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ITALY AND GERMANY. WHO HAS BETRAYED EUROPE?

ABSTRACT

In this paper we take Italy and Germany as prototypes of the peripheral and core countries in the EMU and try to examine their respective faults. However interesting, this exercise has to be completed by an analysis of the Union institutions, their origin (and the forces that drove it away from a more balanced one or a federalist one) and shortcomings. This offers us the opportunity to suggest some changes to them, also to the light of recent changes due to the European reaction to the pandemic.

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RIASSUNTO

Italia e Germania. Chi ha tradito l'Europa?

In questo articolo prendiamo l'Italia e la Germania come prototipi dei paesi periferici e centrali dell'UEM e proviamo ad esaminare i loro rispettivi difetti. Per quanto interessante, questo esercizio deve essere completato da un'analisi delle istituzioni dell'Unione, della loro origine (e delle forze che hanno portato ad un allontanamento da un modello più equilibrato o federalista) e delle loro carenze. Ciò ci offre l'opportunità di suggerire alcune modifiche a tali istituzioni, anche alla luce dei recenti cambiamenti dovuti alla reazione europea alla pandemia.

1. INTRODUCTION

In this paper we take Italy and Germany as prototypes of the peripheral and core countries in the EMU and try to examine their respective faults. However interesting, this exercise has to be completed by an analysis of the Union institutions and shortcomings. This offers us the opportunity to suggest some changes to them, also to the light of recent changes due to the European reaction to the pandemic.

Section 1 offers a bird's eye analysis of the process leading to current EMU institutions, which are then dealt with in section 2. Section 3 tackles the issue of Italy and Germany as prototypes of peripheral and core countries and tries to answer the question of which has betrayed Europe. Since the answer to this question is that there have been violations on both sides, the problem then moves from the issue of betrayal to that of the nature of the institutions that have allowed both sides to violate the rules. Section 4 is about the faults of the EMU institutions and the factors underlying the nature of these institutions. The next section indicates the recent innovations in the EMU institutions due to Covid as the implementation of some of the original inspirations of a different conception of the European institutions. Section 6 concludes.

2. THE BIRTH OF EUROPEAN INSTITUTIONS

The foundations of European integration can be traced to issues raised immediately after WWII (Baldwin and Wyplosz, 2006). The central question was political:

“How can Europe avoid another war?”.

It can then be easily understood that the current step of the integration, i.e. the European Economic and Monetary Union (EMU) or Eurozone (EZ), is the result of a non-linear process, much

‘less an economic project than a political one’ (Minkinnen, Patomäki, 2012: 9).

In particular, in the minds of a large part of the European élites it was a step toward European political unification. The euro was considered as a symbol featuring European unity.

After the war, different proposals were suggested. The one which ultimately prevailed was pursuit of some kind of integration, but its nature was far from being clear until the late 1940s.

At the beginning of the Cold War, the US too tried to promote integration between European countries to counter the emerging power of the Soviet Union. However, the US attempt to favour integration received a cold response from a Europe still deeply divided as a consequence of the war. Genuine European economic cooperation only began with the federalist project traced in the Schuman Declaration of 1950, which led to the constitution of the European Coal and Steel Community (ECSC) in 1951.

It strengthened and expanded further with the Treaty of Rome of 1957, which established the European Economic Community (EEC, usually called the European Common Market) and the European Atomic Energy Community (Euratom) between Belgium, France, Germany, Italy, Luxembourg, and the Netherlands (the Six). Thus, political integration started from the economic sphere and remained focused around it for a long time. The favour met by the Common Market and Euratom can be explained in terms of the almost general acceptance in its member countries of the prospect of the further economic gains that could accrue to countries whose economies still needed further growth to solve their problems.

In the beginning, the Common Market was not much more than a customs union, devoted to lowering internal duties and setting a single external tariff for countries and a few specific common policies, notably in agriculture, transport, and antitrust legislation. There was still a push at avoiding conflicts and implementing cooperation, but also reluctance to give up national sovereignty due to the need to more easily control the orientation of policies.

The European policies were inspired, at least initially, by two opposite views that clearly appear if we compare the attitudes taken towards industry, on the one hand, and agriculture, on the other. Free market competition and internal trade were promoted in the industrial sector (through the customs union), whereas a complex protectionist system was created within Europe and between it and the US in the agricultural one to defend agricultural incomes against internal and external, especially US, competition (Common Agriculture Policy). The common denominator of the two views – and a partial explanation of the final choice – was that both required limited super-national coordination to be implemented. This position, expressing a pragmatic approach to integration, also needed two institutions complementary to free circulation of goods: a common transport policy and antitrust legislation.

