high inward investment as a share of GDP over the last decade, by far the largest share of which originated from other Member States.

Chart 2.5: Inward FDI stock in 1990 and 2003



Source: United Nations World investment report 2004.

2.36 In the longer term, the Commission estimates that enlargement could increase GDP growth in the new Member States by between 1.3 and 2.1 percentage points annually, and for the existing members it could increase GDP by 0.7 percentage points on a cumulative basis[21]. The European Round Table of Industrialists has predicted that enlargement will create 300,000 more jobs in the EU15[22].

2.37 So the economic convergence of new Member States in each successive wave of enlargement has provided new opportunities, and helped European countries to sustain levels of growth and employment. The success of enlargement proves once more Europe's ability to adapt and meet the challenges of the time; it also underlines the potential benefits to the EU of taking a more open, outward-looking approach to economic cooperation.

[21] *'The Economic Impact of Enlargement'*, Directorate General for Economic and Financial Affairs, May 2001. See also Baldwin, E. Francois, J and Portes, R (1997): *'The costs and benefits of eastern enlargement: the impact on the EU and central Europe'*, Centre for Economic Policy Research, 1997.

[22] European Round Table of Industrialists (2001), *'Opening up the Business Opportunities of Enlargement'*.

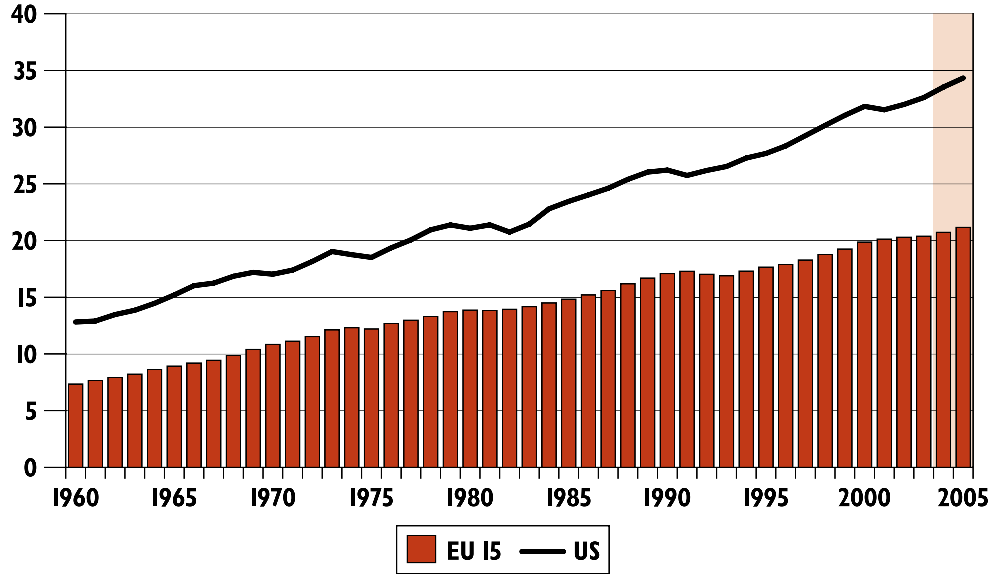
EUROPE IN 2005

2.38 In 2005, Europe now faces significant new challenges. Globalisation, advances in technology and the rapid integration of the world's emerging economies are putting European business under intense competitive pressure. Member States need to adapt quickly if they are to maintain growth and living standards in their economies. Yet at present, although some Member States are performing relatively well, as a whole Europe is losing ground in comparison with key developed economies and unemployment remain high.

Gap in living standards widens

2.39 During the first three decades after the war, Europe's strong growth rates meant it began to close the gap in living standards with the US. As Chart 2.6 demonstates, since the start of the 1990s, this trend has reversed and the gap has widened. High rates of real GDP growth in the US are partly explained by demographic factors; as shown by Chart 2.7, a number of Member States have achieved higher rates of growth in real GDP per capita in recent years. However, many Member States have fallen behind, and since 1996 annual average growth in GDP per capita in the euro area has averaged about 1/2 per cent less than in the US. In 2004, real GDP growth in the Euro area was less than half that in the US. Stronger growth in non-euro area countries (Sweden, UK and also the new Member States) boosted growth for the EU25 as a whole to about 2 1/2 per cent in 2004, compared to 4 1/2 per cent in the US[23].

Chart 2.6: GDP per capita EU15 and US levels



Note: shaded area represents Commission forecasts.
Source: European Commission, Ameco.

Lower employment & productivity levels

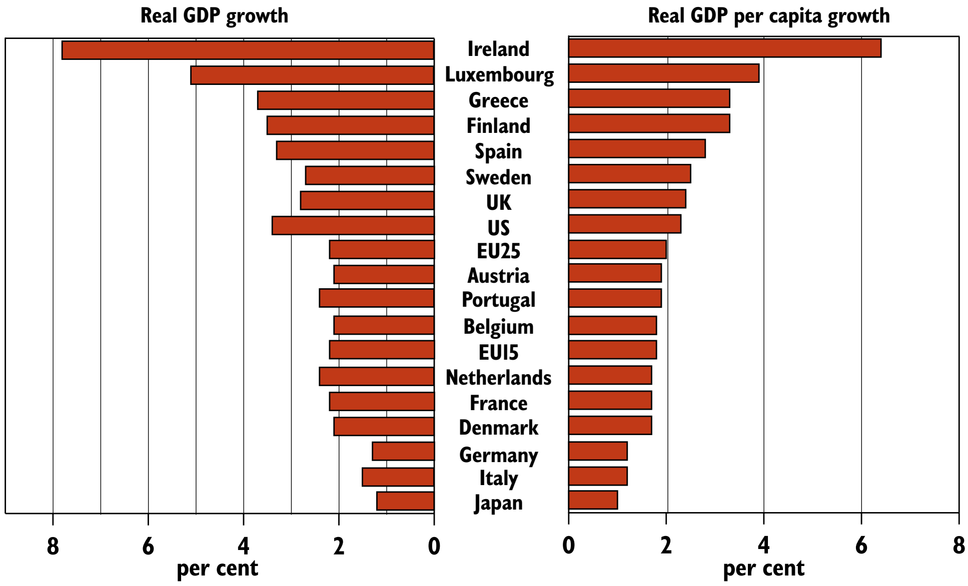
2.40 So as a whole, Europe's growth rate still lags behind those of its main competitors. As a result of this persistent gap, the gap in living standards between the US and EU15 has widened back above 30 per cent. Growth accounting analysis[24] suggests that Europe's labour market performance explains around two thirds of Europe's gap in living standards with the US: the remaining third can be attributed to Europe's lower productivity levels.[25]

[23] There was significant variation in the performance of the Member States over the three years 2001-2003. For example, whilst cumulative growth in Italy was 2 1/2 per cent and Germany just 1 per cent, the UK grew by 6 per cent.

[24] See, for example, European Commission 'EU Economy Review 2003'; 'EU Economy Review 2004'; and OECD '*Economic Policy Reforms: Going for Growth*', 2005.

[25] See, for example, '*Second Implementation Report on the 2003-2005 Broad Economic Policy Guidelines*', Commission staff working paper, January 2005.

Chart 2.7: Average annual growth rates, 1996-2004



Source: Eurostat

2.41 Despite recent efforts to boost employment (rising by an annual average of 1 per cent in the EU15 since the mid 1990s), and marked success in some Member States, particularly in raising female employment (by 4 million jobs over the last 4 years), inactivity rates remain high, with some 93 million inactive people of working age across the EU25[26]. The employment rate of older workers remains especially low: at 40.2 per cent in 2003, it was well below that of major competitors like the USA and Japan, where the rates were 60 and 62 per cent respectively.

2.42 Moreover, at around 9 per cent Europe's unemployment rate is considerably higher than that in the US and Japan, leaving 19.5 million people unemployed. In 2004, unemployment rates averaged close to 10 per cent in Germany, 9 per cent in France and 8 per cent in Italy. Much of this was due to long-term unemployment, reflecting labour market rigidities: nearly 50 per cent of the unemployed in Germany and nearly 60 per cent in Italy are out of work for more than a year, compared with less than 10 per cent in the US and Canada. This reverses a long-standing European strength: unemployment levels were minimal in the 1960s, while the US average is much the same as that of 40 years previously.

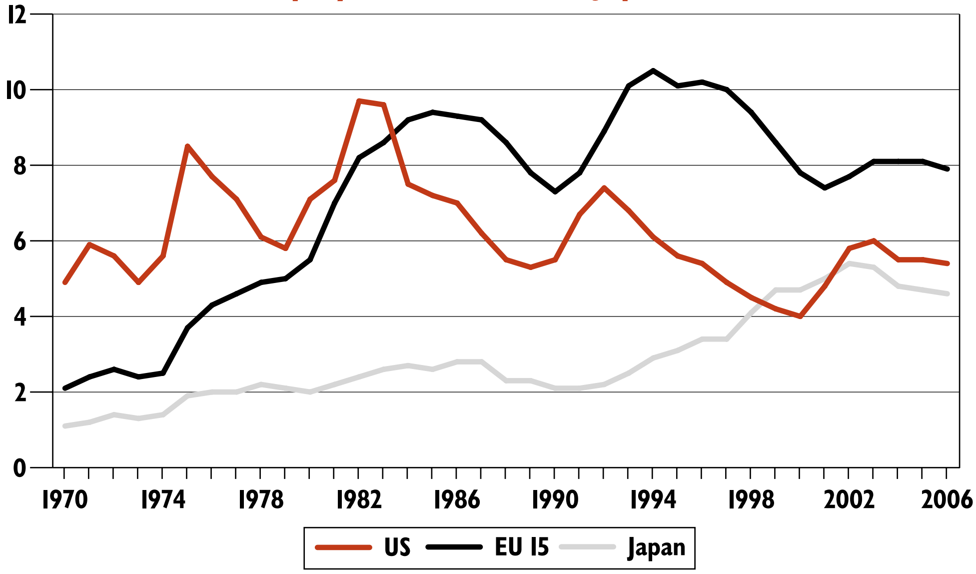
2.43 Raising productivity levels will also be crucial for Europe to improve its long-term economic performance and living standards. Europe underperforms the US in terms of both output per hour and output per worker, and the gap has been widening since the mid-1990s – reversing the trend of catch-up with US productivity levels during the three decades following the war. Recent analysis[27] suggests that the underlying causes are largely structural, reflecting a failure to boost services productivity[28]; the relatively small size of the EU's ICT-producing sector; and the EU's larger share of low-productivity non-ICT using or ICT producing manufacturing industry. This points to a clear need for further action to promote the key drivers of productivity: increasing product market competition, enhancing the EU's frameworks for innovation and enterprise, and upgrading the skills of both existing workers and new entrants to the labour market so that they can exploit the opportunities of new technology.

[26] Source: *'Employment in Europe'* 2004 and 2003, Eurostat.

[27] See O'Mahony, M. and van Ark, B. (2003): '*EU Productivity and Competitiveness: An Industry Perspective – Can Europe resume the catching up process?*', European Commission, 2003.

[28] This applies especially to the wholesale, retail and securities sectors.

Chart 2.8: Unemployment rate – EU, Japan and US

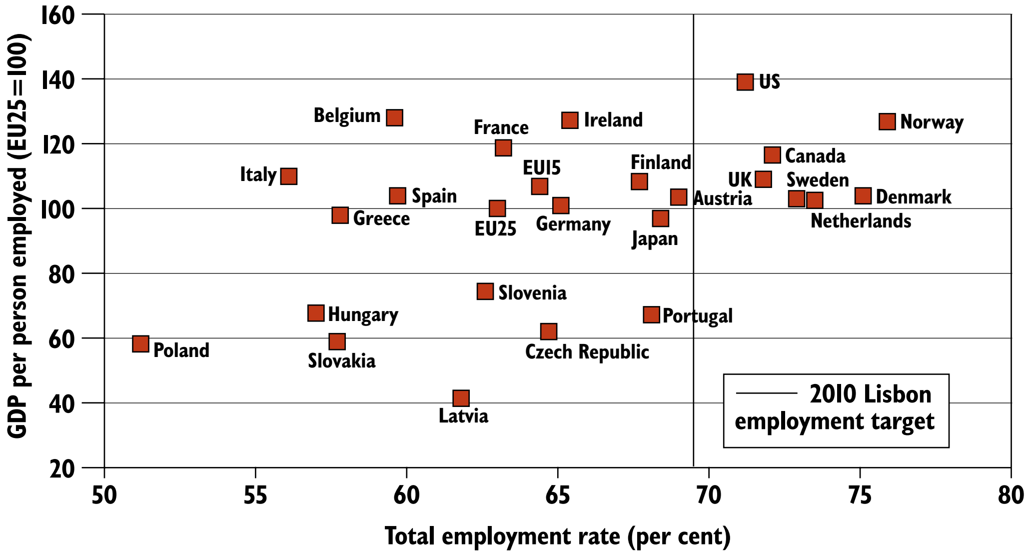


Source: European Commission, AMECO Database.

The need for reform

2.44 This analysis of Europe's performance suggests that low growth stems from structural policy weaknesses. Moreover, it suggests that the EU's focus on internal integration, with policies designed initially to strengthen the links between Member States, may now actively hinder its ability to succeed in a more integrated global economy.

Chart 2.9: Gross domestic product per person employed and employment rate



Source: Eurostat, structural indicators database; all data for 2003.

2.45 To improve its economic performance relative to the US, and match the recent growth rates of other successful developed economies such as Canada and Australia, Europe must take urgent action to promote employment, raise productivity and increase flexibility in labour, product and capital markets. As shown in Chart 2.9, few Member States have yet matched the US in combining high employment with high productivity. These priorities are reflected in the goals of the Lisbon programme of economic reform agreed in March 2000, and in the new focus of European leaders on promoting growth and employment within the Lisbon process. And they are the areas in which Europe most needs to succeed in order to compete in a global economy that puts a premium on skills, innovation and flexibility.

2.46 Translating these aims into concrete progress will be crucial to ensure that Europe continues to realise the benefits of economic integration. Chapter 3 of this paper identifies the key global challenges facing Europe in the coming decade, and the scope for Europe to benefit from completing the Single Market, while, at the same time, opening itself to the opportunities of globalisation. Chapter 4 goes on to set out the key policy priorities that Europe must address, to retain its leading role in the world economy.

CONCLUSION

2.47 At each stage in its history, Europe has come to recognise the need for change, and has adapted its policies and institutions in response to international economic developments. Europe's determination to secure lasting peace and prosperity through economic cooperation was critical to the strength of the post-war recovery. The creation of the Common Market, its development into a broader single market, and the ongoing process of enlargement have successively helped Europe's members to maintain their central place in the evolving global economy.

2.48 However, the EU has not yet realised the full benefits of international economic cooperation. Despite progress with respect to the Single Market, significant inflexibilities in labour, product and capital markets remain, and there is scope for further liberalisation of services. Europe's experience of enlargement shows the value of greater openness to international trade and investment, and suggests the EU can benefit further by seeking broader cooperation and more open relations with extra-EU markets.

2.49 Moreover, policies and institutions that were focussed on strengthening links between Member States, now need to evolve and become more outward-looking if Europe is to succeed in a more integrated global economy. Some policies that proved successful in the era of post-war catch-up are no longer appropriate in a global environment that demands greater flexibility and competition.

2.50 Just as it responded to the challenges of the period after 1945, of the economic instability of the 1970s, and of European reunification at the end of the Cold War, so Europe must act to tackle persistent low growth, and to realise the full benefits of globalisation. As Chapters 3 and 4 go on to discuss, in the midst of a radical transformation in the global economy, Europe needs to change and adapt.

3 GLOBAL ECONOMIC CHALLENGES FOR EUROPE

3.1 The previous chapter described the development since 1945 of Europe's economy, which was supported by co-operation amongst national governments and the construction of Europe-wide institutions. Reflecting the significant economic benefits to be gained from openness, steps towards the creation of a European Single Market played an important role in promoting growth and living standards in the EU. However, despite the benefits from European economic integration, over the past decade Europe's economy has under-performed compared to its main competitors.

Dramatic global change

3.2 The global economy is undergoing dramatic change, brought about by rapid technological change and falling costs of communication; by the increasing ease with which goods and services can be subdivided and traded between countries and continents; and by the market reforms in large emerging economies such as China and India, enabling them to seize the opportunities that come from closer integration into the global economy.[1]

3.3 The need for Europe to respond to the opportunities and challenges posed by global trends is increasingly recognised by its leaders, Finance Ministers and Central Bank Governors.

- As the High-Level Group chaired by Wim Kok noted: *"Even if every [Lisbon] target were to be hit on schedule, Europe would not be on safe ground. Competitor countries and regions are moving on as well, threatening Europe's position in the global economic league table. Europe must find its place in a global economy, which will nonetheless enable it to uphold its own distinctive choices about the social model that it rightly wants to retain….To realise this ambition, Europe needs more growth and people in work."*

- The Report[2] to the 2005 Spring European Council by Commission President Barroso also noted, *"The challenges we face are even more important in the face of … global competition'* and *'the opening of international markets and the strong growth of newly industrialising economies will make a significant contribution to jobs and growth. However, this will only happen if we can ensure a deeper and more rapid process of structural adjustment… to reallocate resources to sectors where Europe has a comparative advantage".*

- The President of the European Central Bank, Jean-Claude Trichet[3], stated, *"The world economy is transforming rapidly, external competition has become stronger, knowledge is easily transferable and the ability to adjust to changing economic circumstances is increasingly important. Many European countries have not been adapting…rapidly enough to face these challenges."*

- Other Member States are also increasingly aware of the need to respond. For example, Finland's Prime Minister Matti Vanhanen recently launched an investigation of the impact of China and other emerging economies on Finland's economic and employment strategy.[4]

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[1] On globalisation more broadly, see references in chapter 1, footnote 6 and 7.

[2] *'Working Together for Growth and Jobs: A New Start for the Lisbon Strategy'* Communication from President Barroso in agreement with Vice-President Verheugen to the Spring European Council, European Commission, February 2005.

[3] Speech by Jean-Claude Trichet, President of the European Central Bank, European American Press Club, Paris, 14 January 2005.

[4] See *'Finland's Competence, Openness and Renewability: The Final Report of the 'Finland in the Global Economy' Project'* Finland's Prime Minister's Office Publication 26/2004.

Six key global economic challenges and opportunities for Europe

3.4 The Treasury paper *'Long-term global economic challenges and opportunities for the UK'*[5] examined the implications for the UK of this dramatic global economic transformation. In particular, it identified six key trends that will shape global economic development over the coming decade. From Europe's perspective, this chapter discusses, in turn, each of the six long-term global economic challenges and opportunities to which Member State governments, and the EU as a whole, will need to respond in order to achieve a strong economy and fair society:

- First, Europe needs to adapt to the changing balance of global economic activity, in which an increasing proportion of global output is produced in the rising Asian economies and other rapidly growing emerging economies. By the end of this decade, China's economy might be larger than Germany's. Within a decade, it might overtake Japan to be the world's second largest economy. The EU and US will account for a steadily diminishing share of world output.

- Second, Europe needs to respond to the increasing integration of global economic activity, which is intensifying competition amongst producers and offering increasingly diverse sources and destinations of foreign direct investment (FDI). Europe is increasingly integrated in the global economy, not least due to enlargement and increased trade integration with Asia. It is already actively investing overseas to a greater degree than the US, although it is investing less in the fast-growing emerging economies. Moreover, the EU has been unable to benefit from inward FDI to the same degree as the US in recent years, missing out on associated benefits to productivity via its impact on skills, innovation and technology, and competition.

