European Solidarity as a Way to Face Globalization and as an Antidote Against Populism

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Abstract

Two opposite positions are facing each other in the euro area. The first one, originating in southern Europe, is based on the observation that the adoption of the euro favored northern economies, allowing them to have persistently high trade surpluses at the expenses of the southern ones. The second position, originating in northern Europe, focuses instead on the risks that the citizens of those countries would incur to cover the high debt of southern countries. Such opposed positions, however, ignore the deep reasons that led European countries to start the process of economic integration, of which monetary integration is a relevant part. In view of what precedes, a market-financed euro area-wide investment plan to be agreed, monitored and even administered by representatives of northern governments, should be acceptable to them and would support the southern ones in their endeavor of risk reduction.

Keywords

Globalization, Populism, Risk reduction, Risk sharing, Fiscal austerity, Investment plan

1. Introduction

The euro area crisis was ignited by the Greek shock and seemed to prove that the northern fear of a southern fiscal profligacy, dating back to the beginning of the process of monetary integration, was fully justified (although such a conclusion ignored the fact that until the beginning of the crisis, public finances of the countries mostly affected were in relative good shape or at least were giving signs of convergence). Still, fiscal austerity was imposed in order to redress the situation, although it was only thanks to the reassurance coming from the ECB, acting de facto as a lender of last resort, that the crisis came to an end.

A different view results from a southern perspective, arguing that northern countries are benefitting from the rigidity provided by EMU, since their trade surpluses do not find any automatic compensatory mechanism to balance them.

Both perspectives seem to lead to the conclusion that creating the EMU was not appropriate and that it would be in the convenience of southern countries to leave and in the convenience of northern countries to let them go.

This conclusion, however, ignores the deeper reasons that are behind the creation of EMU, which is part of the wider project of European integration.

If northern countries want the southern ones to redress their fiscal situation, thereby reducing risk, as the current fiscal rules would oblige them to do, then, considering their self-interest in not disrupting the whole project of European integration, they should be willing to accept some degree of risk sharing in order to counterbalance the negative effects of risk reduction, for example in the form of the market financed euro area wide investment plan proposed by Della Posta et al. (2018).

2. Euro Area Crisis, Austerity Policies and the Stabilizing Role of the ECB

The euro area crisis is usually attributed to public debt imbalances (this is also why it is often defined as "sovereign debt crisis", to distinguish it from the "global financial crisis" that preceded it). This is a debatable conclusion, though, especially considering the role also played by private debt, by current account imbalances and by self-fulfilling expectations, ignited not only by the sudden discovery of the higher than expected Greek public deficit and debt, at the end of 2009, but also by the "Deauville declaration" with which in October 2010 Angela Merkel and Francois Sarkozy acted as "scaremongers of first instance" (the opposite of what a "lender of last resort" should be doing in order to reassure the markets), thereby fostering rather than extinguishing the crisis.

Moreover, before the crisis the public debt-to-GDP ratio had been gradually decreasing in all euro area countries, and it was rather low in Spain and Ireland (respectively about 40% and 20%). It is only after the Greek crisis and after the bursting of the housing bubble in some countries (Spain and Ireland, where the bubble was induced by an excess of private debt made possible also by the capital inflows from northern countries, particularly France and Germany), that public debt had to be increased in order to bail out the private one.

In the case of Portugal, instead, the problem had not to do with a house bubble, but with current account imbalances (also present in the case of Spain, Ireland and Greece), once more resulting from an excess of consumption made possible on one hand by the capital inflows attracted by the higher interest rates and the perception of a rather low risk in southern countries, and on the other hand by the rigidity characterizing monetary unions and preventing any automatic adjustment of the current account imbalances (this point will be further addressed below).

Be that as it may, being the crisis attributed, by Germany and other northern European countries, to public debt imbalances, namely being it believed to be fundamentals-driven (the main economic fundamental to be monitored, however, being public debt and not the private one), the proposals for its resolution have been based mainly on the imposition of fiscal austerity policies, in order to adjust such imbalances.

