Global Economy Podcast – Episode 107

European Competitiveness: Analysing Key Challenges and Solutions

Full Transcript

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Fredrik Erixon: Hello, everyone, and welcome to ECIPE's Global Economy Podcast. My name is Fredrik Erixon, and today I am delighted to welcome my colleague, Oscar Guinea, to this podcast, and we're going to have a conversation about competitiveness. Hello, Oscar.

Oscar Guinea: Hi, hello. Good morning, Fredrik.

Fredrik Erixon: Hello, and well, one starting point for the conversation we're going to have is, of course, that the European Commission published a couple of weeks ago, a Competitiveness Compass. And we have both read that one carefully and we've seen a lot of the discussions that have continued to unfold after the release of the Compass. And what I took away from it was basically in the first place that they do make lots of references to the report on European competitiveness that Mario Draghi published at the beginning of the autumn of last year. And when you look at the analysis that the Commission makes, the contextual points that you want to point to, they do rely heavily on the Draghi report.

The other observation I made is that they don't really come up with any specific proposal yet. the compass itself is a long list of different initiatives that it says it wants to take, but it remains to be seen what's going to come in these different initiatives that it takes. And that at least led me to the conclusion that, well, let's wait and see what they're going to do before we start to evaluate what they're doing. So, I thought this would be a better opportunity just to take sort of a deep dive into the competitiveness issues, the substantive parts that Europe needs to deal with in order to improve itself.

So, Oscar, over to you. How would you describe what are the competitiveness problems that Europe should address?

Oscar Guinea: Well, I will say that Europe has three main challenges regarding competitiveness, and we can cover them one by one. The first one will be energy prices. So, energy prices are pretty high and that has a negative impact on the competitiveness of European companies when they have to compete with other firms in other parts of the world with lower energy prices.

The second challenge is the way Europe has to go about European digital regulation and the impact that that regulation has had on Europe's digital economy.

And the third one is market dynamism. The fact that Europe has lower creative destruction and it tends to go through the status quo is bad for competitiveness in the sense that what you want is an economy that channels jobs and capital, labour and capital, to the most productive companies. And as far as we have seen for the last few years, Europe has been not very good at this.

Fredrik Erixon: Starting with the first one then, energy prices. So, I think we have all seen reports from around Europe of spikes in energy costs especially at the start of the war in Ukraine. But I also gather from Draghi's reporting from lots of analysis that this was just not a one-off. It's more of an endemic problem that you're past that its comparative energy costs are high. So, when you compare it to, for instance, the United States or other countries, it costs a lot more to use energy in Europe than elsewhere. So, how do you think this is affecting competitiveness?

Oscar Guinea: So, let me say from the very beginning that competitiveness and sustainability are not two concepts which are opposite to one another. To have long-term competitiveness, you need to have a sustainable economy. So, that's the start. But what we have in Europe is, let's say, two tiers problem. The first one is energy prices. So, we have higher energy prices than all the regions that you have said up to a point, we could target that problem with higher energy production, increase the supply of energy, and you have more energy, the price of it will go down. But we have a specific problem in Europe too, which is price volatility. What we have been saying in the last years is that we have substituted some energy production that produces CO_2 too, so basically power generation stations that use gas and in a nuclear, which doesn't produce CO_2, but it has its own sensitivities for renewables. Now, the problem with intermittent energy is that it's price volatility. So, when the sun is not shining or the wind is not blowing, energy prices go up and vice versa. So, the problem with Europe is that we have tried to produce more energy, but we haven't taken care of the base load, the amount of energy that will come up to the system with the switch of a button when you need it. That's problematic because many firms in energy-intensive industries might be able to cope with relatively high energy prices, but they definitely need certainty of prices. You cannot expect any company to be able to be competitive when the price of one of the inputs varies so much between day and one day and another.

Fredrik Erixon: I think when a lot of people hear what you were saying, they would have particular one country in their imagination. You would probably guess which country I'm thinking about.

Oscar Guinea: Yes, I am. Germany, I suppose.