- Third, Europe needs to rise to the challenge of increasing tradability of different goods and services, and global dispersion of economic activities. Driven by further advances in technology, production processes are increasingly fragmented, enabling economic activities to become increasingly international, specialised and tradable. Estimates suggest that around 5 million services jobs from the US and Europe could be relocated abroad by 2015.

- Fourth, Europe must take advantage of the increasing rewards from innovation as both global competition and the speed of technological change increase. Compared to its developed economy competitors, Europe's performance with respect to innovation remains relatively poor and many Member States have a lower level of entrepreneurial activity. Moreover, exports from the large emerging economies are increasingly moving up the value chain, and those countries are also stepping up their investment in research and development.

- Fifth, Europe's labour markets and welfare systems need to be able to facilitate rapid technological and market changes. To realise the benefits that come from global integration, countries will require effective education and training systems to provide the higher skill levels critical for success in an increasingly competitive global market, to support flexible labour markets and allow firms and individuals to respond quickly to changed circumstances, and so facilitate

[5] *'Long-term global economic challenges and opportunities for the UK'*, H M Treasury, December 2004, available at http://www.hm-treasury.gov.uk/media/8F5/77/pbr04global_421.pdf

high employment and avoid prolonged unemployment. Skill levels vary significantly between Member States and often lag behind other developed economies. Studies and outcomes both suggest that greater labour market flexibility tends to be associated with countries outside of continental Europe.

- Sixth, Europe needs to take a leading role in finding solutions to the increasing pressure placed on resources and the natural environment by the pace of global economic growth. In the absence of policy changes, global energy demand is projected to increase steadily over the next decade. Whilst two thirds of the growth is likely to originate from developing countries, in particular China and India, the EU is also expected to increase its demand for energy. But Europe can lead the way in developing new market-based solutions, such as Europe's Greenhouse Gas Emission Trading Scheme (EU ETS).

THE CHANGING BALANCE OF GLOBAL ECONOMIC ACTIVITY

3.5 The first key long-term global economic challenge and opportunity, to which the Member States and the EU will need to respond, is the dramatic shift in the balance of global economic activity, resulting from far-reaching and fundamental changes in technology, production, and trading patterns.

- Rapid technological change – particularly with respect to information and communication technologies (ICT) and transport – is increasing dramatically the speed and volume of flows of information, goods and services, thus breaking down geographical barriers to economic activity and driving the integration of world markets.
- More countries are opening up their economies, implementing market-based reforms, offering greater stability and seizing the opportunities that come from closer integration into the global economy. Most notable are the very large emerging market economies such as China and India, which are already rapidly increasing their share of global economic activity.
- The combination of technological advance and policy liberalisation is allowing economic activity to become increasingly specialised and dispersed across countries and continents. The boundary between what can and cannot be traded is being steadily eroded, and the global economy is encompassing an ever-greater number of tradable services and goods.

Increasing share from the large emerging economies

3.6 These changes will intensify over the coming decades, and support the continued rise of the large emerging economies and a further shift in the balance of global economic activity. With high rates of growth, the impact will be most visible in the two most populous countries, China and India – the former with a population of almost 1.3 billion, the latter also with a population over 1 billion, compared to the EU25's combined population of almost 459 million and the US's population of 292 million[6]. The scale of this change is illustrated by projections of economic activity.

3.7 Based upon market exchange rates, the US is currently by far the largest single country economy. The EU25 economy is approximately the same size. About two thirds of EU25 GDP is accounted by the four largest Member States – Germany, UK, France and Italy – which are also the four EU members of the G7. China's size already ranks it amongst the

[6] Source: *'Portrait of the European Union'* Eurostat (2004).

world's seven largest economies. By 2015 it is likely to have become the world's third largest (and perhaps second largest) country economy – after the US, very close to Japan, but clearly surpassing every EU Member State's economy in size. India is also expected to continue to grow rapidly and increasingly impact on the global economy. Reflecting its current lower average income, projections suggest that it will overtake Germany to become the world's fourth largest country economy by 2025.

3.8 The expansion of the emerging economies will mean that they account for an increasing share of global output. The relative economic position of advanced and emerging economies will change.

- Currently, measured by purchasing power parity exchange rates, the US and EU25 each account for just over 20 per cent of global output (the four largest EU Member States account for about 14 per cent). China and India combined account for 19 per cent[7].
- By 2015, China and India combined are projected to account for 27 per cent of global output; the US and EU25 each less than 20 per cent; and the four largest EU Member States combined perhaps barely more than half the share of China.
- The EU economy has recently matched the size of the US through the impact of enlargement. In the future, the scope for further EU enlargements is relatively limited. Moreover, demographic trends will tend to increase the US labour force at a faster rate than that in Europe. Therefore, the ability of the EU to continue to match the US in size will depend significantly on its ability to reverse its recent deterioration in relative economic performance, in particular by boosting the contributions to growth from productivity and labour utilisation.

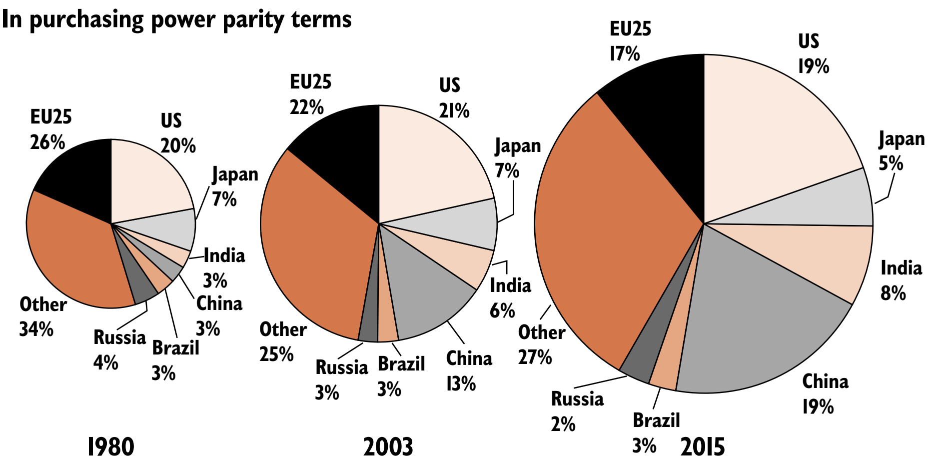
Higher global demand

3.9 Whilst the advanced economies' share of global output will decline, they can nevertheless benefit from the overall global expansion. The fast growing emerging markets are already increasingly contributing to global growth, and as they become wealthier, are correspondingly increasing their demand for goods and services from the developed economies. As noted by the High Level Group chaired by Wim Kok, *"The potential rapid growth of the Chinese economy will create not only a new competitor to Europe, but also a vast and growing market"*. For example, over the past ten years, China's share of EU15 exports has doubled, with particularly impressive growth in recent years. In 2003 alone, China's imports from the EU15 increased by 40 per cent, as China overtook Japan in importance as a destination for European exports.

3.10 World Bank projections suggest that the size of the global economy could be 40 per cent bigger by 2015. China and India will have more than doubled in size; advanced economies such as individual EU Member States and the US might be between 10-25 per cent bigger. Chart 3.1 presents projections of both the changing proportions and the expansion of the size of the world economy.

[7] Source: IMF.

Chart 3.1: Shifting shares in global output: 1980 to 2015



Source: IMF, Consensus Forecast, HM Treasury.
Note: Areas indicate size of global economy.

Impact of demographic changes

3.11 Demographic changes will also have a significant impact on the distribution of economic activity over the next ten years. The United Nations project that, by 2015, world population will increase by 12 per cent, with significant variation in growth rates between countries and regions. While ageing is a global phenomenon, average life expectancy and fertility will continue to vary greatly.

- China and India already account for one third of all global population growth, and populations in emerging and less developed economies will continue to see above average population growth. However, due to lower fertility rates, Europe's population is projected to decline on average by 0.2 per cent per annum to 2015. Japan's population is also set to fall[8].
- Japan is currently the country with the oldest population, with a median age of 41.3 years, followed by a number of European countries, including Italy, Germany and Sweden, with median ages of about 40 years each. Europe's proportion of its population over 65 is set to see a sharp rise. For example, according to the United Nations, the average old-age dependency ratio in the EU is set to rise from 24 per cent in 2000 to 36 per cent by 2025 and 50 per cent by 2050, a steeper rise than in the US. Among the EU Member States, Spain and Italy are predicted to experience the most dramatic population ageing, with the UK among the least.

[8] United Nations Population Division (2002) '*World Population Prospects*: The 2002 Revision', New York, 2003. India, whose population is growing at twice the rate of China, accounted for 20 per cent of annual world population growth between 2000-05. China's median age in 2000 was 30; India's was 23.4.

3.12 Different growth rates in the working age population will be reflected across countries in different trend growth rates, via their differential impact on the contributions to GDP growth from labour input and perhaps also productivity. In its Communication to the 2005 spring European Council, the European Commission estimates that the impact of ageing populations on the EU's growth rate might *"if left unchecked, drag down potential growth rates to a paltry 1 per cent per year"*. The High-Level Group chaired by Wim Kok also concluded *"the cumulative impact of such a decline would be a GDP per head some 20 per cent lower than could otherwise be expected"*[9]. The sharp increase in dependency ratios also has implications for long-run fiscal sustainability, including of pensions provision, and intergenerational fairness[10]. This underlines the need for continued structural reform to boost EU employment rates, including with respect to older workers; secure fiscal sustainability; and boost the potential rate of EU growth.

Table 3.1 Regional population projection

Population (millions)	2000	2005	2015	Growth Rate p.a. 2005-15
Europe	728	725	713	–0.2%
North America	316	332	364	0.9%
India	1,017	1,097	1,246	1.3%
China	1,275	1,322	1,402	0.6%
Japan	127	128	127	–0.1%
Latin America & Caribbean	520	558	628	1.2%
Sub-Saharan Africa	653	733	902	2.1%
Western Asia	192	213	257	1.9%
North Africa	174	190	224	1.7%
SE Asia	520	558	628	1.2%
Other	548	597	704	1.7%
World	6,071	6,454	7,197	1.1%

Source: United Nations Population Division.

Impact of migration

3.13 International migration will represent another important demographic trend over the coming decade. The movement of people – including of temporary migration, which is often work-related – has increased markedly in recent decades, with international migration flows doubling since 1975. However, today's migration flows remain relatively low compared to those at the start of the twentieth century.

3.14 Migration flows into the labour forces of the EU Member States are generally lower than the US,[11] where higher levels of immigration have contributed to higher rates of GDP growth in recent years. Notably, the US has better absorbed immigrants into its labour market. In 2002, in the EU15, the unemployment rate of non-nationals was more than twice the rate for nationals, and the employment rate was over 10 percentage points lower. In the US, the figures for nationals and non-nationals were broadly comparable[12].

[9] Stylised projections for the trend growth rates of G7 countries, isolating the impact of demographic change on labour inputs, are presented in HM Treasury (2003) '*Long-term Public Finance Report 2003*' Chapter 2.

[10] For a fuller analysis of the fiscal impact of demographic change see '*Illustrative Long-Term Fiscal Projections*', Annex A of the Economic and Fiscal Strategy Report, Budget 2005.

[11] *Trends in International Migration* 2003' OECD (2003).

[12] See European Commission (2003) '*Employment in Europe 2003*'. In 2002, the EU15 unemployment rate for nationals was per 7.1 per cent compared to 15.8 per cent for non-nationals; the EU15 employment rate for nationals was 66.4 per cent compared to 52.6 per cent for non-nationals; the US unemployment rate for foreign nationals was 4.2 per cent, compared to 4.0 per cent for nationals; and the US employment rate for foreign nationals was 66.7 per cent compared to 67.2 per cent.

EUROPE AND THE INTEGRATION OF GLOBAL MARKETS: CHANGING PATTERNS OF TRADE AND INVESTMENT

3.15 The second key challenge and opportunity, to which the Member States and the EU will need to respond, relates to the integration of global markets and diversification in the pattern of trade and foreign direct investment. This trend offers significant potential rewards for outward looking countries and regions. External openness brings economic benefits, in terms of growth and living standards, not least through its impact on productivity[13].

An increasingly global Europe

3.16 In recent years, the Member States and the EU as a whole have increased their level of integration with the world economy, via trade in goods and services, and participation in global flows of foreign direct investment (FDI). This openness has been an important driver of EU growth and productivity. But evidence suggests there is scope for the EU to become more open and outward looking, and so there is potential for Europe to reap further benefits from globalisation.

The role of European integration

3.17 As discussed in Chapter 2, post-war European integration provided a key impetus to increasing the openness of the Member States. In particular, following the establishment of the EEC, growth in trade within Europe increased dramatically. This is evident from a closer look at trade between the six original Member States of the then EEC (intra-EEC6 trade), which expanded by 500 per cent between 1960 and 1972, compared with a 200 per cent increase in their trade with countries outside of the EEC[14].

3.18 More recently, by removing tariffs and non-tariff barriers, the EU's Single Market helped trade in goods and services amongst the EU15 Member States (intra-EU15 trade) rise by about 40 per cent in the decade following its launch in 1992. Intra-EU15 trade in goods and services now accounts for over 40 per cent of Member States' total GDP[15], bringing significant economic benefits. According to a recent report[16], EU GDP in 2002 was 1.8 per cent higher (£110 billion) than it would have been without the Single Market.

3.19 In addition to the significant economic benefits accruing from the Single Market, over the past decade Member States have also become relatively more integrated into trade with the rest of the world. Since 1992, extra-EU15 trade grew at a faster rate than trade amongst the fifteen, and at a rate comparable with the equivalent rate of growth of US trade over the same period[17].

The role of enlargement

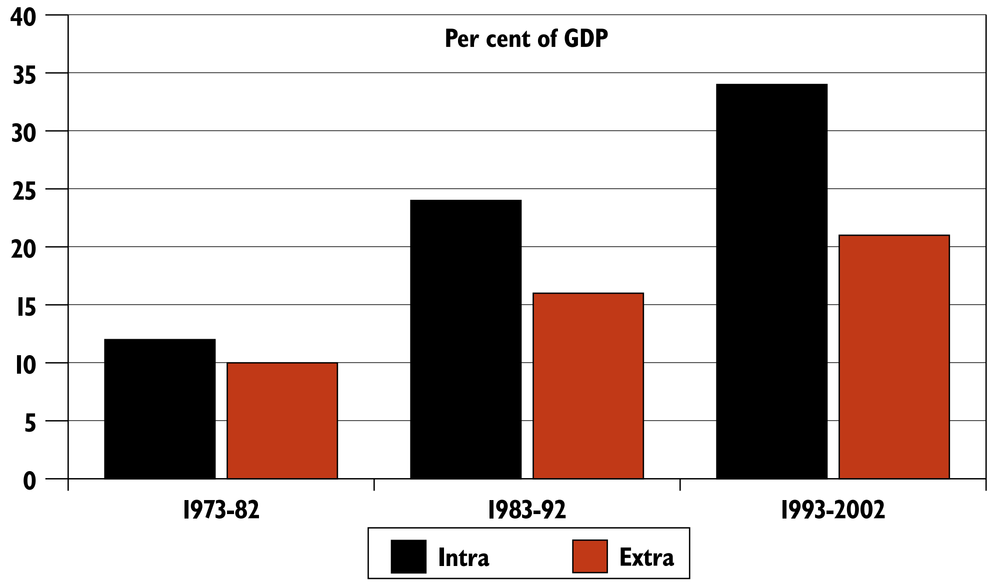
3.20 In line with the experience of past phases of enlargement, the recent addition of ten new Member States (NMS) in May 2004 represents the most significant recent source of extra-EU15 trade growth. Economic benefits from enlargement were reaped many years ahead of accession, since most trade barriers of industrial goods with the NMS were lifted in advance. Over the past decade, EU15 trade in goods with the NMS rose on average by about 15 per cent per year. As a result, the share of EU15 goods trade accounted for by the NMS nearly doubled. By 2003 – still ahead of the signing of the Accession Treaty – the NMS accounted for about 17 per cent of extra-EU15 trade[18], rapidly approaching the fifteen Member States' level of trade with the US. Enlargement has made the EU the largest multi-country single market in the world, which – including both intra- and extra-EU trade – now accounts for 40 per cent of world trade.

[13] See HM Treasury and DTI (2004) *'Trade and the Global Economy: the Role of International Trade in Productivity, Economic Reform and Growth'*.
[14] Source: OECD
[15] Source: OECD.
[16] *"The Internal Market – Ten Years Without Frontiers"*, European Commission, 2003.
[17] Source: OECD. From 1992 to 2003, extra-EU15 trade grew at an average annual growth of 7 per cent; intra-EU15 trade grew at an average annual growth of 5.4 per cent; and US trade grew at an average annual rate of 6.7 per cent.
[18] Source: Eurostat.

Trade integration with emerging economies

3.21 The principal driver of recent European trade growth beyond its borders has come from increased integration with certain emerging economies, particularly China, which now exports and imports more than any Member State with the exception of Germany. With total trade doubling between 1999 and 2003, China is now the EU's second most important trade partner on a country basis[19]. EU-China trade as a share of GDP is now roughly equivalent to the US-China level. Over the past decade, the EU also experienced significant growth in trade with Russia. However, despite their rapid GDP growth, trade growth with many other emerging economies has been less impressive. For example, the shares of EU trade with India and other emerging East Asian nations are little different to a decade ago.

Chart 3.2: The evolution of European merchandise trade



Source: EC, AMECO database.

Scope for a more outward looking EU

3.22 Despite stronger GDP growth outside Europe, adjusting for the impact of enlargement, extra-EU trade has not grown at a markedly faster rate than intra-EU trade. Estimates suggest that existing barriers, such as tariffs, quotas and restrictive standards could cost Europe's consumers up to 7 per cent of EU GDP, or around €600-700 billion a year[20]. So there is ample scope for the EU to be more outward looking, to increase its participation in world trade, and ensure that the EU facilitates global trade creation. In particular, there appears scope to intensify productivity-enhancing trade with the fast growing emerging economies and developing countries, as well as across the Atlantic.

