UNIVERSITÀ DEGLI STUDI DI FERRARA
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Via Voltapaletto, 11 – 44121 Ferrara

Quaderno DEM 6/2013

February 2013

What Europe Needs to Be European

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Quaderni DEM **ISSN 2281-9673**

What Europe Needs to Be European

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Abstract

The way forward for Italy, within a Europe that has to change. A Europe that is too economics-minded and not politically-minded enough, where growth and employment are stifled by tight budgets. Yet another path is possible, if we still keep the single currency but if we change regulations and economic policies. And introduce more democracy, also in the economy.

JEL: E6, O52, P16

Keywords: European crisis, Euro, Economic policy

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1. The supremacy of Economic Europe over Political Europe in the age of the Euro

It is now commonly thought that the economic crisis has hit a Europe which doesn't stand on two pillars, but barely on one. That is, it stands on the pillar of an ***Economic Europe***, which is incomplete and asymmetrical. The pillar that is missing is a ***Political Europe***, which was supposed to evolve into the United States of Europe. Having replaced the prospect of a Europe of States with an intergovernative Europe is the clearest proof that the plan for Europe has lost impetus, and the non-approval of the European Constitution has contributed towards this, even if the "reform" Treaty of Lisbon was signed in 2007.

But the roots of this problem go back further. Due to the difficulties along the road towards a Political Europe in a period when the European Union was marching forward to expansion in the East, the single currency took on importance as an instrument of harmonisation and convergence of the economies of each nation, aiming to achieve political unity in the end (once the economies had been harmonised). As it was impossible to create a Political Europe by political means, the path towards an Economic Europe was followed in order to create a Political one, as second best[2].

However, the single currency needs two conditions in order to function: a similar inflation rate in each country, as well as low fiscal deficit and public debt. Above all, it needs harmonised and converging economic systems. Harmonisation and convergence also imply balanced management of the trade balances of each country and of intra-European trade flows. Yet the European market witnessed an excessive surplus in the German and North European countries which should have been curbed by greater domestic demand and/or higher inflation in these surplus areas. Instead of working in that direction, the countries with trade deficits underwent restrictions to their trade balance policies. Increasingly burdensome demands for structural reforms were made, which became more and more restrictive, imposing constraints to increase flexibility in the labour market and competitiveness in the goods and services markets.

This trend came into conflict with a consequence, partly endogenous, and an event, partly exogenous.

The endogenous effect is the fact that adoption of the single currency did not lead to harmonisation of the economies of the various States in the Union. In fact, the single currency led to, or was utilised for, strengthening the gap between member

[2] Syrquin (2010) on this *Journal* discussed the difficult prospects of political and economic European integration, arising various doubts about the feasibility of the integration path after the economic crisis of 2007-2008, because of the weakness of the "Political Europe".

States. Instead of convergence, there has been a divergence trend in growth rates as well as intra-state trade and finance flows.

Some believe that the "blame" should be laid on certain countries' policies (i.e. the weakest): instead of structurally reforming their national economic systems, their labour markets, goods and services markets and financial systems within the required deadlines, the necessary reforms were postponed, leading these countries to "live beyond their means". However, others believe that it was the strongest countries which benefitted from an initial competitive advantage that helped them march on towards structural reforms, as the single currency protected them from re-evaluation of exchange rates while the single currency put pressure on weaker countries unable to devalue. Whoever is right in this debate, there is no doubt that harmonisation of economic systems has not taken place during the reign of the single currency; in fact, the gap between strong "virtuous" countries and weak, "vicious" countries has increased. Moreover, the increased imbalance in intra-state trade balances has led to an increased gap between public and private debt among countries (Krugman, 2009).

Then in 2008 came the economic crisis, imported at the beginning from the USA and partly endogenous in Europe.

As we know, the first response on both sides of the Atlantic was to curb the crisis in the financial markets and prevent it from spreading to the real markets. Firstly, the banking systems were protected against collapse and then intervention was directed to avoid the credit crunch on corporate and private loans (Eichengreen, 2008).

