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A rearview mirror mentality wrapped in a small-country syndrome
Preventing a historic mistake in designing Europe’s new economic rules

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A year ago, the European Union reached its Hamiltonian moment. The sense of human solidarity in the face of death and the pandemic had pushed European leaders to make unprecedented choices. The heart attack suffered by the economy resulted in a surge in solidarity. To manifest it, European fiscal rules constraining national welfare expenditures were suspended and a sizable and shared financial facility was established through common debt.

The aim was not only to help the most affected countries to overcome the health and economic crisis, but to create structural convergence among all countries. An economically more homogeneous European Union would be more homogeneous politically as well. As a result, the sharing of common resources and the new political harmony would write a new page in European history.

A year later, the European economies are recovering faster than expected. The recession has left behind very high debts, but the sense of emergency is less felt, and Hamilton's spirit is in danger of waning. Next September, the European Union will start debating how to change the rules that regulate its economy. Eventually, the EU institutions and the 27 governments will have to agree on how largely they will use fiscal policies, if they need to pool resources together and share their allocation, or if monetary and fiscal stability are more important than temporary unemployment or chronically low investments. The decision will have an impact well beyond the convergence of the economy. In fact, all political objectives of the European Union – environmental policies, external and internal security, among others – will be affected by decisions on how the money will be spent and how strong the economy will be able to grow. The vision of the future of Europe depends on the design of those new rules, and leaving it only to financial priorities would be a historical mistake.

Past experience bodes badly, showing a distinctive flaw in the European decisions on economic governance. It can be summarized as a rearview mirror mentality wrapped in a small-country syndrome. Countries that are now part of the euro area had their highest inflation levels around 1981, ten years before the Maastricht Treaty was devoted to enforcing price stability through market discipline. The first attempt at establishing fiscal coordination took place, instead, in 1997, again with a ten-year delay after the liberalization of Europe's capital markets and fifteen years after the increase in the real cost of public debts. It was only in 2005 that European economic governance realized that structural reforms (enforcing labor and capital flexibility) were necessary to meet the challenges of the phenomena - globalization and new technologies – that had started ten years earlier.

[1] A version of this paper will be published also by the Brookings Institution.

There seem to be at least two regularities: the first is that rules governing the European economy do not only come late but they stay around for a long time. When the global crisis broke out in 2008, the rules of the past decades remained in place as the only available toolbox: market discipline, monetary dominance, and structural reforms in a context of fiscal straitjackets. The outcome of the policies responding to the euro crisis was unnecessary suffering and persistent stagnation. After the euro crisis, all kinds of flexible adjustments had to be tacitly applied, at the cost of eroding the credibility of European governance. This prevented any common endeavor to design better economic management. In fact, it took a global pandemic to upturn the existing practices and embrace common debt issuance and fiscal support to get out of recessions. However, this exceptional health crisis has made the European policy response also exceptional and not permanent.

The second regularity is that events – and not the battle of ideas, or indeed the battle of prejudices - determine Europe's policy framework. Moreover, not only are those events unrelated to different European economic ideologies (ordoliberalism vs corporatism or others) but most of them are indeed exogenous: inflation was triggered by oil crises in the Middle East; capital markets' influence on the real economy was imported mainly from other countries; so were new technologies and globalization and more recently, financial crises and even the pandemics. Most of those events were not only exogenous but were also largely unexpected by the policymakers who are entrenched in a "small-country syndrome". It is no surprise that European economic governance responded belatedly and with poor outcomes.

The decision to launch a debate on the reform of EU economic governance was thus overdue. However, there is still the risk that the new proposals will keep looking backward rather than forward, focusing mainly on a convenient "policy mix": how much public debts will have to be reduced in relation to the degree of "normalization" of monetary policy. It is indeed sensible to base the new policies on the available empirical data, and the latter is necessarily old water, but too often old mindsets come short of making the right decisions for the unknown future. One example: after the pandemic shock, uncertainty about the future is now being more carefully factored in by firms and households. A more cautionary behavior, in financial issues as well, will become common currency. Against this backdrop, the process of designing economic policies should take into account that private savings are likely to increase although private investment may decline. A connection between private decisions and public investments should become a higher priority than in the past.

The main lesson from the past should be that events that determine Europe's policy responses often come unexpectedly and even more often they come from outside of Europe. Consequently, the first response should be to acknowledge that we know that we do not know. To address the unexpected, Europeans probably need to set up some kind of large rainy-day funds to tackle sudden emergencies. The lack of discretional funds to purchase the Covid vaccines in 2020 was a point in case. A more accurate risk prevention and a forward-looking analytical capacity is at odds with the small-country mentality of most EU member states and should therefore be swiftly brought into being. Discretionary action and strategic thinking can be more than bureaucrats are expected and legitimated to deliver. Consequently, politics must act and not leave the agenda be set by financial priorities only.

Forward-looking analytical capacity is necessary also to unveil the long-term trends that are simply overlooked by time-constrained political cycles. The main neglected factor is probably demography. For 15 years, there have been more Italians aged between 55 and 64 years than those aged between 20 and 29. In demographic trends, Italy, along with Japan, represents the vanguard of the advanced world in which the share of the nonworking population is bound to increase. The impact of an aging population is subject to different interpretations. Some economists muse over the potential positive demand effects, even stoking inflation. Others look at the recent experience and see the opposite: savings propensity increases rather than diminishes and economic stagnation prevails. A correct estimate would change the orientation of monetary policy and, as a consequence, the sustainability of public and private debts. In fact, with a decline of the population estimated around a yearly 0.2%, even a likely modest increase of income per capita would maintain the expectation of better living conditions on average for the population but with a likely polarization between those well-off and the others. It is self-evident that a correct policy response to demography - concerning migration, labor and welfare institutions, as well as family supporting policies – should go well beyond economic policies.

As for the – mostly - exogenous nature of shocks, the EU needs to reflect on its role in the world. Will it remain dependent on other continents for technology and energy? Will it be able to safeguard European values – such as privacy, individual and/or social rights – if it is not able to master the technological frontier? Should it really rely on other states to assure political stability at its borders? Can capital markets, environmental safety or social commitments be more strictly regulated or preserved in Europe without reducing innovation and people's preferences?

Almost inevitably, the world's complex geopolitical landscape is pushing Europe to become more self-reliant. This too affects the design of future economic governance, starting with the relation between savings and investments. Currently, excess savings in the euro area are exported, which pushes growth outside Europe, rather than used inside for common purposes. Recently, general political objectives – such as environmental protection, the improvement of digitalization and the achievement of economic convergence - have been introduced by the European Commission and approved by the national governments. As Marco Buti and George Papacostantinou recently noted,[2] the policy response to the pandemic has brought new instruments (use of grants, new 'own resources', issuance of common debt) and new institutional mechanics (the return of the Community method), as well as a different magnitude of the underlying fiscal effort and liquidity provision, to both national and EU levels. It is the first sign of the fact that Europe is acting more in unison and that intertemporal considerations (sacrifices today to preserve the environment tomorrow) will be relevant for the future rules, introducing more political considerations in the design.

In fact, one can wonder whether the appropriate level of institutional design should be confined within the powers of finance ministries or even within the priorities of economic governance. Defining Europe's role in the world, tackling demographis changes, and disposing of discretionary funds is an eminently political capacity. This new capacity should be the basis of a new political institution. Thus, this is not the time for new economic rules, but rather for new constitutional rules.

[2] https://voxeu.org/article/reshaping-european-economic-integration-post-covid-world