EUROPE IN IDENTITY CRISIS

The Future of the EU in the Age of Nationalism

edited by **Carlo Altomonte** and **Antonio Villafranca**
introduction by **Giampiero Massolo**

ISPI

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Edited by Carlo Altomonte and Antonio Villafranca
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Introduction

The European Union (EU) was built upon the very principles and values which inspired the creation of the Bretton Woods Institutions The lesson learnt from the atrocities and disruption of the two world conflicts was that liberal norms and Institutions were key to provide peace and prosperity. Indeed, the EU turned out to be a successful "liberal experiment", as it allowed to root out military confrontation among its Member States and prompted an impressive process of economic "catching up" with the US, with growth rates well above 4% in the 1960s and 1970s. It was just a matter of time before EU Member States became some of the wealthiest countries in the world, with the inclusion of four of them in the G7 as evidence of such a resounding result. All throughout the Cold War, and even more after the fall of the Berlin Wall, the message to the world was crystal clear: the well-being of citizens goes hand in hand with the adoption of liberal and multilateral norms, and with the ensuing democratic transition. From Asia to Latin America, the EU regional integration process served as an inspiring case study to analyse and possibly replicate. In the same vein, after the end of the Cold War, Central and Eastern European countries kept knocking on Brussel's door to join the successful EU club of wealthy countries. With an average per capita income of some $26,500 and solid growth prospects, the then-15 EU Member States saw the admission of new members not only as an acceptable but also as a desirable result. Against this backdrop, in 2004 the EU went through its biggest enlargement ever.

Fifteen years later, however, the European picture looks much grimmer. Albania and North Macedonia have been kept in the waiting room, as European leaders – or more exactly some of them (led by France) – decided to postpone yet again the opening of their accession negotiations. Other countries that, in the past, seemed committed to walk all the way to full EU membership, such as Turkey, are now drifting away. In the EU, discontent grows out of a sluggish economy in a context of rising income inequality and regional disparities within Member States. The Eurosceptic sentiment, in the past mainly confined to invoking a change of course in EU policies, is now openly calling for the break-up of the EU itself, for the first time since its creation. Brexit stands as the most serious symptom of a broader trend that is clearly mirrored also in the composition of the EU Parliament after the last elections, when Eurosceptic and nationalist parties gained an unprecedented number of seats. Not to mention any recent national election, with these parties and movements jeopardising traditional political actors.

The longstanding "honeymoon" between citizens and Europe risks being over. Indeed, this is also due to the new and profoundly changed international context. In today's world, liberal democracy is not necessarily seen as a precondition for growth and prosperity. A great power such as China can grab the low-hanging fruits of globalisation without being a democracy, in fact becoming even more sceptical about democratic transition – as the recent developments in Hong Kong remind us. Russia and Turkey are going down the path of illiberal democracy, which is a tempting route also for some EU Member States, especially in Eastern Europe. The very founders of the global multilateral order, the United States, are at the front line in criticising it under the banner of Donald Trump's "America First". As a result, the European Union seems to be losing its reference points, as the principles that upheld its creation are being increasingly questioned around the world and within itself.

In a nutshell, the EU appears to be in an identity crisis. Its chances to survive hinge upon its ability to deliver at home

and abroad, without abandoning its values and principles but rather adapting and relaunching them in the new international context.

To this aim, this book poses some key questions: what are the root causes of today's EU identity crisis? How to carve out a new role for Europe in a world of big players? How to benefit from new partners (e.g. China) without severing ties with traditional allies, especially in a time of trade wars? How to contain Eurosceptic forces within Europe by reducing inequalities and disparities? How to strengthen the common currency with a view to relaunching a more sustainable and balanced growth? This volume addresses these issues while proposing viable options to re-start the EU ability to meet the expectations of its peoples.

To better understand the origins and implications of the EU identity crisis, in the opening chapter Carlo Altomonte and Antonio Villafranca investigate the international shifts that constrain the EU's ability to provide peace and security. They then move to analyse the extent to which the post-crisis environment has hampered growth and cohesion within the single market. They conclude with some policy recommendations derived from the other chapters of this volume.

Ioannis Galariotis and Fabrizio Tassinari further analyse the external dimension of the EU identity crisis and, in particular, its implications for the EU foreign and security policy. The authors elaborate on the concept of "strategic autonomy", as outlined in the 2016 Global Strategy of the EU. To deal with faltering old alliances, unstable neighbourhoods, and new challengers to global stability and multilateral governance, EU Member States need to forge a truly common strategic culture.

The evolution and rationale behind today's trade war between Washington and Beijing are at the core of Niclas Frederic Poitiers' analysis in chapter 3. Specific attention is devoted to the effects of the trade war on the world economy and particularly to the implications of a potential disintegration of the WTO on the EU and its member states. The author suggests

viable options for the EU to secure its own interests in a time when the multilateral approach to trade seems increasingly under attack.

Francesco Saraceno and Jean-Paul Fitoussi shift the spotlight on the internal dimension of the EU identity crisis. The integration of global markets is a double-edged sword: while it lifted hundreds of millions out of poverty around the world, income inequalities and regional disparities emerged as a major threat to the well-being of citizens in Europe and beyond. The resulting discontent is fanning the flames of populist and anti-establishment movements. From taxation to investment in education and healthcare, the authors offer some political options to escape the fate of unequal European societies.

Specific attention is then attached to one of the biggest achievement of the EU integration: the Euro. Lorenzo Codogno analyses the fiscal rules of the Eurozone and stresses the need for a reform which goes beyond today's rigidities while preserving stability and enhancing transparency, equal treatment among countries and communicability to the citizens.

As the editors of this volume put it, the EU is struggling to redefine its identity. To this aim, it needs to acknowledge that a new concept of multilateralism is emerging and that it is no longer limited to a "business between states". The new multilateralism and, therefore, the updated European project can be perceived as credible only if shaped in such a way as to give a broader representation also to the new subjects that have overwhelmingly emerged on the scene: civil society, individuals, large companies, non-governmental organisations.

In redefining its identity, the EU must listen to the different voices coming bottom up, giving everyone the chance to be heard. Only by meeting the needs of its "community" can the EU of today (and tomorrow) successfully address the internal and external challenges it faces.

Giampiero Massolo
ISPI President

1. A Revived EU Identity in the Age of Nationalism

Carlo Altomonte, Antonio Villafranca

Defining the EU's Identity

The set of aims of the European Union is enshrined in article 3 of the Treaty on the European Union. It includes both external aims – global peace, security and human rights protection – and internal goals – a borderless area of freedom, well-being, justice and cohesion. The "core identity" of the EU is therefore strictly related to its ability to deliver both in the domestic and international domains by building upon liberal values and norms.

In the relatively "frozen" world of the Cold War period, peace and security were guaranteed in Europe by the NATO alliance. Growth, well-being and cohesion also depended on the link the European markets maintained with the United States. During the 1970s and 1980s, in fact, the US was at the forefront of technological developments in virtually every field. Via trade, European firms could have access to and imitate US technologies, and through that channel catch-up to the US business model[1]. Not coincidentally, European productivity grew by about 3% a year in the 1970s and 1980s, twice as fast as in the US[2].

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[1] D. Acemoglu, P. Aghion, and F. Zilibotti, "Distance to Frontier, Selection and Economic Growth", *Journal of the European Economic Association*, vol. 4, pp. 37-74, 2006.

[2] A. Sapir et al., *An Agenda for a Growing Europe: Making the EU System Deliver,*

Even in case of economic shocks, which certainly happened during the Cold War (notably the two oil crises of 1974 and 1980), trade and capital links with the US remained in place, along with the EU firms' ability to continue importing technology and productivity, which was preserved out of a shared political interest.

In the post-1989 period, the "Washington consensus" and the ensuing liberal order paved the way for the emergence of an initially symmetric globalisation of economic activities. The latter was associated with a general reduction of conflicts in countries equally participating in the international division of production and the rise of Global Value Chains[3]. Hence, for the EU, adhesion to the multilateral rule-based system was a tool to achieve peace and security, its paramount "external" objectives.

In economic terms, the system of rules developed within the World Trade Organization since 1995 avoided the repetition of trade wars (that degenerated into military wars) and opened up new markets, notably China. The positive supply shock of globalisation induced higher growth rates both in the EU and the US. At the same time, the deflationary nature of the globalisation shock helped tame inflation, allowing both the US Federal Reserve and the newly created European Central Bank to maintain relatively low interest rates.

By participating in this multilateral global order, the EU was able to achieve its main internal objective of growth, and well-being. In fact, a record 16 million jobs were created in the Eurozone between the mid-90s and 2008: employment rose by almost 15%, while unemployment fell to about 7% of the labour force (EU Commission, EMU@10, 2008).

In this context, cohesion was achieved through a significant strengthening of the regional policy in the EU budget since

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Report of an Independent High Level Group established at the initiative of the President of the European Commission, Brussels, July 2003.

[3] M. Morelli and T. Sonno, "On Economic Interdependence and War", *Journal of Economic Literature*, 2017.

the 1999 enlargement, at the expense of agriculture[4]. Results showed a remarkable level of economic convergence across countries in the early 2000s, although with less clear results at the regional level (i.e. within countries)[5].

Such a "balanced" scenario, in which the European Union was able to guarantee its main objectives to a large proportion of its citizens, and thus legitimise its very existence, started to deteriorate with the financial crisis[6]. The latter was partly the outcome of the same international order that helped the EU thrive: the low interest rate environment generated by the globalisation shock was the ideal setting for asset bubbles, especially in the US, and for large current account imbalances within the Eurozone.

And yet, when the bubble burst, generating the largest financial shock since the Great Depression, its early consequences were adequately managed at the world level within the "symmetrical" order that globalisation had created. The G-20 met for the first time at the level of Heads of State and Government in November 2008, agreeing to a synchronised monetary and fiscal policy response that led to a rebound in the world economy starting in mid-2009[7]. Since then, the United States has gone through the longest cycle of expansion in its history, with 126 month of continuous economic growth from June 2009 to December 2019, and no signs of recession on the horizon. China also avoided a recession, an event that the country

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[4] See C. Altomonte and M. Nava, *Economics and Policies of an Enlarged Europe*, Cheltenham and Northampton, Edward Elgar, 2005.

[5] For a broader understanding of regional disparities, see chapter 4 of this volume.

[6] Recall that the ultimate source of legitimacy for the EU is not based on an inter-European Constitutional chart, but on international Treaties signed by individual member States, which "confer" to a supra-national Institutions some powers to act in their own interest, in order to better fulfil their own objectives.

[7] W. Cui and V. Sterk, "The powers and pitfalls of quantitative easing", *VoxEU*, January 2019; F. Bruni, J.S., Serrate, and A. Villafranca, "The quest for global monetary policy coordination", *Economics: The Open-Access, Open-Assessment E-Journal*, vol. 13, no. 5, 2019, pp. 1-16.

has now escaped for more than a quarter century. The fate of Europe, as it is widely known, was different.

The inability of the European institutional framework to deal with what ultimately was an internal balance of payment crisis generated by "sudden stops" in internal capital flows[8] led to the debt crisis in the Euro-periphery, and a "double dip" in the EU growth rate that persisted until 2014[9]. When Europe started to re-emerge from its internally generated turmoil, the picture had dramatically changed with respect to the pre-crisis years, both externally and internally.

At the global level, the continuing rise of China not only as an export powerhouse, but increasingly as a producer of world-class technology, had started to unbalance the symmetry of the global order. When China entered the World Trade Organization in 2001, the country was poor and with a strong competitive advantage in some traditional labour-intensive sectors. China's entry in the WTO was expected to lead to the profound restructuring of some Western industries. However, a) these restructuring costs were expected to be of a short-term and diffused nature; b) it was assumed that the economic consequences induced by Chinese competition would have been more than compensated by the larger market access that developed-nation enterprises would have gained in the country.

By 2014, the evidence began to suggest that the economic consequences of the "China shock" on Western countries were profound, had a relatively long-term nature and were concentrated in specific economic areas[10]. Moreover, the market access that multinationals were gaining in China appeared to be not

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[8] J. Pisani-Ferry and S. Merler, "Sudden stops in the Eurozone", *VOX*, 2 April 2012.

[9] E. Farhi and J. Tirole, "Deadly Embrace: Sovereign and Financial Balance Sheets Doom Loops", *The Review of Economic Studies*, vol. 85, no. 3, 2017, pp. 1781-1823. Note that European QE was launched in January 2015, with the euro area recording negative inflation rates.

[10] D. Autor, D. Dorn, and G. Hanson, "The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade", *Annual Review of Economics*, vol. 8, 2016, pp. 205-240.

only relatively constrained, but also subject to a number of local procedures that entailed a substantial technology transfer to Chinese firms[11].

Within the Western world, the very different recovery paths from the crisis had started to create a cleavage between the EU and the US economic systems: at the end of the crisis, the symmetric globalised world had become asymmetric, with two "nodes", the US and China, gaining higher centrality than others. The EU was born out of post-World War attitudes, values, and ideologies, and in response to the bipolar system. While it was still able to maintain its role within the symmetric, multilateral, ruled-based system at the end of the Cold War, in the post-2008 era it began having trouble defending its external identity.

At the same time, within Europe, the legacy of the financial crisis had dramatically interrupted the convergence process across countries, leading to new divergences and persistent periods of economic hardship, which are hard to reverse under the restrictive fiscal policies pursued by the Euro-area periphery. This put the EU's internal identity under threat.

The latter, combined with the legacy of the Chinese shock that disrupted local industries throughout the continent, led to the emergence of populist/nationalist parties in most countries[12,13]. The result is the emergence of a widespread political narrative of criticism towards the EU within most Member

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[11] Si veda l'indagine dello US Department of Commerce sulle pratiche commerciali cinesi relative al trasferimento tecnologico del 22 marzo 2018. Office of the United States Trade Representative Executive Office of the President, Findings of the Investigation into China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation Under Section 301 of the Trade Act of 1974, 22 March 2018.

