THE EXISTENTIAL DILEMMA OF EUROPE

Peter Bofinger, Jean-Paul Fitoussi, Enrico Giovannini, Joseph Stiglitz[1,2]

SEP Policy Brief No. 8

06 August 2014

Europe seemingly is facing an existential dilemma: the rules of the EU and the Eurozone were established by democratic governments. But now, as new democratic governments get elected, those very rules mean that the views of the electorate are frustrated. Those who see the economic policies of austerity as a disaster and have replaced governments who pursued those policies with new governments promising a new course quickly observe the new governments pursuing essentially the same policies, with minor variants. The governments would like to change course, but their hands are tied: their room for maneuver is constrained. Citizens are rightly beginning to ask: what is the meaning of democracy if elections make so little difference to the things they care most about, the economy, their future, their society? The very legitimacy of democracy is being put into question.

This feeling is fully justified if we look at the aims of the European Union. Article 3 of the Treaty says that "The Union's aim is to promote peace, its values and the well-being of its peoples. The Union shall offer its citizens an area of freedom, security and justice without internal frontiers

1 Respectively, Professor of Monetary Policy and International Economics, University of Würzburg, Germany; Professor of Economics Sciences-Po, Paris and Luiss, Rome; Professor of Economic Statistics, University of Rome, Tor Vergata and Luiss University, Rome; Professor of Economics, Columbia University, USA, Nobel Prize In Economic Science

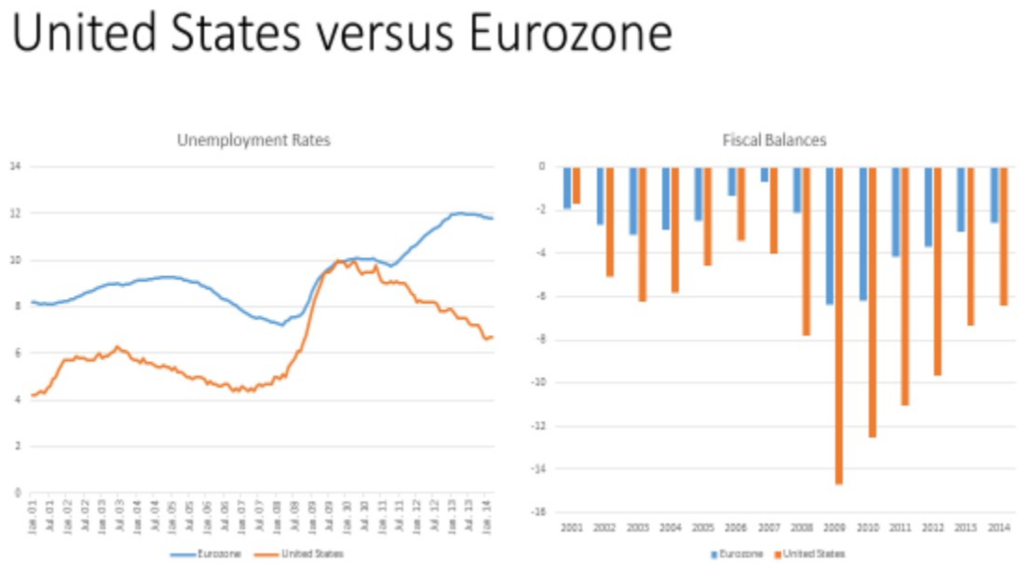
2 Members of the "Council for Growth and Full Employment" established by the French Minister of Economics, France

… It shall work for the sustainable development of Europe based on balanced economic growth

and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance. It shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child. It shall promote economic, social and territorial cohesion and solidarity among Member States".

If this is the framework in which European polices should be carried out, there is something wrong with the current austerity approach, which has failed on most accounts. Above all, in spite of all consolidation efforts public debt in relation to GDP has increased in most countries, mainly due to the recession and its impact on nominal GDP. And people clearly recognize it, feeling that ensuring low deficits and debts and low inflation does not ensure economic prosperity—let alone shared prosperity. The risks this poses for Europe—and the world—should be obvious and are already manifesting themselves.

The current crisis originated in the US, and yet the US seems to have recovered more quickly. In no part of the US does youth unemployment even approaching 50%. In effect, while the United States has reacted with a very stimulating fiscal policy, the response of the Eurozone was relatively weak. As a result, unemployment has now come down in the United States to 6.3 % (although this result is partially due to a reduction in the activity rate) while it is still at a record level in the Eurozone (see Chart). The recent OECD and IMF forecasts clearly indicate that in Europe unemployment will remain unacceptably high for the years to come and that the large internal differentials in growth will persist.