Fredrik Erixon: Germany, yes. And this of course comes on the back of a broader change which has been going on in Germany for quite some time, especially after the Fukushima nuclear disaster in Japan, which led to a forced decommissioning of a lot of nuclear power in Germany. And when you add it to that, that sort of the grand idea that seemed to exist in Germany, which was to try to substitute nuclear and of course coal with a lot of imported gas that would come from pipelines that they had with Russia that this model itself, of course, turned out to be a pretty fragile model when you also threw in geopolitics and other measures into it. But it was also fragile over a longer period of time. And it was fragile even before Russia's war, partly because of these baseload capacity issues, which gas wasn't capable of dealing with in a sort of profound way even before February 2022.

And then of course we have the issue with the intermittency of different types of renewables with solar and wind in particular. But there was also another dimension to it, which was that Europe tried to orchestrate the market with a lot of interconnectivities between countries and sometimes between regions within countries. And so, if I look at my native countries, Sweden, southern Sweden, and including Denmark became very connected to the German market. And when there was very little wind, for instance, in Germany, would sort of entail a lot of export of renewable power that Sweden had invested in, and Denmark had invested in to support the Germans. But then, of course, you ended up in a situation where the wind wasn't just weak in Germany, it was also weak in Denmark, and it was weak in Sweden. So, we have this term, which I think has become popular now, which is called Dunkelflaute in German, which means that you have days when there is very little wind everywhere, which means that you get very little supply, and you get very strong price spikes and volatility into it.

And that seems to me to be, we have sort of both a base load issue, but we also have an energy market type of issue in the sense that we have focused a lot on trying to build into connectivity between markets when all countries are, or at least many countries are trying to go in the same direction, which is that they invest in energy supply, which is intermittent.

But do we have this problem in other parts of Europe, too? I mean, what about your native country, Spain, how is it connected to other markets in its surroundings? I know there have been conflicts around sort of gas pipelines, and cables between, for instance, Spain and France. Do you have an intermittency problem in the Spanish economy, too?

Oscar Guinea: Well, what we have in Spain is that the energy market, the electricity market in Europe is pretty much connected, the wholesale market, right? But Spain is a peculiar case. Well, I will say the Iberian Peninsula is a peculiar case because we are a bit of a, well, we are a peninsula and then the connection, so there is an electricity market in Spain and Portugal, which is very well interconnected, and the only connection that we have with the European wholesale electricity market is through France. So, what happened in Spain is that we had that renewable energy was producing quite a lot of energy, but at the same time, because of the way energies are priced, which is using marginal cost, Spain and many of the countries were paying high energy prices while all the renewable energy was very low in terms of the cost of production.

In order to make energy more affordable for consumers, what they did was tackle how the base load was priced. Gas was priced at the cost of it, but the rest of the energy that was produced through renewables was priced at a different price, which the marginal cost of it is very low. That was called, I don't remember the name now, but in a way what the Spanish economy did was to detach itself from the rest of the wholesale electricity market in Europe.

Fredrik Erixon: But you have price spikes in Spain too, right?

Oscar Guinea: Yes, we do. Yes, we do. And energy-intensive companies, particularly mining in the north of Spain, have been closed quite recently because the energy prices have been so high that they have not been able to compete.

Fredrik Erixon: Yeah. All right. So, energy was one of the factors you mentioned. The other one was digital regulation. So, why is that such a big issue for Europe?

Oscar Guinea: Well, it's a big issue for many reasons.

One is because of the amount of regulations we have had for the last, let's say, ten, or five years. The number of directives and regulations that have been approved with a number of provisions has been staggering. And for anyone who has been thinking about rules, I mean, if you think about how you explain things to your kids and how many rules you have, you'll think that simplicity usually leads to better outcomes. When you have many rules, usually there is more uncertainty, there's confusion, and the amount of rules we have had, the new rules we have had in Europe has been staggering. That's one thing. So, the amount of regulatory burden, the complexity, the uncertainty.

But the second thing is something we have been writing about; we have written about how this regulation doesn't incentivise European firms to produce goods and services that are linked to the digital economy.