Thus, the dominant attitude was in favour of free markets, with the exception of agriculture. This can easily be explained on the grounds of the interests of the rising industry, looking for the possibility to exploit scale and scope economies. Political considerations advised for protecting the interests of small peasants, of special relevance for support in some countries.

On a theoretical ground, the pro-market orientation can be justified at least partially by the fact that the concept of both microeconomic and macroeconomic market failures had not penetrated the political sphere and, to a large extent, also the academic circles. Looking at real economic life,

policymakers could see no apparent market failure. The years in which the Common Market was born were in fact years of rapid growth sustained by the post-war recovery – which was fuelled by catching up technologies and emerging entrepreneurship energies – and with a positive trend for the other main macroeconomic goals for nearly all European countries. In fact, inflation was low and unemployment tended to fade, also in its disguised form. The balance of payments was not a problem, as low wages and new technologies promoted exports towards countries external to the Market. When the US aid terminated, it was partly substituted by their direct investment.

This integration also involved acceptance of some international governance in Europe. In fact, European countries were part of the Bretton Woods system. However, even before its collapse, there was a discussion about being relieved of the constraints imposed by the US leadership. France was seeking European monetary unification in order to lessen Europe's dependency on the US policy.

Discussion reached a higher level with a plan for creating an independent monetary union associated with integrated macroeconomic policies, notably fiscal policy. The ambitious Werner plan of 1970 (Werner, 1970) devised a prospect of currency unification, a common fiscal policy and coordination of regional and structural policies, as being ancillary to economic integration. Reducing and then eliminating fluctuations in the exchange rate was based on the idea that trade significantly benefits from fixed exchange rates (now a more controversial issue; see the review by Baldwin and Wyplosz, 2006, and, more recently, the 'post EMU mea culpa' by Glick and Rose, 2016).

Interestingly, at that time coordination of fiscal, regional and some other structural policies, together with a single currency (but not a common central bank, at least in the first instance) were devised. The plan was deemed necessary for coping with the divergences that had been emerging in the performance of the different European countries. In addition, it followed a period of turbulence in foreign exchange markets, rising deficits in the balance of payments of the US and their decision in 1968 to limit gold convertibility of the dollar to Central Banks. The plan – presented in 1970 – was commissioned by the heads of state or government of the Common Market countries, thus with the agreement of France and Germany. It was rejected by the European Council, which only endorsed the prospect of the common currency, largely due to internal political disagreements, mainly by France (partly reflecting the US opposition).

The Marjolin Report (European Communities, 1975), in criticising the Werner report, suggested new designs for common institutions. However, it recognized the need for a relevant budget managed by a central fiscal authority, a social security system ensuring a certain degree of redistribution and a common Unemployment Benefit Fund, as in federal states.

The idea of some common action in the field of fiscal policy surfaced again in 1977, with the MacDougall Report, which recommended a progressive increase in the budget of the European Communities, starting from the level of 5-7% (or 7.5-10%, if defense were included) of GDP also in order to face redistribution between their members. In progress, the level of the federal budget could reach that of the US or the Federal Republic of Germany, to about 20-25%. This recommendation was never implemented.

European cooperation in the monetary field, instead, continued with the creation of the ‘snake’ (1972) and the European Monetary System (EMS) (1979) to stabilise intra-EU exchange rates. After the dollar devaluations, beginning in 1971 and especially after 1973, the system of fixed exchange rates had been abandoned, in practical terms, first, and in statutory terms, later (after the Jamaica accords of 1976). The underlying justification for the need of stabilization was that fixed exchange rates would favour (or force) convergence of wages and prices. In addition, after the dollar devaluation, this was favoured by the US ‘abuse’ of their dominant role in the International Monetary Fund to create excess money and their apparent inability to ensure international monetary stability and later (around the turn of the 1980s) by the Transatlantic tensions (Henning, 1998; Ludlow, 1982; Story, 1988; Story and De Cecco, 1993, cited by Sadeh and Verdun, 2009).