[12] I. Colantone and P. Stanig, "The Trade Origins of Economic Nationalism: Import Competition and Voting Behavior in Western Europe", *American Journal of Political Science*, vol. 62, no. 4, 2018, pp. 936-953; L. Guiso et al., "Global Crisis and Populism: the Role of the Euro Zone Institutions", *Economic Policy*, vol. 34, no. 97, January 2019, pp. 95-139.

[13] A. Martinelli, *When Populism Meets Nationalism*, Milan, Ledizioni-ISPI, 2018.

States. The narrative is conditioning the political agenda of mainstream parties and putting to the test the ability of the EU itself to pursue the interests of its Member States[14]. These difficulties fuel further resentment and, in turn, generate an additional deterioration of the EU's ability to deliver on its goals, leading to a vicious circle that is jeopardising the EU's identity and, ultimately, its very existence.

To better understand the origins and implications of this identity crisis, we begin by investigating the international shifts and processes which are constraining and challenging the EU's ability to deliver peace and security, i.e. its external identity. We then move on to analyse the extent to which the post-crisis environment has hampered the achievement of growth and cohesion within the Single Market; that is, the internal identity of the EU. We conclude with some policy prescriptions, as derived from the various chapters that appear in this volume.

Hubs and Spokes: The External Dimension of the Identity Crisis

The post-crisis economic world order remains deeply interconnected by unprecedented levels of financial flows, goods and data. At the same time, however, the world order has grown more asymmetric, with certain countries (notably the United States and China) becoming more central "nodes" of the complex system of exchanges characterising the global economy.

In a symmetric world, these high levels of interconnection might reduce the role of states, and give leeway to non-state and transnational actors, such as MNEs. That was at least the prevailing theoretical view at the end of the Cold War[15].

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[14] The only exception is France, in which *En Marche* explicitly used the EU-cleavage as a defining trait of its policy platform. The success of Emanuel Macron in 2017, however, cannibalized the vote share of other traditional parties.

[15] E.B. Haas, *Beyond the Nation-State: Functionalism and International Organizations,* Stanford University Press, 1964; S. Hoffmann, "Obstinate or Obsolete? The Fate

If the world grows asymmetric, however, deep international flows can be instrumental to power grabs by strong states, especially those that are hubs – rather than "spokes" – in global networks and are institutionally capable and willing to take advantage of their privileged position. To determine the winners of this race to global prominence, both material (e.g. infrastructure, resources) and immaterial assets (e.g. sets of values, guiding principles, know-how) are crucial. In fact, they are both needed to enable and facilitate the transformation of a country into a global "hub": the "Belt and Road Initiative" or China's aim to take the lead in 5G technology and, in the near future, artificial intelligence, are telling examples of this tendency. Power plays in tomorrow's global arena will thus require the ability to remain – or become – a hub for global flows, and to have the institutional setup and set of values necessary to reap the benefits of global interdependence.

In other words, the XXI century's multipolar world does not just look like a world where different poles are continuously in search of a balance of power, but also like one in which some power hubs or "nodes" accrue and entrench power in correspondence with certain countries. This argument underpins the so-called "weaponised interdependence" theory, as defined by Farrell and Newman[16]. In other words, interdependence may be "weaponised" by those countries that can take advantage of it as they host financial, trade, and information hubs and can use them to constrain and coerce other states[17].

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of the Nation-State and the Case of Western Europe", *Daedalus*, vol. 5, no.3, 1966, pp. 862-915; W. Wallace, "Rescue or Retreat? The Nation State in Western Europe. 1945-93", *Political Studies*, vol. 42, no.1, August 1994, pp. 52-76.

[16] H. Farrell and A. Newman, "Weaponized Interdependence: How Global Economic Networks Shape Coercion and Surveillance", *International Security*, forthcoming (Summer 2019).

[17] For a specific discussion on the role of hubs in international trade networks, see L. De Benedictis and L. Tajoli, "The World Trade Network", *The World Economy*, vol. 34, no. 8, 2011, pp. 1417-1454.

States with physical or legal jurisdiction over hub nodes can leverage what Farrell and Newman call "panopticon" and "chokepoint effects". Through panopticon effects the location of a hub in a specific country enables it to extract key information advantages *vis à vis* other states. Chokepoint effects are even more pervasive as they may cut other states off from strategic network flows, be they financial, trade or information flows. Thus, the more states can exert advantages from panopticon and/or chokepoints, the more they can gain power with respect to other states.

The authors test their argument by analysing two substantive areas: financial messaging (i.e. the Society for Worldwide Financial Telecommunication, SWIFT) and the Internet, whose hubs are located in Western countries and, specifically, in the European Union and the US. In particular, SWIFT enables over 6.5 billion messages per year involving over 11,000 financial Institutions in 200 countries. Thus, SWIFT has acquired global dominance in financial payment messaging and, due to its location in Brussels, is regulated by EU law, which considers it as a quasi-utility and demands that it follows an open access model[18]. EU norms have always tried to preserve the independence and non-discriminatory setting of SWIFT, out of which its worldwide dominance ultimately emerged. However, in the aftermath of 11 September 2001, EU leaders allowed the US administration to use SWIFT data to monitor illicit activities in the context of the transatlantic efforts to counter international terrorism. In other words, the US was able to pursue a national security goal by seeking cooperation with its European allies which – at least in regulatory terms – control the SWIFT system. A crystal-clear example of the panopticon effect.

Moreover, the US is now trying to take this tactic a step further, demanding that Iran be cut out of the SWIFT system again – as happened in 2012 within the framework of

[18] European Commission, "Following an undertaking by S.W.I.F.T. to change its membership rules, the European Commission suspends its action for breach of competition rules", Press Release IP/97/870, 13 Oct. 1997", 16 April 2019.

international sanctions. Tehran's isolation from the SWIFT system came to an end only in 2015, with the signing of the Joint Comprehensive Plan of Action (JCPOA) on the Iranian nuclear program. Thus, the US administration had already successfully used the chokepoint effect before the Iranian deal and is trying hard to revive it today. The EU, however, stood by the deal with Iran and resisted Trump's request to reintroduce limitations on Iranian banks' access to SWIFT, while trying to contrast and mitigate secondary sanctions imposed by Washington. Thus, the SWIFT's convenient location in Brussels –under EU jurisdiction – turned out to be a foreign policy tool in the hands of the European Union also *vis à vis* its American ally.

It is also worth noting that the weaponised interdependence and the related asymmetric power distribution in a multipolar context holds true not only for existing hubs – such as SWIFT or the Internet – but also for prospective hubs. It is no coincidence that Russia[19] and China[20] are forcing data network operators to store data in centres located within their territories, with the two-pronged aim of not conceding potential security advantages to foreign powers and using data to guarantee domestic security (e.g. Beijing's use of AI to control the Uyghur minority in Xinjiang). China's attempt to position itself as global leader in the development of 5G technology might hide, according to critics, its intention to become a global hub in this field, and to potentially exploit this position to extract strategic information about other countries (panopticon effect) or to hamper and possibly disrupt digital communication as a retaliatory weapon (chokepoint effect). However, the mere condition of being a hub within a global network does not necessarily make it possible to exploit this position, especially in the context of inconsistent political preferences and options (as it is in the case of Europe's concerns toward the American stance on

[19] Deutsche Welle, "Russia's parliament votes to unplug internet from world", 16 April 2019.
[20] The Diplomat, "China's Cybersecurity Law: What You Need to Know", 1 June 2017.

the SWIFT system as a tool for counterterrorism or sanctions).

Another example is the EU's General Data Protection Regulation (GDPR), which regulates the ways in which private Internet providers can store, use, and transfer EU citizens' data and personal information. Notwithstanding its commendable purpose, one cannot overlook the potential "side-effects" of decreasing the ability of EU Member States to use – if deemed strictly necessary – panoptical effects by forcing Internet providers located in the EU to provide their available data. This is all the more true in a context where such legislation does not exist in other countries, including the US[21]. In other words, the chances for a state to take advantage of its position as a hub do not just depend on the location of and jurisdiction over the hub itself. They also depend on its willingness and ability to do so with its existing institutions, decision-making processes, regulations, social preferences, and values.

This is what we mean by the external dimension of the EU's identity crisis: on the one hand, we have an international system increasingly characterised by two big countries exercising weaponised interdependence, and a number of emerging countries with increasingly assertive and illiberal political systems. On the other, we have the European Union, which lacks state-like prerogatives and powers, and has slow decision-making processes and complex institutions effective only within a rule-based multilateral system of relations.

The surge of populist movements and parties across Europe – not only in Eastern Europe, but also within founding Member States – originated partly from this tension, which puts to the test the EU's ability to achieve the peace and stability goals for which it was created. In particular, the cumbersome, and to a certain extent ineffective, management by the EU institutions of the migration/refugee crisis over the last five years has allowed

[21] In 2013, the US administration reached an agreement with Amazon to host on its cloud data from government intelligence agencies. Today, Washington is considering to diversify the number of contractors to avoid outsourcing data storage to a single private contractor.

populist parties to gain consensus by presenting migration as an exaggerated threat to Europe's societies.

The challenge for the EU is thus to reconfirm its ability to deliver in the current asymmetric multipolar system, in which the US and China are better positioned to extract benefits from their present or future ability to host/manage global hubs. This may ultimately turn asymmetric multipolarism into a new form of bipolarism: a specific international power setting where confrontation and rivalry between the incumbent power (the US) and the emerging one (China) is inherent.

In this scenario the EU, with its current institutional setting, is unlikely to stand on equal footing with Washington and Beijing. At the extreme, imagine a purely hypothetical scenario in which the US administration begins a "Cold War" with China over the next months, asking the EU Member States to side with America as they did against the Soviet Union in the past. Such a request, today, would probably split Member States in two, if not three (considering neutral countries). This would probably put an end to any international political role for the EU, and would turn the Old Continent once again into a battleground for the two new super-powers.

Over the next few years, one of the two key challenges for the EU will be for it to defend and strengthen its external identity as the world slips away from a multilateral rule-based system toward a power-based setting of bilateral relations.

Linking Growth and Cohesion: The Internal Dimension of the Identity Crisis

The internal identity of the EU is defined by its ability to achieve both economic growth and socio-economic cohesion. In the current state of affairs, these dynamics are inevitably affected by economic globalisation and asymmetric multipolarism. On the one hand and as already discussed, globalisation contributes to the emergence of inequalities, both at the territorial level and across societies, due to the sluggish reaction

of welfare systems to international trade shocks[22]. On the other hand, the asymmetric power play currently taking place at the international level also risks hampering internal cohesion within the EU, due to the different exposure of countries to economic ties with China, or other idiosyncratic shocks (e.g. the different economic impact of sanctions against Russia on Member States' exports)[23].

One does then find a correlation between the emerging challenge to the EU's external identity, and its internal one. Still, the biggest challenge to the EU's internal identity does not just stem from a changing world order, but also from the way European institutions are adapting to the post-crisis context. In other words, even if the world order is restored back to the original multipolar system, over the last ten years internal causes have emerged that potentially threaten the EU economic model's ability to deliver growth and cohesion.

This is due to the peculiar policy path the European Union has undertaken in response to the financial crisis. In the early years, i.e. around the Greek crisis of 2010-2011, the emergency measures that the EU institutions had to put in place to shore up the single currency from the risk of dissolving ended up in a hotchpotch of policy measures that worsened inequalities across – and within – Member States.

Monetary policy became expansionary at the end of 2011 with the provision of the 1.1 trillion euro Long-Term Refinancing Operation to banks, but as early as the end of 2012 banks started to repay the three-year loan, with the result that the EU monetary base contracted, after its initial expansion, all the way

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[22] V. Lang and M. Mendes Tavares, *The Distribution of Gains from Globalization*, IMF Working Paper No. 18/54, March 2018.

[23] F. Giumelli, "The Redistributive Impact of Restrictive Measures on EU Members: Winners and Losers from Imposing Sanctions on Russia", *Journal of Common Market Studies*, vol. 55, no. 5, 2017, pp. 1062-1080; G. Felbermayr, C. Fuest, J.K. Gröschl, and D. Stöhlker, *Economic Effects of Brexit on the European Economy*, EconPol Policy Report 4, ifo Institute - Leibniz Institute for Economic Research at the University of Munich, 2017.

through 2014. As at the same time the Federal Reserve was implementing its third round of Quantitative Easing: the combined effect of these two opposing dynamics in the Erozone vs. the US monetary base led to an appreciation of the euro, from around $1.2 in 2012 to around $1.4 in 2014. On the fiscal side, the July 2012 agreement on the setup of the European Stability Mechanism was accompanied with the obligation, embedded in the new Fiscal Compact treaty, of a balanced budget across Member States. This implied a dramatic reversal of the Euro-area fiscal policy, which turned pro-cyclically restrictive until 2014[24]. During that same span of time, supervision authorities started to implement the post-crisis reforms of the banking sector, tightening capital and liquidity requirements for banks: the latter was associated to a contraction of credit to non-financial corporations for the Eurozone, on average, until the end of 2014[25].

Hence, by looking at the Eurozone policy mix between 2012 and 2014, one would note the contemporaneous effects of a restriction of the monetary base, an appreciation of the exchange rate, fiscal austerity, and a contraction in bank credit. No wonder that the Eurozone was in deflation by the end of 2014, with stagnating growth rates, and large output gaps in the peripheral countries that bore the brunt of the fiscal adjustment.

The outcome of this quagmire was not only a stagnating (or even shrinking, in 2013) real GDP per capita in the Eurozone, but also, for the first time since two decades, a divergence of its levels across Member States[26]. Since the peak of the debt crisis the EU policy mix has improved, mainly thanks to the actions

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[24] In other words, the euro-area fiscal policy became restrictive at the same time in which economic growth was running below potential. See chapter 5 of this Report.