Fredrik Erixon: So, going back to what you were talking about there initially, so, I mean, the question here is you can regulate in many different ways, right? What I find striking in the first place with Europe's approach to it is that the underlying assumption here has been that we regulate in order to produce stronger outcomes. There has been this notion that you know if we regulate the economy is actually going to perform better as a result of it and that was always sort of a strange concept in the first place. Especially when you bring in international comparisons and you understand that, especially in pretty nascent markets, in the sense that there is a lot of development, there are so many experiments that companies respond pretty quickly to where do they allocate different experiments they're doing, where do they allocate resources, everything from investments they're doing in the infrastructure needed for this development. But also, where do they employ people? Where do they have the location of key human capital that participates in different types of experiments they're doing?

So that was strange in the first place, but then it becomes also the accumulation part of it, which is that it's not just that you get strong regulation in one part, you add lots of different regulations and they build on each other sometimes in a way which just isn't predictable and sometimes in ways which makes it extraordinarily complicated for anyone that is covered by these regulations to understand what is it that the regulator actually wants me to do.

And then we have the third issue that I think is problematic from this sort of regulatory viewpoint, which is what you were talking about, which is the ambiguity of it all. And that of course can be applied to the accumulation part that I just mentioned but can also be applied to the design of specific regulations themselves, where a company start to look at the regulation and they don't understand what it means. And now we're beginning to see some of these consequences. We have companies that are withdrawing services and functions from different services they have because they don't know the extent to which that regulation is actually going to affect them if they provide that particular service. We have new innovations that are not being introduced in the European market. Famously, we talked about the new iPhone that was released in in autumn of 2024 where AI functionality is not available to European consumers it because of regulatory ambiguities and regulatory concerns that the company have here. And there are several other examples where we begin to see that there is this accumulation of denial to European consumers of different services.

So, these are the three things that strike me when I've been sort of following the discussion on either specific digital regulations that we've seen over the last five years or the totality of them trying to understand what type of economic consequences will arise as a result of it.

Oscar Guinea: Yes, and let me add one another thing that is the effect of these regulations. I will say that over the last few years, the focus on digital regulation has been on privacy. And we have had, I mean, the focus now on competitiveness it comes as a bit of a compensation for the lack of focus that we had before.

Let's take, for instance, the GDPR. Because of GDPR, a company can only use the data for the purpose that they have that data. That might kind of sound like a very reasonable thing to do until you think about the effect of such a provision on the ability of European firms to use data. Because you can only use it for what you have it, as data really goes, it counters to the way data is used at this very moment. If you take AI and how artificial intelligence models are designed and produced, they throw a bunch of a lot of different data sets into it. And researchers, companies, they don't really know what they're going to discover. It's just a process, right? So, it's very difficult to say ex-ante whether you will use this data for something and not for something else.

And this is what we've been describing about endowments, right? And in traditional economics, we have labour and capital as economic endowments. More than economies, we have data and software and other things. What these regulations do is stop European companies from being able to use the endowments. And then they will have to specialise in things that are not related to the digital economy. And this is a concern. Why is it a concern? It is a concern because if you look at the innovations that are coming down the pipeline, the most exciting things, the things that really make an economy more productive, are related to the digital economy. It's very likely that in the next years, the value added of products in pharmaceuticals, heavy industry, in cars will be related to ICT.

So, in that sense, digital regulations, what they're doing is a bit of cutting off one's nose to spite one's face. It is making a very bad favour to the European economy and competitiveness.

Fredrik Erixon: One thing related to that, Oscar, we have shown in lots of different papers that European productivity performance has been poor for some time now. And when we compare productivity performance to different frontier countries in technology, countries that are basically at the vanguard of leading with technological change that Europe underperforms also vis-a-vis them. To what extent do you think underperformance and productivity are connected to the digital sector and perhaps even to us having regulated digital sectors too much in Europe?

