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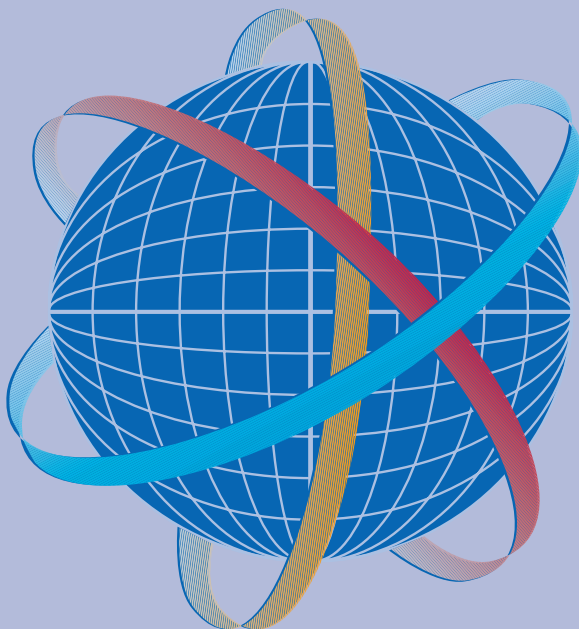
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47th ECONOMICS CONFERENCE 2020
of the OeNB in cooperation with SUERF

25 years of “Northern” EU enlargement



Contents

About SUERF – the European Money and Finance Forum	5
Chapter 1: Introduction and overview: The EU's “Northern” enlargement 25 years on – stocktaking and some thoughts for the future <i>Ernest Gnan, OeNB and SUERF and Robert Holzmann, OeNB</i>	8
Part 1: Global historical context and EU impact on economic performance	
Chapter 2: Covalization: Europe on the rack between globalization and COVID <i>Harold James, Princeton University</i>	20
Chapter 3: The benefits of 25 years of EU membership <i>Jetro Anttonen, University of Helsinki, Vesa Vihriälä, Helsinki Graduate School of Economics</i>	30
Chapter 4: 25 Years of Austria's EU membership <i>Fritz Breuss, Vienna University of Economics and Business, WIFO</i>	40
Chapter 5: The challenges and opportunities in the digitalisation of production <i>Christopher Warhurst, University of Warwick, Stephen Dhondt, KU Leuven</i>	54
Part 2: Monetary and financial integration	
Chapter 6: After 25 years as faithful members of the EU: public support for the euro and trust in the ECB in Austria, Finland and Sweden <i>Felix Roth, University of Hamburg, Lars Jonung, University of Lund</i>	64
Chapter 7: Finland and monetary policy through three crises <i>Meri Obstbaum and Tuomas Välimäki, Suomen Pankki</i>	80
Chapter 8: Financial integration in the Nordic-Baltic region vis-à-vis the EU: a Swedish perspective <i>David Farelus, Stefan Ingves and Magnus Jonsson, Sveriges Riksbank</i>	90
Chapter 9: The European banking supervisory framework and its institutional arrangements since Austria's accession to the European Union <i>Michael Kaden, Michael Boss and Markus Schwaiger, OeNB</i>	104
Part 3: EU membership and economic governance	
Chapter 10: The development of the EU budget – impact on Austria, Finland and Sweden <i>Walpurga Köhler-Töglhofer and Lukas Reiss, OeNB</i>	126
Chapter 11: Revamping policy governance in Austria <i>Heinz Handler, WIFO</i>	144

About SUERF – The European Money and Finance Forum

SUERF stands for “Société Universitaire Européenne de Recherches Financières”, the original name under which SUERF was established in 1963 in France. SUERF is an independent and non-partisan member association. SUERF’s strength lies in bringing together three pillars of members: central banks and supervisors, financial industry representatives and academic researchers. For more than 50 years, SUERF has been dedicated to the analysis, discussion and understanding of European financial markets and institutions, the conduct of financial regulation, financial supervision and monetary policy. SUERF’s main activities are: events, publications and the support of young researchers. SUERF is governed by its Council of Management, which includes senior representatives from central banking, the financial industry and academia. The Oesterreichische Nationalbank has hosted the SUERF Secretariat at its premises in Vienna since April 1, 2000.



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Chapter 1

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Introduction and overview: The EU's “Northern” enlargement 25 years on – stocktaking and some thoughts for the future

Synthesizing main findings from this volume, this article identifies how the three EU Northern enlargement countries have been contributing to the EU's evolution. EU membership has brought substantial economic benefits for all three countries. While these benefits far outweigh financial costs, this is as such no rationale for net financial contributions, as the EU is a win-win situation for all Member States. While a “multi-speed-Europe” seems a pragmatic way to pursue EU integration, if each country follows an “individual utility approach to EU integration”, then externalities and network effects are neglected. The EU policy process needs more ex ante and ex post scientific evaluation of policies. Policy benchmarking should be adopted explicitly with the aim of mutual learning, improvement and reform. COVID-19 appears to propel EU integration and EMU deepening. The question arises, though, whether crisis-induced “forced” integration is sustainable. It is crucial that the EU and its Member States will effectively turn the crisis recovery into a catalyst for transformation towards a greener and digital economy and to resist the temptation just to cover up the economic fallout from the pandemic, rather than embarking on transformative structural adjustment.

JEL codes: E02, E61, E65, F02, F5, H12, H43, H77, N44

Keywords: EU integration, EU membership, Austria, Finland, Sweden, EU budget, NGEU, economic policy evaluation, economic reform, COVID-19, green new deal, digitalization

2020 marks the 25th anniversary of the EU's fourth enlargement round – sometimes referred to as “Northern” enlargement – which, after several years of negotiations, made Austria, Finland and Sweden EU members on January 1, 1995. For a European country, there is hardly any other foreign or economic policy move conceivable in the second half of the 20th century (and in the 21st) that could be more far-reaching and important than EU membership. It is thus worth looking back on what EU membership has entailed for the three countries.

To study this question, the OeNB, in cooperation with SUERF – The European Money and Finance Forum, has compiled this volume. Originally, this publication would have been the outcome of a conference in Vienna planned for May 2020 as a collaboration between the Bank of Finland, Norges Bank, Sveriges Riksbank, SUERF and the OeNB. Unfortunately, due to COVID-19, this conference had to be cancelled. A streamlined

virtual edition of the event took place on September 21, 2020, giving the authors of this volume the opportunity to present and discuss their findings.

Several of the articles in this volume adopt a comparative perspective, reviewing various aspects of EU membership for the three countries in question, while, in some cases also comparing these aspects with other countries. Drawing on these analyses, this introduction aims to flesh out a few general points, which may also be of relevance for the future development of European integration, and comment on the role of the three countries of the EU's 1995 Northern enlargement round.

1 Economic benefits from EU membership have been substantial for Austria, Finland and Sweden

Two studies in this volume (*Anttonen and Vihriälä*, chapter 3; *Breuss*, chapter 4) document, based on the authors' own empirical estimates and the existing

empirical literature, that the economic benefits from EU membership have been substantial for all three countries in question, with cumulated increases in real GDP or per-capita GDP ranging from 5% to 10% over the past 25 years.

Most studies find that Austria benefited by far the most among the three countries, offering two possible reasons: First, Austria had to adapt its economic governance and institutions the most (competition policy, liberalization of services and network industries, public procurement etc. – see *Handler*, chapter 11) and thus reaped the largest benefits from increased competition and efficiency gains. Second, Austria profited the most from the EU's Eastern enlargement (see *Breuss*, chapter 4).

These consistent results pointing to large economic gains from EU membership are all the more interesting given the quite different starting points of the three countries: While Austria entered the EU in fairly good economic shape with a large budget deficit, Finland and Sweden were still suffering from their financial crises (see *Anttonen* and *Vihriälä*, chapter 3; *Breuss*, chapter 4; *Handler*, chapter 11).

It is also worth noting that euro area membership does not seem to have made such a big difference. *Breuss*, chapter 4, finds that euro area membership accounted for just 0.1 percentage point of Austria's annual EU membership growth dividend of 0.8 percentage point (0.4 percentage point from single market effects and 0.3 percentage point from the EU's Eastern enlargement). At the same time, it is worth noting that, in effect, the ECB's and the Sveriges Riksbank's monetary policies are not very different in terms of the primacy of price stability in the sense of a low inflation aim that is pursued by an independent central bank.

What is more, many economic benefits from EU and euro area membership

cannot be easily conceptualized and quantified. For instance, it is an open question how much Austria's EU and euro area membership helped the country in averting a financial crisis from its bank exposure in Central, Eastern and Southeastern Europe (CESEE) during the global financial crisis (GFC). For lack of a suitable counterfactual this will never be known.

2 Substantial benefits put net financial contributions to the EU budget into perspective

While positive economic effects are model-based estimates or hardly quantifiable at all, the financial flows resulting from the EU budget and other EU programs can be pinned down quantitatively and therefore have gained more public attention.

An argument often put forward by critics of EU membership in wealthy countries is that their countries are net contributors to the EU budget. Indeed, there is no denying that payments by Austria, Finland and Sweden have mostly exceeded funds received from the EU through various mechanisms over time (with the exception of Finland's contributions during its first years of EU membership) – see *Köhler-Töglhofer* and *Reiss*, chapter 10. Against this background, it is not surprising that all three countries of the EU's Northern enlargement round were among the “frugal five” (which furthermore included the Netherlands and Denmark) during the summer 2020 negotiations on the EU's new Multiannual Financing Framework (MFF) and the temporary COVID-19 EU recovery fund (Next Generation EU – NGEU).

While recognizing the importance of funding a substantial recovery investment budget, the three countries share an attitude of fiscal caution, which includes careful use of taxpayers' money (in their home countries but also generally) and strict governance of spending. (For an

overview of the three countries' fiscal positions since EU accession, see *Handler*, chapter 11.) In this view, large EU spending and transfers between countries thus need to be accompanied by transparent governance of spending programs and by effective incentives ensuring that spending is used for programs which effectively promote needed structural adjustments during the post-COVID-19 recovery. Moreover, cutting-edge evaluation methodologies are needed to assess whether the program objectives have been achieved. The latter are largely missing and are crucial looking forward.

It should be recalled in this context that, despite tough negotiations in July 2020, which resulted in some concessions as compared to the original proposals by the European Commission and EU Presidency, the EU's new MFF (EUR 1,074.3 billion in constant 2018 prices) in combination with the transfers and loans of the new debt-financed NGEU recovery instrument (EUR 750 billion), will further increase the three countries' net payers' position. The U.K.'s EU exit adds to net payers' contribution (given that the U.K. was a net contributor). From this perspective, the adjective "frugal" should rather be replaced with "ready to generously invest in Europe's future, but financially careful and responsible."

An argument frequently put forward by advocates of very large and lenient EU spending programs is that the net contributor countries reap benefits from EU membership (single market access, participation in the euro area, stronger joint negotiation position on an international level etc.); thus, their net contributions are in a way a "fee" for these economic (and other) advantages from EU membership. This argument is, however, by itself not a reason to justify these payments, since the benefits from EU membership in principle accrue to all EU countries – the EU is a win-win scheme. A priori, there is thus no reason

why some countries should pay for these advantages and others receive funds in return. This would only seem justified if the benefits from EU membership for some countries were proven to be gained at the cost of other countries. If, even in a win-win situation, some countries gain comparatively more than others, one should still, before calling for transfers, raise the question why this is the case and how those that may so far have gained comparatively less might, through structural adjustments in their economies, benefit more from the growth-enhancing properties of the EU's single market, single currency, frameworks for sound fiscal policies etc. Only once this analysis has been made, should one identify possible useful financial support to facilitate the needed structural adjustments.

3 The EU as a federation of states, membership in which is useful for each individual state

Sometimes, discourse about European integration is couched in terms of the creation of a "European family," in which solidarity should be a guiding principle. We do recognize the beauty and appeal of this idea, and indeed there seems to be something like "European values" if one juxtaposes Europe with other parts of the world, where democracy, human rights, social systems and protection of the environment are held in much lower regard than in Europe. At the same time, building the EU's integration process on an overly idealistic approach seems of limited promise, given that solidarity sometimes not even works well within individual nations, finding its limits in the preparedness to give and the incentives to freeride and abuse.

The EU's Northern enlargement implied that a group of small countries with highly developed economies, clearly above-EU-average GDP, high wage and

social security levels, and a tradition of a “(European) integration at arm’s length” attitude joined the “EU club.” The EU’s Northern enlargement thus affected the balance of preferences with respect to the EU’s further integration strategy. This effect was later further accentuated by the accession of CESEE countries, several of which – for different reasons – regard interference from Brussels or any outside countries with skepticism.

Before joining the EU, Austria, Finland and Sweden all had been part of EFTA, the European Free Trade Association, an alternative model of European integration, which aimed at a more limited form of integration focusing mainly on trade cooperation. In the end, the EU prevailed over EFTA, and the Northern enlargement countries basically saw little alternative to joining the EU in order not to be left behind.

The EU’s Northern enlargement also implied that the “Scandinavian group” within the EU was considerably expanded, now including Denmark, Finland and Sweden. The Scandinavian countries have a long tradition of close cooperation, which has also continued in recent years, despite Norway in the end staying outside the EU (see e.g. *Farelius, Ingves and Jonsson*, chapter 8, on financial integration and cooperation in the Nordic-Baltic area). The Scandinavian countries also share a tradition of democracies which emphasize the accountability of national governments and state institutions toward their citizens. For these democracies, delegating far-reaching competences and powers to “EU bureaucracies” and not directly elected decision-making bodies, such as the EU Council, is at odds with their understanding of how democracies should function. The fact that both Denmark and Sweden have actively chosen not to participate in the euro fits into this picture.

From the perspective of the Northern enlargement countries, it may thus seem more useful, pragmatic and indeed appropriate to build the EU’s integration on the aim to create net benefits for each and every of its participating states. In this approach, the EU is a coalition of interests. Further steps of integration are supported by individual Member States, as long as they are – not only, but also – in the interest of individual Member States.

Farelius, Ingves and Jonsson’s account of the careful analysis conducted in Sweden of the pros and cons of Sweden joining the European banking union is instructive in this context. The authors recognize the benefits of the international coordination of financial stability policies in a world of integrated financial systems, while at the same time taking account of the costs of harmonization and cooperation if financial systems are heterogeneous across countries. The decision whether or not to join the banking union then is the result of a cost-benefit analysis at the national level. The authors also take account of a more political argument that Sweden might be further “marginalized” if the country, which already abstained from joining the euro area, furthermore, stayed outside the banking union. In this view, integration could thus proceed based on all Member States pursuing their own cost-benefit analyses and their own interests.

It is obvious that what counts in the end is the perception of costs and benefits and of usefulness by policymakers and the public. The importance of perceived usefulness is also reflected in public opinion on the euro and the ECB. In this context, the analysis by *Roth and Jonung*, chapter 6, provides interesting findings. They show, first, that support for the euro during the GFC and the European sovereign debt crisis remained high in the two euro area countries

Austria and Finland, while the sovereign debt crisis significantly diminished support for Sweden joining the euro. Second, support for the ECB hinges crucially not so much on inflation performance, but on the development of unemployment in the euro area. While this may be viewed as consistent with the short-term demand-side effects of monetary policy on output and employment, it is at the same time at odds with the allocation of responsibilities and economic goals among branches of government. It may simply reflect the fact that the ECB and the euro so far remain the major symbols of European (economic) integration, and whatever happens in the economy is therefore reflected in attitudes toward the ECB and the euro.

4 But: the individual utility approach to integration may also have important shortcomings

There are, however, important counterarguments against an individual utility approach to integration. First, it neglects externalities of individual countries' choices. While, for instance, staying outside the European banking union may indeed be more advantageous for an individual country, this choice may imply negative externalities for its neighboring countries, which may indeed be part of the euro area and whose banking systems may be affected by the decision on joining the banking union. What decision-making in the EU should achieve, is to put such externalities on the table in the decision-making process for the EU's integration strategy, so that they can be incorporated into decisions.

A second argument is that, indeed, there may be integration steps which are clearly in the interest of the EU as a whole, but which unambiguously go against the interests of one or several

member countries. In this case, unanimity requirements may block important, and on the whole beneficial, integration steps. To solve such gridlock situations, the standard solution for economists are compensation payments, in political practitioners' language: package deals and EU transfers. And indeed, this is how many EU negotiation situations and decisions can be interpreted.

Emphasizing the pursuit of individual Member States' interests may also be viewed to be at odds with the fact that the individual EU country level is not necessarily best suited to solve problems. The size of individual EU Member States varies at a factor of 1 to 275 (nominal GDP, Malta versus Germany in 2018) or 1 to 166 (UN population estimate for 2019, Malta versus Germany). Several German federal states are larger by any measure than any of the three Northern enlargement countries. Many of today's pressing problems require global solutions: COVID-19, climate change, a fair and nondistortionary international trade order, etc.; this has led Angela Merkel to predict: "*The nation state on its own has no future.*" (video press conference with Emanuel Macron of May 18, 2020, quoted in *James*, chapter 2). Other problems can and should better be solved at the level of local communities and cities. This leads *James* to conclude that "*old-style nation-states are having to rethink where, and how, they stand in the world.*"

5 A major strength of the EU lies in its diversity, which emphasizes the benefits from the international division of labor and facilitates mutual learning

Many observers and critics of the EU project point out the heterogeneities among EU countries. They emphasize differences in technological development,

the functioning of state institutions, social security systems, per capita GDP, education systems etc. Within the euro area, the differences across countries are sometimes interpreted as proof that Economic and Monetary Union (EMU) does not satisfy the criteria of an optimal currency area, thus causing recurrent phases of instability and requiring temporary or even permanent transfers across countries. Cultures and preferences across EU Member States are pointed out to differ substantially, thus making agreement on policy priorities and joint economic policy philosophies difficult and often unsatisfactory.

However, there are many counter-arguments. A central pillar of the EU is its single market. One main benefit of international trade in goods and services, but also in labor, rests on comparative advantage. Thus, diversity of production structures should increase the benefits from the EU single market and EU membership.

At an institutional level, the different EU Member States can learn from each other. When studying various aspects of economic systems and policies, the differences between countries are striking. When it comes to taxes, social systems, education systems, health systems etc., there are no two countries whose systems are alike. There may be good reasons for this (preferences, history dependence etc.) – or not. Many of these differences may be arbitrary and accidental but should by all means be questioned in the quest for optimal policies. So, it is worth for any country's government to look at what others are doing and learn from it, and to maybe get one or the other good idea from peers.

All policy coordination in the EU – be it with a more or less binding character – contributes toward this aim. In a sense, the EU can be viewed as a huge mutual learning project for governments

and public servants. All countries experienced the same EU membership-induced push toward opening up and an internationalization of perspectives in all areas of government, business and attitudes. What is more, this mutual learning process goes well beyond the level of government and state institutions, and encompasses most areas of business, work, education and life in general.

Preferences and institutions are ultimately not set in stone. Societies may learn and adapt, and institutions can improve over time. The EU is a useful framework to also encourage improvement in state and economic institutions. Various aspects of the EU's structural reform agenda, the EU's competition law (which is quite stringent by international standards) and the dynamics of the internal market in general force governments to pursue reforms which, outside the EU, they might not have the courage to tackle. Austria is a case in point, as *Handler*, in chapter 11, points out in detail for competition policy, public procurement, network industries, but also fiscal policy.

This is no guarantee that reforms proceed as well as they should in all EU countries and that inefficiencies and even corruption are automatically a thing of the past once a country joins the EU. But the EU at least provides strong incentives and the necessary awareness and knowledge base through peer learning to improve institutions and structures in its Member States.

The three Northern enlargement countries had – and continue to have – a lot to offer in this respect. For instance, Sweden has a long history of state transparency and scientifically based policy evaluation. Sweden has also shown how to scale back one of the largest tax rates in the world to moderate levels without causing social upheaval. Austria has a successful and beneficial tradition

of cooperation among social partners. It has shown how an inefficient state industry can successfully be transformed into internationally competitive and profitable private firms (see *Handler*, chapter 11). Finland has a rich experience in dealing with substantial shocks (e.g. the breakdown of the Soviet Union, or the rise and fall of Nokia and the paper industry – see *Obstbaum* and *Välimäki*, chapter 7). The two Nordic countries also offered important lessons for other countries during the GFC, having already shown how to deal with similar crises during financial booms and busts in the late 1980s and early 1990s. In a similar vein, Austria showed how to cope with headwinds faced by its large internationally active banks in the GFC, without abandoning the CESEE markets abruptly and to the detriment of CESEE countries (Vienna Initiative).

In turn, the three countries certainly benefited from the vigorous push toward an internationalization and opening-up of their countries, both economically but also in terms of science, culture and overall attitudes. EU membership forced them to revamp and modernize their economic institutions and to liberalize many areas of their economies (more so in Austria than in Sweden and Finland – see *Handler*, chapter 11).

As *James*, chapter 2, puts it: Crises like COVID-19 “require highly competent governments.” If cooperation within the EU manages to improve mutual learning among governments, both the European project and EU citizens benefit.

6 “Failing forward” versus principles-centered European integration, and variable geometry

James, chapter 2, recalls the political science concept of “failing forward” as the main driving force of European integration and institution building, which

is akin to Jean Monnet’s famous quote that “*Europe is driven by crises.*” *James* questions whether this is a sufficient foundation for the European project and sees a “need for a countervailing motivation, emphasizing fundamental values rather than a technocratic fix.” Let’s call this latter approach to European integration “value-driven” or “principles-centered” integration.

Two remarks seem useful in this context. First, the observation that crises are important triggers for reform (economic and other) is not peculiar to European integration. It applies to individual countries in much the same way as it does to world politics and to personal lives. Big reform steps involve big costs and efforts, which tend to be avoided or delayed if not absolutely necessary and pressing. Given the many players and interests involved in European politics, it may be more difficult to reach agreement, and thus the importance of crisis triggers may be more important than at the national level. But one could also argue that the supranational nature of EU decision-making makes certain decisions easier than at the national level. Indeed, many laws in the areas of safety, environmental and consumer protection, but also rules for fiscal responsibility and monetary stability, seem to be more easily achievable at the European than at the national level. Once far-reaching EU legislation has been decided at the EU level, national politicians no longer (or to a much lesser extent) face the need to justify measures to their national electorate.

Second, the process of crisis-driven change demonstrates useful flexibility to adjust to changing circumstances, requirements and maybe societal preferences over time, which any state and indeed also the EU should have. Take the example of EU banking regulation

and supervision since the Northern enlargement. As *Kaden, Boss and Schwaiger*, chapter 9, show, financial regulation and supervision adjusted its goals and tools several times over the past 25 years to reflect changing environments, requirements and shifting political and societal preferences. This flexibility is no sign of a lack of fundamental vision or of technocrats ruling the system, it is simply the appropriate way for political and economic systems to react to changing circumstances and new insights.

In the end, the EU's and any individual state's approach to development and reform is a combination of values and principles and reactions to changing circumstances, preferences and, in the extreme, crises. National constitutions find their counterpart in the EU Treaty and the Charter of Fundamental Rights of the European Union – both types of texts reflect fundamental values and principles. Within these frameworks, nation states and the European Union may develop and, if far-reaching changes are required, for instance – but not only – in response to crises, even adapt certain aspects of their constitutional structures.

Given EU Member States' quite different starting points, mentalities, societal and economic preferences, history and political cultures and traditions, it may in fact seem quite surprising how much integration actually has already been achieved and how boldly European integration continues to proceed (as evidenced by the recent political agreement on the MFF and Next Generation Europe). One approach which the EU has adopted over the decades is to sometimes allow individual countries to take certain steps at different speeds or to even opt out of them. The adoption of the euro and participation in the Schengen Agreement are obvious

examples. This “multi-speed” or “variable geometry” approach is thus a useful and established, pragmatic way to achieve progress in European integration as the need and desire arises, while not neglecting some EU members' reservations against certain integration steps.

Another development which has come to the fore with the EU's Northern and Eastern enlargement rounds, and also most recently, is that smaller countries form coalitions or subgroupings within (and beyond) the EU. The Scandinavian-Baltic cooperation in the field of financial regulation and supervision mentioned above is just one of many fields in which the Nordic countries form a “subgroup” in the EU, which also extends beyond the EU by including Norway and Iceland. Among CESEE countries, a coalition among the Visegrad countries has gained visibility over the past years. Most recently, the ad-hoc coalition of five small “Northern” countries including Austria, Denmark, Finland, the Netherlands and Sweden gained much attention in the negotiations on the MMF and Next Generation Europe recovery package. Such groupings may be eyed somewhat skeptically by other EU countries. But they may also be read as a reaction to smaller countries' perception that their voices are not sufficiently heard in EU negotiations, which seem – in their perception – to be dominated by the large EU countries and led by Germany and France. The example of Brexit could be interpreted as a lesson that also in wealthy countries, public support for the EU needs to be carefully nurtured and maintained, not only by governments in these countries, but also at the level of the EU by carefully pacing the speed and intensity of the EU integration process and keeping a watchful eye on its financial implications.

7 Challenges ahead can be addressed more effectively together in the EU

The next years will bring formidable challenges for European countries and the EU. In the short term, overcoming the COVID-19 pandemic and responding to its economic consequences will take center stage. Leaving medical issues aside, economic responses include both mitigating negative effects on firms and workers in the shorter term and embarking on necessary structural adjustments resulting from permanent COVID-19-triggered consequences. Both the Eurosystem and the EU body politic have taken bold steps to address both aspects. As short-term demand-oriented measures are easier and more popular, particular attention will need to be paid to the long-term structural measures needed.

This links with required action for climate protection. Climate action is a typical area where individual small countries can achieve little alone and acting together in the EU is essential. The EU as a grouping of – in a global comparison – rich and technologically advanced countries must take the lead in climate action. This could create powerful synergies with the post-COVID-19 recovery strategy. By being proactive, Europe can also gain a competitive edge – so far it has not shown sufficiently convincing action and progress in this area. The European Green Deal is a bold and visionary program which now needs to be filled with life.

A major global challenge which has already been affecting Europe, and will continue to do so, is global population growth. Population growth in developing countries is a major impediment to development. It also further diminishes climate sustainability, particularly if the

aim is to lift living and consumption standards in these countries. Ultimately, the combination of these factors may increase immigration pressure on Europe. As the experience since 2015 has highlighted, the EU finds it hard to deal with this challenge effectively and without causing major disruptions among EU Member States. At the same time, non-European countries such as China, are seizing the opportunity to secure their economic and political influence in Africa and other regions. The EU should, both in its own and in the interest of the countries in developing countries, adopt a more proactive and comprehensive approach to development and neighborhood policy.

The next years and decades will also bring secular changes in production structures, work and consumption patterns, due to digitalization. Digitalization raises fundamental questions regarding the organization and allocation of work, and the mechanisms governing the allocation of income from production, as *Warhurst* and *Dhondt*, chapter 5, point out. Digitalization often requires big concerted research effort and favors large firms due to extensive scalability. In central areas of digitalization, Europe is not in the lead or is about to lose a leading role. Individual Member States have every interest to support and contribute to the advancement of the European Digital Strategy. Again, particularly for small, developed, high-wage countries such as the three Northern enlargement countries, participating in a joint EU digitalization strategy is helpful in many ways (being part of transnational research projects, larger firm size due to European-wide operation, European power in the setting of technical standards etc.).

Being part of the EU puts Austria, Finland and Sweden – and indeed all EU countries – in a better position to convert these challenges into opportunities. To appreciate this, it is useful to abstract from differences in opinion on various detailed measures and aspects of the EU and its ongoing integration process in the short term, and to keep the bigger picture in mind. After all, the diverse skills, approaches, views and

preferences of its members are the EU's major asset. No member country should thus shy away from articulating its views and preferences. It is the culture of listening and negotiation which brings this diversity to a fruitful result. The three countries of the EU's Northern enlargement round certainly have important contributions to make in shaping the EU's future course.

Part 1:

*Global historical context and EU impact on
economic performance*

Chapter 2

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Covalization: Europe on the rack between globalization and COVID

A historian's perspective on the European Union: Europe and globalization

The European Union is often thought of as a manifestation of the phenomenon of globalization (understood as the mobility of capital, goods, people, but also as a demonstration of the limits of the nation-state). Populist critics often simply lump the European Union and globalization together as eroders of national sovereignty; while defenders of the integration project emphasize the way in which the EU can harness or tame globalization, and Europe's population from its wildest and most dangerous excesses. At a moment when the corona virus is thrusting globalization into reverse, the EU might be particularly vulnerable.

Globalization has often been strained. We can trace this history of questioning globalization in phases:

- In the 1930s, there was a complete collapse of globalization with the Great Depression (what I termed "The End of Globalization" in a 2001 book).¹
- In the 1970s, oil price shocks, the perception that the geography of power in the world was shifting, and inflationary pressures led to a discussion of a New International Economic Order.
- In the 1990s, in the wake of the collapse of communism in central Europe, and with very large capital flows threatening financial and economic stability, the question of global governance in a post-Cold War world gave rise to fantasies of an "end of history," the overcoming of all traditional divisions and hostilities.²

- In the 2010s, the aftermath of the global financial crisis prompted a wave of populism, and a backlash against mobility of labor and capital. At the beginning of the postwar era, Europe needed to be rethought and remade in the wake of the political, economic, social, and moral catastrophes of the 1930s and 1940s. The European Economic Community provided a specific way of insuring against a repetition of the 1930s. Trade integration would prevent a repetition of trade wars and beggar-thy-neighbor policies. The spending activities of the EEC were also in line with the political priority of preventing a repetition of interwar failures. In particular, the large farming populations had been hit by the crisis of interwar globalization, the drying up of bank credit, and the collapse of raw material and food prices. Farmers, mostly as a result of economic misfortune, moved to support the radical anti-system parties, including the Italian fascist party, the French fascist leagues, and National Socialism in Germany. From the 1960s, the Common Agricultural Policy was designed as a mechanism for protecting farmers from price collapses, and more generally of managing the gradual decline of agricultural activity without provoking the radical populist backlash of the interwar years.

There was an explicit learning from the past, that still seems relevant. Pius XII spoke to a meeting of European federalists in his palace at Castegandolfo in November 1948: "There is one danger

¹ James, H. 2001. *The End of Globalization: Lessons from the Great Depression*. Cambridge Mass.: Harvard University Press.

² Fukuyama, F. 1992. *The End of History and the Last Man*. New York: Simon and Schuster.

which cannot be overstated: the abuse of postwar political superiority in order to eliminate economic competition. Nothing could better succeed in irreparably poisoning the work of rapprochement and mutual understanding. The great nations of the continent, with their long histories filled with memories of glory and power, can also thwart the constitution of a European union, exposed as they are to the temptation of measuring themselves on the scale of their own past rather than on that constituted by the realities of the present and predictions of the future. This is precisely why we should expect them to disregard their greatness of yesteryear in order to align themselves with a higher political and economic unity. They will do it all the more willingly because they will not be forced, for the exaggerated concern of uniformity, to a forced leveling, while the respect for the cultural characters of each of the peoples would cause, by their harmonious variety, an easier and more stable union.”³ It is striking that there is some ambivalence: does the phrase about “the abuse of postwar political superiority” apply primarily to the Soviet Union, which was extending its grip over central Europe, and was frequently a target of heavy criticism by the Pope, or also to the United States, in whose image a great deal of west European politics was being reconstituted? Or to the war-ravaged countries of Europe as well?

The early phase of European integration gave rise to a peculiarly self-confident doctrine: that Europe would always learn from crises. So it did not matter if the European construction was half complete, jerry-built. Political

scientists sometimes describe this approach to institution building as “failing forward,” in imitation of a self-help psychology book of John C. Maxwell. Jean Monnet formulated this view in the often cited formula that Europe is driven by crises. In his *Memoirs*, he provides an eloquent account of the characteristic frenetic all night discussions to establish the European Coal and Steel Community, the antecedent of the European Economic Community and hence of the European Union. As he left the French Foreign Ministry on the Quai d’Orsay, the sun was rising, and he spoke to a French official:

“Now we have a few hours to test and a few months to succeed.

After that - ”

“After that,” said Fontaine, smiling, “we shall face great difficulties, and we shall use them to make further progress.

That’s it, isn’t it?”

“It is indeed,” I said. “You’ve understood what Europe is all about.”⁴

There is always a possibility of failing to resolve a crisis. In the 1940 film of Géza von Bolváry, *Wiener G'schichten*, there is a running gag in which the waiter in a Vienna coffeehouse repeatedly stumbles with a heavily laden tray and almost lets them fall, but recovers at the last moment: but at the end he crashes, and the glasses all break. There is also a broader problem: This method is not very appealing to people outside the limited circle who enjoy the logic of late night discussions sustained by cold Belgian sandwiches – the *demos* neither likes or understands the process. Václav Havel castigated “the erroneous belief that the great European task before us is

³ *Allocution de S.S. Pie XII aux congressistes de l’Union Européenne des Fédéralistes (Castelgandolfo, 11 novembre 1948)*, https://www.cvce.eu/en/obj/address_given_by_pope_pius_xii_to_participants_at_the_congress_of_the_union_of_european_federalists_castelgandolfo_11_november_1948-en-49d37c3f-0975-4ae3-91bd-7d8d8c069784.html.

⁴ *Monnet, J. (transl. Richard Mayne). 1978. Memoirs. London: Collins, 1978. 371.*

a purely technical, a purely administrative, or a purely systemic matter, and that all we need to do is come up with ingenious structures, new institutions, and new legal norms and regulations.”⁵

There is a need for a countervailing motivation, emphasizing fundamental values rather than a technocratic fix, but Europeans find this very hard to think or speak about. They – like the population of the USA – are deeply polarized, with very large differences of vision and outlook. Speaking at the shrine of Santiago di Compostella, John Paul II urged: “Do not become discouraged for the quantitative loss of some of your greatness in the world or for the social and cultural crises which affect you today. You can still be the guiding light of civilization and the stimulus of progress for the world. The other continents look to you and also hope to receive from you the same reply which James gave to Christ: ‘I can do it.’”⁶

In the 1970s and 1980s, there was a widespread sense that European integration had lost momentum and credibility. The initial euphoria of the 1950s faded. But there was a new crisis of globalization, driven by the oil shocks and the monetary instability of the 1970s, and by the belief that the US dollar had lost its role as the central anchor of global monetary stability. When the US dollar was soaring from 1981 to 1985, when American manufacturing was threatened and when there appeared to be the possibility of a protectionist backlash, the finance ministers of the major industrial countries pushed for exchange rate agreement. The G-7 finance ministers Louvre meeting in 1987 agreed to lock exchange rates into a system of target zones. In practice, nothing

came of that global plan, but then Edouard Balladur, the French finance minister who had largely been responsible for the Louvre proposal, came up with a tighter European scheme. When German foreign minister Hans Dietrich Genscher appeared sympathetic, Europe’s central bankers were asked by the president of the European Commission, Jacques Delors, to prepare a timetable and a and a plan for currency union.⁷

In the 1990s, a new source of crisis appeared. Would the collapse of the Soviet Empire generate geopolitical instability? Just as in the 1950s, the EEC had been a way of consolidating democracy in states such as France, Germany, and Italy, which had all had their recent experiences with failed democracy and dictatorship; and just as in the 1980s the European Community had been seen as a way of building a solid democratic order in Greece and then Spain and Portugal, all also emerging from the legacy of authoritarianism and dictatorship; the EU looked like an answer to the aspiration of former communist countries to become European and democratic. Poland’s Lech Walesa and Czechoslovakia’s Václav Havel heralded their country’s “return to Europe.” The problem was, however, that the big west European countries had no possible plans for a bold vision – say a military or security union – and that in consequence the only ready-made or shovel-ready project in Europe’s conceptual drawer was ... monetary union.

The 2008 Global Financial Crisis generated a new European uncertainty. The initial response was complacency: after all the crisis seemed to demonstrate the weakness of the American, not the European, model. German Finance

⁵ Hável, V. 1993. *How Europe Could Fail*. *New York Review of Books*. November 18.

⁶ John Paul II. 1982. *Declaration to Europe in Santiago de Compostela*. November 9.

⁷ James, H. 2012. *Making the European Monetary Union*. Cambridge Mass.: Harvard University Press.

Minister Peer Steinbrück called the financial collapse “above all an American problem.”⁸ Then the economic downturn seemed to indicate all the vulnerabilities created by globalization: vulnerability to trade, in that many European areas affected by the “China shock” turned to populism; vulnerability to capital movements, as the sudden stop of flows to eastern and southern Europe created a financing gap; and vulnerability to flows of people. The latter, always a latent fear of Europeans, erupted after the 2015 refugee crisis.

What is the European response to such challenges? Angela Merkel is good for surprises. Her long Chancellorship has been marked by dramatic changes of policy orientation: in 2010, in bringing the IMF into a rescue plan for Greece that she presented as “without alternative,” in 2011, in taking Germany out of atomic energy production after the Fukushima disaster, in 2015, in accepting Syrian refugees moving into Germany, and in 2020, in agreeing to the new joint EUR 500 billion rescue mechanism after the corona crisis. Each produced a howl of outrage from Germans worried about the costs of integration, and from Europeans frightened about German leadership in Europe. Each time the Chancellor insisted there is no alternative.

The latest step is by far the boldest. “The nation state on its own has no future,” she said in a joint video press conference with Emmanuel Macron on May 18, 2020.⁹ Many Germans are now debating whether they are at a “Hamiltonian moment,” equivalent to the key constitutional move when Treasury Secretary Alexander Hamilton worked out a passage for the federal government

to “assume” the debts of states from the war of independence. During the long drawn out European debt crisis, American economists and policy-makers repeatedly urged Europeans to learn from Hamilton: now the moment seemed to have come.

Integration follows from an emergency, but it is wrong to think that just any crisis produces a new moment of integration. There have been plenty of challenges and crises to Europe over the past twelve years: they come thick and fast. European federalists first hoped that the Euro crisis would work that way; but debt meant a larger divide between northern Europe and a southern European periphery. Then Putin and the attack on Crimea and eastern Ukraine? But Russia skillfully drew more and more members of the EU into its orbit. Then Brexit, or Trump? But by that time the refugee crisis had prompted new lines of division, between eastern and western Europe.

So far the key historical conditions for a bold move to end Europe’s attachment to the nation-state have been missing. Why should COVID-19 do what Putin, Trump, Brexit and debt could not do? There are two reasons: one is concerned the world, the other with political competence and effectiveness.

The pandemic demonstrates more clearly than the other crises the dilemmas of globalization. Macron at the press conference began with the statement that the “virus is global.” But that does not mean that every bit of globalization has to be reversed, or that it even can be. Effective combatting of the virus requires global cooperation.

Second, the corona virus is by itself not a catastrophe on the level of many

⁸ <https://www.spiegel.de/wirtschaft/finanzkrise-steinbrueck-wirft-usa-massives-versagen-vor-a-580331.html>. September 25, 2008.

⁹ <https://www.bundeskanzlerin.de/bkin-de/aktuelles/pressekonferenz-von-bundeschkanzlerin-merkel-und-dem-franzoesischen-praesidenten-emmanuel-macron-1753844>.

previous episodes of pandemic mortality, but the economic fallout is terrifyingly dramatic. Fighting both the virus and the economic shutdown is a task that requires highly competent governments.

Mortality data and rates of infection are already being politicized in order to score points about relative competence. The comparisons occur between countries, but also between regions. Why is the devastation worse in the United States, the United Kingdom, Brazil? It is an easy exercise to connect the dots between incompetent, ideological and uncoordinated government responses and poor health outcomes.

Neither Merkel nor Macron is really good at doing political emotion, but both – and especially Merkel – pride themselves on being skillful managers, who make evidence-based decisions. The COVID crisis demonstrates terrifyingly that the nation state cannot do many things. Many effective interventions have to be local, and not national; but many others depend on the international provision of public goods.