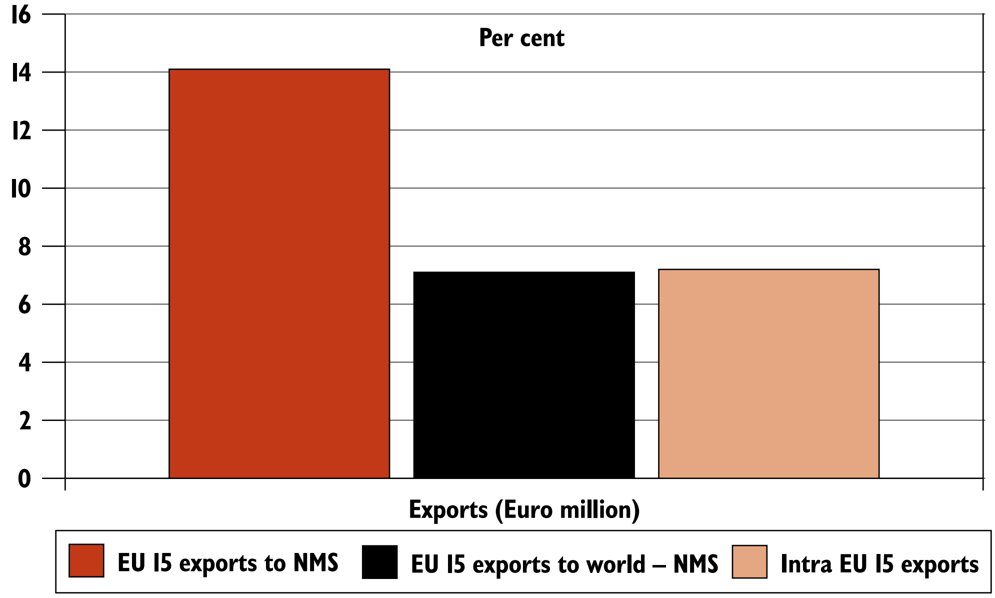
Large gains from trade depend on further liberalisation

3.23 Global markets for goods and services have the potential to become significantly more integrated by 2015, not only as a result of technological advances but, given the high levels of trade barriers and protectionism that remain to be tackled, further trade liberalisation. As in Europe, much of recent global trade growth has occurred in the context of regional integration agreements (RIAs), whether of the form of a Free Trade Area, Customs

[19] Source: Eurostat. In 2003, among the EU25 Member States, Germany was the largest exporter to China, with 18.3 billion euro, or 44 per cent of the total, followed by France (4.7 bn or 11 per cent). Germany (22.5 bn euro or 21 per cent) was also the largest importer from China, followed by the United Kingdom (17.3 bn or 16 per cent), the Netherlands (14.7 bn or 14 per cent), France (9.6 bn or 9 per cent) and Italy (9.5 bn or 9 per cent).
[20] Messerlin (2001) '*The real cost of European protectionism*', Institut d'Etudes Politiques de Paris.

Union or Common Market[21]. If well designed, RIAs can offer significant economic benefits through trade creation. However, they might provide fewer economic benefits than multilateral free trade if they lead to trade diversion, which can occur if imports from countries outside the region are replaced by less efficient production from countries within the region.[22]

Chart 3.3: Average annual merchandise export growth: 1994 – 2003



Source: Eurostat.

3.24 RIAs often retain tariffs and non-tariff barriers (e.g. quotas, technical standards, rules of origin, and anti-dumping measures), which increase prices for consumers. While the recent past has been a period of generally falling barriers, they are still maintained by the EU on a wide variety of products, for which the impact is often greatest on the poorest consumers. For example, as shown in Table 3.2 below, the nature of existing protection in the EU means that the heaviest costs of protection tend to fall on necessities of life such as food, clothing and footwear, on which the poorest people spend a relatively higher share of their income.[23]

[21] The removal of tariffs on trade among member nations forms a Free Trade Area, leaving members with autonomy in setting their tariffs on trade with non-member countries. A Customs Union applies a common tariff structure to trade with non-members. A Common Market allows free movement of factors of production, as well as goods and services, between member states. RIAs can be found on all continents; in addition to the European Union, examples include NAFTA (North American Free Trade Agreement), MERCOSUR (Mercado Común del Sur, in South America), ASEAN (Association of South East Asian Nations) and COMESA (the Common Market for Eastern and Southern Africa).

[22] For example, see Baldwin, R.E., and T. Venables(1995), '*Regional Economic Integration*' in Handbook of International Economics, edited by G. Grossman and K. Rogoff, Vol. 3 (New York: North-Holland).

[23] DTI (2004) '*Liberalisation and Globalisation: Maximising the Benefits of International Trade and Investment*' Economics Paper No. 10.

Table 3.2: EU protection on selected products

	Average MFN rate %	Maximum rate %	Non-tariff barrier %	Anti-dumping %	Overall %
Cereals	14.0	15.2	5.0		19.0
Meat	11.2	12.1	64.8		76.0
Dairy products	9.7	10.3	100.3		110.0
Other agriculture	8.9	179.7	11.2	5.3	20.0
Food products	19.5	236.4	5.0		24.5
Tobacco	47.3	81.9			47.3
Clothing	11.6	13.0	19.0		30.6
Footwear	7.4	17.0		17.5	8.9

Source: DTI (2004), "Liberalisation and Globalisation: Maximising the Benefits of International Trade and Investment", Economics Paper No. 10.

3.25 It is important that all RIAs act as engines for trade creation, not trade diversion, and are effective building blocks towards further multilateral liberalisation. For a start, there is potential for significant economic gains through reducing regulatory and administrative barriers at the international level, notably on a transatlantic basis. A recent study[24] reported lower-bound estimates of potential welfare gains for the EU from EU-US liberalisation of between 0.7-0.9 per cent of annual GDP in perpetuity, with optimistic estimates of up to 2-3 per cent of GDP.

3.26 The greatest benefits – for both developed and developing countries – from trade integration and expansion over the next decade depend on progress in multilateral trade liberalisation, led by the Doha Development Agenda (DDA) within the current WTO round. By further integrating developing countries into the world trading system while supporting their development needs, the expansion of trade and increasing integration of the global economy could be one of the key drivers of increased global prosperity, productivity and development over the coming decade.

Europe can attract more FDI

3.27 Shifts in foreign direct investment (FDI) could also significantly affect the global distribution of economic activity in the decade ahead. The EU15 and US currently dominate global FDI flows, which are running in real terms at more than five-and-half times the average prevailing in the first half of the 1980s[25]. However, as for trade, a high proportion of EU FDI flows are between EU Member States (i.e. intra-EU FDI flows). In 2003, two thirds of FDI into the EU15 came from other EU15 Member States.[26] Therefore, EU participation is relatively less impressive focusing on EU FDI flows with the rest of the world.

[24] Vandenbussche, Wooton and Venables (2003), *'Enhancing Economic Co-operation Between the US and the Americas: An Economic Assessment'*, CEPR, HM Treasury and Netherlands Ministry of Finance.

[25] Global FDI activity peaked in 2000, when inflows totalled US$1.4 trillion. There was a sharp contraction in 2001 and 2002 as the world economy weakened and merger and acquisition slackened, But 2003's level of US$ 560 billion is, in real terms, still double the average of the first half of the 1980s. Between 1985 and 1999, global GDP rose at an average annualised rate of $2^1/_2$ per cent; global exports grew at an annualised rate of about $5^1/_2$ per cent; and global FDI inflows rose by an annualised real-terms rate of over 15 per cent. (See 'Barba-Navaretti and Venables (2005) *Multinational Firms in the World Economy*').

[26] Source: Eurostat

3.28 Inward investment can bring significant economic benefits, through its impact on labour productivity, capital formation and growth in the host country[27]. In particular, it delivers economic benefits through technology transfer, skills and managerial know-how; by stimulating competition and innovation; and by providing domestic investment that would not otherwise have been possible. In Europe, inward FDI appears to have played an important role in the recent successful economic development of Ireland and many NMS. The UK has received more inward FDI than any other Member State.

3.29 The EU appears to have fallen behind the US in terms of its ability to attract inward (non-EU15) investment. Between 1995 and 2002, the US received a cumulative inflow of inward investment of USD1.2 trillion, fifty per cent higher than the cumulative inflow to the EU15 (only USD800 billion). Given its much higher population, over the same period on a per capita basis Europe has attracted just half the cumulative level of US FDI[28]. So Europe has potentially foregone benefits from attracting higher FDI. A range of structural issues, including the regulatory environment, skills and labour costs are likely to be important factors (see Boxes 3.2 and 3.3 on factors determining the location of economic activity).

Increasing participation in global FDI flows

3.30 Outward EU FDI can also often impact positively on the productivity of EU firms investing abroad and boost their demand for skilled workers at home[29]. Europe's stock of outward investment has increased sharply in recent years. At the beginning of the 1990s, EU firms tended to be less integrated into the world economy than their counterparts in the US, which were quicker to expand internationally in the 1960s and 1970s. Data now suggest the EU has caught up and exceeded the US in terms of international exposure. However, in 2003 two thirds of the EU15's outward FDI was directed at other EU15 Member States.

3.31 The geographical distribution of FDI remains very uneven. Most FDI flows still take place among developed economies, which are home to the wealthiest firms and in the past offered some of the best investment opportunities. However, there is wide variation among Member States regarding participation in global FDI flows. The UK, France and the Netherlands are particularly integrated; but a number of Member States (e.g. Italy and Greece) display very low levels of integration into global FDI flows, with both inflows and outflows amounting to less than 1 per cent of GDP.

Increasing FDI flows to and from emerging economies

3.32 Over the next decade, sustained growth in FDI seems likely to continue. Greater integration of the large emerging markets into the global economy will contribute to significant changes in global FDI flows, with rapidly growing economies attracting increasing inflows and becoming more important suppliers of FDI. These trends are already apparent. In 2003, emerging and developing economies accounted for 31 per cent of total global FDI inflows, up from 18 per cent in 1990. The growth of FDI inflows to China has been particularly striking. In 1990 China accounted for 1.7 per cent of global FDI inflows. By 2003 it accounted

[27] See DTI (2004) for discussion of the link between inward FDI and growth. Also see Lipsey (2002), '*Home and Host Country Effects of FDI*', NBER Working Paper No. 9293, October 2002, which finds that within host countries, foreign-owned firms tend to pay higher wages than domestically-owned firms, and their presence generally raises wage levels in host countries. Foreign firms are found generally to have higher productivity than local firms, but the evidence for spillovers to local firms' productivity is mixed, depending on host country policies and environments. The same mixture of impacts applies to host- country growth in general. The impact of FDI in promoting the growth of host country exports and linkages to the outside world is clearer.

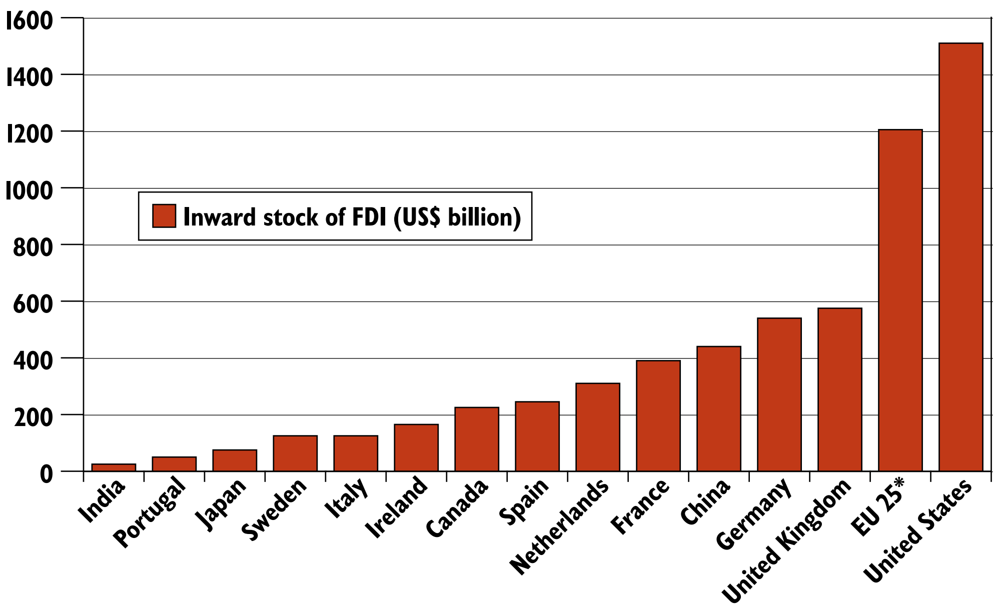
[28] Source: Eurostat. As a share of GDP the difference in cumulative FDI inflow between 1997-2002 was also significant: an annual average of 1.7 per cent of GDP into the US, compared to an annual average of 1.2 per cent of GDP into the EU15.

[29] For a European example, see Barba Navaretti and Castellani (2004) '*Does Investing Abroad Affect Performance at Home? Comparing Italian Multinational and National Enterprises*', CEPR Discussion Paper No. 4284, March 2004. Analysis of the Italian firms studied found that domestic factories of firms with foreign activities were on average 17 per cent more productive than those of Italian firms with no foreign activities.

for almost 10 per cent[30], above all Member States except the UK and Germany. Forward-looking survey evidence points to a continuation of this trend, with China and India particularly attractive.

3.33 Notably, US firms appear to be investing more in fast-growing emerging countries than their EU counterparts: Asian emerging economies were the destination of 12.3 per cent of US FDI between 1999-2002; for the EU15 the corresponding share was only 5.2 per cent. Meanwhile, as they become more developed, emerging economies are also increasingly seeking overseas investment opportunities and representing sources of FDI. Therefore, there appears scope for Europe to develop its investment relationship with emerging economies further, with respect to both outward and inward FDI.

Chart 3.4: Largest recipients of inward FDI, 2002



**Note: Excludes intra-EU 25 investment.*
Source: Eurostat.

INTERNATIONAL ECONOMIC ACTIVITY: GLOBAL SOURCING OF PRODUCTION AND SERVICES

3.34 The third key challenge and opportunity, to which the Member States and the EU will need to respond, relates to the internationalisation and subdivision of activities within and between firms. Many production processes are becoming increasingly specialised, international and dispersed. This dispersion of production processes represents an increasingly international division of labour, splitting up the provision of goods and services into different units, which can be located in the region or country that can produce them most efficiently. With an expected continuation of these trends over the next ten years, the emerging economies will become increasingly important centres for the sourcing of production and services.

[30] UNCTAD (2004) '*World Investment Report: The Shift Towards Services*', United Nations, New York and Geneva, 2004.

The internationalisation of economic activity

3.35 One important aspect of this trend is the internationalisation of some kinds of economic activity. There are several reasons why this process has become more cost effective than in the past:

- First, technological advances have lowered the costs and enhanced the ability of firms to manage complex, geographically dispersed and highly fragmented and specialised production processes. For example, computers have allowed virtually costless means of communication via e-mail and the Internet, with national borders no longer providing boundaries to such transmission. Major advances in transport and information technology, enabling innovation in logistics, have also enabled firms to source components internationally, where previously they were constrained to local sources of supply.

- Second, policy liberalisation has permitted certain cross-border activities that were previously prohibited, and lowered the costs on others. Widespread deregulation of services activities – e.g. insurance, banking and transportation – has opened further opportunities.

- Third, developments in emerging economies – including greater stability and openness, enhanced business and investment climates, improved infrastructure and rising education and skill levels – have helped make foreign provision of certain goods and services more economically viable.

3.36 Increasing specialisation and internationalisation of the provision of goods is reflected in the growth of trade in intermediate goods, which are used as inputs in production processes. There is growing evidence that this accounts for an increasingly large proportion of total trade. Intermediate goods trade represents around 30 per cent of world trade in manufactures. Also important is the growth of trade within industries rather than between industries. Intra-industry trade now accounts for about 70 per cent of European trade,[31] and evidence suggests its growth is linked closely to FDI flows[32].

Increasing exports of services

3.37 Recent technological change has also intensified international trade in services. Production and consumption of services can now be separated through the standardisation of process and the capacity for data storage, or because geographical distance is not a barrier for the simultaneous production and consumption of services. In addition to cost advantages, international service provision can raise productivity or the quality of service provision. Increasing trade in services should bring about overall gains for the global economy as service production is reallocated more efficiently across countries to harness the benefits to be derived from international specialisation. There appears clear potential for continued rapid expansion. The global services sector accounts for over 70 per cent of GDP in advanced economies and over 50 per cent of GDP in developing countries. But currently only 10 percent of services are traded, compared to over 50 per cent of manufactured goods, and services accounted for only around 20 per cent of total global exports in the late 1990s.

[31] OECD (2002) '*Intra-industry and Intra-firm Trade and the Internationalisation of Production*', OECD Economic Outlook no. 71, Paris

[32] The relationship between FDI and trade will depend on whether FDI is aimed simply at accessing a foreign market or at fragmenting production, e.g. through intra-industry or intra-firm trade. For more on the relationship between trade and FDI see Nicoletti, Golub, Hajkova, Mirza and Yoo (2003) '*The Influence Of Policies On Trade And Foreign Direct Investment*'', OECD Economic Studies No. 36, OECD, Paris

Box 3.1: Outsourcing and offshoring of services

In the past, services were typically produced when and where they were consumed. Over 50 per cent of manufactured goods are currently traded, compared to only about 10 per cent of services. However, recent advances in information and communication technology have increasingly facilitated the tradability of services as well as goods. In this context, according to UNCTAD's World Investment Report (2004), *'offshoring represents the cutting edge of the global shift in production activity, giving rise to a new international division of labour in the production of services'* and it is expected to continue. Recent studies have examined the phenomenon more closely.

Bhagwati et al (2004)[33] analyse outsourcing of services, defined as *'services traded internationally at arm's-length and principally on-line*: what the WTO calls Mode I services'. Suppliers of such services include call centres, banking service back offices, software programmers, designers, architects and certain consultants. The authors conclude that outsourcing is *'a trade phenomenon, with effects that are not qualitatively different from those of conventional trade in goods. Thus, outsourcing leads to gains from trade and increases in national income, with the caveats that are standard in this literature.'* In particular, whilst outsourcing is likely to bring overall gains for a country in aggregate, and *'over time, high-value jobs can be expected to arise and expand'*, policymakers need to be concerned about the impact of outsourcing on displaced workers.

Amiti and Wei (2004)[34] look closely at recent trends in trade of business, computing and information services, which have been the focus of much public debate on outsourcing. They note that *'trade in services, like trade in goods, is a two-way street. Most countries receive outsourcing of services from other countries as well as outsource to other countries.'* Their findings include:

- **There is evidence of increasing exports of such services from emerging economies such as India and China. However, both countries are also themselves significant outsourcers (importers) of business services.**
- **The main recipients of cross-border outsourcing of business and computer services in 2002 were the US (US$59 bn), UK (US$37 billion), Germany (US$28 billion); France (US$21 billion) and the Netherlands (US$20 billion). India was ranked in sixth place (US$18.6 billion); and China fourteenth ($10 billion).**
- **The largest surplus countries – i.e. countries to whom the rest of the world outsources more than the reverse - of combined computing and business services were the UK, US, Hong Kong, India and Singapore. Of the EU Member States, France was also a significant net exporter of these services, whilst Germany and Italy were significant net importers.**
- **Looking at the impact of outsourcing on employment in the UK, the authors find no evidence that sectors with higher growth of service outsourcing have a slower rate of job growth, and conclude that service outsourcing has the potential to make those firms and sectors more efficient leading to further job creation.**

[33] J. Bhagwati, A. Panagariya and T.N. Srinivasan (2004), *'The Muddles over Outsourcing'*, Journal of Economic Perspectives, Vol.18, No. 4, Fall 2004.

[34] M. Amiti and S-J. Wei (2004), *'Fear of Service Outsourcing: Is it Justified?'* IMF Working Paper, WP/04/186.

3.38 The growing relevance of services activities around the globe has been mirrored in a shift in the composition of global FDI, with services now accounting for a growing proportion of investment. Between 1970 and 1990 the share of services in the world FDI stock grew from one quarter to almost a half, and by 2002 had risen to about 60 per cent[35]. This has been reflected in the EU: almost 70 per cent of Member States' inward FDI and almost 60 per cent of its outward FDI is related to services. Indeed, services trade and FDI tend to be complementary, because establishing commercial presence abroad even for goods manufacturing also often brings stronger services trade, for example in terms of transport (e.g. supplying goods to foreign affiliates), and communications (e.g. data transactions with foreign affiliates).