In the current debate the euro and the impediments to adjustment that are associated with it has been the focus of attention. But the real problem goes further: the ambition of the euro was not matched by the institutional reforms necessary to make it work, and the adverse effects were compounded by the strictures of the Eurozone, and the policies that the 3 Eurozone has been pursuing, in compliance with those strictures. It does not need more than a modicum of historical sensitivity to understand that when such binding constraints make the politicians impotent, at the very moment social suffering is fast increasing, some tragedy may be underway. Such a dysfunctionning of democracy may prompt a change in the political regime whose danger should not be underestimated.

Most of the countries of Europe have a lower real per capita income than they did in 2008, and in even the better performing economies, large fractions of the population are seeing a decline in standards of living. Even Germany, widely viewed as the best performing major economy, has been growing at a pace so slow that in any other circumstance, it would be given a failing grade—even worse than Japan since the turn of the century, with its long running malaise,

especially once one takes into account the pace of decline in its working force.

The stability pact and the fiscal compact (now written in the national laws of all members' state of the euro area) impose everywhere a restrictive fiscal policy, forcing governments to decrease public spending, typically in ways that lead to a decrease in social security and in public infrastructure. The citizens of Europe are being given seemingly contradictory messages: the euro, they were told, will lead to an increase in economic performance; at the same time, the euro requires a decrease in standards of living. Some will say: short run sacrifice is required for the long run good. In the long run, the euro will lead to an increase in standards of living, but so far citizens have seen no evidence that this is the case. It is an unproven theory—and on the basis of this unproven theory, the lives of millions are being wrecked. While they may be uncertain whether in the long run the theory will prove out, they are certain that in the long run they will be dead: and unfortunately, for many, the latter will prove a reality before the promises of the euro will be delivered.

Uncertainty in people's lives and lack of trust in institutions are not good for the economy and society. This is why EU needs to jointly look at economic and social sustainability, rebalancing its policies and strengthening the social dimension of the EMU. The evidence of the past few years show that financial and economic instabilities, without appropriate policies, can lead to social and political instabilities, which can be as dangerous even for the economy as turmoil in the financial sector. In the current situation, the only responses left to the countries in crisis are austerity—which we know only brings more unemployment—and "supply side" policies. Whether such policies are appropriate for the long run is not the question: the problem today 4 is demand, and these supply side policies often aggravate the problem of inadequacy of demand.

The results are before our eyes. Different types of capital have been destroyed, not just conventional financial and economic capital, but especially human capital and social capital (including trust). But today, only investments in economic capital are being argued for as a “special case,” to be exempted from the strictures of Europe’s fiscal rules, which seem to look at only one side of a country’s balance sheet, focusing on liabilities without recognizing assets. This is nonsense, especially as we know that human capital is a main driver of growth and social progress, and that without social capital societies and markets cannot work properly. The right policy should be an extraordinary investment in these forms of capital to re-build the economy, just as one would if Europe had been afflicted with a natural disaster like an earthquake. What is needed is to reestablish the capacity of European firms and people to adapt to a fast changing world, to develop the competencies needed for the economy and the society of the XXI century, to make the European economy and society more competitive and dynamic. This effort cannot be left to individual countries; it must be a European common effort and must be perceived as such by European citizens. This would be seen as a clear signal that European and national institutions still believe in the future of the European Union and in the objectives of the Treaty, and that the spirit of solidarity between Member States mentioned in art. 3 still survives.

It is good to encourage national governments to make structural reforms, but European institutions need them as well. Speeding up the development of the banking union, rethinking the role of ECB, including its excessive preoccupation with inflation, revising fiscal rules to allow the rebuilding of capital destroyed by the recession, leaving room for industrial policies, especially essential for those countries within the EU that lag to catch up, strengthening the social dimension of the EMU, strengthening or developing new European instruments to address youth unemployment, to fight against poverty, to manage the social consequences of asymmetric shocks are all ingredients of a new approach for European policies. The European elections may be the wake-up call for national and supranational institutions to change their approach. If they fail to do so, the risks of anti-EU populism, already so evident, will only grow. A change towards a new economic framework would lead to convergence and growth, rather than divergence and unemployment.

Let no one confuse the end of recession with the return to shared prosperity. Europe rightly celebrates the end of the downturn and that somehow, the euro has survived. The economic consequences of the current predicament are severe; but those for the future of European democracy may be even worse.

There is an alternative: closer economic, social and political integration. That will take time, but nothing prevents Europe going far further than it has gone so far. This is quickly becoming a matter of urgency.