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Real Competitive Advantages In The Single Currency Europe

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**40th Congress of the European Regional Science Association
Barcelona, 29 August - 1 September 2000**

**REAL COMPETITIVE ADVANTAGES
IN THE SINGLE CURRENCY EUROPE**

by

Paolo Guerrieri and Salvatore Rossi

Abstract

The euro era has just begun, and Europe is at a delicate juncture: low economic growth, high unemployment rate, competitive decline with respect to the rest of the developed world, regional disparities. This work focuses on some long-run, structural aspects of the European disease. They are assessed in the framework of globalization and integration. Residual differences among national/regional systems fuel systemic competition, a difficult notion to define and to analyze in economic terms. The paper shows that it can be given a very precise analytical content, provided that the balance of payments be recognized as the appropriate competitive arena. Though integration will most likely strengthen Europe's competitive position in the world, the paper questions its potential for improving internal cohesion: the galaxy of European local economies seems rather stuck in a trend of progressive rarefaction, or dis-integration, which may accentuate as the political project of real and monetary integration continues. But if cohesion is jeopardized, then structural competitiveness is as well. Since the European disease is caused by delays in adjusting economic structures to changes in the world scenario and to the lack of connections between regional economies, Europe needs coordinated policies aimed at stimulating and diffusing technological and organizational innovation, communication networks and systems in order to optimize the use of productive factors on a continental scale.

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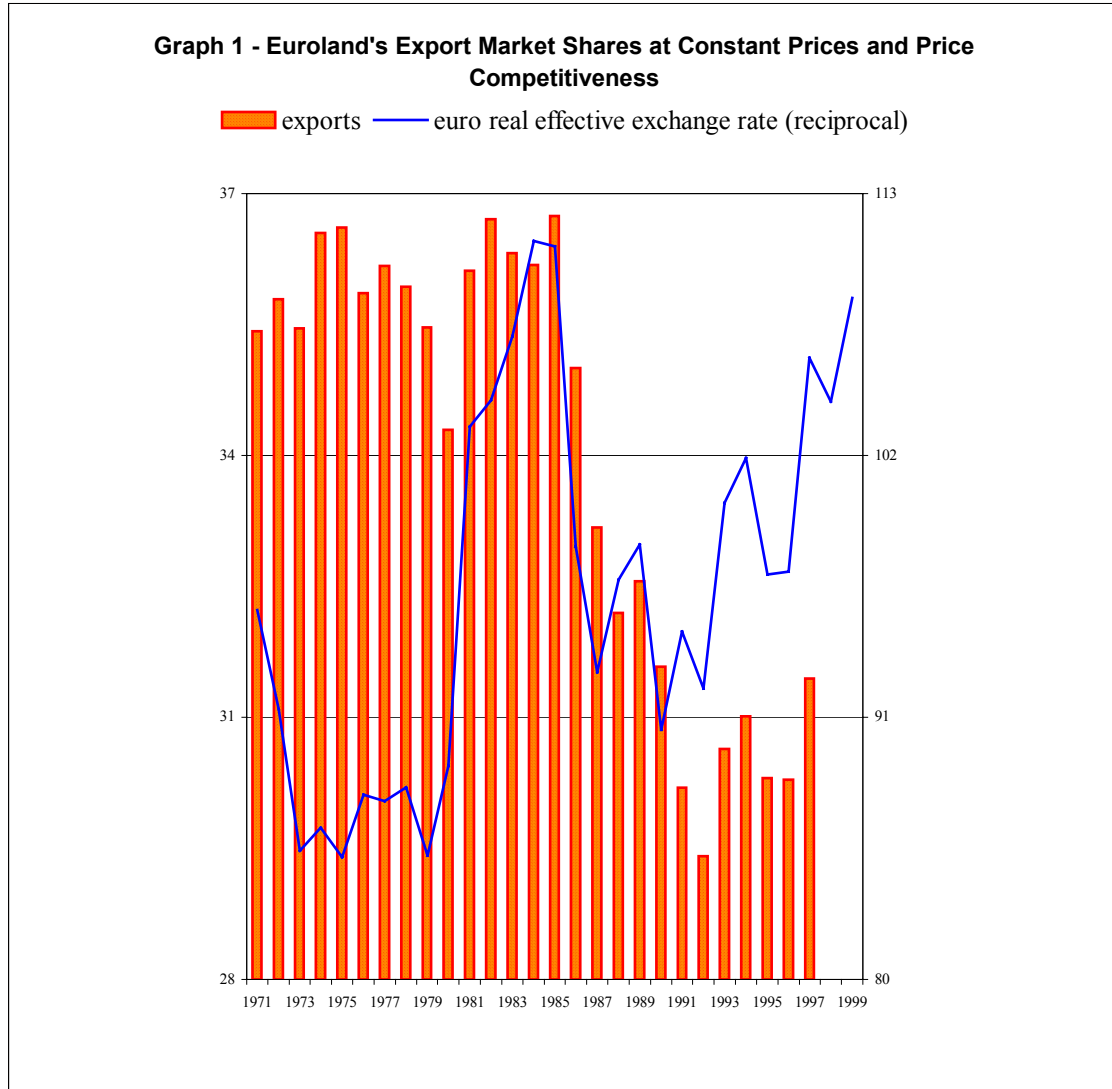
1. Introductionⁱ