3.39 Although there are likely to be some limits to the potential for growth in services trade[36], these trends are expected to continue for some time and future growth in services trade is projected to be significant. A recent study by the German Confederation of Industry[37] showed that one third of respondents were already investing in R&D abroad, whilst an additional 17 per cent are planning R&D offshoring in the next 3 years. UNCTAD's World Investment Report (2004) notes that among the world's 1,000 largest companies, some 70 per cent have still not relocated any business processes to emerging economies. Additionally, in a 2004 survey of the top 500 European firms, only 39 per cent had experience with the offshoring of business services. Estimates[38] suggest that around 5 million jobs from the US and Europe could be relocated abroad by 2015. Box 3.1 examines more closely recent studies on the nature of outsourcing of services.

3.40 Member State governments and the EU need to respond to the challenges affecting the location of both manufacturing production and services. In practice, a range of factors might be important in determining the location of economic activity, with different needs for different activities. While certain activities will continue to be attracted to low cost locations, other activities – perhaps within the same industry - benefit from factors such as access to a pool of specific skilled labour and technology, and proximity to related firms for example in clusters. Therefore, many activities will continue to be located in advanced economies.

[35] Source: OECD.

[36] For example, not all services will become tradable. First, since services tend to be much less structured than manufacturing, it is often too complex to source services remotely. Second, some services are simply not suited to remote provision, particularly those based upon face-to-face or physical contact. Third, there can be capacity constraints on remote service provision.

[37] Deutscher Industrie- und Handelskammertag DIHK, *'Offshoring of R&D: Examination of Germany's Attractiveness as a Place to Conduct Research'*, February 2005.

[38] See projections published by Forrester Research at www.forrester.com.

Box 3.2 What does globalisation mean for the location of economic activity – lessons from economic theories

Rapid technological change and policy liberalisation are dramatically increasing the scope for the relocation of economic activities. Economic theories can provide an insight into the relevant factors in determining location decisions.

Traditional neo-classical trade theories[39] suggest that a nation's characteristics, such as the availability of low cost inputs including labour and natural resources, determine the types of economic activity in which they specialise. On this basis, countries specialise according to 'comparative advantage'. With falling trade barriers and technological advance, such theories are useful in explaining the accelerating trend to shift economic activities to areas of abundant cheaper labour. But they fail to account for the bulk of trade between advanced countries. Trade of this nature is often in similar goods, or within the same firm or industry; intra-industry trade accounts for about 70 per cent of trade in the EU.

Moreover, many firms do not chase low cost locations for all of their activities. Production often concentrates in relatively few industrial locations; firms in related industries may co-locate; and these patterns may persist over time. Firms may locate close to similar firms to enjoy knowledge 'spillovers', to have access to a specialised, skilled labour force, and to benefit from specialist suppliers – an explanation associated with the 'new economic geography'[40]. The implications of globalisation for firms in these industries may be to consolidate activity in relatively high-cost locations. Because clusters of firms can generate increasing returns to scale – i.e. the bigger the cluster, the bigger the benefits from being a part of it – early decisions of firms and governments can have long-lasting implications, and gains from clusters can be cumulative.

The response of individual businesses to globalisation will therefore differ, depending on their characteristics. Globalisation will not always simply accelerate the shift of economic activity to lower cost locations. Lower trade barriers and more integration may also increase the benefits of clustering for economic activities that benefit from external economies of scale. These higher value added activities may in fact become more entrenched in successful regions as a result of greater international trade and investment.

Both old and new trade theories are supported by evidence in Europe.[41] In particular, from the early 1980s, the mix and the productivity of industrial sectors across European economies have gradually become more dissimilar. Some industries, which might be expected to have external economies to scale, are becoming more geographically concentrated, e.g. high technology and high skill industries in Ireland and in Finland.

One of the challenges for governments will be to ensure that policies are in place to allow businesses to maximise their advantages in their economic activities, and so to take the opportunities of growing, more integrated and rapidly changing global markets. Policymakers need to consider the impact of a range of actions both on traditional concerns of businesses, like labour costs and skills, and also on the ability of firms to exploit the gains from agglomeration.

[39] See the following works: Heckscher (1919) *'The Effect of Foreign Trade on the Distribution of Income'* Economisk Tidskrift 21; and Ohlin (1933) *'Inter-regional and Inter-nationalTrade'*, Cambridge, MA: Harvard University Press.

[40] As set out in Krugman and Venables (1995)., *'The Seamless World: A Spatial Model of International Specialisation'*, CEPR Discussion Paper No 1230; and (1996) *'Integration, Specialisation and Adjustment'* European Economic Review 41. See also Overman, Redding and Venables (2001) *'The Economic Geography of Trade, Production, and Income: A Survey of Empirics'*. CEPR Discussion Paper 2978.

[41] See Midelfart-Knarvik, Overman, Redding and Venables (2000), *'The Location of European industry'*, European Commission Economic Paper Number 142; and Galli R. (1997) *'Is there Long-Run Industrial Convergence in Europe?'* International Review of Applied Economics, Volume 11, Number 3, September 1997.

Box 3.3 What does globalisation mean for the location of industry – evidence from business surveys

Business survey results complement economic theories that try to predict the location and investment decisions of firms, and econometric studies seeking to explain past decisions. Recent surveys point to a range of factors which might play a role in location decisions:

Regulatory regime. A recent survey by AT Kearney[42] found that 64% of global investors identified government regulation as the most critical risk to corporate operations. Regulation and bureaucracy top of the list of concerns about FDI in China and India respectively.

Access to market. The larger the host market, the greater the likelihood that trans-national enterprises will be able to recoup the fixed cost of their foreign plants. Access to the Single Market is often quoted as a determining factor for businesses locating in the EU.

Highly skilled and productive labour force. The Invest in France Agency[43] found this to be one of the main reasons for international business gravitating to France. AT Kearney found that education and skills were the top reason for companies choosing not to offshore.

Availability of good infrastructure. AT Kearney identified concerns of investors in the context of FDI in some of the new Member States.

Tax regime. A recent study by the Federation of German Industry (BDI)[44] highlighted the impact on decision-making of the perceived burden created by the complexity of the German tax system. At the same time, evidence from empirical studies[45] on the effect of tax rates on FDI is less robust, ranging from significantly positive to significantly negative.

Production and labour costs. A German Industry Confederation (DIHK)[46] survey identified lower labour costs as an important motivating factor for companies planning to 'offshore' their R&D facilities, after the need to support those companies' overseas production facilities.

3.41 The experience of London's financial services firms illustrates this. In recent years, many back office activities have shifted away from the more costly labour and rent of London to new locations, including Bangalore, where skilled labour and IT and other infrastructure have allowed remote provision of services. At the same time, the higher value added activities of the City rely on proximity to related services, a deep and flexible pool of skilled labour, an efficient financial market infrastructure and regulatory environment, and a competitive tax regime in creating an attractive business environment. Boxes 3.2 and 3.3 summarise what economic theory and recent European survey evidence suggest about possible determinants of business location.

[42] AT Kearney FDI Confidence Index, October 2004.

[43] The Invest in France Agency, *'The Attractiveness of France'*, May 2004.

[44] BDI, *'Die Steuerbelastung der Unternehmen in Deutschland'*, September 2004.

[45] Chakrabarti, A., 2001, *'The Determinants of FDI'*, Kyklos, 54.

[46] Deutsche Industrie-und Handelskammer (DIHK), *'Offshoring of R&D: Examination of Germany's Attractiveness as a Place to Conduct Research'*, February 2005.

TECHNOLOGY AND INNOVATION

3.42 The fourth key challenge and opportunity, to which the Member States and the EU will need to respond, relates to the increasing rewards from innovation and increasing pressures on firms to make the best use of innovation, as both global competition and the speed of technological change increase. As the global economy becomes more open and competitive, this also puts a premium on governments ensuring an enterprising and flexible economy through policies that promote an enterprise culture, encourage new businesses, and promote competition.

3.43 Rapid advances in technology are transforming the world economy. The rate of innovation in information and communication technologies (ICT) can be expected to continue over the next ten years, with significant further technological advances. ICT remains a critical driver of economic activity: there is increasing evidence of a strong relationship between ICT and improvements in economic performance. For example, recent studies[47] have highlighted the role of ICT-using and producing sectors (in particular ICT manufacturing, and wholesale, retail and financial services) in explaining the superior productivity performance of the US relative to the EU since the mid-1990s. In this context, it is the diffusion and application of new inventions and technology – e.g. to services activity – that is most important in determining the pace of economic growth[48]. The rapid expansion of Internet access across the world, coupled with marked price declines in computer equipment, seems likely to continue in the future, supporting further significant expansion in the diffusion and adoption of ICT.

Emerging economy exports moving up the value chain

3.44 Economic activity in all countries is under pressure to move up the value chain, utilising more sophisticated technology. An increasing proportion of manufacturing is focussed on high-tech activities. In 1981, high tech products accounted for just 14 per cent of world manufactured products. By 2000, they accounted for 28 per cent and were the second largest category. Many emerging economies have already experienced substantial diversification of exports, and shifted towards more sophisticated goods.

3.45 A recent study[49] of Chinese exports to the EU provides a good example[50]. Over the past two decades, Chinese exports diversified from low cost goods such as textiles and toys to electronics goods. Between 1995-2000, China's market share in EU imports of electronics increased from 5 per cent to just under 10 per cent, and then more than doubled over the following three years to almost 20 per cent in 2003. Consumer electronics, which were responsible for about 80 per cent of EU imports of electronics from China in 1988, represented only 20 per cent in 2003. Over the same period, the share of computer and office equipment increased from less than 10 per cent to over 50 per cent. Moreover, whilst China remains dependent on imports of high tech components, its own exports of components, telecommunication equipment and consumer electronics all moved up the value chain (for example, the latter has shifted from audio to video products). This shift up the value chain can be expected to continue: according to the study, Chinese spending on research and

[47] O'Mahony, Van Ark, Commission (2003, 2004) op cit.

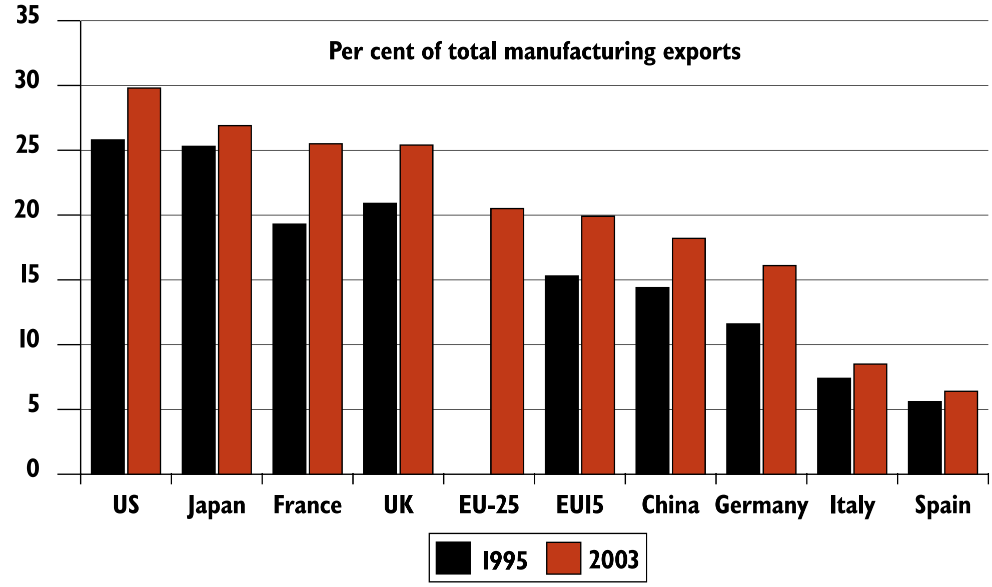
[48] See Bronwyn H. Hall & Beethika Khan (2003) *'Adoption of New Technology'*, NBER Working Paper, Cambridge Mass, 2003.

[49] See Hallaert (2004) *The Changing Patterns of EU-China Trade'*, in Euro Area Policies: Selected Issues (IMF Country Report No. 04/235).

[50] A further example can be provided by India's growing software production industry, which now employs more than 450,000 employees, having sustained annual growth rates of 30-40 per cent in revenues and employment over more than 10 years. See Arora and Gambardella (2004), *'The Globalization of the Software Industry: Perspectives and Opportunities for Developed and Developing Countries'*, NBER Working Paper No. 10538, May 2004.

development doubled as a share of GDP between 1996 and 2002[51]. Measured at purchasing power parity exchange rates, China spends more on research and development than any Member State[52].

Chart 3.5: Share of high-technology



Source: Eurostat structural indicators database; and UNIDO.

Need to promote innovation

3.46 The increasing rewards to innovation and predominance of knowledge-driven industries, combined with strong growth in emerging markets, means that economies must find new technology driven and high value added areas. Member State governments and the EU have a critical role to play in stimulating investment and promoting access to ICT: funding basic research; tackling the market failures that slow the diffusion of new ideas; facilitating partnerships between researchers and industry to turn invention into innovation; and opening up access to ICT throughout society.

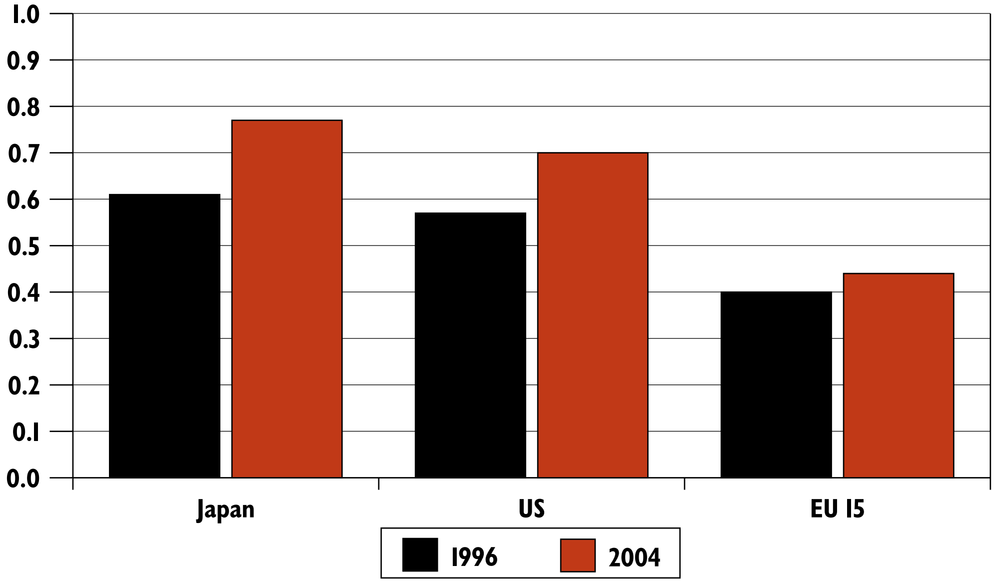
3.47 Since the launch of the Lisbon strategy in 2000, several Member States have taken such measures to promote innovative economic activity. However, according to the Commission's 2004 European Innovation Scoreboard (EIS)[53], the EU's innovation performance remains relatively poor, particularly in comparison with other developed countries such as the US or Japan:

- The US leads Europe on nine of the eleven performance indicators, which are used to compare innovation performance between the two. The US clearly outperforms the EU with respect to patenting, business R&D expenditure, tertiary education and early and expansion stage venture capital.
- Only with respect to science and engineering graduates and employment in medium-high technology manufacturing does the EU exceed the US; and with respect to ICT expenditure does the EU exceed Japan.
- Moreover, despite recent policy initiatives, whilst the US and Japanese innovation performance recently further improved, the EU's has been relatively constant since 1996, thus widening the innovation gap.

[51] Hallaert reports that Chinese spending on R&D rose from to 0.6 per cent of GDP in 1996 to 1.1 per cent of GDP in 2002.
[52] Source: OECD Science, Technology and Industry Outlook 2004. See Chart 4.4 of this paper.
[53] *'European Innovation Scoreboard 2004: Comparative Analysis Of Innovation Performance'*, Commission Staff Working Paper, Brussels, 19 November 2004

- Amongst the Member States, there is wide variation in performance: the Nordic countries are the strongest performers, and Germany and the New Member States are amongst those who have made recent progress.

Chart 3.6: Indicator of innovation



Note: Based on a set of comparable data for 12 innovation indicators.
Source: European Innovation Scoreboard, 2004.

Need to promote enterprise

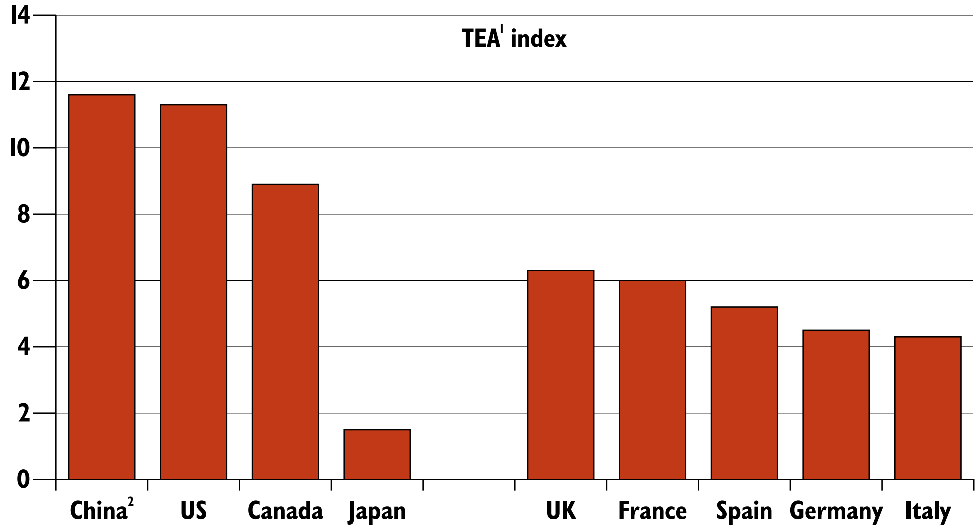
3.48 Hand in hand with increased innovation, Europe's success in meeting the challenge of rapid technological and market change also demands increased levels of entrepreneurial activity. A thriving and dynamic small business sector is vital for enhanced economic flexibility, since new businesses bring new or improved products and services to consumers, increasing competition and providing their own stimulus to incumbent companies to innovate and improve their own performance.

3.49 Evidence suggests that in many Member States the framework for supporting entrepreneurship may be relatively lacking. Levels of entrepreneurial activity in Member States lag behind those not just in North America, but also in China[54]; and surveys indicate more favourable public attitudes to entrepreneurial activity in the US than EU[55]. Lack of financial support and administrative complexity are regarded as specific barriers to starting a business in Europe. Moreover, due to the impact of government regulation, the cost and time taken to start a business in many Member States compares unfavourably not just with the US, but sometimes also with China. There is variation amongst Member States, and signs of progress, both with respect to the volume of entrepreneurial activity and attitudes. However, there is a need for further action to stimulate entrepreneurial activity, to develop a European enterprise culture; increase access to affordable finance for new and innovative companies, at both early and expansion stages; and, crucially, improve the regulatory framework in Europe to reduce the administrative and competitiveness burdens on business.

[54] Global Entrepreneurship Monitor 2004 Executive Report.