The USA saw the creation of a tepid but crucial and quantitatively substantial expansionary fiscal policy, alongside an undoubtedly expansionary monetary policy which led to zero interest rates. In Europe, fiscal rigour was initially loosened up and an accommodative monetary policy was adopted to satisfy demand for money for the banking system (Quadrio Curzio, 2008). Inflation rates however were kept down, as price stability was the key aim of the ECB. But the anti-crisis measures did not prevent balance deficits or public and private debt from worsening, to a somewhat unequal extent among European member countries. In fact, the crisis has aggravated debt in weaker countries (Krugman, 2012).

As we know, this led to a situation where, not even having got over the crisis of 2008-2009 and with tepid signs of recovery in 2010, European financial markets again plunged into a crisis[3], followed by the economic crisis and recession of 2011[4]. While in the USA monetary policy was more expansionary and fiscal policy less harsh, in Europe the 2011 crisis was tackled by curbing public expenditure and restricting *welfare* systems in order to reduce the balance deficit and public debt. Harsh austerity measures were taken and the demand for structural reforms was stepped up: especially on the labour market, on the goods market (though not

[3] The role of the Greek crisis in late 2009 as a "sovereign debt crisis" and its effects for the European monetary system have been discussed shortly after by Prodi (2010) and Quadrio Curzio (2010) in this *Journal*.

[4] Galbraith (2009) made clear that the first phase of the crisis was just the start of a long-lasting crisis.

excessively) and financial markets (rather little) (Krugman, 2009, 2012; Pianta, 2012; Bianchi, Pini, 2009).

2. The responses to the second crisis

After the (brief) first phase of the crisis during which liberal and neo-liberal economic policies were blamed for their negative effects on market functioning regarding growth and employment, it was especially in Europe that pressure on the markets convinced many to go back to old restrictive policies at all costs and non-intervention of the State in sustaining aggregate demand and welfare expenditures.

The logic in response to the crisis in financial markets was a mixture of rigour and liberalism: losses were suffered by all, gains enjoyed by a few individuals. Applied to a financial system undergoing crisis, this meant spreading private market losses throughout society and offloading them onto public finance and the community, which has had to pay higher tax. This entails making everyone pay twice, also for the growth in deficit and public debt[5]; with the introduction of austerity measures and reduction of welfare for the sake of rigour, and possibly also the transfer of a share of public welfare onto the markets with privatisation of welfare (Bianchi, Pini, 2009; Brancaccio, Passarella, 2012; Pianta, 2012; Stiglitz, 2012).

Obviously this trend is not proceeding in a linear way, nor with the same rigidity as some liberal and neo-liberal experts would wish.

This is due to a series of reasons, both exogenous and endogenous to the scenario in Europe.

First, the most important external reason is that in the USA the policy of economic austerity and market deregulation aimed at guaranteeing even more wealth to 10%, or even just 1% of the population is not so popular with the electorate. So expansionary monetary measures are being adopted, whereas regarding fiscal policy there is conflict between the liberal and non-liberal (not to be called “Keynesian”, however) approach, as has happened concerning the *fiscal cliff*. And what happens on the other side of the Atlantic translates into demand for less austerity and pressure for expansionary economic policy on this side of the Atlantic.

Secondly, in Europe the policy of austerity has produced serious damage: it stifles income growth and de-stabilises public accounts, as well as producing noisome effects at a political level (imminent elections in important countries). Due to enforced austerity measures, weaker countries are paying for the consequences, not only regarding loss in income and employment but also concerning the worsening of their deficit and public debt that they hoped to improve. This worsening situation is far beyond the gloomy forecasts because, as the International Monetary Fund observed (Blanchard, Leigh, 2013; Corsetti, Meier, Muller, 2012) the fiscal policy multipliers were greatly under-estimated, so restrictive fiscal measures have had

[5] In two recent contributions published on this *Journal* (Fortis, 2011, 2012), the problem of national debts during the crisis has been deeply discussed, arguing that it is necessary to consider both public and private debt, and public and private wealth as well, in order to evaluate the relative position of each country.

much more negative impact on income than predicted, determining strongly negative GNP growth rates for weaker countries, starting with Greece and Portugal and also Spain and Italy. What is more, there has been a notable slowing down of growth in the whole Euro area, also affecting Germany, the economic forecast for which is no longer positive. All this contributes to raising doubts as to the choice of austerity at all costs.