This lesson about “necessary responses” is especially poignant in the case of Germany. Like Italy, it was a creation of nineteenth century nationalism. Before Otto von Bismarck (and his Italian equivalent, Camillo Cavour), there were multiple small states, which were quite beautiful in giving a sense of local identity. But they were not good at responding to the technical and economic challenges of the world of increased globalization, where markets were quickly developing as communications and transport became cheaper. One leading commentator, the liberal journalist who invented the term Realpolitik, Ludwig August von Rochau, concluded that nation-state was “nothing

more or less than a simple business transaction (*eine reine Geschäftssache*), in which no one wants to lose, but everyone wants to extract as much as possible for themselves.”¹⁰

It was in that spirit of simplifying state structures to make them more effective that the national project was driven forwards. It is even possible to think of some kind of law of history: Before the Treaties of Westphalia in 1648 there were between three and four thousand independent territorial units, subject only to a loose imperial jurisdiction. By the eighteenth century there were three or four hundred. After 1815, there were only members of the German Confederation. By the end of the nineteenth century, there were just three countries that had a large number of German speakers, the German Empire, the Austro-Hungarian Empire, and the Swiss Confederation. An arithmetically focused historian might conclude that the number of states in central Europe fell every century or so by a factor of ten.

Does that mean that soon there will only be 0.3 states in central Europe, because of a process of federation? History does not move that simply, in neat arithmetic lines. But it is clear that old-style nation-states are having to rethink where, and how, they stand in the world.

The ruling of the German constitutional court on May 5, 2020, apparently setting a limit to the participation of the German central bank in the ECB’s bond buying programs was the final push to the new integration. Far from stopping a process of Europeanizing crisis responses, however, the ruling called for a legal and political backing for a new orientation. In fact, no country has in its constitution as much emphasis on Europe as does Germany. The 1949 Basic Law (the equivalent of a constitution)

¹⁰ von Rochau, A. L. 1869. *Grundsätze der Realpolitik Vol. 2. Stuttgart: Göpel.* 26–27.

for a Federal Republic that was then part of a divided country explains that the German people is “inspired” by “determination to promote world peace as an equal partner in a united Europe.” And reference to European unification occurs in other substantive parts of the constitution: Article 24 specifically refers to the abdication of sovereign rights for the sake of “a peaceful and permanent order” in Europe.

It is worth thinking more precisely about what makes the COVID-19 challenge so unique, why the challenge is not a simple repetition of the Global Financial Crisis, and why the uncertainties it has created about the globalization process are so peculiar. The consequence of COVID-19 has been a simultaneous shock to demand and output, as governments imposed lockdowns. Governments responded with stimulus measures, as well as targeted spending on health equipment and research, at a time when the reduction in economic activity drastically cut tax revenue. The result has been the sharpest ever increase in fiscal deficits outside wartime. Monetary authorities all over the world, including the ECB, responded with accommodative measures. A European peculiarity has been the extent of the support given through loans and guarantees to businesses hit by the lockdowns. The total volume of the German guarantees amounts to at least EUR 757 billion (23% of GDP), that in Italy to EUR 400 billion (25% of GDP), and in France there are bank loan guarantees and credit reinsurance schemes of EUR 315 billion (close to 14% of GDP).

There are two major uncertainties. The first concerns the timing and speed of recovery. Even if there is a successful combination of vaccination and antiviral treatment, it is unlikely that some areas of activity will recover for a long time. Some of the crisis-era shifts are

likely to be longer term: for instance, the move to remote office working and internet conferencing. Cruise ships, tourism, restaurants and hospitality, trade fair and conference business are all likely to take a longer term hit. Fashion and clothing may suffer with fewer opportunities either to socialize or meet in offices. Universities and hospitals have seen their business model shaken. If the longer term alterations materialize, it is likely that a very large proportion of the loans will never be repaid, leaving a substantial fiscal burden. High levels of unemployment are also likely to remain, with pressure for more permanent support mechanisms once the very widespread (and successful) short term support (*Kurzarbeit*) expire.

The second uncertainty concerns the monetary consequences of the new environment. The ECB has embarked on a wide range of asset purchases, collateral easing, as well as the new low-interest liquidity facility (Pandemic Emergency Longer-Term Refinancing Operations, PELTROs); other central banks are taking similar measures, and the Bank of England is reflecting on negative interest rates. Since February 2020, in every industrial country broader monetary aggregates are rising.

Measuring the effects in terms of inflationary/deflationary impact is extremely hard at the outset. The collapse of demand has unsurprisingly led to major price falls for a range of consumer goods, including textiles and automobiles. Petroleum prices fell by record amounts (with negative prices for forward contracts because of the shortage of storage facilities). On the other hand, the collapse of supply chains and a politically driven reversal of globalization is likely to make many goods more expensive, including many food products. Consumers are accumulating large cash balances, that one day

will be spent. Europeans are historically highly sensitive to inflation, and many see inflation as a process that destroys democracy (as it encourages groups to organize and fight for their interests).

There is likely to be a rapid increase in “felt inflation,” in that trips to the supermarket are already becoming much more expensive. Asset prices already look as if they are being driven by a monetary overhang, as the initial post-COVID losses are reversed. For at least a few months, or even a few years, however, the tug of war between inflation and deflation may be unresolved, and policy uncertainty will prevail.

If and when the inflationary scenario materializes, there will be a rapid move away from fixed yield instruments, and government financing will become much more expensive. That outcome would see a return to the euro debt crisis of the early 2010s. The environment surrounding the EU is likely also to be more unstable, as a return to inflation fears is likely to occur earlier and faster there.

If this scenario is realistic, it changes the policy incentives, and creates in particular a great attractiveness to fund as much debt as possible quickly, including very long term maturities, or even as suggested by Francesco Giovazzi and Guido Tabellini and by George Soros non-maturing permanent debt, modelled on the very successful British “consols” launched in the eighteenth century. Such instruments can however only be issued by very secure borrowers. An enormous amount of constitutional design was required for the framework

for eighteenth century British public finance.

If there is any doubt as to the credibility, such long term bonds would not be likely to find much of a market. The ECB without an adequate long term fiscal arrangement would simply look like a version of the post-World War I German central bank, desperately selling loans at grotesquely negative real interest rates, and mopping them through monetary expansion. Already it is clear that small European countries, or emerging markets, will not be able to access this type of instrument.

The consol proposal thus depends on a very radical move to debt mutualization in Europe, a move much more radical than the limited EUR 750 billion agreed in July 2020 by the European Council as the “Next Generation EU”. Already that proposal has provoked a pushback. There is perhaps no political appetite for a broader scheme, which would have to be implemented very quickly, with all the constitutional mechanisms of eighteenth century Britain to ensure that debt is serviced and taxes collected.

If the moment of opportunity is brief, Europe may well be about to give up a very substantial free lunch. This will be the great last chance, the moment when retrospectively historians conclude that Europe was lost – or saved. As advertisers like to say, this is an offer that cannot and will not be repeated. In the nineteenth century, nation-states were created out of blood and iron. Now something new is emerging as a necessary medicine for a political fever.

Chapter 3

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The benefits of 25 years of EU membership

In 2020, a quarter of a century has passed since Finland along with Sweden and Austria joined the European Union. While perceived economic benefits were only one of the reasons to join, and arguably less important in the case of Finland than political factors, it is obviously of great interest to assess to what extent the membership has been economically beneficial. While economic theory suggests that such an integration boosts economic growth and welfare through several channels, making an empirical assessment of the magnitude is far from easy.

The fundamental problem is that it is hard to define the counterfactual, i.e. what would have happened in the absence of the membership. Eichengreen and Boltho (2008) discuss extensively different phases of European integration precisely from this point of view. A key point in their analysis is that many of the effects of different steps of integration – e. g. the European Payments Union to the Common Market, the Single Market Programme and ultimately the Economic and Monetary Union – could have materialised through alternative arrangements. In the case of the three countries joining the EU in 1995, an obvious alternative had been the European Economic Area (EEA), which provides essentially the same access to the internal market as the membership but without political influence and a degree of solidarity that arguably comes with being part of the same “club”.

In both cases, full membership and remaining as a silent partner in the EEA, the question remains about the size of the benefits of such an economic integration. While there are many studies about the impacts of European economic integration, the results vary a great deal. Eichengreen and Boltho consider 5% higher GDP per capita a sort of ball park benefit of European

integration on average, while Badinger finds even as high as 20% benefits.

In a recent paper, Campos, Coricelli and Moretti/CCM (2019) analyse systematically the impacts of all EU enlargement rounds on joining countries' GDP per capita using what has become to be called synthetic control method. Their conclusion is quite positive: The joining countries' GDP per capita is about 10% higher 10 years after the entry (and somewhat more beyond that time span) than had been without the economic integration.

For the three 1995 accession countries, the benefits CCM arrive at are somewhat less after 10 years in their preferred specification: Finland 4%, Sweden 2.3% and Austria 6.3%. Some alternative specifications suggest considerably higher benefits for Finland (up to 12%) while the benefit for Austria comes out smaller and rather unstable for Sweden.

In this paper, we expand the CCM analysis for the three 1995 accession countries by including 9 more years in the sample, i.e. covering also the years 2009 to 2017. CCM terminate their analysis in 2008 on the argument “to avoid confounding effects from the global financial crisis (GFC)”. While there obviously is a risk that the GFC affected the countries in question differently from the “donor pool” countries and thus including the period may bias the results, while leaving these years out is also problematic. It restricts the analysis to a period of relatively rapid growth in the EU. This high growth period turned out unsustainable, being based on debt-financed consumption and in many times unprofitable investments. Excluding years with more adverse external conditions, plagued by the euro crisis, might therefore lead to biased results as well. While we do our

analysis for the three countries, our main focus is on Finland.

Our basic finding is that the benefits of integration do not disappear in the post-GFC years, although they appear somewhat smaller than in the pre-GFC period.

1 The approach

We assess the potential benefits of the EU membership of Finland, Sweden and Austria on the basis of the real GDP per capita and real GDP per employed as a broad measure of labour productivity. The time period considered is from the year of the accession 1995 to 2017.

The analysis uses the so-called synthetic control method (SCM), developed by Abadie and Gardeazabal (2003) and Abadie et al. (2010, 2015), in which a counterfactual is constructed to estimate the effect of the EU accession to the countries of interest. The counterfactual is constructed by using data from periods prior to the treatment period, which in our case is the year of EU enlargement, that is 1995. The data consists of dependent variable and predictive variables from the country of interest and from the countries in the donor pool. The dependent variables in our analysis are the real GDP per capita and real GDP per employed, for which separate counterfactuals are constructed.

The counterfactual – that is the synthetic control unit – is constructed as a weighted average of the countries in the donor pool. The weights are chosen according to a solution of a nested optimization problem in order to minimise the mean squared difference between the dependent variable of the counterfactual and that of the country of interest prior to treatment period, but also to minimise the difference between the predictors. Most importantly, the dependent variable is time series, whereas the predictors

are means, or other statistics, from periods prior to the treatment period. The role of the predictors is to ensure that the counterfactual resembles the country of interest not only in the dependent variable, but in other relevant aspects as well. This prevents over-fitting and makes for more reliable and robust results.

After construction of the counterfactual, the estimated dynamic effect of the treatment (EU accession) to the dependent variable (real GDP per capita and real GDP per employed) is simply the difference between the realised value of the dependent variable and that of the counterfactual in the post-treatment periods. More technical exposition of the synthetic control method and the estimation algorithm is available in Abadie and Gardeazabal (2003) and Abadie et al. (2010, 2015).

We follow very closely the choices made by CCM in order to make the results comparable. In particular, the additional predictors are the same ones as in CCM. They include thus in addition to the GDP, the pre-1995 means of (i) investment share of GDP per capita, (ii) population growth, (iii) share of agriculture in value added, (iv) share of industry in value added, (v) secondary gross school enrolment and (vi) tertiary gross school enrolment. For some countries in the donor pool, the values of some of the predictors are not available for all the periods from 1970 to 1994 otherwise used in the estimation of the synthetic control and as in CCM, in those cases the means of only available values are used.

The donor pool consists of non-EU countries and plausibly not affected by the EU enlargement. The full donor pool used in the analysis can be read from tables 1 and 2. The tables also display the estimated country weights for our baseline models, using the full

Table 1

Weights for baseline synthetic control units with real GDP per capita as the dependent variable

	Austria	Finland	Sweden
Argentina	0	0	0
Australia	0.26	0.77	0.39
Switzerland	0	0	0
Chile	0	0	0
China	0	0	0
Colombia	0	0	0
Egypt	0	0	0
Indonesia	0	0	0
Republic of Korea	0	0	0
Morocco	0	0	0.16
Mexico	0	0	0.08
Malaysia	0	0	0
New Zealand	0.31	0	0
Philippines	0.33	0	0.36
Thailand	0	0	0
Tunisia	0	0	0
Turkey	0	0	0
Uruguay	0.1	0.23	0

Source: Authors' compilation.

Table 2

Weights for baseline synthetic control units with real GDP per worker as the dependent variable

	Austria	Finland	Sweden
Argentina	0.04	0	0
Australia	0.27	0.66	0.1
Switzerland	0	0	0
Chile	0	0	0
China	0	0	0
Colombia	0	0	0
Egypt	0	0	0
Indonesia	0	0	0
Republic of Korea	0	0	0
Morocco	0	0	0
Mexico	0	0	0.57
Malaysia	0	0	0
New Zealand	0.28	0.34	0.05
Philippines	0.37	0	0.27
Thailand	0	0	0
Tunisia	0	0	0
Turkey	0	0	0
Uruguay	0.01	0	0

Source: Authors' compilation.

donor pool of countries for which there was sufficient data available.

2 The results

The results of the analysis are summarised in table 3. Three observations stand out. First, the benefits of the EU membership in terms of GDP per capita extend to post-GFC years. Second, the suggested benefits are somewhat lower in this latter period than in the earlier years for all countries. Third, the gains in labour productivity from EU membership appear large compared to the GDP per capita gains. As a whole, the results for the period up to 2008 are – as they should be – very similar to those obtained by CCM.

The overall level of estimated effects in our analysis appears to be slightly higher than in CCM. The small differences are not surprising, given a slightly different donor pool, and consequently in some cases very different composition of countries with a positive weight in the baseline synthetic control unit. The fact that we have obtained very similar results to those in CCM despite the differences in composition of the donor pool and synthetic control units is however reassuring. Most notably, Japan, Iceland and Canada are all discarded from the donor pool in our analysis due to insufficiencies in the data of predictive variables we were able to collect. In all of the baseline synthetic control units in CCM for Austria, Finland and Sweden, at least one of those countries had a significant positive weight.

The only estimated effect that differs considerably from the baseline results in CCM is the effect on labour productivity of Sweden. Our estimate of over 13% on average for the period from 1995 to 2008 is much higher than the about 3% effect implied by the baseline results in CCM. The sensitivity analysis in CCM however suggests the

results to be highly sensitive to the choice of countries in the donor pool and the probable effect to be much higher than implied by the baseline results. Our estimate of a larger effect is also well supported by our sensitivity analysis in the next section.

Overall, the uncertainties around the estimates of the exact effects are large, as well illustrated by the sensitivity analysis in CCM. Qualitatively, everything however suggests the effect of the EU accession to have been clearly positive for all Austria, Finland and Sweden, even after the onset of the GFC.

The estimate of some 5% GDP per capita benefit of the EU membership by 2017 is somewhat less than 10% of the GDP per capita growth of Finland (53% in all between 1994 and 2017) and Sweden (58%). However, for Austria, the membership gain appears to be much higher: The almost 10% benefit is almost a quarter of the overall change in GDP per capita (39%) in the same period.

A more nuanced picture emerges from the evolutions of the counterfactual and actual GDP per capita and GDP per employed shown in chart 1. The dashed line depicts the constructed baseline synthetic control, whereas the solid line is the actually observed dependent variable. The vertical dotted line marks the time of the EU enlargement and the first period not used for construction of the synthetic control.

The vertical dashed line marks the spot for the financial crisis of 2008.

Austria’s economic growth performance is more stable than that of the two Nordics. At the same time, the benefits as measured by the discrepancy of the two lines are rather steady. Sweden and Finland display considerably more volatile GDP growth patterns, and also the discrepancy of the actual and counterfactual is more variable over time.

In the case of Finland, the actual GDP per capita fails to exceed the counterfactual in two episodes. In the first years after the accession, GDP per capita remained below the counterfactual reflecting the deep recession of the economy into which Finland has entered a few years earlier. More interestingly, towards the end of the sample period 2013–2017 the actual and counterfactual GDP per capita lines almost coincide.

Finland’s growth performance since the accession was affected greatly by the evolution of the ICT sector led by Nokia. While EU membership probably helped the Finnish ICT production, its phenomenal growth in the second half was mostly unrelated to EU integration. Given that Nokia’s contribution to Finland’s GDP reached 4% at its peak, it is likely that the discrepancy between the actual and counterfactual overstates the benefits of the EU membership prior to the GFC.

Table 3

Average percentage deviations from the counterfactual

	GDP per capita			Labour productivity		
	1995-2017	1995-2008	2009-2017	1995-2017	1995-2008	2009-2017
Austria	9.71	10.86	7.93	13.8	14.77	12.3
Finland	4.82	5.33	4.04	6.64	6.7	6.54
Sweden	4.92	6.12	3.06	13.68	12.95	14.8

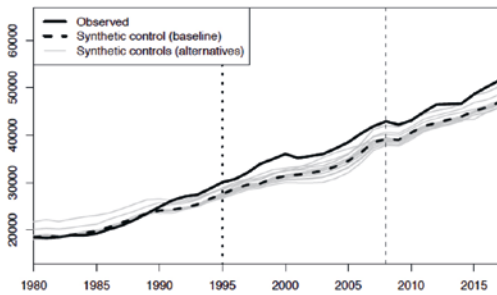
Source: Authors’ compilation.

Chart 1

The evolution of the true (observed) and counterfactual (synthetic control) GDP per capita and GDP per employed

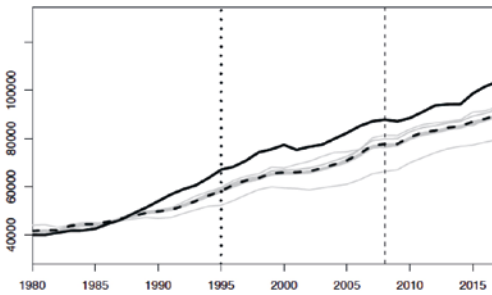
Austria – GDP per capita

Real GDP per capita



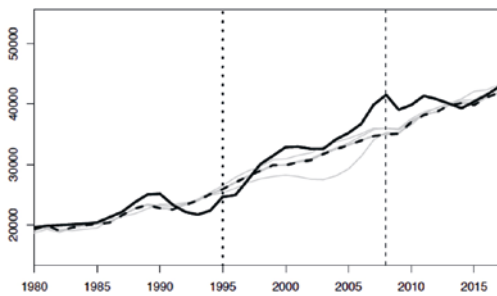
Austria – Labour productivity

Real GDP per worker



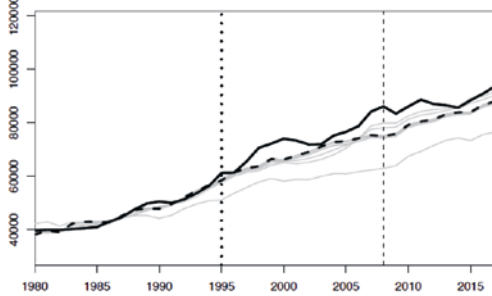
Finland – GDP per capita

Real GDP per capita



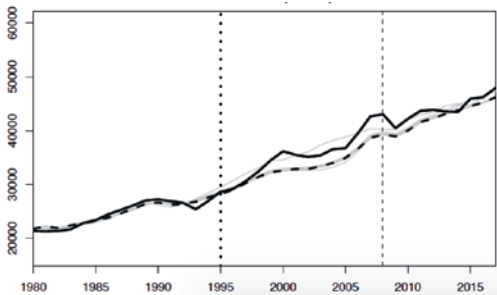
Finland – Labour productivity

Real GDP per worker



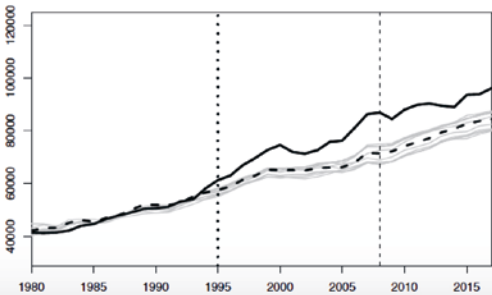
Sweden – GDP per capita

Real GDP per capita



Sweden – Labour productivity

Real GDP per worker



Source: Authors' compilation.

On the other hand, following the GFC, the Finnish economy was not hit badly only by the global and subsequent euro area crisis, but also by the decline of Nokia's cell phone business. About half of the GDP decline between 2008 and 2015 was due to the ICT sector dominated by Nokia (Kaitila et al., 2018). Given that this loss of high value-added production implied overall decline of productivity, it is noteworthy

that this factor was not enough to eliminate the productivity gains attached in the synthetic control exercise to EU membership. As Nokia's decline had nothing to do with the EU membership, one could argue that productivity benefits suggested by the analysis work as a lower bound for the true ones.

The fact that GDP per capita gains from EU membership disappear in our analysis in the last years while the

productivity gains remain clearly positive implies that labour input has developed badly relative to the counterfactual in this period. Two explanations appear plausible. One is a secular decline in the working age (15 – 64 years of age) population, which started in 2010. The second is the loss of cost competitiveness, which had a negative impact on labour demand. Unlike the first one, this second explanation may be linked to EU integration in the sense that the deep recession that started in 2008 was the first such episode while Finland was part of the monetary union. It might be argued that the Finnish labour market institutions had not adjusted to the new integration-induced monetary regime.

3 Robustness

The synthetic control method is in an obvious way vulnerable to the choice of countries in the donor pool. It is therefore useful to check how much the results would change if the donor pool was changed. We do this by the so-called leave-one-out validation. The synthetic control is re-estimated multiple times, each time leaving a different country out of the donor pool. This way the sensitivity of the results can be assessed, since if the results significantly differ after the deletion of one country from the donor pool, the difference should be interpreted as stemming from idiosyncratic shocks in this individual country alone and not from the difference in the true counterfactual and the dependent variable.

The results of the robustness checks are presented in chart 1 with grey lines. With regard to GDP per capita, the results for Austria seem quite robust, since all the alternative counterfactuals (grey lines) are in close proximity of the baseline model. With Finland, however, the deletion of Australia would

seem to widen the gap between the realised values and the counterfactual (at least before the financial crisis), supporting the interpretation of the results as a lower bound of the effect of EU accession.

With Sweden, the deletion of Philippines would seem to make the realised value of GDP per capita and the counterfactual not to significantly differ from each other. This suggests that the evidence on the effect of the EU membership on the real GDP per capita of Sweden is relatively weak, since the results of the baseline model seem to be mainly driven by Philippines alone. Similar observations were made in CCM regarding the robustness of the results for GDP per capita of Sweden.

However, little surprisingly, the counterfactual for labour productivity in Sweden seems much more robust, as well as indicating larger percentage effects even before the robustness checks. For Finland the results for labour productivity seem robust apart from the deletion of New Zealand, implying yet again a possibility for even larger effect than estimated. For Austria, the results for labour productivity do not seem quite as robust as they did for GDP per capita. Again, the deletion of New Zealand causes the estimate of the gap between the realised value and the counterfactual to widen significantly. This suggests, as in the case of Finland, that the baseline estimate of the effect of the EU accession on labour productivity of Austria is a lower bound of the true effect.

4 Conclusions

Our simple synthetic control analysis of the GDP per capita and labour productivity suggests that EU membership has indeed been economically advantageous for Finland as well as the two other 1995 accession countries, confirming

the earlier results of a similar analysis with a shorter time span. The benefits appear stronger in the first decade after the accession when the EU economies were in general growing fast. Nevertheless, also in the post-GFC years, when the EU struggled with the euro crisis, the three accession countries appear to have benefitted from the EU membership. The results for Sweden are nevertheless not as robust as for Finland or Austria.

In the case of Finland, GDP per capita outcomes relative to the counterfactual are affected quite a bit by the volatility of labour input. The weakness of the observed GDP per capita performance relative to the counterfactual in the years following the GFC might in part be due to inadequate adjustment of the labour market institutions to the conditions created by membership in EMU.

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Chapter 4

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25 years of Austria's EU membership

Austria's EU accession 25 years ago, alongside Finland and Sweden, was preceded by an extended period of convergence toward the EU via the free trade agreement concluded with the European Community in 1973, and the participation in the European Economic Area (EEA) in 1994. Although the Corona crisis in 2020 seems to overshadow the overall positive balance of 25 years EU membership, on average the real GDP growth dividend amounted to 0.8 percentage points (pp) per year since 1995. This effect is composed of 0.4 pp GDP growth due to participation in EU's single market, 0.1 pp GDP growth from EMU/euro participation and finally 0.3 pp GDP growth due to the EU enlargements since 2004. Implementing EU policies, Austria has modernized and Europeanized its economy. Even before EU accession, Austria had emerged as a social and economic gateway between Western and Eastern Europe after the fall of the Iron Curtain in 1989 and benefited from the opening-up of Eastern Europe. The EU enlargement rounds in 2004 and beyond reinforced these developments and enabled Austria to achieve, together with its neighbours, a kind of miniature globalization.

JEL classification: F15, C51, O52

Keywords: European Integration; model simulations; country studies

The year 2020 – paraphrasing Queen Elizabeth II – will be remembered as an “annus horribilis”. The world has been infected by the Corona virus and as a reaction most governments locked down all activities of the economy. This resulted in the worst recession since the Great Depression in the thirties. Many celebrations are overshadowed by the Corona crisis: The 75th anniversary of the end of World War II, the 70th anniversary of the foundation of the EU (Schuman Declaration – “Europe day”) and the memory of 25 years of EU membership of Austria, Finland and Sweden. This must be kept in mind when in the following the experience with the EU is evaluated. Nevertheless, the unique Corona crisis year 2020 should not make forgotten the achievements during 25 years of EU membership.

Austria, together with Finland and Sweden, joined an EU with twelve Member States 25 years ago, which grew to 28 Member States by 2013. With the Brexit, it shrank to 27 countries. As a member of the European Free Trade Association (EFTA), Austria had already closely approached the EU's trade policy through the Free Trade Agreement with the EC in 1973 (in the following FTA-EC-EFTA) and the participation

in the European Economic Area (EEA) in 1994. With its accession to the EU in 1995, Austria participated in all subsequent deepening steps of EU integration (EMU with the euro; Schengen Agreement) and in the EU enlargement process. Austria's membership in the EU has made it politically more European, more modern and more open, and it has also benefited economically from all levels of integration.

This article describes firstly Austria's approach towards the EU. Then it confronts the expectations ex ante with the macro-economic outcomes of the EU membership. This is done by a comparison with Finland and Sweden which jointly entered the EU and lastly by presenting the results of own model simulations.

1 Austria's step-by step approach towards the EU

Austria had been a member of EFTA since 1960, participated then one year (2014) in the European Economic Area (EEA) and, together with Finland and Sweden, joined the EU 25 years ago (For a short history, see table 1). An intensive political discussion in Austria preceded EU accession; above all, there were initially concerns about the compatibility

of Austria's status of permanent neutrality with a full EU membership (Breuss, 1996; Gehler, 2002; Griller et al., 2015). Happily, the collapse of communism in 1989 and the resolution of the Soviet Union in 1991, also removed the fear of a Soviet veto against Austria's EU accession. After a hot political debate, the then ruling grand coalition (SPÖ and ÖVP) reached a consensus that Austria should join the EU. Therefore, on July 1989 the Austrian federal government decided to apply for EU membership.

After joining the EU, Austria participated in all steps of deepening the Union: a must for every new member is the entry into the internal (or single) market. It grants the four freedoms for goods, services, capital and labour. Austria was also among the first eleven countries that founded the EMU in 1999 and introduced the euro as legal tender in 2002. In the meantime, 19 EU Member States are euro area countries. Austria also joined the Schengen Agreement on April 28, 1995, which led to the end of border controls on April 1, 1998.

This means that Austria (unlike Sweden, which has not yet introduced the euro) has advanced formally to become a role model EU Member State. However, the lack of implementation of EU law shows that this is not quite the case in practice (Wolfmayr, 2019; European Commission, 2018).

The dual nature of European integration in the 1960s (European Economic Community, EEC (since 1967 European Communities, EC)) versus EFTA was overcome by the FTA-EC-EFTA in 1973. By the middle of 1977, these created a large free trade area in Europe (at least for industrial and commercial goods). The next step towards Austria's rapprochement with the EU came with participation in the EEA in 1994, which already implemented two-thirds of the law concerning EU's internal market. The full liberalization then took place on January 1, 1995 by participating in the four freedoms of the EU internal market (Breuss, 2020c).

Before the start of each integration step, several studies were carried out in the EU¹ and also in Austria (especially

Table 1

A short history of Austria's approach towards the EU

17 July 1989	Austria (as a then EFTA member) applies officially to join the EC ("letter to Brussels").
1 February 1993	Start of the accession negotiations
1 January 1994	The European Economic Area (EEA) enters into force: EC plus Austria, Finland, Iceland, Norway, Sweden and Liechtenstein
30 March 1994	End of accession negotiations: Accession Treaty
12 June 1994	In a referendum in Austria 66.6% of the population voted for an accession to the EU.
24–25 June 1994	European Council meeting in Corfu, Greece: Austrian representatives sign the Accession Treaty EU-Austria.
1 January 1995	Austria (together with Finland and Sweden) becomes the 15 th member of the EU. Austria leaves the EFTA.
28 April 1995	Austria accedes to the Schengen Agreement.
1 January 1999	Austria becomes one of the 11 founding members of the Economic and Monetary Union (EMU).
1 January 2002	The euro is becoming the legal tender in the euro area.
1 May 2004	The EU-15 is enlarged by 10 new Member States: EU-25
1 January 2007	Bulgaria and Romania become members of the EU-27.
1 July 2013	Croatia becomes a member of the EU-28.
1 February 2020	The United Kingdom leaves the EU: the EU shrinks to EU-27.

Source: Author's compilation.

¹ *Cecchini Report (1988) evaluating the impact of the Single Market; European Commission (1990) studied the implication of EMU and the single currency in Europe. A summary of studies about the quantitative effects of European Post-War Economic integration can be found in Badinger and Breuss (2011).*

by the Austrian Institute of Economic Research, Wifo) in order to estimate ex ante the possible integration effects². Austria had already earned a big part of the economic fruits through the intensification of foreign trade relations with the EU via the FTA-EC-EFTA of 1973 and the membership in EEA in 1994. So, the expectations about an additional welfare gain through a full membership in the EU were subdued but realistically positive. Most Austria's EU accession studies predicted an annual increase in real GDP by around ½ percentage points.

The constant deepening of EU integration has also increased its complexity and caused an ever bigger challenge to estimate the possible integration effects. The EEC Customs Union established in 1968 could still be evaluated with the simple theoretical effects developed by Viner (1950) – trade creation and trade diversion. With the advancement of EU integration – internal market (with the four freedoms) as well as the EMU and the introduction of the euro – other macroeconomic effects had to be considered in addition to pure trade effects.

2 Participating in an ever closer union

Connected with the accession to the EU there was a restriction of national autonomy and the transfer of competences to the EU in favour of an increased participation in the European community³. Participation in the supranational organization European Union (it is a hermaphrodite between the confederation and the federal state, namely a confederation of states) resulted in significant changes to the Austrian constitution (Öhlinger, 2015). The attempt to gradually create the “United States of

Europe” – an old dream – by means of the “Treaty establishing a Constitution for Europe” (TCE or Constitutional Treaty) failed after the negative referenda in France and the Netherlands in 2005. Ultimately, however, essential elements have taken up in the currently valid Treaty of Lisbon – in force since December 1, adopted in 2009, in the form of two partial contracts (The Treaty on European Union, TEU and The Treaty on the Functioning of the European Union, TFEU). In the preamble to the Treaty on European Union (TEU), the finality of the EU is addressed relative vaguely but decisively by the target “.. *creating an ever closer union among the peoples of Europe, in which decisions are taken as closely as possible to the citizen in accordance with the principle of subsidiarity.*” For the British people, this goal was one step too much. In the “Brexit referendum” in 2016, the Brits obviously assessed the benefits of this ever-increasing shift of competences to Brussels less than the recovery of their state autonomy (“taking back control”).

Since the entry into force of the Lisbon Treaty, competences between the EU and the Member States have been divided into three categories (Articles 3–6 TFEU):

- *Exclusive competence of the EU:* Customs Union (Common Customs Tariff, CCT), Common Trade Policy (GTP).
- *Shared competence between the Union and the Member States:* internal market, social policy, regional policy, common agricultural policy (CAP), environment, energy, consumer protection, transport, trans-European networks (TEN), area of freedom, security and justice, research programs, development cooperation.

² An overview of such Austrian studies can be found in Breuss (2012) and Beer et al. (2017).

³ For an analysis of the impact of EU law on the national legal system in Austria, see Griller et al. (2015).

- The Union shall have competence to carry out actions to support, *coordinate or supplement the actions of the Member States*: human health, industry, culture, tourism, education, youth and sport, civil protection, administrative cooperation. In addition, the Member States coordinate their economic policies within the Union (Art. 5 TFEU). The council adopts measures for broad guidelines for these policies, e.g. employment and social policies.
- Special rules apply to the *Member States whose currency is the euro*. Due to the asymmetrical construction of the EMU (central monetary and decentralized fiscal policy), there is a whole arsenal of procedures – extended after the Great Recession in 2009 (including the European Semester) and instruments (Reform of the Stability and Growth Pact, Fiscal Pact with a debt brake obligation, etc.) to coordinate the different fiscal policies of the EU and euro area countries. This necessary coordination works relatively well in "good weather periods", but hardly in times of crises, like in the 2009 recession and the following euro crisis.

Overall, Austria and its governments, which have been changing since 1995, have dealt very well with the changed political framework as an EU member and have given the Union many important impulses. Finally, Austria has shown solidarity by the *Vienna Initiative* with the new EU Member States of Eastern Europe that were in need due to the financial crisis (Selmayr, 2019). Occasional outliers (referendum on leaving the EU in 2015; the memory of H.-C. Strache's "Öxit" debate after the Brexit referendum) have disappeared from the political debate since the struggle for Brexit and are also largely rejected by the population (Schmidt, 2020).

3 Performance of Austria, Finland and Sweden in the last 25 years

Economies develop with and without EU membership. Before analysing how much of the general economic development can be attributed to EU membership, it is worth taking a comparative look at the economic development of the three Member States that joined the EU in 1995, Finland, Austria and Sweden (table 2).

Table 2

Macroeconomic indicators of selected countries: 1995–2020

Annual averages Indicator	Unit	Austria	Finland	Sweden	EU-15	Germany	USA	Switzerland
GDP, real	%	1.60	1.95	2.23	1.20	1.11	2.14	1.57
GDP p.c., real	%	1.14	1.62	1.58	0.93	1.01	1.25	0.76
GDP, nominal 2020	billion PPS	344	184	371	13,073	3,029	14,054	404
GDP p.c., nominal ¹ 2020	PPS	38,602	33,224	35,804	31,777	36,380	42,470	46,485
Inflation ²	%	1.78	1.37	1.16	1.74	1.39	2.14	0.54
Unemployment rate	%	4.82	9.13	7.60	8.88	7.24	5.84	4.13
Net-lending	% of GDP	-2.51	0.05	-0.21	-2.98	-1.87	-5.86	-0.34
Public debt 2020	% of GDP	78.80	69.40	42.60	100.3	75.6	136.20	42.00
Intra-EU exports	%	5.99	3.87	4.05	4.34	4.97	x	x
Intra-EU exports 2020	Share in %	70.80	58.80	57.90	61.1	58.4	x	x
Current account	% of GDP	1.19	2.33	4.82	1.10	4.15	-3.16	9.61
Net-contribution to EU budget ³	% of GNI ⁴	-0.25	-0.14	-0.34	x	-0.38	x	x

Source: European Commission: European Economic Forecast, Spring 2020 (AMECO data base); IMF World Economic Outlook April 2020.

¹ PPS = Purchasing Power Standard.

² National consumer price index.

³ European Commission: Operating budgetary balance, average 1995–2018.

⁴ GNI= Gross National Income.

- Between 1995 and 2020, *real GDP* grew on average in Austria by 1.6%; this was lower than in Finland (2.0%) and Sweden (2.2%). In Austria (−1.4 percentage points) and Finland (−1.0 percentage points), economic growth was weaker in the 25 years after EU accession than in the previous 25 years. Only Sweden (+0.3 percentage points) grew faster. While the three countries that joined the EU in 1995 grew faster than Germany (Austria + 0.5%, Finland + 0.8%, Sweden + 1.1%), apart from Sweden, GDP development was weaker than in the USA. Austria, Finland, and Sweden are among the richest EU Member States. In terms of GDP per capita, Austria was the second richest country in the EU-15 in 1995, with Finland in tenth place and Sweden in fifth. In 2020 Austria was third in the EU-27, Finland seventh and Sweden sixth.
- The *inflation* rate in Austria (1.8%) was higher in the last quarter of a century than in Finland (1.4%) and Sweden (1.2%). In all three countries it fell compared to the previous 25 years - in Finland (−6.2%) and Sweden (−6.0%) more than in Austria (−2.1%).
- Austria has the best position in terms of *unemployment*. At 4.8%, the unemployment rate was on average much lower than in Finland (9.1%) and Sweden (7.6%).
- In terms of *fiscal policy*, Austria fell behind Finland and Sweden both in terms of the development of the budget balance and of government debt.
- Austria already benefited greatly from the opening-up of Eastern Europe in 1989 and was able to further increase its foreign trade after the EU enlargement in 2004. Overall, Austria has therefore expanded its intra-EU trade much more than Finland and Sweden. This is reflected in the average annual

increase in intra-EU exports (Austria + 6.0%, Finland + 3.9%, Sweden + 4.1%). With an intra-EU export share of 70.8%, Austria is clearly ahead of Finland (58.8%) and Sweden (57.9%).

- Overall, the *current account* has improved in all three countries over the past quarter century, most notably in Sweden (a surplus of 4.8% of GDP), but also in Finland (2.3%) and Austria (1.2%).

Austria was able to raise its R&D (research and development) quota and reached the high level of that of Sweden (around 3½% of GDP), not least because of the increasing participation in EU research programmes. Finland fell from 3.9% in 2009 to less than 3%. While Austria and Finland introduced the euro from 1999 onwards, Sweden was able to improve its international competitiveness by devaluing the Swedish krona (by 0.7% per year since 1995). However, especially in Austria, the introduction of the euro meant that the previously strong appreciation trend of the Austrian schilling was stopped.

Regarding the fight against climate change, the Scandinavian countries are considerably more advanced than Austria. From 1995 to 2017, CO₂ emissions (per capita) decreased by 27% in Finland, by 38% in Sweden and by only 0.4% in Austria. Last but not least, the early introduction of a CO₂ tax in Finland in 1990 and in Sweden in 1991 contributed to this better result.

4 Benefits of 25 years EU membership

Given the better overall economic development in Finland and Sweden compared to Austria (table 2), it is surprising that almost all studies assessing the effects of EU membership in the three countries are less favourable for the Scandinavian countries than for Austria (table 3). A main reason for this

Estimates of integration effects: A comparison

Authors	Method	Scale	Period	Austria	Finland	Sweden
London Economics (2017)	Econometric estimates with 5 indicators	SM: GDP p.c. %	1995–2015	2.58	1.71	1.50
Felbermayr et al. (2018)	ifo trade model	SM: Welfare cum. %	2000–2014	6.17	3.78	4.22
Mion-Ponattu (2019)	CGE model	SM: Welfare cum %	2010–2016	3.92	2.52	2.80
in 't Veld (2019)	QUEST DSGE model	SM: GDP, real cum. %	long-term	11.80	7.70	7.70
Oberhofer (2019)	Gravity cum IO model	GDP, real % p.a.	1995–2014	0.70	0.30	0.20
Breuss	Integration model	GDP, real % p.a.	1995–2020	0.46 ¹ (0.81) ²	0.44 ¹	0.41 ¹
Breuss	CGE model GTAP10 ³	Welfare cum (% GDP)	1995–2014	7.90	3.80	5.30

Source: Author's compilation.

¹ Trade and FDI results of the integration model of Breuss (2020d).

² Results of all integration effects of the integration model of Breuss (2020d).

³ Simulations with a 10x10 (10 countries and 10 sectors) CGE model with GTAP10 data of 2014; assumption: the EU accession reduces NTBs by 20%.