[55] See, for example, *Entrepreneurship* survey conducted on behalf of The European Commission, Directorate-General Enterprise and Industry by EOS Gallup Europe, Survey: April 2004, Analytical Report: June 2004.

Chart 3.7: Entrepreneurial activity



[1] TEA: Total entrepreneurial activity.
[2] Data for China is for 2003, whereas all other data are for 2004.
Source: Global Entrepreneurship Monitor, 2004 Executive Report.

SKILLS, FLEXIBILITY AND FAIRNESS

The impact of global change on individuals

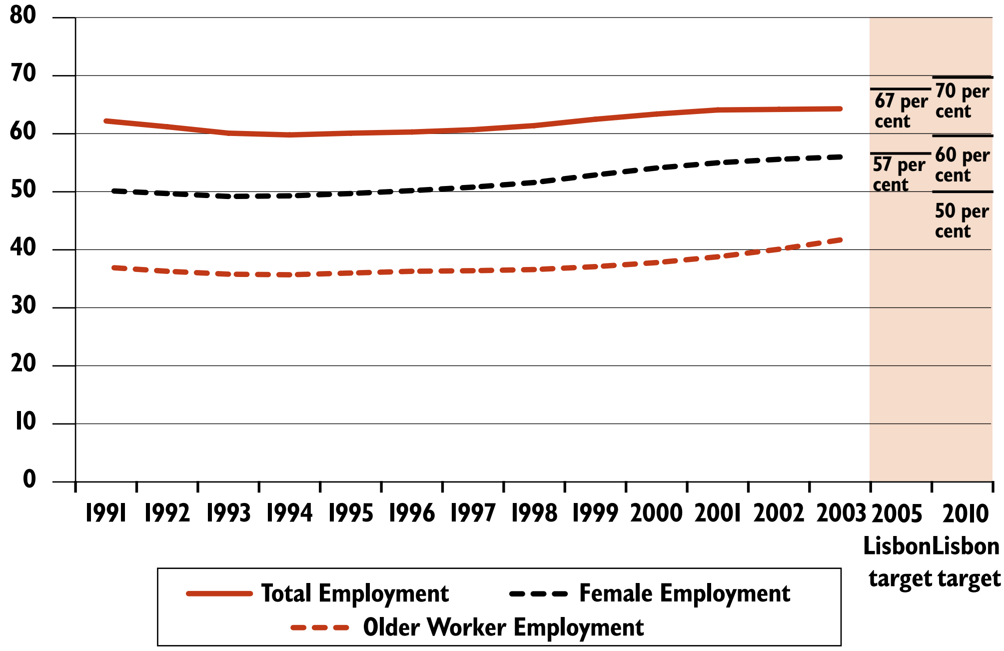
3.50 The fifth key challenge and opportunity, to which the Member States and the EU will need to respond, relates to the impact of the global changes on individuals and labour markets. There are two key trends, which are related to the need to combine flexibility and fairness, so that the most vulnerable are supported and are not left behind:

- As firms in advanced economies find it difficult to compete in low value-added products and services, comparative advantage will lie in knowledge-based goods and services, which require highly skilled workers. So the demand for skilled workers is likely to increase.
- Moreover, in the more competitive and integrated global economy, the pace of change will continue to be rapid and intense. This has great potential benefits in terms of growth and prosperity. However, it also means that there may be transitional impacts for individuals and firms as labour and capital are redeployed from declining sectors to expanding ones.

Outturns show that Europe's labour market needs reform

3.51 These global trends represent significant challenges to Europe's labour markets. Looking at its outcomes, Europe's labour market is already under-performing and, as discussed in Chapter 2, this underperformance is a key factor in explaining Europe's shortfall in standards in living with respect to the US. Policy-makers recognise the clear need for urgent action. For example, at Lisbon in 2000 and Stockholm in 2001, EU leaders set targets for employment: 70 per cent of the EU's working age population in a job by 2010, including 60 per cent of women and 50 per cent of older workers. There has been recent progress in terms of both job creation (especially in the smaller Member States) and reforms (e.g. recently with the implementation of the Hartz reforms in Germany). However, current trends suggest the EU will not meet these targets without creating around another 22 million jobs. 19.5 million people in the EU are unemployed, representing 8.8 per cent of its workforce[56], a rate far higher than in other developed economies. Adjusting for cyclical developments, the OECD estimates structural unemployment rates in 2004 of 8.2 per cent for the euro area, compared to 4.8 per cent for the US and 3.9 per cent for Japan[57].

Chart 3.8: Employment rates in the EU



Source: European Commission, Employment in Europe 2004.

3.52 However, there is significant variation in outturns[58] between Member States.

- Employment rates are above 70 per cent of the working age population in Denmark, the Netherlands, Sweden and the UK, which also demonstrate higher rates of female employment. According to Eurostat, the employment rates in those Member States are higher than in the US and Japan. However, employment rates remain below 60 per cent in a number of Member States, including Belgium, Greece, Italy and Poland, which also demonstrate lower rates of female employment.

- Denmark and Sweden also have rates of employment of older workers (aged 55-64) near or above 60 per cent, rivalling equivalent rates in Japan and the US. However, many other Member States have rates below 40 per cent, including Belgium, France, Germany, Italy and Poland.

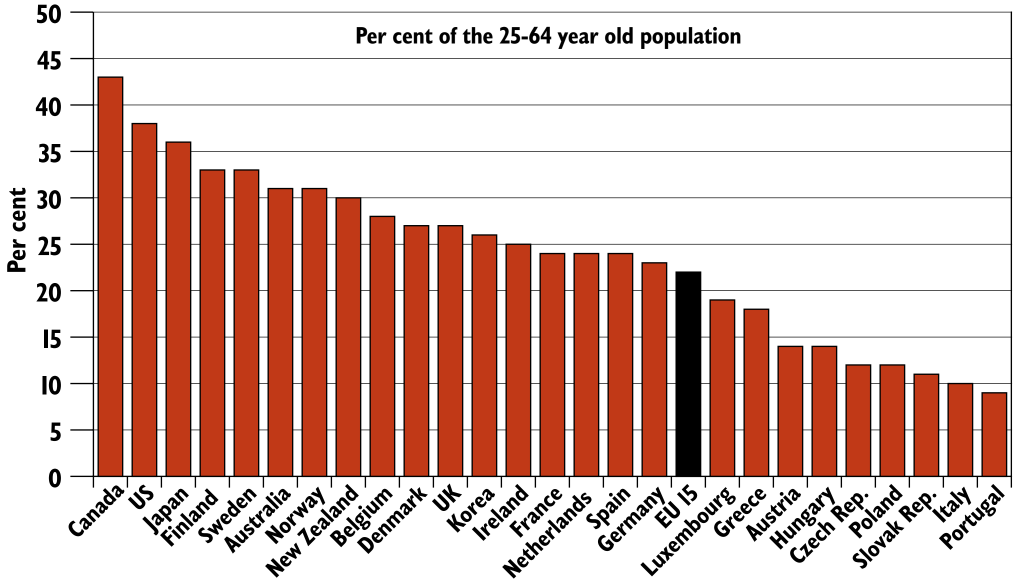
- Unemployment, in January 2005, was less than 5 per cent in Austria, Ireland, Luxembourg, Netherlands and the UK. However, it was over 9 per cent in a number of Member States, including France, Germany, Greece, Spain and Poland.

- Unemployment of young people (under 25 years) in the EU was 18.7 per cent in January 2005, compared to 11.7 per cent in the US. Over 20 per cent of young people were unemployed in the Czech Republic, France, Finland, Poland, Slovakia and Spain.

[56] Source: Eurostat. Seasonally adjusted unemployment in EU25, January 2005.
[57] Source: OECD Economic Outlook December 2004.
[58] Source: Eurostat.

- 20 per cent or less of the unemployed in Denmark, Sweden and the UK are unemployed for at least twelve months, compared to over 40 per cent in many Member States, including France, Germany and Italy.

Chart 3.9: Tertiary education attainment in OECD countries, 2002



Source: OECD At a Glance 2004.

Education and skills

3.53 At the time of the 2004 Pre-Budget Report, the Government published a paper on *'Skills in the Global Economy'* recognising the specific challenges imposed by global trends. In particular, this emphasised the importance of strengthening skills and human capital to increase the ability of individuals to adapt to change. With respect to education and skills, levels in the EU vary significantly between Member States and often lag behind peer groups:

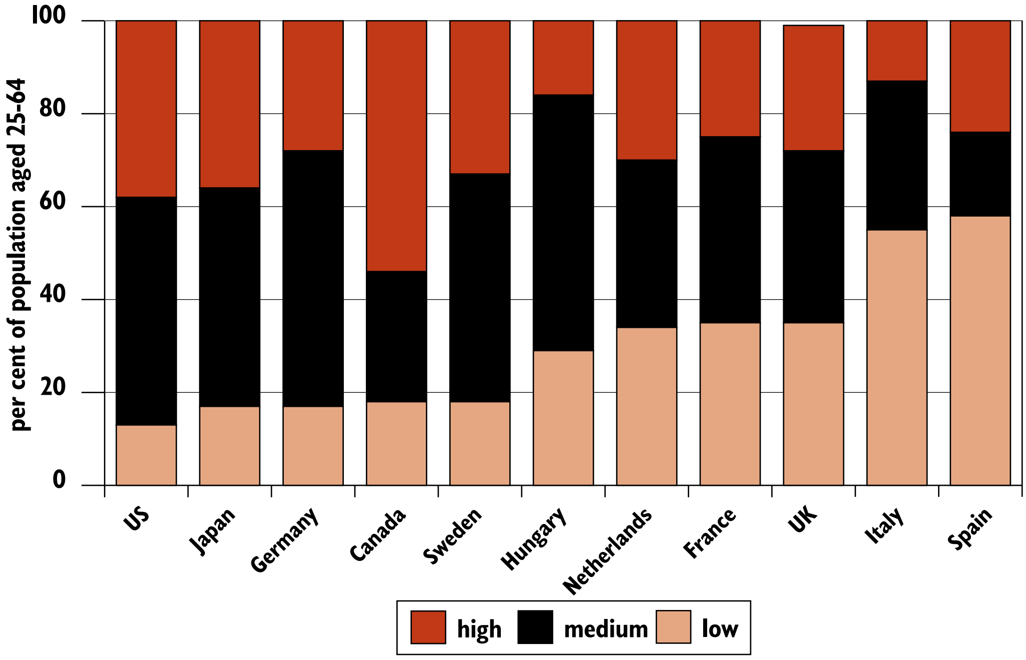
- Nordic Member States have the highest share of their population aged between 25-64 that has completed tertiary education. A number of southern Member States and the new Member States have the lowest share. All Member States lag behind Canada, the US and Japan in this respect.

- Recent trends suggest that most Member States are moving in the right direction, with most showing rising tertiary education attainment as a percentage of the total population. Spain and Ireland have seen the largest gains in this respect. However, even those, such as the Nordic countries, that already have a larger proportion of their workforce with high skills have seen recent increases.

- France has been relatively successful at reducing the proportion of low-skilled adults, with the proportion of people with low-level qualifications falling by over 40 per cent in the 1990s. Germany retains a large intermediate skills base, also with over half of its workforce trained to that level, compared to less than one third in the UK, where the share of workers with intermediate skills has not increased significantly in the past 30 years.

- Wide variation also exists with respect to youth educational attainment. For the EU as a whole, just over 75 per cent of the population aged 20-24 completed at least upper secondary education in 2003. The highest shares were seen in the new Member States of Central and Eastern Europe; a number of larger Member States including the UK, Germany, Italy, Spain, and the Netherlands saw shares below the average[59].

Chart 3.10: Distribution of highest completed level of education, 2002 comparison



Source: OECD (Education at a glance, 2004) ; O'Mahony and De Boer (2002).

3.54 However, skill levels are rising even faster, albeit from a lower base, in emerging market countries than in advanced economies. For example, while the proportions of young people entering higher education in China and India are still relatively low, they each educate over 2 million graduates per annum compared with around 250,000 in the UK.[60] The proportion of 25-34 year-old South Koreans with a tertiary level qualification rose from 29 per cent in 1995 to 40 per cent in 2001[61]. These changes have, in part, been enabled by rises in secondary enrolment rates.[62] By 2015, the emerging market economies are likely to have experienced significant increases in their human capital. These increases in skills should spur productivity growth, helping to raise prosperity and lift more people out of poverty.

Recent structural change

3.55 Rapid change of markets and technology will inevitably require workers to move from sectors in decline to those in new and growing sectors. The sectoral composition of the EU's output and employment has already evolved significantly in response to recent changes. In particular, since 1997 every Member State has seen a clear increase in output and employment of the service sector. The share of business sector services of total EU employment has risen continuously since 1997, and knowledge intensive services represent the largest source of employment growth with over 7 million new jobs between 1997-2002[63]. New Member States, which started from a low base, showed the largest rise in the share of service sector employment.

[59] Commission (2005) *'Second Implementation Report on the 2003-2005 Broad Economic Policy Guidelines'*, Commission staff working paper.

3.56 A comparison of the EU's structural composition of output and employment with the US shows that, in recent years, the US has experienced an even greater shift to services. Moreover, whilst experiencing higher growth in high productivity high technology-using manufacturing sectors, its low productivity sectors account for a smaller share of manufacturing output. Further growth in the EU of employment in services and high tech manufacturing sectors appears desirable for promoting gains in EU living standards. This might require better targeted state/EU aids systems focused on promoting entrepreneurship and innovation in new and growing high-tech sectors rather than declining sectors or state monopolies.

Flexibility to promote fairness

3.57 Faced with the challenges of global change, the countries that succeed will be those that are flexible and open. If markets and individuals do not have the flexibility and adaptability to respond to change, then exposure to overseas competition and new technologies may result in falling relative earnings, periods of unemployment, or a combination of the two, particularly among lower skilled workers. A flexible labour market does not come at the expense of employment and security. Globally, the flexible economies tend to be also the ones with higher employment.

3.58 A Treasury study[64] looked more closely at the issue of labour market flexibility in the UK and Europe. Two related concepts of labour market flexibility can be identified. The first relates to how labour markets adjust to any period of disequilibria, through a combination of adjustments in wages, and the supply and demand for labour, to ensure that any disturbance to the labour market is short-lived. The second relates to the institutional factors that determine the structural level of unemployment. In practice, there are a number of ways by which labour markets can adjust: relative, real and nominal wage flexibility, geographic labour mobility, and employment and functional flexibility (the latter related to skills and education levels, as discussed above).

3.59 Labour market policies in many Member States have often placed greater emphasis on mitigating the effects of change. While benefit systems should help insure households against labour market shocks, it is also important that they enable individuals to make the transition from traditional activities into expanding ones, while maintaining incentives to work and save. In aggregate, during the past 30 years, the EU labour market appears to have adjusted less well to shocks, resulting in higher and persistent unemployment in the EU, compared to lower and more stable unemployment rates in the US and Japan.

[60] Source: *China Statistical Yearbook* (2004) China Statistics Press; and PwC (2004) '*A fine balance: The impact of offshore IT services on Canada's IT landscape*'.

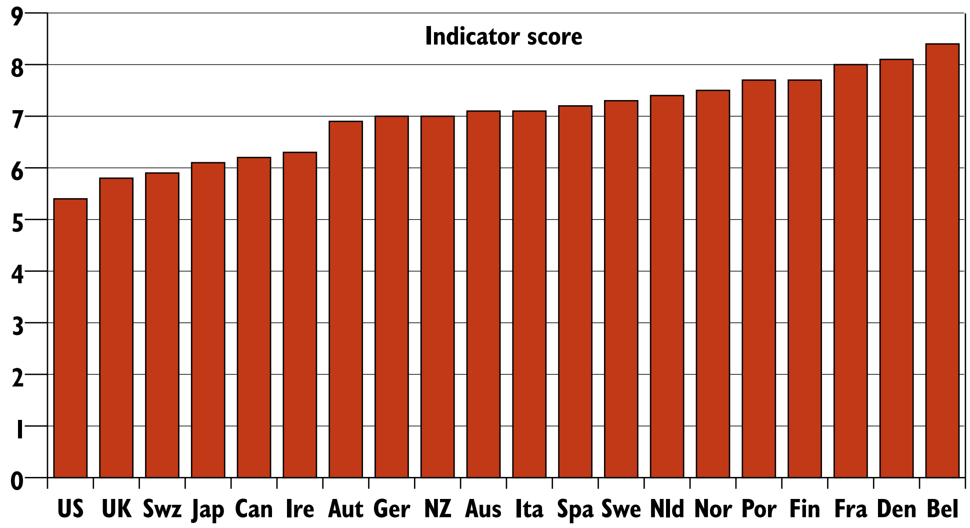
[61] Source: OECD Education at a Glance (2004).

[62] Source: Asian Development Bank Key Indicators (2004).

[63] See *Employment in Europe 2004*, European Commission 2004.

[64] *EMU and Labour Market Flexibility*, supporting study for '*UK Membership of the Single Currency. An Assessment of the Five Economic Tests*', HM Treasury (2003).

Chart 3.11: Labour market flexibility indicator



Note: A lower value implies a more flexible institutional environment.
Source: HM Treasury.

3.60 The Treasury paper noted that studies have suggested that greater labour market flexibility tends to be associated with countries outside of continental Europe. This assessment was borne out by labour market outturns, which suggested that rigidities in the EU's labour market existed. It was also supported by Treasury estimates of an indicator of labour market flexibility – reproduced in Chart 3.11 – pooling together the evidence on the institutional environment. Therefore, it noted that while there has been recent progress in job creation and reducing rigidities through labour market reforms, particularly in some smaller Member States, e.g. Ireland and the Netherlands, progress in the larger Member States has been slower. Europe needs to take further labour market policy action to meet the new global challenges.

ENERGY AND ENVIRONMENT

Growth will place increasing pressures on resources

3.61 The sixth key challenge, to which the Member States and the EU will need to respond, is that the rates and patterns of economic growth will place increasing pressures on resource use and the natural environment. First, expanding demand is likely to have economic impacts on the supply and price of environmental resources, such as energy. Second, there will be a range of effects on the environment resulting from the interaction of economic and natural processes – effects such as climate change, air and water pollution, soil erosion, loss of biodiversity and deforestation.

3.62 There are substantial differences in energy intensity and also energy efficiency across the different Member States of the Union[65]. Throughout the 1990s energy demand increased in western Europe, where energy efficiency improvements were not sufficient to offset the increase in demand. In the new Member States of central and eastern Europe, however, energy consumption decreased due to economic restructuring. Across Europe as a whole, however, these trends resulted in an overall decrease in energy intensity. At the same time, the contribution of renewable and nuclear energy sources to total energy production increased throughout the 1990s.

[65] European Environment Agency (2004) *Impacts of Europe's changing climate.* http://reports.eea.eu.int/climate_report_2_2004/en/summary_of_europes_changing_climate.pdf

Rising demand for energy

3.63 In the absence of policy changes, global energy demand is set to grow strongly over the next ten years. Energy demand growth in Europe is not expected to be as rapid as in other regions, particularly in emerging and developing economies. However, as the chart sets out below,[66] it is expected to rise, bringing with it possible associated environmental impacts. Natural gas is expected to account for a growing share of primary energy source, with growth rates of around 2 per cent per annum. Oil demand will also continue to grow, but at a slower pace, whilst both coal and nuclear demand are forecast to decline.