The start of a “euro era” will entail deep consequences for the European continent, partly not yet explored. The creation of a single currency in a supranational area has practically no precedents in the history of modern economies. Which long-term effects will it produce on the economic and political behavior of both individuals and territories is still a matter of conjectures.

Under a strictly economic point of view, preconditions and effects of monetary unification have been mostly discussed in a macro framework. The links with the process of "real" integration have been less studied, in spite of the eight years already elapsed since the formal completion of the European Single Market project. For the time being, the introduction of euro has mainly stirred up speculations about the appropriate level of its nominal effective exchange rate. The sharp devaluation of the euro after the inception of the new exchange rate regime had raised worries about its prospective international role as means of payments and reserve currency. Any signal of a possible recovery, in contrast, raises worries about the international competitiveness of European products. The latter seem largely overstated, in our view. The trade openness of Euroland, though significantly increased in the nineties, is much less pronounced than that of each of the participating countries, and has the same order of magnitude as that of Japan and the USA, around 20%. But even if one thought, as we do, that the degree of openness of the euro area will tend to grow further, exposing its productive system to increased competition from producers of other areas (both old competitors and newcomers in the international trade arena), it is highly questionable that the exchange rate will play the decisive role.

A quick look at graph 1 can help to set this point. The real exchange rate of euro, computed back to the early seventies on the basis of ECU parities and national producer prices, does not seem to have much influenced Euroland's market shares at constant prices (graph 1 shows a proxy of such variable) during the last three decades. The correlation appears particularly weak in the most recent years, signaling the increasing relevance of non-price factors. Analogous evidence for the USA

would show a much stronger correlation. Therefore, what should matter most in connection with monetary unification and the integration process in Europe is the impact on structural competitiveness.



European integration is viewed here as a single complex process, simultaneously involving the real side of the economy, money, finance, and institutions, with mutual interactions. Our analysis will focus on real economies, though, in the belief that real market integration remains the core of the European construction, while developments on the monetary side can just speed it up, but can not change its essential nature and expected outcomes. The hypothesis discussed here is that *integration* of markets and institutions in Europe may go hand in hand with a *disintegration* of the participating economies. This, in turn, would pose a problem of *real competitive advantages and disadvantages* for the area as a whole and for each

national economy belonging to the area. These advantages and disadvantages would essentially have a *structural* nature. Macroeconomic developments and policies may be important at times, but what should really attract the attention of analysts and policy-makers is the systemic environment in which production and trade take place.

This is the kind of issues this paper wants to address. These are not totally new ideas, of course. But we intend to explore them in a thorough way, starting from a survey of the diverse strands of theoretical literature that have dealt with the issue.

In paragraph 2 we will sketch the two main factors for change of the last decade: the start up of an euro age, and the completion of the European Single Market. Such epoch-making events have given new fuel to the old debate on structural competition among nations: its nature, its economic sense, the places where it develops and the ways in which it operates, the instruments territories can use to foster their competitive advantages. In paragraph 3 this debate is reviewed, and an eclectic theoretical approach to structural competitiveness is proposed. Paragraph 4 investigates the overall competitive performance of Europe in both the product market, focusing on trade specialization and on firms' internationalization patterns, and the location market, scrutinizing divergence-convergence trends between European nations (regions). Paragraph 5 presents some conclusions and policy implications.

2. Monetary and real integration in Europe: effects on the real economies

The possible short- and long-term effects of the introduction of the euro on participating countries' real economies have been extensively explored in the theoretical literature.

A well-known *microeconomic* argument in favor of a common currency is based on "network externalities": the utility, for an economic agent, of a medium of exchange lacking intrinsic value is proportional to the probability of its acceptance by another economic agent in exchange for goods and services possessing an intrinsic

value (Dowd, Greenaway, 1993). It is, therefore, proportional to the *number* of agents willing to accept that medium of exchange. The coexistence of many currencies, though mutually convertible, generate transaction costs. In addition, if exchange rates are flexible, the uncertainty related to their fluctuations implies an additional cost for a risk-averse investor.