The counterproductive effects of those policies had been immediately recognized by many observers (including Krugman 2010), who had applied the basic Keynesian model to conclude that with their adoption the public debt to GDP ratio would have increased rather than decreased because of the contractionary effect they would have had on GDP, the denominator of the public debt-to-GDP ratio.

As a matter of fact, as De Grauwe and Ji (2013) had promptly shown, the public debt-to-GDP ratio did not all, and in fact it kept increasing, in spite of fiscal austerity.

It is undeniable, then, that rather than thanks to fiscal austerity, the crisis came to an end only when the ECB stepped in and reassured the markets by acting, eventually, as a "lender of last resort". This happened with the famous Draghi's "whatever it takes" speech (accompanied by the prompt adoption of the unlimited Outright Market Transactions program), that reduced dramatically the interest rate on public debt.

Such an ECB role, however, like any other form of implicit or explicit fiscal solidarity, had been denied that far, following too literally the prescriptions of the Maastricht Treaty, with the motivation that doing otherwise would have risked providing the wrong incentives to the market. This is why the little Greek fire was allowed to grow (an image that I am borrowing from Paul De Grauwe), putting at risk the whole of Europe.

The role of incentives is well-known in economics and their importance cannot be discarded. It should be also recognized, however, that there are instances in which they may play a rather limited role, for example if divergences are structural rather than dependent on the deliberate actions of agents. This is the case, for example, when countries differ in labor or market institutions, or when the public debt that they have inherited is larger than that of other countries, thereby implying the need to impose higher taxes (especially when considering the indirect ones, like VAT) to repay it. This would undermine the domestic competitiveness since, in such a case, countries belonging to a monetary union would be characterized by different inflation rates, in spite of the same monetary policy being run in the area by the common central bank. Another instance is when countries have a different productive structure and the process of economic specialization based on comparative advantages has implied concentrating in a sector whose productivity increases less than that of other sectors. A further problem exists if, as argued above, no self-stabilizing market mechanisms are allowed to be in place by the system that has been adopted.

3. Opposing Views on the Way EMU Should Be Run: Exit EMU, Risk Reduction or Risk Sharing in EMU?

3.1 Exit EMU from a Southern Perspective

A quite wide spectrum of economists of southern euro area countries, both of a progressive and a conservative orientation (in Italy, for example, including names like Alberto Bagnai, Domenico Mario Nuti and Paolo Savona, just to list some of the most well-known of them) observe that the adoption of the euro has coincided with the relative impoverishment of their countries and with the enrichment of the Northern ones, therefore arguing that their countries should leave EMU, which is for them a sort of straightjacket that does not allow them to operate freely and that forces them in a subordinate role vis-à-vis the northern ones.

This is a long standing argument, that was raised already when the European Monetary System was created. After the fall of the fixed exchange rates system created in 1944 in Bretton Woods, European currencies started fluctuating widely against each other, thereby disrupting the otherwise intense intra-European trade. The late Marcello de Cecco also observed, however, that an additional effect of floating exchange rates within Europe would have been the appreciation of the German mark vis-à-vis the other European currencies. As a matter of fact, the economic strength of Germany would have attracted capital from the rest of the world, thereby appreciating the D-Mark and reducing its commercial competitiveness. Moreover, any German competitive advantage over its trading partners, resulting in a trade surplus, would have created the automatic conditions for rebalancing the situation through the appreciation of its currency, as it was the case when the "rules of the game" in the Gold Standard were not infringed by Britain's sterilization policies. Joining a fixed exchange rate system, then, this was the argument made by Marcello de Cecco, was in the full interest of Germany, since it allowed that country to avoid the appreciation of the D-Mark that would have prevented the accumulation of current account surpluses. The same is true, of course, for the adhesion to a monetary union, which is an extreme form or irrevocably fixed exchange rates.