3.64 Many factors will affect demand growth, including government policy on climate change mitigation measures, the pace of technological advance and GDP growth. The IEA project that proven energy reserves are adequate to meet global energy demand until at least 2030. However, additional oil reserves, from new discoveries and confirming probable reserves, will be needed if oil production is not to peak before then. Further efforts to reduce the energy intensity of the economies across the Union, increasing energy efficiency across the different sectors and increasing the proportion of renewable energy sources, will be crucial to ensuring that energy demand is met in a way which is environmentally sustainable; avoids high and volatile prices; and contributes to security of energy supply.

Impact on climate change

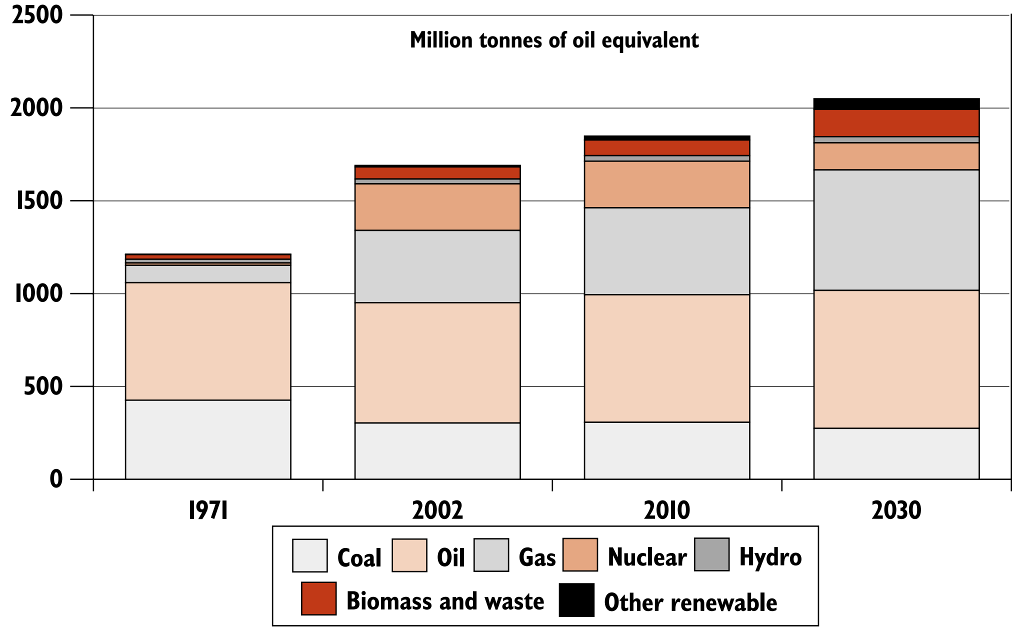
3.65 Climate change is the key environmental issue resulting from the emissions of greenhouse gases. As a trans-boundary issue it needs to be addressed at international level. There is strong evidence, from both global climate models and observed climate patterns that climate change is occurring and is due largely to human activity[67]. Although it is too early to link extreme events unequivocally to climate change, recent experience in Europe shows that extreme events, which will become more frequent as the climate changes, can have significant human and economic costs. For example, the 2003 heat-wave that affected much of Europe and is estimated to have caused some 26,000 premature deaths and had an estimated direct economic cost of $13.5bn. In 2002, the severe floods in Europe caused 37 deaths and had an estimated direct cost of $16bn. A recent report from the Association of British Insurers noted that in 2000 the UK experienced its wettest autumn for almost 300 years, with heavy rainfall leading to damage to 10,000 properties and nearly £1 billion in insurance claims. The Intergovernmental Panel on Climate Change (IPCC) estimated that indicative global economic costs associated with an increase in average global temperature of $2^1/_2$ degrees Celsius would add up to between 1.5 and 2 per cent of global GDP per annum, with a wide variety of impact between world regions.

3.66 Collectively Europe emits 14 per cent of global emissions of greenhouse gases, with the US and Canada at 23 per cent, Japan and other southeast and east Asian countries 24 per cent and the rest of the world at 39 per cent. Comparative rates of economic growth mean that European emissions will rise at a slower rate than those of other regions over the next 20 years, so by 2050 Europe is predicted to emit around 8 per cent of global emissions under business-as-usual scenarios. However, historically, of the total emissions over 200 years that have cumulatively generated the problem of climate change, Europe and other developed economies have been the source of a very significant proportion.

[66] IEA World Energy Outlook (2004).

[67] Recent research on climate change science from the Hadley Centre (December 2003) http://www.metoffice.com/research/hadleycentre/.

Chart 3.12: Primary energy demand in the European Union



Source: IEA World energy outlook 2004.

CONCLUSION

3.67 This chapter has set out the six key long-term global economic challenges and opportunities to which Member States and the EU as a whole need to respond, notably:

- the shifting balance of global activity, which will pose a challenge to industries and sectors that have historically been the preserve of advanced economies such as those in Europe, placing a premium on flexibility, dynamism and entrepreneurship supported by an active and responsive welfare state to ensure economies can succeed;
- the greater integration of global economic activity as international trade and investment expand, offering new and larger markets for Europe's goods and services, and increasingly diverse sources and destinations of foreign direct investment;
- underlining the need for sound and sustainable macroeconomic policies and institutional arrangements that generate increased confidence, promote stability and support investment;
- increasing rewards from innovation and further technological change, putting a premium on fostering innovative activities, promoting the adoption and application of new technologies, and removing the barriers to new ideas and entrepreneurship;
- the increasing importance of skill levels and flexible labour markets, enabling individuals to adapt swiftly and smoothly to change, underscoring the need to invest in skills and education and reform labour market policies; and
- increasing pressures on the global environment, requiring action to improve the environmental efficiency of the economy at both domestic and multilateral levels.

3.68 In the face of these long-run trends, the next chapter looks at Europe's economic policy priorities for the decade ahead.

4 Policy challenges for Europe

4.1 This paper has looked at the global economic challenges and opportunities that Europe faces as a result of the radical transformation of the global economy in the coming decade. It has set out the historical development of the European Union, discussing how Europe has responded to the economic challenges of the past. It argues that now, in the face of new global challenges, a new commitment to urgent and fundamental reform is essential. Putting in place the foundations for economic success in the global economy, and delivering growth, jobs and rising living standards for all, will require:

- a **stable macroeconomic environment** that promotes growth, investment and fiscal sustainability in the face of long-term demographic challenges and increased global flows;
- the **right climate for enterprise and innovation**, including support for research and development and intellectual property, and a new approach to regulation;
- a **dynamic and competitive Single Market** which reaches its full potential, allowing growth of high value added activities, including through more pro-active competition policy and reduction of distortive state aids which hinder change;
- efforts to **shape global trends and be more outward-looking**, taking a lead in multilateral liberalisation to deliver benefits for the developing world and Europe alike, strengthening economic cooperation with major partners such at the US; and playing a leading role in raising the resources needed to reduce international poverty and ensure globalisation can be of benefit to all;
- **modern social policies, respecting Europe's historical commitment to matching enterprise with fairness**: including active and responsive welfare states, which equip people with the necessary skills to respond flexibly to change, underpin high levels of economic growth and employment, and tackle inequalities and ensure social cohesion; and
- enhanced **environmental sustainability** through more efficient use of energy resources while at the same time reducing costs to the environment, particularly in the context of global climate change, with Europe playing a leading role in promoting market-based solutions.

Action by Member States and the EU

4.2 Europe's policy-makers have a critical role to play in responding to and addressing these challenges, which demand concerted action to strengthen the key drivers of economic growth – employment and productivity. They call for greater flexibility in product markets, labour markets and capital markets to ensure that Europe's businesses and individuals are equipped to adapt to economic change and take advantage of new opportunities when they arise. Structural reform, which promotes flexibility and fairness together, is the key to success in the modern global economy. There can be no security without change.

4.3 So it is essential that Europe's policy makers take the difficult long-term decisions at the Member State and EU level to promote stability, flexibility and enterprise, high employment, openness and opportunity for all. There are some areas where the EU has responsibility and must demonstrate global leadership, for example with respect to multilateral action to promote free and fair trade. There are also areas where joint action at both Member State and EU level is essential for success. For example, national competition policies should be complemented by proactive enforcement of an effective EU-wide competition policy. However in many areas, even if the challenges are global, it is still right that Member States are responsible for policy action and for taking the right long-term decisions. A clear example is tax, where globalisation demands not tax harmonisation but flexible and competitive tax systems. The key policy challenges facing Europe are discussed in more detail in the sections below.

A STABLE MACROECONOMIC ENVIRONMENT

Effective policy frameworks

4.4 The first challenge for Europe, in addressing the trends set out in Chapter 3 of increasing cross-border trade and investment, more integrated capital markets and greater global competition, is to entrench macroeconomic stability. A strong macroeconomic framework is essential to maintaining high and stable levels of growth and employment. In an integrated global economy, where shocks can be transmitted more rapidly, robust macroeconomic frameworks help mitigate against uncertainty. Moreover, greater competition in global product and capital markets increases the importance of establishing the right policy framework to compete successfully and provide a strong investment climate.

4.5 Experience has shown that a robust macroeconomic framework will achieve three key objectives:

- Credibility, so that policymakers have public trust. Building a strong track record is central to achieving this;
- Flexibility, so that policymakers can take early and forward-looking monetary and fiscal policy action in the face of upturns and downturns of the economic cycle, without jeoparising the credibility of the Government's long-term goals;
- Legitimacy, meaning there is widespread support for the framework. To promote legitimacy, frameworks must be seen to be based on a sound economic rationale and applied consistently over time. Accountability and transparency are key contributors to legitimacy.

The principle of constrained discretion

4.6 Problems with fine-tuning and complete discretion, and with overly rigid rules that do not allow the flexibility to respond to shocks, have pointed countries towards the principle of constrained discretion as the basis for delivering these three objectives of credibility, flexibility and legitmacy. This approach combines the discretion necessary for effective economic policy with a credible institutional framework that constrains policy-makers to deliver clearly defined long-term policy objectives. It rejects the idea of frameworks based solely on complete discretion or fixed rules.

4.7 The key principles for a framework of credible 'constrained discretion' are:

- clear and sound long-term policy objectives: this requires governments to set realistic and appropriate objectives for macroeconomic policy which are clearly defined, and against which performance can be judged;
- pre-commitment, through institutional arrangements and procedural rules: credibility can be enhanced by designing procedures and institutions so as to ensure they support long-term stability. The more difficult it is for the government to fail to deliver, or to change its objectives, the more likely it is that the public and investors will believe that decisions are being taken for sound long-term reasons;

- maximum openness and transparency, and clear accountability: the public and markets need to have confidence in data provided by governments; and greater transparency also means it is easier to hold policy-makers to account for their performance.

Monetary policy

4.8 In applying these principles to monetary policy, policy-makers have increasingly recognised the following factors: that the long run goal of monetary policy should be price stability, which is an essential pre-condition for high and stable levels of growth and employment; that in terms of institutional arrangements, there is a strong case for monetary policy being conducted by an independent central bank; and the importance of putting in place procedures to strengthen transparency and openness. On the objective, one consideration is whether the inflation target should be symmetric, and therefore treat inflation below target or deflation as seriously as inflation above target. An asymmetric target that aims to reduce inflation to a set level or less is likely to introduce a deflationary bias into policy. Procedures to improve transparency include the publication of voting records, minutes of decision-making committees, inflation forecasts and the publication of the target range itself.

Fiscal policy

4.9 The management of fiscal policy inevitably involves wider economic and social objectives. However, there is a prevailing consensus on the importance of fiscal sustainability. In terms of building credibility, goverments have a range of options. They could, for example, establish explicit fiscal rules, legal requirements that commit governments to set long-term objectives and account for their performance, and public expenditure management procedures to ensure that spending plans are consistent with the fiscal objectives of the government as a whole. (Box 4.1 describes the approach taken in the UK.)

4.10 A number of European countries have secured that pre-commitment by setting explicit fiscal rules that allow some room for flexibility to respond to shocks. In the short term, provided that rules are adhered to and sustainability is not in doubt, fiscal policy should be flexible enough to be able to support monetary policy in smoothing economic fluctuations and stabilising output. To this end, fiscal policy should be counter-cycical – fiscal policy should be more relaxed when the economy is below trend and tighter when above trend. For countries with sound public finances and economic stability, the fiscal framework should provide maximum capacity for policies that help deliver structural reforms and long-term economic benefits, but require significant investment in the short run. To ensure transparency, governments should give a clear statement of their fiscal objectives and any operating rules they choose to adopt. Where departures are made from those rules, these should be fully explained and justified.[1]

The Stability and Growth Pact

4.11 In the context of monetary union in particular, it is important that countries' public finances are sustainable to prevent high-debt countries from continuing to run high deficits and debts that could adversely affect all members. The introduction of the Stability and Growth Pact (SGP) in the late 1990s represented a major step forward in recognising the importance of long-term budgetary discipline and as a framework for coordination by Member States of their fiscal policies. The UK has supported the principle of a strong SGP, recognising that fiscal sustainability is a prerequisite for macroeconomic stability, and that collective fiscal co-ordination is desirable within an integrated economic community, and essential for a successful monetary union.

[1] On policy frameworks, see *Policy frameworks in the UK and EMU: EMU Study*, HM Treasury (2003).

Box 4.1: Achieving the objectives of macroeconomic frameworks in the UK

In 1997, the new Government embarked on a radical overhaul of the frameworks which guide monetary and fiscal policy, against a legacy of a poor track record in macroeconomic policymaking[1]. The design of the UK fiscal framework reflects the three reinforcing principles set out above. These principles are not only features of the fiscal policy framework but are evident in the monetary policy framework and public spending framework, strengthening the UK's overall macroeconomic framework through a principled approach.

Clear and well defined long-term policy objectives

The Government has set two objectives for fiscal policy:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations;
- and over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

These objectives are implemented through two fiscal rules, against which the performance of fiscal policy can be judged:

- the **golden rule** – over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- the **sustainable investment rule** – public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

Pre-commitment to sound institutional arrangements

The Code for Fiscal Stability, which was given legal backing in the 1998 Finance Act, underpins the fiscal framework and demonstrates the Government's commitment to improve the conduct of fiscal policy, ensuring that fiscal policy is conducted in an open and transparent manner.

Maximum transparency

The principle of transparency is a central feature of the Code for Fiscal Stability and the Government has taken a number of steps designed to increase transparency.

These include:

- having the key assumptions used in the public finances independently audited by the National Audit Office to assess whether they are reasonable and cautious; and
- regular publication of data on the public finances in the Budget and Pre-Budget Report combined with more detailed publications such as the End of year fiscal report, and the Long-term public finance report.

[1] See Balls and O'Donnell (eds.) (2002).

4.12 However the operation of the SGP has highlighted a number of issues that need to be addressed. The slowdown in the global and European economies in recent years tested its effectiveness in supporting both stability and growth, and the implementation of the SGP's Excessive Deficit Procedure (EDP) for a number of countries highlighted problems surrounding its operation and design.[2]

[2] On the SGP, see *The Stability and Growth Pact: A Discussion Paper*, HM Treasury (2004).

4.13 In particular:

- While the SGP has played an important role in enhancing the credibility of governments' commitment to fiscal discipline in the EU, implementation of the SGP has tended to focus on short-term deficits with rather less consideration being given to debt levels and longer-term fiscal challenges, for example those relating to an ageing population. While gross debt fell slightly in the lead up to EMU, the average level for the euro area countries has now risen above 70 per cent of GDP;

- The effectiveness of the SGP may have been adversely affected by the lack of emphasis on cyclical factors. In the UK, the fiscal rules are set over the economic cycle. There is less emphasis on the role of the economic cycle and the importance of policy symmetry in the SGP framework. Indeed, in practice the SGP does not appear to have supported counter-cyclical policy in recent years. The SGP framework would also benefit from greater recognition of the importance of measures to promote structural reform and public investment that delivers long-term economic benefits;

- In terms of legitimacy, a key to ensuring public support for the Pact is to ensure that elected national governments remain responsible for fiscal policy and accountable for it to their Parliaments. A number of proposals have been made to increase the role of the Commission in EU fiscal policy. This could have implications for the legitimacy of the EU fiscal framework, by shifting the institutional balance away from the Council and Member States, which are accountable for fiscal policy. The UK Government strongly supports an intergovernmental approach through the Council.

A prudent interpretation

4.14 The UK Government has consistently argued for reform to promote a prudent interpretation of the SGP. A prudent interpretation would take into account:

- the economic cycle – by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy, so providing the flexibility to take the right decisions over the cycle;

- sustainability – taking into account that low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate, and providing a sound basis for investment in public services. Assessment of sustainability should also take into account the long-term budgetary impact of ageing populations, such as that set out in Annex A and in the *Long-term public finance report*; and

- public investment – recognising that public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy.

4.15 Proposals for reform are being discussed in Europe. These proposals are an important step forward, with increased attention to the economic cycle, debt levels, and country specific circumstances. However, much will depend on implementation. It is also essential to recognise the importance of national frameworks and national ownership of fiscal policy.

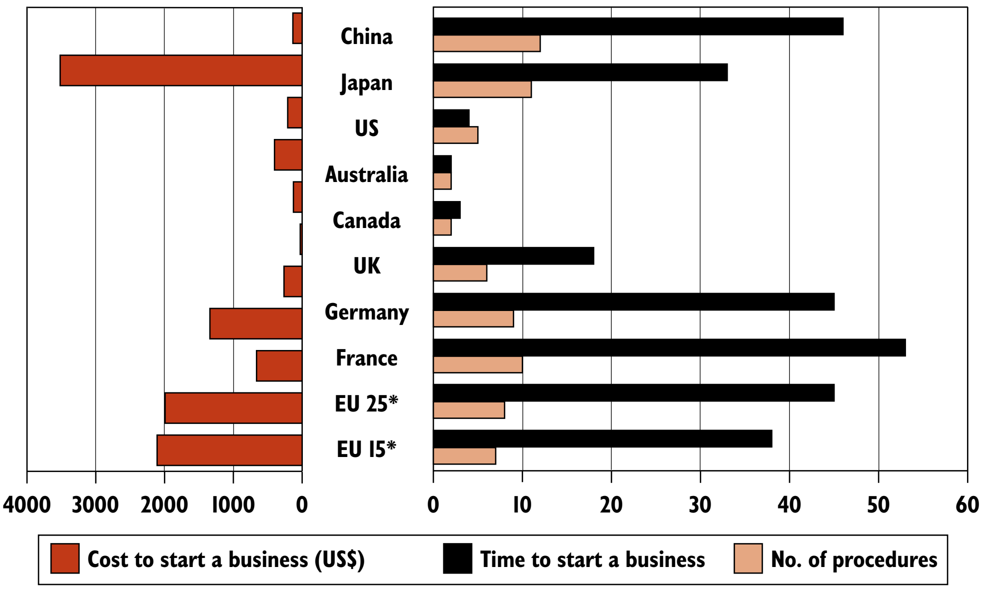
PROMOTING ENTERPRISE AND INNOVATION

4.16 As described in Chapter 3, as both global competition and the speed of technological change increase, there will be increasing rewards from innovation. To capture these rewards, the second challenge for Europe is therefore to ensure the right conditions are in place to encourage increased innovation and enterprise including through the creation of new firms, which often play an important role in responding to new market demands.