Thirdly, in Europe there exist institutions, political and social forces and also sharp economists that have softened the blow, though certainly not enough, of these austerity measures. Steps giving more power to the ECB have been brought in, with monetary operations influencing financial markets and the behaviour of financial and lending institutions.

However, we know that a large part of this liquidity injected by the ECB has gone to the banks (a) to finance themselves cheaply and to purchase public bonds with yields higher than the rate paid by the ECB itself, rather than catering for corporate and private loans needed to boost the real economy, and at the same time (b) to work towards the recapitalisation required by the review of the Basel agreements (Ruffolo, Sylos Labini, 2012; Leon, 2012). There is no let-up in the negative effects brought about by austerity, although there has been relief on financial markets and the spread between state bonds issued in member countries. Meanwhile, imbalances in trade figures between Euro area countries have not diminished but increased. These imbalances are part of the European crisis, with strong countries building their growth on demand from abroad, on intra-European trade quotas rather than extra-European ones, risking a *Beggar Thy Neighbour*- type policy: a type of no-win game where one country’s exports are another’s imports and by the same token one country’s deficit and debt (public, but also private) is the other’s surplus and credits. (Eichengreen, 2012; Protopapadakis, 2012, iAGS, 2012). Then the economic scenario for the near future remains gloomy, as short-term forecasts by international institutions clearly show.

3. Two visions of Europe and how to tackle the crisis

There is no doubt that this negative trend based on economic reasoning rather than political arguments is at the heart of how the crisis has been dealt with. The policy of austerity has prevailed over that of growth, and a new term seems to become popular: “expansionary austerity”[6]. This policy has been governed by a fundamentally liberal view of Europeanism, as opposed to a view interpreting Europeanism in terms of social market economy, as it was in the pre-Euro age when a stronger and more progressive vision of a Political Europe was on the agenda.

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[6] This term derives from the *Expansionary Fiscal Contraction* (*EFC*) hypothesis introduced by Giavazzi-Pagano (1990) during the debate on fiscal restructuring in Denmark and Ireland in the Eighties. There is substantial literature both for and against the EFC hypothesis. A recent IMF paper contests the solidity of this literature and finds new evidence against the “expansionary austerity” view. See Guajardo-Leigh-Pescatori (2011).

The government of the European Union and particularly its economic policy has followed a conservative way of thinking. Even apart from the political setups in each country, which have changed and continue to do so, what has emerged in Europe is closer to liberalism than reformism. The dominance of this conservative view has led to rigour in the economic field, the supremacy of the markets over the welfare state now being downsized and partly privatised, the introduction of stricter limits concerning fiscal policy, and above all deregulation of the labour market. Within this view, competitiveness is the winning card to play on foreign markets, as domestic markets are scaled down: competitiveness must be achieved by adopting all possible measures of flexibility in order to increase export capacity.

As they are unable to utilise the leverage of devaluation, some countries such as Italy have suffered more than others, while the stability of the single currency has enabled other countries, particularly Germany, to avoid revaluation of a national currency which would certainly have taken place following increasingly substantial increases in their trade figures. The fact that this implies limited growth, low and poor-quality employment, and increased inequality, is in a certain sense a side effect, which may be tackled by a minimal *welfare* system and by markets busy replacing *public welfare* with *private* health and pension insurance schemes. Thus the path traced out by modern liberalism is that presented as *true progressivism*, to be distinguished from the "wrong" one of those who aspire to maintaining a public *welfare state* (even though a reformed one) but are accused of conservatism.

It is clear that those who support a vision of Europe based on a social market economy, including European the social democracy movement, will find themselves in an unwelcoming climate; and if they don't go for a facile but ineffective opposition to the introduction of the Euro and reject any populist view, they will only find obstacles and restrictions along their path, as well as the reality of globalisation. In fact, the internationalisation of financial markets and resistance to world-scale (even to European-scale) regulation contribute to the adopting of austerity measures for national states in Europe now that there is a single currency. The context in which growth policies may operate has now changed, narrowing down dramatically.