Macroeconomic costs and benefits of a common currency, compared to a multi-currency system, have been assessed essentially looking at the way in which the economies joining a monetary union would respond to shocks. The question is whether a national economy hit by a shock could benefit from the availability of a national monetary policy and from exchange rate flexibility. If the shock is financial (nominal), its impact on flexible nominal exchange rates would cause a (temporary) shift in the relative costs/prices of that economy, compared to other economies, “unnecessary and harmful from the standpoint of the ‘real fundamentals’, and a source of real, albeit temporary, adjustment costs” (Buiter, 1997). In such cases, a common currency regime is undeniably superior. If, instead, the shock is real, the literature on optimum currency areas does attribute a merit to a multi-currency regime with flexible exchange rates. The argument in favour is very well known and we need not discuss it here.

A third category of real effects of EMU has to do with the *strategic interactions* between European countries in international trade. The question goes more or less like this: a common currency in Europe is the necessary complement of the single market, since it assures that the allocative benefits of the latter are not compromised by strategic trade policies fomented by exchange rate fluctuations. In fact, such fluctuations, even when due to endogenous volatility, considerably alter the competitive positions of member countries’ firms, and may generate in one or more countries unmanageable action-reaction chains in the “public opinion-electorate-political class-government” circuit: suspicions of (aggressive) competitive devaluations by some partners could proliferate and exert irresistible pressure on other partners to adopt protectionist retaliation measuresⁱⁱ. EMU has placed Europe definitively beyond the reach of such risks, allowing it to freely enjoy the fruits of the completion of the Single Market.

The Single Market has been the chief catalyst of the recent deepening of real integration of Europe. Since January 1993 it has worked to eliminate many of the residual barriers within the European area, accelerating thereby trade and production integration of the traditional type (“shallow integration”). But it has also brought about the most advanced experiment in what has been defined “deeper integration” (Lawrence, 1996; Lawrence et al., 1996) so far. The effects have been both a closer interaction-competition among national institutional and regulatory systems, with significant cross-cutting effects on the strategies of firms and on national economic policy choices, on one side, and a broad convergence of different national structures, on the other.

Various economic effects of the Single Market have been studied: reallocation of resources among countries and sectors; overall reduction in the degree of monopoly across markets; higher production efficiency; greater institutional convergence (Pelkmans, 1997).

The first effect is the most well known and is at the core of the traditional theory of trade integration with perfect competition: assuming that trade creation more than offsets trade diversion, integration can actually increase welfare in all member countries. The increased market size plays no significant role here. Instead, if imperfect competition is assumed (economies of scale and/or differentiated products), the level of demand, and hence the size of the market, become the central factors. Net gains from integration for the whole area are thus far greater than those predicted by the traditional theory, being essentially dynamic: greater efficiency in the integrated area, which may lead, through increased saving and investment, to higher capital accumulation and production at the macroeconomic level (Baldwin, 1989); dynamic scale economies induced by cumulative specialization and learning-by-doing, which increase the long-term rate of growth of productivity in the member economies (Grossman and Helpman, 1997; OECD, 1996). However, as shown by several studies on endogenous growth (Grossman and Helpman, 1997), it is the linkage between dynamic scale economies and production specialization that allows integration to have a positive impact on long-term growth in the countries involved. Such impact may find limits in the degree and content of specialization of

each economy: efficiency gains will be the lower the higher the degree of sectorial specialization already achieved in the integrated area; they will be relatively modest in size if the economy's specialization is characterized by low technological opportunities and learning elasticities (Hansen and Nielsen, 1997). As a matter of fact, the current European specialization appears strongly characterized by these features. Furthermore, low technological and learning-inducing activities are concentrated in southern countries and regions, with strong implications for the geographic distribution of dynamic gains potentially deriving from integration.

In addition to that, the European Single Market is also, as we noted before, a pioneeristic case of deeper international integration, in which not only firms and markets but also national institutions and structures are affected, both converging and competing (Lawrence et al., 1996). Costs and benefits of integration in Europe must also be read in this perspective. A relative convergence of national structures and the increase in market contestability, both consequences of integration, make strategic decisions by firms - for example, on the localization of new activities - even more dependent on the residual differences in national and regional institutional settings. In other words, the more countries become similar to each other, the more important become the residual factors - *in primis* institutions - which continue to differentiate these countries from one another.

This prompts us to go somewhat deeper into the concept of economic competitiveness between countries.

3. Theories of international competitiveness

3.1 The nature of the competitive contest. - The notion of "international competitiveness" implies the existence of a contest among national economies, aimed at the appropriation of some form of economic value.

