“EU’s future and the sovereign option”

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The European economy has been growing at a satisfactory pace and it is close to or about to go back to pre-crisis performance. This is turning attention to the longer term agenda: what is the post crisis Europe going to look like? To address this point one should start from recognizing that over the more recent past Europe has become, for an increasing number of EU citizens, part of the problem after being, for a long time, part of the solution. This is reflected in the surveys about citizens trust in Eu institutions and , more importantly in election outcomes in several member states. What is often referred to as populism can be defined as anti Europeanism. For those of us who believe in the European project this is shocking, yet it is imperative that we recognize that Europe is indeed becoming part of the problem. Conversely, for those who do not share a pro EU approach the solution should be outside the European project and, eventually, in terms of a “sovereign state approach” which implies confrontation rather than cooperation among member states. This, in a nutshell, is the policy dilemma we are facing today.

Since its inception the European project has been driven by the idea that more integration would bring more growth, more jobs, more welfare, and more security. This formula has worked for a long time. Europe has succeeded in setting up a social protection system unparalleled in the world; it has prevented wars and produced decades of peaceful cooperation and welfare. This is no longer the case. Presently, while growth is weakly resuming, unemployment remains elevated in several EU member states. Growth may come back but it is not inclusive and leaves behind large segments of the population. New technologies are an important source of productivity growth but also a cause of job destruction. Welfare systems are becoming increasingly expensive due to ageing populations and unable to secure adequate protection in a context of fast changing labor conditions. Migration is putting under pressure the control of EU borders and, more importantly, is increasingly perceived as a threat to domestic security.

These symptoms of distress and severe difficulty of the European construction have one element in common: the difficulty in identifying convincing and effective European responses and, the rise of national responses instead. National responses that imply less, not more, integration. National responses that exacerbate the contrast between traditional political parties (both Popular and Social Democrats) all in different ways pro Europe, and new “populist” parties and organizations, also in different ways, anti Europe.

In addition to the new domestic divides the emergence of highly vocal ”sovereign” political programs exacerbate areas of disagreement between countries. High debt versus low debt countries, high growth versus low growth countries, countries hosting significant migration inflows versus countries opposing them, net payers versus net receivers. The picture is not new. What is new is that, contrary to the past, the “more integration” approach is not able to overcome national differences and preferences and provide consensus over a collective shared solution.

National preferences have always existed and always will, reflecting healthy national diversities and cultures. The challenge is not to cast aside such differences, but to develop a common European culture that can flourish alongside national cultures and support solutions that include both European and national components.

Let me offer a few examples of how the challenge is developing on some key issues in the EU agenda: banking union, a stabilization function for the Eurozone, the Eu budget, growth and jobs in a digital economy .

The Banking Union is one of the most ambitious projects in history of European integration. Member States agree that banking union is necessary to strengthen the economic and monetary union. However, progress towards the completion of banking union, including its third pillar, a common deposit guarantee scheme, has been uneven and increasingly difficult. It is a good example of the interaction and in some cases of the conflict between the national and the European dimensions in the process of integration. It has taken a specific form and language: the relationship between risk reduction and risk sharing. Risk reduction is about dealing with national sources of risk, such as a high debt (both public and private) and /or excessive accumulation of non performing loans and other risky assets, and it requires domestic policy action such as debt reduction measures but also EU action in the form of e.g. new UE regulation such as implementation of stricter capital requirements. Risk sharing is about recognizing that risks are also system related and require system level (EU level) responses such as a common deposit insurance scheme or a common backstop to the single resolution fund.

So far much progress has been achieved in addressing risk reduction, much less has been achieved in terms of risk sharing. The debate has been characterized by a clear divide. A group of countries has been repeatedly asking for "sufficient" risk reduction (to be implemented by "high risk" countries); another group of countries has been requesting parallel progress in risk reduction and in risk sharing arguing that the two elements would mutually support each other. EU members states have recently adopted additional risk reduction measures (in the so called banking package) while decisions about risk sharing measures (including the "backstop") have been postponed.

The stabilization function. To perform effectively a monetary union needs stabilization mechanisms both at the national and at the Union level. National level instruments include the building up of fiscal buffers (most notably in good times) that can be used in bad times and help prevent negative shocks having excessively adverse impacts on the economy. In addition, debt dynamics should be put on a downward path at a reasonable pace (meaning that the decline of debt should be maximized while avoiding exerting an excessive break on demand). This requires maintaining a high nominal growth rate, a sustained primary surplus and a low risk perception reflected in the interest rate. Italy's "narrow path policy" as implemented over the past legislature is an example of an effectiveapproach. Let me add that a domestic stabilization function should also prevent excessive private debt from accumulating as this, as we have seen during the euro area crisis, can significantly exacerbate fragilities.

So much for the national dimension, what about the European dimension? Absent the exchange rate, experience shows that negative shocks can hit monetary union members significantly through labor markets as well as investment activities. Negative shocks can lead to over adjustment in both areas (employment and capital accumulation) and lead to undesirable impacts on potential growth through hysteresis, with negative consequences for monetary union as a whole. Therefore there is a strong case for stabilization mechanisms to deal with rainy day situations. The objection to such mechanisms is well known. They could lead to a (permanent) transfer union thus exacerbating national divergence rather that promoting convergence, while possibly activating opportunistic behavior. However stabilization mechanisms, such as, for instance, cyclical unemployment insurance schemes, can be designed in ways that avoid permanent transfers while being effective in smoothing shocks. Such mechanisms could well complement national stabilizers schemes while providing other benefits such as supporting the introduction of labor market reforms, as they could mitigate the short term negative impacts of such reforms.