German economists and citizens, then, should consider the role played by the mechanisms described above if they want to understand the true origins of the current account deficits of most southern euro area countries and, as a result, the origins of their persistent current account surpluses.[1]

3.2 Exit EMU from a Northern Perspective

The appeal signed by 154 German economists and published in the Frankfurter Allgemeine Zeitung on May 21, 2018 against Macron's proposal to transform the European Stability Mechanism to a permanent European Monetary Fund in order to be able to absorb future economic shocks, goes in the opposite direction.[2] The most prominent of those signatories are Hans-Werner Sinn, former president of the Ifo Institute, and Jürgen Stark, former member of the European Central Bank executive board. Their views are also in line with the position expressed by another well-known German economist like Bernd Lucke, who has been among the first ones to interpret and represent the German sentiment of fear of the mutualization of southern public debt. A similar fear characterizes the appeal signed in March 2018 by eight northern euro area countries (Finland, Denmark Sweden, Lithuania, Latvia, Estonia, Ireland and The Netherlands).

The northern view resulting from those documents only focuses on the risk they face to be asked to pay the debt of southern countries. This is why they encourage the states that are not capable to keep their accounts in order to leave EMU and to make this possible they suggest to set up a procedure to be followed by insolvent countries to quit the euro.

This position might convey the idea that they do not fear the risk that some countries may be leaving the euro area. What is not clear, however, is whether they would be willing to accept the risk that such an exit process involved more than just an outsider country like Greece, and whether they are well aware of the effects and implications this would imply in terms of the overall process of European integration.

One possibility is also that they rely on the fact that a deflagration of the European Union might not be in the interest of follower countries either, since this would mean to have to cope with a newly isolated and strong Germany, precisely what European countries wanted to avoid when EMU was created.

3.3 Risk Reduction and Risk Sharing (Namely Fiscal Solidarity) in EMU and the Benefit for Northern Countries of Being Part of It

Opposite, although less radical positions are those that, at least in principle, do not question the participation in EMU, although they subject it to the fulfillment of either risk reduction (to be performed by southern countries) or risk sharing (to be provided by the northern ones).

Risk reduction is required by northern countries, arguing that if South and North have to remain together in a monetary union, the former has to behave properly, not expanding public finances in the implicit hope of a northern bail out. Such risk of fiscal profligacy is something that has been present in the debate from the very beginning of the process of monetary unification, namely from the Delors Report (Delors 1989).

It is far from clear, though, why risk reduction should only apply to budgetary issues. This is what has emerged after 2010, with the adoption of the European Semester, according to which a whole set of potential macroeconomic imbalances has to be monitored by the European Commission. As a matter of fact, not only fiscal divergence might represent a potential risk for EMU, but also any other indicator of competitiveness divergence could. Introducing labor market reforms in an uncoordinated manner (a clear example being the German Hartz reforms) or adopting a preferential fiscal treatment in favor of foreign companies, also creates a divergence within EMU, which increases the risk of a long run unsustainability. The latter case, for example, in which countries act the facto as free riders (this is the case of Ireland and the Netherlands, for example), produces the paradoxical result of strengthening the public finances of the countries adopting such fiscal measures, while weakening the public finances of the countries not adopting them, whose revenues will be decreasing and creating an equally disruptive trade divergence within EMU because of the competitive advantage it gives them.

Risk sharing is required instead by southern countries, arguing that if South and North have to remain together in a monetary union, the latter should acknowledge and give back to the former at least part of the advantage gained with the creation of the monetary union.

As a matter of fact, the euro area crisis itself would have been avoided by the application of fiscal solidarity, that has been exerted only at a later stage, and only being subject to conditionality in order for northern European countries to be reassured of not being exploited by the southern ones.

If the two perspectives reported above—the northern and the southern one—are brought to an extreme, the conclusion would be the one presented in the previous section, namely that southern countries that are not capable to provide the required risk reduction or that are going to lose from their participation in EMU because of the permanent competitive advantage that export countries have, should leave EMU.

4. The Need for a Comprehensive View: Risk Reduction and Risk Sharing

In my view both extreme positions make the mistake of looking at only one aspect, assigning to it an exorbitant weight that overcomes all other aspects and reasons for the creation of the euro, that should be considered instead in order to have an overall, balanced view on being part of EMU.