This notion has raised much attention in recent years in policy debates around the world. However, it makes professional economists uneasy, basically for

two (alternative) reasons. According to some (see, for instance, Krugman, 1994, 1996), those who care for their own country's international competitiveness simply ignore the classical theory of comparative advantages and the related prediction of gains from trade for all participants. Indeed, the new trade theories provide for some form of rivalry between economies involved in international trade, but the benefits of any national trade policy, even provided that policy-makers be able to optimally design it, would be uncertain and small. Therefore, the idea of competitiveness is a misleading obsession, and the world should get rid of it.

Conversely, according to others (see, for instance, Reich 1990), it should be taken for granted that national economies compete with each other, as firms do. What is not obvious is that the interests of a nation in the competitive game coincide with those of "its" firms (i.e., the firms owned by residents in that economy). In fact, firms tend to become "global", and the benefits of their activity tend to spread over a territory much wider than that of the country hosting their head offices. Following this view, international trade is no longer the arena where national economies compete; direct investment is: particularly investment in high-wage, high-technology sectors, since national interests essentially lie in the accumulation of human capital.

In spite of such objections, in the eighties and nineties several definitions of international competitiveness were proposed (Jacquemin, Pench, 1997). However, they tend to be generic, or based on a list of heterogeneous features.

For economic international competition to have any meaning, one has to prove that international economic transactions dynamically produce welfare-enhancing opportunities, whose grand-total and distribution-key are not exogenously given, but depend, among other things, on national policies.

Let us focus on *trade*. Generally speaking, the greater the openness of an economy, the greater its consumers' welfare, irrespective of the trade balance. This comes from the broader variety of goods supplied in the domestic market. Of course, in order to benefit from a continuous and increasing flow of imports without encountering foreign debt sustainability problems, an economy must be able in the long run to produce goods and services that are "competitive" enough in export markets.

Nonetheless, if the real world looked like the one assumed by the theory of comparative advantages, no true competition would take place: every economy would “naturally” specialize in sectors with a higher intensity of the relatively more abundant production factor; products would “naturally” find their export market shares, for they would be made at “naturally” competitive costs.

However, today’s international trade is mainly intra-industry. Most industries involved in international trade present increasing returns. Firms often enjoy excess-profits as a result of market failures. The speed of accumulation of technological knowledge and human capital may differ from one firm to another, from one nation to another: that would allow a firm, or a nation, to establish a lasting dominant position in international markets for highly innovative goods and services.

If an economy is able to take advantage of such conditions in the long run, through “its” firms (we shall come back on this later), in order to increase exports (in volume or in unit value) at a higher rate than that of other economies, it may then decide to employ the extra-flow of income either importing more, thus increasing the welfare of its present consumers, or acquiring net foreign assets, thus taking care of the welfare of its future consumers (up to the point where trading partners will permit the accumulation of a net creditor position without adopting protectionist measures)ⁱⁱⁱ.

Those who object on empirical grounds, à la Krugman, to the practical relevance of any strategic trade policy normally refer to traditional policies, such as import duties or export subsidies, which may actually fail in most cases. Other policies are relevant in this context, aimed at improving the externality network where national firms operate (security, education, scientific research, market regulation, etc.): according to a rich literature^{iv}, such policies do have significant effects on competitiveness.

To assess the link between *direct investment* and welfare we need first to overcome Reich’s objection that firms involved in international trade have lost their national identity^v. To this end, a significant segment of literature can help us. For instance, Porter (1990) claims that even for a purely multinational enterprise a home-nation can always be identified: it is the country where strategies are planned, key

products and production processes are developed, firms' "essential and proprietary skills" are cultivated. Cantwell (1989) uses the similar concept of "intangible assets" (patents, organizational and entrepreneurial capabilities, reputation, lobbying power, etc.) to reach basically the same conclusion.

If an outward direct investment is meant to help a firm enter a new market, supporting its exports there (by establishing marketing facilities, technical assistance points, production plants), it does positively affect the home-nation's welfare, through technological spill-overs entailed by the firm's strengthened international position. In the short run fractions of productive capacity and employment may be lost at home, but in the long run the domestic growth rate is going to rise. Instead, if an industrial group acquires a foreign company only in order to diversify the group's income sources in a sector far from its core activity, with no economies of scope, possibly with the explicit intention to reinvest profits locally, then the investment will have very indirect and delayed repercussions on the home-nation, through distributed earnings to national shareholders, which are normally negligible in macroeconomic terms. What prevails is the short-run effect of crowding out domestic investment.

Similar considerations can be made, *mutatis mutandis*, for inward direct investment. It can increase welfare in the hosting country to an extent that depends on the nature of the investment and the strategic goals pursued by the foreign investing company.

