1. Funding European solidarity

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The year 2018 marked at least two important anniversaries worth mentioning. First, 100 years ago, several successor states of the Habsburg empire were established in the Central, Eastern and Southeastern European (CESEE) region, including the First Republic of Austria. Too few people believed then that the new small state would be able to survive. Consequently, it took another reboot to learn that small open economies can provide a high quality of life and social security for their citizens. Unlike the interwar period, the development of the Second Republic of Austria was embedded in a process of international cooperation and European economic integration, which culminated in European Union (EU) membership. Democratic integration into something bigger turned out to be the more sustainable and more promising political and economic concept.

Second, ten years ago, Lehman Brothers collapsed, and the global financial system was on the brink of falling apart. Today, we can truly say that all the efforts undertaken to prevent the worst from happening have succeeded in the end. Initially, coordinated monetary and fiscal expansion on a global scale was instrumental in avoiding an economic meltdown of the kind experienced during the Great Depression in the 1930s. Later, reforming the micro- and macroprudential regulatory frameworks helped to fix the financial system. Having established much larger capital and liquidity buffers as a result, banks have now significantly reduced the risks on their balance sheets. In Europe, new emergency funds, centralized banking supervision and resolution as well as more stringent procedures to deal with fiscal and macroeconomic imbalances addressed critical weaknesses of Economic and Monetary Union (EMU). Yet, there is no reason for complacency. High global debt, large global imbalances, a weaker post-crisis growth path, pending monetary policy normalization and remaining EMU imperfections pose challenges that will have to be tackled. To say nothing of the political risks exemplified by Brexit, recent trade tensions and populism that jeopardize the European project and multilateral cooperation in urgent global matters. Hence, there are many challenges ahead.

1.1 COHESION AND CONVERGENCE: THE CORNERSTONES OF EUROPEAN INTEGRATION

Against this backdrop, this book examines the political, social and economic challenges that Europe is facing, putting a special focus on CESEE as well as public and private funds that help EU Member States align their economic performance and thus stick together. After all, cohesion and convergence form the cornerstone of European integration. The EU Treaty states in Article 3 that the EU ‘shall promote economic, social and territorial cohesion, and solidarity among Member States’. The Treaty’s Preamble refers to the resolution of the signatories ‘to achieve the strengthening and the convergence of their economies and to establish an economic and monetary union including . . . a single and stable currency’ (see European Union 2016).¹

When we talk about monetary integration, convergence – which implies a narrowing of countries’ economic indicators – is not only an objective but also a condition. Here, the so-called Maastricht criteria immediately spring to mind. They first and foremost refer to inflation, interest rates and public deficits, which are nominal convergence criteria. Yet, when we have the theory of an optimal currency area in mind, real convergence is equally important. When it comes to catching-up with per capita income levels, real convergence is *de facto* a political condition for cohesion. In terms of business cycle synchronization, real convergence reduces the probability of asymmetric economic shocks. In the event of such shocks, which would affect only some countries of a currency union, the central bank of that currency union would face a dilemma: its centralized monetary policy would not fit all members. But then another type of convergence – structural convergence – helps to smooth the impact of idiosyncratic shocks. That is, flexible prices and costs as well as the mobility of labour and capital assume the role that exchange rates would play outside a currency union. There is a trade-off between real and structural convergence: the more diverse the economic performance of regions in a currency area is, the more flexible their adjustment mechanism needs to be (see Van de Coevering 2003).

The good news is that the business cycles of the euro area countries have become more similar (see Campos et al. 2017). Also, structural reforms in crisis-ridden countries have supposedly improved their adaptive capacity and resilience. The bad news, however, is that the gap in income levels has widened rather than narrowed due to the financial crisis. In CESEE, the catching-up process only paused during the crisis years and continued thereafter, albeit at a slower pace than before and benefiting people

unevenly. Small wonder that populism has been on the rise and has become a source of disintegrative tendencies.

Hence, there is a need to foster convergence and cohesion through public and private investment in vulnerable regions. Fortunately, we can look back on periods of successful catching-up: to quote the World Bank ‘the European Union (EU) has become the modern world’s greatest “convergence machine”’ (see Ridaò-Cano and Bodewig 2018, p. 13).² The EU’s regional or cohesion policies were instrumental to that development. It is also true, however, that these policies need an upgrading. For them to be more effective, the EU should target its funds more specifically to skills and innovation and disadvantaged regions, and seek synergies with private investment flows. At the same time, recipient countries should increase their absorption capacity. Finally, with a view to sustainable development, ‘blended’ funding that combines credit, grants, expertise and advice is the way to go.