Note: SM = Single Market; cum = cumulative.

result may be the fact that most studies justify the EU effects solely with increased trade growth. Austria has an advantage in this regard because its intra-EU trade has been more dynamic than in the Scandinavian partners (table 2).

All studies compiled in table 3 report positive GDP or welfare effects of EU membership. In't Veld (2019) finds the largest impact of the EU membership in the three countries with Austria (a long-term increase in real GDP of 11.8%) in the lead; Finland and Sweden benefit equally with +7.7%. In't Veld considers in the European Commission's QUEST DSGE model trade effects (reduction of tariffs and NTBs) and a reduction of mark-ups due to fierce competition as member in the internal market. Felbermayr et al. (2018) estimate with the ifo trade model the second highest Welfare (income) effects in the long run: Austria (+6.2%), Finland (+3.8%) and Sweden (+4.2%). The study by Mion and Ponattu (2019) achieves effects of only half of those of Felbermayr et al. The highest positive GDP effects per annum are postulated by London Eco-

nomics (2017). Accordingly, Austria should have profited from EU membership by an annual increase of real GDP p. c. of 2.6%, Finland of 1.7% and Sweden of 1.5%.

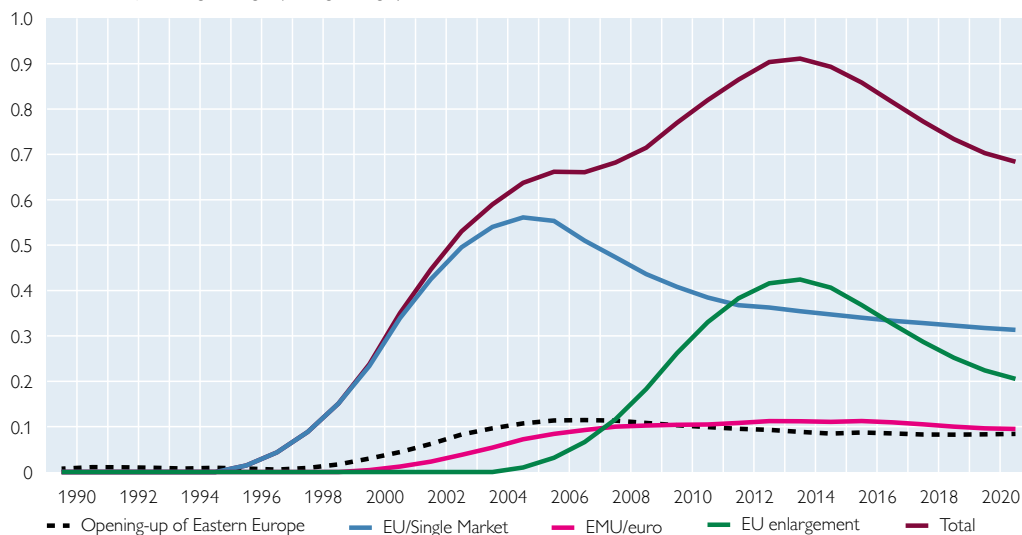
Studies by Austrian researchers show lower, but more realistic effects. Oberhofer (2019) with a structural Gravity cum Input-Output model finds that Austria's EU membership added 0.7 percentage points to the annual growth rate of real GDP. For Finland (+0.3%) and Sweden (+0.2%) this methodology results in only less than half the Austrian effects.

With two approaches, Breuss come to similar results. Using the GTAP10 world trade model the simulation results in a cumulative GDP effect since 1995 of 7.9% in Austria, in Finland 3.8% and in Sweden 5.3%. A specifically constructed macroeconomic integration model (Breuss, 2020d) confirms the overall pattern of the other international studies if the integration model is reduced only to trade and FDI effects: Austria (+0.5% additional annual real GDP growth) has benefitted

Chart 1

Growth effects of Austria's 25 years EU membership

GDP, real, annual percentage changes (moving averages)



Source: Author's compilation.

Note: Total = EU/Single Market + EMU/euro + EU Enlargement.

more from the EU membership than Finland (+0.4%) and Sweden (+0.4%).

In the integration model for Austria, Breuss (2020d) includes several effects which can be expected from the deep integration into the EU: 1) Trade and FDI increased after the full participation in EU's single market and was enhanced through EU enlargement in 2004; 2) The EMU and the introduction of the euro improved Austria's relative competitiveness against countries in the periphery which in the pre-euro area devaluated against the Deutsche Mark and also against the Austrian schilling; 3) Productivity increased due to a better utilization of EU research programmes; 4) More competition in the single market reduced price mark-ups in Austria; 5) Austria is a net-contributor to the EU budget on average of 0.25% of GNI (table 2); 6) The EU accession in 1995 caused little net-immigration; it increased, however, after the EU enlargement in 2004 (although

cushioned by the seven years transitional arrangements).

An assessment of 25 years of Austria's EU membership comprises three stages of EU integration (chart 1):

1. Participation in EU's Single Market: The full integration into EU's single market led to an increase in real GDP of 0.4 percentage points per year. Inflation fell due to increased competition. 8,000 jobs were created each year.
2. Participation in EMU and introduction of the euro: The participation in EMU and the introduction of the euro contributed only 0.1 percentage points to real annual GDP growth. These results are below estimates using the synthetic control method (SCM) by Breuss (2019). Accordingly, the introduction of the euro led to annual GDP growth of 0.3%. McKinsey Germany (2012) calculated significantly stronger effects of the euro for the first ten

years after its introduction: in Austria cumulated +7.8% more real GDP (an annual growth of 0.8%), followed by Finland (6.7%) and Germany (6.4%) and the Netherlands (6.2%).

3. *EU enlargement in 2004 and the following years:* The EU enlargement supplemented the already existing advantage Austria had from the opening-up of Eastern Europe in 1989. EU enlargement contributed to Austria's real GDP an additional 0.3 percentage points per year. Most EU enlargement studies find a 1:10 rule. This means that the welfare gains of the new EU Member States are ten times higher than those of the old EU Member States (Breuss, 2002; Levchenko and Zhang, 2012). Already the world-historic event in 1989 – the fall of the Iron Curtain and the following opening-up of Eastern Europe – was beneficial for Austria (Brait and Gehler, 2014). This historic event moved Austria politically and economically from the border to the centre of Europe. Austria quickly took advantage of these new opportunities for trade and foreign direct investment. The memory of the old Austro-Hungarian monarchy were certainly helpful. The opening to the east led to an annual increase in real GDP of around 0.1%.

The *overall economic benefits* of Austria's 25 years EU membership sum up to an additional annual increase of real GDP of 0.8%. A total of around 420,000 jobs were created. Inflation fell annually by around 1/10 percentage point. The current account improved significantly because of EU integration. This tendency has weakened in recent years. Despite its position as an EU net contributor, Austria was able to improve its national budget. Real exports increased

cumulatively by 31%, imports by 55%, which corresponds on average (exports and imports) to an additional trade volume of 43%. Austria's FDI stocks abroad increased cumulatively by 48% of GDP, the stock of foreigner's direct investments in Austria by 36% of GDP. Welfare (GDP per capita per year) improved in Austria by EUR 7,100 (at 2010 prices) and by USD 14,600 per capita (at prices and purchasing power standards from 2011).

5 Conclusions and outlook

Austria's accession to the EU in 1995 was the final step of its steady effort to become European. After the EFTA membership since 1960, the FTA-EU-EFTA in 1973 and the one-year participation in the EEA in 1994, Austria was already strongly integrated in Europe. Favoured by the collapse of communism in Eastern Europe and the dissolution of the Soviet Union, Austria were free to accede the EU. International studies and our own prove that 25 years of EU integration was beneficial for Austria. Whereas for incumbents to the EU membership is welfare improving this must not be true for the EU as a whole. There is a so-called EU integration puzzle (Breuss, 2014) postulating that it is difficult to explain why the EU – in spite of a steady deepening of integration since World War II – could not achieve higher economic growth than the United States (see also, Breuss, 2017). This contradicts all predictions of the various integration theories. So, while the EU overall did apparently achieve no growth impulses (Andersen et al., 2019) or only small ones (Breuss, 2018b), this does not apply to individual countries that joined the EU. This applies to Austria (+0.8%) as well as to Finland and Sweden (table 3).

Despite the positive judgment of 25 years EU membership, one has,

however, to assume that the best years of Austrian EU membership are already behind us (Breuss, 2020a, 2020b). Even if one takes into account that a full exploitation of the internal market potential (Wolfmayr, 2019) could lift real income by around ½ percentage points, four developments give reason to assume that Austria's economy can hardly expect any significant new integration impulses in the near future:

Firstly, the breakdown of the economic dynamic in Eastern Europe: So far, the new EU Member States in Central and Eastern Europe have always grown faster than the old ones. This was also necessary to catch-up to the rich western states. With the exception of Poland, which survived the Great Recession in 2009 without a slump in growth, all new EU Member States experienced a much stronger decline in economic growth in 2009 (particularly dramatically in the Baltic states) than the old Member States. However, recent forecasts indicate that the growth rates of the new EU Member States are slowly adapting to those of the old ones. The dynamic of the East, which gave traditionally a strong boost to Austria's foreign trade in particular, will slow down significantly, not at least after the Corona recession in 2020 (Breuss, 2018a).

Secondly, one can hardly expect new impulses for foreign trade and economic growth if the euro area expands.

Even if the euro were to be introduced in all EU Member States (“the euro for all”) in the near future (Breuss, 2019), the euro area would – with the exception of Poland – consist of only rather small countries (Bulgaria, Denmark, Croatia, Poland, the Czech Republic, Romania, Sweden and Hungary) and would therefore deliver no significant growth impulses to Austria.

Thirdly, the possible costs associated with the final Brexit – hard or soft – should not be underestimated. Even a soft Brexit with a comprehensive trade agreement with the EU will at least dampen economic development in the remaining 27 EU Member States. In addition, this should result in restrictions in the EU budget. The gap left by the net contributor to the UK must either be compensated for by savings in the EU's Multiannual Financial Framework (MFF) 2021–2027. Especially if one takes into account the new EU Commission's ambitious Green Deal program (Von der Leyen, 2019), which provides EUR 1 trillion for the transformation (decarbonization) of the European economy by 2050.

Fourthly, the Corona crisis will not only cause the deepest recession since World War II in 2020, but it could also – despite the EUR 750 billion EU recovery plan – significantly slow down the European integration process in the years to come.

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Chapter 5

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The challenges and opportunities in the digitalisation of production

In recent years two types of digitalisation have sparked fears amongst policy-makers in the EU and beyond about the future of work. The first is what might be termed the *digitalisation of production* and epitomised by *Industrie 4.0*. The second involves the digitalisation of work, sometimes referred to as *gig work* based on *Uberisation*.

In different ways, both developments are important for both the volume and quality of jobs (Warhurst et al. 2019). However this chapter focuses on the first development – the digitalisation of production and its exemplar, *Industrie 4.0*. This singular focus is adopted because it is said to be at the forefront of a new 4th Industrial Revolution (WEF, 2017).

In the context of the 4th Industrial Revolution, the chapter first outlines what is meant by the digitalisation of production and *Industrie 4.0*. It then highlights some of the opportunities and challenges that they present. The following section then describes how EU policy is currently responding to these opportunities and challenges before making recommendations about how policy might be developed to ensure that the opportunities can be extended to all in the EU.

1 Digitalisation of production

Any technological revolution disrupts the economy and society but is capable of providing long-term development benefits (Perez, 2002). Strange to say that there is no consensus about which industrial Revolution is currently occurring. For some it is the 2nd, for others an extension of the 3rd and for yet others already the 5th or 6th. That it might be the 4th Industrial Revolution was popularised by Schwab (2016) via the World Economic Forum. The term is used as

shorthand to describe the new digital technology. This technology is general purpose and can transform all aspects of our lives: the way we buy, sell, network, communicate, participate, create, consume and, of course, the way we work (Meil and Kirov, 2017).

The term *Industrie 4.0* was first used in Germany in 2011 and was positioned as a strategy to modernise and make more competitive the country's manufacturing sector (EC, 2017). According to German Chancellor Angela Merkel, *Industrie 4.0* is “the comprehensive transformation of the whole sphere of industrial production through the merging of digital technology and the internet with conventional industry” (quoted in Davis, 2015: 2). It is also sometimes referred to simply as the “smart factory”. Significantly, it has not only become emblematic of the 4th Industrial Revolution (WEF, 2017) but also spread out of Germany to become global and beyond manufacturing to be applied to services.

As a form of the digitalisation of production, it involves a cyber-physical system of machines and humans, with Artificial Intelligence (AI) and advanced automation combined with big data, the internet of things and ever-increasing computer power. Although there are definitional problems and, as yet, there are few pure forms, even in Germany, *Industrie 4.0* has a number of agreed features:

- Application of information and communication technology (ICT) to digitise information and integrate systems across the whole production system within and outwith the host company
- Cyber-physical systems that use ICTs to monitor and control physical processes and systems such as embedded sensors and intelligent robots that can

configure themselves as product needs arise

- Use of network communications that link machines, products, systems and people both within the factory and outwith the factory amongst suppliers and distributors
- Simulation, modelling and virtualisation in the design of products and the establishing of manufacturing processes
- Collection, analysis and exploitation of vast quantities of data from within and outwith the factory
- ICT-based support for workers using augmented reality and intelligent tools (Davis, 2015)

This digitalised production system has become the inspiration and aspiration for both the EU and many of its Member States.

2 The opportunities and challenges

In assessing the impact these technologies have on organisation and employment, two main views dominate. On the one hand, the optimists see technology supporting new organisational forms with increased flexibility, reduced production time and enhanced productivity and growth. Organisations are transformed into smart producers of goods and services. With massively enhanced computer processing power, information and systems are integrated across the whole value chain including suppliers, distributors, contractors and customers. Customers can suggest bespoke products, which can be produced quickly (Davies, 2015). Processes are monitored and controlled and configured as product and production needs arise, with workers using augmented reality and intelligent tools. Furthermore, the vast quantities of data from these systems, activities and networks are collated and analysed for further commercial exploitation.

Moreover, combined with the emergence of big data, the internet of things and ever-increasing computer power, robotisation is *clever*. These robots do not just work continuously as they did in the past. Now, they are able to learn, machine from machine, and so adapt to be more efficient at these tasks. These technologies both enable production to become autonomous and offer opportunity to integrate the conception, production and consumption of goods and services. Digitalisation thus makes production of goods and services more efficient. Opportunities for more and better economic growth therefore beckon.

On the other hand, the technology pessimists worry that there will be massive job losses with increased social exclusion, and reduced job quality for remaining workers. The clever robots can undertake both physical (manual) tasks and, increasingly, cognitive (mental) tasks. In doing so, they can substitute human labour. The outcome is the end of (paid) work and mass redundancies. Triggered by the influential report by Carl Frey and Michael Osborne (2013) which claimed that up to 47% of jobs in the US were at risk of eradication, a raft of publications quickly followed. Although citing different numbers, all contained the same message: significant job losses will occur – what has been called “robo-geddon” in a 2019 review from the Welsh Government. If economic growth occurs, it could be without employment. Existing concerns that the distribution of value generated by firms is draining away from workers and being consolidated in the hands of management and shareholders are compounded by this fear of technology-driven mass unemployment. If wages are a key distributor of wealth from production, with fewer people in work,

even if more wealth is created from the new technologies, less of it will be spread around, creating exclusion, poverty and even political unrest.

Even if paid work remains, there are other challenges. The new production system could lead to polarised workplaces with a small number of high-skilled workers designing, introducing and maintaining the digital technologies, and low-skilled other workers either being left with only monotonous tasks for which technological substitution would be too expensive or sidelined into machine-minding, simply overseeing machines that do the work. The digital illiteracy that exists amongst some types of workers and regions within the EU (EC, 2015) could become entrenched. There are also concerns that the new technologies will create new psychological strains as humans are subordinated to intense machine surveillance that intrusively monitors workers' behaviour and impersonally measures and evaluates their performance, sometimes in discriminatory ways (e.g. Eurofound, 2016).

To try to get the balance right between the opportunities and challenges, the German Federal Ministry of Labour and Social Affairs (2017) argues that policy has to avert a techno-centric future in which machines make the decisions without human consideration. Instead, the Ministry argues, the future has to be human-centric in which people make decisions for people.

3 How is the EU responding?

Despite this call for a human-centric approach to the 4th Industrial Revolution, much current policy thinking is based on the new technology determining the future, assuming that the predictions will simply translate into socio-economic reality. Policy is then shaped to

that assumed reality. In this respect, two main policy positions can be identified, one a feature of mainstream politics, the other of more radical politics (Warhurst and Hunt, 2019).

The first policy position, evident in mainstream politics, recognises and worries about mass unemployment. It offers two approaches to policy: one more conservative, the other more ground-breaking.

The more conservative response rests on workers needing help to adjust to the new circumstances. The solution offered is to develop policies that, firstly, will ensure the employability of workers in what will become a highly competitive labour market and, secondly, help regions adjust by creating jobs that are less at risk of technological substitution. A number of policy prescriptions follow from the OECD, ILO and European Commission that, in effect, seek to shape welfare broadly defined around the anticipated mass unemployment (e.g. OECD, 2017; ILO, 2017; EPSC, 2016). Active labour market policies are needed to support workers displaced by digital technology to find new jobs. Social protection needs to include income support and re-employment assistance. Enhanced skill policies need to focus on both digital literacy and soft skills such as problem-solving. Schools and university curricula need to focus more on STEM subjects, human interaction and employability. Lifelong learning opportunities need to update workers' skills over their working lives. Big Data could be used to monitor skills demands and changing occupational compositions to enable better career advice and guidance. To aid regional development, entrepreneurship skills are needed to help create new jobs in sunrise industries. The call for Industrie 4.0 itself typically suggests a vertical policy for

support of traditional manufacturing industries to enable digital changeover.

The more ground-breaking response argues that if growing poverty and social inequalities are to be avoided, welfare will need to be more drastically redesigned. It will mean entitlement aligning within individual needs rather than jobs or unemployment. Residual work could be distributed across the workforce, with workers again supported by digital, soft skills and other types of training. For periods between work, welfare support will again be needed as a safety net. However this welfare would be based on explicit redistribution policies, delivering a guaranteed minimum income level financed through robot (including algorithm) taxes. In addition, a minimum level of employment protection would be introduced for all workers (e.g. Berg et al., 2018; OECD, 2017; Ojanpera et al., 2018). Going further, some argue that Industrie 4.0 requires a new social contract with improved worker consultation and participation (e.g. Davies, 2015). Such arguments resonate with calls for new minimum standards of job quality and which might even extend along global value chains. New cooperative ownership models or sustainable ownership models might also be encouraged to give workers a voice in business development, a fairer share of the gains and provide location-specific benefits.

To varying extents, what is being suggested in this first position are versions of flexicurity for the digital age. Safety nets for workers between jobs are to be created and transitions for workers to new jobs are to be enabled. These jobs should be good jobs. The underlying principle is that workers, welfare and regions need to accept and adjust to the changes that are coming.

The hope is that fear of digitalisation would be eradicated and public support for the impending changes secured.

The second, more radical position rests on a post-work scenario, and tends to be argued outwith mainstream policy circles. Proponents of this position do not see the point of safety nets and transitions. They do not seek to adjust work and tinker with welfare but instead want to realise the full potential of the new digital technology to eradicate not redistribute work. They advocate the end of all paid work and see a new welfare society replacing capitalist society. Claiming that paid work is exploitative and dehumanising, they call for full unemployment to be adopted as policy. Humans would be liberated as a consequence. The robots would create value still; indeed they are needed to maximize the productive capacity of digital technology. The wealth created would then be redistributed to all through a *universal basic income (UBI)*. This UBI would go beyond the provision of minimum needs intended to sustain workers between jobs and support them into new jobs. Instead, it would provide for all life's needs. In doing so, it would provide social stability and support outside the wage system and also end the inequalities that are structural features of capitalism. Freed from paid work, humans could then relearn how to be human (e.g. Dunlop, 2016).

The crux of this second position is that work in the future should be done by the clever robots. Policy should focus less on delivering decent jobs but instead on providing decent lives underpinned by a revolution in welfare provision. Whilst unashamedly utopian, this policy position highlights the ultimate possibilities of digitalised production and infuses more radical politics.

4 Ensuring opportunities extend to all in the EU

The two policy positions outlined above emerge from what might be called the first wave of thinking about the digitalisation of production. A new wave of policy thinking is beginning to emerge that is more cautious. It appreciates that, as with all technological change, there is likely to be job creation and job change as well as job loss. However it still needs an evidence base that identifies not just the challenges and opportunities but also the available options for policymakers.

This need for new policy thinking comes at a time when the EU is already concerned about a rise in non-standard work, job polarisation, labour market flexibility and now the likely recession caused by the Coronavirus. The European Commission has introduced the European Pillar of Social Rights to address some of these concerns (EC, 2018). These rights cover equal opportunities and access to the labour market; fair working conditions; and social protection and inclusion. To support these rights, the Commission also wants upward convergence towards better living and working conditions in the EU (Eurofound, 2018).

Thus, in the context of an emerging digital transformation of work and welfare, there is already a clear political desire to develop an inclusive European future that provides decent work and decent lives for all. The key issue is how to deliver that future in ways that maximize the opportunities and mitigate the risks with the digitalisation of production.

To ensure that opportunities of the digitalisation of production extend to all in the EU, policymakers need to recognise that technology is not deterministic. Instead, choices exist in how digital technology is used by firms.

Moreover a role exists for government and other social partners in shaping these choices across sectors, regions and countries. It is exercising these choices that will make the future human-centric, as the German Federal Ministry of Labour and Social Affairs (2017) desires.

The focus of debate also needs to be extended. Current mainstream policy thinking about the digitalisation of production focuses on job losses, the solution to which is supply-side interventions in the labour market, most obviously skill acquisition through education and training. However, it is just as likely that new jobs will be created and residual jobs reconfigured. As part of their deliberations, policymakers therefore also need to focus on the issue of job quality as much as job quantity.

In this respect, whilst the challenges for workers arising from Industrie 4.0 are currently clear, what opportunities exist is less clear. How increased efficiency and productivity for firms translates into mutual gains for workers needs to be made evident. What the benefits are for workers and how they are to be realised requires understanding of the business models of companies and how value is created, captured and then used and distributed (Findlay et al., 2017).

One way to think about these benefits and how they might be accrued for the benefit of all is for government to proactively steer innovation and investment towards particular objectives or missions, for example to enhance the wellbeing of EU citizens (Jacobs and Mazzucato, 2016). Firms digitalising their production could then be encouraged to compete for government funding based on how they help deliver this mission. In doing so, government can have a role in *market shaping* rather than just deal with *market failures*, providing

safety nets to deal with rising inequality. This government role will also be crucial in delivering post-coronavirus economic recovery. At the same time, there is a role for the social partners in negotiating and delivering this mission and within which trade unions and other worker representative organisations can protect and promote the interests of employees and workers – vulnerable or otherwise. As the OECD and ILO (2018) notes, strong labour relations are important in helping to reduce inequality and meet the challenges of the future of work.

Finally, government needs to re-think the design of welfare in the digital

age so that it can shape not just respond to work. Longstanding policy thinking is premised on moulding welfare to work, funded through tax receipts drawn from standard employment relationships, maximising employment participation and business models in which revenues and revenues streams are transparent. The digitalisation of production is a challenge to the standard employment relationship. Governments need to rebalance labour markets and, with it, the welfare of citizens if the debate about the digitalisation of production is to turn from fear to favour.

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Part 2:

Monetary and financial integration

Chapter 6

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After 25 years as faithful members of the EU: Public support for the euro and trust in the ECB in Austria, Finland and Sweden

Austria, Finland and Sweden became members of the EU in 1995. This paper examines how support for the euro and trust in the European Central Bank (ECB) have evolved in these three countries since their introduction at the turn of the century. Support for the euro in the two euro area members Austria and Finland has remained high and relatively stable since the physical introduction of the new currency nearly 20 years ago, while the euro crisis significantly reduced support for the euro in Sweden. Since the start of the crisis, trust in the ECB was strongly influenced by the pronounced increase in unemployment in the euro area, demonstrating that the ECB was held accountable for macroeconomic developments. Our results indicate that citizens in the EU, both within and outside the euro area, judge the euro and the ECB based on the economic performance of the euro area. Thus, the best way to foster support for the euro and trust in the ECB is to pursue policies aimed at achieving low unemployment and high growth.

JEL code: E42, E52, E58, F33, F45

Keywords: euro, trust, ECB, EU, monetary union, Austria, Finland, Sweden

1 Introduction

In 1995, Austria, Finland and Sweden joined the European Union. A few years later, Austria and Finland joined as founding members of the common currency, the euro, whereas Sweden, following a public referendum in 2003, chose to remain outside and to maintain the krona as its national currency.¹ Now, after a quarter of a century of EU membership, we look back and trace how the public in these three countries has regarded the performance of the common currency and the European Central Bank (ECB). In short, we trace the evolution of public support for the euro and of public trust in the ECB using survey data produced regularly by the Eurobarometer.

These three countries share many traits. They are small open economies, with most of their trade conducted within the EU. Moreover, none of them is party to a military pact. But they differ in their monetary arrangements, with Sweden

declining to join the euro area (EA), while Austria and Finland became members from its very start at the turn of the century. We will examine how this fact has impacted the outlook of Swedes compared to the views of Austrians and Finns.

Our paper is organized in the following way. We first describe the data used. Second, we give a short account of the main findings, focusing in particular on the impact of the economic crisis in the euro area and of the post-crisis recovery on the public's response. As a third step, we introduce econometric results to trace the determinants of the views of the public. We explain the different patterns in the three countries, stressing the path dependence created by the prevailing monetary system, and finally offer our conclusions.

To the best of our knowledge, there is no study of a similar kind comparing cross-country patterns among these three countries.

¹ For an analysis of the 2003 referendum on the euro in Sweden, see Jonung (2004).

2 Data used

We use survey data from the biannual Eurobarometer for the period 1999 to 2019. These surveys turn to a representative set of respondents with the following question: “*What is your opinion of each of the following statements? Please tell me for each statement, whether you are for it or against it. A European economic and monetary union with one single currency, the euro*”. There are three alternative responses: “*For*”, “*Against*”, “*Don’t know*” and after Eurobarometer number 90, “*Spontaneous refusal*”. The replies to this question are used to construct our series for support for the euro.

Our measure for trust in the ECB is based on responses to the following question: “*Please tell me if you tend to trust or not to trust these European institutions. The European Central Bank*”. Respondents have three choices: “*Tend to trust*”, “*Tend not to trust*”, and “*Don’t know*”.

As a measure of net public support, we use the number of “*For*” responses minus the number of “*Against*” responses, according to the expression: $\text{Net support} = (\text{For} - \text{Against}) / (\text{For} + \text{Against} + \text{Don't Know})$. Net public trust is measured by the number of “*Tend to trust*” responses minus “*Tend not to trust*” responses, according to the expression: $\text{Net trust} = (\text{Trust} - \text{Tend not to trust}) / (\text{Trust} + \text{Tend not to trust} + \text{Don't Know})$.

3 The main patterns

First, we focus on the public support for the euro across all EU member states by examining the response pattern within the euro area (EA-19) and outside the euro area (non-EA-9) before we turn to the evidence for Austria, Finland and Sweden. We also bring in the average rate of unemployment in the EA-19 because this variable represents the state of the euro area economy for the respondents.

3.1 Support for the euro

Chart 1 plots the EA-19 unemployment rate against public support for the euro inside the EA-19 as well as public support for the euro in EU member countries outside the EA-19 – the non-EA-9. During the crisis of 2008–2013, the EA-19 unemployment rate rose sharply. Whereas this increase of unemployment in the EA-19 only slightly dented public support for the euro *inside* the EA-19, it led to a strong decline in public support for the euro *outside* the EA-19. In contrast, while the fall in unemployment during the recovery 2013–2019 significantly strengthened public support for the euro inside the EA-19, it only led to a minor recovery in support for the euro *outside* the EA-19.

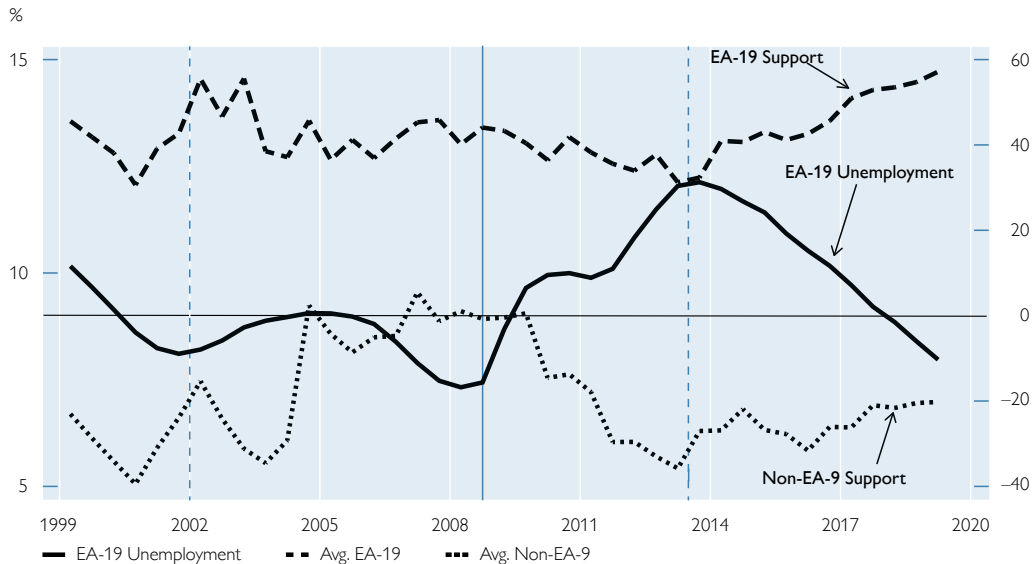
We conclude from chart 1 that the fact of being *outside* the euro area during the euro crisis had the effect of permanently lowering public support for the euro. The euro was blamed for the crisis, while support for the national currency increased. Thus, there is a strong path dependence in the response of the public. The same reaction is documented for the euro area in the sense that here the euro is the national currency, and thus its support was fostered by the fall in the rate of unemployment during the recovery following the euro crisis.

Next, we turn to the question of how the increase in unemployment affects public support in the individual countries inside and outside the euro area. Chart 2 plots the EA-19 unemployment rate against public support for the euro in the 19 individual euro area member countries.

Given our focus on Austria and Finland, these two countries are highlighted in chart 2. During the early phase of the euro, only a slight majority supported the new currency in Austria (at 10%) in the spring of 2000, and even a slight minority supported the new currency

Chart 1

The rate of unemployment in the EA-19 and net support for the euro in the EA-19 and non-EA-9, 1999–2019



Source: Eurostat and Standard Eurobarometer 51–91. Chart 1 is an updated and modified version of Figure 8.1 in Roth and Jonung (2020).

Note: The left-hand y-axis plots the EA-19 unemployment rate in percent. The right-hand y-axis displays net support. As the figure depicts net support, all values above 0 indicate that a majority of the respondents support the euro. The vertical lines represent three milestones in the history of the single currency: the physical introduction of the euro in January 2002, the start of the financial crisis in September 2008 and the start of the recovery at the end of 2013. EA-19 unemployment rates, net support data in the EA-19 and in the non-EA-9 are population-weighted.

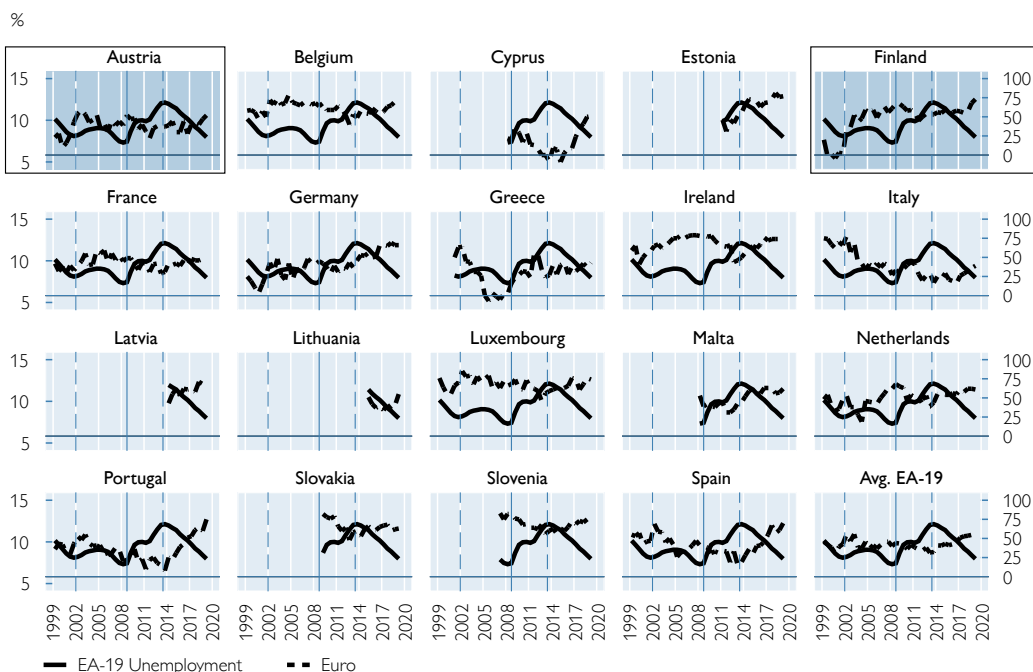
in Finland in the autumn of both 1999 and 2000, at -2% and -4% , respectively.

A striking feature is that support for the euro rose sharply in Austria and Finland prior to the introduction of the euro as a physical currency in the start of 2002. It then remained at a high level until 2008, when it fell slightly during the crisis of 2008–2013, and from 2013 to 2018, it stayed relatively stable, at which time it once more rose sharply. In November 2019 public support for the euro has increased to a net support of 52% in Austria and to an all-time high of 73% in Finland.

Overall, the two euro area members Austria and Finland have displayed stable support for the common currency since its physical introduction in 2002, remaining higher in Finland than in Austria since 2004. As seen in chart 2 – in line with the general trend in each of the EA-19 countries – the increase in unemployment in the EA-19 is negatively related to public support for the euro.² A detailed picture directly comparing Austria and Finland is found in chart A1 in the Annex.

² This is also seen from the negative correlation coefficients displayed in table A1 in the Annex for Austria and Finland during the crisis of -0.56 and -0.72 , and of -0.54 and -0.71 during the recovery, respectively. The overall negative correlation coefficient for the EA-19 is -0.84 for the crisis period and -0.95 for the recovery period.

The rate of unemployment in the EA-19 and net support for the euro in individual EA-19 states, 1999–2019



Source: Eurostat and Standard Eurobarometer 51–91. Chart 2 is an updated and modified version of Figure 8.A1 in Roth and Jonung (2020) and Figure A6 in Roth et al. (2016).

Note: The left-hand y-axis plots the EA-19 unemployment rate in percent. The right-hand y-axis displays net support. As the figure depicts net support, all values above 0 indicate that a majority of the respondents support the euro. The vertical lines represent three milestones in the history of the single currency: the physical introduction of the euro in January 2002, the start of the financial crisis in September 2008 and the start of the recovery at the end of 2013.

We now turn our attention to the nine EU member countries outside the EU-19, as shown in chart 3. The Swedish pattern stands out as significantly different from that of Austria and Finland. Net public support for the euro is barely positive until 2009, when the euro crisis first erupts. In the following years, support falls sharply till 2013, reaching a low of -60% . From then on, it displays a small increase but stays in negative territory. The strong negative correlation coefficient of -0.84 (as displayed in table A1 in the Annex) suggests that this decline is related to the pronounced increase in the average rate of unemployment *inside* the euro area. In short, the Swedish public associated the rise in unemployment *inside* the euro area

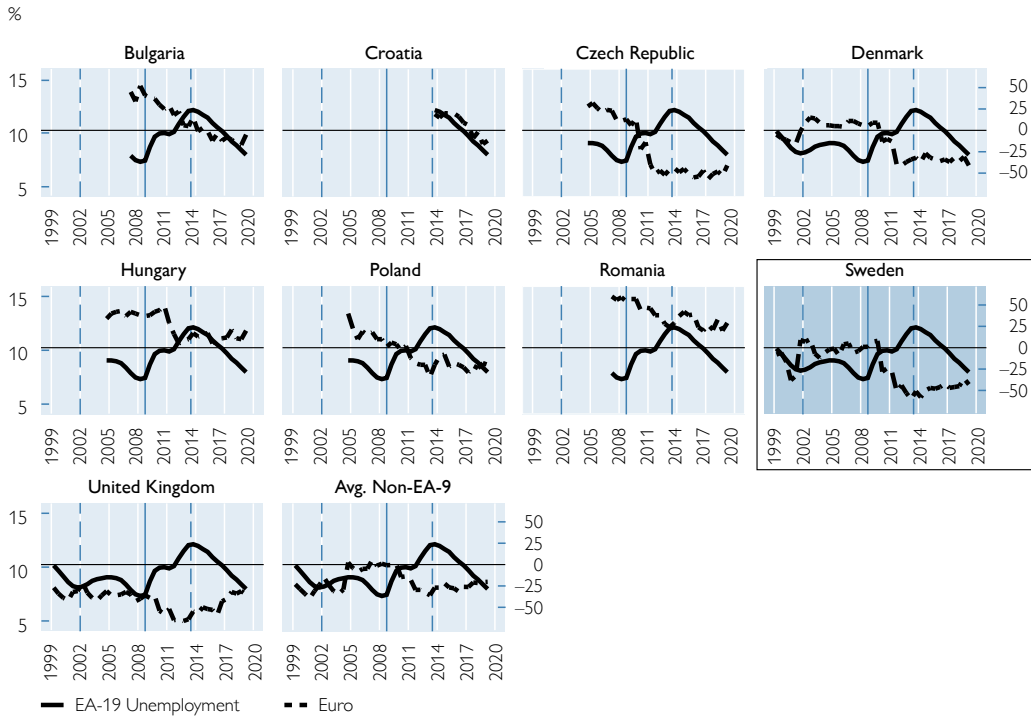
with the euro. A detailed picture directly comparing Sweden with Austria and Finland is displayed in chart A1 in the Annex.

3.2 Trust in the ECB

A different pattern emerges when comparing the EA-19 unemployment rate against net trust in the ECB in the countries inside the EA-19 and outside the EA-19 as displayed in chart 4. During the crisis period 2008–2013, net trust in the ECB clearly declined. Although we detect a significant decline in net trust in the ECB *outside* the EA, the decline was less pronounced than *inside* the EA. The unemployment recovery 2013–2019 led to a pronounced increase in net trust in the ECB *inside* the EA-19.

Chart 3

The rate of unemployment in the EA-19 and net support for the euro in individual non-EA-9 states, 1999–2019

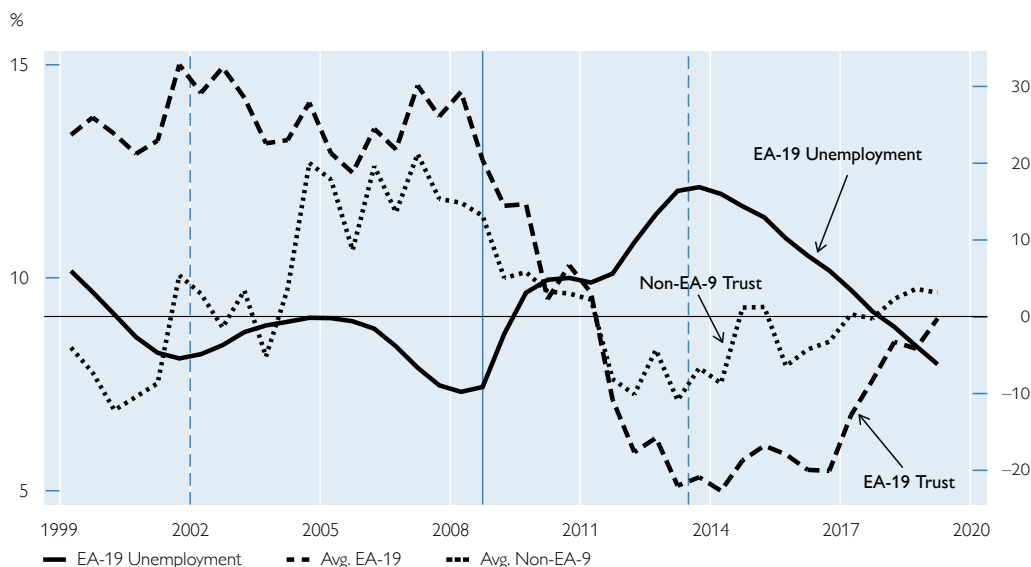


Source: Chart 3 is an updated and modified version of Figure 8.3 in Roth and Jonung (2020), Figure A2 in Roth et al. (2016) and Figure A1 in Roth et al. (2019), based on data from Eurostat and Standard Eurobarometer 51–91.