3.2 An eclectic model of structural competitiveness. - It is clear from the previous section that national economies do compete with each other, but in two different "markets", where the actors are different^{vi}. In the *product market* competitors are national firms - in the broad sense specified above, that is firms whose home-nation is clearly identifiable with the considered economy, even when they are multinational - and nations through their firms. In the *location market* competitors are territories. For both categories of competitors (firms/nations, territories) we would want to measure: i) the position of each competitor relative to

the others (which we shall call *competitive advantage*); ii) its determinants (*sources of competitive advantage*).

Let us start with *firms/nations*.

We define as *rival* two firms which produce goods that are perceived as close substitutes by their potential buyers^{vii}. Each of them may try to gain a *competitive advantage* over the other essentially in two ways: i) lowering its unit selling price; ii) differentiating its product vertically (i.e., with respect to quality: Eaton, Lipsey, 1989).

Intuitively, let us suppose that the representative consumer attributes a “true” value to a unit of the product of both firms, reflecting its quality according to his subjective perception. Let such value be expressed in a common *numéraire*, the same as that used in denominating unit prices. We shall say that firm A has a competitive advantage over firm B if the difference between true value and price is greater for its product than for B’s^{viii}. This definition can be easily generalized to a multilateral competitive arena, with more than two rival firms.

There are many ways in which a firm can acquire a “quality” or “price” (i.e. “cost”, if we abstract from mark-up policies) competitive advantage. There are plenty of examples both in business literature (Porter, 1990; Shapiro, 1989; Kay, 1992) and in microeconomic modelling (Grossman, Hart, 1986; Perry, 1989; Chandler, 1990): better organization of each phase in the production process (input, manufacturing, marketing, customer assistance); more effective use of support activities (finance, research, etc.); more intense technological innovation; better vertical integration with main suppliers or customers; merging policies; strategic interaction with rival firms. All this has to do with firm’s proprietary skills: those skills that originated and developed inside the firm, mirroring its specific culture, traditions, praxis, and the personal skills of the individuals who work for it.

But acquiring a competitive advantage, for all firms sharing the same home-nation, is also related to national externalities, which concern the structural features of that particular community: history, economic geography, civil liberties, political institutions, governance, law, economic policies (Dunning, 1993; Nelson, 1996).

The set of firm skills and national externalities which determine the ability to acquire and defend a competitive advantage over foreign rivals constitutes the *sources of competitive advantage of a firm*.

As noted above, in the product market nations compete through their firms. Therefore, the *competitive advantage of a nation* must be a weighted average of the competitive advantages of its firms. A first assessment of the “aggregate” competitive advantage of a nation in international trade may be derived from traditional macroeconomic indicators: the real exchange rate, signaling the cost/price advantage; and the estimated elasticity of demand for exports and imports, signaling the quality/differentiation advantage. The *sources of competitive advantage of a nation* will be the union of the corresponding sets for all its firms. It will include elements pertaining to individual behavior (firms’ skills), as well as elements pertaining to collective behavior (externalities), in particular public policies.

Let us now turn to *territories*.

Just like a good offered to a consumer, a territory offered to an investing firm has a price and a “true value” reflecting its quality as a location in the view of the firm. The price is the sum of all costs the investing firm would sustain should it locate its investment in that particular area: taxes and social contributions; labor costs, for all those jobs that can not be covered by personnel from the head office; the cost of living for the latter; explicit or hidden costs attributable to the interaction with local public authorities (red-tape, bribes).

As in the case of a firm offering its products in the goods market, a government offering its territory in the location market can adopt a price policy, maneuvering its “profit margins” (net fiscal pressure). The investing firm will compare the “price” of the offered territory with the “true” value it attributes to that territory. The difference will represent the *territory’s competitive advantage*. The *competitive advantage sources of a territory* coincide with its essential humus: social capital, political system, scientific research and the educational system, the financial system, the industrial relations framework, cost and quality of the labor force, infrastructure, public facilities and regulation.

The conceptual scheme sketched in the present section is summarized in table 1. It gives substance to the notion of international structural competitiveness used in this article.

In what follows we investigate the competitive performance of Europe as a single economic area with respect to the other advanced areas of the world in both product and location markets, following two lines of enquiry: one concerned with microeconomic issues, the other with the theory and history of economic and political institutions.