In the early 1980s, a pause in the process of European integration followed. This lasted until 1984, when the Treaty for European Union establishing the European Political Cooperation was agreed upon. This foresaw the Single European Market (SEM) – agreed on in 1986, after the 1985 White Paper on completing the Internal Market – to be implemented by the end of 1992 through the free movement of the factors of production and further market integration as an outcome of elimination of any residual non-tariff barriers (NTBs). This included: open access to public procurement and to all markets by firms being licensed to do business in one-member state; common professional recognition; a minimum of common labor market standards (the ‘Social Chapter’), open access to all markets by firms being licensed to do business in one member state,

common commercial laws, and so on. It also set out new objectives for European action in the areas of the environment, technological research, economic and social cohesion, and health and safety in the workplace. Numerous long-term objectives were confirmed, such as continuing progress towards economic and monetary union and institutional changes, including a shift from unanimous to qualified majority voting in the Council of Ministers. The Treaty mentioned the necessity to exploit

‘the experience acquired in cooperation within the framework of the European Monetary System (EMS) and in developing the ECU’ (article 102a, p. 311),

but did not raise the issue of monetary unification.

The proposal of a single currency was revived in the late 1980s. The French President Mitterrand’s push toward monetary unification seems to have played an important role in this. Later, Germany re-unification convinced the leaders of other countries, notably France and Italy, of the necessity to accelerate the steps for some kind of European integration as a way to keep the new Germany tied to the rest of Europe. The Werner Plan presented in 1970 was set aside and the decision was taken to go ahead with fastening the pre-existing institutions, notably the fixed exchange rate mechanism. According to Gros and Thygesen (1992), there was also the idea that the emergence of imbalances in the current account of some countries derived not only from divergent fiscal policies, but also from different wage and price dynamics. This progressively made the target of fixed exchange rates and monetary integration to prevail over the others devised by the Werner Plan, as a way to correct for the different wage and price dynamics.

Thus, the Maastricht accords, amending again the Treaty of Rome, were agreed upon in December 1991 and were followed by the Maastricht Treaty, signed on February 7, 1992. They heralded the formal birth of the EU and established the future creation of the EMU. As said, at the time of its formal start, January 1, 1999, this had 11 members only (out of the 15 countries composing the EU), that soon after (2001) were joined by Greece.

Simultaneously to the progress of economic integration, there was also a ‘spatial’ evolution of both the EU and the EMU, making its management more complex since the enlargements increased both the number of decision-making centers and the imbalances. Membership of both the EU and the EMU progressively augmented, amounting, respectively, to 28 and 19 countries in 2019. The

UK withdrew from EU in 2020. Various further institutional changes have been implemented since the advent of the Euro, notably those of the Lisbon Treaty, which also contains a clause providing for a member to leave the EU (not the EMU).

In a way similar to the Bretton Woods system, which had the IMF as a coordinating institution and could work only through the US hegemony, monetary institutions emerged in Europe – or, at least, were conceived – as coordinating, albeit imperfect, devices to ensure existence and unicity in the equilibrium. The EMS had the European Commission (actually the Monetary policy committee) as a social planner in its initial phases; but later that role switched *de facto* to the Bundesbank as central bank to the EMS regime.

3. THE EUROPEAN UNION INSTITUTIONS

The EU institutions are largely based on: a common monetary policy, implemented by the ECB, aiming at ensuring price stability; no fiscal union, a very tiny common budget, with fiscal policy delegated to each member country, but with EU limitations to country deficits and debt (under a SGP and a fiscal compact); limited financial assistance, first by the European Financial Stability Facility and then by its successor, the ESM; cancellation not only of tariff, but also of non-tariff barriers, many of which have been levelled out; introduction of a European competition law prohibiting all agreements preventing, restricting or distorting competition; prohibition of abuse of a dominant position and of aid granted to firms by each country; limited common social policy; important common industrial policy in a number of fields in the 1970s and 1980s; a substantial deregulation of the financial sector and a disputable way of arranging the remaining supervisory system of controls that played a key role for the development of the crisis in the EZ, as in the US; an interesting environmental policy based on a ‘cap and trade’ system, the Emissions Trading System, setting caps for emissions and instituting a trade system of permits to pollute.

The logic underlying the EMU institutions has been properly characterised by Andreozzi and Tamborini (2017: 1-2), who say:

“In the end, there is no such a thing as ‘the EMU’, which is just the statistical average of what the single countries are doing. ... Consequently, the blame for failures, and the need for reforms, is mostly placed at the level of single countries, whereas the general institutional setup is kept out of discussion”.

In addition to the faults of specific institutions – such as, e.g., the targets assigned to the ECB – we must address those that derive from the whole institutional architecture and the failure to guarantee coordination in different areas. As an example of these, think of the free movements of factors and goods without complementary rules and action that refer to common public finance and debt. As Stiglitz (2017) points out, free movement of labour, capital and goods without a harmonized system of taxes and expenditures as well as a common debt, distorts allocation and leads to inefficient allocation of production, creating agglomeration and concentration, external effects, both positive and negative. In addition, the Single Market principle for financial institutions and capital can lead to a race to the bottom in financial regulation. Absence of common regulation and of funds for bailing out banks leads to capital flights from countries with lower bailing out capacity.