Note: The left-hand y-axis plots the EA-19 unemployment rate in percent. The right-hand y-axis displays net support. As the figure depicts net support, all values above 0 indicate that a majority of the respondents support the euro. The vertical lines represent three milestones in the history of the single currency: the physical introduction of the euro in January 2002, the start of the financial crisis in September 2008 and the start of the recovery at the end of 2013.

Chart 4

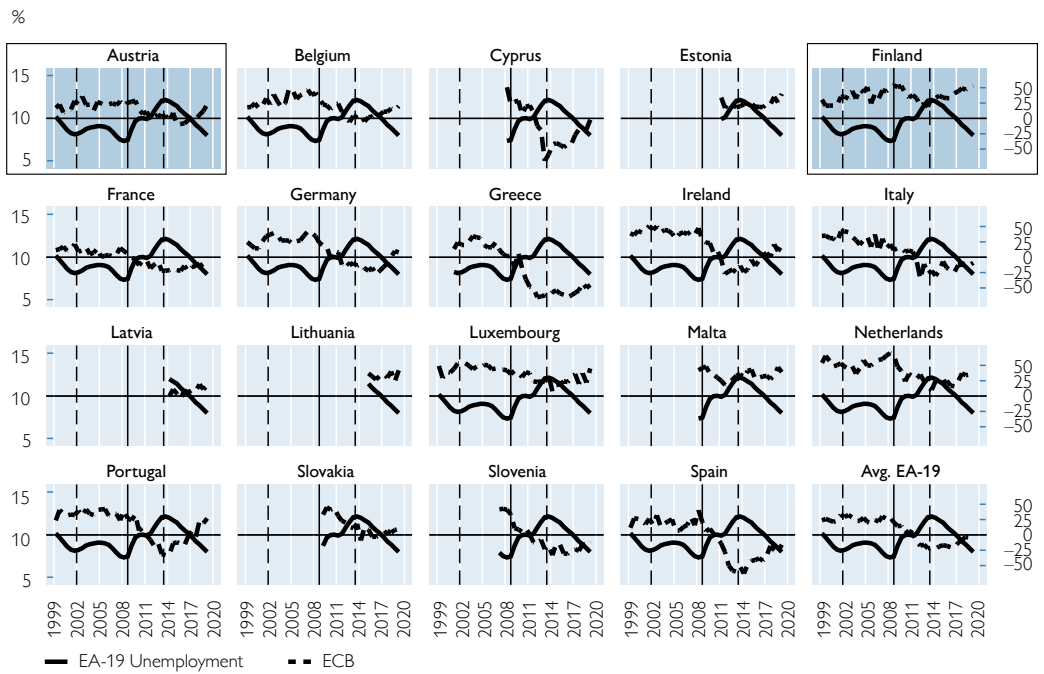
The rate of unemployment in the EA-19 and net trust in the ECB in the EA-19 and non-EA-9, 1999–2019



Source: Eurostat and Standard Eurobarometer 51–91. Chart 4 is an updated and modified version of Figure 8.1 in Roth and Jonung (2020).

Note: The left-hand y-axis plots the EA-19-unemployment rate in percent. The right-hand y-axis displays net trust. As the figure depicts net trust, all values above 0 indicate that a majority of the respondents trust the ECB. The vertical dashed lines represent three milestones in the history of the ECB: the physical introduction of the euro in January 2002, the start of the financial crisis in September 2008 and the start of the recovery at the end of 2013. Unemployment rates and net trust values in the EA-19 and in the non-EA-9 are population-weighted.

The rate of unemployment in the EA-19 and net trust in the ECB in the individual EA-19 states, 1999–2019



Source: Eurostat and Standard Eurobarometer 51–91. Chart 5 is an updated and slightly modified version of Figure 8.2a and b in Roth and Jonung (2020).

Notes: The left-hand y-axis plots the unemployment rate in percent. The right-hand y-axis displays net trust. As the figure depicts net trust, all values above 0 indicate that a majority of the respondents trust the ECB. The vertical lines represent three milestones in the history of the single currency: the physical introduction of the euro in January 2002, the start of the financial crisis in September 2008 and the start of the recovery at the end of 2013. EA-19 unemployment rates are population-weighted.

How has trust in the ECB evolved in the individual countries inside and outside the euro area? The answer is given in charts 5 and 6. Again, focusing on Austria, Finland and Sweden, we observe that all three countries display a similar pattern. Trust was rising from 1999 to 2008/2009 and then it fell during the euro crisis and began to rise again after 2013/2014. Trust is highest in Finland, followed by Sweden and then Austria. A direct comparison of the three countries is found in chart A2 in the Annex.

4 Econometric results

Here we take a more systematic look on the data displayed in charts 1 to 6. We

do so by first estimating support for the euro using the following model:

$$Support\ Euro_{it} = \alpha_i + \beta_1 EA-19\ Unemployment_{it} + \chi_1 EA-19\ Inflation_{it} + \delta_1 EA-19\ Growth_{it} + \phi_1 EA-19\ Z_{it} + w_{it}, \quad (1)$$

Next, we estimate trust in the ECB using this model:

$$Trust\ ECB_{it} = \alpha_i + \beta_1 EA-19\ Unemployment_{it} + \chi_1 EA-19\ Inflation_{it} + \delta_1 EA-19\ Growth_{it} + \phi_1 EA-19\ Z_{it} + w_{it}, \quad (2)$$

where $Support\ Euro_{it}$ is net support for the euro and $Trust\ ECB_{it}$ is net trust in the ECB for country i during period t . $EA-19\ Unemployment_{it}$, $EA-19\ Inflation_{it}$, $EA-19\ Growth_{it}$ and $EA-19\ Z_{it}$ are, respectively, the EA-19 population-weighted average for unemployment, inflation,

Chart 6

The rate of unemployment in the EA-19 and net trust in the ECB in the individual non-EA-9 states, 1999–2019



Source: Eurostat and Standard Eurobarometer 51–91. Chart 6 is an updated and slightly modified version of Figure 8.3 in Roth and Jonung (2020).

Notes: The left-hand y-axis plots the unemployment rate in percent. The right-hand y-axis displays net trust. As the figure depicts net trust, all values above 0 indicate that a majority of the respondents trust the ECB. The vertical lines represent three milestones in the history of the single currency: the physical introduction of the euro in January 2002, the start of the financial crisis in September 2008 and the start of the recovery at the end of 2013. EA-19 unemployment rates are population-weighted.

growth of GDP per capita and control variables deemed of potential importance, which can be lumped together in Z .³ α_i represents a country-specific constant term (fixed effect), and w_{it} is the error term.

Table 1 displays the econometric results for a Fixed Effects Dynamic Feasible Generalized Least Square (FE-DFGLS) estimation for our three macro variables on public support for the euro and trust in the ECB inside the EA-19 against the Member States outside the EA-19 – the non-EA-9.

Regression (1) in table 1 depicts our econometric results for the EA-19

countries. The results demonstrate that a 1 percentage increase in the average EA-19 unemployment rate is associated with an average decline of 4.2 percentage points in net support for the euro among the 19 individual EA countries. Moreover a 1 percentage point increase in inflation is associated with a decline in net support of 12 percentage points.

Regression (2) in table 1 depicts the results for the EU Member States outside the EA-19. Interestingly, we find that the unemployment coefficient is almost twice as high as inside the EA-19. Outside the EA-19, a 1 percentage point increase in the EA-19 unemployment

³ The components of Z could potentially be macroeconomic or socio-political control variables. However, given the cointegrating relationship between support for the euro and our macroeconomic variables (see tables A2–A4 in the Annex), we are confident that these Z -variables do not cause bias in the coefficients of unemployment, inflation and growth.

Table 1

The rate of unemployment in the EA-19 and net support for the euro, net trust in the ECB, inside and outside the EA-19: FE-DFGLS Estimation from 1999 to 2019

Regression	(1)	(2)	(3)	(4)
Dependent variable	Euro	Euro	ECB	ECB
Country sample	EA-19	Non-EA-9	EA-19	Non-EA-9
Period	FS	FS	FS	FS
EA-19 Unemployment	−4.2*** (0.91)	−7.1*** (1.82)	−11.6*** (1.18)	−6.8*** (1.10)
EA-19 Inflation	−12.0*** (3.34)	−13.6*** (4.88)	−10.6*** (3.70)	−11.3*** (4.30)
EA-19 GDP per capita growth	2.8 (3.52)	1.5 (5.39)	10.5*** (3.91)	10.7** (4.65)
Durbin-Watson statistic	2.26	2.06	2.41	2.40
Adjusted R-Squared	0.82	0.93	0.90	0.90
Country fixed effects	Yes	Yes	Yes	Yes
Control for endogeneity	Yes	Yes	Yes	Yes
Elimination of first-order autocorr.	Yes	Yes	Yes	Yes
Observations	527	233	527	233
Time observations T	35	35	35	35
Country observation N	19	9	19	9

Source: Authors' calculations.

Note: FS=Full sample, 1999–2019. Standard errors are in parentheses. *** $p < 0.01$ and ** $p < 0.05$.

rate is associated with an average decline of 7.1 percentage points in net support for the euro. With a coefficient of -13.6 , inflation exhibits a similar coefficient, as inside the EA. The econometric results support our findings from the graphic analysis in charts 1–3. Due to a twice-as-large-impact of unemployment on public support for the euro, we conclude that the strong increase of the EA-19 unemployment rate from 2008 to 2013 played a significant role in explaining the pronounced decline in public support in Sweden during the crisis.

Regressions (3) and (4) show that the opposite holds for net trust in the ECB. The unemployment coefficient inside the EA (-11.6) is almost twice as large as outside the EA (-6.8). This pattern explains why trust in the ECB declined more strongly inside the EA than outside the EA.

5 Why is support for the euro more stable than trust in the ECB?

Support for the euro has hovered at a relatively stable level within the euro

area throughout the first 20 years of the common currency, while trust in the ECB fell sharply during the crisis years of 2008–2013, followed by a rise during the subsequent recovery. This difference in support raises the question: What were the driving forces behind this pattern? It may at first glance appear to be a riddle: Why did trust in the central bank decline while support for the currency supplied by the very same central bank remained constant?

We have given a reply to this question in an earlier study – see Roth and Jonung (2020). Here we simply reiterate our explanation. The public in the euro area distinguishes between the micro-economic role of the euro as its medium of exchange and its store of value from the macroeconomic role of the euro with the ECB as its central bank. The euro as a currency has given stability to the European public. Inflation has remained at a low and stable level. Nevertheless, the public associates negative macroeconomic developments, as reflected by high unemployment and low growth, with actions of the ECB. Thus, the trust in

the ECB, which was lost during the euro crisis, has not so far been fully regained. This will likely take a long time.

6 Conclusions

We find that support for the euro and trust in the ECB during the first 20 years of the euro were strongly influenced by macroeconomic developments in the euro area, as primarily measured by the rate of unemployment. The effects differ significantly between members of the euro area, such as Austria and Finland, and EU members outside the euro area, such as Sweden.

Concerning public support behind the euro, the negative relationship between the rate of unemployment in the EA-19 is much higher outside the euro area than inside. The pronounced increase of unemployment inside the euro area during the euro crisis led to a strong decline in support for the euro in countries outside the euro area, such as Sweden. In countries inside the euro area, e.g. Austria and Finland, support for the euro declined only slightly during the euro crisis. It increased during the recovery while it remained stable at a low level in Sweden.

Conversely, the opposite holds for trust in the ECB. We find that the unemployment coefficient inside the euro area is almost twice as large as outside.

The ECB was thus made accountable for macroeconomic developments within the euro area.

Our results indicate that citizens in the EU, both within as well as outside the euro area, judge the euro and the ECB on the basis of the economic performance of the euro area. Thus, the best way to foster support for the euro and trust in the ECB is to promote policies within the EU that encourage low unemployment and high growth.

Finally, we ask a speculative question: Will Sweden join the euro? Judging from our data, such an event is highly unlikely in the wake of the euro crisis, which undermined support for the euro in that country. Still, Swedish monetary policy has closely followed that of the ECB. In this way, the country is acting as if it were a member of the euro area. Had Sweden joined the euro after the euro referendum in 2003, its support for the euro would most likely have been roughly as high as in Austria and Finland, as there is a considerable path dependence in the choice of national currency. Once a currency is introduced and the public becomes used to it, it gains support over time, especially if unemployment is kept at bay and if growth develops in a positive way.

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Annex

Table A1

Correlation coefficients between the rate of unemployment in the EA-19, net support for the euro and net trust in the ECB in the individual EA-19 and non-EA-9 states

Country	Recovery 2013–2019		Crisis 2008–2013		Pre-Crisis 1999–2008	
	Unemployment EA-19		Unemployment EA-19		Unemployment EA-19	
	Net support	Net trust	Net support	Net trust	Net support	Net trust
EA-19	–0.95	–0.68	–0.84	–0.84	–0.13	0.09
Austria	–0.54	–0.58	–0.56	–0.75	–0.34	–0.28
Belgium	–0.82	–0.89	–0.76	–0.88	–0.12	–0.43
Finland	–0.71	–0.93	–0.72	–0.89	–0.31	–0.37
France	–0.76	–0.63	–0.68	–0.8	–0.09	–0.06
Germany	–0.85	–0.71	–0.31	–0.84	–0.44	–0.65
Greece	–0.41	–0.69	0.4	–0.81	0.05	0.76
Ireland	–0.85	–0.91	–0.87	–0.82	–0.33	–0.42
Italy	–0.74	–0.64	–0.32	–0.74	0.36	0.26
Luxembourg	–0.71	–0.55	–0.72	–0.72	0.05	–0.11
Netherlands	–0.82	–0.74	–0.81	–0.92	–0.39	–0.28
Portugal	–0.97	–0.94	–0.29	–0.85	0.28	0.06
Spain	–0.96	–0.92	–0.78	–0.9	0.08	–0.39
Cyprus	–0.93	–0.92	–0.72	–0.8	xx	xx
Estonia	–0.70	–0.63	0.55	–0.51	xx	xx
Latvia	–0.72	–0.72	xx	xx	xx	xx
Lithuania	–0.61	–0.51	xx	xx	xx	xx
Malta	–0.51	–0.15	–0.17	–0.63	xx	xx
Slovakia	–0.38	–0.04	–0.31	–0.78	xx	xx
Slovenia	–0.91	–0.34	–0.87	–0.91	xx	xx
Non-EA-9	–0.22	0.03	–0.86	–0.84	–0.39	–0.65
Bulgaria	0.72	–0.18	–0.91	–0.51	–0.13	0.39
Croatia	0.92	–0.21	x	x	x	x
Czech Republic	0.02	0.17	–0.79	–0.76	0.89	–0.51
Denmark	0.41	0.27	–0.78	–0.67	–0.32	–0.57
Hungary	–0.09	–0.75	–0.66	–0.54	–0.04	0.51
Poland	0.46	–0.16	–0.81	–0.56	0.57	–0.68
Romania	0.56	–0.09	–0.87	–0.87	0.48	–0.14
Sweden	–0.77	–0.88	–0.84	–0.91	–0.16	–0.58
United Kingdom	–0.89	–0.68	–0.84	–0.84	0.22	0.09

Source: EB51-EB91 and Eurostat.

Note: Correlation coefficients for the recovery sample run from 2013 to 2019 and are based on 12 observations. The correlation coefficients for the crisis sample run from 2008 to 2013 and are based on 10 observations. The correlation coefficients for the pre-crisis sample run from 1999–2008 and are based on 19 observations.

Table A2

Summary statistics EA-19 and non-EA-9 countries from 1999 to 2019

	Number of observations	Mean	Standard deviation	Minimum	Maximum
EA-19					
Net support for the euro	578	47	18.7	-9	85
Net trust in the European Central Bank	578	14.3	27	-69	70
EA-19 Unemployment rate	578	9.7	1.3	7.3	12.1
EA-19 Inflation	578	0.7	0.6	-0.6	2.1
EA-19 GDP per capita growth	578	0.5	1.1	-4.3	2.3
Non-EA-9					
Net support for the euro	257	-6.2	31.9	-66	60
Net trust in the European Central Bank	257	14.4	21.1	-41	59
EA-19 Unemployment rate	257	9.7	1.4	7.3	12.1
EA-19 Inflation	257	0.7	0.6	-0.6	2.1
EA-19 GDP per capita growth	257	0.5	1.1	-4.3	2.3

Source: EB51-EB91 and Eurostat.

Table A3

Pesaran's CADF Panel Unit Root Tests EA-19 and non-EA-9 countries

	Observations	CADF-Zt-bar	Probability
EA-19			
Net support for the euro	563	2.12	0.98
Net trust in the ECB	563	-1.09	0.14
EA-19 Unemployment	563	18.20	1.00
EA-19 Inflation	563	18.20	1.00
EA-19 GDP per capita growth	563	18.20	1.00
Non-EA-9			
Net support for the euro	247	0.25	0.60
Net trust in the ECB	247	1.05	0.85
EA-19 Unemployment	247	12.48	1.00
EA-19 Inflation	247	12.48	1.00
EA-19 GDP per capita growth	247	12.48	1.00

Source: EB51-EB91 and Eurostat.

Note: H_0 : series has a unit root (individual unit root process). H_a : at least one panel is stationary. Table A3 shows that all series have a unit root. A time trend and two or three lagged differences were utilized. Latvia, Lithuania and Croatia were not included due to the brevity of their time series.

Pedroni residual cointegration test EA-19 and non-EA-9 countries

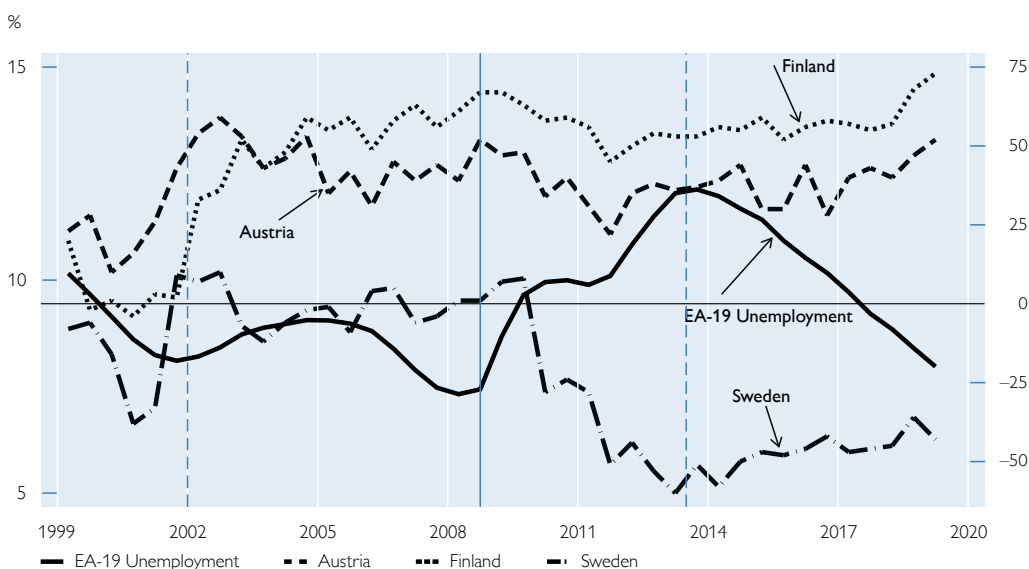
Cointegration between the following set of variables:			
	Observations	ADF-t-statistic	Probability
EA-19			
Net support for the euro, EA-19 unemployment, EA-19 inflation, EA-19 GDP per capita growth	617	-0.87	0.00
Net trust in the ECB, EA-19 unemployment, EA-19 inflation, EA-19 GDP per capita growth	617	-6.88	0.00
Non-EA-9			
Net support for the euro, EA-19 unemployment, EA-19 inflation, EA-19 GDP per capita growth	369	-3.67	0.00
Net trust in the ECB, EA-19 unemployment, EA-19 inflation, EA-19 GDP per capita growth	369	-3.15	0.00

Source: EB51–EB91 and Eurostat.

Note: H_0 : no cointegration. Table A4 shows that the series are cointegrated and thus stand in a long-run relationship.

Chart A1

The rate of unemployment in the EA-19 and net support for the euro in Austria, Finland and Sweden, 1999–2019

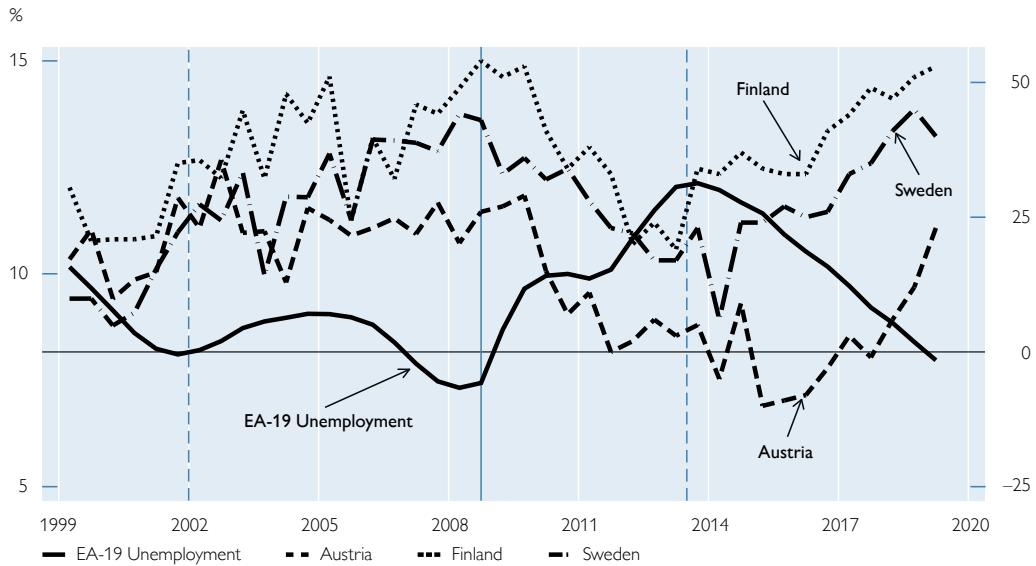


Source: Eurostat and Standard Eurobarometer 51–91.

Note: The left-hand y-axis plots the EA-19 unemployment rate in percent. The right-hand y-axis displays net support. As the figure depicts net support, all values above 0 indicate that a majority of the respondents support the euro. The vertical lines represent three milestones in the history of the euro: the physical introduction of the euro in January 2002, the start of the financial crisis in September 2008 and the start of the recovery at the end of 2013 EA-19 unemployment rates are population weighted.

Chart A2

The rate of unemployment in the EA-19 and net trust in the ECB in Austria, Finland and Sweden, 1999–2019



Source: Eurostat and Standard Eurobarometer 51–91.

Notes: The left-hand y-axis plots the EA-19 unemployment rate in percent. The right-hand y-axis displays net trust. As the figure depicts net trust, all values above 0 indicate that a majority of the respondents trust the ECB. The vertical lines represent three milestones in the history of the ECB: the physical introduction of the euro in January 2002, the start of the financial crisis in September 2008 and the start of the recovery at the end of 2013 EA-19 unemployment rates are population weighted.

Chapter 7

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Finland and monetary policy through three crises

The focus of this article is on monetary policy in the (financial) crises, Finland has gone through in recent decades. Since 1999, Finland has been part of the common currency area applying single monetary policy together with a growing number of other EU Member States. Therefore, when dealing with the Global Financial Crisis we are by and far discussing the monetary policy of the ECB. We review the Finnish performance as a member of the euro area in the Global Financial Crisis against the backdrop of the domestic (or Nordic) banking and economic crisis in the early 1990s. Seemingly, some lessons had been learned facilitating Finland in coping with the Global Financial Crisis, but some had not.

In the aftermath of the Great Recession, the euro area addressed weaknesses that had made it vulnerable in the crisis. However, the ECB couldn't normalize its monetary policy, and also the fiscal policy could have been more countercyclical also in Finland before the corona pandemic hit the euro area in early 2020. The containment measures to address the health crisis caused a sharp drop in economic activity in the spring 2020 globally, in the euro area, and in Finland. The current crisis has not (yet) turned into a financial crisis but has, however, caused financial stress also in the euro area. Operating at the effective lower bound of interest rates and with very high initial indebtedness in the public finances brings about additional challenges for the euro area and its countries in managing the ongoing crisis.

1 The financial crisis of the 1990s in Finland

The severe recession in Western Europe in the beginning of the 1990s turned

out to be most severe in the Northern periphery of the continent. Finland and Sweden experienced a typical boom-bust cycle where both monetary and fiscal policies played a role first in creating and then in alleviating the crisis. The focus here is on Finnish experiences although the crisis was very similar in Sweden.

Initially, Finland applied fixed exchange rates policy and the Finnish financial markets were strongly regulated. In the boom phase in the latter half of the 1980s, financial deregulation together with low real rates of interest initiated rapid credit expansion.

As a result of the liberalization of capital movements and phasing-out of interest rate controls, bank lending doubled during the latter half of the 1980s. The real interest rate was low and the real *after-tax* interest rates were barely positive thanks to the deductibility of the interest rate expenses on bank loans. The relatively high nominal interest rates were not high enough to dampen credit-fueled demand. Also, lending in foreign currency rose dramatically. The inflow of foreign capital increased liquidity and fueled the domestic credit expansion, also exposing many SMEs to foreign exchange risk.

During the boom, the unemployment rate was way below the estimate of the natural rate, at just above 2%, and the sharp increase in asset prices increased household wealth. There was rapid growth in consumption and investment. High wage increases led to weaker foreign competitiveness and growing trade deficits.

In order to dampen the boom, the Bank of Finland raised interest rates slightly in 1987–89. The impact of these actions was, however, of limited significance since the tightening of domestic

monetary conditions was offset by the inflow of foreign capital. Since monetary policy was committed to fixing the exchange rate for the Finnish markka, more responsibility for stabilizing the economy fell on fiscal policy. However, fiscal policy was too loose to restrain rapid growth and the widening of the current account deficit.

At the same time, foreign investors started to have doubts about the sustainability of the exchange rate peg. In March 1989, the Bank of Finland revalued the markka to dampen inflation, but this contributed, at the same time, to the overvaluation of the Finnish markka.¹ By making imports cheaper, it deteriorated the country's terms of trade, and further widened the current account deficit.

The boom ended abruptly in 1990 as higher real rates of interest led to falling asset prices, falling profits and increasing savings. The exchange rate was still overvalued while GDP and employment continued to fall. As devaluation was ruled out from policy options for political reasons², the government tried to resort to incomes policy measures. To address the shock, a rapid and large reduction of labor costs either by an internal devaluation or a depreciation of the external value of markka was needed.

When it became apparent that the social partners couldn't agree on cutting nominal wages, the credibility of the exchange rate peg collapsed. Facing rapid currency outflows, the Bank of Finland tried to support the exchange rate by raising interest rates, but this was not enough to stop the run on the Bank's foreign reserves. The credibility of the peg was further weakened, and

finally Finland devalued the markka in November 1991.

The Finnish economy experienced an unprecedented wave of bankruptcies, credit losses in the banking sector, and a fall in house prices. Despite the increasingly restrictive fiscal measures, fiscal deficits widened and the development of public debt turned explosive. The corporate sector responded to the crisis by cutting costs and selling off assets. This further sharpened the debt deflation spiral in the economy.

Eventually, the markka was left to float in September 1992. Its value immediately fell by about 10% and depreciated by a further 20% in following months. As interest rates were subsequently reduced, the crisis started to calm down and the recovery started.

The stable (or strong) markka policy has been debated extensively in ex-post analysis of the depression of the 1990s. The policy was partly supported by developments in economic theory which stressed the role of credibility and rules. The new theories suggested that monetary policy makers should concentrate on fighting inflation as an anchor for economic policy instead of fixing the foreign exchange rate – i.e. aiming at domestic instead of external price stability. In practice, the experience of well-functioning financial markets under pegged exchange rates and free capital flows was rather limited. The crisis was a clear illustration against trying to combine international capital mobility, a fixed exchange rate and monetary policy sovereignty, commonly known as the impossible trinity or the *trilemma for an open economy*.

An important *lesson from the 1990s crisis was that indebtedness and financial*

¹ In those days, Finland was one of the (if not the) most expensive country in the world according to Purchasing Power Parity comparisons.

² Eventually, the Finnish markka was pegged unilaterally to the European Currency Unit, ECU, in early 1990.

risks within the private sector have to be more closely supervised. Credit expansion had not been controlled and during the crisis the government was forced to socialize a large part of the losses caused by the debt deflation process. Consequently, a new Financial Supervision Authority was created in 1993 into the proximity of the Bank of Finland. Another lesson is that, in addition to flow variables, also the financial stocks such as the assets and liabilities of households and firms deserve great attention. The crisis showed that public debt to GDP can suddenly jump due to excessive leveraging in the private sector. This applies to the banking crisis in Finland, but also to the housing market boom and bust in Spain and Ireland that started to build up.

Recovery, EU accession and the road to the euro area

The long recovery was facilitated by a sharp depreciation of the markka and the rapid fall in the short- and long-term interest rates. The recovery was also sped up by the rapid growth of the Information and Communications Technology (ICT) sector led by the Nokia cluster which boosted the productivity and competitiveness of the Finnish economy. Finland adopted an inflation target in 1993, and three years later, decided to join the euro area among the first participating countries. Finland joined the exchange rate mechanism of the European Monetary System in 1996, and eventually in 1999 the markka was replaced with the single currency.

In the latter half of the 1990s, lower interest rates and the previous budgetary cuts created new leeway for policy-makers, who used the higher-than-expected

tax revenues to finance tax cuts and increase public spending. In the environment of falling real interest rates, improved competitiveness and growing employment, expansionary fiscal policy was no threat to fiscal stability. *The spectacular improvement in fiscal balances achieved in 1995–2000 was caused not by fiscal tightening but rather by strong growth, lower interest payments and declining unemployment-related expenditures.*

2 The Great Recession in the euro area and Finland

Before the financial crisis, the dominant central bank model in most advanced economies was that of an independent central bank pursuing price stability within an inflation-targeting approach by moving interest rates according to some version of the Taylor rule³. This meant in practice that financial stability was not an integral element of central banks' objectives. That is, financial stability was more seen as a precondition to price stability rather than a separate goal.

The global financial crisis that started in 2008 in the euro area was not different from previous crises. Also this time, the economic developments preceding the crisis was characterized by excess credit growth.

In the first decade of the euro area, the benign economic developments of its 12 Member States masked factors that laid the ground for a financial crisis. The first of them is the mere fact that the economic developments were so benign. The two decades preceding the financial crisis are characterized in advanced economies by *Great Moderation*. Steady growth in income per capita was combined with decreased volatility of macroeconomic aggregates. The volatility of output, employment and inflation

³ See Papadia and Välimäki (2018) for a comprehensive review of changes in central banking over past decades and for a richer treatment of ECB's monetary policy in Great Recession in particular.

decreased not only in the euro area but also in the United States, Japan and the UK. These developments lowered crisis awareness in general, and allowed macroeconomic and financial imbalances to grow under the surface.

Macroeconomic imbalances emerged globally, but they took different forms in the euro area and the USA. The common feature was high credit growth. In the euro area, the ranking of countries in terms of the increase in the ratio of credit to income broadly corresponds to the ranking of severity of the subsequent crisis. The global dimension of credit growth was visible, in particular, in the huge current account deficit of the USA, matched by the huge current account surplus of China since the end of the 1990s.

In the euro area, imbalances developed between core and periphery countries. Price and wage inflation were faster in the periphery than in the core countries, which thanks to the single monetary policy resulted in lower real rates in the periphery, and hence, facilitated the build-up of excess credit. The full convergence of nominal interest rates and partial convergence of inflation

(and inflationary expectations) meant that the behavior between the financial and the real sector was asymmetric. At that time sovereign spreads between euro countries were very small, i.e. they did not reflect the build-up of imbalances. Rather, macroeconomic imbalances were reflected in the divergent development of the euro area economies' external balances (chart 1).

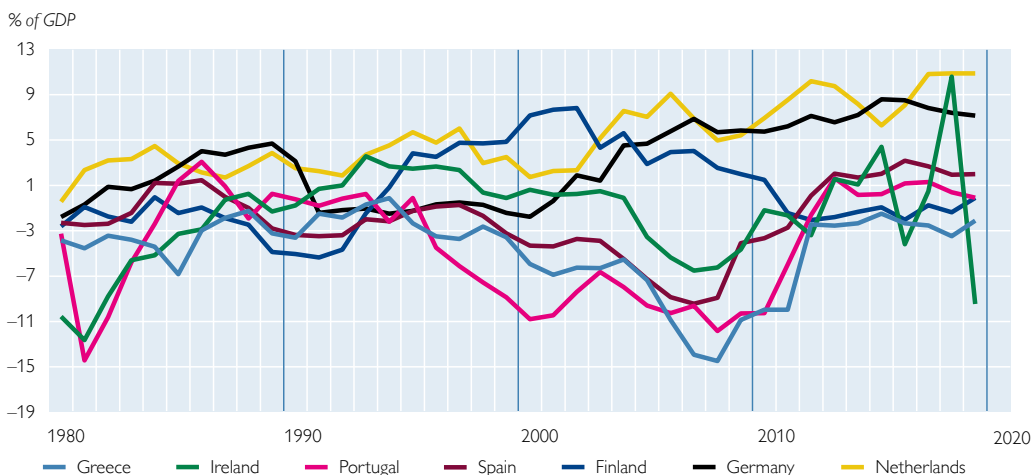
While central banks have a very holistic view of the financial system, the limited responsibilities they had in financial stability before the financial crisis meant that this view did not translate into a macro approach in regulation and supervision. Macroprudential policies were still to be discovered.

In retrospect, it is easy to say that the signs of an approaching financial crisis were present way before the crisis materialized. Financial cycles and the theory of multiple equilibria tell us that an economy is prone to sharp changes for minor causes, once the country has reached the danger zone, where its fundamentals are consistent with both the good and the bad equilibrium.

In the Global Financial Crisis, Finland benefited from the long shadow of

Chart 1

Current account balances in selected euro area countries



Source: IMF World Economic Outlook Database.

its domestic banking sector crises less than twenty years earlier. The banking sector was in good shape after the major restructuring that took place in the 1990s crisis. Also the corporate sector's balance sheets were much stronger than before the domestic crisis. Households' mortgage credit had grown roughly hand in hand with disposable income and the public sector's debt to GDP ratio had been brought down to around 35%. Thanks to these developments Finland was able to maintain a high sovereign rating throughout the crisis, which again helped banks to receive cheap liquidity from abroad. As a result, the global financial crisis did not manifest itself as a financial crisis in Finland, but rather as a huge shock to external demand.

Finland was one of the best performing economies of the world in the decade preceding the global financial crisis. The success was largely driven by the ICT sector, in particular the performance of Nokia. The performance of the Nokia cluster was reflected in rapidly improving cost competitiveness measured by the real effective exchange rate and a large surplus in the current account (over 5%/GDP on average between 1999 and 2008). Finland's terms of trade were, however, steadily deteriorating as the price of mobile phones on the international market fell, and the *terms of trade adjusted* cost competitiveness was rapidly decreasing before the financial crisis. This was not understood to a sufficient degree by social partners and policy makers, and consequently general wage increases were agreed in line with the overall REER. The strong reliance of the favorable economic development on one sector together with a lack of flexibility to adjust turned out to be one of the key vulnerabilities of Finland in the subsequent crisis.

3 Managing the crisis from the monetary policy perspective

Before the crisis, three key assumptions determined the conduct of monetary policy⁴:

- The central bank can tightly control the interest rate it uses as the operational target.
- There is a stable relationship between the central bank rate and the market rates that have more direct impact on the real economy.
- The central bank can adjust its rates by as much as needed to reach the monetary policy target.

In the crisis, these assumptions fell one by one.

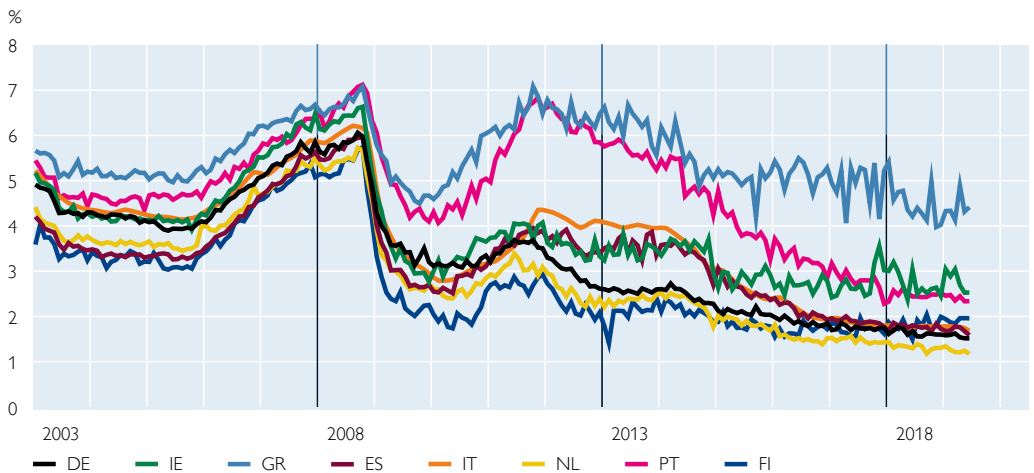
First, at the start of the financial crisis, the demand for liquidity grew significantly and irregularly as banks wanted to hoard liquidity for precautionary purposes. Consequently, the central bank's control over the short-term rates weakened.

Second, the transmission from the short-term risk-free rate to the rates more directly relevant for the economy became less efficient. For example, the widening of the spread between the Euribor and the Overnight Interest Swap (OIS) rates at all maturities meant a sudden increase in the borrowing costs of economic agents just when the crisis would have called for monetary easing.

Also, in the European sovereign debt crisis, the cost of financing of small and medium-sized enterprises increased substantially in peripheral countries compared to the core, reflecting the impaired transmission of monetary policy. This impairment was largely driven by the developments in the sovereign spreads. Hence, monetary policy easing manifested itself conversely to its needs. Even though the ECB was increasing monetary policy

⁴ For a richer treatment see Papadia and Välimäki (2018).

Composite lending rate on loans to non-financial corporations



Source: ECB.

accommodation, the monetary conditions tightened in countries which were most severely hit by the crisis (chart 2).

The *third* key condition for conducting monetary policy before the financial crisis, namely the ability of the central bank to adjust its interest rate in line with the needs fell when the steering rate hit the zero lower bound (ZLB) at the end of 2014.

Central bank responses

The ECB reacted to the three key challenges by changing its operational procedures and in particular by engaging in balance sheet management. Balance sheet management deals both with the length of the balance sheet (quantity) as well as the quality of its asset side in particular. With the new measures, the ECB regained the control of the short term rates, facilitated to bring order in the spreads between the policy rate and more macro-economically relevant interest rates and indeed brought extra monetary policy accommodation when the short term interest rate had reached its lower bound.

Concerning the operational framework, the ECB managed to tackle with

volatility in the banks' demand for liquidity by switching liquidity provision from variable-rate to fixed-rate tenders with full allotment. That is, by fixing the price of central bank reserves and letting their supply to fully adjust to banks' demand, the ECB isolated the short-term interest rate volatility from the unpredictable changes in the demand for liquidity. This change effectively addressed the reduced control of the operational target.