Developing an enterprise culture

4.17 There is substantial evidence to suggest that much of Europe's entrepreneurial potential remains untapped. This reflects a wide range of factors, including cultural or social barriers, such as a fear of failure or a lack of appropriate skills; the existence of regulatory barriers to entry and business development (see chart 4.1 below); and the lack of access to early stage and expansion risk capital, particularly for smaller firms. Policies to foster and support entrepreneurial activity must address each of these barriers and reflect a mix of national and Community-led intervention.

Chart 4.1: Cost, procedures and time to start a business



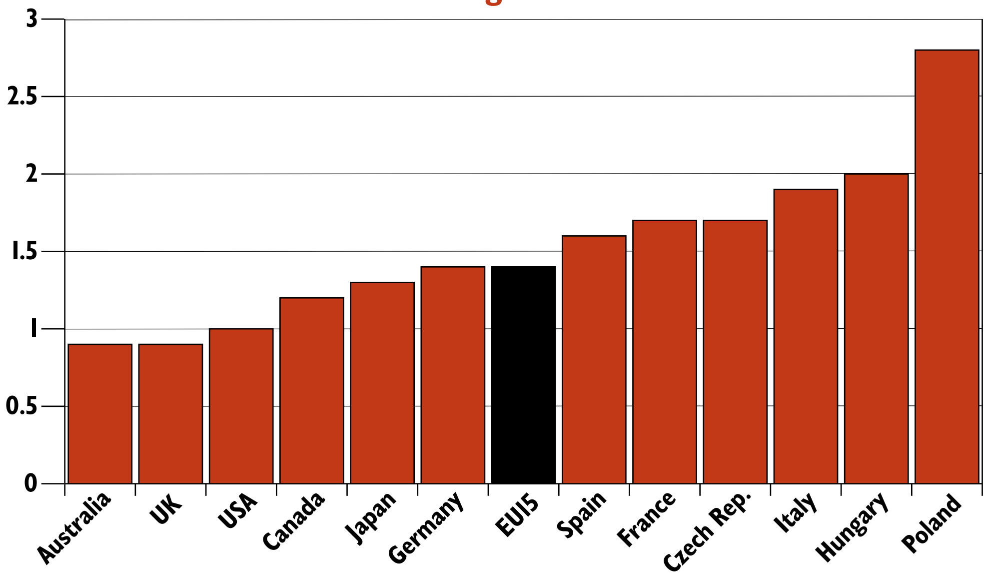
Note: EU 15 excludes Luxembourg; and EU 25 Cyprus, Estonia, Lux. and Malta.
Source: World Bank.

4.18 The education system can help to promote an entrepreneurial culture, for example by integrating enterprise learning into national curricula. There is also an important role for national action to tackle the barriers to workforce training faced by many small businesses across the EU. Such barriers can take a variety of forms, including financial constraints, time pressures and information shortages, and Member States should develop national strategies for ensuring that new and enterprising businesses have the capacity to develop the skilled workforces they need to grow and succeed. National governments and the Community as a whole should also take steps to raise the profile of successful enterprise policy and encourage others to learn from such success.

Regulatory reform

4.19 Regulatory reform is key to reducing the burdens on new and innovative businesses. Research by both the OECD[4] and the IMF[5] has concluded that the regulatory framework in Europe inhibits the performance of many EU economies, with OECD analysis[6] suggesting that improvements in regulatory regimes could raise productivity levels by up to 6 per cent in many EU countries. As Chart 4.2 shows, while levels of product market regulation vary, the EU as a whole is more heavily regulated than the US or Japan.

Chart 4.2: Product market regulation



Note: A lower value implies a less restrictive level of regulation.
Source: Conway, Janod and Nicoletti (2005): "Product market regulation in OECD countries: 1998 to 2003", OECD working paper.

4.20 Further action is therefore needed to reduce the burden of regulation on European businesses. With a substantial proportion of significant new regulation in many Member States now European in origin, reform is needed to reduce the burden of EU regulation, building on the steps already taken by the Commission in this area and on the December 2004 Six Presidencies' initiative, *Advancing Regulatory Reform in Europe*, which set out a series of proposals to:

- ensure that competitiveness considerations and the costing of administrative burdens feature prominently in the impact assessment of new regulations;
- deliver faster and more effective simplification of existing regulations;
- establish clear and measurable goals for monitoring and controlling the economic impacts and administrative burdens imposed by EU legislation;
- strengthen business input into the process of regulatory reform in Europe;
- develop new arrangements for external ex-post audit and quality control of EU regulatory impact assessments;
- enhance pre-legislative consultation in the policy-making process, including through more systematic use of Green and White Papers; and
- make greater use of non-legislative approaches at the EU level.

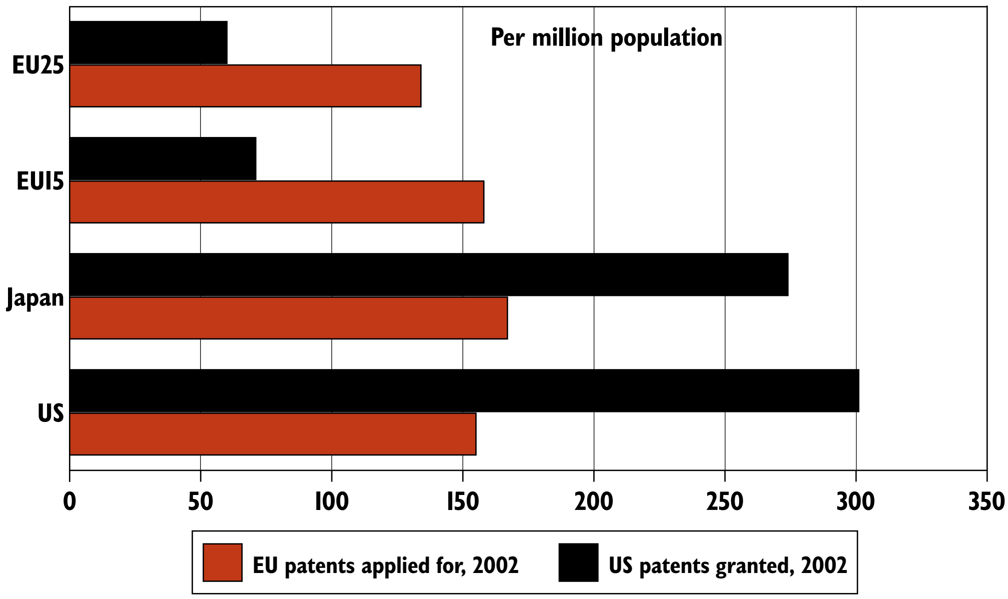
[4] OECD (2003), *The sources of growth in OECD countries*.
[5] IMF (2003), *When leaner isn't meaner: Measuring benefits and spillovers of greater competition in Europe*.
[6] OECD (2002), *Product market competition and economic performance*.

4.21 At the national level, Member States should also introduce reforms to minimise the cost of regulation on enterprise, building on established best practice elsewhere, tailored to local needs. Within the spirit of the Six Presidencies' Initiative, several Member States including Belgium, France, Germany, Hungary, Poland and Slovakia have launched programmes to reduce regulatory burdens, particularly for small businesses. The UK is moving towards a more risk-based approach to regulation, identified as the most efficient approach in the final report of the Hampton Review, published alongside the Budget 2005.

Access to finance

4.22 Access to finance is vital in fostering enterprise. While large firms tend more frequently to use internal sources of finance as well as capital markets, newer and smaller enterprises generally depend to a greater extent on external sources of finance and face barriers in the market that prevent them from raising even relatively modest sums of capital. Alongside action to improve the regulatory and administrative environment, there is an important role for public intervention, at the national and Community level as appropriate, to improve the availability of risk capital to small firms. Most Member States have established schemes for closing the funding gap through forms of public-private partnership in the provision of risk capital and there is scope for further learning from one another, building on examples of best practice. The EU's state aid rules should be reformed to allow Member States to introduce appropriate measures to tackle the funding gap. At the EU level, there is also scope for improving the targeting and effectiveness of support provided through the Community's financial instruments and by the European Investment Bank (EIB) and European Investment Fund.

Chart 4.3: Indicator of patent activity



Source: Eurostat structural indicators database.

Promoting innovation

4.23 Most internationally-comparable indicators of innovative activity show Europe lagging its key competitors. For example, Chart 4.3 shows patent activity in Europe is well below that in the US and Japan.[7]

[7] For a full description of this issue see 'Competing in the Global Economy', DTI Economic Paper No. 7, 2004.

4.24 Improvements in the regulatory regime and in access to finance have a key role to play in stimulating the growth and development of innovative businesses. But if Europe is to respond effectively to the challenge of global competition it must also invest more, and more effectively, in research and development (R&D) and take further steps to establish the framework conditions needed to stimulate private R&D investment. This means:

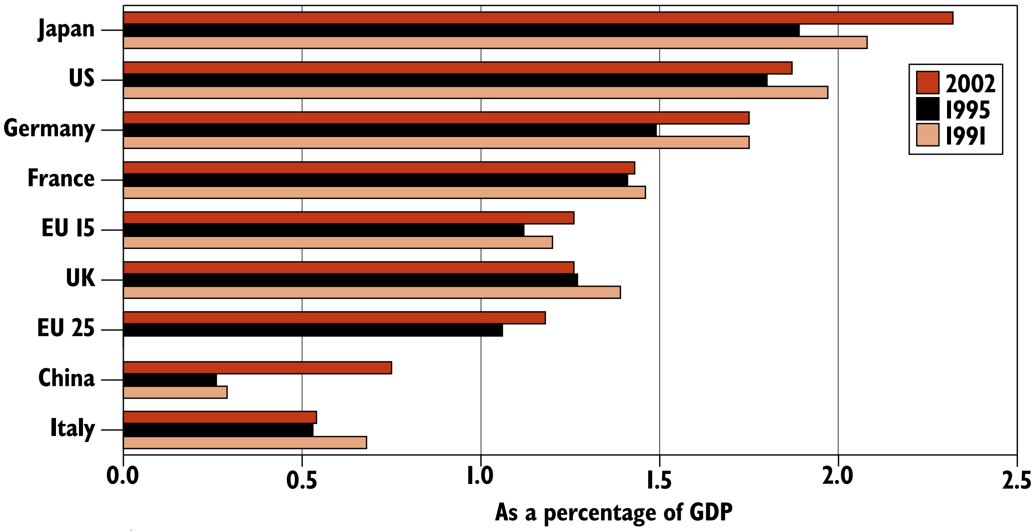
- refocusing and improving the delivery of EU support for R&D, including through the EIB, to raise the Union's capacity to conduct the very best basic research and to improve industrial competitiveness. The allocation of EU funding must be based on excellence and be driven by the research needs of businesses. Community support programmes should also be underpinned by a dedicated stream of funding for basic research, managed by an independent European Research Council;

- ensuring that national and Community funding for R&D supports knowledge transfer and stronger links between science and industry. Businesses rely on a variety of knowledge sources as inputs to the innovation process and effective collaboration and information flows between businesses and universities therefore has an essential role to play in fostering innovation and the commercialisation of research activity;

- ensuring that national education and training strategies address the skills needs of innovative and high-tech businesses. In particular, Member States must increase their efforts to popularise scientific activities and encourage more young people to take up professional careers in science; and

- comprehensive reform of Europe's costly and inefficient system of intellectual property rights to improve incentives to innovate, create market opportunities for science-based firms and facilitate technology diffusion. Patenting across the EU through the European Patent Office is currently up to five times more expensive than under the US system, and twice as slow, contributing to a substantial shortfall in innovative activity.

Chart 4.4: Business expenditure in research and development, 1991, 1995 and 2002



[1] 1991 value is EU 15 expenditure on business R&D.
Note: constant USD, 1995 PPPs.
Source: OECD Science, Technology and Industry: Outlook 2004.

A DYNAMIC AND COMPETITIVE SINGLE MARKET

4.25 The challenges set out in chapter 3, and in particular the likely shift in the balance of global economic activity and increased potential for specialisation and relocation, increase the need for a dynamic and competitive Single Market in Europe. This will not only allow Europe to realise the full potential benefits of the Single Market as a source of growth and jobs, but also be an important factor in increasing the attractiveness of the EU as a centre and destination for economic activity. The Single Market remains one of Europe's defining economic achievements and demonstrates the economic benefits of opening markets to competition. However more needs to be done to ensure those benefits are translated into improved economic performance on the ground.

EU trade in services

4.26 A huge potential source of growth and prosperity in the EU that remains untapped is cross-border trade and provision of services. As set out in Chapter 3, the potential for international trade in services to increase, spurred by rapid technological change is great. The same is true within Europe. The services sector already accounts for 70 per cent of EU GDP but its share of EU employment is still less that in the US, and services only make up 20 per cent of EU trade. Indeed according to the High Level Group chaired by Wim Kok[8], Europe remains fragmented into separate national markets, many of which are essentially closed to external service providers. Removing barriers to open up markets to trade in services, both within the EU and between the EU and the rest of the world, must be a priority.

A new strategic focus

4.27 Looking further ahead, global economic integration demands a new strategic focus to the development of the Single Market. Existing regulation to open up markets has served the Union well and the priority must be to ensure even and effective implementation by all Member States. But with many markets now global and the pace of economic change faster than ever before, Europe must increasingly look beyond the rigid confines of regulation to more flexible, economics-based and non-regulatory instruments for delivering a Single Market that supports the needs of business. This requires that competition policy is enforced pro-actively and that the EU's state aid rules work efficiently to tackle protectionist subsidies which inhibit competition:

- Despite various agreements to liberalise European markets, many studies have shown that competitive pressures remain weak in a number of key sectors. Indeed, the OECD[8] estimate that restricted competition could be reducing productivity by double-digit percentages in some EU markets. The pro-active enforcement of competition policy, prioritised on the basis of economic significance, is key to unlocking these benefits. This should be based on the use of sectoral enquiries to identify barriers to competition in European markets and must focus on removing impediments to competition and preventing incumbents from raising new barriers to entry or pursuing restrictive strategies.

- The state aid rules should allow Member States to grant aids to tackle market failures in their economies in support of enterprise and innovation. But businesses that are sheltered from competition in their domestic markets are unlikely to be able to cope effectively with the rigours of international competition and the state aid rules must also ensure that misplaced concerns over changing patterns of economic activity are not managed through the

[8] Report by the High Level Group, November 2004, op cit.

[9] OECD, (2002). *Product market competition and economic performance*.

inefficient use of public subsidy to create national champions. Further action is required to strengthen the state aid framework to deliver tighter control over distortive aids.

Towards a new strategic approach

4.28 Financial services and public procurement provide good examples of where non-regulatory solutions are the best route for ensuring dynamic and competitive markets. In both areas there is now a comprehensive stock of regulation in place designed to open up markets and deliver the benefits of competition to governments, business and consumers. Looking forward, further action to integrate and strengthen competition in these sectors should be based on the strategic development of non-regulatory approaches:

- an effective and integrated EU financial services market is one of the key pillars of the Single Market, and will benefit the European economy by reducing the cost of capital, providing firms with increased opportunities to access markets in other Member States and giving customers access to a wider range of competitively priced products. With adoption of the legislative programme under the Financial Services Action Plan (FSAP) almost complete, the challenge now is to ensure that the FSAP delivers the integrated financial services market it is designed to achieve. The focus should now be on improving implementation and enforcement of existing legislation and monitoring the degree of integration achieved. Future action should make greater use of alternatives to legislation including the pro-active use of competition policy, and strengthening regulatory cooperation by making the Lamfalussy arrangements work well. As a rule, future regulation should only be considered in circumstances where comprehensive consultation and cost-benefit analysis, including of the impact of regulation on the external competitiveness of EU financial services providers, shows it to be absolutely necessary[10]; and
- despite the existence of regulation governing the award of public contracts, the Wood Report[11], published in November 2004, highlighted that significant obstacles to competition remain in EU public procurement markets as a result of complex public procurement practices, unfair national preference and uneven commitment to competition and liberalisation. To overcome such problems, action is needed to identify and spread best practice among Member States, to compare national approaches and outcomes including through the use of scorecards, and to raise the skills of procurement practitioners in Member States.

Ensuring tax policy enhances competitiveness

4.29 Globalisation also demands that we consider how we can ensure that our tax systems adapt to new challenges. The UK Government believes that Member States should work together on the modernisation of the VAT regime to ensure that the growth of e-commerce does not undermine the Single Market by creating distortions between international and domestic distributors and producers. But there are other aspects of tax policy, such as the rate and base for corporation tax, where tax competition among governments is the most effective way to ensure that tax policy supports specific economic reforms, provides value for money and fosters competitiveness in the Single Market. Fair tax competition is the best approach for a competitive Europe.

[10] See, *After the EU Financial Services Action Plan: A new strategic approach*, HM Treasury, FSA, Bank of England, May 2004.

[11] Alan Wood, *Investigating UK business experiences of competing for public contracts in other EU countries*, November 2004.

AN OUTWARD-LOOKING EUROPE

4.30 Europe has met the challenges of the past through focussing particularly on internal policy reform. As set out in the 2004 Trade and Investment White Paper[12], the fourth challenge is for Europe to resist the temptation to fall back on outdated protectionist policies and instead to be more outward-looking. It must take advantage of new trading and investment opportunities to boost growth and productivity, and ensure the benefits of globalisation are shared by all. The EU therefore needs to develop more outward-looking policies, and in particular to:

- lead the way in achieving an ambitious and pro-development outcome to the Doha Development Agenda Round of WTO negotiations (DDA); and
- enhancing its bilateral economic relationships with rapidly growing emerging economies and its largest trading partner, the US.

4.31 Although EU Member States are already well integrated into the world economy, the discussion of sources of recent trade growth and FDI flows in Chapter 3 suggests there is ample scope for Member States to benefit further from increased trade and from attracting more FDI, particularly with respect to emerging markets. Although China has become an increasingly important external trading partner, with the share of extra-EU trade going to China more than doubling since 1990[13], shares of EU trade with India and other emerging East Asian nations are little different to a decade ago. In particular, EU companies could do more to take advantage of opportunities to invest in fast-growing Asian markets. For instance, whereas Asian emerging markets were the destination of 12.3 per cent of US foreign investment between 1999 and 2002, the corresponding share for the EU was only 5.2 per cent.

The costs of protectionism

4.32 External openness to trade and investment has the potential to make a vital contribution to economic performance, by reinforcing the drivers of productivity and growth[14]. It can play a significant role in raising the long-term sustainable rate of productivity growth in the economy by: encouraging a more efficient allocation of resources across countries; providing greater opportunity for economies of scale; improving incentives for, and rewards from, innovation; fostering more competitive markets; providing access to new technologies; and reinforcing incentives for investment and encouraging more Foreign Direct Investment (FDI).

4.33 Failure to open up markets imposes significant costs. Estimates suggest that existing barriers to external trade and investment, such as tariffs, quotas and restrictive standards could cost consumers up to 7 per cent of EU GDP, or around €600-700 billion a year[15]. The costs of protectionism are particularly high in agriculture with the Common Agricultural Policy (CAP) costing the EU public some €100 billion each year, or around €1,000 a year for the average family of four[16]. The OECD has recently identified CAP reform as a priority to boost growth in Europe[17]. The CAP also inhibits economic development in some of the world's poorest countries.

[12] DTI (2004), *Making globalisation a force for good*. Trade and Investment White Paper, Cm 6278, July 2004.

[13] Source; Eurostat – share of trade as a percentage of total extra-EU15 trade: 1990 = 2%, 2001 = 5.3%.