A further fault of the EU (more specifically, of the EMU) refers to the asymmetries created specifically by the free movements of goods and capital between countries with divergent price dynamics¹ and, then, divergent – and practically untackled – current accounts. The different price dynamics originated net capital outflows from the core to the peripheral countries, where they caused asset bubbles, which reinforced the higher price dynamics in the latter. When the financial crisis spread to Europe, capital was repatriated to the core countries and the states of peripheral countries had to intervene in order to save banks that had lost a part of their funding.

Other faults of the EMU will be dealt with in the next section.

4. ITALY AND GERMANY AS PROTOTYPES OF PERIPHERAL AND CORE COUNTRIES. WHO HAS BETRAYED EUROPE?

4.1 The Rules

In 1998, the Stability and Growth Pact (SGP) was adopted stating that member states were supposed to have budgets in surplus or balance over the medium-term, i.e. over the business cycle. The maximum permissible normal budget deficit as a percentage of GDP in a year was the same as that envisaged in the Maastricht Treaty for admission to the monetary union (3%), with a constraint on public debt of 60% of GDP. The fiscal compact prohibits structural deficits higher

¹ In particular, this was due to the repeated wage cuts implemented by Germany.

than 0.5% of GDP, as measured over the business cycle, and prescribes reductions of the debt/GDP ratio each year by at least 1/20th of the excess over 60%. In addition, the compact prescribes adoption of consistent constitutional rules by each member state.

The Microeconomic Imbalance Procedure (MIP) was devised in 2011 and requires member countries, not only to comply to the prescriptions of the SGP, but also to adjust their current account imbalances, prescribing that current account deficits cannot be higher than 4% of GDP on a 3-year average, whereas the boundary for surpluses is 6%.

4.2 The Faults

On the side of peripheral countries' faults one should first mention the many shortcomings in the conduct of peripheral countries, beginning with Italy's violation of the SGP and the fiscal compact² with frequent higher budget deficits, together with Greece's and other peripheral countries' violation of the same rules. Also the Macroeconomic Imbalance Procedure (MIP) has been violated. These countries tolerated inefficiencies in the public and private sectors – which have not been overcome either before the crisis or, in many cases, later – as well as the interests of the financial and construction sectors in fostering a financial-led growth with soaring asset prices. Obviously, policymakers in these countries did play an important role, in tolerating inefficiencies and the specific interests of those sectors, to the detriment of the interests of the whole system. This is clear if one reflects on the role of self-interested politicians in being elected on the basis of a program of soft budget constraint.

Peripheral countries (most of the GIIPS, i.e., Greece, Ireland, Italy, Portugal and Spain) still think, however, that they may draw some profit from the external constraint of fixed exchange rates (really, now the common money) and from other EMU institutions. They might like reforming some of these institutions, but are not powerful enough to counter German opposition. This helps explain why they have accepted a number of institutional rules.

On the side of core countries' faults, one should recall the violation of the SGP in 2003-2004 by France and Germany. In addition, also the incredible allowance of a higher current account

² The latest case of violation of the deficit and debt rules was in 2019, as the European Commission opened a debt-based Excessive Deficit Procedure (EDP) against Italy for the infringement of the deficit and of the debt rules.

surplus introduced by the MIP has been violated, as Germany and the Netherlands have usually run surpluses of the order of 9 or even 10%³.

It is then clear that the MIP has been tailored to the German and Dutch interests and that these prevail, as in practice even the privileged 6% limit has been disregarded by Germany for many years. As for fiscal policy, the SGP requires budgets in surplus or balanced over the medium-term. This allows countries as Germany to run a surplus for a long time, which makes elimination of imbalances asymmetric and deflationary. The fiscal compact and other EMU institutions have had an additional deflationary impact on each country, thus making it more difficult to raise the revenues needed to comply with the Pact and implying, in turn, an additional deflationary impact on the rest of the Euro-zone.

Then there have been violations of the rules by both sides, that of peripheral countries and the one of core countries. The problem therefore arises as to why these violations have been possible, without receiving effective sanctions. However, in addition to the issue of which side has violated the rules, is the other issue of why asymmetric rules designed to the benefit of core countries have been conceived and to which imbalances they have led. To be true, we have already mentioned the asymmetry of the MIP rules, but also on the side of fiscal rules there are asymmetries. In fact, to the SGP and the fiscal compact, sanctioning fiscal deficits and debts, there are no corresponding rules prohibiting fiscal surpluses.