A similar case can be made for investment stabilization tools with respect to public investment which tends to be reduced in times of fiscal consolidation. In the case of public investment the scope for better coordinating national and European instruments is particularly relevant. I can mention two aspects. While a European stabilization tool could fill gaps in resources available for public investment it is the responsibility of national policies to improve and streamline public administration and red tape impediments to public investment, as well as removing other structural impediments to investment (more on this later) . Secondly, EU financed public investment in infrastructure, material and immaterial, can act as a powerful multiplier for private investment .

The stabilization function requires instruments and resources. One option is to introduce a dedicated budget line in the EU budget. Although the amount currently envisaged may be little more than symbolic symbols are important and can contribute to building a common Eu approach. Another element that goes in this direction is the consideration of EU "common goods" such as security, management of common borders, competitiveness and innovation, and cohesion. Resource allocation within the EU budget should prioritize such common goods reflecting the rapidly evolving challenges facing Europe as a whole that require EU in addition to national responses.

A strategy for growth and jobs clearly calls for a dual national/European strategy. Boosting growth requires structural measures at both levels. Potential growth has been declining, especially since the outbreak of the financial crisis and throughout the European Union, although at different rates in different countries. Convergence among countries (and regions) has reversed following the crisis . The decline in productivity growth has been particularly severe in the total factor productivity component, signaling poor performance in innovation related activities. Improving productivity growth among regions and countries requires establishing the conditions for the introduction and diffusion of new technologies, both digital and related to other innovation driven activities. This, in turn, requires reforms at the national level to facilitate investment in material and immaterial capital, improve the business environment , support innovation diffusion and catching up between advanced and lagging regions and companies .

We know, however, that the benefits of reforms usually materialize with a lag with respect to implementation costs, which are felt at the outset of the reform process. This can lead to hesitation in the implementation of reforms or fatigue in keeping the pace of reforms healthy and lively. Evidence also shows that benefits of reforms are larger when implemented in the upswing of the cycle as a growing economy helps mitigate adjustment costs. These facts suggest that there is scope for establishing a link between structural reforms and flexibility in the design of the fiscal adjustment path. Last but not least in an integrated economy such as the EU, reforms in one country (especially if large) can produce positive spillovers in neighboring countries, for instance because of stronger growth. Finally, to the extent that structural reforms increase resilience and flexibility in countries where they are introduced, they facilitate the transmission of monetary policy measures by the ECB, while minimizing the possible differential impact of the monetary policy stance. In short there are good reasons from a Eu perspective to boost structural reforms at the national level.

National reforms efforts are necessary in all countries. No single country can be said to be immune from impediments to investment that require reforms. However there is also need to strengthen the European dimension of the structural agenda, in short revitalize the Single Market in its main components, digital, service, financial, as well as strengthening investment in human capital. A healthy and dynamic single market is needed for the same reasons that were behind its launch decades ago: to exploit scale and scope economies, to boost competition, to eliminate barriers to factor mobility , to provide a large market for digital infrastructure investment. Indeed the digital revolution makes the case for a strong Single market more compelling

Boosting the digital economy as a source of growth implies taking into account the employment consequences, which may be significant in terms of job destruction while not necessarily generating new jobs in amounts and quality sufficient to replace what has been lost.

Europe needs more growth, but growth must be inclusive. If, also as a consequence of digitalization, growth increases inequalities, consensus for reforms and for the European project will decrease, possibly vanish, and national solutions will most likely prevail. Leading to more barriers, less integration and ultimately less growth in a self-defeating vicious circle. Let me add that inclusion enhancing policies go beyond traditional regional cohesion policy. They also deal with issues such as intergenerational and income disparities. Above all they deal with equal opportunities in addition to more equal income and wealth distribution.

The four cases I have discussed: banking union, stabilization, Eu budget, structural and innovation agenda for growth, suggest that performance in Europe can be improved if action at both the national ad the Eu level is implemented. Purely national solutions would underperform and, in some cases generate economic and social dynamics pointing in the direction of increasing fragmentation and disintegration.

Multilevel solutions are the more needed today as new global challenges are facing Europe and the world: trade tensions, large migration pressures, incredibly fast technological change impacting on everyday life styles, possible instability arising from financial innovation. It is difficult to believe that national responses alone can lead to sustainable solutions.

But if multilevel solutions deliver better results why are we witnessing a growing support to national/sovereign solutions instead? The short answer is that multilevel, as opposed to “purely national” solutions, require collective rather than individual approaches. And this, in turn, requires trust. And in Europe trust is in short supply. Trust of citizens in European institutions.

Trust within member states about other member states. Trust of citizens in political elites. Trust takes a long time and hard effort to accumulate. It takes short little time to be destroyed. Trust is accumulated through behavior. Respecting and implementing commonly agreed rules is a basic ingredient to build trust. Only once trust has reached a “reasonable“ level it is possible to reconsider existing rules. Trust accumulation must work both ways. All parties involved must behave by the rules, and be open to changing the rules if there is consensus to do so.

As trust fades away the temptation to ignore rules becomes stronger. Nationalism prevails and trust further weakens. Such a situation can get out of control and become the driver of nationalistic attitudes which become hard to eradicate. This, unless the “EU approach”, which implies more risk sharing and collective solutions, better integrated national policies, prevails and bears results that can be clearly perceived and appreciated by the European citizens.