[14] The spring European Council 2004 noted that *'increasing external openness globally and improving the dynamic economic relationships between trading partners will enhance growth prosect'*.

[15] Patrick A. Messerliin, 'The real cost of European protectionism', Institut d'Etudes Politiques de Paris and Group d'Economie Mondiale de Sciences Po (2001).

[16] OECD, *Agriculture Policies in OECD Countries at a glance* (2004).

[17] OECD, *Going for Growth*, (2005).

Multilateral trade reform

4.34 The gains from liberalisation will be greatest if trade barriers are reduced in a multilateral context. The framework for continuing the DDA negotiations agreed in July 2004 offers a vital opportunity to make real progress in global trade liberalisation and significant progress towards an ambitious agreement is needed at the Ministerial meeting to be held in Hong Kong in December 2005. An agreement must offer real improvements in market access, while recognising and addressing the specific constraints on developing countries. The EU must show increased flexibility in advance of the WTO Ministerial in Hong Kong in order to lead the Doha Development negotiations towards an ambitious and pro-poor agreement.

4.35 An ambitious agreement in the DDA that reduced distortions and increased market access to developed country markets, as well as South-South trade, would also provide a significant boost to long-term economic growth and development in developing countries, lifting millions of people out of poverty and making an important contribution towards the achievement of the Millennium Development Goals. The World Bank[18] has estimated the gains from a good agreement, as set out in table 4.1 below; gains that could lift 140 million people out of poverty by 2015.

Table 4.1: Real income gains in 2015, in $ 1997 billion

	Gains to lower and middle income	Gains to high income countries	Global gains
Agriculture and food	240	117	358
Manufacturing	108	48	156
All merchandise trade	349	169	518

Source: World Bank.

4.36 However, developing countries must have the flexibility to appropriately sequence trade reforms into their own development and poverty reduction strategies, and need assistance to build trade capacity so that they can benefit from greater market access and develop the infrastructure to produce and deliver goods to international markets competitively – the UK has proposed that this be financed through the International Finance Facility. Action is also needed to address seriously the short-term transition costs that some countries will face to ensure that the most vulnerable people are protected as they adjust to more open markets.

The Common Agricultural Policy

4.37 Freer agricultural trade would be a big step forward in promoting fairer trade. Aid flows to the developing world amount to approximately US$60bn a year, yet subsidies to farmers in developed countries are six times greater and equivalent to the entire income of sub-Saharan Africa. The CAP has done much in the past to fulfil the Treaty's aims for EU agriculture, and recent reforms mark an important improvement. But the CAP is still not right for Europe or for the world. It distorts the EU economy, it distorts international trade, it inhibits economic development in some of the world's poorest countries and, as already set out, it is very costly to the EU. Half these costs are still in the form of the most trade distorting market price support, whilst only a fraction is targeted on securing wider societal (e.g. agri-environmental) benefits. On the basis of the most conservative estimate cited by a recent European Commission paper[19], the CAP will leave the EU over $120 billion poorer over the seven years of the next financial perspective than it would otherwise be.

[18] World Bank (2003), *Global Economic Prospects 2004: Realising the Development Promise of the Doha Agenda*, Washington DC, 2003.

[19] '*Economics of the common agricultural policy*', European Commission Economic Papers, Number 211 (2004).

4.38 Our long term vision for EU agriculture is for an industry which is fundamentally sustainable and fully integrated with the European and world economy, internationally competitive without reliance on subsidy or protection, rewarded by the market for its outputs, not least safe and high quality food, but also by the taxpayer for producing benefits for society and the environment that the market would not otherwise deliver.

4.39 The EU should continue to reduce trade-distorting domestic support, extending and deepening recent reforms, and should agree to further significant reform, particularly of the sugar and dairy regimes, so that the effect of quotas and tariffs is substantially reduced and export subsidies are no longer an issue for world trade by 2010. All tariff peaks should be reduced towards the maximum level for non-agricultural products.

Effective international cooperation

4.40 As global economic integration intensifies, differences in regulatory approaches and standards, so-called behind-the-border barriers to trade and investment, are increasingly the most significant impediments to doing business with major economic partners[20]. Overcoming these obstacles, and ensuring new barriers are not created, requires cooperation among policy makers and regulatory bodies. Effective international regulatory cooperation in areas such as financial services is an important challenge if Europe is to realise the benefits of globalisation. International cooperation is also required to tackle the problems of tax evasion and avoidance that can arise as markets become increasingly global. The right approach is international exchange of information between tax authorities, supported by national measures to ensure profits and income are taxed in the right place. The EU should fully support the OECD's work to develop international standards for transparency and exchange of information in national tax systems, and expand participation to a wider group of countries, reflecting the emergence of developing economies.

Strengthening EU-US cooperation

4.41 Closer transatlantic economic cooperation is a particular priority, given the size of the relationship and the depth of integration. The EU and US are each other's most important economic partners with transatlantic commercial relations, based predominantly on FDI, worth over $2.5 trillion per year and supporting 12 million jobs on both sides of the Atlantic. Important regulatory and other barriers still remain and it has been estimated that closer cooperation to remove barriers could boost EU GDP by up to 2 per cent per year[21]. The importance of enhancing cooperation in key areas such as financial services has been recognised by Heads of State with a call for a new forward-looking EU-US cooperation strategy due to be launched at the 2005 EU-US Summit.

Dialogues with large emerging markets

4.42 It will also be important to pursue dialogues with other key partners and emerging economies such as China and India to minimise the potential costs of regulatory barriers as our economies become increasingly integrated. The UK has recently agreed a five-point plan to strengthen cooperation with China in financial services and is also pursuing a new UK-India dialogue on financial services which will include senior business practitioners.

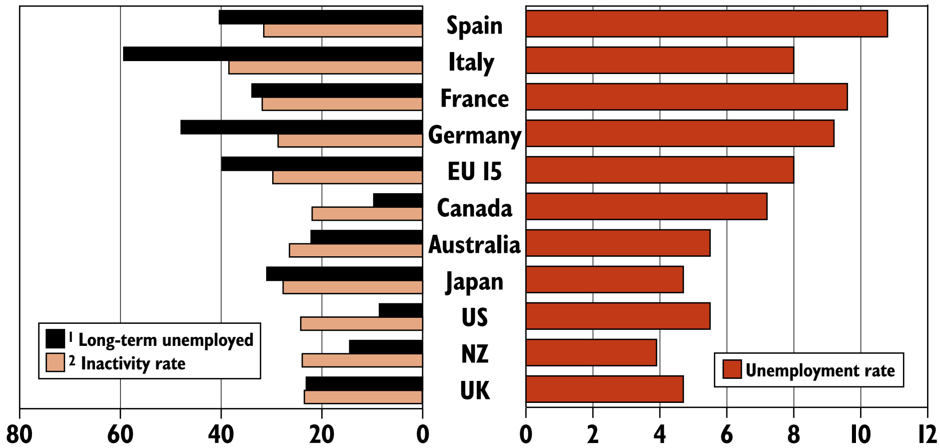
[20] The need to address international regulatory cooperation is recognised in Commission President Barroso's Communication to the Spring European Council, '*Working together for Growth and Jobs: A New Start for the Lisbon Strategy*', European Commission, Brussels, February 2005.

[21] Vandenbussche, Wooton and Venables, '*Enhancing Economic Co-operation Between the US and the Americas: An Economic Assessment*', CEPR, HM Treasury and Netherlands Ministry of Finance, 2002.

DELIVERING SUSTAINED EMPLOYMENT GROWTH AND SOCIAL COHESION

4.43 The fifth challenge is for Europe's labour markets and welfare systems to be able to cope with rapid technological and market changes. This is important both to realise the economic benefits that come from global integration and to ensure that Europe delivers on its commitment to social justice and social cohesion. Raising employment and increasing skill levels are critical to achieving both aims, and will require action to improve education and training as labour markets are more flexible and inclusive. As set out in Chapter 3, the fact that Europe's labour market is already under-performing, particularly in respect to unemployment levels (see Chart 4.5 below), heightens these challenges. This is confirmed by the recent OECD report on structural policy priorities[22].

Chart 4.5: Unemployment rate, inactivity rate and long-term unemployed



[1] *Long-term unemployed (in excess of 12 months) as percentage of total, based on 2002 data.*
[2] *Percentage of persons aged 15-64 years not in employment.*
Source: OECD Structural Indicators, OECD Employment Outlook 2004.

4.44 The original Treaty of Rome recognised that markets are social structures and work best when there is an explicit social dimension – when enterprise is matched with fairness. However, while Europe's social objectives are still highly relevant, the means of achieving them needs to be radically updated. The old European model, drawing heavily on the experience of the small group of founding member states, typically rested on providing high levels of social protection, and on a harmonizing approach. Neither of these will work in a more global environment, or in the more diverse circumstances of the European Union today. Social and labour market policies need to accept that change is an inevitable and essential part of the modern economy, and must be geared towards facilitating it and managing its consequences.

[22] OECD, *Economic Policy Reforms: Going for Growth*, March 2005.

Matching flexibility with fairness

4.45 As described in Chapter 3, creating flexibility in the labour market, while providing opportunities for all to participate, must be at the centre of the approach: if markets and individuals cannot adapt to change, exposure to foreign competition in new markets and new technologies may result in falling relative earnings or long-term unemployment, particularly among lower-skilled workers. Adaptable labour markets, in combination with providing active and responsive welfare systems which support household incomes while maintaining incentives to work and save, can both equip economies to change and protect social cohesion.

4.46 In the past the tendency has been to support state monopolies or long-established national industrial champions at the expense of new enterprise; only to protect employment rights for prime-age skilled workers while the old and young find it hard to find work; or to build employment legislation mainly around a full-time work pattern that does not recognise the increasing problem of supporting those who balance work with caring responsibilities.

4.47 However, a more forward-looking approach – one that accepts change and puts strategies for managing change at its centre – is increasingly recognized by Europe's policy makers, building on the recommendations of the November 2003 European Employment Taskforce report[23] which set out a clear strategy for labour market reform in Europe. The recent European Commission communication to the Spring European Council also summarises it well: "*The opening of international markets and the strong growth of newly industrialising economies will make a significant contribution to growth and jobs. However, this will only happen if we can ensure a deeper and more rapid process of structural adjustment of our economy to reallocate resources to sectors where Europe has a comparative advantage.*"

Investing in skills

4.48 Skills strategies must be placed at the heart of social provision, both to increase the ability of individuals to adapt to change and to meet the likely increase in demand for skilled workers. The effects of globalisation – increased international competition and rapid technological change – mean that new skills are continuously needed. Skills that were once regarded as high-level such as ICT literacy are now increasingly viewed as basic skills. Alongside action to promote opportunity and incentives to work, Member States must therefore invest more, and more effectively, to raise the skills of young people entering the workforce from the education system and to tackle skills gaps of those already in the workforce. Effective strategies for lifelong learning will be particularly important to enable individuals to update and extend their skills regularly during their working life so that they can move quickly between firms and sectors in response to changing economic circumstances.

4.49 As illustrated in Chapter 3, skills gaps differ widely across Member States. Country-specific responses will therefore be needed that focus on particular needs to facilitate increased labour market participation. A number of Member States have recently introduced reforms to improve skills levels. For example there have been new measures to promote vocational training in Hungary, modernisation of education and vocational training systems in Portugal, and France has put in place a new social cohesion plan which extends training and apprenticeship opportunities to the young and excluded. However, in the face of global changes and the increasing skills levels in large emerging markets, promoting skills in Europe remains a priority.

[23] European Employment Taskforce, *Jobs, Jobs, Jobs: Creating More Employment in Europe*, November 2003.

Modernising the welfare state

4.50 Many European countries are engaged in reforming tax and benefit systems as part of ensuring that the welfare state is fit for purpose in a more global environment. Key principles are to ensure that rights are matched by responsibilities; tax and benefit systems work together to support work incentives, while also providing adequate protection for those that cannot work; and that active help, advice and support is provided for people seeking work, particularly those who have been jobless for some time. Flexibility and choice also needs to be available for those balancing work and family commitments. Ensuring the availability of good, affordable childcare is increasingly recognised as an essential pillar of the modern welfare state.

4.51 In pursuing these broad aims, the framework of European economic policy coordination offers Member States opportunities to learn from best practice elsewhere. In certain areas, such as common entitlements to holiday pay and maternity leave, European action has been helpful in establishing a common policy framework, providing a solid foundation of minimum standards to protect the rights of workers, and support the integrity of the single market. But in most areas the key tools of labour market and social policy – tax, benefits, education and skills – remain the responsibility of Member States. This is right not only to ensure proper accountability to the citizen, but also so that policy solutions deliver the outcomes that are intended. Social policy challenges rarely suit a one-size-fits-all approach: they manifest themselves to varying degrees in different countries; institutional contexts are often quite different across member states; and national or regional governments are usually better placed to ensure a quick response to changing economic circumstances.

ENHANCING ENVIRONMENTAL SUSTAINABILITY

4.52 With the global economy set to expand by 40 per cent over the next decade, driven in particular by strong growth in the emerging economies, significant pressures will be placed on global resources and on the natural environment. Expanding demand is likely to have economic impacts on the supply and price of critical resources, particularly energy. Moreover, there will be a range of 'external' effects caused by the interaction of economic and natural processes, such as air and water pollution, biodiversity loss and, potentially most damaging of all, climate change. This presents a serious challenge to governments, to businesses and to individuals.

4.53 As set out in Chapter 3, European and other G8 countries account for over half of current emissions, and have been the source of a very significant proportion of the carbon emissions over the past 200 years that have generated the problem of global climate change. Therefore, although comparative rates of economic growth mean EU emissions will rise more slowly in the coming years than in other regions, Europe, with other developed countries, bears a critical responsibility.

Energy challenges

4.54 All economies, including those in Europe, are now facing the linked challenges of energy security, rising energy prices and climate change. These challenges all point in the same direction: the need for an increased emphasis on energy efficiency and on the decarbonisation of energy sources. Achieving these goals, in a way that enhances growth and competitiveness, will require, first, the development and use of the most cost effective policy mechanisms, and second a coordinated international policy framework.

4.55 Improving energy efficiency in Europe should be seen as an opportunity to improve the productivity of the economy and of individual businesses. As the High Level Group chaired by Wim Kok emphasised in its report on the Lisbon strategy,[24] environmental

[24] Report by the High Level Group chaired by Wim Kok, op cit.

innovation can create new markets and increase competitiveness through greater resource efficiency and new investment opportunities. Governments' role is to ensure effective policy levers are in place and that barriers are removed to encourage the development and commercialisation of new eco-efficient technologies and products.

4.56 Environmental policy goals can often be achieved most effectively through non-regulatory means such as the use of economic instruments[25], which generate least-cost responses and stimulate technological innovation. Europe has already taken an important lead in developing market-based solutions through the recent introduction of the EU emissions trading scheme (EU ETS). Phase One of the EU ETS should help Member States move towards their legally-binding Kyoto targets; it is important that Phase Two helps to ensure that these targets are met. In view of the significant contribution that aviation emissions make to total greenhouse gas emissions, the UK Government is committed to the inclusion of intra-EU aviation in the next phase of the EU ETS.

Multilateral action

4.57 International action beyond the EU is also essential to tackle climate change. The current international policy framework for doing this is the United Nations Framework Convention on climate change which underlies the Kyoto Protocol, establishing legally binding targets for reducing greenhouse gas emissions for developed countries and economies in transition. However, the USA, which produces 24 per cent of all global greenhouse gas emission has not ratified Kyoto, and the Protocol does not require emission reductions or reductions in the increases in emissions from emerging economies. Looking beyond 2012, when the current Kyoto commitment period ends, further action will be required.

4.58 Just as the EU played a leadership role during the negotiations and ratification of the Kyoto Protocol, most recently through encouraging Russia to ratify, so it should continue to play a leadership role in developing the post-Kyoto framework. Therefore, in addition to taking further action to ensure the EU 15 meets its target of reducing emissions by 8 per cent by 2012, Europe should consider establishing longer-term greenhouse gas emission reduction targets and agree an ambitious EU mandate for UN negotiations on post-Kyoto action in November. The Kyoto framework already introduces international carbon trading, through the Joint Implementation and Clean Development mechanisms. The UK will continue to press for the development and implementation of an international emissions trading regime, building on the example of the EU ETS. In addition the EU and EU businesses have a particular opportunity to work with the emerging economies such as China and India in support of their investment strategies in lower-carbon energy generation and energy efficiency.

CONCLUSION

4.59 This chapter has set out the long-term policy priorities for Europe if it is to respond to the challenges and opportunities of global economic change. Helping to address these challenges and opportunities will be an important part of the Government's approach to the UK Presidency of the EU in the second half of 2005, building on progress made in the G7/G8 in the first half of the year. However, meeting these policy challenges will require sustained action over the long term, well beyond the six months of the UK's Presidency of the EU. Just as Europe has advanced the regulatory reform agenda through an initiative spanning six Presidencies, the UK will be working closely with other Member States and the institutions of the EU to take up these challenges in the years to come.

[25] For further discussion of the potential role of economic instruments see *'Tax and the Environment: Using Economic Instruments'*, HM Treasury, 2002.

Priorities for the UK's Presidency of the EU

4.60 Whereas in the past Europe has tended to focus on internal policy issues, most recently on the single market project, it must now build on the historic achievement of enlarging the Union from 15 to 25 Member States, and turn outwards. The Government will aim, through the Presidency and beyond, to develop a consensus on the need for a more Global Europe: a Europe which by becoming more outward-looking and embracing greater flexibility in labour, product and capital markets, delivers high employment for its citizens. At the same time a Global Europe must step up to its responsibilities to take action to reduce international poverty, advance fairer trade and support the drive to tackle global climate change.

4.61 During the six months of its Presidency of the EU, the Government will work closely with the Commission, the European Parliament and other Member States, including through the ECOFIN Council, to tackle the long-term policy challenges this chapter has identified. In particular, it will seek to make progress in the following areas, building on on-going work under the Luxembourg Presidency:

- Fostering enterprise and innovation in Europe: driving forward the regulatory reform agenda to improve the quality of Commission impact assessments and to simplify and reduce burdens in the existing stock of regulation;
- Creating a more dynamic Single Market: working to achieve progress on a single market in services; and towards a future strategy on financial services which focuses more on implementation and enforcement of existing legislation and use of non-legislative alternatives such as pro-active competition policy;
- Promoting high employment across Europe: encouraging further action by Member States to develop and implement active labour market strategies to help the unemployed and inactive find work and policies to raise skills levels and improve adaptability among the workforce;
- Creating a more outward looking Europe: encouraging the EU to show leadership on fairer trade to work towards an ambitious and pro-poor agreement in the Doha Development Agenda WTO negotiations; and strengthening bilateral economic relations, particularly with the US, through a new EU-US economic cooperation partnership; and
- Encouraging Europe to play a leadership role in meeting global challenges: increasing resources to help meet the Millennium Development Goals; and tackling climate change.

4.62 This paper has set out how Europe succeeded in facing up to the economic challenges of the last 50 years, recognising the need for change and adapting its policies and institutions in response to international economic developments. It must now rise to the new set of long-term challenges driven by far-reaching global economic trends, which have significant implications for Europe. By addressing the long-term policy priorities set out in this paper, Europe can once again ensure the needs of its citizens are met, and take advantage of the opportunities of global economic change.

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