As said, the EMU institutions have a deflationary bias. This bias can be inferred from the rules governing the ECB as well as from the SGP, the fiscal compact and, most importantly, the MIP (see, e.g., Marani and Altavilla, 2001; Acocella, 2011; Stockhammer and Sotiropoulos, 2014). As to the ECB, it is well known that monetary stability is its overriding goal and the Bank's has always had a very strict practical interpretation of this role (Bibow, 2006) up to the crisis and even later for some years. From a point of view, in the first years of its existence, this conduct can be understood by reflecting on the need of the new bank to create a reputation, which could not have derived only from the inheritance from the Bundesbank. Pending the crisis in 2011 it even overvalued the risks of inflation, moving back to an unjustified deflationary stance. In addition, only lately and with the fierce opposition of the Bundesbank, it faced the financial and sovereign

³ One should also note that the failure in 2003 of the European Council to sanction France and Germany, which – together with Portugal – had violated the SGP could have raised moral hazard out of the decision not to sanction France and Germany.

crisis by means of the same unconventional monetary policies used elsewhere, years after the Fed and other central banks.

In addition to the effects of a monetary policy that tends to be contractionary, also fiscal policy confirms this tendency, as can be inferred from what we said before.

Finally, the existence of untackled asymmetries between different countries, which nourished foreign imbalances, while moderating the deflationary environment in peripheral countries before the crisis (but issuing wrong signals on the state of their economies and reinforcing the asymmetric price trends), translated into a very powerful deflationary bias, due to debt deleveraging after the crisis.

The deflationary rebalancing mechanism imposed on peripheral countries – practically negating or limiting the expansionary role of the public sector in these countries – could have been avoided indirectly, had core countries expanded their public budgets or raised their wages. The cost of not following this option has been very high. It has been estimated to be as high as 47% of the peripheral countries' GDP, if these wanted to eliminate their current account deficits (Stockhammer and Sotiropoulos, 2014). In addition, imposing deflationary macroeconomic policies has reduced both efficiency and equity in the EZ (Fitoussi and Laurent, 2009), weakening the European social model, and has further reduced the ability to face the financial crisis, by limiting the action of automatic stabilizers. In addition, by imposing structural reforms directed at cutting wages and restricting public budgets, the solutions have tended, on the one hand, to cure (some) symptoms of the crisis, not its roots; in fact, imbalances within the EZ depend on both the contractionary demand and wage policies pursued by surplus economies and the structural inefficiencies of peripheral countries, reflecting specifically in their lower productivity growth. On the other side, imposition of supply-side reforms in some case aggravated the crisis, as at a certain point this was due to lack of demand. In the short-medium run the structural reforms advocated by the EMU for peripheral countries, i.e. increasing liberalization in the labour and product markets, can aggravate the crisis, as they act on the side of supply. They not only do not support demand, but reduce it, thus adding to the issues deriving from the interest rate stuck at its Zero-Lower-Bound level (Eggertsson and Mehrotra, 2014; Eggertsson *et al.*, 2016). These policies would also lower potential output (Campos *et al.*, 2018). By contrast, only by boosting demand some structural reforms can be effective (De Grauwe, 2014).

Another shortcoming of the fiscal constraints – keeping deficits at a level lower than 3% (or even at a lower one, in order to fulfil the fiscal compact, in case of a debt higher than the 60% ratio of the GDP) – derives from their limitations of the operation of automatic stabilizers, especially in countries with a strong welfare state (see, e.g., Eichengreen 1997; De Grauwe and Ji, 2015) as those of the Western part of the EU. Similar findings come from an agent-based model: the SGP makes the economy more volatile, raises unemployment and is likely to produce deeper crises and have depressing effects also in the long-run (Dosi *et al.*, 2014). We must however say that, in contrast with these positions, according to Buti and Sapir (1998) the limit of 3% is sufficient to make automatic stabilizers work.

At this point, the roots of the deflationary bias of the EMU institutions and policies must be discussed. These are indeed numerous. One important factor is the pre-eminent role of Germany and its meme against inflation. Also the role of wrong theories predicating expansionary austerity, low or null fiscal multipliers and the like must be stressed. Finally, the importance of vested interests, first in nourishing growth of the financial sector, then in influencing the action of the ECB and finally in choosing policy solutions for the financial crisis and in particular the issue of Greek public deficit and debt.