The debate in Europe is open, and in Italy we cannot "wear ourselves out" in post-electoral debates, when in Europe itself democratic and socialist parties and movements (iAGS, 2012, EuroMemoGroup, 2012) show how another *Way* is possible. Starting with Europe, at least **seven key actions** can be determined, if we want to support the vision of a *social and political European market economy*. These actions would enable Europe, and therefore Italy rooted as it is in Europe, to once again find the path to growth, full employment and collective welfare. Only within the sphere of these key actions will there be the chance of undertaking specific instrumental policies to achieve growth and employment.

1) It is necessary to extend the powers of the ECB so that it may operate as an effective Central Bank with the primary task not only of controlling the dynamics of monetary variables influencing interest rate movements but also guaranteeing the strength and solidity of the single currency on international markets, protecting

fiscal policies, and guaranteeing their efficacy, from speculation on financial markets. In other words, the ECB must be in a position to operate as "lender as a last resort".

2) At a European level, public investments *also as an anti-crisis measure* financed on national budgets must be allowed, and not limited by a rigid interpretation of the regulations laid down by the *Treaty on stability, coordination and governance in the economic and monetary union* passed in March 2012 (the *Fiscal Compact*) so that fiscal policy may be utilised to combat the crisis and encourage growth.

3) It is necessary to issue the various types of *Eurobonds*[7]. Some of these will finance large-scale European projects leading to quantitative and qualitative growth of economies in Europe, such as those supporting the *digital economy*, the *green economy* and the *economy of knowledge*. Other types of *Eurobonds*, such as the *EuroUnionBonds* must be utilized to stabilize the management of national public debt and create a wide market of European bonds based on real guarantees, as many economists have been suggesting for some time.

4) The European public budget must be increased, as at present it accounts for only 1% of the GDP of all member States contrasting the view that has forced the debate on this issue to be frozen until June 2013 (the *Budget 6*). The raising of the European Commission budget, defying the policy of those who instead want it reduced, would make it possible to finance larger projects not just for the structural re-balancing of the member countries but also for infra-structural projects of a physical and intangible nature.

5) We need to speed up fiscal levelling throughout the Community, as this will enhance homogeneity of fiscal regimes within the Union. The fact that fiscal systems greatly differ clearly encourages the practice of competitive national policies that do not foster cooperation between member States and clearly reduce the efficacy of fiscal industrial and labour policies.

6) We must direct initiatives for coordination of economic policies of member States non only towards reducing national debt, the *timing* of which must be reviewed, but also towards reduction of imbalances in trade flows among member States. These imbalances constitute one of the major causes of tension concerning the single currency. Coordination policies must operate non only in countries with structural deficits, these countries having to carry out structural reforms of their internal markets, but especially in countries with structural surpluses in their trade balances, to induce them to sustain domestic demand and not entrust growth only to the expansion of foreign markets.

[7] On the different types of *EuroBonds* and the specific characteristics of *EuroUnionBonds*, see Prodi-Quadrio Curzio (2011, 2012a, 2012b), and Quadrio Curzio (2011).

7) We must take actions on the banking system, increasing control over this sector in order to reduce systemic risk by fiscal means (taxing specific financial instruments and transactions) as well as regulatory means (prohibiting specific activities and transactions) relying much less on “risk weighting” instruments and “capitalization” which have proved largely ineffective or even counter-productive (introduced with Basel 2 and Basel 3). The banking system has lost its function as a complement to the real economy, failing to support companies and households, and has become practically self-referential, as the separation between commercial banking and investment banking introduced after the banking crisis at the beginning of the last century was abandoned decades ago. If the loan system is to become part of the real economy, we must re-create that separation in the current new climate[8].

We believe that each project for national economic policy, no matter how ambitious it may be, must take into consideration the two pillars of Europe, *Political Europe* and *Economic Europe*, and the **seven key actions** outlined above, and face the need to intervene so as to reform the Europe we have now. The United States of Europe remain, and must still remain, the goal for our politics and economics. However, the Europe we have now is unfortunately a Europe in which the single currency, because of the intrinsic errors made at its birth, forces restrictions and rules which must be changed as soon as possible. It is a matter of economic growth, employment performance and social cohesion, and so it is also a matter of democracy.

[8] See the proposal by Eichengreen (2013) to have a new Glass-Steagall Act. Who will be the new Ferdinand Pecora?

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