Those reasons might have to do, for example, as recalled above, with the high inflation rate of the 1970s and part of the 1980s, that was reduced also with the help (although not without costs, as the rational expectations theories of those days would have suggested instead) of the fixed exchange regime that had been adopted, and that set the adhering countries on a sustainable path of credibility. Needless to say, it is easy today to forget about inflation, given its current low level.

Similarly, we have forgotten the consequences of exchange rate volatility for an economic area open to trade and characterized by many different currencies and in which the suspect of "beggar thy neighbor" policies induce competitive devaluations and produces a spiral of retaliatory measures. Would that problem disappear if we leave the euro? May be that this is the case, since after all world trade operates under a flexible exchange rate regime. The intensity of such trade, though, is much higher in Europe. Not to mention that we came to the conclusion that we need intra-European trade and open commercial relationships, in order to keep away war and the phantoms of the past.

Maybe even more importantly, we have forgotten that the euro was part of a larger design, aiming at the political unification of the European continent. True, that might have been risky (as the Italian politician Carlo Ripa di Meana observed in discussing the project of EMU: “It is not the European Union that creates money but money that should be creating the European Union: it’s a risky game”), but the final objective of a European Union, after the dramas of two world wars, as Altiero Spinelli and the other authors of the Ventotene Manifesto had dreamed, was the main ideal motivation behind it and the previous moves, the creation of the customs union in 1957 with the Treaties of Rome and the adoption of the Single European Act in 1987 had shown that the neo-functionalist approach had been giving good results.

Finally, behind the beginning of the process of European integration, and indirectly behind EMU, then, there is the need for European countries to cooperate to better resist the pressures of globalization and protect their citizens, being aware that this would only be possible by joining forces and by sticking together.

Still, in order to reap a (limited) advantage (or to avoid incurring a limited loss), both northern and southern countries criticize EMU by focusing on a single aspect and by neglecting the risk to ignite the breakup of the process of European economic, monetary and political integration, which would be a much worse and potentially disruptive conclusion.

In other words, this implies the risk to play a prisoner’s dilemma game, in which both northern and southern European countries do not resist the temptation to play alone in the hope to reap a small benefit, not realizing that by doing so they will end up in a Pareto inferior equilibrium.

5. Negative Implications of Austerity Policies and the Need for an Investment Plan

The austerity policies that have been applied in order to solve the “sovereign debt” crisis have implied a dramatic fall of investments—the only expenditures that can be cut easily by policymakers interested to preserve an electoral consensus without receiving any objections or complaints on the part of those who would have benefitted from them, namely the voiceless future generations.

Most crises of the past, however, have been put to an end by following an opposite route: economic growth has been pursued in order to reduce the public debt-to-GDP ratio, thanks to the beneficial effects of the Keynesian multiplier, so that even if the numerator would be growing further, the denominator would grow even more. This has been the case, after World War II, in Britain with its 240% public debt-to-GDP ratio, or in the USA, where GDP growth has been the key element to stabilize and make public debt sustainable.

The least that this may imply is that the austerity policies followed by southern euro area countries, should have been supported and partially compensated in a cooperative environment in order to avoid the GDP fall of fragile countries that would nullify their effort, by expansionary domestic policies to be undertaken by the northern euro area members. Such a compensatory (not necessarily direct, through fiscal transfers from North to South countries, but also indirect, through higher internal absorption—consumption, investment, government expenditure—that would have favored a rebalancing of North-South current account divergences) would be fully beneficial because it would increase the GDP growth of the most fragile countries, so that the public debt/GDP ratio will surely decrease. Since this was not done, no surprise that the Greek paradox emerged, implying that not only austerity policy imposed a heavy social cost (that became apparent also in the mortality rates, as documented in the literature), but the public debt to GDP ratio did not fall, due to their contractionary effect on GDP growth.

It could still be understood that this would be hard to accept by citizens who speak another language, have a different religion, different traditions, culture and history, and different beliefs, although this signals clearly that they do not feel being all Europeans.