The impaired monetary policy transmission from short-term rates to rates more directly relevant to the real economy, was addressed, first, by shifting bank refinancing from short term liquidity provision to increasingly longer term funding. Eventually, the ECB provided banks with funding for up to four years and at rates even below the rate it paid for holding liquidity at the central bank's deposit facility. To facilitate the pass through of the monetary impulse, the cheapest form of funding required the banks to increase their lending to the real economy.

Concerning the impairments in the sovereign bond markets, the ECB conducted initially smaller asset purchase

programmes to support the impaired sovereign bond markets. However, the real game changer in this sense was the ECB President's famous pledge to do "whatever it takes", and the subsequent Outright Monetary Transactions (OMT) programme that operationalized the commitment.

To deal with the zero lower bound, ECB engaged in three types of monetary policy responses: First, with Forward Guidance the ECB brought the expected lift off from the lower bound forward in time, hence, pulling the longer-term interest rates down. Second, by engaging in large scale asset purchases (QE), the ECB lowered financing costs in general and secured the flow of credit to the real economy. Third, by lowering the policy rate into the negative territory, the ECB evidenced that the true effective lower bound for nominal rates was below zero. With these non-standard monetary policy measures, the ECB managed, at least partly, to address the lack of leeway to adjust the traditional tool. Yet, even though many new measures were introduced, the ECB did not manage to lift medium term inflation expectations to its inflation aim before the crisis hit the global economy. Consequently, there is room for rethinking the ECB monetary policy strategy, as already decided by the ECB's Governing Council.

4 Lessons from previous crises and way forward

The impact of the Great Recession was hardest on peripheral European economies, as many of them had let themselves to drift into a vulnerable situation over the preceding years. These developments turned the spotlight on their fiscal positions, the health of their banking sectors and in particular the interaction between the two. Sustainable fiscal policy is a key condition for

everyone, but especially for a sovereign participating a common currency. The public debt to GDP ratio decreased in the euro area during the recovery from the Global Financial Crisis from 2013 to 2019, but deleveraging has been moderate and uneven across Member States.

The negative feedback loop between sovereigns and their national banking sectors manifested itself severely during the euro area sovereign debt crises. To address this, a *European banking union (BU)* was created with *Single Supervisory Mechanism and Single Resolution Mechanism* as integral parts of it. Yet, the third pillar to complete the BU is still missing; i.e. the *European Deposit Insurance Scheme* is still on the drawing board of the policy makers. In this sense, stability would be further increased if banks in the euro area operated more across the national borders.

For Finland, the Great Recession was only one problem among many others in the past decade's economic development. The Global Financial Crisis was for Finland a large negative shock on external demand but it did not cause large-scale financial stress in the domestic economy nor in the banking sector. Together with i) the collapse of the ICT sector, ii) the downward trend in the forest industry, iii) the shrinking of the working age population, iv) the problems of the Russian economy and v) deteriorated cost competitiveness it however resulted in a decade of very poor productivity growth and output levels that did not reach the pre-crisis levels before 2017.

As part of the single currency area, Finland lacked its traditional macro tool to deal with large economic shocks, i.e. the terms of trade could not be improved by a competitive devaluation or depreciation. However, as the single monetary policy was extremely accommodative throughout the years of slow

growth, it is not at all obvious that this kind of monetary conditions could have been maintained outside the euro area.

The keys to economic success as part of a large currency area seem to be the same as everywhere: i) sustainable public debt and sound fiscal policy guarantees effective flow of funding to the economy and consequently the room for automatic stabilizers to work even in a severe downturn, ii) flexibility in the labor markets can compensate the lack of own foreign exchange rate to adjust for negative shocks, and iii) neither domestic nor single monetary policy can be seen as a substitute for structural reforms as a source of sustainable economic growth.

The sharp drop in global economic activity in the spring of 2020 due to the corona pandemic as well as governments' efforts to contain economic effects of the virus will result in a new jump in public debt levels in the euro area. Thanks to the new *Pandemic Emergency Purchase Programme*, the ECB has, so far,

prevented a financial crisis, but the possibilities to speed up the recovery and to reach the inflation aim in the medium term are somewhat limited. The Bank of Finland is eager to participate actively in the monetary policy strategy review to overcome the challenges looming ahead. Being a member of the Eurosystem, our possibilities to impact European policy making will be much greater than they were when we were running domestic monetary policy.

The pandemic has also brought about unprecedented uncertainty. The outlook for both the evolution of the Corona virus as well as for its economic consequences is blurred, and the consequences for the conduct of monetary policy are still far from certain. In addition to the pandemic, also uncertainties in the global trade have been looming in recent years. Now, in times of large uncertainties, being part of a larger economic entity like the euro area, is likely to increase stability for a small open economy like Finland.

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Chapter 8

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Financial integration in the Nordic-Baltic region vis-à-vis the EU: A Swedish perspective¹

We first provide an overview of the financial integration and cooperation in the Nordic-Baltic region. At the EU-level, integrating the capital markets in Europe as a whole is a priority. A notable part of this process is the European banking union. We therefore also discuss two issues regarding Sweden's participation in the banking union. First, the trade-offs of supranational supervision in the Nordic-Baltic region vis-à-vis the EU. Second, the risk faced by those EU Member States that are outside of both the banking union and the currency union of becoming marginalised in negotiations at the EU-level versus the risk – if joining only the banking union – of being marginalised in negotiations within the banking union.

JEL classification: F02, F36, F65, G15, G28

Keywords: Financial integration, banking union, Nordic-Baltic region, European Union

“Global banking institutions are global in life, but national in deaths.”

Mervyn King²

The limits of monetary policy are sometimes discussed based on the well-known monetary trilemma of an open economy under free capital mobility across borders, see Mundell (1963). The trilemma highlights the difficulty of combining (1) independent monetary policy, (2) free capital mobility, and (3) a fixed exchange rate. Two, but not all three, of the objectives can be achieved at the same time. If monetary policy is independent and, at the same time, capital mobility is free, the exchange rate cannot be fixed.³

A perhaps less known trilemma is that of financial stability policy, which emphasises the limits of national financial policy.⁴ According to this trilemma (1) national financial policy, (2) cross-border financial integration, and (3) financial stability are incompatible. As

is the case with the monetary trilemma, only two of these three objectives can be achieved at the same time. For example, if the objectives are financial integration across borders and a stable financial system, financial policy cannot be national.

The financial trilemma is illustrated in chart 1. In essence, when financial integration increases in a region, the incentives among national supervisors to act in a way that preserves financial stability in the region as a whole decreases. If the benefits of stability oriented policies spread to the region as a whole, the willingness of national supervisors to bear the cost of these policies declines, see Schoenmaker (2011). Hence, there is a positive externality – that is not fully internalised by national supervisors – of stability oriented policies at

¹ We thank Susanna Engdahl and Mattias Hector for valuable comments and suggestions. The opinions expressed in this article are our own and cannot be regarded as an expression of the Riksbank's view.

² Quote from “The Turner Review: A regulatory response to the global banking crisis”, March 2009.

³ Recent experiences show that national monetary policy with free capital movements can be difficult to achieve even with a flexible exchange rate, i.e., the monetary trilemma could be a dilemma, see for example, Rey (2015) and Ingves (2017).

⁴ By national financial policy we mean micro- and macroprudential policy and other financial regulations that are decided upon nationally without coordinating with out-of-the-country supervisors.

the national level.⁵ To increase financial integration and at the same time maintain financial stability at the regional level, greater cooperation among national supervisors is necessary to internalise the externality. The trilemma is best viewed as an illustrative example of the benefits of supranational supervision. When evaluating these benefits in practice factors that are not included in the trilemma also need to be accounted for.

In this short article, we take the financial trilemma as a starting point to discuss financial integration and cooperation in the Nordic-Baltic region vis-à-vis the EU from a Swedish perspective. The discussion focuses on the potential participation of Sweden in the European banking union, which is an issue that currently is in the public eye. The Swedish government has held a public inquiry to evaluate the effects if Sweden were to join the banking union, see Swedish Government Inquiries (2019). In addition, the Riksbank has recently responded to the inquiry, see Sveriges Riksbank (2020a).

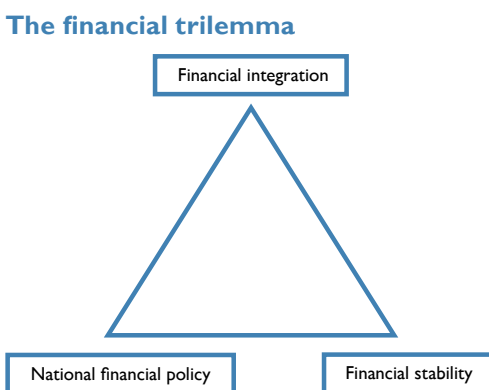
The article proceeds as follows. In the next section, we discuss financial integration and cooperation in the Nordic-

Baltic region. The following section briefly reviews the banking union. The final two sections discuss two issues regarding Sweden's potential participation in the banking union. The first of these two sections discusses the benefits and costs of supranational supervision in the Nordic-Baltic region vis-à-vis the EU, while the second section discusses the risk for EU Member States that are outside of both the banking union and the currency union of becoming marginalised in negotiations at the EU-level versus the risk – if joining only the banking union – of being marginalised in negotiations within the banking union.

1 Financial integration and cooperation in the Nordic-Baltic region

The Nordic-Baltic region has a high degree of financial integration. Chart 2 shows the share of lending of six large regional banks. These banks account for between 40% to 75% of the share of lending to the public in the region. The fact that the region has been dominated by a handful of large cross-border banks has created incentives for cooperation between financial stability authorities in the region. This cooperation was strengthened during the global financial crisis (GFC) that broke out in 2008. Apart from a number of national measures aimed at boosting the functioning of local financial markets, regional cooperation was key to promoting an effective crisis management. For example, in May 2008, the central banks of Denmark, Norway and Sweden entered into swap agreements with the central bank of Iceland. Later in 2008 the Riksbank and Nationalbanken agreed on swap arrangements with the Latvian

Chart 1

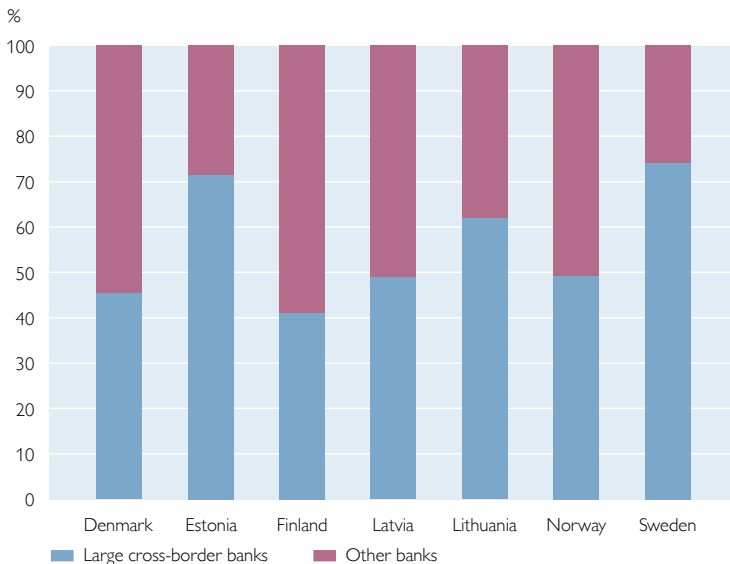


Source: Authors' illustration.

⁵ It can also be the case that a country that benefits from stability oriented policies in neighbouring countries may be tempted to exploit "imported" stability to pursue more expansionary, potentially destabilising, financial policies.

Chart 2

Share of lending to the public



Source: Bank reports and Sveriges Riksbank (2018).

Note: Large Nordic cross-border banks include: Danske bank, DNB, Nordea, Handelsbanken, SEB and Swedbank.

Central Bank as a bridge to the funding from the IMF. Furthermore, a swap agreement was also concluded between the Riksbank and Eesti Pank in 2009.⁶ This cooperation laid the foundation for deepened cooperation in the Nordic-Baltic region as the GFC subsided. Several regional groups have been set up for this purpose, not only between central banks but between supervisors, resolution authorities and Ministries of Finance.

2 Regional groups of cooperation

An important forum of cooperation in the macroprudential area is the Nordic-Baltic Macroprudential Forum (NBMF). This forum was created in 2011 and brings together central banks and supervisory authorities at senior level in

twice-yearly meetings.⁷ The task of the NBMF is to discuss risks to financial stability in the region and the implementation of macroprudential policies to counter such risks. The Forum also discusses topical issues – with relevance from a macroprudential perspective – that are discussed in other international forums.

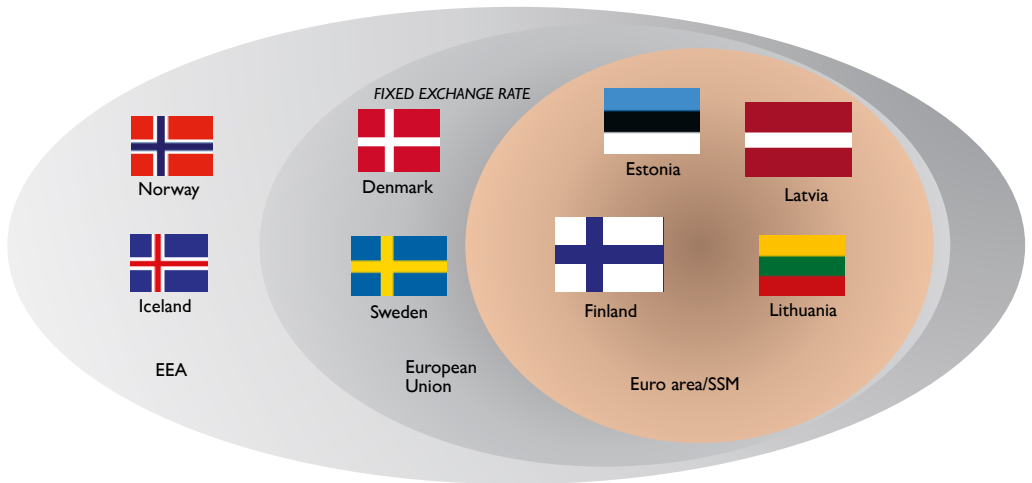
While financial sector integration is strong in the region, the countries are not as homogenous as might be the general perception. As is shown in chart 3, all countries are members of the EU except Iceland and Norway. Finland and the three Baltic states have adopted the euro and are thus members of the banking union. Denmark is pursuing a fixed exchange rate while Sweden has a floating exchange rate.

⁶ For further reading on the measures that were taken during the GFC, see Sveriges Riksbank (2020b).

⁷ See Farelus and Billborn (2016) for a discussion.

Chart 3

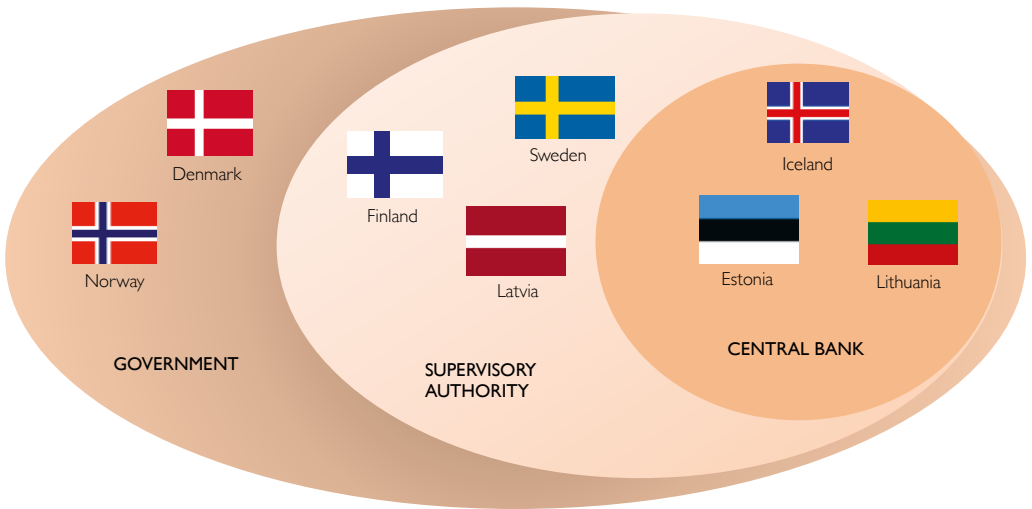
Different characteristics of the Nordic-Baltic countries



Source: Authors' illustration.

Chart 4

Designated macroprudential authority in the Nordic-Baltic countries



Source: Authors' illustration.

There are also differences between the countries when it comes to whom has been given the role as designated macroprudential authority, see chart 4. While both Norway and Denmark have put their Ministries of Finance in charge of macroprudential policy, in Finland, Latvia and Sweden, the same role is performed by the supervisory authorities.

And finally, in Estonia, Iceland and Lithuania, the central bank is the designated authority.

Prior to the global financial crisis in 2008–2009, the concept of macroprudential policy as such did not exist in the Nordic and the Baltic countries. However, the Baltic countries introduced certain measures prior to the financial

Table 1

Overview of the implementation of macroprudential measures in the Nordic-Baltic countries

	Loan-to-value restriction	Debt-service to income restriction	Increased capital requirements ¹	Liquidity coverage ratio	Net stable funding ratio	Amortization requirements/ maximum loan maturity
Denmark	X		X	X		
Estonia	X	X	X	X		X
Finland	X		X	X		
Iceland	X		X	X	X	
Latvia	X		X	X		
Lithuania	X	X	X	X		X
Norway	X	X	X	X		X
Sweden	X		X	X		X

Source: Nordic-Baltic Macroprudential Forum (2019).

¹ Includes Counter-Cyclical Capital Buffer, Systemic Risk Buffer, Capital Conservation Buffer, Additional Capital Requirements for Systemically Important Institutions, Sector Specific Risk Weight Floor, Risk Weight Floor.

crisis to dampen growth in mortgage lending, but the high penetration of foreign branches reduced the effectiveness of these policy measures.⁸ Setting regulatory standards higher than the regulatory minimum was from time to time seen as threatening the competitiveness of domestic institutions in a number of countries when market shares of foreign branches were growing rapidly. The lack of dedicated measures to safeguard financial stability also sparked a discussion of the possible use of monetary policy to “lean against the wind”.

Since the creation of the NBMF in 2011, a number of measures of macroprudential nature have been taken in the region. Table 1 provides an overview of the implementation of macroprudential measures in the Nordic-Baltic countries. The measures focus on capital and liquidity requirements. Borrower-based measures, such as loan-to-value restrictions, are also implemented across the region. Tools targeting mortgage lending, such as debt-to-income or

debt-service-to-income measures, are also prevalent, but to a lesser degree.

3 Main lessons and challenges

The NBMF has proven to be an important informal forum for discussion of financial stability risks and macroprudential measures. It has enabled central banks and supervisors to meet regularly and discuss issues of mutual interest. It has promoted an increased understanding of cross-border issues and more in-depth analysis of the detailed implementation of the various macroprudential measures. As it provides a regional perspective, it supplements European groups such as the European Systemic Risk Board (ESRB).

In order for macroprudential policy to be effective in an environment with a high degree of cross-border banking and banks operating in the form of branches, the issue of so called reciprocation of macroprudential policy becomes important. To illustrate, if a country is hosting a number of foreign branches

⁸ See RCG Europe Working Group (2016).

and sees the need to increase capital requirements for a particular exposure, the national designated macroprudential authority does not have jurisdiction over the exposures in the foreign branches. Hence, it can only ask the home supervisor of the branch to reciprocate the measure, i.e., to also increase capital requirement in its own jurisdiction for exposures taken by the branch. In the absence of such reciprocation, the measure can become less effective. Chart 5 shows the relative importance of branches and subsidiaries in the region. In many countries foreign branches are important, making the reciprocation of macroprudential policy necessary to ensure the effectiveness of the measures taken. In view of the close cooperation between the Nordic-Baltic authorities, not least in the context of the NBMF, reciprocation has worked well.

4 Close cooperation on crisis preparedness

The Nordic-Baltic countries have also established close cooperation in the area of crisis management. In 2010, the Nordic-Baltic Stability Group (NBSG) was established between Ministries of

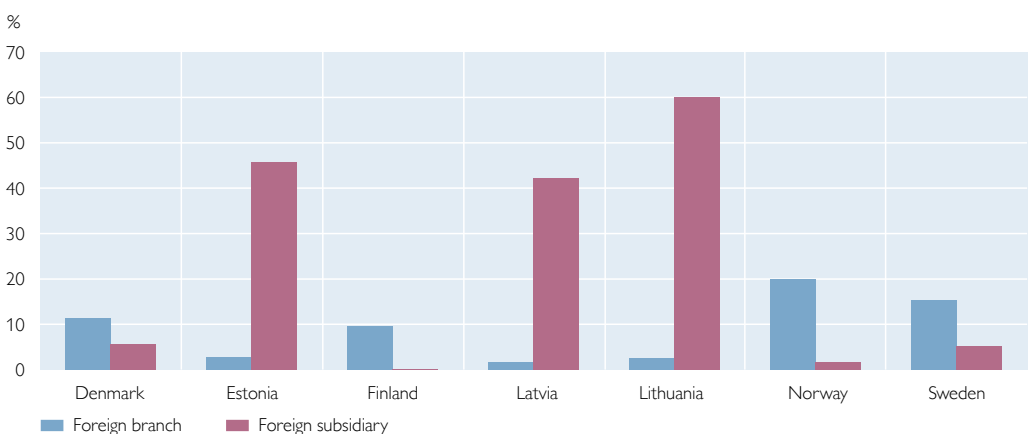
Finance, Central Banks and Supervisory and Resolution authorities. The NBSG was the first stability group in Europe. The main focus of the NBSG has been to discuss and exchange information on a regular basis on important issues related to financial stability concerns in the region. Another main task has been to prepare and hold regular financial crisis simulation exercises.

In January 2019, a major financial crisis management exercise was carried out in the Nordic-Baltic region. A working group, under the chairmanship of the Riksbank, had prepared the simulation, which included around 300 persons from 31 different authorities in the region, as well as relevant European organizations. The two-day exercise simulated the need for liquidity provision as well as resolution of two fictitious regional banks.

The exercise provided a wealth of experiences that the authorities continue to discuss, including a number of challenges. One such challenge was the communication between home and host authorities and information sharing within the supervisory and resolution colleges of the fictitious banks involved

Chart 5

The importance of foreign branches and subsidiaries in the region



Source: Bank reports and Sveriges Riksbank.

Note: Percent of total assets in local currency of large Nordic banks, end 2018 data.

in the simulation. In the scenario set-up, the home authorities of both banks were outside of the Euro Area and hence the banking union, while both banks had subsidiaries in countries within the banking union. This was the first time the European Bank Recovery and Resolution Directive was tested in a truly cross-border setting, involving authorities both within the banking union and authorities outside of it.

5 The European banking union – single supervision and resolution of banks

The initiative to form a banking union in Europe was announced in 2012, in the aftermath of the global financial crisis 2008–2009 and the following European sovereign debt crisis 2010–2012.⁹ As the debt crisis in Europe deepened, the financial markets started to lose confidence in the currency union and began to speculate of a break-up of the euro area. A break-up would have led to severe negative consequences for the economic prospects in Europe. The formation of the banking union, together with a number of rescue packages, helped restoring confidence in the euro.

The origin of the banking union was thus a response to the European debt crisis, but the union is also an essential complement to other financial policies and regulations in Europe. It reduces market fragmentation by further harmonising the rules of the finan-

cial sector and deepening the European market for financial services. This helps creating a so called level-playing field for banks, which encourages higher competition and efficiency in the banking sector.¹⁰

The banking union is an “institutional framework” that organises supervision and crisis management of banks. At the moment it is based on two pillars: The Single Supervisory Mechanism and the Single Resolution Mechanism, which also includes the Single Resolution Fund. A potential third pillar, the European Deposit Insurance Scheme, is under discussion but remains to be agreed upon. Members of the euro area are obliged to participate in the banking union, but non-members, i.e., Sweden and a number of other countries in the EU, can participate under certain conditions.¹¹

6 The trade-offs of supranational supervision

Free capital mobility is a prerequisite for free trade, which in particular for small economies is a key factor for economic growth.¹² Moreover, free capital mobility encourages banks to open up subsidiaries and branches in other countries and regions contributing to lower investment costs.¹³ Furthermore, it gives investors better opportunities to diversify risk, which, for example, help pension funds to provide a more secure retirement income.

⁹ *The banking union is supposed to be supplemented by a capital markets union. This is not a union in the same sense as the banking union, where you can chose to become a member, but an EU-wide initiative to increase cross-border financial operations in Europe and to increase the share of financing in financial markets relative to bank financing. There are also voices suggesting a fiscal union with a common budget.*

¹⁰ *An objective of the banking union is to strengthen financial stability in the euro area and in the EU as a whole, i.e., to ensure that banks are stable and can withstand future financial crises, see Ehrenpil and Hector (2017) for a discussion of the banking union's purposes and functions.*

¹¹ *See Sveriges Riksbank (2020a).*

¹² *Free movement of labour is also important but is not the topic of this study.*

¹³ *The three largest banks in Sweden have subsidiaries and branches in Denmark, Estonia, Latvia, Lithuania, Finland, Germany, Netherlands, and Poland in the EU and, as already discussed, Swedish banks have particularly strong linkages to the Nordic-Baltic region.*

However, free movement of capital is not without challenges. Large capital inflows can fuel macroeconomic and financial imbalances that later unwind as financial crises. A strong national financial system with adequate financial policies and regulations is the first line of defense against financial crises. This may not be enough, though, as the financial trilemma suggests. When movement of capital is free and cross-border banking activity is high, coordination and cooperation between national supervisors is also needed, i.e., supranational supervision of banks.

Supranational supervision is thus a central feature in preserving financial stability when cross-border banking activity is high, but it can be associated with economic costs. Beck and Wagner (2016) argue that the heterogeneity of countries make supranational supervision costly. They look at heterogeneity along three dimensions: (1) the banking and the market structure, (2) the political, legal and regulatory structures, and (3) the societal risk preferences. There is therefore a trade-off between more supranational supervision due to cross-border externalities and less due to heterogeneity across countries. In addition, Beck and Wagner show that even when a higher degree of supranational supervision is optimal, it may only happen if both regions benefit.

Beck et al. (2018) and Beck (2019) construct an index that is intended to capture the cross-border externalities and another one that captures the heterogeneity across countries.¹⁴ Both indices are normalised to be between zero and one, to make them comparable with each other. A high value indicates high levels of externalities as well as heterogeneity.

Hence, the higher the externality index and the lower the heterogeneity index, the more supranational supervision is called for.

The externality index of the Swedish banking sector within the Nordic countries is 0.38, while it is 0.31 within the Nordic-Baltic region and 0.25 within the European Union. The higher externality within the Nordic and Nordic-Baltic regions is mainly driven by the externality from the financial trilemma and not by the other externalities included in the index. The heterogeneity index shows the opposite ranking: within the Nordic countries the index is 0.30, within the Nordic-Baltic region 0.38, and within the European Union 0.48. The indices thus suggest relatively strong externalities and low heterogeneities across the Nordic-Baltic region. This is likely one of the reasons why financial cooperation across this region is successful and has been contributing to strengthening financial stability in Sweden and the region as a whole.

Taken at face value the indices suggest less support for the idea that Sweden should join the banking union compared to Nordic-Baltic cooperation. However, the quantitative difference in the indices for the Nordic-Baltic region and the EU should not be exaggerated. The difference is also likely to diminish over time as the financial integration in Europe moves forward. It is also already the case that the subsidiaries of two major Swedish banks in the Baltic region are under the supervision of the ECB, since they have market-dominant positions in this region. From an individual bank perspective, being supervised by the ECB can be preferred, as the move of Nordea from Sweden to Finland suggests.

¹⁴ The externality index also includes three other externalities that advocate supranational supervision, i.e., market linkages, regulatory arbitrage and currency unions.

7 Risk of marginalisation within the banking union but also outside

EU Member States that are outside of both the currency union and the banking union, such as Sweden, face a risk of becoming marginalised in negotiations, even more so since the UK have left the EU. From a financial cooperation perspective, Sweden has relatively little in common with the other non-euro countries, Denmark being the exception. Sweden is the home country of large banking groups, while other non-euro area countries – Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania – are primarily host countries of foreign banks, see Figure 6. This can potentially lead to different interests in negotiations. Sweden's international influence has also been declining over the years, see Swedish Government Inquiries (2019) for a discussion. This trend will likely continue, but participating in the banking union could potentially mitigate the trend.

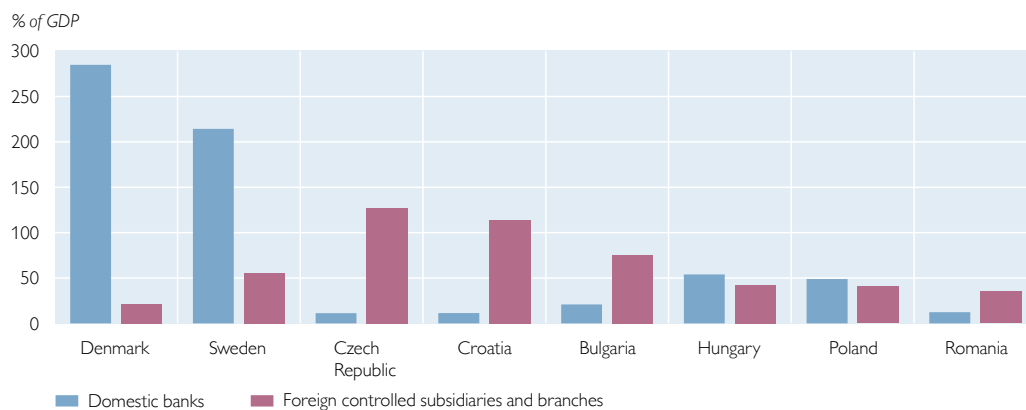
In normal times, participation in the banking union will most likely not affect the regulation and crisis manage-

ment of the Swedish banks in any major way. There are pros and cons. On one hand, Swedish supervisors have greater flexibility to design national requirements if Sweden stays out, although this room for manoeuvre is likely to shrink over time. On the other hand, participation would give access to the large supervision and resolution resources of the banking union – on top of national resources.

Participation in the decision making process within the banking union is not the same for the euro and non-euro countries.¹⁵ Non-euro countries do not have voting rights in the Governing Council of the ECB. Hence, there is, in principle, a risk for non-euro countries of being marginalised in negotiations within the banking union. This is discussed in Sveriges Riksbank (2020a). However, there are two safeguard mechanisms that have been created to compensate non-euro countries for the lack of voting right in the ECB Governing Council. First, if a supervisory decision goes against Sweden, we would have the right to explain that we do not intend to comply with the decision,

Chart 6

Size of the banking sectors in non-euro area countries in Q3 19



Source: ECB.

¹⁵ The efficiency of resolution cases and the risk a politicised crisis management are other key issues in a financial crisis, see Sveriges Riksbank (2020a) for a discussion of these issues.

which could have the consequence that the ECB decides to expel Sweden from the banking union. Second, there is a possibility for a non-euro country to withdraw from the banking union at any point after three years' participation (this does not have to be linked to a supervisory decision against one of the country's banks).

8 Concluding remarks

The integration of European countries is an ongoing process involving many different institutions and markets. At the core of this process is the European Union and its institutions. From a financial perspective, integrating the capital markets in Europe and creating a level-playing field is a priority. This process is not straightforward, though, and long-term planning is often difficult. New institutions and structures do in many cases not emerge until they are deemed to produce value added, as, for example, was the case with the creation of the banking union.

The Swedish government has recently held a public inquiry where an in-depth analysis of different issues regarding a Swedish participation in the European banking union has been presented, see

Swedish Government Inquiries (2019) and the response of Sveriges Riksbank (2020a). See also Beck (2019) for a discussion of the main issues from a Swedish perspective. We have discussed two of the specific issues in this article – the trade-off of supranational supervision and the risk of marginalisation in the decision process for countries outside of the euro area. We have also given an overview of the financial integration and cooperation in the Nordic-Baltic region. Leaving the many specific issues aside, the broader picture suggests that an extension of financial integration and cooperation from the Nordic-Baltic region to the EU-level is a natural next step for Sweden. The economic benefits of more cross-border banking activities across Europe are potentially large and the banking union is an important step in this direction. When evaluating the benefits of more cross-border banking, the benefits should not only be assessed through the lens of one specific country. Such an analysis does not account for the positive externalities of a greater market with better competition and increased efficiency that will benefit all members. Such benefits are potentially large.

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Chapter 9

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The European banking supervisory framework and its institutional arrangements since Austria's accession to the European Union¹

The European banking supervisory framework has changed fundamentally over time with regard to the objectives pursued, the legislative approaches adopted and the institutional arrangements used, and last but not least also with regard to the scope of regulation and supervision. When Austria joined the EU, the goal of establishing a single market was paramount. Policymaking was focused on removing obstacles to the freedom to provide services and the freedom of establishment, and on ensuring a level playing field across all Member States. Specific amendments to EU legislation in this regard were laid down in a range of EU directives, usually without providing for supporting institutional arrangements. At the turn of the new millennium, the focus shifted toward facilitating faster and more flexible regulation processes by setting up European regulatory agencies. This change was motivated by the urge to address emerging developments in financial markets in a timely manner and to advance financial integration to be able to gain higher benefits from monetary union. In parallel, EU legislators made an effort to stop adding to what was perceived as a flood of overly detailed legislation by putting “better regulation” principles at the heart of policymaking processes. The 2007 financial crisis, finally, significantly altered the motivation for regulation and hence the scope of the supervisory framework. Without abandoning earlier goals, EU law-making has since been dominated by efforts to address the regulatory deficiencies uncovered by the crisis and to prevent such crisis scenarios from re-emerging. Relying on directly applicable regulations as the instrument of choice, measures have been taken to strengthen the crisis resilience of individual financial institutions and the financial sector as a whole, and to establish European supervisory and regulatory mechanisms with a view to creating and eventually completing the – as yet incomplete – European banking union.

JEL classification: G21, G28

Keywords: banking regulation, banking supervision

When Austria joined the European Union (EU) on January 1, 1995, EU-wide banking regulation was still very fragmented and based on a wide range of directives. As a result, there was little harmonization across the EU in this area, and little harmonization in the area of banking supervision. Things have changed fundamentally in the 25 years since then. The adoption of the Single Rulebook provided for a harmonized set of prudential rules, and the 2007 financial crisis caused the intensity of legislation to increase substantially. Moreover, the establishment of the banking union enhanced the convergence of supervisory practices within the euro

area. Thanks to these regulatory developments and the resulting improvements to risk-bearing capacity and risk management in banks, the banking sector in the EU and thus also in Austria is more resilient to crises today than it was 25 years ago. At the same time, the playing field in the European banking sector has leveled out considerably. The financial crisis was one of the major drivers of this development – or at any rate acted as a catalyst for it. Responses to the crisis not only saw the regulatory framework tightened, but also led to supervisory practices being converged and the banking union being established in the euro area.

¹ The views expressed by the authors in this report do not necessarily reflect the views of the Oesterreichische Nationalbank or the Eurosystem. The authors would like to thank Ernest Gnan and Karin Turner-Hrdlicka (both OeNB) for their helpful comments and valuable input into the discussions underlying this paper.

The following paper consists of four sections. Section 1 describes the situation leading up to the financial crisis, a time which saw thoughts turn to harmonization in the form of a single market and trends toward deregulation. Section 2 looks at paradigm shifts in banking regulation based on lessons learned from the financial crisis, while section 3 addresses the establishment of the banking union in response to the crisis, including a discussion on the completion of the – as yet incomplete – banking union. The key conclusions are then summarized in section 4. The first three sections address the key issues of the regulatory debate that took place during the phase in question – including the events leading up to and following the phase – which means that there are overlaps in the timeline of the events described.

1 Harmonization and deregulation leading up to the financial crisis

After applying for membership of the European Community (EC) – as the EU then was – in July 1989, Austria subsequently had to transfer the *acquis communautaire*² of the European Union – which had been formed by this point – into national law.³ While preparing to join the EU, Austria had to take into consideration around 4,000 directly

applicable EU regulations and approximately 1,000 EU directives that needed to be written into national laws.⁴ In the alignment process, the existing banking act (Kreditwesengesetz) was replaced with the Austrian Banking Act (Bankwesengesetz).⁵

At the European level, the idea of creating a single financial market was by no means new – the concept was first mentioned as far back as in 1966, when it appeared in a report on the development of a European capital market, which was drawn up by a group of experts appointed by the Commission of the European Economic Community (EEC) and chaired by Claudio Segré,⁶ and which contained recommendations on resolving any obstacles to creating a level playing field.⁷ This report came at a time when the arrangements in place in most member countries “concerning the working and supervision of banks [continued to] date from measures taken to palliate the effects of the great economic crisis of the inter-war period.”⁸

In 1973, the EC’s efforts to achieve a single market for banking services were ramped up with the introduction of corresponding European legislative acts, with the European legislator adopting the first directives. Held up against the supervisory rules and regulations in force today, however, these

² The *acquis communautaire* (Community legislation) is the entire body of EU law and obligations that are binding on all EU Member States. It consists of the primary legislation (the EU treaties), the secondary legislation (all EU legal acts such as regulations and directives) and the judgments of the European Court of Justice, as well as all international treaties in respect of EU matters. To become a member of the EU, candidate countries must accept the *acquis communautaire*, enact it into national law in advance and apply it after accession (see www.parlament.gv.at/PERK/GL/EU/).

³ Owing to the obligations resulting from the Agreement on the European Economic Area, which entered into force on January 1, 1994, the Republic of Austria was actually required to implement the *acquis communautaire* a year prior to its accession to the EU (on January 1, 1995).

⁴ Holzinger (1992), p. 177.

⁵ Hlawati et al. (1994), p. 270.

⁶ Segré Report (1966).

⁷ In particular, it proposed harmonizing provisions on the management of assets and liabilities and provisions on participation rules.

⁸ Segré Report (1966), p. 269.

Chart 1

Acquis communautaire in the areas of banking regulation and banking supervision in 1995

Main elements of the banking supervisory framework ¹
Directive 73/183/EEC – Council Directive on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions
Directive 77/780/EEC – First Council Directive on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions
Directive 83/350/EEC – Council Directive on the supervision of credit institutions on a consolidated basis
Directive 89/299/EEC – Council Directive on the own funds of credit institutions
Directive 89/646/EEC – Second Council Directive on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC
Directive 89/647/EEC – Council Directive on a solvency ratio for credit institutions
Directive 92/30/EEC – Council Directive on the supervision of credit institutions on a consolidated basis
Directive 92/121/EEC – Council Directive on the monitoring and control of large exposures of credit institutions
Directive 93/6/EEC – Council Directive on the capital adequacy of investments firms and credit institutions (CAD)
Additional body of rules and regulations
Directive 86/635/EEC – Council Directive on the annual accounts and consolidated accounts of banks and other financial institutions
Directive 89/117/EEC – Council Directive on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents
Directive 94/19/EC – Directive on deposit-guarantee schemes

Source: Authors' compilation based on EU legislation.

¹ Excluding provisions on ancillary matters (consumer borrowing, anti-money laundering prevention, etc.).

legislative acts were comparatively minimalist, their main focus being to remove identified obstacles to banks' freedom of establishment and freedom to provide services and, subsequently, to implement the provisions laid down in the 1988 Basel Capital Accord of the Basel Committee on Banking Supervision (BCBS; Basel I).⁹ Subsequent regulatory discussions were driven by the EC's landmark decision to implement the Basel provisions for all banks operating in the EC, regardless of their size or complexity, with a view to creating a level playing field.

Austria joined the EU at a time when the EU was pursuing a selective, gradual approach to harmonizing banking regulation, issuing directive after directive to cover specific aspects of banking

regulation (chart 1), with which the Austrian Banking Act had to be aligned.

In May 1999, several months after the introduction of the euro, the European Commission adopted the Financial Services Action Plan (FSAP)¹⁰ to achieve the goal of realizing a single market for financial services. The plan contained 42 action points, including 25 specific proposals for directives, designed to “reap the full benefits of the euro and ensure continued stability and competitiveness of EU financial markets.”