It is then clear that the asymmetric provisions of the MIP on current accounts, and the fiscal compact have been tailored to the German and Dutch conceptions and interests and that these prevail. As for fiscal policy, the SGP requires budgets in surplus or balanced over the medium-term. This allows countries as Germany to run a surplus for a long time, which makes it difficult elimination of imbalances asymmetric and is deflationary.

A further consequence of this deflationary bias is that fragmentation between the different European countries is thus rising, even if it appears to be repressed, until now.

Relying on punishment, especially by markets, in order to reduce moral hazard and to secure compliance to the rules, has been at the heart of the interventions to cope with the public debt crisis and the route actually followed for fixing EMU institutions, in particular for stiffening the mechanism of the SGP and imposing a ‘bail-in’.

Another value judgment underlying the management of the financial crisis has certainly been not only that debt is equivalent to guilt and that public deficits and debt should be avoided, but also that the burden of adjusting current account imbalances should be left mainly on 'debtor' countries. This, together with the different bargaining power of deficit and surplus countries and vested interests, can easily explain in particular the asymmetric MIP.

Briefly, summing up what we have said hitherto, responsibility for the crisis in the EMU is thus largely attributable to the unsuitable institutions for an area too heterogeneous in terms of economic growth and inflation, in addition to the different orientations and interests among member countries. An area without a federal government and whose only common policy is that of a conservative central bank can face shocks of the kind and size that have hit Europe only at the cost of depression.

5. THE FAULTS OF THE EMU INSTITUTIONS

Within existing institutions, the burden is borne by deficit countries, which are asked to comply with the SGP as well as the fiscal compact, thus implying the risk of accelerating an economic crisis. The institutional implication is evident that the existing rule should be reversed or, at least, made more balanced.

Since the net effect of these constraints may be unclear to some people on a theoretical side (Lindbeck and Niepelt, 2006), the controversy about the benefits and costs of the SGP can only be settled by proper empirical analysis. Most such analyses show an important contribution of automatic stabilizers in the EU, even if of a differing exact amount, due to different definitions and methodology (more recently, Dolls *et al.*, 2014). Results are even accentuated if one considers the counterfactual to automatic stabilizers, i.e. the state of the budget without automatic stabilisers, which can be expressed in a fixed nominal value of expenditures and taxes – or, alternatively, as a ratio to the GDP. If this is the case, empirical analysis shows that the relevance of automatic stabilizers is much higher than the constraint imposed by the SGP (in't Veld *et al.*, 2012). As a matter of fact, in line with the recent empirical evidence (e.g. De Grauwe and Ji, 2013), the SGP austerity policy appears to be self-defeating, as the public debt to GDP ratio has skyrocketed, while under Keynesian fiscal policies it would have remained low and stable.

As a further argument for dropping reference to fiscal deficits, it must be considered that they can only be calculated with reference to structural balances, i.e. cyclically-adjusted budget balance indicators, net of one-off and temporary measures. Assessment of the non-accelerating wage rate of unemployment (NAWRU) is crucial to this end and that requires to calculate structural indicators of the potential growth. Problems derive from the difficulty of measuring potential output accurately, which is necessary to indicate the cyclical budget deviations. Rules of this type can thus be manipulated, or be the object of quarrels, and lack credibility. In addition, the NAWRU, as estimated by the European Commission, is not stable over time and is not independent from the economic cycle. Problems also arise in the estimation of the hysteresis effects, which can lead to different output gaps. The higher this estimation, the higher the structural effect and, then, the lower the need to adjust current imbalances as violating 'fundamental' disequilibria (Cottarelli *et al.*, 2014). Finally, it should be noted that the method leading to the estimation of potential output in Europe leads to its undervaluation with respect to the computation of the IMF and the OECD, who make use of the non-accelerating inflation rate of unemployment (NAIRU). This implies a pro-cyclical effect on structural balances, affecting peripheral countries more than core countries (Fantacone *et al.*, 2015). In addition, it implies an emphasis to be put by countries on structural policies, with a consequent supply-side adjustment. This kind of adjustment, however, can aggravate the demand problems that certainly hit the EZ during the Great Recession and the pandemic and has led to an extension of the fiscal tightening and deflation in the EZ.

The SGP and, even more, the fiscal compact show a bias against public investment, as recognized by the IMF (2014). In fact, cuts in public investment expenditures have been the usual consequence of fiscal consolidation and the attempt to pursue a deficit constraint, due to their greater flexibility.