[25] The Fourth Capital Requirement Directive entered into force on 17 July 2013: this transposed into EU law the latest global standards on bank capital adequacy commonly known as Basel III.

[26] Based on Eurostat data, the coefficient of variation (the dispersion) of GDP per capita steadily decreased across Euro area members since the mid-90s, but this trend has stopped after 2013.

of the European Central Bank. The Asset Purchase Program, as well as the targeted long-term refinancing operations, restored appropriate liquidity conditions in the money markets, paved the way for a devaluation of the euro, and fostered the provision of credit to the corporate sector. Inflation rebounded as a result, and growth rates resumed between 1 and 2 per cent, on average, after2014, with an increase in the average GDP per capita across the Eurozone. However, the dispersion in per capita terms across Member States has not abated.

Note that the latter does not mean that business cycles have diverged in the Eurozone; on the contrary, we have ample evidence that growth rates have synchronised across countries in the Eurozone thanks to the workings of the Single Market and the monetary union[27]. However, along with this synchronisation the EU has not acquired the ability to cope with idiosyncratic shocks that might hit individual countries, setting them on a divergent course with respect to the rest of the Member States. In other words, the current institutional context seems to be crystallising the disparities across countries that emerged at the time of the crisis. This puts into jeopardy the objective of cohesion at the EU level, and hence its internal identity.

In the Eurozone, in fact, only around 25% of national shocks are smoothed through the Single Market, while this figure is up to more than 80% for individual states in the US. Here, labour and capital mobility, credit markets, and fiscal transfers, in this order of importance, all operate to mitigate negative shocks[28]. In the EU, instead, cross-country factor mobility is structurally more limited than in the US, fiscal transfers are ruled out, while

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[27] To quote from Mario Draghi's speech, "Stabilisation policies in a monetary union", of 1 October 2019: "Multiple studies find that business cycle synchronisation in the euro area has risen since 1999. A substantial share of the variation in GDP growth across euro area countries can now be explained by a common factor that is not shared with other G7 economies. Overall, growth dispersion among euro area countries is now at the same low level as among US states – and roughly half the level before the crisis".

[28] M. Buti, J. Leandro, and P. Nikolov, "Smoothing economic shocks in the Eurozone: The untapped potential of the financial union", *VoxEU*, August 2016.

credit markets are still fragmented across national lines, especially after the crisis[29].

Hence, even if economic cycles in the EU are actually converging, the ability to cope with idiosyncratic shocks is much lower, and disparities persist or risk worsening. This is due to another unpleasant characteristic of the EU market, namely the fact that Member States are still different not only in terms of industrial structures, but also in local credit markets and public finances. The latter entails that even a common shock (e.g. a global recession) could have very different consequences from one Member State to the next.

In particular, the southern EU periphery is especially sensitive to market pressures compared to the core of the Eurozone. The lack of room to manoeuvre at the central level makes it very difficult to smooth out the local, more acute consequences of shocks. In addition, the current set of rules on fiscal policy might even end up producing a pro-cyclical contractionary adjustment, worsening the initial outcome to the point of having a self-fulfilling crisis, even where a crisis was not necessarily expected in the first place[30]. This is the epitome of the current EU internal identity crisis.

In principle, a large part of the solution to this problem is in the hands of Member States, to the extent that they could agree on forms of risk sharing across the Eurozone, or on a common fiscal capacity aimed at demand stabilisation. Indeed, in recent years the EU has hammered out reform plans based on new processes, rules and institutional changes[31]. But these plans do not take into full account what the above-mentioned vicious cycle brought to light: a profound EU identity crisis which is

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[29] Again from Mario Draghi "Stabilisation policies in a monetary union" speech: "Cross-border banking M&A activity within the euro area is currently at historical lows".

[30] P. De Grauwe and Y. Li, "Self-Fulfilling crises in the Eurozone: An empirical test", *Journal of International Money and Finance*, vol. 34, 2013, pp. 15-36.

[31] European Commission, *The Five Presidents' Report: Completing Europe's Economic and Monetary Union*, June 2015.

caused not only by the functioning of EU institutions, but also by the current and future effectiveness of EU policies, by the policy preferences of its citizens, and by its set of values and guiding principles.

Some answers to the current internal identity crisis of the EU can certainly come from major institutional reforms, but they alone cannot solve the EU's legitimacy crisis that has been brought about and reinforced by the emergence of populist movements. As James A. Caporaso clearly puts it "when preferences of member states diverge, institutions may prove to be of little help"[32].

Conclusions: Handling the EU Identity Crisis

In this volume we put together a number of contributions to investigate key aspects of the European identity crises, both external and internal. At the same time, we offer policy options to revive the EU identity by restoring legitimacy and credibility in the eyes of its citizens and the rest of the world.

When it comes to the challenge of enhancing the EU external dimension, a crucial aspect revolves around the idea of achieving an EU strategic autonomy, possibly in line with the 2016 Global Strategy. The EU should find the courage to walk new paths if it is to effectively deal with the unpredictability of its old allies, as well as its unstable neighbourhood in a global context which is growing increasingly asymmetric. To this end, EU Member States need to forge a truly common strategic culture, move to a greater degree of defence autonomy from the US (while avoiding the implosion of the Nato), and carefully ponder all the pros and cons of cooperation with new partners such as China.

[32] J. Caporaso, "Europe's Triple Crisis and the Uneven Role of Institutions: the Euro, Refugees and Brexit", *Journal of Common Market Studies*, vol. 56, no. 6, 2018, pp. 1345-1361.

This holds true also for the EU response to the current trade war between Washington and Beijing. In particular, the EU needs to carefully weigh up the potential impact and consequences of the impasse of the WTO after the decision of the US to block new appointments to its appellate body. The EU has already stepped up its efforts to strike new bilateral trade deals and signed agreements on alternative dispute settlement systems with Canada and Norway. These initiatives are welcome for the time being as they may partially fill the void left by the WTO. However, any "strategic" EU response should take into serious account (some) legitimate requests by the US for a fairer level playing field in the global economic and technological competition, while avoiding a stand-off with China. The strategic EU response may also encompass some concessions by the EU to her own global partners, especially in the area of a greater market access to agricultural products.

More generally, the EU needs to set its own strategyto revamp multilateral cooperation and relaunch dialogue both across the Atlantic and within the G7/G20 summits and beyond. In a nutshell, the EU should keep defending multilateralism and its own liberal identity. But in doing so, it should not be naïve: all in all, time does not seem to be on the EU's side. While relaunching multilateralism and inclusive governance of global hubs should remain its lodestar, Europe should also find a way to deal effectively with the consequences of the "weaponised interdependence" and growing economic inequalities, which are triggering mounting opposition against liberal objectives within the EU itself. Its inability to deliver at home may hamper its ability to defend and enhance liberal values abroad. This is one more reason to link the external dimension of the EU crisis to the internal one.

Indeed, the rise of nationalism and euroscepticism is by far the biggest internal challenge to the EU's future, with income inequalities and regional disparities as major root causes of such threats. They are strictly related to the dynamics of global economy over the last decades and – at least partially – to the

EU fiscal and economic policies. A more redistributive taxation policy and some leeway in public spending (especially in education and healthcare) could all be instrumental to relaunching socio-economic cohesion. Since these are not strictly EU competences, the latter policies require a stricter coordination at the member states' level even through the mechanism of the enhanced cooperation.

Such measures should go hand in hand and be consistent with those strengthening one of the biggest achievements of EU integration: the Euro. This is key to escape the fate of a new global crisis threatening the very existence of the single currency and the EU as a whole.

In principle, preventing episodes of disordered sovereign defaults in the euro periphery is in the very interest of core Eurozone countries given the high degree of economic interdependence within the area. By the same token, it is in their interest to avoid a scenario where the rise of eurosceptic parties on the euro periphery calls into question the very existence of the common currency. Core EU countries, however, are not immune from the rise of populist/nationalist movements either. As nationalism and euroscepticism grow in these countries as well, they push traditional parties towards harder stances, albeit in the opposite direction than populists and nationalists from southern Europe: instead of asking to ease Brussels' "technocratic grip", they demand EU rules to be rigorously followed and/or strengthened for the sake of economic and monetary stability. At the present time, thus, any further step in the direction of more risk-sharing between Eurozone countries – including proposals for a common EU budget to counter asymmetric shocks – advance at a snail's pace. To break the impasse between austerity and stability on the one hand, and public investment and growth on the other, the fiscal rules of the Eurozone need to move beyond their current rigidity and address key questions in terms of transparency, equal treatment among countries and communicability to the citizenry.

In this vein, the recent proposals put forward by the European Fiscal Board seem to be gathering some consensus. They include the possibility of getting rid of the deficit rule by relying on a medium-term debt ceiling and on a limit on net primary expenditure growth, while granting more room for public investment to national governments.

This volume suggests a few ingredients of the recipe to overcome today's EU identity crisis. To be sure, this is not to say that the key ingredient of the EU identity – its liberal values and norms – should be removed from the recipe. On the contrary, it still needs to be abundantly used to better deliver on both the external and internal aims of the EU: peace, security, economic, well-being, justice, and cohesion.

2. The EU and the World: Tuning To Be Heard

Ioannis Galariotis, Fabrizio Tassinari

In the rapidly changing environment both within the European Union (EU) and outside its border, several factors have proven to be major challenges to the EU's external action. Among others, these include the rise of populism in EU Member States, the ongoing migration/refugee crisis, instability near the EU's borders, Russia's geopolitical activism and revisionist policy, Turkey's aspiration to become a regional power autonomous from Western institutions, the foreign policy implications of the ongoing Brexit negotiations, and a decline in transatlantic cooperation. With these facts in mind, it is fair to ask what the EU's response should be to a world that has fundamentally changed and is continuously being transformed.

On 28 June 2016, the High Representative of the Union for Foreign Affairs and Security Policy Federica Mogherini presented the "The Global Strategy for the European Union's Foreign and Security Policy" (EUGS) to the European Council. The EUGS' main objective is to articulate and sustain a coherent vision for the external action of the EU. As such, it sheds some light on the matter of the EU's strategy in world affairs, its effectiveness, the variables affecting it, and Europe's reaction to them, particularly as regards the emergence of a "strategic autonomy" as the means to pursue Europe's goals.

This chapter attempts to provide an assessment of the first three years of the EUGS by examining the EU's relations with

its major partners. We discuss the concept of strategic autonomy and how the EU's relations with its partners contribute to this debate. In doing so, we first provide a brief overview of the EUGS and discuss what "strategic autonomy" entails. We then examine the relationship between the EU and the United States (US) in the context of NATO. We continue our analysis with EU-Russian relations, current EU-Turkish relationship, EU-China cooperation and the outlook of the Western Balkans in joining the EU. We conclude by examining Italy's foreign policy agenda towards the EU security and defence policy and the development of a European strategic autonomy.

The EU's Global Strategy: A Brief Overview

The EUGS is a brave attempt to assemble and analyse numerous dimensions of the EU's external action in one document[1]. This exercise is not an easy task, but it is a very ambitious one. Conceivably, the key feature of this document is that "for the first time ever an EU document lists our vital interests (which is a breakthrough in its own right)"[2]. It comprises four main building blocks that are closely interrelated: a) a global strategy to promote EU's citizens' interests, b) the principles guiding the EU's external action, c) the priorities of the EU's external action and d) strategies to transform "words" (i.e. the vision) into "deeds" (i.e. the action).

Anyone reading the EUGS could draw a number of conclusions[3]. In her foreword, HR Federica Mogherini strikes a tone that highlights the complexity of the document and the

[1] H. Dijkstra, "Introduction: One-and-a-half Cheers for the EU Global Strategy", *Contemporary Security Policy*, vol. 37, no. 3, pp. 369-373.
[2] S. Biscop, "The EU Global Strategy: Realpolitik with European Characteristics", Security Policy Brief, Egmont Royal Institute for International Relations, no.75, June 2016, p. 2.
[3] N. Tocci, "The Making of the EU Global Strategy", *Contemporary Security Policy*, vol. 37, no. 3, 2016, pp. 461-472.

challenges it faces in adopting an overarching approach to the EU's sometimes conflicting internal agenda:

"Global" is not just intended in a geographical sense: it also refers to the wide array of policies and instruments the Strategy promotes. It focuses on military capabilities and anti-terrorism as much as on job opportunities, inclusive societies and human rights. It deals with peace-building and the resilience of States and societies, in and around Europe. The European Union has always prided itself on its soft power – and it will keep doing so, because we are the best in this field. However, the idea that Europe is an exclusively "civilian power" does not do justice to an evolving reality. For instance, the European Union currently deploys seventeen military and civilian operations, with thousands of men and women serving under the European flag for peace and security – our own security, and our partners'. For Europe, soft and hard power go hand in hand[4].

Critics point out that it is one of several EU documents that aim to strike an internal balance while lacking substantial policy orientation. But, as Biscop suggests, "it is the strategy now. Therefore the question is not what it could have said that it doesn't, but whether it gives us something to work with to render EU foreign and security policy more effective". As Biscop continues, "the answer is: yes, and quite a lot"[5]. More than that, the foreign and security policy priorities laid out in the EUGS encompass a broad range of the EU's external action. This sends a message to the many Euro-sceptical pundits who believe that the EU has nothing to show in the foreign policy realm[6].

The EUGS is clear about the priorities of the EU's external action. The core argument is that security starts at home[7]. This

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[4] European External Action Service, *Shared Vision, Common Action: A Stronger Europe: A Global Strategy for the European Union's Foreign and Security Policy*, 2016, p. 4.

[5] S. Biscop (2016), p. 1.

[6] M.K.D. Cross, "The EU Global Strategy and Diplomacy", *Contemporary Security Policy*, vol. 37, no. 3, 2016, pp. 402-413.