What is harder to understand, though, is the fact that solidarity if not accepted even if its cost would be close to zero. As a matter of fact, Germany and other northern euro area countries would only be required, following for example the proposal of the adoption of a euro area wide investment plan made by Della Posta, Marelli and Signorelli, to join forces with the southern euro area ones and issuing European bonds to collect the necessary financing on the international markets. As a matter of fact, the guarantee by euro area countries would be sufficient to attract market capital, so as to enjoy a high leverage effect. Moreover, still according to the proposal made by Della Posta et al. (2019), for example, investments would be selected, administered and monitored by the countries who provide a guarantee on them. Such a solidarity would imply neither a financial nor a monetary sacrifice, given the eagerness with which international financial markets would be looking for additional ways to diversify their portfolios.

Similarly, expansionary and growth enhancing proposals, contributing therefore to the reduction of the public debt-to-GDP ratio, are reported in Discussion Group: "Growth, Investment and Territory" (2018).

The Juncker Plan (implying investing up to 2% of GDP in four years in the economies under stress) has done something similar, having been administered through the EIB (European Investment Bank). Such a plan should be greatly relaunched and reinforced.

6. Fighting Against Populism

It deserves to be underlined that the proposed policy would have a further very relevant implication, namely fighting against populism. As a matter of fact, the fiscal austerity policies adopted in response to the euro area crisis have negatively affected the sentiment towards Europe in southern countries. Adopting an expansionary, market-financed investment plan, then, promises to produce a positive effect not only on GDP growth, on interest rates and on public debt-to-GDP ratios, but also—and maybe even more importantly—on the perspectives themselves of the long run success of EMU and potentially of the EU.

It could be argued that while this would gain the favor and the consensus of southern euro area countries, the opposite would be true for the citizens of northern Europe. But they should be reminded that the true choice they have to make is not between accepting or not accepting a big Pan-European, market financed and growth enhancing investment plan, but rather between accepting the investment plan or having to face a situation in which the euro area breaks up, since no country will desire to remain in a union in which the costs exceed the benefits and not protecting its citizens, contrary to what initially promised.

In other words, they risk playing with southern countries the well-known prisoner's dilemma game, leading to an undesired to both but inevitable Pareto inferior Nash equilibrium.

7. Concluding remarks

The euro area crisis was ignited by the Greek shock and seemed to prove that the northern fears of a southern fiscal profligacy, dating back to the beginning of the process of monetary integration, were fully justified, in spite of the fact that until the beginning of the crisis the public finances of the countries mostly affected were in relative good shape or at least were giving signs of convergence.

In spite of that, fiscal austerity was imposed in order to redress the situation, but it was only thanks to the reassurance coming from the ECB, acting de facto as a lender of last resort, that the crisis came to an end.

From a southern perspective it is often argued that northern countries are benefitting from the rigidity provided by EMU, since their trade surpluses do not find any automatic compensatory mechanism to balance them.

Both perspectives seem to lead to the conclusion that creating the EMU was not appropriate and that it would be in the convenience of southern countries to leave and in the convenience of northern countries to let them go.

This conclusion, however, ignores the deeper reasons that are behind the creation of EMU, which is part of the wider project of European integration.

If northern countries want the southern ones to redress their fiscal situation, then, as the current fiscal rules would oblige them to do, considering their interest in not disrupting the whole project of European integration they should be willing to accept some risk sharing. In this paper, for example, I refer to the proposal of a euro area wide investment plan agreed, monitored and even administered by representatives of the governments of northern euro area countries and financed by Eurobonds (namely by money collected on the market and not through the taxes of euro area citizens. In such a way, risk sharing and solidarity would be exerted without actually asking northern countries any financial disbursement, something that should be acceptable for them and that would help the southern ones in their endeavor of risk reduction.

1. When discussing the role played by the European Monetary System, however, it also needs to be recalled that, according to an old argument introduced by Giavazzi and Pagano (1988), the German monetary discipline might have helped reinforcing the anti-inflationary credibility of follower countries, including Italy, so as to contribute to the reduction of their inflation rate. Such a conclusion, however, is subject to several caveats and discussions that cannot be reported here but that should be considered.
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