In addition to what we have said until now about the defects of the EMU, we must now insist on a point that has been mentioned only *en passant* before. Absence of a fiscal union has implied not only a different conduct of the various countries in terms of fiscal deficit or surplus, but has also led to differing tax rules. There are true tax havens in the EU, as many countries have introduced lower tax rates than others. In addition, there are ad hoc tax rebates granted by some countries. In fact, Luxemburg's 'tax rulings' and Irish tax preferences grant a tax treatment even more favourable than the usual one to transnational countries that intend to invest in the country in

question⁴. These are indeed a case of unfair competition, due to the illegal state aid they imply. In 2014, the European Commission requested Luxembourg to provide complete information on its tax rulings practices. At the Luxembourg's refusal, it opened infringement procedures. Similar procedures have been conducted also against Belgium and the Netherlands, finding in all three cases that tax rulings violated the state aid rules. As to Ireland, in August 2016 the European Commission has stated that in the decade 2003-2014 it had granted undue tax credits for a total of 13 bn euros to Apple. In January 2016, the EU Commission has envisaged an 'Anti Tax Avoidance Package' to fight tax avoidance practices. More recently, in 2017 the European Parliament has made plans to clamp down on aggressive tax competition. It has also set up two special committees on tax rulings. At the same time, the EU Council of Ministers has implemented a directive introducing a common framework for the automatic exchange of information about tax rulings and preventive agreements on transfer prices. An inquiry committee has also been set up by the European Parliament to look into the 'Panama papers', a dossier listing about 214,000 offshore corporations and their shareholders, including some that are located in European countries, flying to 'tax holidays' to reduce their tax burden.

The issue must now be discussed of the forces driving away from a different type of institutions, in particular a more balanced one or a federalist one. The latter seemed to be the prospect in the early 1980s. In fact, in February 1984 the European Parliament passed the Spinelli draft of a European Union Treaty. Initially, the opposition came from a Franco-German axis, tending to constitute a guide for the European Union. Soon after the destruction of the Berlin wall, however, a direction different from both the Werner Plan and the Spinelli draft and that of the axis⁵ was impressed, as Germany intended to tie the other countries through a suitable substitute of the Deutsche Mark, the euro⁶. As to fiscal policy, even if divergent fiscal policies could produce current account imbalances, the common (i.e., European) fiscal policy devised in the Werner Plan was not implemented, possibly due to the changes that had intervened in the prevailing economic thought, from a Keynesian to a public choice orientation (as in the Delors Report of 1989), intervened meanwhile (see Kydland and Prescott, 1977), which had spread all around Europe⁷. As

⁴ See Acocella (2022).

⁵ However, this axis was not so solid. In fact, Germany was a federal state with strong regional governments, conceiving the Maastricht Treaty as a set of rules, whereas France had a more centralized government (Brunnermeier *et al.*, 2016).

⁶ According to Galli (2020), the euro has been 'occupied' by the Deutsche Mark and Ordo-liberalism.

⁷ This is one of the reasons why the orientation was accepted by other countries (Gros, 2021).

a substitute for a common fiscal policy, limits to the national policies were introduced, as in the SGP.

6. RECENT INNOVATIONS FOR COVID: INCREASING THE LEVEL OF THE EU BUDGET LEVEL AND RAISING COMMON DEBT

Apart from the interventions of the monetary authorities and macroprudential policy, new credit measures have been introduced at the Community level. As for the ESM, the details of its financial sources were only clarified in early May 2020. On the occasion of the epidemic, it was specified that conditionality relates only to the object of expenditure (medical and health care), and not to the adoption of other measures to reorganize the existing public debt (which has been suspended until the end of 2022), which would otherwise have slowed the use of the Mechanism by heavily indebted countries such as Italy. The loans have a term of ten years and a rate of 0.1% is applied to them. If we consider that the interest rate on Italian 10-year BTPs was 1.83% at the beginning of May 2020, recourse to the ESM became convenient for Italy, as it ensured a lower financing cost of 1.73 % per year. On a loan of up to 36 billion, the savings would be greater than 600 million euros per year (Accademia dei Lincei, 2020)⁸. However, it should also be noted that access to the Mechanism by a country could imply a reduction in its credibility and therefore an increase in the cost of other loans.

The ban on state aid to companies has also been suspended until the end of 2021⁹. The EU Commission can authorize state support for some items.