According to the FSAP, the European legal framework in place at that time had already established a sufficient “bulwark against institutional failure and systemic risk” and was providing adequate protection to depositors and insurance policy holders against the risk of payment

⁹ The Basel I Capital Accord was the first global initiative to establish minimum own funds requirements for banks on the basis of risk-weighted assets and (depending on the risk of the assets concerned) graded risk weights. See BCBS (1988).

¹⁰ European Commission (1999). Following quotations from *ibid.*

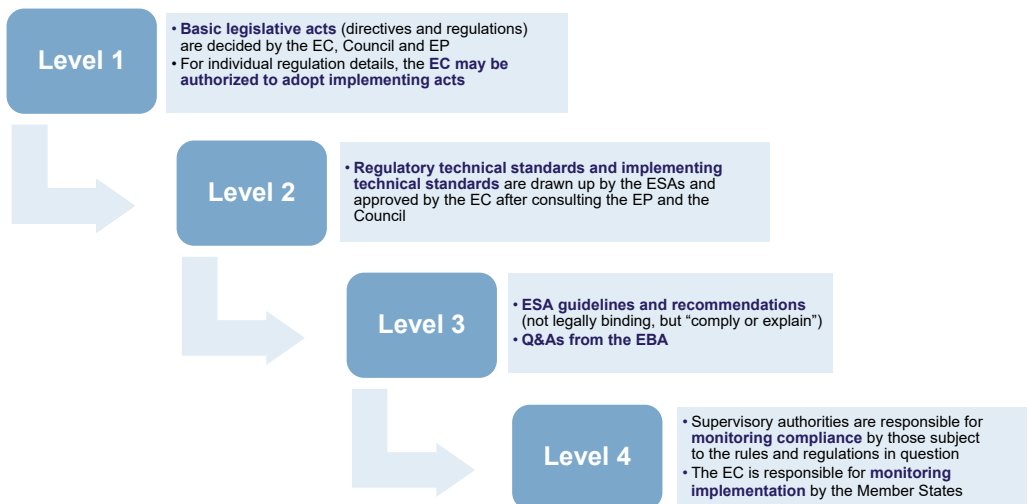
default. As relevant measures to be taken in the areas of banking regulation and supervision, the FSAP pointed in particular to implementing the changes made to own funds requirements in the Basel framework (Basel II)¹¹ and adopting the directive on the winding-up and liquidation of banks, also known as the Bank Insolvency Directive (BID).¹²

According to the FSAP, the introduction of the euro opened up the opportunity to equip the EU with a “modern financial apparatus in which the cost of capital and financial intermediation are kept to a minimum,” but also heralded new challenges for financial regulators and supervisors which called for swift action. The focus was on ensuring the balanced regional distribution of the benefits of competitive and integrated financial services markets. Considering

that the “adaptation of EU prudential rules to cope with new sources of instability or to align it on state-of-the-art regulatory/ supervisory practice [was] painstakingly slow,” the European Council established a committee in July 2000, led by Alexandre Lamfalussy, which was tasked in essence with reviewing the regulation of European securities markets. The committee examined how to best address current developments in the securities markets using EU regulations and how to make sure the markets were working efficiently and dynamically.¹³ One of the main proposals in the “Lamfalussy Report”¹⁴ was introducing a four-level regulatory approach (chart 2) and creating representative “comitology committees” to be consulted in the four-level process of legislation, starting with a committee for securities markets in 2001 followed

Chart 2

Lamfalussy process: the comitology procedure in EU financial market law



Source: Authors' compilation on the basis of EU legislation, legal situation since January 1, 2011.

Note: EC= European Commission, EP = European Parliament, ESAs = European Supervisory Authorities, EBA = European Banking Authority. Based on the legislation in force since 2011 with the successors of CEBS, CEIOPS and CESR, i.e. the ESAs (EBA, EIOPA and ESMA); see also section 2.

¹¹ Negotiations to revise the Basel I framework pursuant to the BCBS (1988) were initiated in 1999, ultimately resulting in the publication of the Basel II framework from 2004 onward (see BCBS, 2004 and 2006). See section 2 for further details of the key changes introduced by Basel II.

¹² Subsequently adopted on April 4, 2001. See BID (2001).

¹³ Karpf et al. (2007), p. 6.

¹⁴ Lamfalussy et al. (2001).

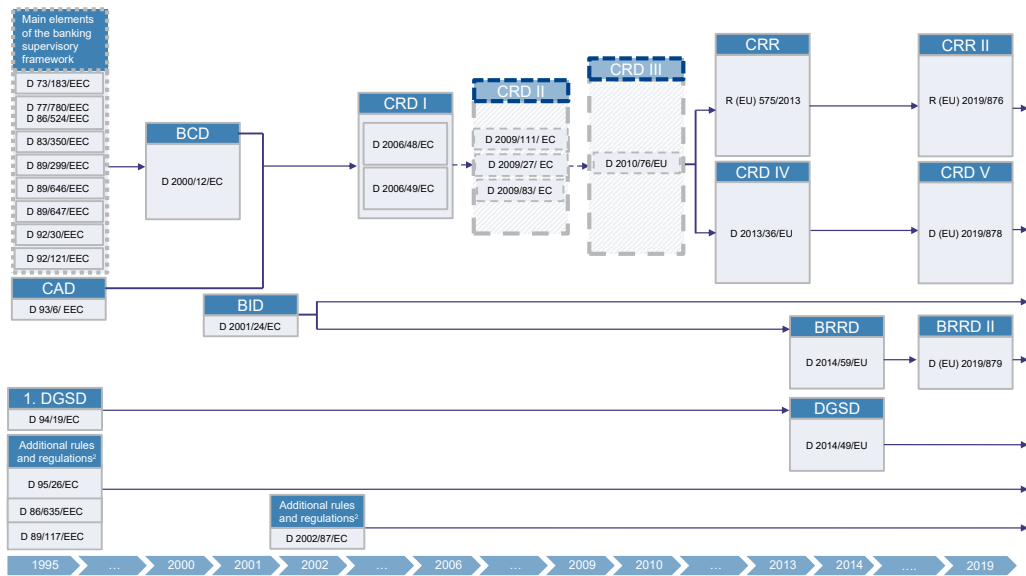
by additional committees for banking and insurance in 2004.¹⁵

The introduction of the comitology procedure laid the foundations for the European legislative model that is in use today, which seeks to provide for the timely and flexible adjustment of supervisory legislation to current developments. Since the European Supervisory Authorities (ESAs)¹⁶ became operational on January 1, 2011, a wide range of binding technical standards to be determined have been developed by the ESAs rather than being laid down in primary law.¹⁷ In parallel, the supervisory framework started to increase in

scope and complexity because of the emergence of a new practice to delegate to the ESAs not only numerous technical specifications, but also points of disagreement, for which the ESAs were tasked with finding a compromise. Moreover, the ESAs – as the committees before them – were mandated to establish coherent, efficient and effective supervisory practices through the adoption of binding technical standards, guidelines and recommendations, as well as Q&As. For example, the legislative packages adopted in 2013 and 2014 to implement the global lessons learned from the financial crisis¹⁸ in the EU

Chart 3

Introduction of the Single European Rulebook



Source: Authors' compilation based on EU legislation.

¹ Excluding provisions on ancillary matters (consumer borrowing, anti money laundering prevention, etc.).

¹⁵ Namely the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR). See Karpf et al. (2007) for a detailed description.

¹⁶ Consisting of the succeeding organizations of the committees mentioned in footnote 14, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). These were set up as independent authorities with their own legal personality and granted more extensive powers than their predecessors. See also chapter 2. See, for example, Ladler (2014), pp. 185 et seq. for a more detailed description.

¹⁷ As the ESAs themselves do not have any legislative powers here, these standards are simply developed as drafts of technical standards that are subsequently adopted by the European Commission. See, for example, Article 10 et seq. of ESAR (2010).

¹⁸ See section 2.

contained a mandate for the European Banking Authority (EBA) to create a collection of technical standards and guidelines stretching into the triple digits.

2000 brought with it another significant development with the adoption of the Banking Consolidation Directive (BCD) relating to the taking up and pursuit of the business of credit institutions. Providing for the first ever partial codification of the European regulatory framework, the BCD replaced the fragmented framework of directives that had been in force up until that point (chart 3). In terms of substance, however, the changes introduced by this directive were relatively insignificant.

To implement the Basel II framework published between 2004 and 2006, the European legislator subsequently amended and recast the BCD and the Capital Adequacy Directive (CAD), which together became known as the *CRD I package*.¹⁹ Basel II brought about comprehensive changes in the field of banking regulation. This naturally resulted in challenges for the banking sector, which were not received without criticism.²⁰

Ultimately, Basel II was the regulatory response to financial sector requests to align supervisory practices with progress made in quantifying and managing risks since the late 1980s. Thus, Basel II enabled banks to determine their minimum own funds re-

quirements on the basis of internal models to be approved by the supervisor. Basel II also complemented the mandatory minimum own funds requirements (pillar 1) set out under Basel I with a supervisory review process to take into account institution-specific risks (pillar 2)²¹ and enhanced disclosure requirements (pillar 3). The underlying idea is that if the supervisory authority does not deem certain risks to be (adequately) covered by pillar 1, it can require banks to hold own funds under pillar 2 beyond the minimum requirements laid down by pillar 1.²² This Basel II principle formed the basis of the additional pillar 2 own funds requirements introduced in EU legislation as part of the CRD I package.²³

Achieving an integrated European financial services market – and removing the obstacles standing in the way of this goal – remained the main driving force behind the CRD I package.²⁴

As the EU's regulatory activities increased, so too did its critics, with many people perceiving the regulatory framework – still fragmented by today's standards – as excessive. Critics claimed that European and U.S. credit institutions considered the relentless increase in supervisory requirements to pose a far greater banking risk than all market risks.²⁵ Furthermore, critics called upon supervisory committees to stop overregulating, arguing that Europe was holding itself hostage to its own

¹⁹ *CRD I (2006a) and CRD I (2006b)*.

²⁰ For a more comprehensive description, see, for example, Putz (2006); Jansen (2002); or Bärenfänger et al. (2006).

²¹ Consisting of the internal capital adequacy assessment process (ICAAP) and the supervisory review and evaluation process (SREP).

²² See BCBS (2006), p. 239, principle 3 of the supervisory review and evaluation process.

²³ See Article 136 of CRD I (2006a).

²⁴ See, for example, recital 2 of CRD I (2006a).

²⁵ See Pichler (2005), citing from an unspecified PriceWaterhouseCoopers study: "Der unerbittliche Anstieg der Aufsichtsvorschriften stellt nach Ansicht europäischer und amerikanischer Kreditinstitute das größte bankgeschäftliche Risiko vor allen Marktrisiken dar."

harmonization dogma.²⁶ This was partly due to the fact that Basel II had been implemented quite differently in the individual jurisdictions – both in terms of the number of banks affected²⁷ and in terms of the specific supervisory practices.²⁸ In addition, the broad consultations and impact assessment studies that are used to gauge the costs and benefits of regulations in today’s regulatory landscape were not yet common practice at that time.

Having gained significantly in number and intensity by the mid-2000s, these critical views also became increasingly reflected in corresponding legislative initiatives. The European Commission embraced the concept of “better regulation” and acknowledged both gold-plating and excessive regulation as issues impeding the creation of the single market for financial services.²⁹ The CRD I package adopted in 2004 was, in fact, among the first attempts to live up to the spirit of “better regulation.”³⁰

In its “*White Paper – Finance Services Policy 2005–2010*,”³¹ the Commission also highlights the topic of “better regulation” as its main focus, the keywords being open and transparent consultations, impact assessments with a focus

on costs and benefits, close monitoring of the implementation and enforcement of the EU regulatory framework by the Member States and their authorities, ex-post evaluation of the FSAP as a whole and simplification and codification of the rules and regulations.

To support these aims, the paper emphasizes the need to adapt the regulatory and supervisory structures in place, taking into account the Lamfalussy process, and reduce regulatory costs where possible.³² In addition to clarifying the roles of home and host supervisors and minimizing duplicative reporting requirements, developing a real pan-European supervisory culture was also listed high up on the Commission’s agenda.

2 Paradigm shifts in banking regulation triggered by the financial crisis

The outbreak of the global financial crisis in 2007 marked a fundamental turning point in regulatory discourse. The principle of “better regulation” was pushed into the background, overshadowed by questions of how such a crisis could happen given the regulatory framework in place, and of how to considerably

²⁶ Schackmann-Fallis (2007), p. 9.: “Ich bin davon überzeugt, daß sich Europa in den letzten Jahren zur Geißel seines eigenen Harmonisierungsdogmas gemacht hat.”

²⁷ While in the EU the Basel regulations were implemented for all banks to ensure a level playing field, they were only applied to major banks in the U.S.A – partly because additional own funds requirements (leverage ratio, capital buffer) outside the Basel framework were already mandatory for all U.S. credit institutions prior to the introduction of Basel II.

²⁸ The U.S.A. and Japan, for example, have not implemented any of the pillar 2 own funds requirements for banks that are standard practice in the EU.

²⁹ See, for example, the speech by Charlie McCreevy, European Commissioner for Internal Market and Services, McCreevy (2005).

³⁰ In addition to the wide range of implementing powers granted to the Commission to be developed as part of the comitology procedure together with CEBS, the Commission is required to prepare reports on the application of certain provisions at certain stages of the process. For certain areas of regulation, the Commission is obliged to propose modifications on the basis of the Member States’ progress reports, as well as to report on the application of the body of rules and regulations as a whole and their impact on the economic cycle. See, for example, Article 150 of CRD I (2006a), Article 41 of CRD I (2006b), Article 119 of CRD I (2006a), Article 28 of CRD I (2006b), Article 62 of CRD I (2006a), Article 12 of CRD I (2006b), Article 51 of CRD I (2006b) and Article 156 of CRD I (2006a).

³¹ European Commission (2005b).

³² European Commission (2005b), p. 9.

reduce the likelihood of another crisis. While in the past the directives adopted contained recitals focused on “*making it easier to take up and pursue the business of credit institutions*,” on “*eliminating the most obstructive differences between the laws of the Member States*” and on “*the achievement of the internal market*,”³³ legislation adopted in the aftermath of the crisis prioritized taking “*step[s] to address shortcomings revealed by the financial crisis*.”³⁴

In November 2008, the European Commission appointed an expert group chaired by Jacques de Larosière to make recommendations on navigating the course out of the crisis and on avoiding crises in the future. The final report submitted in February 2009, named the “*de Larosière Report*,”³⁵ analyzed the causes of the crisis and offered a total of 31 recommendations for addressing shortcomings in the European regulatory and supervisory framework, underlined by two strategic objectives. The first was to make banks more resilient and therefore reduce the likelihood of crises in the banking sector, and the second was to contain the systemic damage caused by banking crises as far as possible, thus minimizing the costs

to the public purse. This was to be achieved by strengthening regulations on capital and (for the first time also) liquidity³⁶ – harmonized at the EU level and on a global scale under the Basel framework – and establishing a regulatory framework for crisis intervention and resolution for banks and other financial intermediaries. At the institutional level, the de Larosière Report recommended gradually developing a decentralized network of competent supervisory authorities (“European System of Financial Supervision”), which should rely on a common set of core harmonized rules and supervisory tools, and supported an extended role for the European Central Bank (ECB) in the identification of macroprudential risks.³⁷

In September 2009, the CRD II package³⁸ was adopted, containing – in addition to measures planned prior to and independently of the de Larosière Report³⁹ – the initial responses to the crisis.⁴⁰

In November 2010, the European legislator adopted the Capital Requirements Directive, known as CRD III,⁴¹ as a further partial response to the crisis,⁴² as well as the legislative acts which provided for the creation of the

³³ Recital 2 of CRD I (2006b) and recital 4 of the BCD (2000).

³⁴ See the first recital of CRD II (2009a).

³⁵ The de Larosière Group (2009).

³⁶ See the implementation of these measures as well as other recommendations on strengthened supervisory regulations in footnotes 47 and 48.

³⁷ The changes to the European regulatory and supervisory framework described in the rest of this section are all based on recommendations made in de Larosière Report, the vast majority of which have been implemented.

³⁸ CRD II (2009a), CRD II (2009b) and CRD II (2009c).

³⁹ Such as on large exposures or hybrid financing instruments; see Lembeck (2009).

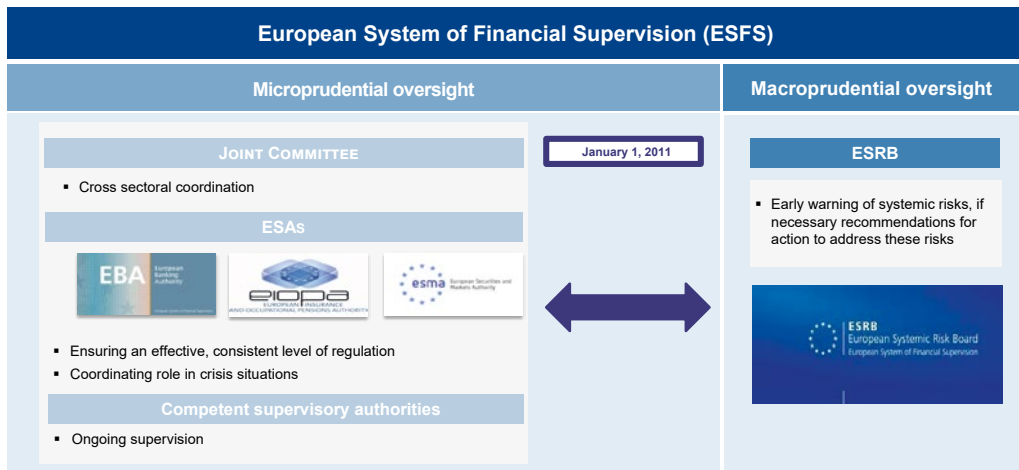
⁴⁰ CRD II focused in particular on revising the large exposure regime, strengthening cross-border supervision, establishing stricter requirements for using securitized products and establishing uniform criteria for recognizing hybrid financing instruments as own funds.

⁴¹ CRD III (2010) focused on introducing rules governing remuneration practices, increasing own funds requirements for securitized exposures in the trading book, increasing risk weights for re-securitizations, enhancing disclosure requirements and ensuring that authorities have effective, proportionate and dissuasive financial and non-financial sanctions and measures at their disposal.

⁴² “Excessive and imprudent risk-taking in the banking sector has led to the failure of individual financial institutions and systemic problems in Member States and globally,” recital 1, sentence 1, CRD III (2010).

Chart 4

ESFS: Better links between microprudential and macroprudential oversight



Source: Authors' compilation on the basis of EU legislation.

ESAs (EBA, EIOPA and ESMA, as successors to the former “level 3 committees”)⁴³ and for the establishment of the European Systemic Risk Board (ESRB). Together with the competent supervisory authorities, the ESRB, the ESAs and their Joint Committee form the European System of Financial Supervision (ESFS, chart 4).⁴⁴ These measures also reflected the lessons learned from the crisis and recommendations made in the de Larosière Report.⁴⁵ In June 2013, the Capital Requirements Regulation (CRR, 2013) and CRD IV (2013) were adopted, marking the pan-European implementation of the new Basel framework (Basel III),⁴⁶ which had been fundamentally overhauled in response to the crisis. In this respect, even the type

of legislation reflects the paradigm shift triggered by the financial crisis. The CRR is the first ever regulation to have been issued by the EU in the area of banking supervision, based on the consideration that regulations are directly applicable, allowing for greater uniformity in the legislative framework, in line with the principle of maximum harmonization, and therefore a more level playing field for banks’ business activities. In addition to the decision to issue both a directly applicable regulation⁴⁷ and a directive to be written into national law by the Member States,⁴⁸ the abundance of mandates for the EBA – some of which with ambitious deadlines imposed – is particularly remarkable. By harmonizing basic rules as

⁴³ See pages 4 and 5, in particular footnotes 14 and 15.

⁴⁴ For details about the tasks and objectives of the ESFS, the ESRB and the ESAs, see Weismann (2011).

⁴⁵ “Financial stability is a precondition for the real economy to provide jobs, credit and growth. The financial crisis has revealed important shortcomings in financial supervision, which has failed to anticipate adverse macro-prudential developments and to prevent the accumulation of excessive risks within the financial system.” See recital 1 of ESRBR (2010).

⁴⁶ BCBS (2011).

⁴⁷ CRR I (2013) lays down enhanced regulations on the quality of own funds, minimum own funds requirements, liquidity requirements, the leverage ratio, disclosure and the large exposures regime.

⁴⁸ CRD IV (2013) sets out, in particular, rules on licensing, cross-border activities, supervisory measures, macroprudential tools, corporate governance and pillar 2.

much as possible and entrusting the EBA with additional tasks in this respect, CRD IV aimed to bring the Commission closer to realizing its vision of a Single European Rulebook, a term coined in 2009 in order to refer to the aim of a unified regulatory framework for institutions throughout the EU.⁴⁹ Key innovations triggered by the CRR/CRD IV package included the introduction of macroprudential supervisory instruments and specific liquidity requirements, as well as a leverage ratio (initially only applicable as a reporting requirement). Existing prudential rules, meanwhile, were developed further, with the main aim of ensuring that credit institutions hold an adequate level of own funds in terms of their total loss-absorbing capacity and risk adequacy.

In April 2014, further recommendations from the de Larosière Report were implemented with the adoption of the Deposit Guarantee Schemes Directive (DGSD).⁵⁰ This directive requires EU countries to introduce an *ex ante* deposit guarantee fund financed by the banking sector, while the funds held in these schemes may also be used to prevent the failure of a credit institution.

In May 2014, the Banking Restructuring and Resolution Directive (BRRD)⁵¹ was adopted, marking the start of another new chapter in European banking regulation. The BRRD equipped supervisory authorities with new tools for preventing crises, granting them the possibility to redress the situation by taking early

intervention measures – i.e. allowing them to act before an acute crisis situation takes hold. Furthermore, the BRRD grants the resolution authority, a public administrative body to be established in each Member State as part of the directive, the power – under certain circumstances⁵² – to resolve failed credit institutions in a way that has the least impact on the system as possible. Specifically, the “bail-in” resolution tool was introduced, involving creditors in absorbing losses to be covered in the course of bank resolution. In addition, banks have to contribute to newly set up national resolution funds. The measures and instruments under the BRRD are aimed at ensuring that, as far as possible, taxpayers no longer have to foot the bill for bailing out institutions that have run into difficulties. This principle of replacing bail-out with bail-in in the future is intended to eliminate the implicit state guarantee in place, in particular for very large banks (“too big to fail”) and to address the issue of moral hazard associated with this. In other words, as evidenced by the BRRD’s recitals, these rules are clearly intended to implement lessons learned from the crisis and safeguard financial market stability.⁵³

The most recent relevant act of legislation was adopted in May 2019 in the form of the European banking package, which consists of amendments to the current body of rules and regulations, resulting in CRR II (2019), CRD V (2019), and BRRD II (2019). This was

⁴⁹ See www.eba.europa.eu/regulation-and-policy/single-rulebook.

⁵⁰ DGSD (2014).

⁵¹ BRRD I (2014).

⁵² Particularly if it is in the public interest to do so.

⁵³ See the first three recitals of BRRD I (2014).

accompanied by a range of reforms,⁵⁴ with the recitals again highlighting the implementation of lessons learned from the crisis.⁵⁵ Other recitals acknowledge the need to enhance financial stability, address the current uncertainties in the economic outlook, implement internationally agreed standards and take targeted deregulation measures by applying proportionate supervisory requirements.⁵⁶

Over the last few years, the scope and complexity of regulations adopted since the financial crisis, in the form of

both primary legislation and accompanying binding technical standards, has prompted discussions about the necessity of having a proportional supervisory approach.⁵⁷ The banking package adopted in 2019 was an essential step toward achieving such an approach. It was the first piece of legislation to introduce a category of small, less complex banks for which certain regulations, such as in the areas of remuneration and disclosure, will not be applicable, or apply only to some extent.

Box 1

Impact of EU regulations on banking regulation in Austria

To meet its obligation to transfer the *acquis communautaire* into national law, Austria replaced the existing banking act (*Kreditwesengesetz – KWG*) with the Austrian Banking Act (*Bankwesengesetz – BWG*) on January 1, 1994. In addition to adopting the European *acquis communautaire*, the national legislator also consolidated a range of domestic laws, resulting in a fundamental reform of Austrian banking supervision law. Subsequent additions or amendments to EU legislation were written into domestic law first and foremost by making corresponding amendments to the BWG or to regulations adopted on the basis of corresponding powers of authorization in the BWG (for example, before the CRR came into force around 20 regulations based on powers of authorization in the BWG were in force).

When implementing the BRRD, the Austrian legislator decided to adopt a dedicated piece of legislation – the Federal Law on the Recovery and Resolution of Banks (*Sanierungs- und Abwicklungsgesetz – BaSAG*).

The DGSD was enacted as Austria's Deposit Guarantee Schemes and Investor Compensation Act (*Einlagensicherungs- und Anlegerentschädigungsgesetz – ESAEG*), and new regulatory frameworks were created for deposit guarantee and investor compensation at credit institutions, areas previously governed by the Austrian Banking Act (chart 5).

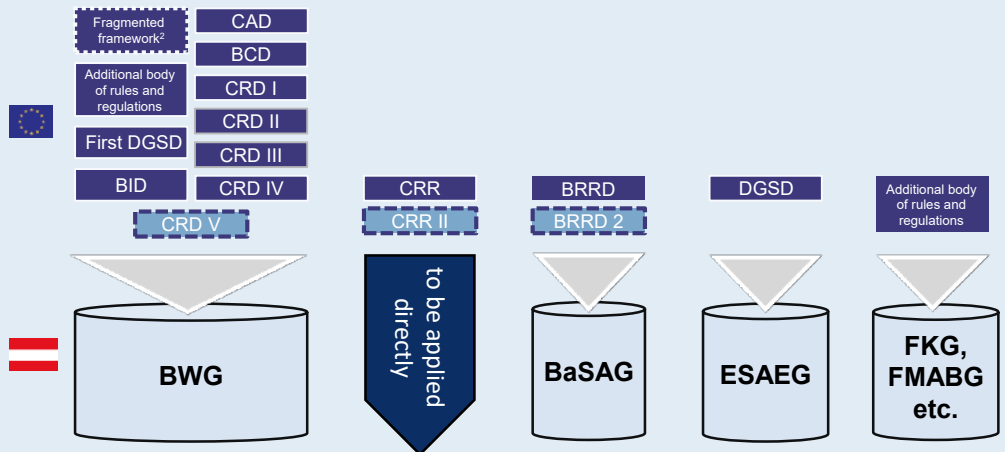
⁵⁴ These measures include binding obligations regarding the leverage ratio (LR) and the net stable funding ratio (NSFR), introducing targeted simplifications for small and non-complex institutions (proportionality), tightening regulations on own funds eligibility, establishing the pillar 2 guidance, reviewing the interaction between pillar 2 and macroprudential instruments, tightening the requirements related to the trading book, and revising the basis for calculating the minimum requirement of own funds and eligible liabilities (MREL).

⁵⁵ “(1) In the aftermath of the financial crisis that unfolded in 2007-2008, the Union implemented a substantial reform of the financial services regulatory framework to enhance the resilience of its financial institutions... (2) While the reform has rendered the financial system more stable and resilient against many types of possible future shocks and crises, it did not address all identified problems... (3) In its communication of 24 November 2015 entitled “Towards the completion of the Banking Union”, the Commission recognised the need for further risk reduction and committed bringing forward a legislative proposal that would build on internationally agreed standards...”, recitals 1–3 of CRR II (2019).

⁵⁶ See recitals 4–8 of CRR II (2019).

⁵⁷ See Angeloni (2018), Boss et al. (2018), and Castro Carvalho et al. (2017).

Implementation of the European framework in Austria at a glance¹



Source: Authors' compilation based on EU legislation.

¹ This figure is intended to provide a rough overview of the national laws into which the most relevant provisions of the banking supervisory directives have been transferred – but does not constitute an exhaustive list. The laws mentioned are to be understood independently of any national regulations that were adopted owing to a power of authorization contained in the law in question.

² Excluding provisions on ancillary matters (consumer borrowing, anti money laundering prevention, etc.).

Note: FKG = Finanzkonglomeratengesetz (Financial Conglomerates Act); FMABG = Finanzmarktaufsichtsbehördengesetz (Financial Market Authority Act). All other abbreviations explained in the text.

3 Establishing the European banking union in response to the sovereign debt crisis

There have long been discussions about whether having an integrated financial market raises the need for a competent cross-border supervisor. The introduction of the euro in particular had people asking whether, to reach its full potential, a monetary union needed to be accompanied by a banking union with a view to creating a system of uniform banking supervision. Back in 1998, for example, the International Monetary Fund (IMF) highlighted challenges that could be encountered in managing a banking crisis under the institutional framework in place in the euro area at

that time, with the ECB also joining calls for a common approach to banking supervision in the euro area.⁵⁸ Proposals to more closely coordinate the national supervisory authorities of cross-border banks were also advocated beyond the euro area, for the EU as a whole. The concepts discussed ranged from having a lead supervisor responsible for a cross-border group⁵⁹ to having a competent one-stop supervisor,⁶⁰ while the challenge of supervising cross-border institutions based on limited national jurisdictions was generally acknowledged.⁶¹ For instance, an IMF recommendation issued prior to the outbreak of the financial crisis concerning banking supervision in Europe aimed to resolve two

⁵⁸ See IMF (1998, p. 106), Padoa-Schioppa (1999) and de Rynck (2016) for a more comprehensive overview of this discussion.

⁵⁹ See, for example, Christl (2005).

⁶⁰ See, for example, Čihák et al. (2007).

⁶¹ See, for example, Pisani-Ferry et al. (2012).

problems that had been identified: the lack of uniform requirements for business activities and issues relating to cross-border financial stability.⁶² With the benefit of hindsight, the colleges of supervisors⁶³ created by CRD II no doubt have come to play a crucial role and can be considered one of the initial lessons learned from the crisis.

Nevertheless, the European sovereign debt crisis was the last nudge needed to set up the *banking union*. During the EU summit in June 2012, the Union's heads of state and government decided to establish a Single Supervisory Mechanism (SSM) involving the ECB as a precondition for the direct recapitalization of banks by the European Stability Mechanism (ESM). They mandated the Commission to present proposals for a suitable supervisory mechanism. In March 2013, the European Commission, the European Parliament and the European Council finally reached an agreement on the creation of the SSM,⁶⁴ and in March 2014 decided on the creation of the Single Resolution Mechanism (SRM).⁶⁵ In November 2015, the Commission presented a proposal for completing the banking union, including a legislative proposal for establishing a single deposit guarantee scheme (European Deposit Insurance Scheme – EDIS).⁶⁶ EDIS continues to be under discussion, however, as the Member

States have not been able to agree on a compromise so far. Together, SSM, SRM and EDIS constitute the three pillars of the euro area banking union. With a view to ensuring uniform business conditions across the EU, any non-euro area EU Member State can join the banking union through an arrangement known as “close cooperation.” While the idea of close cooperation failed to gain traction in the early years of the SSM, recent times have seen both Bulgaria (2018) and Croatia (2019) apply for membership. In Sweden, the Ministry of Finance released a publication in 2019 analyzing the effects of Sweden potentially joining the banking union,⁶⁷ and Denmark has also been considering the idea.⁶⁸

Even before the SSM was established, the ECB was in regular contact with the national supervisory authorities of the euro area countries via the Banking Supervision Committee (BSC).⁶⁹ The BSC provided advice in areas that were in the common interest of both the ECB and the national supervisory authorities, and conducted studies on the national financial systems. However, it was not until the SSM was established that the ECB took on an operational role in banking supervision. Under the SSM, the ECB has been responsible for the operational supervision of the approximately 120 “significant credit institutions”⁷⁰ in the euro area, in cooperation with

⁶² Čihák et al. (2007).

⁶³ *A college of supervisors is essentially a permanent committee consisting of a cross-border bank's “home” and “host” supervisors. Supervisory colleges facilitate a better understanding of a cross-border bank's risk profile and vulnerabilities and provide the authorities tasked with supervising this bank with a framework for addressing key issues that are relevant from a supervisory perspective. See www.bankingsupervision.europa.eu/about/ssmexplained/html/supervisory_colleges.en.html.*

⁶⁴ See SRMR I (2014).

⁶⁵ See SRMR I (2014), which has already been amended as part of the banking package described above to form SRMR II (2019).

⁶⁶ See European Commission (2015a) and European Commission (2015b).

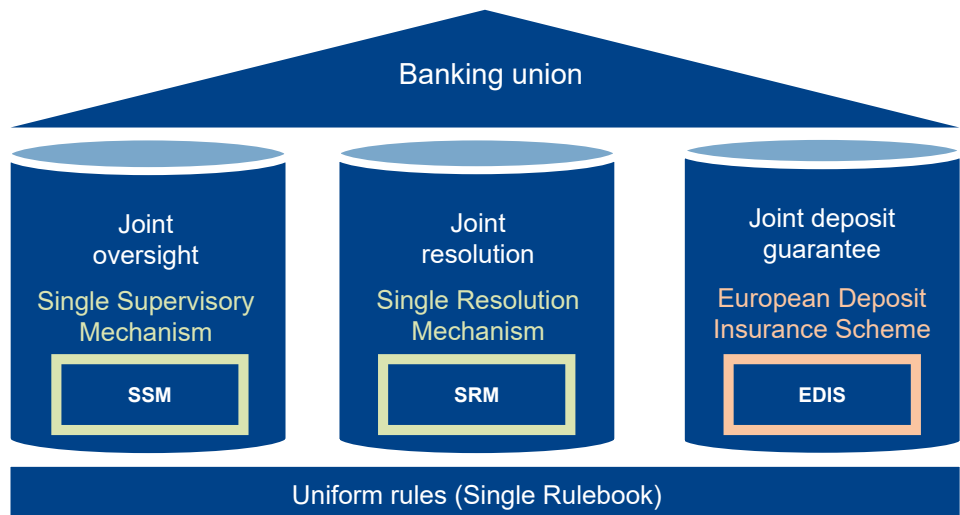
⁶⁷ Government Offices of Sweden (2019).

⁶⁸ Danish Ministry for Industry, Business and Financial Affairs (2019).

⁶⁹ The BSC was subsequently replaced by the Financial Stability Committee (FSC); see Ladler (2014), p. 162.

⁷⁰ See Article 6 of the SSMR (2013).

Establishing the banking union in the euro area as a second response to the financial crisis



Source: Authors' compilation on the basis of EU legislation.

the competent authorities of the Member States, since November 2014. “Less significant credit institutions” continue to be supervised by the relevant competent national supervisory authorities, though the ECB bears the primary responsibility for ensuring the effective and uniform functioning of the SSM. In the Member States, too, the lessons learned from the financial crisis have resulted in central banks becoming more strongly involved in banking supervision. In Belgium, Ireland and the United Kingdom, for example, banking supervision was transferred back to the central banks, while in Luxembourg the central bank was entrusted with the supervision of bank liquidity. Thus, 16 out of the 19 euro area central banks also played a role in banking supervision within the national division of responsibilities in 2020.⁷¹

The second pillar of the banking union, the SRM, started its operations on January 1, 2015. Similarly to the SSM,

the SRM is a system of collaboration between a central resolution authority – the newly established Single Resolution Board (SRB) located in Brussels – and the national resolution authorities, supported by a single resolution fund. The division of powers between the SRB and the national resolution authorities, in particular in terms of the banks placed directly under the SRB’s responsibility, largely corresponds to the division of powers under the SSM.

In its legislative proposal, the Commission proposed that the third pillar of the banking union, the EDIS, be developed over three stages. In the first stage of its implementation, the re-insurance phase, risks would remain largely at the national level and mutualized funds would only be distributed – to a limited extent – after national funds available had been fully depleted. In the second stage (co-insurance), coverage of deposits would be shared between the EDIS and the national participating deposit

⁷¹ See Nowotny (2019).

guarantee scheme, with the share of funding provided by the EDIS in the event of a pay-out increasing gradually each year. In the third stage, losses would be fully mutualized.⁷²

Since the Commission published its legislative proposal, progress in the negotiations on the concrete terms of the EDIS – particularly the extent to which losses should be mutualized – has been sluggish. A range of different models, targeted at the first two stages in particular, and the prerequisites for the transition to the next respective stage have been considered and discussed. At the euro summit on December 13, 2019, the Eurogroup was mandated to continue working on strengthening the banking union in all areas⁷³ – however, the concrete terms of the EDIS and a concrete timeline for its implementation are yet to be determined.

4 Conclusions

Looking at the developments in banking regulation and supervision over the past 25 years, changing levels of importance attached to the motivations and objectives behind law-making in this area over this time are clear to see. When the Segré Report was prepared in 1966, the frameworks of most European Economic Community member countries for regulating banking and banking supervision continued to reflect the measures taken to address the great economic crisis of the inter-war period. From 1970 to the mid-2000s, the central aim of the prevailing regulatory practice was harmonization, with efforts focused on creating uniform conditions for banks' business activities and completing a single market for financial services, as well as the implementation of internationally established supervisory

standards. In the 2000s in particular, more attention was paid to finding the right balance of regulatory intensity, guided by the “better regulation” principle.

The outbreak of the financial crisis in 2007 significantly shifted the emphasis of targets once again, albeit this did not result in earlier goals being abandoned. Policymakers made dedicated efforts to strengthen financial market stability, minimize risks and lower the burden on the public purse in crisis situations. At the same time, they continued to pursue the objectives of creating a level playing field (harmonizing regulatory and supervisory conditions for banks' business activities in the different Member States) and continued to adhere to the “better regulation” approach. Testament to the latter are the discussions surrounding the application of the principle of proportionality to the Single Rulebook over the last few years, a subject also taken on board in the banking package in 2019.

It is not just the objectives that have been changing, however – the legislative approach to banking regulation has also undergone a transformation. While the process started with what tended to be fragmented European standards in individual areas, the Banking Consolidation Directive (BCD) in 2000 and the subsequent Capital Adequacy Directive (known as the CRD I package) laid down the framework for a more all-embracing approach. This was subsequently accompanied by a large number of mandates for technical work to be carried out by the EBA. In 2013, supervisory norms aimed at strengthening the single market were for the first time implemented through a regulation directly applicable in all Member States.

⁷² For further information, see *European Commission (2015b)*.

⁷³ *Eurogroup (2012)*.

At the institutional level, too, the European supervisory framework continued to develop, with key changes induced in part by the crisis. This is reflected in the creation of the European System of Financial Supervision (ESFS) and the foundation of the first two pillars of the banking union, namely the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). On top of this, the increased focus on macroprudential aspects of supervision and crisis management led to central banks assuming a stronger role in banking supervision, as seen in the transfer of responsibility for supervising credit institutions in the euro area to the ECB.

In terms of substance, both the scope and complexity of the regulatory

framework in place have increased significantly. This is partly the result of closing the gaps in supervisory rules following the financial crisis – a necessary step – and partly due to extensions to these rules and regulations to take into account, among other things, national exemptions when transferring international standards into European law. In light of lessons learned from the financial crisis, efforts to reduce complexity must therefore not involve rolling back important, stability-enhancing regulations, but rather focus on applying more proportionality and reducing the number of historical, predominantly national derogations with a view to creating a uniform, consistent regulatory framework for the entire EU: the Single European Rulebook.

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Part 3:

EU membership and economic governance

Chapter 10

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The development of the EU budget and its impact on Austria, Finland and Sweden¹

The EU budget shows the EU's financial relationship with the individual Member States and the EU's political priorities. The priorities have changed significantly in the past few decades. This is particularly evident in the falling share of spending on agricultural policies in the EU's total expenditure. The revenue structure has also shifted over time and is complex because various Member States receive rebates on their membership contributions. Since joining the European Union in 1995, Austria and Sweden have always been substantial net contributors to the EU budget, while Finland joined the ranks of the latter only in 2006. As two of the biggest net contributors, Austria and Sweden have both long benefited from rebates on their membership contributions. At the same time, Austria and Finland get comparatively more back from agricultural policy funds than many other EU Member States with high gross national income (GNI) per capita. However, the proposal submitted by the European Council for the EU's multiannual financial framework (MFF) for the period 2021–2027 includes, inter alia, a debt-financed fund to help EU Member States cope with the economic crisis caused by COVID-19, which entails an increase in the actual net contributions of high-income Member States.