Table 1: Sources of Competitive Advantage for a Firm, a Nation, and a Territory

	<i>Firm</i>	<i>Nation</i>	<i>Territory</i>
Product market	<ul style="list-style-type: none"> ◆ firm' proprietary skills ◆ relevant national externalities 	<ul style="list-style-type: none"> ◆ proprietary skills of all national firms ◆ externalities relevant for at least one national firm 	X
Primary location market (home bases)	X	X	<ul style="list-style-type: none"> ◆ social capital ◆ political system ◆ scientific research and education ◆ financial system ◆ industrial relations
Secondary location market (subsidiaries)	X	X	<ul style="list-style-type: none"> ◆ labor costs and worker skills ◆ infrastructure ◆ public services ◆ regulation

4. Europe's competitive position in the product and location markets, and the effects of integration

It is widely recognized that Europe's disappointing macroeconomic performance in the nineties is largely due to its structural weaknesses, stemming primarily from its inability to adjust specialization to the far-reaching changes occurring in the global competitive environment (Fagerberg, Guerrieri, Verspagen, 1999). First, Europe's specialization (with the exception of the United Kingdom) is still largely concentrated in manufacturing (Mulder, Rabaud, 1998). Second, among its manufacturing activities, Europe's strong assets lie in relatively mature or, in any case, less growth-enhancing sectors, which often utilize "incremental" and process innovations (Guerrieri, 1993, 1998).

In particular, EU specialization patterns reveal a declining trend in the *science-based* industries, particularly in microelectronics and in information and communication technology (ITC) hardware (Begg et al., 1999; Guerrieri, Milana, 1995).

On the contrary, the US comparative advantages have been increasingly concentrating in the science-based sectors, confirming a high-level scientific research capability and a large availability of 'primary' innovation in the US industry (Begg et al., 1999).

According to some, monetary unification offers the chance to formulate for the first time a macroeconomic policy conceived for Europe as a whole, and for its growth and competitiveness requirements (Fitoussi, 1997; Eichengreen, 1997).

Rather, we share the view of those who think that the role of macroeconomic policies in enhancing the competitive position of Europe has to be scaled down.

The challenge is microeconomic: Europe is facing a new competitive scenario world-wide (Sachs, 1998), whereby the sharp drop in transportation and communication costs makes it possible to divide the value chain of production into multiple phases, that may be localized in the most disparate territories of the planet,

depending on local competitive advantages (Dicken, 1992; Ernst and Guerrieri, 1998).

This has important implications for Europe. Increasing integration (real/monetary) will tend first to consolidate the current comparative and competitive advantages in Europe. On one hand, this will intensify incentives to relocate the more labour-intensive phases of the production processes in countries and regions with lower labour costs, both within and outside the EU area. On the other, it will promote concentration of the high-technology and knowledge-intensive phases in the most advanced countries and regions.

Finally, as integration further increases (this being the inevitable consequence of monetary union), the trade and productive specialization of individual countries will become more pronounced, with sectorial reorganization on a continental (if not global) scale. Table 2 shows the productive specialization of the four leading countries in Euroland (Germany, France, Italy, and Spain) by adopting a sectorial classification à-la-Pavitt (1984, 1988), slightly revised to take into account the different sources, and diffusion channels, of technology (Guerrieri, 1993, 1998)^{ix}. We use a specific specialization index (the contribution to trade balance) that considers both import and export trends: positive (negative) values of the indicator will signal a strong (weak) competitive position^x.

Table 2: Trade Specialization of Selected European Countries (manufacturing) (1)

Industry	Germany			France			Italy			Spain		
	1970-73	1980-83	1992-95	1970-73	1980-83	1992-95	1970-73	1980-83	1992-95	1970-73	1980-83	1992-95
Agricultural products and raw materials	-10.8	-6.8	-3.8	-0.7	1.5	0.9	-10.9	-6.3	-4.6	0.0	-2.5	1.1
Fuel	-5.8	-14.7	-4.9	-11.1	-21.6	-5.7	-14.1	-25.6	-6.0	-12.2	-33.6	-7.8
Other raw materials	-2.9	-1.7	-0.8	-1.4	-0.8	-0.4	-1.5	-1.0	-0.8	-1.9	-1.6	-0.6
Primary resource-intensive	-6.4	-5.9	-2.2	-3.5	-2.0	-2.2	-0.1	-1.5	-3.5	0.2	4.3	0.9
Food	-5.7	-1.6	-1.6	2.8	3.8	2.9	-5.7	-2.7	-2.9	10.6	5.8	0.7
Traditional	-2.9	-2.5	-5.5	3.0	-0.2	-3.7	19.1	22.2	19.7	16.4	15.2	2.6
Scale-intensive	16.9	18.0	10.0	11.3	13.1	3.8	6.3	4.5	-4.8	3.5	16.0	9.4
Specialized suppliers	14.5	10.8	8.5	-0.2	2.7	-0.1	6.9	10.0	10.5	-6.8	1.1	-1.4
Science-based	5.3	3.6	0.7	-0.3	3.1	2.7	0.8	0.4	-4.3	-8.5	-3.9	-5.3
Other	-2.0	0.8	-0.3	0.0	0.4	1.9	-0.8	0.1	-3.2	-1.2	-0.7	0.4

Source: SIE-World Trade Data Base.