In addition, the European Investment Bank (EIB) has created guarantee funds for bank loans to companies with an endowment capable of supporting loans for a total of 240 billion euros. Various funds were then set up such as SURE (Support to mitigate Unemployment Risks in an Emergency) and other funds for a total of 540 billion euros to give temporary support to reduce the risk of unemployment in emergency situations and could raise up to 100 billion on the market through a system of guarantees by member countries to finance member countries in difficulty (European Commission, 2020a). In addition, the EIB will set up a pan-European guarantee fund to support

⁸ In November 2021 the yield has lowered to around 1%, but also in this case access to the ESM would be advantageous.

⁹ The apparent generosity of the concession – in the past particularly opposed by Germany – was linked by the media to the fact that German companies have already benefitted from half of the aid measures passed by the European Commission.

European workers and businesses affected by the pandemic crisis, and finally the agreement to channel support through the ESM has been confirmed. In July 2020, the so-called ‘Recovery Fund’ was also defined. It has been renamed ‘Next Generation EU’ (European Commission, 2020b). With this newly created fund, the European Commission intends to raise up to 750 billion on the market¹⁰, giving long-term funds as collateral made available by a (temporary) increase in the European budget 2021-2027 up to 2% of GDP (therefore doubling the current amount of the budget) for a value of 1,100 billion over the seven years, from new direct contributions (for 390 billion) and greater guarantees from member countries¹¹. The funds will be repaid against future budgets, not before 2028 and not after 2058¹².

It should be noted that the disbursement of funds is conditional on the preparation of detailed spending programs and that after the payment of the first 10% the European Commission will exercise controls on the use of funds and on the initiation of reforms.

There are a number of other policies and reforms that could be introduced in the EMU. It would first be desirable to transform part of the national debt into European debt (Eurobonds or similar), to reduce in the various countries the ratio of public debt to GDP, which is particularly high – or destined to become so – in some countries such as Greece and Italy. The advantages of issuing this form of mutualized debt are many. Among them, the lack of dependence on market ratings (i.e., assessments) of the reliability of sovereign debts and their variations, the reduction of spreads for the most indebted countries, which would thus reduce their exposure to the financial market and the possibility of banks using Eurobonds to diversify their portfolios, often burdened with lending to domestic securities.

Further initiatives could concern: 1. the creation of a single European institution to be entrusted with the competences of national institutions, such as the ministries of health, in the event of an

¹⁰ In its essential lines, the Fund follows many of the proposals already suggested by Garicano (2020). The general features of the Fund and the repercussions for Italy are outlined in Romano (2020). Various criticisms have been raised, in particular by Clancy (2020), who points out the relative scarcity of the size of the Fund compared to the initial advances of the President of the European Commission, Ursula Von der Leyen. According to the President’s initial statements, the total recovery effort would have amounted to 2.4 trillion euros, which is obviously an exaggerated value, perhaps deriving from the sum of inconsistent figures. An in-depth analysis of the issue is in Clancy (2020).

¹¹ Gros (2020) had made proposals similar to the content of the Fund under consideration, suggesting to activate Coronabonds or, better, transfers from the EU budget, for example, simply by exempting the weaker countries from their contributions to this budget for the next seven years 2021-2027.

¹² Giavazzi and Tabellini (2020) had already suggested the issuance of very long-term (50 or 100-year) or irredeemable securities, which would not substantially burden the existing public debt countries and could be bought by the ECB.

epidemic involving more than one country; 2. enhanced cooperation, to carry out a European investment project financed with securities and destined to specific investment fields (for example, bio-medical research, transport infrastructures, information technologies, creation of a level-playing field, i.e. equal access to the market, in this case through a level-playing field); 3. a European industrial policy that not only identifies priority sectors in which to invest, but also favours aggregations between European companies, for example in the energy, telecommunications and bio-genetics sectors, strengthening European research platforms useful for innovative medium-sized enterprises and start-ups, on the model of CERN and other trans-European infrastructures; 4. a limitation of short-run capital movements and a common agency to control them; 5. harmonisation of tax rates and rules and a movement towards a true fiscal union.

7. CONCLUSIONS

Both Germany (and other core countries) and Italy (and other peripheral countries) have violated European rules. However, on the top of their faults, the negative performance of the European Monetary Union has to be connected to its deflationary and unbalanced institutions. These were driven away from the federalist route that they seemed to be following in the early 1980s first by a Franco-German axis and then by a decisive German switch towards an Ordo-liberal and tough monetary regime. From this point of view one could say that Germany bears the heavier responsibility for the ruinous performance of the Union. Only recently, due to ... the pandemic, there seem to have arisen a change of direction. The next months will say whether this is lasting or simply the effect of the epidemic, fading away with contagions.

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