JEL classification: H87, F53

Keywords: EU budget, the EU's multiannual financial framework, the EU's own resources, transfers from the EU budget, net contributions

Austria joined the EU on January 1, 1995 – the same time as Finland and Sweden. For each of the three countries, integration into the EU and the single market in particular meant far-reaching changes to the framework of their economies. The adjustments to the EU's institutional framework covered a wide range of areas, ranging from the legal system through to competition, tax and budget policy, and the labor market. The opening of the borders and the liberalization of the product and factor markets resulted in an increasing mobility of tax bases and, hence, impacted on national tax policies. In addition, all three countries committed themselves to developing their budget policy in line with the EU's fiscal framework, i.e. the requirements

of the Maastricht Treaty and the Stability and Growth Pact adopted in 1997.

Joining the EU brought about an extensive financial relationship with the EU budget. Every EU Member State is obliged to pay membership contributions, as well as certain taxes to the EU budget (mainly customs duties). At the same time, however, every EU Member State receives transfers from the EU budget in the form of e.g. support for businesses, farmers and rural/regional development, Erasmus scholarships and cofinancing of cross-border infrastructure projects. Thanks to their relative economic strength, Austria and Sweden joined the ranks of net contributors right in 1995. Finland became a substantial net contributor (i.e. with an average net contribution above 0.1% of GNI) only in 2006. All three economies have

¹ *Opinions expressed by the authors of studies do not necessarily reflect the official viewpoint of the OeNB or the Eurosystem. The authors would like to thank Maria Auböck, Fritz Breuss, Ernest Gnan and Robert Stehrer for helpful comments and valuable suggestions. This article builds on a previous contribution on the same topic (Köhler-Töglhofer and Reiss, 2020), differing from the latter, however, in that it includes a cross-country comparison between Austria, Finland and Sweden as well as additional information on the EU's next multiannual financial framework (MFF) for the period 2021–2027.*

benefited significantly from being part of the EU's single market, currently the most economically important single market in the world (Mion and Ponattu, 2019), judging from GDP/level of income gains evidently attributable to EU membership. This is shown by various empirical studies that have been conducted in recent years,² as well as articles in this publication (Breuss, 2020; Anttonen and Vihriälä, 2020).

Membership of the EU provides a financial relationship through the EU's wider financial architecture, as well as through the EU budget specifically. The EU's wider financial architecture comprises a number of entities outside the EU budget which are connected to it through guarantees and/or transfers, such as the European Fund for Strategic Investments (EFSI) and various credit facilities secured by the EU budget. The latter include the Balance of Payments Facility and the European Financial Stabilisation Mechanism (EFSM), which granted loans to Ireland and Portugal as part of their adjustment programs following the economic and financial crisis. The European Investment Bank (EIB) is also part of this wider financial architecture. It raises additional funds to meet various EU objectives (e.g. financing SMEs, infrastructure projects, EU climate change policy and the EIB's external mandate). However, the EIB's nominal capital is not financed from the EU budget, but by the Member States directly. Funds are also raised based on specific agreements between the EU and Member States, such as the EU Facility for Refugees in Turkey and the European Development Fund (EDF). The wider financial architecture also includes a number of institutions serving European Monetary Union (EMU) (primarily), such as the European Central Bank

(ECB), the European Stability Mechanism (ESM) and the Single Resolution Fund (SRF). The new budgetary instrument for convergence and competitiveness (BICC) for the euro area, which is essentially to be financed from the EU budget, would also be part of the wider financial architecture through the share of its financing that could be based on a voluntary agreement with Member States. The same is true for the newly established substantial recovery funds to cope with the negative impact of COVID-19.

This article discusses the specific features of the EU budget in the narrower sense and its relationship with Austria since 1995, comparing the resulting findings with those of Finland and Sweden. The first section gives an overview of some of the specific features of the EU budget. The article will then highlight the interdependencies between the EU budget and the three countries under review since their accession to the EU in 1995. The third section briefly discusses the EU's future MFF for the period 2021–2027 and the realignment of economic priorities that it is intended to bring about, taking into account the fact that the U.K. is leaving the EU. Some brief conclusions will then be drawn.

1 EU budget: areas of focus, specific features and transfers

The EU budget reflects the EU's political priorities on the one hand and its financial relationship with the individual Member States on the other. It provides information on the origin of the funds allocated to the EU, as well as on the use of funds in the form of support/cofinancing (monetary backflows to the Member States) in line with the EU's objectives and political priorities. These are mainly reflected in the EU's MFF.

² Beer et al. (2017), Mion and Ponattu (2019), Breuss (2015 and 2016), Felbermayer et al. (2018) and Oberthofer (2019).

The EU does not have financial autonomy, i.e. it has no right to collect its own taxes, nor is it allowed to finance its spending through borrowing, i.e. in principle, the EU budget has to be balanced.³

The EU budget is approved annually after being agreed by the European Parliament and European Council (unanimously) based on a proposal by the European Commission. However, it has to respect the upper limits on spending defined in the MFF for each of the EU's different areas of expenditure. The EU normally sets its annual budget plan at a level below the upper limits in order to be able to meet any unforeseen spending needs if necessary. To ensure spending discipline, the Own Resources Decision, which governs the EU's income described in section 1.2, sets binding upper limits that may not be exceeded. This spending limit currently amounts to 1.20%⁴ of the EU's GNI⁵.

1.1 EU spending is focused on agricultural policy, as well as regional and cohesion policy

EU spending is based on the EU's MFF (which currently runs for seven years). It sets the spending priorities and limits for the whole period. Each MFF is based

on a regulation establishing the MFF, which is to be passed unanimously by the European Council – once it has been approved by the European Parliament.

The MFF stipulates annual ceilings both for EU spending as a whole and for the main individual areas of spending. These have to be taken into consideration by the European Commission in the respective proposals for the next annual budget – as well as by the European Parliament and European Council. The annual ceilings determine both the maximum total amount for commitment appropriations (legally binding promises on spending that does not necessarily have to take place in the same year, but may stretch over several financial years) in the individual spending areas and an overall ceiling for payment appropriations (the actual amounts authorized for disbursement in a given year).⁶ The MFF is a seven-year framework for the policies that the EU has set out in figures, as it specifies the maximum amounts of funding allocated to the different policy areas. Chart 1 shows how the EU budget increased until the mid-1990s and has since been comparatively stable in relation to GNI – slightly fluctuating around 1% of GNI. It also

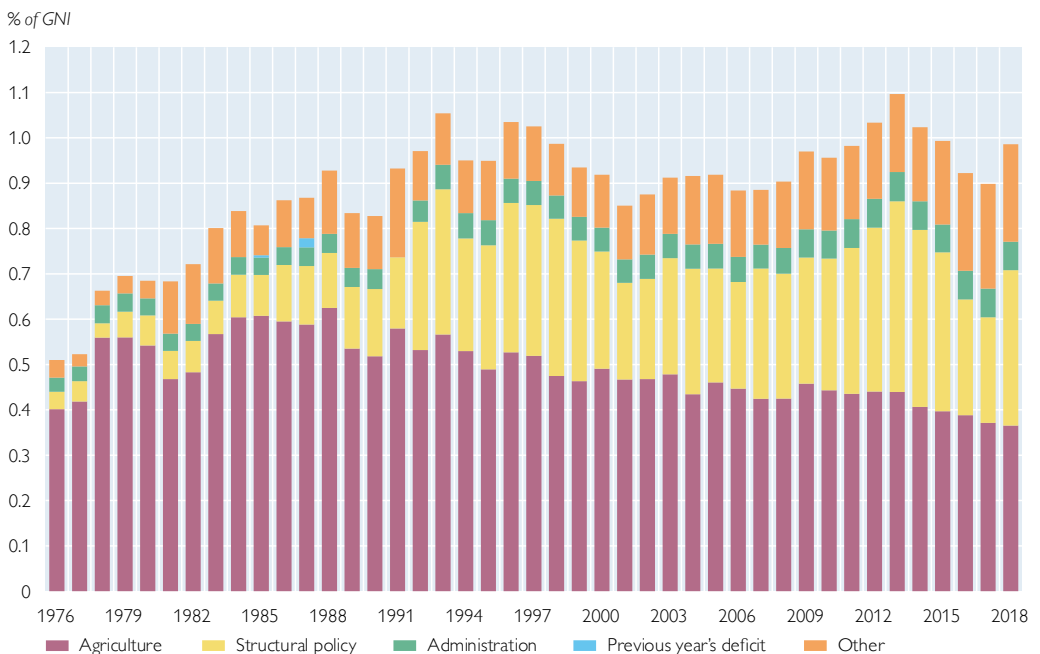
³ However, within the framework of the new MFF for 2021–2027, the European Council (2020) agreed on Next Generation EU, a temporary scheme outside the EU budget financed by joint debt issuance.

⁴ See European Commission (2018, page 13). The last Own Resources Decision was adopted in 2014 based on ESA 95 and set a ceiling of 1.23% of the EU's GNI. The switch to ESA 2010 was tough, with the rate being reduced to 1.20% of the EU's GNI (the nominal amount of funding made available to the EU was retained). According to the European Council's (2020) proposal for the 2021–2027 MFF, the ceiling allocated to the EU to cover annual appropriations for payments is fixed at 1.40% of the GNI of all the Member States and the total annual amount of appropriations for commitments is limited to 1.46% of the GNI of all the Member States.

⁵ Conceptually, GNI is identical with the previously used gross national product (GNP). According to Eurostat (2020), GNI is "the sum of incomes of residents of an economy in a given period". It is equal to gross domestic product (GDP) minus primary income payable by resident units to nonresident units, plus primary income receivable from the rest of the world (from nonresident units to resident units). For most Member States, GNI and GDP differ by less than 3%. In Luxembourg and Ireland, however, GNI is considerably lower than GDP (more than 35% and more than 20%, respectively); it has also tended to be lower than GDP in the Member States that have joined since 2004 (albeit less than 10% in each case).

⁶ The upper limit for commitment appropriations is higher than the one for payment appropriations, as not all legal obligations that the European Commission enters into are accompanied by payments in the same year. This applies in particular to payments within the framework of the Structural and Regional Funds, which are sometimes spread over several years.

EU budget expenditure



shows the relative shifts in the areas of spending and thus the change in the EU's economic policy priorities since 1976.

The Common Agricultural Policy (CAP) has always been the biggest individual item of expenditure. It was set up in 1962 and has since undergone numerous reforms.⁷ Essentially, the goal of the CAP is to maintain an independent agricultural sector in Europe, i.e. to achieve a high degree of self-sufficiency or independence in the EU in terms of food supply.⁸ At the same time, it is supposed to promote rural regions, as well as taking account of environmental

policy goals such as the sustainable use of natural resources and the fight against climate change. Since 1985, shortly before the first multiannual budget came into force (Delors I package for the period 1988–1992), the share of spending on agricultural policy in total expenditure has been falling continuously. Around EUR 420 billion is being paid through the CAP in the current seven-year budgetary period, of which the majority (around three-quarters) is being paid to farmers in the form of direct subsidies for market-related measures (first pillar of the CAP).⁹ Just

⁷ From 1992, the system of agricultural aid included unlimited purchase guarantees at set prices. These were replaced by a system of compensatory income support consisting of single farm payments following the fundamental reform of 2003 in order to decouple aid from production. Furthermore, all measures to control supply were abolished, for example the quota system for sugar in 2017. Milk quotas had already been abolished in 2015.

⁸ As the European agricultural sector is characterized by comparatively small or family-owned farms, the production costs are higher than in other regions of the world. Because of this, subsidies were regarded as essential when import barriers and customs duties for agricultural products were being abolished.

⁹ See Austrian Federal Ministry of Finance (2018, page 11).

under a quarter of CAP funds are available for the second pillar, which comprises rural development measures (the European Agricultural Fund for Rural Development, EAFRD) – cofinanced by Member States.

In the past few decades, there has been a rise in spending on structural policy, which mainly comprises the cohesion, regional and social funds. The structural and cohesion funds¹⁰ in particular aim to permanently close the considerable economic and social gaps between the Member States and between the regions, as well as to increase their own development potential. For example, the European Regional Development Fund (ERDF) supports regions with structural problems and whose development is lagging behind; it provides transfers to create jobs in SMEs, boost energy efficiency and support research and technological development. The focus of the ERDF is therefore on projects that are important for the competitiveness of regions as globalization continues. The cohesion fund supports projects concerning the environment and Trans-European transport networks. It is only available to Member States with GDP per capita of below 90% of the EU average and is one of the multiannual investment programs managed on a decentralized basis, as is the ERDF. The main beneficiaries of the regional and cohesion funds are the least-developed regions, especially the Member States in central and eastern Europe (where approximately 70% of the funds are concentrated), but also a number of EMU countries on the southern periphery. The European Social

Fund (ESF) is the EU's most important social policy financing instrument and is aimed at helping to re-integrate the unemployed into the labor market. It promotes training and qualification measures, as well as social integration. The structural funds and the EAFRD follow the cofinancing principle, i.e. the Member States have to take on a share of a project's financing, which rises according to the income level of the relevant Member State or region.

The strong focus on agricultural and regional policy has been controversial ever since. The economic theory of federalism supports European financing for those policy fields for which pan-European responsibility either results in economies of scale or cost benefits, or those that cannot be provided efficiently at the national level because of externalities – whether they be positive or negative. This is particularly the case when the preferences of Member States with regard to individual policy areas differ only marginally. However, politicians representing Member States in negotiations have an eye on the potential monetary backflows from the EU budget. This is an example of common pool resource theory. According to Heinemann (2018), this states that a pan-European budget funded by the Member States collectively creates more of an incentive for financing than having lots of local/national budgets.¹¹

There has been an increased focus on other policy areas in the past two decades, which can be seen in the current MFF (2014–2020). This includes various programs for research, development and infrastructure, which comprise

¹⁰ The EAFRD was set up in the course of the reform of the structural funds with the MFF for the period 1993–1999. The priorities of this MFF were determined by the Maastricht Treaty of 1992 with a view to EU enlargement.

¹¹ For an up-to-date evaluation of the effectiveness of the cohesion fund, see Darvas et al. (2019).

around EUR 142 billion of funding,¹² amounting to a fifth of the EU budget.¹³ As part of the mid-term review of the current MFF in mid-2016, more importance was placed on pursuing an investment drive, as well as dealing with youth unemployment and migration.

1.2 Rebates on EU contributions limit net payments of EU Member States with high income

In accordance with Art. 311 of the Treaty on the Functioning of the European Union, the EU budget is essentially financed by the EU's own resources, which consist of the taxes collected by the Member States for the EU budget (traditional own resources) and national contributions. The Own Resources Decision governs this financing. It has to be agreed unanimously by the European Council and comes into force after being ratified by the Member States. In principle, it then applies indefinitely.¹⁴ This means that the EU has the necessary funds to pay for the annual budget without requiring the prior consent of Member States.

Chart 2 illustrates the change in the level of revenue (in line with the rising expenditure) and in the revenue structure of the EU budget since 1976. Traditional own resources were a relatively large source of revenue until the early 2000s. These comprise taxes that are collected by the Member States,¹⁵ but transferred to the EU. The vast majority of these taxes are customs duties. There are also sugar levies at present.

However, these duties have become less important as a source of revenue for the EU budget following the liberalization of trade. National contributions, which are paid out of Member States' individual budgets, have become increasingly important over the years.

Since 1979, the national contributions have included the VAT-based own resources, for which Member States have to pay a fixed percentage of a notional harmonized VAT assessment base to the EU budget (currently 0.3% for most Member States). Since the late 1980s, they have also had to make payments based on their respective GNI – initially just as a supplement. The percentage of GNI to be transferred to the EU budget is determined in such a way that it meets the requirement for the EU budget to be balanced. As a result of concerns about the harmonized VAT assessment base (such as measurement problems and a higher relative burden on a number of lower-income Member States), GNI-based resources have become much more important as a source of funding in the course of the last 30 years. In addition, any budget surpluses from previous years are carried over to the next financial year and are therefore also shown as revenue in the EU budget. Other revenue, which is becoming more important, includes fines imposed on Member States.

The fact that there are various rebates makes the system of national contributions complex. This explains why there are considerable differences in the

¹² See Austrian Federal Ministry of Finance (2018, page 11).

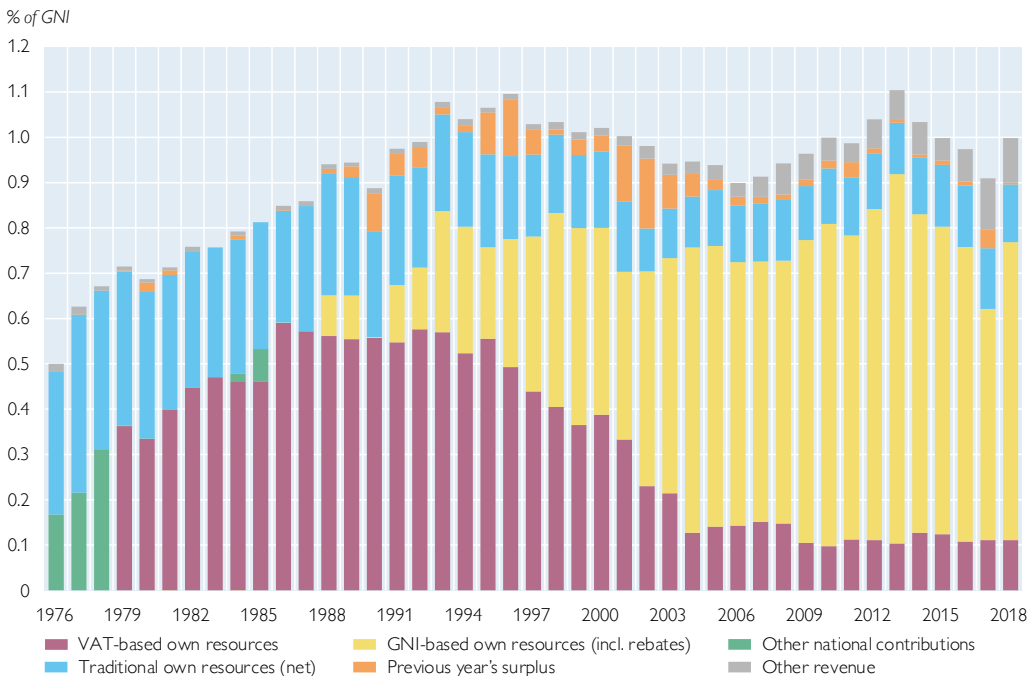
¹³ These include the Horizon 2020 program to promote cutting-edge research and innovation; the Connecting Europe facility to promote pan-European infrastructure projects in the areas of transport, energy, and information and communication technologies; the Erasmus programme; the COSME programme; Galileo; and Copernicus.

¹⁴ Once the European Parliament has been consulted, each change to the Own Resources Decision has to be unanimously agreed by the European Council and ratified by all EU Member States. The Own Resources Decision was last changed in 2014 in line with the new MFF.

¹⁵ As compensation for collecting sugar levies and import duties, Member States retain a portion; in the next MFF (2021–2027), the percentage of collection costs retained will be 25% of the amount collected, compared to 20% in the current MFF (2014–2020).

Chart 2

EU budget revenue



Sources: European Commission, OeNB.

Note: Until 1987, traditional own resources were shown in the EU budget in gross terms and collection payments recorded as expenditure. For the purpose of consistency with the years from 1988 onward, these two items are offset for this chart.

relationship between national contributions and GNI within EU Member States (see chart 3). Denmark, Germany, the Netherlands, Austria and Sweden receive rebates, as did the U.K. The Netherlands in particular benefit greatly.

If it were not for rebates, the percentage contributions of GNI between Member States would be almost identical (blue bars in chart 3).¹⁶ There are three different types of rebates:

- rebates on VAT-based own resources for Germany, the Netherlands and

Sweden (a rate of 0.15% instead of 0.3%; purple bars in chart 3);¹⁷

- U.K. rebate¹⁸ (yellow bars in chart 3; Germany, the Netherlands, Austria and Sweden receive a rebate when the U.K. rebate is distributed to Member States); and
- rebates on GNI-based own resources in the form of lump sums for Denmark, the Netherlands, Austria¹⁹ and Sweden (green bars in chart 3).

These rebates, or budgetary correction mechanisms, are designed to avert

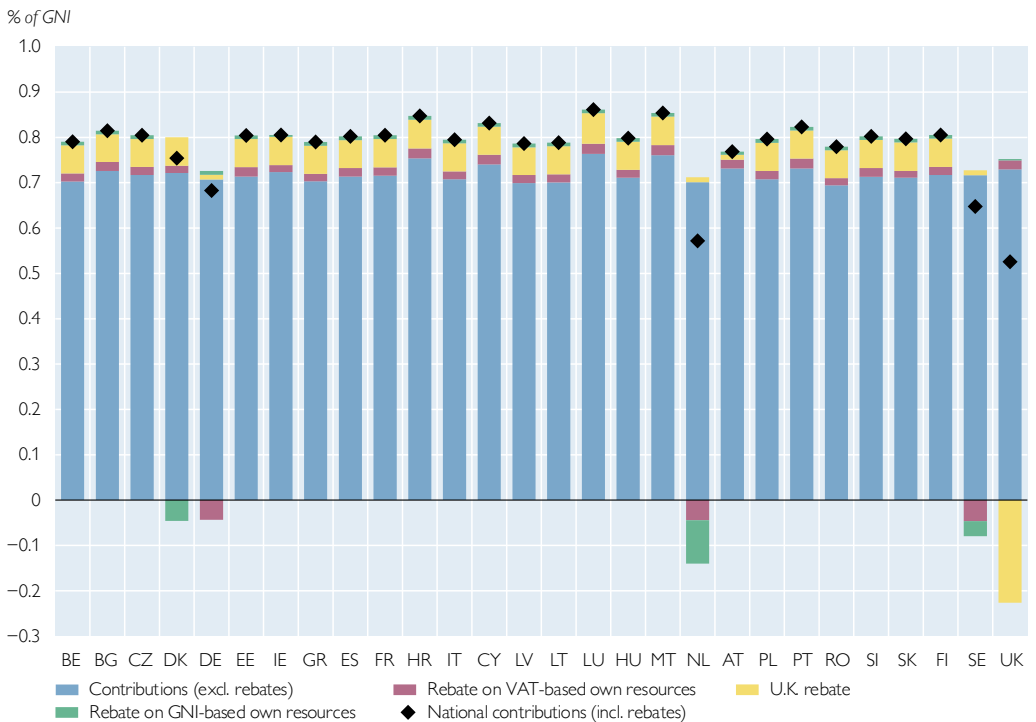
¹⁶ Minor differences may result from revisions to the GNI data. Differences may also result from the national harmonized VAT assessment base compared with GNI.

¹⁷ The U.K. rebate and the rebate on GNI-based own resources are shown in the EU budget as zero-sum games, with the other Member States financing these rebates for Denmark, the Netherlands, Austria, Sweden and the U.K. The rebates on VAT-based own resources are also shown this way for chart 2 – in contrast to the way they are presented in the EU budget.

¹⁸ The U.K. rebate is calculated in such a way that the country's net contribution is reduced by two-thirds compared with a scenario without a rebate (excluding certain spending associated with EU enlargement from 2004).

¹⁹ In the 2014–2020 MFF, the rebate for Austria amounted to EUR 30 million for 2014, EUR 20 million for 2015 and EUR 10 million for 2016. It is not visible in chart 2 because the amount is so small.

National contributions to the EU budget from 2016–2018



Sources: European Commission, OeNB.

“excessive” net contributions by certain Member States.

1.3 Significant redistribution in EU budget even though amount is small

Germany, the Netherlands, Sweden and the U.K. – the four net beneficiaries of the complex system of rebates – are Member States with very high GDP per capita that get comparatively little back from the EU budget (chart 3 shows that the contributions (excluding rebates) exceed the national contributions actually paid by these Member States). This is mainly because they receive significantly less agricultural subsidies than, say, France, Austria, or Finland. That explains why those countries come

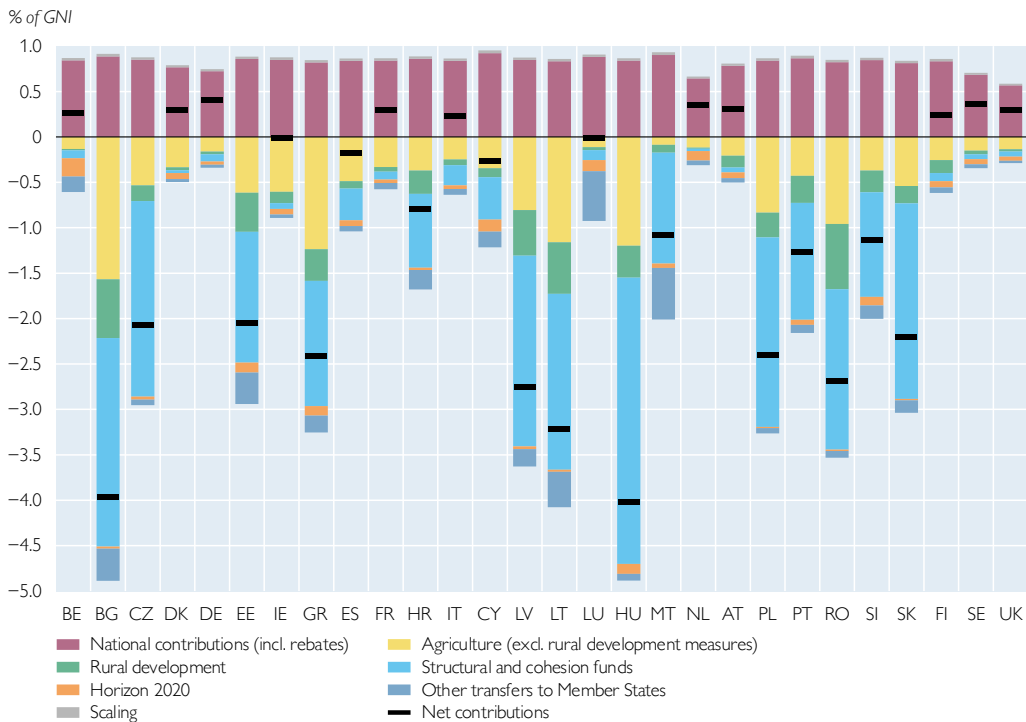
first, second, third and fifth in the net contributor²⁰ rankings from 2014 to 2018 (Austria ranks fourth and Denmark sixth) despite their reduced national contributions (see chart 4).

Thanks to the rebates, none of the net contributors have to pay a net amount of more than 0.5% of their GNI. At the same time, however, lower-income EU Member States have net inflows of more than 2% of GNI (some even have considerably more). This strong redistribution effect comes about because most of the transfers coming from structural funds goes to the lower-income Member States (by definition in the case of the cohesion fund). In addition, many of the transfers coming from regional funds go to

²⁰ The European Commission calculates the net contributions by offsetting spending from the EU budget (without administration) in the individual Member States against their respective national contributions. The national contributions are scaled so that these estimated net contributions total zero (this minor scaling effect is also shown in charts 4 and 5).

Chart 4

Net contributions to the EU budget from 2014–2018



Sources: European Commission, OeNB.

regions in lower-income Member States.²¹ It is primarily funds flowing back under agricultural programs that go to higher-income Member States. Hence, agricultural policy is also an important factor determining the relative net contributions of the higher-income Member States. For example, France does not receive any rebate at all, even though its GNI per capita is similar to that of the U.K. Despite this, it is a somewhat lower net contributor because it receives higher transfers from agricultural policy funds. The same applies when comparing Austria with the Netherlands or Sweden. It is also largely the higher-income Member States that avail themselves of the various programs for research, development and infrastructure that are managed at the

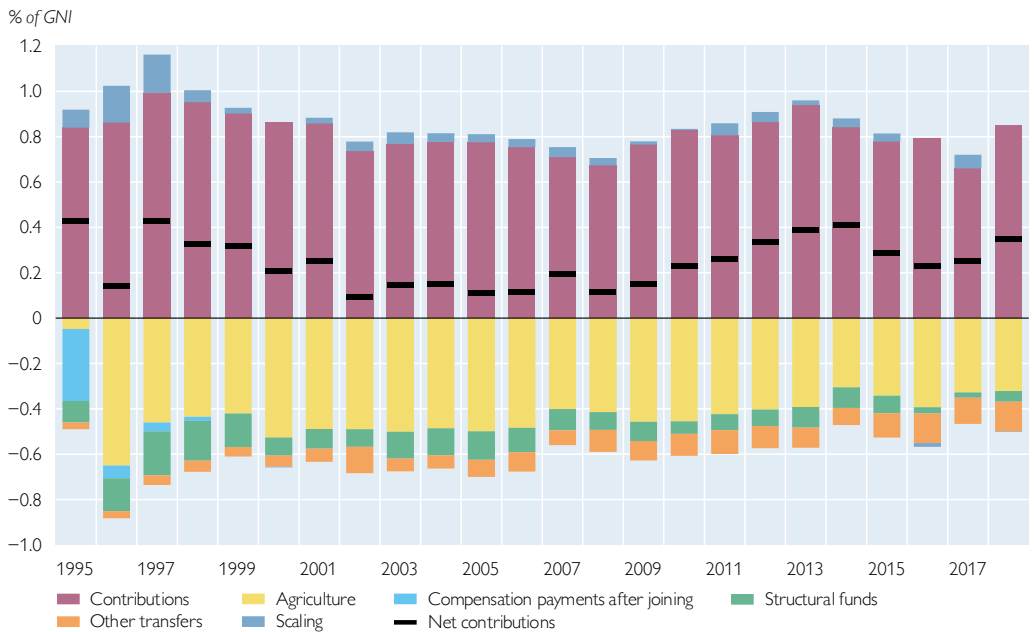
European level. The European Council's proposal for the new MFF envisages that rebates on national contributions will be maintained for Denmark, Germany, the Netherlands, Austria and Sweden for the period 2021–2027.

2 Austria's, Finland's and Sweden's relationship with the EU budget

Since joining the EU in 1995, Austria has always been a net contributor to the EU budget (see chart 5). However, various rebates on national contributions have reduced the extent of the net payments slightly. Ever since 2002, Austria has received a rebate on its share when the U.K. rebate has been distributed. From 2009–2013, there was also a rebate on the VAT to be paid (which saved

²¹ However, the monetary backflows from the cohesion fund that go to lower-income Member States also have a positive impact on Member States that do not receive transfers from the fund, as well as on third countries. This is as a result of macroeconomic spillover or feedback effects (increase in foreign trade, etc.). See Naldini et al. (2019).

Austria's financial relationship with the EU budget from 1995–2018



Austria approximately EUR 0.1 billion per year). From 2014–2016, there were smaller, lump-sum rebates as compensation for the withdrawal of this rebate (of EUR 30/EUR 20/EUR 10 million).

2.1 Austria's EU budget returns mainly come from agricultural policy funds

Most of the monetary backflows that Austria receives from the EU budget come from agricultural policy funds, which have amounted to approximately 0.3% of GNI in the last few years. Monetary backflows to Austria are increasing at a slower pace than GNI in this sector. This is in line with the diminishing role of agricultural policy in the EU budget that was outlined in section 1. The fact that Austria's GDP per capita went up at a faster pace than that of the EU as a whole also contributed to the slight fall in the share of transfers coming from structural funds over time (see chart 5). The faster increase can be attributed to

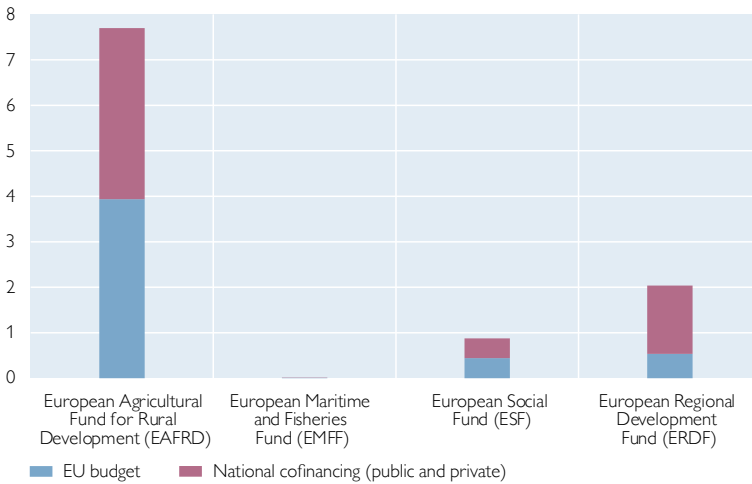
the comparatively minor impact of the global economic and financial crisis in Austria on the one hand and the EU's eastern enlargement on the other. These transfers include regional aid to Burgenland, which was initially an Objective 1 area owing to its low regional GDP per capita and became a transition region with a higher share of cofinancing following the EU's first wave of eastern enlargement. The rising share of spending outside the traditional areas of the EU budget (i.e. agricultural and structural funds) can also be seen in Austria through an increase in budget returns in other areas, such as for research as part of the Horizon 2020 program, Erasmus scholarships or the financing of the cross-border Brenner base tunnel project.

Around 60% of the agricultural transfers are direct payments to farmers, which are financed exclusively by the EU budget (single farm payments and expenditure related to market regulations from the first pillar of the CAP).

Chart 6

Cofinanced spending envisaged for Austria from 2014–2020

EUR billion



Source: European Commission, OeNB.

The second pillar of the CAP – rural development measures (EAFRD) – accounts for the remainder (approximately 40%). In order to make use of these funds, cofinancing by Member States is compulsory, with the extent of the cofinancing being determined primarily by the income level of the respective Member State or region in relation to the average income level in the EU. This is also the case for structural funds (i.e. regional funds, cohesion fund, social fund).²² The EAFRD is the most important cofinanced EU funding pool by a

distance from an Austrian perspective. The cofinancing share for Austria is 50% (see chart 6).

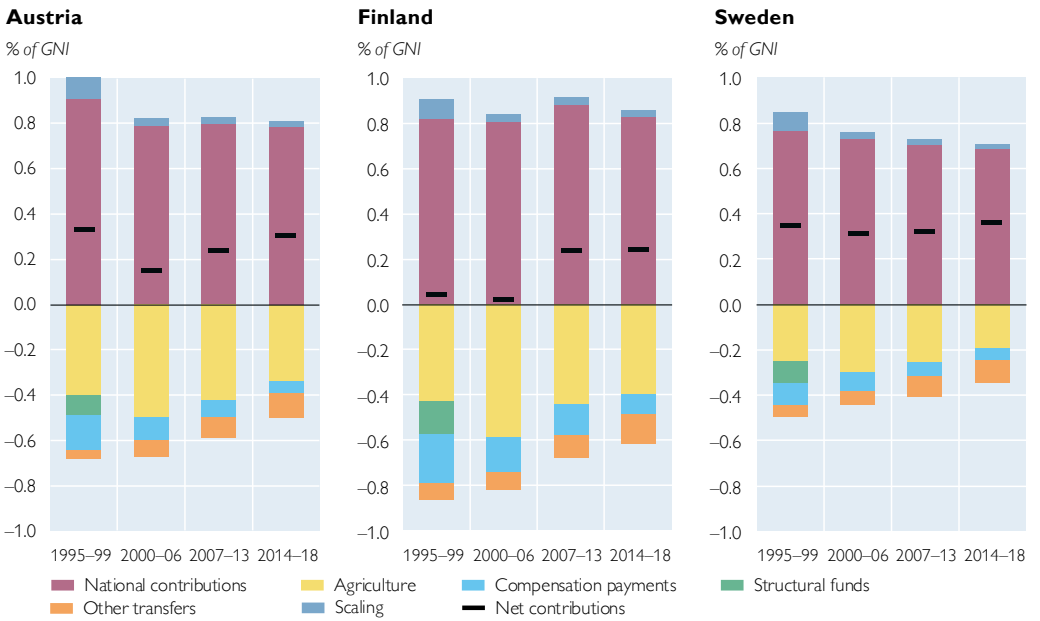
2.2 Finland's and Sweden's financial links to the EU budget are similar to those of Austria

Finland and Sweden joined the European Union in 1995, alongside Austria. While Austria and Sweden have been substantial net payers into the EU budget since their accession in 1995, Finland joined the ranks of the latter only in 2006 (see chart 7).

²² The EAFRD, European Maritime and Fisheries Fund (EMFF) and the structural funds are brought together under the term “European Structural and Investment Funds” (ESIF).

Chart 7

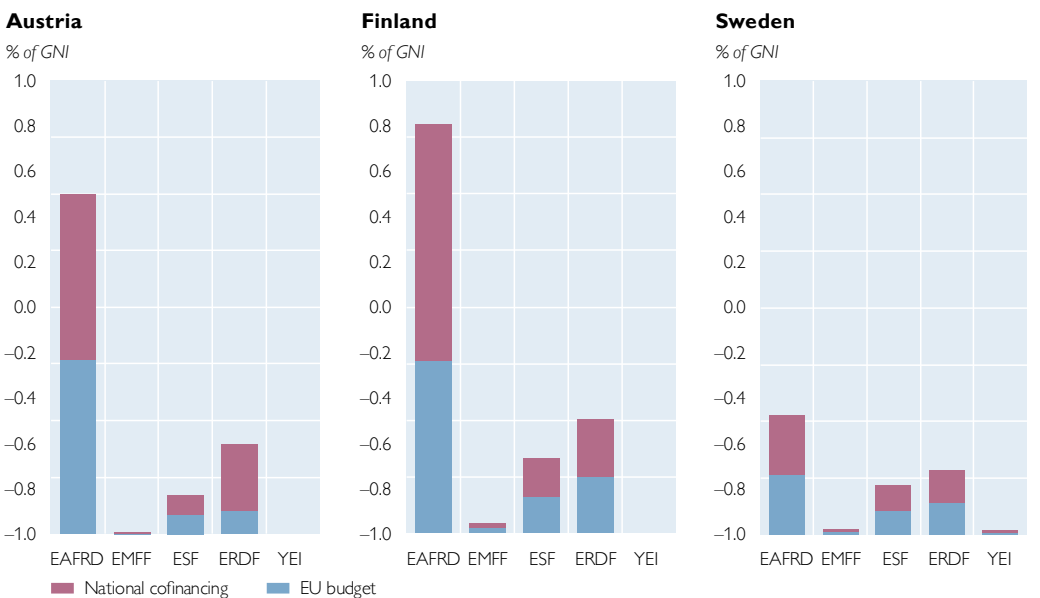
Austria's, Finland's and Sweden's financial relationship with the EU budget



Source: European Commission.

Chart 8

Cofinanced spending envisaged for Austria, Finland and Sweden from 2014-2020



Source: European Commission.

Note: EAFRD = rural development; EMFF = fishery; ESF = social fund; ERDF = regional fund; YEI = youth employment

As in the case of Austria, most of the monetary backflows to Finland from the EU budget come from agricultural policy funds, which have amounted to

approximately 0.4% of GNI in the last few years (see chart 7). Compared to Austria and Sweden, Finland has received higher transfers (in % of GNI)

from structural funds (see chart 8). Sweden, in contrast, has benefited somewhat less from both agricultural funds and structural funds. Nevertheless, the net positions of these three countries in the current MFF are very similar, given that Sweden gets a higher rebate on its contributions than Austria and Finland does not get any rebate (see section 1.2).

3 Outlook for the 2021–2027 MFF

Negotiations over the next MFF for the period 2021–2027 began back in 2018, with tough negotiations having taken place between the European Commission, European Parliament and, in particular, between the individual Member States as well as within the European Council. The negotiations were complicated by Brexit (despite its large rebate, the U.K.'s net contributions came to around EUR 7 billion per year) and by the question of how to deal with the economic crisis caused by COVID-19.