(1) Comparative advantage (>0) or disadvantage (<0). See the text for the formula.

A fairly sharp distinction between two groups of economies immediately stands out. In one we have Germany and France, specialized in sectors with higher value added and technology content; the other includes Italy and Spain, increasingly specialized in traditional or highly diversified sectors (Italy) or in sectors with large economies of scale (Spain), while losing ground in science-based sectors.

As integration will further increase (this being the inevitable consequence of monetary union), specialization of individual countries will become more pronounced, with sectorial reorganization on a continental (if not global) scale.

For thirty years after the end of the war, income and productivity differences across European countries and regions had decreased. This process came to a halt in the eighties, and differences in per capita income have remained virtually unchanged since then (Neven and Gouyette, 1995).

Recent studies assign a major role to technological capability and innovation in explaining these differences (Verspagen and Fagerberg, 1996; Cappelen, Fagerberg and Verspagen, 1998). Dynamic scale economies can give rise to polarization and accentuate geographical imbalances, since capital moves to areas where clusters of activity generate positive externalities, which make investment more attractive (Krugman, 1991; Baldwin and Venables, 1994). Dynamic scale economies and clusters are considerably more common in productions where technology (the stock of knowledge) plays a decisive role in the competitive advantage of firms. Hence, such activities tend to be located in the most advanced countries and areas. This appears to describe recent developments in Europe. Globalization and economic integration have increased opportunities to exploit dynamic scale economies, encouraging restructuring and mergers. A shortage of factors supporting technological diffusion contributed to bringing convergence to a halt.

Differences in specialization will go hand in hand with differences in institutional arrangements (Guerrieri and Tylecote, 1997).

Europe's institutional and systemic traits (financial system, innovation system, social climate, labour market features, etc.) have strongly influenced the economic performance of European countries, and distinguish Europe, at least

continental Europe, from the other advanced areas of the world, first and foremost the United States.

Various studies on national innovation systems have recently explored these aspects. Although quite heterogeneous as to the theoretical approach, they have assessed a vast set of determinants of what we termed “structural competitiveness” of a country, such as: scientific and technological research capability; financial markets; institutions; governance of firms^{xi}.

Many observers predict the rapid disappearance of institutional differences in Europe, as a consequence of both integration and globalization. The final outcome, according to this view, can not be but one: the Anglo-Saxon model of highly contestable markets and deregulation will prevail Europe-wide. However, national institutional peculiarities have proven to be far more resistant than expected. Important systemic differences do and will continue to exist between Europe and the United States. This leads us to foresee both an acceleration of institutional convergence in Europe and a growing institutional competition between Europe and the other advanced areas and countries of the world, extending to domestic regulatory policies (Rodrik, 1997).

5. Conclusions and policy implications

The euro era has just begun, and Europe is at a delicate juncture. In the medium run, economic growth seems insufficient to reduce the persistent high unemployment rate. In a long-run perspective, Europe suffers from a competitive decline with respect to the rest of the developed world, as well as from persistent regional disparities. As integration progresses in Europe, residual differences in national systems fuel competition. Competition between national economies has become a central issue in policy debates all over the world. A dynamic framework of free trade and free capital movements yields extra-welfare to be distributed to the participating economies; they compete to secure as much as they can of the extra-

welfare at stake. Economic policies may influence the outcome, especially if they are directed towards domestic externalities affecting the business environment.

We have stressed that there are two markets where competition takes place: in the *product market*, each nation competes through “its” firms (i.e. firms, even multinationals, for which that nation is the home-nation), whose competitiveness is determined by a mix of proprietary skills and domestically-determined externalities. In the *location market*, territories compete directly with each other, brandishing weapons as diverse as infrastructure, regulations, the tax system, and the cultural environment.

The single market and monetary union, the two policy-determined factors of systemic change Europe has experienced in the nineties, are considered here as a single process resulting from an “institutional integration policy” for Europe. In particular, we look at monetary union more as a chemical reagent aimed at facilitating real integration than as an autonomous force shaping production patterns in Europe.

Integration will most likely strengthen Europe’s competitive position. We question its potential for improving internal cohesion.