[7] External Action Service, Shared Vision, Common Action: A Stronger Europe:

entails that it is imperative for the Union to deal with terrorism, hybrid treats, the volatility of global markets, climate change and the challenges for energy security. In doing so, the EUGS explicitly calls for an appropriate level of strategic autonomy as the main foundation upon which the Union can build the conditions to foster peace and promote security. Therefore, the Union needs to invest in collective security by strengthening its links with its partners, especially NATO. At the same time, the EUGS argues that the Union's enlargement policy is necessary for the Union to grow, whereas a more concrete approach should be followed to address migration and consolidate regional resilience[8]. The EU can pursue the peaceful settlement of international and regional disputes by promoting political and socio-economic stabilisation in unstable regions such as the Middle East, Libya, Syria, Africa and the Mediterranean[9]. Overall, the above-mentioned goals and perspectives can be accomplished via a multilateral approach to global governance. As the EUGS characteristically points out: "Without global norms and the means to enforce them, peace and security, prosperity and democracy – our vital interests – are at risk"[10].

The Concept of Strategic Autonomy: What Does It Mean and Why Does It Matter?

"Strategic autonomy" seems to have emerged as the "holy grail" of the EU's approach to world affairs. In the scholarly literature – but also among European leaders, policy-makers and

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A Global Strategy for the European Union's Foreign and Security Policy, EUGS, 2016, p. 9.

[8] W. Wagner and R. Anholt, "Resilience as the EU Global Strategy's New Leitmotif: Pragmatic, Problematic or Promising?", *Contemporary Security Policy*, vol. 37, no. 3, pp. 414-430.

[9] M. Smith, "Implementing the Global Strategy where it Matters Most: The EU's Credibility Deficit and the European Neighbourhood", *Contemporary Security Policy*, vol. 3, no. 3, 2016, pp. 446-460.

[10] EUGS (2016), p. 39.

practitioners – the term originated as a reaction to tectonic shifts in the US approach to Europe and their repercussions on defence and security. Likewise, as evidenced in numerous declarations and documents, the quest for EU autonomy has recently paved the way for a better understanding of the EU's self-perception in foreign affairs and, more importantly, what the EU wants to achieve beyond its borders[11]. As Mogherini bluntly puts it in her foreword in the EUGS text: "The Strategy nurtures the ambition of strategic autonomy for the European Union. This is necessary to promote the common interests of our citizens, as well as our principles and values"[12].

However, there is considerable confusion regarding the scope of this term: sometimes, as Fiott explicitly says, it goes beyond security and defence and "calls for greater 'European sovereignty' apply to economic and foreign policy, too"[13]. Most of the time, however the concept is more narrowly applied to EU defence and security policy goals, and is explicitly associated with the development of an autonomous European defence industry. As stated in the EUGS: "a sustainable, innovative and competitive European defence industry is essential for Europe's strategic autonomy and for a credible CSDP"[14]. Barbara Lippert, Nicolai von Ondarza, and Volker Perthes provide a broader and more normative definition of strategic autonomy "as the ability to set one's own priorities and make one's own decisions in matters of foreign policy and security, together with the institutional, political and material wherewithal to carry these through – in cooperation with third parties, or if need be alone"[15].

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[11] D. Fiott, *Strategic Autonomy: Towards 'European Sovereignty' in Defence?*, Policy Brief, European Union Institute for Security Studies, November 2018.
[12] EUGS (2016), p. 4.
[13] D. Fiott (2018), p. 2.
[14] EUGS (2016), p. 46.
[15] B. Lippert, N. Von Ondarza, and V. Perthes, (eds.), *European Strategic Autonomy: Actors, Issues, Conflicts of Interests*, SWP Research Paper 4, March 2019, Berlin, 2019, p. 6.

There are three main constraints on the EU's ability to conceptualise, formulate and orchestrate a coherent strategy on autonomy: a) deficiencies in the overall strategy of the EU regarding foreign, defence and security policies; b) the diverging national interests of the EU Member States and c) the absence of 'true' EU capabilities to complement or replace the waning appetite of the United States to continue to ensure Europe's security through NATO[16]. It is evident that despite the key institutional developments since the adoption of the Lisbon Treaty, the intergovernmental nature of the CFSP and CSDP continues to be the rule rather than the exception. This has hindered the adoption of a single European foreign and security policy, which has in turn constrained the development of strategic autonomy. Additionally, the diverging nature of the national interests of EU Member States reinforces a political context in which a truly strategic autonomy cannot emerge[17]. For many observers, the most important constraint on the EU's ability to create the conditions for strategic autonomy is its continuing dependence on the US, although several EU Member States would disagree. Initiatives such as the establishment of the Permanent Structured Cooperation (PESCO) in December 2017 and Macron's European Intervention Initiative in June 2018 point to stronger cooperation in the defence field in Europe. But they also belie a high degree of fragmentation in EU security and defence policy[18]. One can conclude that "the EU is not yet able to move towards a higher level of autonomy in security and defence, but the Union is displaying greater responsibility for its security and defence and it is hedging against strategic uncertainties"[19].

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[16] A. Billon-Galland and A. Thomson, *European Strategic Autonomy: Stop Talking, Start Planning*, European Defence Policy Brief, European Leadership Network, May 2018.

[17] F. Tassinari and S. Tetzlaff, *European Security post-Merkel: Denmark should urge Franco-German Coordination on EU Defence*, DIIS Policy Brief, November 2018.

[18] B.O. Knutsen, "European Defence Research in Crisis? The Way Towards Strategic Autonomy", *Global Affairs*, vol. 2, no. 3, 2016, pp. 287-295.

[19] D. Fiott (2018), p. 1.

Dealing with the Major Partners: The EU Response in World Affairs

The objectives set out in the EUGS can be translated into specific actions for the EU to accomplish in world affairs. Below, we examine and assess the relations and strategic priorities of the EU with its major partners in the global political arena. We begin our analysis with the EU's most important partner, the US, and continue with Russia, Turkey, China and the Western Balkans.

EU-NATO relations and the transatlantic enigma

Despite recent misgivings, strong cooperation with the US within the NATO framework is a crucial goal for the EU[20]. As the EUGS stresses, the EU will invest in a solid transatlantic partnership in order to reinforce resilience and address conflicts as part of its broader goal to promote and consolidate global governance[21]. The EUGS builds upon this and highlights the need for the development of a European strategic autonomy within the context of EU-NATO cooperation. As the EUGS' authors characteristically write, "in this context, the EU needs to be strengthened as a security community: European security and defence efforts should enable the EU to act autonomously while also contributing to and undertaking actions in cooperation with NATO. A more credible European defence is essential also for the sake of a healthy transatlantic partnership with the United States"[22].

For the EU, undoubtedly, the US remains the most significant partner not only in the sphere of security and defence, but also for its broader economic and political implications. Notwithstanding the rocky state of relations under the current

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[20] S. Biscop, (2016b) "All or Nothing? The EU Global Strategy and Defence Policy After the Brexit", *Contemporary Security Policy*, vol. 37, no. 3, pp. 431-445. S. Biscop, "All or Nothing? The EU Global Strategy and Defence Policy After the Brexit", *Contemporary Security Policy*, vol. 37, no. 3, 2016b, pp. 431-445.

[21] EUGS (2016), pp. 36 and 37. EUGS (2016), pp. 36 and 37.

[22] Ibid., p. 20.

US administration, the European External Action Service (EEAS) explicitly defines the EU-US partnership as constructed on a solid foundation of common values, including the rule of law, democracy, respect for human rights and alleviation of global poverty[23]. The two partners account for more than 50% of the global GDP and their economic interdependence is significant, with bilateral relations comprising the largest trade volume in the world. Both partners contribute close to 80% of global development assistance[24].

In the security and defence realm, the EU-US bond is increasingly defined in narrow, interest-based terms. When shared interests are at stake, both entities are supportive of each other or at least work closely to solve global challenges. However, in the last two decades, there is evidence of growing divergence regarding transatlantic security mutual understanding and joint actions[25], coupled with a gradual US disengagement from the European theatre.

The complexity of EU-US cooperation in security and defence impacts the perspectives of the development of a European strategic autonomy. Whether within EU Member States or in international fora, the debate about strategic autonomy "has come in response to recent US criticism of the EU"[26]. Consequently, it typically turns reactive: on the impact of strategic autonomy on the transatlantic relationship and on the need for differentiation from the US[27], rather than on the necessity for an autonomous European actor in defence and security[28]. How far Europe can go without the US and espe-

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[23] European External Action Service, The United States and the EU, 6 September 2017.

[24] Ibid.

[25] M. Smith, "Transatlantic Security Relations since the European Security Strategy: What Role for the EU in its Pursuit of Strategic Autonomy?", *Journal of European Integration*, vol. 40, no. 5, 2018, pp. 605-620.

[26] U. Franke and T. Varma, *Independence Play: Europe's Pursuit of Strategic Autonomy*, European Council on Foreign Relations, July 2018, p. 3.

[27] A. Billon-Galland and A. Thomson (2018).

[28] U. Franke and T. Varma (2018), p. 3.

cially the binding context of NATO becomes a matter of its willingness to be prepared for some controversy and political disputes with the US[29].

Plainly, President Trump has sent mixed signals concerning the development of a European strategic autonomy. On the one hand, he sticks to an 'America first' doctrine conducted independently of international partners, while delivering withering criticism of the unwillingness of European NATO members to increase defence spending to the agreed-upon benchmark of 2% of GDP. In such a context, an autonomous EU in the field of security could find room for development without the restrictive commitments of the NATO framework. On the other hand, the US defence establishment remains sceptical of providing the conditions to allow Europe to become an autonomous security power given the US interests that are at stake in Europe, such as US access to European bases[30].

In a strategic environment where the US is no longer willing or able to play the role of global hegemon, the rise of the EU would mark a momentous change both for the future of the EU as a global security actor and the strengthening of the transatlantic cooperation[31]. Yet, at present, its record both in terms of normative legitimacy and actual achievements remains mixed. Undoubtedly, "Europe needs strategic autonomy in the policy area of defence. This sort of autonomy is crucial because it opens the door to the creation of an autonomous EU defence industry. But, this is not apparently an easy task due to the close dependence of European defence key technologies on the US. The solution is more cooperation at the EU level, but always with a balance with the US"[32].

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[29] B. Lippert, N. Von Ondarza, and V. Perthes (2019).

[30] Ibid.

[31] J. Howorth, "Strategic Autonomy and EU-NATO Cooperation: Threat or Opportunity for Transatlantic Defence Relations?", *Journal of European Integration*, vol. 40, no. 5, pp. 523-537.

[32] I. Galariotis, *The Role of National Parliaments in EU Defence Cooperation*, Policy Brief, School of Transnational Governance, European University Institute, Issue

The EU-Russia relations

The EU-Russian relations have been in flux over the past decade. Traditionally, the EU has regarded Russia as a geopolitical rival with a revisionist approach aimed at fundamentally altering the *status quo* in the wider region of Eurasia[33]. Russia had an alternative geopolitical project in the common periphery throughout the 2000s, when it refused to join the European Neighbourhood Policy project. In addition, the Strategic Partnership with the EU has been effectively frozen since 2007, when the two parties were supposed to but failed to renegotiate a Partnership and Cooperation Agreement (PCA)[34]. At the same time, though, Russia has always been a 'strategic partner' within EU political circles. The interdependence of the two entities, sealed by Europe's gas dependence on Russia, remains unchanged. In fact, it is likely to rise in years to come as EU demand for gas is expected to grow, and alternative providers are nowhere in sight[35]. Russia's annexation of Crimea in 2014 marked a turning point that led to a substantial deterioration in the relationship between the two entities.

The EUGS stresses the importance of Russia's compliance with international democratic norms as a key strategic challenge for the European security order[36]. As one of the world's main upholders of human rights, the EU is very critical of Moscow's record. As stated in the EUGS document,

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2019/04, June 2019, p. 6.

[33] I. Galariotis, *Powering Europe. Russia, Ukraine, and the Energy Squeeze*, in *Europe-Asia Studies*, vol. 68, no. 8, 2016, pp. 1463-1464 (book review).

[34] M. Emerson, F. Tassinari, and M. Vahl, *A New Agreement between the EU and Russia: Why, What and When*, CEPS Policy Brief, no. 103, May 2006, Centre for European Policy Studies.

[35] R. Kandiyoti, *Powering Europe. Russia, Ukraine, and the Energy Squeeze*, New York, NY & Basingstoke, Palgrave Macmillan, 2015.

[36] M. Mälksoo, "From the ESS to the EU Global Strategy: External Policy, Internal Purpose", *Contemporary Security Policy*, vol. 37, no. 3, pp. 374-388.

> […] peace and stability in Europe are no longer a given. Russia's violation of international law and the destabilization of Ukraine, on top of protracted conflicts in the wider Black Sea region, have challenged the European security order at its core. The EU will stand united in upholding international law, democracy, human rights, cooperation and each country's right to choose its future freely[37].

In contrast to this critical EU tone, the EUGS recognises that the relations between the two entities are strongly interdependent and that they have to work together in areas where their interests overlap. In March 2016, EU ministers of foreign affairs and the High Representative Federica Mogherini agreed on five guiding principles for the EU-Russian relations: "full implementation of the Minsk agreements; closer ties with Russia's former Soviet neighbours; strengthening EU resilience to Russian threats; selective engagement with Russia on certain issues such as counter-terrorism; and support for people-to-people contacts"[38]. Cooperation should be also strengthened in numerous policy areas including climate change, maritime security, education and research, and cross-border assistance. In the last three years, the EU has done exactly what the EUGS suggests: namely, a two-track approach in its Russia policy. Therefore, on the one hand, it has imposed several restrictive measures on Russia due to its violations of international law (mainly for the case of the annexation of Crimea). On the other, the EU has figured out how to further develop its political and economic bonds with Russia through the consolidation of the Partnership and Cooperation Agreement (PCA) in crucial areas such as energy, education, science and technology, justice and freedom, and trade. In addition, the EU has worked very closely the last three years to enhance its multidimensional approach to resilience in Ukraine. This has been mainly accomplished through major financial support to Ukraine to consolidate a robust

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[37] EUGS (2016), p. 33.