Oscar Guinea: Very much so. I think it's one of the most important insights of the Draghi report. When the Draghi report compares productivity between the EU and the US it shows that the gap between both is increasing because the US is increasing, is growing its productivity and the EU is not doing it at the same pace. Then they go through sectors, and it shows that for many sectors European productivity is equal to or higher than US productivity.

The clear sector, the one which is lagging behind is ICT. And that is where the problem is and that is where the focus should be in terms of policymaking. That is clear that there are factors that make the European ICT sector, the contribution of the European ICT sector to the European economy much lower than the contribution of the US ICT sector to the US economy.

Fredrik Erixon: Yeah. All right. The third factor that you started with Oscar was market dynamism. So, what do you mean by that?

Oscar Guinea: Well, by market dynamics and what I meant is that the productivity, let's say, I mean, we should have talked about this before, but our, and I said ours because we have written about this, the concept of competitiveness is very much related with the concept of productivity. And the productivity of a country is very much made of the productivity of its firms. So, when you think about the productivity firms or a sector, what you want is that the firms which are more productive, more innovative, which are at the frontier of technology, which is a clear driver of productivity technology use, will be able to grow. And to be able to grow, they will be able to receive labour and capital that is in the economy. And for that, you need a degree of creative destruction. You need companies to fail and others to emerge. So those losing their jobs can work in another company with higher productivity and better prospects. And if you look at how Europe's Market dynamism has been for the last few years, it's been disappointing. And then when you compare it with the United States, particularly in the ICT sector and in other sectors too, what you see is that it's a much more vibrant economy. So, part of the reason why the EU productivity ah levels are lower than the US and growing at a slower pace, also in ICT, is because of market dynamism.

Fredrik Erixon: And this also goes to a point which I was a bit disappointed with when I was reading the Draghi report, because there was one absent actor in the Draghi report, at least. He didn't have a big focus on it. What does sort of entrepreneurial dynamism create from a destruction perspective? What we're talking about here, of course, is an economy with significant churn rates, where there is entry and exit of firms, where we have a reallocation of capital and also human capital, where we have a progressive transfer in the economy, where we have more capital in all its dimensions, which are moving from low productivity entities into high productivity entities.

In order to achieve that we also need to have dynamism on the entrepreneurial side because many of those companies are going to become high-productivity companies, if we talk about it today and say well, which companies are going to lead the market in 2035? The answer to that question would be we don't know, at least we shouldn't know right now who they are because they are going to be companies that today may be quite small. If you are in that sector, you may have heard of them, but in the broader public, very few would have heard of them. But they are through not just technology, but also entrepreneurial capabilities. They are going to move to become very, very significant companies and going to challenge the incumbent ones. And for that to happen, they need to be allowed to challenge the incumbent one.

And as a result, if you want to have that, we also need to have sort of less of an industrial policy, which is basically conserving the companies that we have right now.

Oscar Guinea: Yes, absolutely. I think you nailed it there in the sense that when we're discussing this, what comes to my mind is industrial policy and the template of industrial policy that we're using at the moment, which is very much in Europe, which is very much to decide which technologies and, in a way, indirectly you are deciding which firms will get some subsidies. And then the subsidies and the way the subsidies are delivered is very much to maintain the status quo. And as you said, we don't know which will be the companies that will emerge in the next ten, fifteen years that will be leaders, that will be the ones that are pushing European growth forward.

So, in that sense, what you have is a contrast between an industrial policy, which is dirigisme, saying, okay, these are the technologies, these are the firms we want to nurture. And so, it's an industrial policy which is much more focused on the supply side, on horizontal conditions, on letting companies grow and succeed, but without deciding which one will do, or which technologies will be the ones that will be more important in the future, because basically, we don't know. And I think that we should recognise that and use it in our policymaking.

Fredrik Erixon: And another way to say the same thing sort of is, and also going back to what you were talking about, the digital sector and underperformance in Europe's digital sector, which is, well, if we want to see European companies growing and start to challenge the incumbent and large company that exists there right now, they're probably not going to be the company and the brand names in Europe that we know of right now, they're probably going to be new place that will come up that will have better technology, more entrepreneurial agility, and they're going to succeed on the basis of that rather than having been around for hundreds of years already and having factories and having employees in human capital all day today.