1.2 THE ROLE OF MONETARY POLICY IN CATCHING-UP

Central banks of currency unions do certainly benefit from greater convergence, as they can hardly accommodate incompatible needs of individual Member States. Hence, the European Central Bank (ECB) too raises the question of how to best advance and fund the catching-up of economies in the euro area and in CESEE (see Cœuré, Chapter 2 in this book). With regard to the euro area, it should be borne in mind that the Governing Council of the ECB has already ended the net purchases under the Asset Purchase Programme in December 2018, but announced that it intends to continue reinvesting the principal payments from maturing securities. The ECB expects interest rates to remain at their present levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2 per cent over the medium term. But it should also be borne in mind that market interest rates that stay very low for a long time pose challenges, as this might impair financial stability.

With regard to CESEE, this book also touches on the role that independent monetary policy plays in economic catching-up outside of the euro area, as seen from the point of view of three central banks in the region (see Angelovska Bezhoska, Chapter 3; Isărescu, Chapter 4; and Radev, Chapter 5). Two of the countries represented – that is Romania and Bulgaria – are in the middle of a vigorous boom that has been driven by domestic demand and helped by solid EU fund absorption.

Interestingly, the two countries follow different exchange rate regimes, with the Romanian leu under a managed float regime and the Bulgarian lev pegged to the euro within a currency board arrangement. In North Macedonia, the third country represented in this book, the denar is effectively stabilized, with the euro serving as anchor.

Overall, significant progress has been made so far in deepening EMU and improving the resilience of the euro area economy (see Sachs, Chapter 6 and Orphanides, Chapter 7). Of course, there is enough room for improvement in terms of both risk-sharing and risk reduction: this applies to the fiscal backstop for the Single Resolution Fund that has already been agreed on and is provided by the reinforced European Stability Mechanism, and to a European Deposit Insurance System that is still under negotiation. Further progress toward a rudimentary fiscal union would be provided by the Commission's proposals for a Reform Support Programme that would cover the short-term costs of domestic structural reforms, and a European Investment Stabilisation Function that would help to maintain investment levels in the event of large asymmetric shocks (see European Commission 2018). Apart from that, the Eurogroup is debating other options for a euro area budget, including a European unemployment insurance fund for cases of severe economic crises (see Council of the European Union 2018). Reaching an agreement on all of these institutional innovations requires a minimum of mutual trust. Compliance with existing rules is certainly an essential ingredient for building confidence.

1.3 THE ROLE OF THE EU BUDGET IN CATCHING-UP

The actual and potential role played by the EU budget in fostering cohesion is addressed in Chapters 8, 9 and 10 (Richter, Schratzenstaller and Saurel, respectively). The European Commission has presented its proposal for the next Multiannual Financial Framework (MFF) 2021–2027, trying to match ambitions with resources. The plan would include a rule of law mechanism to ensure sound financial management as well as more investment in research, migration, border control and defence, partly financed through reallocation as well as through an increase of the EU's own resources.

When looking at industrial policy and investment in this context, the current 2014–2020 MFF supports industrial policy mainly under the heading of 'smart and inclusive growth' (European Council/Council of the European Union 2019),³ targeting, in particular, small and medium-sized enterprises (SMEs) and innovation. Certainly, advocating the old-style

industrial policy of ‘picking the winner’ and distorting competition is a relic of the past. New industrial policy does not rely on market restrictions: it fosters skills, innovation and (digital) infrastructure instead (see De Haas and Höflmayr, Chapter 11), as does, for instance, the European Commission strategy for a smart, innovative and sustainable industry. In practice, these strategies centre on soft measures such as cluster policies, investment promotion or green growth.

Finally, this book also discusses the size of the investment gap in CESEE and how to close it (see Slačik, Chapter 12). When putting the focus on how to improve host countries’ investment environment, structural reforms come to mind; yet 60 years ago, Fritz Machlup, a disciple of the Austrian School of Economics, stated that ‘[s]tructure, I am afraid, is often a weasel word used to avoid commitment to a definite and clear thought’ (see Machlup 1958, p. 281). To avoid that trap, we need more precise policy prescription that is relevant in CESEE countries, including transparency, coherent regulation and capital market deepening (see Watt, Chapter 13). Taken together, we hope that this book gives some accessible guidance in the all too often narrow-minded political debates on the EU budget.

NOTES

1. For more information, see https://www.ecb.europa.eu/ecb/legal/pdf/oj_c_2016_202_full_en_txt.pdf.
2. For more information, see <https://www.worldbank.org/en/region/eca/publication/europe-growing-united>.
3. For more information, see <https://www.consilium.europa.eu/en/policies/eu-budgetary-system/multiannual-financial-framework/mff-2014-2020/>.

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