[38] M. Russell, *The EU's Russia policy: Five guiding principles*, European Parliamentary Research Service, European Parliament, PE 614.698, February 2018, p. 1.

reform process, including fighting corruption, developing the public administration sector and the judiciary, and strengthening civil society[39].

When it comes to its strategic autonomy, the EU is interested in reinforcing its relations with the countries of the Eastern Partnership. Moscow sees these developments more as threats to its own aspirations of regional hegemony than as a framework of cooperation between it and the EU. In this respect, in a zero-sum logic, the fractures that appeared in the transatlantic relationship after President Trump took office are being seen as an opportunity for Russia to shape a multipolar world order based on the influence of major powers (such as China, Russia and the US, and the EU as well). Additionally, Russia is more interested in collaborating with individual EU Member States than with the Union as a whole; therefore, the consolidation of EU strategic autonomy has importance for Russia only in the sense of detaching the EU from the US[40]. For the EU, the enhancement of European strategic autonomy as an antidote to Russia's assertive policy will only come if EU Member States effectively work together towards the development of an independent EU defence policy. Yet, this would be a difficult task because profound differences among EU Member States on how to deal with Russia will persist.

The EU-Turkish Conundrum

Turkey's longstanding hopes for EU accession have faded over the last decade, especially after the advent of the economic crisis in Europe. Turkey is no longer attracted to a Union experiencing deep socio-political and economic crises. At the same time, Europe does not want a new member state that may create more problems than it solves. One would argue that Turkey's prospects for EU accession were always questionable given substantial

[39] European External Action Service, The European Union's Global Strategy: Three Years On, Looking Forward, EUGS, 2019.

[40] B. Lippert, N. Von Ondarza, and V. Perthes (2019).

concerns from several powerful EU Member States, such as Germany and France, regarding Turkish integration in the EU family of states. The fraught relationship between the EU and Turkey has been significantly complicated by the 2015 migration crisis and President Recep Tayyip Erdogan's aspiration to transform Turkey into a regional power in the wider Eurasian region.

The EUGS does not mince words when it comes the EU's Turkey policy. The basic proposition is that under the framework of the current EU enlargement policy, the EU seeks to stabilise and consolidate the resilience of the Turkish economy and society. This could be achieved through a strict conditionality approach that aims to reform and transform the internal political landscape in Turkey based on the rule of law and the norms of democratisation. In addition, the strategic challenge for the EU is to promote economic convergence and good neighbourly relations with Turkey, together with cooperation in sectors such as migration, energy security, terrorism, and organised crime[41].

Three years after the presentation of the EUGS, the EU positively evaluates its existing cooperation with Turkey. The EU evaluation of the EUGS states: "The EU has successfully cooperated with Turkey on preserving multilateralism and addressing common challenges in areas such as migration, counterterrorism, energy, transport, economy and trade"[42]. It continues by stating that considerable improvements have been made in the realm of foreign policy between the EU and Turkey regarding "issues of common interest, notably Syria, Iraq, Iran, the Middle East Peace Process, Libya and the Gulf"[43], which is quite surprising since Turkey's EU accession perspectives have come to a standstill, as confirmed in the 2019 EU progress report[44]. At the time of writing, the ongoing Turkish military incursion in the Kurdish-populated areas of Northern Syria has further strained the faltering relations.

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[41] EUGS (2016), p. 24.
[42] EUGS (2019), p. 18.
[43] Ibid.
[44] European Commission, *Turkey 2019*, Report, Brussels, 29 May 2019.

Strengthening European strategic autonomy will create fundamental challenges to Turkey's aspirations to become a regional power with a different geopolitical agenda from that of the EU in the common EU-Turkish neighbourhood. Turkey would not welcome a strong EU that could contain Turkey's strategy and influence in the wider geographical region of Eurasia. Erdogan's anti-Western sentiments are clear evidence on this. However, one would consider that Turkey's case is considerably complex given the national security concerns within Turkey regarding the Kurdish question. The challenge for the EU is to transform its policy of transactionalism towards Turkey (see, for instance, the agreements between the EU and Turkey the last two years for the migration crisis) in such a way as to allow Turkey to accept and comply with the EU rules-based order[45]. But, this has to be done carefully taking into account the specificities of Turkey's case and based on the 'sensitive' relations between the two entities, especially in the last decade (see, for instance, Müftüler-Baç's argument for an External Differentiated Integration approach)[46]. This would help the EU on its path towards strategic autonomy, since Turkey would become a cooperative partner in combating common problems such as immigration and terrorism.

The EU-China partnership

The relations between the EU and China have grown substantially in recent decades. Although there was very little trade between the two as recently as twenty years ago, they have now established a multi-billion dollar commercial partnership[47]. Diplomatic and political ties between the EU and China have

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[45] M. Pierini, *Options for the EU-Turkey Relationship*, Carnegie Europe, 2019.

[46] M. Müftüler-Baç, "Turkey and the European Union: External Differentiated Integration or a Transactional Relationship?", Paper prepared for the EUSA Conference, 9-11 May 2019, Denver, Colorado.

[47] J. Howorth, "EU Global Strategy in a Changing World: Brussels' Approach to the Emerging Powers", *Contemporary Security Policy*, vol. 37, no. 3, 2016, pp. 389-401.

also strengthened significantly. There are summits taking place on an annual basis, regular ministerial meetings and an extensive sectoral dialogue aiming to strengthen the bond between the two entities[48].

At the same time, the EU acknowledges the challenges that arise from China's penetration in numerous international economic spheres (as evidenced by the lengthy debate within the EU regarding the diffusion of Chinese 5G equipment in various EU Member States)[49] and the difficulties that are evident within the EU Member States in welcoming a model that is based on principles that contrast with the EU one (consider, for instance, the "cautiousness" with which the EU faces the reception of the memoranda of understanding under the Belt and Road Initiative as well as the 17+1 framework between China and several Central and Eastern European Countries). For this reason, the EU attempts to arrive at "a flexible and pragmatic whole-of-EU approach enabling a principled defence of interests and values" considering China as a strategic competitor[50].

The EUGS is purely strategic when it comes to the EU position towards China by highlighting the need to create coherent trade and investment ties, "seeking a level playing field, appropriate intellectual property rights protection, greater cooperation on high-end technology, and dialogue on economic reform, human rights and climate action"[51]. More than that, the EUGS asks for the deepening of the EU's economic diplomacy in the wider region of Asia, "working towards ambitious free trade agreements with strategic partners such as Japan and India, as well as ASEAN member states, with the goal of an eventual EU-ASEAN agreement"[52]. Considering the latter, it

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[48] European External Action Service, EU-China Relations Factsheet, Brussels, 18 October 2019.

[49] G. Grieger, *5G in the EU and Chinese telecoms suppliers*, European Parliamentary Research Service, European Parliament, PE 637.912, April 2019.

[50] European Commission, EU-China: A Strategic Outlook, 12 March 2019, p. 1.

[51] EUGS (2016), pp. 37 and 38.

[52] EUGS (2016), p. 38.

is fair to point out that the EU's pivotal engagement in the region of Asia would create an atmosphere of severe antagonism between the EU and China challenging the EU's attempts to cooperate with China[53].

Three years after the announcement of the EUGS, we have seen the EU enhance its partnerships in Asia and reach trade agreements with Japan, Vietnam and Singapore. At the same time, and despite the aforementioned concerns, the comprehensive strategic partnership with China has been updated to reflect the EU-China 2020 Strategic Agenda for Cooperation. This does not come as a surprise, since the EU considers China a source of economic growth and an important market for Europeans who want to invest in China and Chinese businesses seeking to transfer capital to Europe[54]. However, one should not disregard the implications of the US-China trade war on how the EU will attempt to defend the norms and principles of the liberal international order and, consequently, how the EU will formulate a strategy concerning EU-Chinese relations in the years to come. Apparently, the impact of the trade war between the US and China has already hit the EU since the global growth prospects have been diminished with an effect on fragile economies such as the ones in the EU[55]. It remains to be seen whether the EU will keep a cautious yet constructive approach towards China or will become more critical putting in danger the collaboration between the two entities[56].

China would like to see the EU become an autonomous actor in global politics across the board, and in this respect it

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[53] X. Chen, *The EU's "Pivot to Asia" Will Increase Competition with Beijing*", ISPI Commentary, Italian Institute for International Political Studies (ISPI), 27 September 2019.

[54] EUGS (2019).

[55] R. Basedow, "The US-China trade war: Risks and opportunities for the EU and the United Kingdom", LSE EUROPP Blog, 2019.

[56] N. Casarini, *US-China Trade War: Why the EU Should Take Sides and Favour the Rules-Based Order*, IAI Commentaries, Istituto Affari Internazionali (IAI), 19/47, July 2019.

would welcome any EU progress towards strategic autonomy[57]. Obviously, this would be convenient for China only if there are no negative repercussions for it. The appointment by China of a special envoy for the first time in the history of EU-China diplomatic relations is a strong sign that China would like to follow a more engaged and 'strategy-driven' approach towards the EU. For such an approach to succeed, the EU should expand its China policy beyond the merely economic sphere, and pursue a foreign policy strategy that assumes that China can be important partner and contributor to global security and peace in unstable regions.

The EU and the Western Balkans' European perspective

The strategic priorities of the EU towards the Western Balkans focus on a "credible accession process grounded in strict and fair conditionality" in order to reinforce the resilience of the region's countries[58]. The EU's commitment to improving its relations with the countries of the Western Balkans and to continue working with them until they join the EU family was fully re-affirmed in the 2018 European Commission's "Strategy for the Western Balkans"[59]. However, the recent veto from a few EU Member States on the EU accession perspective of North Macedonia and Albania in October 2019 created a negative '"throwback" in the wider strategy of the EU towards the Western Balkans. One possible implication would be the end of North Macedonia's pro-EU government. Another risk is that the Serbia-Kosovo peace process could take a dangerous turn[60].

Seen in this light, the EUGS is too complacent in assessing the future of the relations between the EU and the Western

[57] B. Lippert, N. Von Ondarza, and V. Perthes (2019).
[58] EUGS (2016), p. 9.
[59] European Commission, A credible enlargement perspective for and enhanced EU engagement with the Western Balkans, Brussels, 6 February 2018.
[60] A. Rettman and E. Zalan, "Macron warned on danger of Balkans veto", *EUObserver*, 17 October 2019.

Balkans. The EU considers the geographical region of the Western Balkans as "an integral part of the EU's own regional space" and this is fundamental for the European accession perspectives of all regional counties[61]. For instance, key examples of the current developments in the region concern

> the historic Prespa Agreement between Greece and North Macedonia, the ambitious reform agendas such as the unprecedented judicial reform in Albania, the increased cooperation through resilience-building measures on security and counter-radicalization, and the regional roaming agreement signed by all Western Balkans governments[62].

The development of EU strategic autonomy would be a game changer in the consolidation of the European perspective of the countries of the Western Balkans. One key reason is that these countries could rely on the EU to face security challenges typically originating from the East. In this respect, these countries are now more than ever in favour of the evolution of the EU as coherent security actor in Europe's close neighbourhood. The key premise for this to take place is that the EU resolves its continuing ambiguity over enlargement, which at present fundamentally undermines the credibility of its position. Despite internal political constraints within most EU Member States, the EU should not follow buy into the "enlargement fatigue" hypothesis, but instead offer official membership to the countries of the Western Balkans. This would be a crucial step towards the consolidation of EU strategic autonomy, encompassing the geographic region of the Western Balkans in its sphere of influence.

[61] EUGS (2019), p.17.
[62] Ibid.

The Italian Position, at Home and Abroad

While a comprehensive review of Italy's foreign and security policy is beyond the scope of the present chapter, it is evident that each of the policy and geographical areas discussed here have repercussions and consequences on Italy's own standing and positions. This is on account of both domestic and external factors. At home, Italy has displayed and in some cases anticipated some of the same disruptive trends witnessed in other European and Western countries: slow growth, rising Euroscepticism and anti-migrant sentiments across the political spectrum, as well as the mainstreaming of so-called populist forces, which have inevitably had a knock-on effect on foreign policy views in the country.

Abroad, the bedrock of Italian foreign policy, which has traditionally rested on pro-EU and Atlanticist pillars, has been shaken to its core in light of ongoing European introspection and of the absence of a reliable partner in the US. On the European front, and notwithstanding Rome's substantial contribution to the conceptualisation of the EUGS, Italy has assumed a more critical posture on a variety of European dossiers. The need for EU "reform" has become the code word for questioning key positions, from Eurozone governance to migration policy. On transatlantic relations, Italy remains a trustworthy partner of the US, mitigated by a traditionally deferent position towards Russia. It has also been explicitly open to China's advances in Europe, first and foremost in relation to Beijing's Belt and Road Initiative.

In this context, the ongoing discussion on strategic autonomy assumes particularly interesting connotations. Italy has consistently been a strong supporter of the need to develop European defence capabilities and interests. It has strongly supported the development of Permanent Structured Cooperation as well as parallel initiatives, such as the French-led European Intervention Initiative, which Rome officially joined in September 2019 with a view to strengthen interoperability and

strategic "anticipation". As such, the more disruptive underpinnings of "strategic autonomy", particularly as seen in the French interpretation of the concept and as regards the diminished role of NATO in European security, displays "Gaulliste" instincts that are likely to be unpalatable for Rome. This is not only for the thinly-veiled anti-American implications of the concept, but perhaps also in view of the recent spats between Rome and Paris as regards other key dossiers from industrial policy to migration and to the support key Italian figures have given to the *gilets jaunes* movement. Yet, Italy has displayed remarkable dynamism in developing what effectively amounts to a "multi-vector" approach to strategic partnerships. Moreover, while the constraints illustrated in this chapter limit Italy's room for manoeuvre, Rome is right to focus on developments in its geopolitical sphere of influence, as demonstrated by its continuing engagement in Libya and by its recent overtures to the North Macedonian government in the wake of the EU accession rejection.