Oscar Guinea: Yes, absolutely.

Fredrik Erixon: Just to wrap up then, Oscar, there was another thing I wanted to bring up as well, which I was also surprised about in the Draghi report. He doesn't seem to think constructive, output-oriented trade policy to be very important for Europe. Were you surprised about that too?

Oscar Guinea: I was also very surprised and a bit disappointed, to be honest, in the sense that what I will say is one of Europe's strengths and is one of Europe's strengths when you compare the EU and the US economy. It turns it upside down and makes it a vulnerability. And I don't think that's the case. European companies from, I mean, look at our countries, most of them are relatively small in terms of population size. For a company to grow, they need to tap into external demand. So, trade allows European companies to scale up. And it also allows European companies to get better and cheaper inputs. I mean we're talking about Europe when our share of GDP is shrinking, our population is shrinking, and there is no way we'll get the top expertise, skills and inputs from inside, only from inside Europe. We will need to tap into external demand. And I think that's one of Europe's strengths. And we can see that at the moment with Donald Trump, we see that Europe wants to ratify and sign agreements with all the countries to have a kind of rule-based international trade that provides certainty. And that's definitely one of Europe's strengths.

Fredrik Erixon: And I saw a figure coming out for 2024 suggesting that 95% of all global growth happens outside Europe. And that, of course, goes to the point, which is saying, which is that you need to tap into external demand. You need to expand the base of consumers that you can sell to if you want to become productive. And if you're not taking constructive steps in order to improve the ability to do that, well, then you're handicapping yourself.

Oscar Guinea: Yes, yes, completely in agreement.

Fredrik Erixon: And this sort of problem with the Draghi report is mostly that he's treating trade as a vulnerability and he's treating trade as something that should be folded into an economic security dimension where Europe needs to be more proactive in order to reduce its dependence on foreign markets.

Oscar Guinea: Yes, absolutely. I think our focus should be in terms of competitiveness, should be to kind of look at energy prices, look at regulation, look at market dynamism. The focus should be to make Europe a very exciting economy where we can export and engage with other countries and where firms from other countries want to come and invest in Europe. I think that's fundamental.

And the fact that we have seen a plummeted foreign direct investment in Europe, I think is pretty symptomatic that we're becoming less relevant. The way to become more relevant for all this is to be at the technological frontier, to be a place where people want to come, to invest, to live and prosper. And for that, they need profitable business opportunities. And I mean, we have a strong comparative advantage in Europe, we have the rule of law, we have good and strong institutions, we have good quality of life, good food and in some countries good weather. But we need something else, and we need to make Europe an exciting place for people to invest and dedicate and innovate as well.

Fredrik Erixon: Just to pick up one point more of what you were saying, because I found that interesting, you say that foreign direct investments are plummeting. What do you mean?

Oscar Guinea: What I mean is that when you look at the profile of FDI in Europe, what we have is that foreign companies are not investing as much as they were investing before in Europe. And I think that's pretty symptomatic because you'll think of the reasons why a foreign company wants to invest in Europe and it will be because the market is exciting, because there are business opportunities, because we have some skills in human capital that cannot be found in other places. And the fact that FDI has been dry and reduced, I think it's a symptom of losing competitiveness.

Fredrik Erixon: But when you say that it's been plummeting, I mean, has it gone down a little or has it gone down a lot?

Oscar Guinea: I don't have the figures on top of my head, but it has been a lot from before. I mean, it is staggering when you look at the graph.

Fredrik Erixon: All right. Oscar, thank you very much for taking the time to talk about competitiveness. I mean, as I said initially, we had the European Commission launching a competitiveness compass a couple of weeks ago. It remains to be seen what they actually are going to propose in the weeks and months that will follow. And of course, we are going to keep a close track of these developments and I'm sure we are going to come back on that issue also in the Global Economy Podcast. Thank you very much.

Oscar Guinea: Thank you.