On July 21, 2020, the European Council (EU heads of state or government) eventually reached a political agreement on the future design of EU finances (European Council, 2020), i.e. on a package worth EUR 1,824.3 billion which combines the new MFF (EUR 1,074.3 billion) with the Next Generation EU (NGEU) recovery instrument (EUR 750 billion). NGEU encompasses both grants and loans to Member States and is primarily targeted at Member States with GDP per capita below the EU average. It thus facilitates redistribution between the Member States and implies significant net contributions from countries like Austria, Finland and Sweden. As much as 30% of the total amount of resources available under the MFF and NGEU are earmarked for spending on tackling climate change. The own resources ceiling, the maximum level of resources that can be called from the Member States annually, will rise

permanently from 1.20% to 1.40% of the EU's GNI to take account of developments such as the smaller total GNI of the post-Brexit EU and the uncertain economic outlook owing to the pandemic. In addition, a temporary increase in the ceiling, worth a further 0.60% of the EU's GNI, will be devoted exclusively to borrowing operations for NGEU and apply until December 2058 at the latest. This temporary increase enables the European Commission to borrow on a much larger scale than in the past (e.g. for the EFSM) and aims to preserve the EU's AAA credit rating.

As a first step in a broader reform, a new own resource based on non-recycled plastic waste will be introduced as of 2021. Moreover, EU leaders paved the way for further proposals by the European Commission for other new own resources, such as a border carbon adjustment mechanism and a digital levy, and for a revised proposal linked to the EU's Emissions Trading System (ETS). EU leaders also agreed on lump-sum corrections that reduce the contributions of five Member States (Austria, Denmark, Germany, the Netherlands and Sweden) to the EU budget, increasing the total amount of rebates for these countries in the next MFF. Finally, the share of customs duties that Member States can retain as compensation for collection costs, was increased from 20% to 25%. Once again, rebates and compensations for collection costs were used as a means to achieve unanimity for the approval of the 2021–2027 MFF in the Council. Due to the significant rebates granted to Austria and Sweden, their net contributions to the EU budget in the narrower sense (i.e. excluding the highly redistributive elements of NGEU) should broadly match those paid in the 2014–2020 MFF. The net contributions of Finland, in contrast, are set to increase somewhat.

4 Conclusions

Austria, Finland and Sweden are net contributors to the EU budget. As two of the biggest net contributors (in % of their GNI), Austria and Sweden benefit from rebates on their membership contributions. Compared to Sweden and most other high-income Member States, Austria and Finland tend to get higher budget returns from agricultural policy funds, which is why Sweden's net payments into the EU budget are even larger despite the relatively higher rebate on its national contributions. With the next MFF, the actual net contributions (i.e. including the distributive effects of NGEU) of high-income Member States like Austria, Finland and Sweden (despite the rebates for Austria and Sweden) are set to increase, as the extrabudgetary

NGEU funds are primarily targeted at low-income Member States and the net contributor U.K. has left the EU.

However, the narrow focus of the negotiations on contributions from, and monetary backflows to, Member States should be questioned – the advantages of the single market should also be considered. Moreover, there are also positive spillover effects to net contributors resulting from payments to lower-income Member States. This holds true for Austria in particular, as it belongs to those countries that tend to benefit most from these spillover effects thanks to their close trading relationship with the Member States that, in turn, benefit from the cohesion fund (see European Commission, 2017b and Naldini et al., 2019).

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Chapter 11

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Revamping policy governance in Austria

The EU's impact 25 years on

This contribution reviews some economic governance aspects of the EU's 1995 enlargement. The focus is on selected fields of internal market pertinence in Austria compared with Finland and Sweden. The analysis starts with an overview of Austria's initial position and reviews the instruments of EU economic governance at the time, including fiscal rules and instruments. The central part of the paper is devoted to the adjustments required to comply with the gradual completion and refinement of the internal market. Special attention is given to competition policy and public procurement. Overall, economic governance in Austria was significantly "modernised" in the course of approaching and implementing EU membership. Although this contributed to a sustained improvement in competitiveness, Austria was in many respects lagging behind the comparative performances of Finland and Sweden.

JEL codes: F15, H11, H60, K21, K23, L16

Keywords: economic and fiscal governance, internal market, competition policy, public procurement, network industries, competitiveness

1 Introduction

25 years ago, when the Fourth Enlargement was to form the EU-15, the three accession countries Austria, Finland and Sweden were already part of the free trade area between the European Free Trade Association (EFTA) and the European Community (EC, established in 1973), of the Single Market as an element of the European Economic Area (since 1994), and, given the Maastricht Treaty of 1992/93, of the evolving monetary union. Austria and Finland subsequently introduced the common currency, while Sweden until now has obviated such a step.

The following remarks will concentrate on the consequences for economic policy governance in the countries of the Fourth Enlargement. Norway and Germany will sporadically be covered as reference countries. The next section is devoted to the initial position of the accession countries¹ with special emphasis on the structural characteristics of the Austrian economy just before entering the EU. Section 3 covers the economic and fiscal governance of the EU at the time of the Fourth Enlargement and the developments thereafter. Drawing

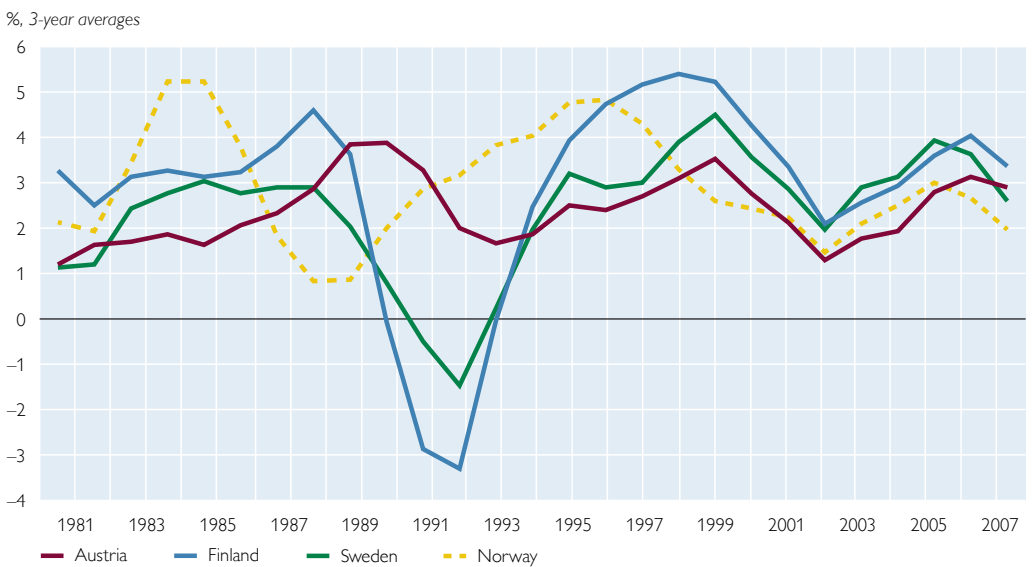
on Austrian experiences in selected areas, Section 4 asserts that EU membership was expected to effectuate, and it actually entailed, a swift implementation of the internal market rules. The final section 5 summarises these aspects under the heading of competitiveness.

2 Diverging conditions in the candidate countries

In the decade before joining the EU, the countries concerned showed quite differing economic developments. In terms of the real growth of GDP, the three accession countries experienced a steady increase in growth rates during the 1980s. In the first half of the 1990s, political turbulences and the trough of the European business cycle were mirrored in low growth and even in recession. Finland was severely hurt by the dissolution of the USSR in 1991 and the ensuing collapse of bilateral trade between Finland and Russia, followed by a stunning recovery. In Sweden, the banking crisis of 1991/93 resulted in a backlash, followed by a dynamic recovery. In Austria, economic development was only mildly hurt by these events, but after accession growth remained more hesitant

¹ „Accession countries" here always refers to Austria, Finland and Sweden.

Real GDP growth rates



than in the other two countries. Norway was anyway a special case because of the oil and gas exploration and extraction activities, and a production structure lopsided towards shipyards and fishery (Handler, 1976). Since then, and until the onset of the financial crisis, GDP growth exhibited the ups and downs of regular business cycles, partly disturbed by early liberalisation efforts and the ups and downs of international prices of crude oil (chart 1).

In Austria, accession to the EU was preceded by

- a long history of discussions, starting already in the 1960s, as to the political possibility of joining the EU (given the Peace Treaty of 1955, obliging Austria to refrain from any association with Germany, and the following constitutional law to remain a permanently neutral country);
- fierce public debates as to the economic feasibility of EU membership (weighing the pros and cons); and

- a series of policy decisions to make the Austrian economy compatible and competitive with conditions in the EEA and the EU.

At the beginning of the 1990s, Austria availed of a solid structural basis for joining the EU, chiefly characterised by a functioning social partnership and the experiences from the hard currency policy. Still, a number of weaknesses remained, as repeatedly assessed by consultation missions from the IMF and the OECD as well as by national witnesses:²

- a large sector of nationalised industries with limited exposure to competition;
- low productivity in the heavily regulated services sector;
- meagre efforts to liberalise the financial markets, with setbacks such as the “Ordnungspolitische Vereinbarungen” of 1985 (reducing competition between banks and resulting in an overbanked economy);

² Among the latter are Breuss, Handler and Stankovsky (1988), Handler (1989), Kramer (1994), Butschek (2004), Seidel (2017).

- higher inflation in Austria than in Germany (in spite of pegging the Austrian schilling to the Deutsche Mark); and
- deficiencies in the structure of industry, leading to a rather weak export performance.

In January 1987, the newly-formed Federal Government stated in its inaugural declaration that “the narrowness of the Austrian domestic market is one of the main obstacles to Austria’s economic development” and therefore “participation in the further development of the European integration process is of central importance to Austria” (Legtman, 1989). At this stage, Austria followed a threefold approach to integration: multilateral efforts via EFTA, bilateral initiatives with the EC in specific areas (free movement of labour, freedom of establishments, financial services), and autonomous measures to harmonise Austrian legislation with EC law. The overarching goal was to achieve a level playing field with other countries of the emerging internal market, either with or without EU membership.

However, membership was seen to round off previous integration steps such as the free trade agreement between EFTA and EEC and the Treaty on the EEA, including the internal market for members. One of the major arguments in favour of Austria joining the EU was the chance to participate in the wider policy making system and to “internationalise” the rather inward-oriented sectors of the Austrian economy (chiefly services, agriculture and the public sector). This would extort long-overdue structural improvements and, in the medium term, would strengthen the competitive position of Austrian firms on world markets.

Stemming the original opposition from small business and agriculture, the social partners joined forces and

endorsed the government’s accession strategy, supporting the “cost pressure model”, already applied earlier by the hard currency policy: More competition would increase productivity of firms which in turn would be compensated by lower inflation, so that real incomes would be sustained and competitiveness improved. The economic challenges of membership seemed manageable, but were amplified when in late 1995 the federal government was dissolved and parliamentary elections were called. Some of the planned liberalisation measures had to be postponed, especially in the telecommunication and postal sector. The natural gas market was already quite open, while liberalisation in the electricity sector was partly guided by environmental concerns to further hydroelectricity and keep off electricity generated by nuclear power plants.

3 Backlogs in economic and fiscal governance

Before the financial crisis, a recurring criticism of the *EU’s economic governance system* was the dominating focus on short-term fiscal and medium-term competitiveness targets, thereby losing sight of the long-term vision of improving the well-being of the peoples, as stipulated in Article 3(1) of the Consolidated Version of the Treaty on European Union (TEU). This changed as the euro-crisis called for decisive action with immediate effect, also allowing for medium to long-term goals such as social justice and sustainable development. In 2010, the long-term growth strategy was laid down in the “Europe 2020” programme for employment, education, innovation, climate and the fight against poverty. The major coordinating instrument was the European Semester, guiding the economic policy cycle of Member States during the

calendar year. On the short end it includes the Macroeconomic Imbalance Procedure (MIP) and the accompanying scoreboard, aiming to identify and counter early on any macroeconomic risks and imbalances.

In the second half of 1998, when Austria for the first time held the European Presidency, an impulse was given to establish a consultative forum among representatives from the Commission, the Council, the European Parliament, the European Central Bank, national governments, and the European social partners: the Macroeconomic Dialogue (MED). It was formally established at the European Council of Cologne in June 1999 as a biannual event for the joint discussion of monetary, fiscal, and incomes policies. In a reformed version, the MED still exists, and a complement for the Eurozone is in discussion (Koll, 2020).

A more modest success has so far gained the recommendation of the Council of the European Union (Council, 2016) to establish a National Productivity Board (NPB) in each country of the euro area, other EU Member States being invited to join in. As independent institutions, NPBs are supposed to engage in high quality economic and statistical analysis with results open to the public domain. In its progress report, the European Commission (2019b) complained that advances have been slow and uneven across Member States. In the meantime, NPBs are existent in 14 euro area countries and 3 non-euro area Member States, although neither in Austria nor in Finland and Sweden.³ Sweden has actually decided not to participate in the exercise, while in Austria the reasoned concept of entrusting the Austrian Institute of Economic Research

(WIFO) at least with a coordinating function (as noted, e.g., in Lacuesta and Tello, 2016) has not been affirmatively answered by the relevant authorities.

In contrast to economic governance, the principles of the *EU's fiscal governance* were already well established around the mid-1990s. Compliance with the rules, though, differed markedly from country to country. While Austria was well prepared in terms of monetary policy, the fiscal deficit was running out of line in the early 1990s, culminating at some 6% of GDP in 1995. The main reason was a gracious social policy in 1992-93 and a tax reduction package in 1994. After the collapse of government in late 1995, the eventual consolidation happened in 1996-97, bringing the deficit back to the Maastricht range of less than 3% of GDP. Even more disturbing were the developments in Finland and Sweden, where net lending in percent of GDP gyrated between plus 4% to 6% in the late 1980s and minus 8% to 10% in 1993 (chart 2), returning to high positive values by the end of the 1990s.

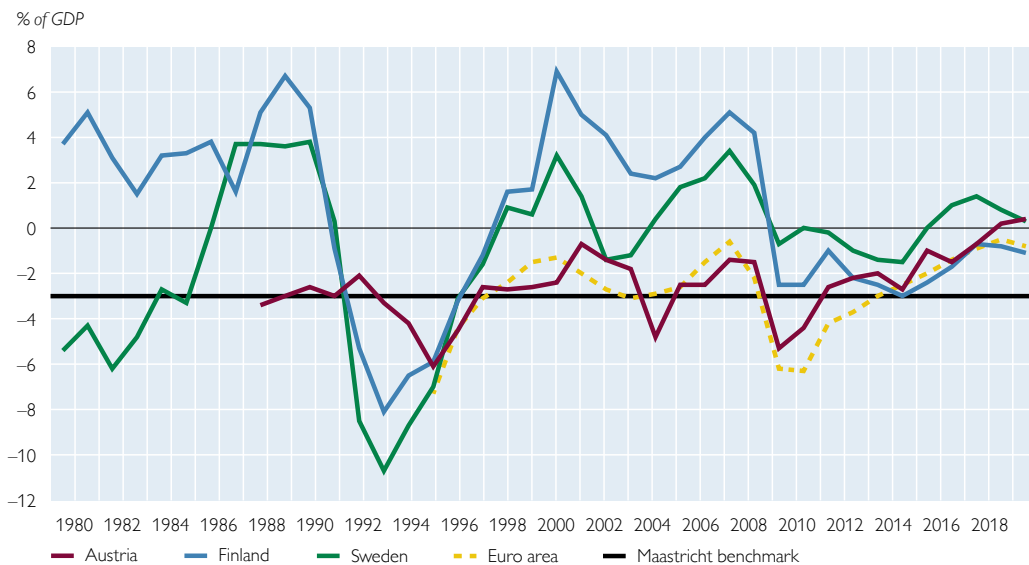
When Austria prepared for joining the euro area, public debt was just increasing beyond the Maastricht limit of 60% of GDP. That threshold has never been reached since. The debt ratio remained quite stable before the financial crisis but surged up thereafter, culminating in 2015 at almost 85% of GDP. The downturn since has now been stopped by the fiscal and economic consequences of the COVID-19 pandemic (chart 3).

By comparison, the Finnish debt ratio was just in the tens before the breakdown of the Soviet Union, it surged dramatically upwards thereafter but remained just below 60% of GDP. In the first phase of Finnish EU membership, the debt ratio declined (to less than

³ See European Commission, *National Productivity Boards*. https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/national-productivity-boards_de (retrieved 13 June 2020).

Chart 2

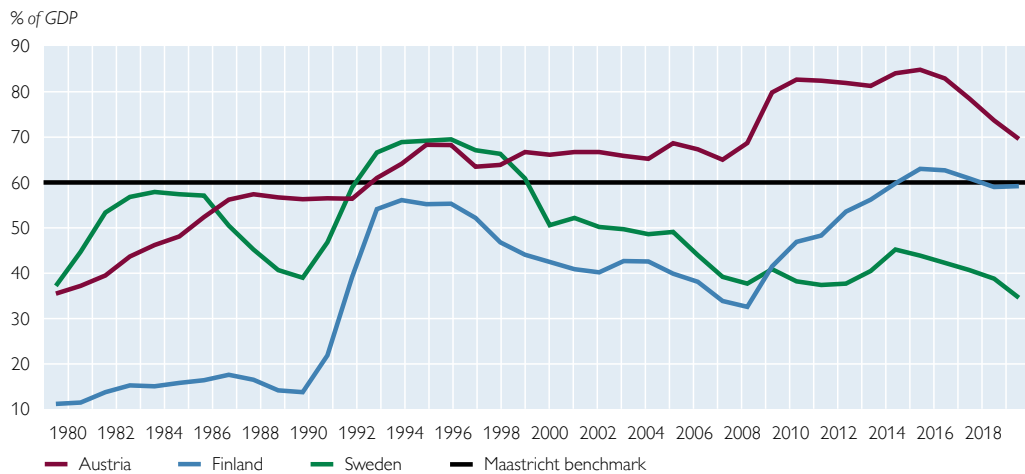
General government net lending from 1980 to 2019



Source: AMECO and World Bank.

Chart 3

General government debt from 1980 to 2019



Source: AMECO.

33% in 2008), but almost doubled in the following period until 2015 and 2016, when the ratio slightly surpassed the benchmark. The Swedish debt ratio, not being bound by euro rules, meandered around the Austrian ratio in the years before EU membership, hitting a high value of almost 70%. In the years preceding the financial crisis, it experienced a

similar decline as the Finnish ratio, but remained stable thereafter and in 2019 amounted to less than 35%. All three countries are now confronted with the fiscal and economic consequences of the COVID-19 crisis, Austria starting from a relatively uncomfortable debt position with many years to come devoid of meeting the Maastricht criterion.

When the international financial crisis developed into a fiscal crisis, the focus turned to the possible surveillance role of independent fiscal institutions (IFIs) which the European Commission sees as “non-partisan public bodies aimed at promoting sustainable public finances.” IFIs are now operating in most EU Member States. Sweden established the Fiscal Policy Council in 2007, Finland the National Audit Office in 2013, and Austria the Fiscal Advisory Council also in 2013 (replacing a forerunner that was in place since 1970). Beetsma and Debrun (2016) have shown that the existence of a national fiscal council contributes to the quality of fiscal policy by taming the deficit bias of well-intended governments.

4 The internal market as productivity boost for Austria

Although the internal market was declared complete in 1992, the years thereafter were laden with lagging compliances but also with further improvements of the system. To keep pressure on EU Member States to implement the internal market legislation, the European Council of Amsterdam in 1997 established the Single Market Action Plan. National advances of countries and their relative performance were publicised by the Single Market Scoreboard. The Austrian Presidency in the second half of 1998 was keen to take up open internal market issues, such as “better regulation” (Handler, 1998), and long-term aspects of competitiveness (Darlap and Handler, 1998). Austria also proposed to drastically reduce the number of Councils to just a Macro-Council and a Micro-Council but failed to get a majority of Member States on board. Already in 1997, Austria had started to liberalise shop-opening hours (Burger, 1998), moving ahead jointly with Finland, and both following the lead by Sweden where

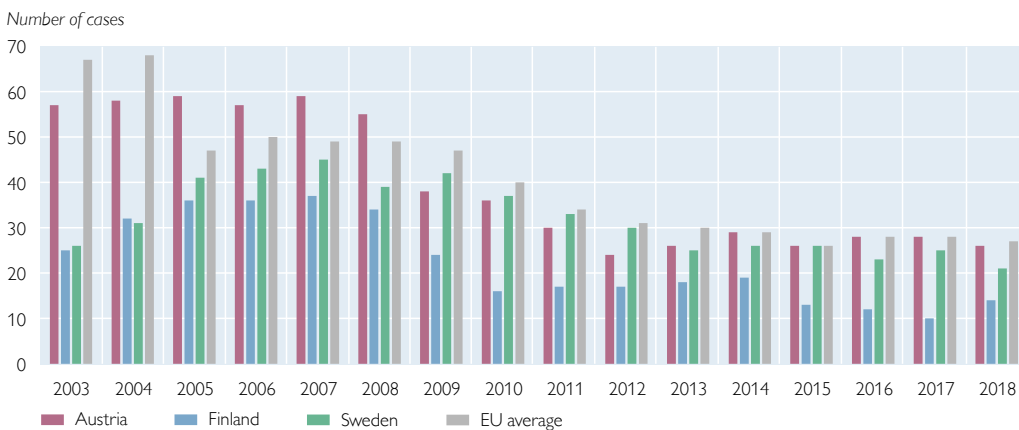
deregulation had occurred already in 1978.

The Single Market Scoreboard (SMS) measures the national *transposition deficits* as the percentage of Single Market Directives not yet notified to the Commission in relation to the total number of Directives that should have been notified by a specific deadline. When the SMS was first published in November 1997, Austria (with a deficit of 10.1%, largely the result of delays in transposing agricultural legislation) attained the worst position of all EU-15 Member States, closely followed by Germany and Belgium. Finland (4.3%) was among the most advanced countries, Sweden (6.2%) somewhere in the middle range. Five years later, all new members had achieved significant progress with Sweden (0.4%) scoring best among all EU Member States. Since the late 2000s, the transposition deficit of Austria has generally been somewhat above EU average. Sweden’s deficit has mostly stayed below average, while Finland’s deficit has grossly moved in line with the EU average. Latest figures for December 2018 show deficits for Austria, Finland and Sweden of 1.2%, 0.5% and 0.1%.

In case a Member State does not apply Single Market rules correctly or fails to transpose an EU Directive timely and correctly into national law, the Commission may initiate an *infringement proceeding*. In the last fifteen years or so, the number of new infringement cases against Austria has consistently been higher than in Finland and mostly also higher than in Sweden (chart 4). This is also mirrored in the number of infringement cases pending. In December 2018, Austria was subject to 66 cases pending, of which 34 were late transposition cases and 22 cases of incorrect transposition. The figures for Sweden were 48, 26 and 17, for Finland 32, 22 and 6.

Chart 4

Number of new infringement cases



Source: European Commission (2019a).

Wolfmayr et al. (2019) compare various indicators for the compliance with Single Market legislation and conclude that the transposition of EU Directives to national law is fairly advanced, while the potential of reducing infringement proceedings and increasing the number of solved cross-border disagreements is still large.

5 Rewriting the basic understanding of competition policy

The start of the EEA in 1994 also marked the application of EC competition law in the accession countries. Competition policy itself was in a stage of transformation, characterised by a gradual shift from the orthodox legal approach to the “more economics-based” approach which weighed legal principles against economic efficiency (Hildebrand, 1998). It anyway required an adjustment of Austrian legislation, although many of the existing rules were not in stark contrast to EU law and could therefore remain unchanged. However, the basic understanding of competition policy had to be reshaped fundamentally. The old Cartel Act (Kartellgesetz) had provided for a strong realm of the social partners who could bring cases to the

Cartel Court and who were also involved in nominating laymen judges. This system was known to create conflicts of interest, making the system vulnerable to pressures from special interest groups (OECD, 2001). A weird result was the evolvment of market concentration in various areas, most prominently in the media sector and in food retailing, as the Cartel Court did not prevent mergers that resulted in severe market dominance (Böheim, 2002).

A formidable improvement was accomplished in 2002, when the reform of the Austrian competition law entailed the creation of the independent Federal Competition Authority (Bundeswettbewerbsbehörde) with broad investigative power (on background considerations, see Barfuß, 2001). Alongside the Authority, the Federal Cartel Prosecutor (Bundeskartellanwalt) was established as an official arm of the Federal Minister of Justice. Both bodies can now bring cases to the Cartel Court where the influence of the laymen judges was reduced. The social partners have retained some consultative influence, though, via the newly established Competition Commission. The central deficiency of the Austrian Competition Authority was for many

years the insufficient number and quality of professional staff. This has partly been corrected in 2017 and the years since. 2017 also brought an update of competition rules including the legal possibility to act as a whistle-blower.

6 Deficits in the implementation of public procurement rules

In industrial countries, the share of goods and services procured by public authorities absorbs about one quarter to one third of general government expenditures. According to OECD data for 2017, general government procurement spending in percent of GDP accounted in Austria for 13.2%, in Sweden for 16.2% and in Finland for 17.8%. Compared with 1995, these shares declined in Austria and Sweden but remained fairly stable in Finland (table 1).

Of much less importance is cross-border procurement within the EU with just 1.5% of all public contracts awarded, which suggests “that the full benefits of cross-border trade and competition are not being fully reaped” (European Commission, 2010). Part of the explanation may be found in the tenacious implementation of EU Directives, as already demurred in the White Paper on Completing the Internal Market (European Commission 1985, para.81–87).

At that time, important fields of production – energy, transport, water and (in the case of supply contracts) telecommunications – were not even covered by the Directives.

The regional distribution of direct public procurement contracts with bidders from other countries differs substantially according to the respective neighbourhoods. Between 2009 and 2015, Austria allotted 64% of all contracts to German and 8% to Italian suppliers. In Finland, 29% went to Swedish and 9% to German bidders. In Sweden, 28% were contracted with Danes and 13% with Germans (European Commission 2017, Table 23).

With its public procurement legislation, the EU “seeks to create an open and competitive pan-European procurement market” which “can be an important source of support for innovation, environmental protection and employment” (European Commission, 2010). The “2014 Directives” have broadened the view from the dominant orientation on competition and efficiency to a broader view that has been termed “strategic procurement” (Handler, 2015). Instead of focusing on the lowest price, tenders under the new regime are evaluated to potentially include issues of environmental sustainability, social policy,

Table 1

General government procurement spending

Country	1995	2000	2007	2010	2015	2017	2007	2017
	% of GDP						% of general government expenditure	
Austria	18.4	17.1	12.4	13.7	13.5	13.2	25.2	26.9
Finland	16.3	15.4	14.4	17.2	17.5	17.8	30.8	32.9
Sweden	22.1	19.4	14.5	16.1	16.0	16.2	29.3	32.8
Norway	x	x	11.2	12.6	13.9	14.6	27.0	29.2
Switzerland	x	x	7.7	8.3	8.8	9.1	25.2	26.6
Germany	18.0	17.0	12.9	14.8	15.1	15.5	30.2	35.3
EU-15	17.3	16.0	x	x	x	x	x	x
OECD	x	x	11.8	13.1	11.9	12.2	30.2	29.1

Source: OECD, *Government at a Glance, various issues*.

Table 2

Single Market Scoreboard: Public procurement in 2018

	Austria	Finland	Sweden	Norway
Single bidders	Light green	Light green	Light green	Dark green
No calls for bids	Light green	Light green	Light green	Dark green
Publication rate	Light red	Light green	Light green	Grey
Cooperative procurement	Light green	Light green	Light green	Dark green
Award criteria	Light green	Light green	Light green	Dark green
Decision speed	Light green	Light green	Light green	Dark green
SME contractors	Light red	Light green	Light green	Dark red
SME bids	Light red	Light green	Light green	Dark red
Procedures divided into slots	Light red	Light red	Light red	Dark red
	Satisfactory	Average	Unsatisfactory	Not available

Source: Based on European Commission (2019c).

Note: The colours are based on qualitative policy judgment on what constitutes good practice.

innovation, education, and public health. According to the Public Procurement section of the SMS for 2018, the accession countries of 1995 and Norway were all facing various deficits in the implementation of common procurement rules, Austria being on the low side (table 2).

Major deficiencies in Austria stem from a low publication rate in the Tenders Electronic Daily (TED), lack of procurement with more than one public buyer (cooperative procurement), only few SME contractors and unsatisfactory division of procurement procedures into slots, indicating that mostly large companies are suited to bid. When approximated by the average number of bids per procurement in the period from 2006 to 2010, Austria (5.2 bids) ranked below Sweden (5.6) and Finland (5.7) – for comparison, the figure for Germany was 7.6 bids. With respect to procurement procedures (open, restricted, negotiated, competitive dialogue), Austria stood out with a comparatively high share of negotiated contracts with TED publication. In a comparison with other EU Member States, Strand et al. (2011) moaned about the low degree of competition in Austrian public procurement.

7 Liberalisation of network industries: Austria late and expensive

The network industries (telecommunications, electricity, transport) were long regarded as “natural monopolies” subject to state regulation, if not state ownership. EU legislation has attempted to unhinge from vertically integrated networks those parts that can be ceded to the market, and to create independent regulators for the non-competitive parts.

When the “Northern Enlargement” became effective, the liberalisation of network industries was in Austria proceeding along the following timeline:

- The liberalisation of the telecommunications sector was under way and was completed in 1998.
- 1999 marked the start of the stepwise unbundling of the electricity sector with effective completion by October 2001, much earlier than required by EU Directives (OECD, 2001). Also, the natural gas market was liberalised earlier than the required deadline in autumn 2002.
- Only in 2001 started the liberalisation of the railway system, also delayed was the opening of postal services.
- Independent regulatory authorities were introduced in 1999 for railways;

in 2001 for telecommunications and electricity, in 2002 for natural gas and financial services.

In all competitive sectors analysed by Gönenç et al. (2001), Austria was less open in 1998 than Finland and Sweden. This holds for mobile telephony, air passenger transport, road freight, and especially retail distribution. Also, in industries with non-competitive segments, Austria was visibly behind the other two accession countries.

In the *energy sector*, liberalisation efforts in Austria were rather modest at the outset, permitting only large customers to freely choose their suppliers, without sufficient unbundling of production and transmission. National implementation of Directive 96/92/EC was accomplished in Finland already in 1997, in Sweden in 1998 and in Austria not before 2001 (Steiner 2001). A few years later, the OECD (2005) criticised that „Although the electricity sector is completely liberalised in Austria there is still lack of competition. ... All in all, it appears that intensity of competition is rather low and that mergers of the past have contributed to this situation.”

The slow pace of harmonising the EU energy markets is visible in the

widely diverging electricity price levels. On the low side were prices in the Nordic countries with open borders between them and low-cost hydroelectric production facilities, while in Austria, in spite of its abundant hydroelectricity, prices were mostly above EU average. For the period from early 1997 and mid-2002, the European Commission (2003) observed an improvement in the overall level of market opening in the electricity sector, while the prospects for competition in the gas market were significantly behind. Over the whole period, the EU experienced a sweeping drop in electricity prices and an increase in gas prices – also mirrored by price developments in the accession countries (table 3).

The deregulation of *telecommunication services* brought a significant drop in prices for telephone calls via fixed networks (table 4). Between 1997 and 2003, the average price level of EU-15 member states was slashed almost by half. Just Finland experienced a slight increase, though starting from a rather low level. In contrast, Sweden, with comparably low prices, reduced them further by 45.5%. Among the accession countries, Austria started from the most

Table 3

Development of energy retail prices between January 1997 and June 2002

	EU average		Austria		Finland		Sweden	
	Jan. 97	June 02	Jan. 97	June 02	Jan. 97	June 02	Jan. 97	June 02
Electricity consumption	<i>EUR per MWh</i>							
Large: 24 GWh/year	52	48	69	60.1	37	37	37	26
Medium: 50 MWh/year	108	92	163	97	60	57	70	36
Small: 3.5 MWh/year	99	96	98	77	73	70	68	69
Gas consumption	<i>EUR per GJ</i>							
Large: 418 TJ/year (120 GWh/year)	3.6	4.4	3.8	4.8	3.6	4.4	–	3.5
Medium: 418 GJ/year (120 MWh/year)	6.5	7.7	x	8.1	x	x	6.7	7.1
Small: 16 GJ/year (4.5 MWh/year)	10.9	12.0	8.3	11.6	x	x	9.9	11.6

Source: European Commission (2003).

¹ Latest available data: 1/1999.

Note: Current prices before taxes.

expensive position which it still held after a formidable reduction of 71.7% (Handler et al., 2004).

The deregulation of vertically integrated network industries is closely related to the issue of *privatising state-owned enterprises*, although providing services of general economic interest (SGEI)⁴ is not primarily an issue of ownership, but is rather guided by the general targets of improving market conditions, fostering competition, and increasing efficiency (European Commission, 2016). Within the EU, privatisation projects started in the late 1980s and boomed in the second half of the 1990. The results were ambiguous, depending inter alia on the government level of ownership. Loeffler et al. (2012) concluded that “increased competition was only achieved in countries and sectors that had a state monopoly at the outset. On the other hand, when a number of regional or local monopolies existed, market concentration increased as larger companies bought up their smaller competitors.”

The role of state-owned enterprises (SOE) in Austria goes back to Nazi times and the post-World War II attempts to stabilise and recoup the devastated and abandoned parts of industry. What in the immediate post-war period turned out to be a success-story, over time became a rather clumsy and inefficient corner of an otherwise internationalising and thriving production sector. Solutions to this problem were elaborated but implementation often failed due to ideological struggles among the social partners and their hassle with the government. Many incentives in favour of large-scale privatisation came from the repeated interventions by the IMF and OECD consultation missions and from the European Commission in course

Table 4

Prices for telephone calls via fixed networks

	1997	2003	Change
	EUR		%
Austria	4.36	1.23	-71.7
Finland	1.05	1.11	+5.7
Sweden	1.10	0.60	-45.5
EU-15 average	2.74	1.39	-49.3

Source: Handler et al. (2004).

Note: Prices are for 10 minutes local calls plus 10 minutes within-country long distance calls.

of evaluating the application for EU membership.

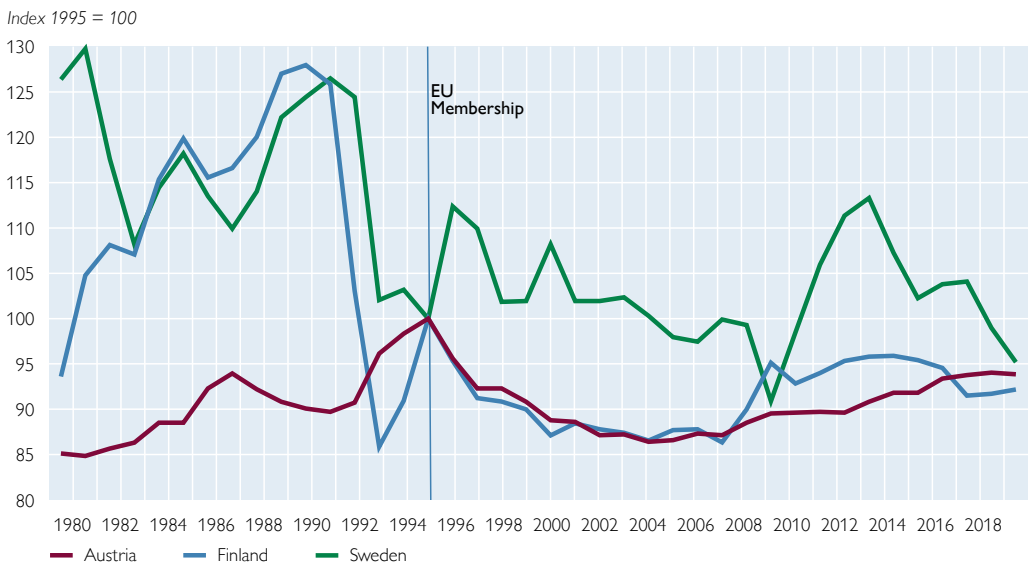
Based on the number of employees in SOEs as a share in total employment, Austria cannot be considered a special case. According to OECD (2017), the 2015 share amounted in Austria to 1.9%, in Sweden to 2.7%, and in Finland to 3.1%. Just Norway was an outlier with 9.5%, which is due to the large oil exploring and extracting sector. More generally, Høj et al. (2007) found that in some countries (including Austria and Norway) there was considerable scope for further privatisation, though frequently not without friction. “In some cases, privatisation may be hindered by the need for parliamentary consent (Norway), constitutional restrictions (Finland and Austria), or the legal requirement to maintain controlling stakes (France).” Other barriers to timely realising privatisation programmes may have been unfavourable stock market conditions and public ownership at lower levels of government, e.g. in the electricity sector (Austria, Finland, Germany, Norway) and the telecommunications sector (Finland).

8 Converging competitiveness

International competitiveness, a prime issue of economic policy already in normal

⁴ See Article 14 TFEU and Protocol No. 26 annexed to the TFEU.

Real effective exchange rates



Source: AMECO.

Note: The real effective exchange rates are based on unit labour costs for the total economy and are calculated relative to EU-15 countries. Double export weights are used, reflecting competition in the home markets of the various competitors as well as competition in export markets elsewhere. A rise in the index means a loss of competitiveness.

times, emanated in Austria even more into the foreground when membership in the EU and the euro area had become a reality. Using as indicator the real effective exchange rates (REERs), deflated by relative unit labour costs, chart 5 provides a view of the developments in the three accession countries. For Austria, the REER increased during the 1980s indicating a relative loss of competitiveness. This was partly due to an appreciation of the Austrian schilling vis-à-vis the US dollar and the Deutsche Mark, but also the result of increasing relative prices. During the political, economic and financial turbulences of the late 1980s and early 1990s, the REER first declined but resumed the upward trend until 1995. During the first decade of EU membership, Austrian competitiveness improved, to turn around again after the financial crisis, though not falling back to 1995 levels.

The history is a bit different for the other two accession countries. Even

more pronounced than Austria in the early 1980s, Finland followed a “hard currency” policy with a rising path of the REER. Due to the liberalisation of interest rates and capital movements in 1986, Finland experienced an overheating of the economy. This came abruptly to an end when the Soviet Union was dissolved in 1991 and the Finnish export industry fell into crisis (Ahtiala and Junttila, 2016). A Finish markka devaluation terminated the peg to the ECU basket of currencies. In the wake of the ECU currency crisis of September 1992, the markka became a floating currency which it remained until being replaced by the euro in 1999. Since the mid-1990s, the Finnish REER developed more or less parallel to the Austrian index.

In the late 1980s, Sweden had also experienced an economic boom with rising inflation rates. In the course of the currency turmoil in 1992, the Swedish krona left the peg to the ECU

currencies, and has since been under a regime of managed floating. Although EU membership as a rule entails entering the euro area, Sweden has not (yet) taken that step as public opinion indicates a possible negative outcome of an inevitable referendum. Since 1995, the Swedish REER index has fluctuated around a slightly falling trend, also interrupted by the crisis in the global financial system.

Chart 5 is indicative for the divergent preconditions of the three accession countries before joining the EU and for the overall impact of EU membership on them. Austria had comparatively favourable starting conditions in macroeconomic terms but was about to gain most in terms of market regulation and institutions. While monetary policy was perfectly on track for the introduction of the euro, fiscal policy was struggling to fulfil the Maastricht criteria. Many more adjustments were required to match the dynamic progress in the completion of the internal market and to make economic governance competitive. Austria was lagging behind Finland and Sweden in terms of transposing internal market directives, adequately staffing its independent competition authority, eliminating the deficit in public procurement rules, and introducing market elements in the network industries.

However, when measured in terms of competitive advances, Austria has fared quite well. In 2019, all three accession countries had somewhat lower REER levels than in 1995 which means that, over time, competitiveness relative to the EU-15 average has slightly improved and has also converged. This result is corroborated by the Global Competitiveness Index of the World Economic Forum. In the last two decades, all three countries have consistently been among the world best 25 countries. In most years, Austria has trailed the others of the group, the overall top position has interchangeably been held by Finland or Sweden.

Competitiveness has been discussed here as an issue of individual Member States, but it is also relevant for the position of the EU as a political entity in the context of global politics and economic relations. An important ingredient to competitiveness is the system of policy governance at EU and national levels, the focus of the current paper. In the Austrian case, the upgrading of public governance to the continuously ameliorating EU standards is by far not a finished task. It is, above all, subject to changing political priorities, as the euro crisis showed, and as we currently experience with the COVID-19 crisis.

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