In recent months, foreign policy headlines in Italy have understandably concentrated on problematic cases such as Russia and its presumed meddling with individual Italian parties and policy makers, yet it is striking how much, Italian foreign policy is characterised by continuity rather than change, especially in light of the momentous changes of the previous years at home and abroad. Ongoing domestic instability means that Rome is unlikely to take the lead in most of the dossiers described in this paper, let alone develop a grand strategy for them. Yet it displays a remarkable resilience of the underlying values and interests guiding European foreign policy.

Conclusions: Towards an Enhanced EU Strategic Autonomy?

The above analysis provides encouraging signs that the EU, three years after the announcement of the EUGS, has managed to reach some of its objectives regarding its relations with

several partners in different policy areas. This is remarkable, since the relations of the EU with its major partners, i.e. the US, Russia, Turkey, China and the countries from the Western Balkans, were not an ideal starting point.

Yet, one aspect that is considerably difficult to ascertain is how far Europe can go in developing a broader strategic autonomy framework that can help the Union to act as a coherent and efficient actor in world affairs. The underlying question is whether the EU Member States, despite their internal divisions in several policy areas, are willing to formulate and forge a truly joint strategic culture for the Union as a whole. The way forward towards an enhanced EU strategic autonomy should have the following characteristics with regard to the EU's main partners:

- In a narrow sense, the EU should follow an independent path in the realm of defence policy detached from the US. This strategy would reinforce its goal towards the development of a strategic autonomy for the Union and will stabilize the EU's relations with relevant partners such as Russia and Turkey.
- Less fragmentation or a more coordinated approach of Europe's often polyphonic positions is a necessary condition for numerous policy areas, so that the EU speaks with one voice and acts with one body in world affairs. This was admirably displayed in the October 2019 official visit of President Macron to China, where he was accompanied by German business leaders, a German minister and other EU officials.

Which leads to:

- The approach of the EU to China should go beyond a deterministic economic framework. China is a powerful player in world affairs and the EU needs to establish a broader cooperative scheme with China in the foreign policy realm in order to jointly face common security problems and consolidate multilateralism globally.

- Turkey should be seen as a major partner that could still reorient itself towards the Union through mutual efforts to take on international challenges ranging from migration to organized terrorism, climate change and human rights' violations. A similar strategy could be articulated for Russia, despite the long-lasting fraught relationship between the two entities.
- The enlargement strategy of the EU should continue being the major transformative process towards democratisation and stabilisation in the countries of the Western Balkans. The countries of the Western Balkans should be given an unequivocal signal from Brussels, even as some EU Member States would like to revise its enlargement policy.

3. Multilateralism in Crisis: The EU's Response To Trade Wars

Niclas Frederic Poitiers

Over 36 million jobs in the European Union depend directly or indirectly on extra-EU trade[1]. The world trading system is based on the World Trade Organisation (WTO) framework. Since its inception as the General Agreement on Tariffs and Trade (GATT) in the post-World War II era, the scope of this multilateral set of rules that govern world trade has expanded greatly, and now covers 164 countries. The 1986 to 1995 Uruguay round of negotiations in particular advanced the framework considerably. This round of trade negotiations, which introduced the WTO as a successor to the GATT, not only extended the framework of the GATT, but also considerably advanced the dispute settlement system, which gave the world trade organisation teeth.

Under the WTO's Most Favoured Nation (MFN) rule, members cannot discriminate in tariff rates between countries, and the "national treatment" rule implies that governments cannot treat foreign companies differently from local ones. The WTO framework allows countries to set up comprehensive free trade agreements to set tariffs lower than the MFN tariff they apply to any WTO member and to align non-tariff trade impediments.

* I am greatful for the comments from Antonio Villafranca and Marta Domínguez-Jiménez.

[1] A.F. Amores et al., *EU Exports to the World: Effects on Employment*, Publications Office of the European Union, 2018.

As WTO reform has stalled since the early 2000s, bilateral trade deals have become increasingly important. As a

> reaction to the lack of progress in further developing the WTO, the EU has signed a vast number of free trade agreements now covering roughly a third of EU exports. However, some major economies are still missing, including Europe's two largest trading partners: the US and China.

Not only do WTO rules govern trade between countries, but the WTO has also established a system that determines how disputes on these rules are settled. In case that a country violates a WTO rule or a provision in a trade agreement, other countries can use the WTO dispute settlement body to contest this violation and obtain the right to retaliate through punitive tariffs. An integral part of the dispute settlement body is the appellate body, where decisions made by the ad-hoc dispute settlement panels can be appealed against. The WTO rules solve the "prisoner's dilemma" of foreign trade, where every country has the incentive of applying tariffs in order to improve its terms of trade. Together with the dispute settlement, this increases international trade and gives foreign investors certainty for their investments.

This multilateral rules-based system seems to be unravelling. The US, which initially championed this international system, seems to perceive that the WTO is at an impasse and that it can better advance its economic interests in a more power-based post-WTO system. The WTO had been paralysed by its principle of unanimity, which rendered significant reform nearly impossible. The problems of the WTO became apparent after the accession of China in 2001. In order to be accepted into the WTO, China agreed to open its markets to foreign companies, and the expectation was that its system would gradually converge to that of market economies. This hope has not been fulfilled. China today still has the status of a developing country in the WTO, even though it is one of the three largest economies in the world and has a GDP per capita roughly equal to that of

Turkey or Bulgaria. This gives China considerably more time to implement commitments taken under the WTO. While China has conducted some reforms in order to get approval for its WTO accession, it lags behind when it comes to forced technology transfers, joint venture requirements, and access to public procurement. In fact, the official justifications behind US tariffs on China are claims of violations of American intellectual property rights and forced technology transfers.

In the last years, due to its rapid economic growth, China is increasingly seen by the US as a systemic rival. After the election of President Trump, who ran on a protectionist platform, this rivalry has escalated into a full-blown trade war. This has major implications for the EU, which has to balance its policy between an ally that increasingly acts unilaterally and the non-market, totalitarian Chinese regime. The U.S. has not only started a trade war with its geopolitical rival China, but also introduced tariffs against some of its allies that are arguably incompatible with WTO rules, while undermining the dispute settlement body by blocking appointments to the appellate body. This has led to the fear that the WTO might disintegrate. We might very soon live in a post-WTO world, which has large repercussions for the EU, its economic policy and its geopolitical interests.

European countries differ in terms of their trade openness. Some countries, such as Germany or the Netherlands, are highly integrated in international trade. Large shares of their exports go to the US and China, whereas other countries are much more closed in their economic structure. However, the economic integration of the EU is very deep, and even though some countries might have limited direct trade with China, they are integrated into the supply chains of companies that export through Germany or the Netherlands, or are indirectly affected through the common currency and demand for tourism services from these countries.

Strikingly, the pattern of economic indicators among European countries has reversed over the last year. The economic

powerhouse of the last decade, Germany, is dependent on exports of its goods to a growing Chinese economy, and thus is at risk of a recession, whereas southern European countries that are much less integrated into the world economy are now reaping the benefits of reforms undertaken during the crisis. In this chapter, we will explore how the trade war unfolded, and what a disintegration of the WTO would imply for Europe and European economies. The chapter ends with a discussion on what the EU should do to protect is commercial interests in an increasingly difficult international environment.

Multilateralism in Crisis

International trade is now governed to a vast extent by the WTO, which replaced the GATT in the Uruguay round of trade negotiations. The GATT and later the WTO were largely supported by the US, which was the only global superpower left after the end of the Cold War. However, given as the WTO now has 164 members, its system of unanimous decision making has proven to be a major obstacle to any reform. The Doha round of global trade negotiations, which commenced in 2001, is largely considered to be a failure and much-needed reforms have not materialised since. This has become particularly problematic with the rise of China, which was accepted into the WTO in 2001. China has conducted a variety of reforms in order to access the WTO, but its economic system is still based on subsidised state-owned enterprises and features many impediments to foreign investment. The status of China as a "developing economy", which gives it longer time spans to implement commitments under the WTO, has particularly sparked the ire of the US.

After the WTO appellate body issued an adverbial ruling in 2002 that held that the US foreign sales corporation tax program was providing illegal subsidies, the US began to criticise the procedure of this body. The US administration under Trump has since 2017 blocked new appointments to it. With

increasing opposition from the world's largest economy, the multilateral system of trade is now under threat. This section first discusses the crisis of the WTO appellate body, then moves on to the US trade war before looking at the strategic reasoning behind American policy.

WTO appellate body crisis

The WTO appellate body is an integral part of the WTO dispute settlement mechanism. Complaints about other countries violating WTO rules are first adjudicated by ad-hoc panels, whose decisions are subject to appeal before the appellate body. In such cases, 3 "judges" are drawn from the 7 appointed members of the appellate body. They decide on whether the accused country has violated WTO rules, and whether the accuser has the right to retaliate against it with tariffs[2].

The United States started complaining about procedural issues in the appellate body in the early 2000s. In particular, it claimed that members of the appellate body have ruled on cases that they took on during their term even after resigning from the body. Furthermore, the WTO appellate body has often needed more than the allotted 90-day time period to produce its final verdict. Finally, the US believes that the appellate body is overstepping its mandate, in particular on anti-dumping and subsidy regulations and the interpretation of WTO treaties[3].

Because of these grievances, in 2017 the US started blocking any new appointments to the appellate body. As of November 2019, the number of members of the body has dropped to 3, the minimum required for any decisions, of whom 2 are set to retire on 10 December. One of the retiring members, the American Thomas R. Graham, has already declared that he will not continue with the practice of ruling on cases that he took

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[2] See World Trade Organisation, "Working Procedures for Appellate Review", WT/AB/WP/W/11, 27 July 2010.

[3] For a discussion of the complaints see: G.C. Hufbauer, T. Payosova, and J.J. Schott, *The Dispute Settlement Crisis in the World Trade Organization: Causes and Cures*, Policy Brief 18-5, Peterson Institute for International Economics, March 2018.

up after his retirement. This means that unless new members are appointed soon, the appellate body will cease to be operational by mid-December[4].

The complaints of the US can be placed in three categories: procedural, fundamental, and political. The procedural issues concern the aforementioned legal procedures of the appellate body. As the cases brought before the appellate body are of very sensitive nature and can have profound economic consequences, procedural issues are to be taken very seriously. However, it is difficult to believe that the US would jeopardise the system of international rules that it helped establish in the 20th century over mere procedural concerns. A "benign" interpretation of the US policy with regard to the WTO would be that, as unanimity among the WTO membership is hard to achieve, reform can only be achieved through a policy of applying strong pressure by blocking the appointment of appellate body members and bringing the organisation to the brink of collapse.

However, this interpretation seems unlikely, as the US has more fundamental concerns about the dispute settlement body. A more profound issue concerns the scope of appellate body rulings. As international treaties that govern the WTO are subject to interpretation, the series of appellate body rulings have created a case law of sorts. The US perceives that rulings of the appellate body go beyond the scope of the treaties, and as such the WTO dispute settlement body is acting as if it could set case law, despite the fact that it is not a sovereign legal body. The lack of WTO reform contributes to this problem[5].

The most important reason behind by the US policy of blocking the appellate body is arguably political: the rise of China as

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[4] Moreover, there are reports that the US is threatening to block the biennial budget of the WTO, which would paralyse the institution by 1 January 2020 (Bloomberg News, "U.S. Raises Prospect of Blocking Passage of WTO Budget", 12 November 2019).

[5] A reflection of this is that the appellate body members are referred to as members and not as judges. A reflection of this is that the appellate body members are referred to as members and not as judges.

the second largest economy in the world. The US perceives that the rules of the WTO enabled "unfair" Chinese practises, and that the rules that allow China to trade under preferential terms as a "developing economy" mean that it has a competitive advantage over the US in some areas. Finally, it is argued that the US is in a new type of technological "Cold War" with China, which must be fought in the economic sphere as well. With its preferential treatment of China, the WTO framework is an impediment to the American trade war, as it both gives some benefits to the "developing economy" and places restrictions on the type of tariffs the US can use to impede China's economic advancement.

If the US and the other WTO members are not going to reach an agreement by the end of 2019, the number of members in the appellate body will drop to one, in effect blocking the dispute settlement body. Furthermore, there is the risk that adverbial rulings of the dispute settlement body against the US might lead it to leave the WTO. The US is still the largest economy in the world and the most important geopolitical power, and it is hard to imagine the system surviving its withdrawal. However, this is not necessary for the US to put an end to the WTO as we know it. A continuation of the blockade of appellate body appointments and a simple disregard for the rules would have almost the same effect. It is unclear how a system of rules can be upheld if there is no jurisdiction to enforce it. A post-multilateral world would allow large countries to use their power in order to advance their economic interests against smaller ones[6]. The risk is that the US, as the largest player in international trade, perceives such a power-based system as in its interests. The absence of a functioning WTO dispute settlement mechanism would allow the US to more freely apply tariffs that it deems advance its economic and geopolitical interests.

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[6] For a discussion of a post-WTO world trade regime see U. Dadush and G. Wolff, *The European Union's response to the trade crisis*, Bruegel, Policy Contribution, Issue no. 5, 2019.

Trump's trade war(s)

After winning the US presidential election with an anti-globalisation campaign, blaming international trade for the decline of manufacturing and jobs in the US, President Trump started to threaten American trading partners with tariffs immediately after taking office.