We have argued that competitiveness in Europe is a structural problem. Therefore, structural adjustments are warranted. Integration may alter innovation and production systems area-wide, allowing for better exploitation of scale economies and for efficient relocation processes. Increased competition reinforces the link between dynamic economies of scale and specialization, thus providing new incentives for restructuring, especially in the services sector. Relocation and concentration will follow. Knowledge-intensive production phases will be those most involved in restructuring processes, thus favoring the most advanced countries and regions.

It is more uncertain that such processes will bring about any significant reduction in the competitive gap between continental Europe and the other industrial areas of the world in advanced sectors such as information and communication technology. Externalities greatly affect competitiveness in these sectors, hence the creation of a single European market will not ensure decisive competitive advantages

for European firms. Specific policies are required. Measures only promoting free competition in the European single market are necessary, but not sufficient. In order to put countries, regions, and firms in a position to intensify and diffuse innovation, radical changes in industrial organization and technological systems are required. Should these changes come late, completing economic and monetary integration will only stress Europe's competitive anomaly more and more.

Territorial specificity matters, even in a framework of global markets and production internationalization. The galaxy of European economies seems stuck in a trend of progressive rarefaction, or dis-integration, which may accentuate as the political project of real and monetary integration continues. In fact, the federalist program was historically conceived as a gradual and selective action: it has involved one institution at a time. If there are residual discrepancies or inconsistencies between some of them (for instance, monetary policy or antitrust policy) and some of those micro or macroinstitutions directly affecting structural competitiveness (such as the legal system of incentives, or the organizational patterns prevailing in the economy), the internal cohesion of the European economy will be weakened.

But if cohesion is jeopardized, then structural competitiveness is as well. The case of Italy's Mezzogiorno is illuminating in this respect: it is widely recognized that North-South economic dualism is a source of competitive disadvantage for the whole Italian economy.

Even though regional differences in the euro area may represent an asset, they will most likely prove to be a constraint, or even an obstacle on the path towards greater market and institutional integration. To avoid this risk, cohesion policies must openly deal with the distribution puzzle: how to distribute among countries and regions the extra-welfare from integration and, possibly, from increases in the area's competitiveness.

Policy prescriptions for a one-market, one-currency Europe are thus more complex than those usually discussed in the current debate, which are mainly focused on labor market flexibility. The European disease is caused by delays in adjusting economic structures to globalization and advances in technology and to the lack of connections between regional economies. Europe needs coordinated policies aimed at

stimulating and diffusing technological and organizational innovation, communication networks and systems in order to optimize the use of productive factors on a continental scale.

Community policy-makers should engineer cross-sector interventions in the field of infrastructure, research, education and on-the-job training so that European firms can compete on an equal footing with firms of other areas that are already used to operating on a continental scale.

Notes

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- ⁱ Any opinion expressed in this article does not involve the institutions the Authors work with.
- ⁱⁱ A partial example might be the Italo-French dispute consequent to the devaluation of the lira in 1992.
- ⁱⁱⁱ The first approach was followed by Italy and Germany in the second half of this century: high rates of export growth (around 11-12% a year, in value) allowed similar rates of import growth: as a result, net foreign assets grew very moderately. The second approach is being followed by Japan, where national savings constantly exceed domestic investment needs: as a result, net foreign assets keep growing, as they are seen as necessary to meet future needs due to the progressive ageing of the population.
- ^{iv} See, among others, Thirlwall (1992), Lazonick (1993), Jessop, Nielsen, Pedersen (1993).
- ^v See also Soete (1994).
- ^{vi} A similar qualification is recalled in Boyd (1996).
- ^{vii} For instance, firms belonging to the same “sector” in the Porter’s sense (1990), or facing the same “relevant market” in the sense of Hay, Vickers (1987).
- ^{viii} If the difference is positive. If negative, it must be smaller than for B. In both cases, however, the consumer may not choose A’s product: for instance, if A’s price is not compatible with the consumer’s budget constraint.
- ^{ix} Six types of industries are included in this classification: primary resource-intensive, food, supplier-dominated or traditional sectors, science-based, scale-intensive, specialized suppliers. All other non-industrial products are grouped into three broad categories: agricultural product and raw materials, fuels, and other raw materials, for a total of nine product groups.
- ^x The formula is as follows:

$$CTB_j = \left| \frac{(X_{ij} - M_{ij})}{(X_i + M_i)/2} - \frac{(X_i - M_i)}{(X_i + M_i)/2} * \frac{(X_{ij} + M_{ij})}{(X_i + M_i)} \right| * 100$$

with X_{ij} = exports of product j of country i ; M_{ij} = imports of product j of country i ; X_i = total exports of country i ; M_i = total imports of country i .

- ^{xi} Lundvall (1992), Nelson (1993) and Edquist (1997) offer significant examples of this literature on national innovation systems.

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