In 2018 the US imposed tariffs of 25% and 10% on steel and aluminium, respectively, based on national security grounds. The EU, Mexico, and Canada were initially exempt from these tariffs, but these exemptions where revoked in June 2018. The EU, as many other countries, retaliated by applying tariffs of its own on a list of goods designed to hit key Republican voting districts, most prominently Harley Davidson motorcycles.

The US government also started to renegotiate the NAFTA trade agreement between the US, Canada, and Mexico. It has applied pressure on its two neighbours by means of the steel and aluminium tariffs and by threatening to withdraw from NAFTA. The newly negotiated trade agreement features stricter rules of origin and new chapters on e-commerce, but is otherwise largely seen as NAFTA 2.0. Furthermore, the US has withdrawn from a number of negotiations on large free trade agreements. It has ended the negotiations on the Transatlantic Trade and Investment Partnership (TTIP) with the EU, the negotiations on a Trans-Pacific Partnership (TTP) with countries around the Pacific Rim, and has renegotiated the US-South Korea trade agreement.

However, the main target of the US trade wars is China. The US began by imposing sanctions on solar panels and washing machines, and then imposed more and more additional sanctions on Chinese intermediate goods. The list of sanctions was expanded on grounds of "unfair" trade practices: intellectual property theft and forced technology transfer through joint venture requirements. The list of goods that are subject to these tariffs has increased to covers roughly 70% of Chinese exports to the US, and the average tariff rate on them has increased from 3.1% to 23.8%. At the time of writing, the US and China

are negotiating a partial trade deal. However, if these negotiations fail (as previous ones have), almost all Chinese exports are set to be put under tariffs in mid-December, raising the average tariff rate to 26.6%. The Chinese have retaliated with sanctions of their own, now affecting around 50% of US exports to China. The Chinese tariffs have largely focused on agricultural goods, such as soybeans and sorghum, and intermediate goods[7].

In addition to the trade war, the US government increasingly uses its market power and the role of its currency as international tender in order to achieve geopolitical goals. It uses access to its capital and banking markets as a tool for foreign policy, and pressures the Belgium-based international transfer platform SWIFT to block adversaries from making international transactions. This "weaponisations of the dollar" has increased over recent years, effectively blocking the EU from conducting independent foreign policy in some areas. This is particularly poignant in the case of the JCPOA, the treaty that was meant to keep Iran from acquiring nuclear weapons and to reintegrate it into the international system. The EU has a very different strategic assessment of the region and different policy goals and did not withdraw from the treaty. However, US secondary sanctions (threatening European companies that trade with Iran with sanctions) have brought EU-Iran trade to a standstill[8].

Strategic considerations

Officially, American tariffs are based on complaints about China misusing WTO rules for unfair trade practices, stealing intellectual property, and supporting its state-owned enterprises (SOE) with government subsidies. Furthermore, China has not opened its procurement markets to foreign companies, and there are a wide range of complaints in terms of joint venture control

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[7] C.P. Bown, *US-China Trade War: The Guns of August*, Peterson Institute for International Economics, 2019.

[8] C.D. Cimino-Isaacs, K. Katzmann, and D.E. Mix, *Iran: Efforts to Preserve Economic Benefits of the Nuclear Deal*, Congressional Research Service, in Focus 10916, 2019.

and forced technology transfer. Therefore, US policy is aimed at ending these Chinese practises and pursuing "fair trade" between China and the US. Many US complaints are shared by the EU, whose companies are also subject to the same practices and would greatly benefit from China liberalising its markets.

It is clear, though, that the US is not just targeting Chinese exports in order to pressure it to open its market, but it is also trying to block Chinese technological advancements. Some of the measures taken by the US, in particular visa restrictions for American universities and increased investment screening, are directly aimed at impeding Chinese progress in a new technological "Cold War"[9]. China is already the leader in research and development in certain areas of AI and Blockchain technology. China is also massively building up its military. The Chinese government is claiming large parts of the South China Sea as part of its exclusive economic zone, and one of its stated goals is to reintegrate Taiwan into China. Hence, there is the fear that a rising China will start using its military power against other countries in the region. The trade war may be seen as one front on which the US is trying to assert its dominance in order to stop China from becoming too big to contain.

The Chinese government perceives US demands as almost amounting to a sort of regime change, something that is unacceptable to the Chinese Communist Party (CCP). They perceive the US blockade of Chinese technology as an attempt to stop China from moving up the value chain, and more importantly from taking its rightful place as global power. Conceding to American demands of opening up its markets and upending its system of state-owned enterprises (often chaired by high-ranking party officials who receive substantial economic gains from this) would undermine President Xi Jinping's power base. With a declining growth rate, the civil unrest in its main financial hub Hong Kong, and macroeconomic problems

[9] J. Crabtree, Y. Jie, and M. Schneider-Petsinger, *US-China Strategic Competition – The Quest for Global Technological Leadership*, Chatham House, Research Paper, 2019.

especially in the banking sector, China is in a very difficult economic situation.

As some of the official US goals are seemingly out of reach, and the US is not looking for allies in its attempt to contain China, but instead is threatening to disintegrate the WTO and is imposing tariffs on its allies as well, it is difficult to believe that its only goal is to achieve policy change in China. Another stated goal of the US administration is the reduction of bilateral trade deficits. However, as Jean et al. argue[10], there is no robust evidence that bilateral trade deficits are directly affected by trade protection, nor do most economists support the notion that exports should be the goal of trade. The trade balance is mostly defined by net savings, and focusing on bilateral trade deficits misses the interlinkages in supply chains. As goods that are assembled in China and exported to the US contain parts manufactured in many other economies, the US-China trade balance should be considered in the context of the overall US trade balance. In particular, the US retreat from the TPP, a trade agreement between Pacific Rim countries that was aimed at reducing their dependence on China, seemed to have been counterproductive to the goal of containing China's advance as international power. As such, these two goals (decreasing America's trade deficit and impeding Chinese advancement) are conflicting to some extent.

The anti-free trade policy of the US is also a political reaction to the structural change of the US economy, where manufacturing has declined strongly since the 1970s. Large parts of the country deindustrialised as an effect of both globalisation and technological advancements. While the academic debate on the extent to which the China shock or technological change were the drivers of the structural change in the U.S. economy (and the European one) is still ongoing, outsourcing of manufacturing to Mexico and China in particular have featured prominently

[10] S. Jean, P. Martin, and A. Sapir, *International trade under attack: what strategy for Europe?*, Bruegel, Policy Contribution, Issue no. 12, 2018.

in the public debate. Trump's electoral victory was enabled by the support of voters in the so called "Rust Belt", which was particularly affected by outsourcing and automatisation.

Although the lack of a coherent strategy seems to be a feature of the Trump presidency, in terms of foreign policy strategy there is some continuity and shared vision in the US political establishment. Both Hillary Clinton and Bernie Sanders supported renegotiating the NAFTA trade agreement (despite the fact that NAFTA was signed by President Bill Clinton). The two front-runners in the 2020 Democratic primary, Elisabeth Warren and Joe Biden, have both expressed strong anti-China views. The trade strategy of Elisabeth Warren mirrors many of the "America First" policies of President Trump. Therefore, even though some measures taken by the current US administration are indeed ad-hoc and not part of a larger geopolitical strategy, it would be short-sighted to interpret this policy shift only as an outcome of the President's personal anti-globalist views.

The Effect of the Trade War on the EU

The EU has developed largely under the auspices of the US, which provided military protection from the Soviet Union during the Cold War. Even after the fall of the Iron Curtain, EU foreign policy was largely dependent on alignment with US goals and US willingness to intervene in order to protect common Western interests. However, the multilateral system on which the EU has relied upon and upon which its trade policy is based is now unravelling. The next sections will discuss how the EU has been affected so far, and what its reaction has been.

Direct effects

So far, the US has imposed tariffs on steel and aluminium exports from the EU on "national security" grounds. The EU was initially exempt from these tariffs, but this policy was reversed

in 2018. Furthermore, a dispute settlement decision of the appellate body in October 2019 ruled that the US is allowed to impose retaliatory sanctions on $7.5 billion worth of European goods in reaction to illegal state aid to Airbus. The EU has a similar case against Boeing currently under review, which should make it possible to resolve the issue. However, in the current climate, it is unclear whether the current US administration is willing to seek out an agreement with the EU. Furthermore, should the appellate body collapse, there might be no final ruling on this case anyway. In terms of geography, the steel and aluminium tariffs imposed by the US mainly affect steel and aluminium producing countries like Germany, Italy, France, and the Benelux countries. The retaliatory tariffs in the Airbus case are aimed at the countries where these airplanes are manufactured (Germany, France, Spain, and the UK), and affect civilian aircraft as well as whisky, cheese, and wine.

In addition to the tariffs imposed by the US, the Transatlantic Trade and Investment Partnership (TTIP) between the EU and the US, already under strong pressure in the EU, has been cancelled by President Trump. This partnership would have been the largest trade agreement in history, but was highly controversial in Europe as well. As tariffs are already very low between the two economies, the agreement mostly tried to achieve a higher degree of regulatory alignment. While EU-US negotiations resumed in mid-2018, the likelihood of reaching an agreement any time soon seem very low.

Furthermore, the US has threatened to put tariffs on European cars. In February 2019, a report by US Secretary of Commerce Wilbur L. Ross concluded that European car exports to the US pose a national security risk. The decision on whether or not to impose sanctions has been postponed multiple times, and the time given by the Trade Expansion Act to take action upon this report has now run out (however, there is debate on whether this precludes any further action)[11].

[11] According to section 232 of the 1962 Trade Expansion Act, 180 days are given

Indirect effects

The trade conflict escalation in the Pacific does not just affect the EU through direct tariffs against it. European companies are invested into value chains that span the globe. As uncertainty on whether these supply chains are sustainable in a more hostile environment is growing, this is affecting the growth outlook of European economies. This is harming both European exporters that have supply chain operations in the region, and companies that are directly and indirectly affected by the worsening economic outlook of the competing parties.

The FED is estimating that the US-China trade war had already decreased global growth rates by 1 percentage point in 2017[12]. Global economic growth is mainly affected by trade uncertainty, leading to a decrease in investments. Productivity growth in advanced economies is stagnant, and the growth of export-oriented European economies in particular depended on selling goods to fast-growing emerging markets, China first and foremost. The decline in global growth is hurting export-oriented European economies such as Germany's. While Germany managed to sustain its economic growth during the crisis and was a growth engine for Europe of sorts, it is now at risk of a recession. On the other hand, more closed southern European economies like France and Spain are now reaping the benefits of the reforms they undertook during the sovereign debt crisis, and are growing at relatively strong rates. This again leads to an imbalance in Europe's growth rates, which causes problems for macroeconomic policies. However, as the economies that are now experiencing lower growth are mostly northern European countries with low levels of public debt, there is the capacity for fiscal stimulus. A special case here is Italy, which did not manage to profoundly reform its economy and has a very high

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which ended on 14 November.

[12] See D. Caldara et al., *Does Trade Policy Uncertainty Affect Global Economic Activity?*, Washington, Board of Governors of the Federal Reserve System, FEDS Notes, 4 September 2019.

level of public debt. Therefore, it is particularly at risk of being affected by a global economic slowdown.

There are some positive effects of the trade war on European economies. There are some displacement effects of US and Chinese companies and consumers buying goods from the EU instead of each other. As Chinese goods are subject to American tariffs, and American goods are subject to Chinese tariffs, this increases the competitiveness of European producers in both markets. Furthermore, even though the US does not seem to seek allies to fight its trade war with China, China seems to be keen to keep Europe from engaging in the trade war on the side of the US It lifted joint venture requirements for some European investments and cut its tariffs for non-US exporters[13].

The EU's reaction

With the failure of the Doha rounds of WTO negotiations, the EU has started to implement an increasing number of bilateral trade deals to advance its interests. This has become an even more important element on the agenda with the start of the U.S. trade war. The signing of the Mercosur trade agreement at the G20 in Osaka was a strong signal that the EU is willing to engage in bilateral trade agreements in the absence of progress on the multilateral front. However, this trade agreement also highlights the challenges that the EU is facing in advancing its free trade agenda. The treaty has faced serious opposition from some EU countries due to environmental concerns, in particular the inaction of the Brazilian government to prevent forest fires in the Amazonian rainforest. As Baltensperger and Dadush (2019) show, the economic benefits of this agreement are fairly limited, and with a new left-populist government in Argentina the risks for its ratification have increased even more[14].

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[13] For a discussion of the economic effects of the Chinese-US trade war on the EU, see A. Garcia Herrero, *Europe in the Midst of China-US Strategic Competition: What are the European Union's Options?*, Bruegel, Working Paper, Issue no. 3, 2019.

[14] M. Baltensperger and U. Dadush, *The European Union-Mercosur Free Trade Agreement: prospects and risks*, Bruegel, Policy Contribution, Issue no. 11, 2019.

However, these trade deals, many with small economies, not only serve to increase growth in the signatory countries thanks to lower trade barriers, but also play an important role as "insurance policy" for a post-WTO world. Furthermore, the EU has sought allies in order to establish an alternative dispute settlement mechanism in case the appellate body stops being operational. So far, the EU has signed agreements on alternative dispute settlement systems with Canada and Norway[15]. As WTO reform seems very unlikely at this stage, and WTO disintegration is a possible outcome, bilateral trade relationships have become more important than ever.

What the EU Should Do

The discussion about how the EU should position itself in order to protect its economic interests is now very much ongoing. One side of the argument thinks that the EU should "toughen up" in order to protect itself against foreign influence – summarised by the statement of the former German Minister of Foreign Affairs Sigmar Gabriel that "it's difficult to be a vegetarian in a world of carnivores"[16]. The other side of the argument thinks that the EU should "not become a monster in order to fight a monster" (as the Director General of Trade in the European Commission Sabine Weyand put it[17]) and not engage in thinking in unilateral terms. The fact that incoming European Commission President von der Leyen has given her presidency the title "Geopolitical Commission" seems to be very much an acknowledgement of this debate[18].

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[15] While Norway is part of the European Economic Area (EEA), most of EU-Norway trade is subject to the jurisdiction of the EEA court, therefore the alternative dispute settlement only concerns fisheries and agriculture.

[16] Interview in Der Spiegel, Heft 2/2018.

[17] During a panel on "Enhancing Europe's economic sovereignty" at Bruegel's Annual Meeting (BAM2019), 4 September 2019.

[18] See "Mission Letter to High Representative of the Union for Foreign Policy and Security Policy/Vice-President-designate of the European Commission

As an international organisation based on treaties, multilateralism and rules-based politics are very much in the EU's nature. However, it seems that the WTO system is at an impasse. Many of the complaints raised by the U.S. are serious concerns and regardless of whether one agrees with the U.S. government's strategy, the disintegration of the WTO is a real risk and the EU should have a strategy that goes beyond just trying to save it. Furthermore, even though many in the EU are discontent with American foreign policy (Huang and Poushter (2019) show that the share of French and Germans who see the U.S. as a threat to their country has increased by 30 percentage points since 2013, and more Europeans see the U.S. as a threat than China[19]), it is clear that the EU has many more values in common with the U.S. than with China. In fact, many of the justifications for current U.S. policy are shared by the EU. Moreover, on the economic side, the integration between the EU and the U.S. is vastly deeper than that between the EU and China. Dadush et al. (2019) show that EU-China trade is 40% smaller than EU-US trade, and the difference is even larger in terms of FDI: the FDI stock of the EU in the U.S. and the FDI stock of the U.S. in the EU are more than 10 times larger than their respective FDI stocks in China[20].

Furthermore, the EU is far from being at risk of becoming a "monster" itself. In many policy areas, much more reform is needed just to increase the EU's ability to conduct independent foreign policy. Developing these capabilities neither means embracing unilateralism nor abandoning the multilateral system, but only that the EU can advance its own interests where they diverge from American ones. This applies to economic and geopolitical interests, as well as to environmental and social

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Josep Borrell" by President-elect of the European Commission Ursula von der Leyen.

[19] C. Huang and J. Poushter, *Climate Change Still Seen as the Top Global Threat, but Cyberattacks a Rising Concern*, Pew Research Center, February 2019.

[20] U. Dadush, M. Domínguez-Jiménez, and T. Gao, *The State of China-European Union Economic Relations*, Bruegel, Working Paper, Issue no. 12, 2019.

policies. At the same time, the EU should seek like-minded allies and prepare for a post-WTO world in case the trade war escalates further. The US used to be a champion of the international rules-based trading system, and as the world's largest trader the EU should do its best to take up the baton as the home of free trade. In this period of crisis of multilateral institutions, size is becoming of increasing importance, and no single European country is big enough to protect its economic interests on its own.

It is very clear that the multilateral trade system is at a difficult juncture, and the EU should invest in developing a forward-looking agenda by expanding its toolbox and strengthening its economic governance[21]. The EU's outlook in achieving trade agreements with either the US or China seems limited. The negotiations with the US on TTIP appear to have been at an impasse even before their cancellation by President Trump. The incoming European Commission seeks to sign an investment agreement with China. However, the environmental and social concerns that are threatening the EU-Mercosur agreement are even more relevant with regards to China, while human rights concerns are a huge burden for the relationship. The interment of the Uyghur minority in Xinjiang is a sad reminder of the totalitarian nature of the Chinese system, and a further escalation in Hong Kong could produce an environment where it would be very difficult for European politicians to make concessions to China.

The EU has already concluded alternative dispute settlement agreements with Canada and Norway, which would provide an alternative to the WTO dispute settlement body if it stops being operational. However, these two countries are not really problematic in terms of investment protection or the rule of law. Norway especially is already part of the EEA, and as such the vast majority of EU-Norway trade is already subject to the

[21] For a discussion of how the EU could strengthen its economic sovereignty, see M. Leonard et al., *Redefining Europe's economic sovereignty*, European Council on Foreign Relations (ECFR), June 2019.

EFTA court. Moreover, with the WTO being unable to reform, the EU has to advance its interests through free trade agreements. These agreements have become more and more difficult to ratify, and they are facing strong civil society opposition. As the importance of free trade agreements is increasing, the EU has to improve its internal discussion on free trade. More transparency during negotiations and a higher priority for non-commercial interests such as the environment could help increase civil society ownership. Deeper capital markets, a more integrated banking sector, and coordinated fiscal policy would help to establish the euro as international currency, and make the EU less dependent on the dollar. Foreign investment screening has the potential to protect European technology. European countries have to strengthen their military power (as long demanded by the US), given that the US is retreating from Europe and the Middle East in its "Pivot to Asia", and there Europe needs to be able to protect itself. Finally, in order to be sovereign during an AI "Cold War", Europe has to develop its digital capacities by completing the digital single market and increasing funding for research and development in digital technologies.

4. Inequality, Growth, and Regional Disparities. Rethinking European Priorities

Francesco Saraceno, Jean-Paul Fitoussi

Scholars agree that there have been two waves of globalisation. The first started in the 19th century and came to a sudden stop with the First World War. The second wave started after the Second World War and is still continuing. This second wave of globalisation, in turn, can be roughly divided in two phases. A first phase, which could be called a phase of internalisation, was managed through cooperative institutions and limited mobility of capital. It coincides with the intellectual dominance of the Keynesian paradigm and lasts from the late 1940s to the turbulent decade of the 1970s, the fall of the Bretton Woods System marking the beginning of the end. The second starts with the so-called conservative revolution at the turn of the seventies and the 1980s. Both phases are characterised by a steady increase of the share of trade over world GDP, but while during the first one capital flows and the share of finance did not increase substantially, during the second, especially from the 1990s, they were the predominant factor behind increasing interconnectedness[1]. This is when the predominance of capital, due to the progressive dismantling of the obstacles to its mobility, leads to a great transformation. No wonder that it also marks the end of

[1] S. Griffith-Jones, R. Gottschalk, and J. Cailloux (eds.), *International Capital Flows in Calm and Turbulent Times*, University of Michigan Press, 2003.

the twentieth century "anomaly" of decreasing inequality, and gives birth to a new increase in income and wealth inequality[2].

The increase in inequality, both personal and territorial, that accompanied the latest phase of globalisation has been an important source of macroeconomic instability in advanced economies. It can be counted among the factors explaining a profit boom in the context of what looks like a secular stagnation, the malaise leading to the weakening of Western liberal democracies, and the rise of populism. This chapter will quickly survey the increase of inequality at several dimensions and link it with economic policy choices that were made in advanced economies, most notably in Europe. We will then offer a few possible lines of action at the national and at the European level, most notably concerning budget and tax system reforms, to try to return to a more regulated and growth-friendly system.

Globalisation and Inequality

The increase of inequality and the broken social elevator

It is widely recognised that inequality increased substantially, both in developed and in emerging economies, starting from the late 1970s[3]. In some countries, particularly in Europe and in the United States, those who lost ground were the middle

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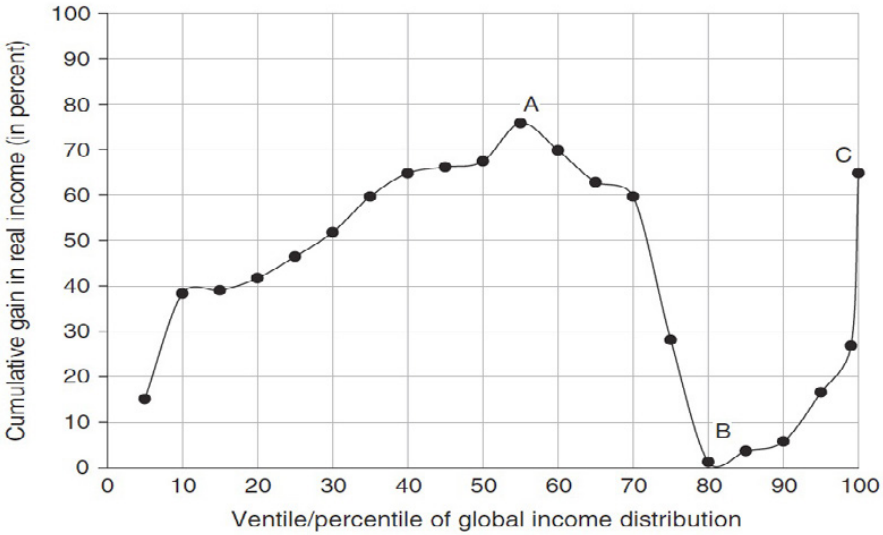
[2] B. Milanovic, *Global Inequality: A New Approach for the Age of Globalization*, Harvard, The Belknap Press, 2016; T. Piketty, *Le Capital Au XXIe Siècle*, Paris, Seuil, 2013.

[3] IMF, *World Economic Outlook - Globalization and Inequality*, 2007; B. Milanovic (2016); OECD, *Growing Unequal? Income Distribution and Poverty in OECD Countries Distribution*, 2008; T. Piketty, E. Saez, and A.B. Atkinson, "Top Incomes in the Long Run of History", *Journal of Economic Literature*, vol. 49, 2011, pp. 3-71; T. Piketty and G. Zucman, "Capital Is Back: Wealth-Income Ratios in Rich Countries 1700-2010", *The Quarterly Journal of Economics*, vol. 129, no. 3, 2014, pp. 1255-310, J.E. Stiglitz, *The Price of Inequality: How Today's Divided Society Endangers Our Future*, W.W. Norton & Company, 2013.

classes, while in others (e.g. China) they were the very poor. But in all cases the redistribution has benefited mainly the rich and the very rich (the top one percent of the population). The famous "elephant curve" (figure 4.1), first introduced by Lakner and Milanovic (2016), depicts the cumulative gain in real income by percentile of the global income distribution.

Fig. 4.1 - Relative gain in real per capita income by global income level, 1988-2008



Source: C. Lakner and B. Milanovic, "Global Income Distribution: From the Fall of the Berlin Wall to the Great", *World Bank Economic Review*, vol. 30, no. 2, 2016, pp. 203-32.

The elephant shows that among the winners of globalisation are the middle-upper class in emerging countries and the "global plutocracy" (as Milanovic calls it), while he clear losers are the bottom 50% in the most advanced economies, which in the global distribution lie between the 80th and the 90th

percentiles (those around point B in figure 4.1). The elephant curve has been invoked at length, we would say rightly so, to justify the rise of populism and of protest movements like the yellow vests in France. Those relatively affluent parts of the world population that were squeezed between emerging countries' middle classes and the predatory behaviour of the top 1%, are the ones who today fight to reverse globalisation, as they are sliding towards the bottom (note that the cumulative gain of the 95th percentile of the world distribution is not different from that of the 5th percentile!).

In the past decades, the increase of inequality was mostly ignored by mainstream economists. This is explained by the revival of the neoclassical tradition after the crisis of Keynesian economics in the 1970s. The neoclassical theory identifies the conditions for efficiency in the allocation of resources, which in turn are rooted in a fundamental tenet of the theory: the equality between productive factors' remuneration and their marginal product. Productivity is an "objective" criterion for determining the efficient allocation of resources among participants in the economy. This has the very strong implication that the social desirability of such an allocation, its fairness, is not of direct concern for the economists. But it is fair to recognise that, when taken outside their field of competence, the same economists may of course approve of redistribution based on extra-economic concerns, like social stability, fairness, and the like. But within the field, neo-classical economists only need to make sure that such redistribution does not introduce distortions, i.e. that it does not break the link between marginal productivity and factor income. And how can they be truly concerned by inequalities if their models are based on the behaviour of the representative agent?

Within this traditional view, two long-recognised and related phenomena help explain the increase of inequality. The first is the skill bias introduced by the recent waves of technological progress. The impact of the IT revolution was to increase the productivity of high-skilled workers much more than that

of those with no or little education[4]. Diverging wages would therefore reflect the widening productivity gap[5]. The second phenomenon is globalisation. Low-skilled workers entering the global labour market from emerging and developing economies (the great doubling in the words of Richard Freeman) lowered the average marginal productivity of labour, thus lowering its share of national income with respect to capital. Furthermore, the increase of competition in labour markets reduced the bargaining power of unions and wage setters. Taken together, skill-biased technical progress and increased competition in global labour markets could explain increasing wage inequality as an unavoidable process that policy was not supposed to address, if not at the price of reducing efficiency and growth. The idea of a "rising tide lifting all boats", or the trickle-down theory, would then serve as a justification for the impetuous growth of high and very high incomes that accompanied the two prosperous decades of the 1990s and 2000s. The traditional view may also admit other drivers of inequality, for example imperfect financial markets that prevent liquidity-constrained agents from investing in human capital. These are nevertheless "easily" dealt with, once structural reforms limit market imperfections.

The financial crisis challenged the traditional view: in spite of the heavy hit taken by the financial sector, it disproportionately affected middle and low incomes[6]. In a nutshell, the financial sector was compensated by the taxpayers, but the losers of the second globalisation were not. In particular, Galbraith (2012) and Stiglitz (2013) argue convincingly that much more than

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[4] L.F. Katz and D. Autor, *Changes in the Wage Structure and Earnings Inequality*, Handbook of Labor Economics. Elsevier Science, 1999; R.G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press, 2010; OECD, *Divided we Stand: Why Inequality Keeps Rising*, OECD Publications, 2011.

[5] The world does not really resemble that picture: Our society of services have also seen a dramatic increase for the demand of less qualified worker like nurses, persons to take care of old people, pizzaiolo, car driver, etc. Inequality will grow but not necessarily unemployment among the less qualified.

[6] OECD, *Divided we Stand: Why Inequality Keeps Rising*, OECDPublishing, 2011.

the "fundamentals", like globalisation and technological progress, what accounts for most of the increase of inequality in the past decades is the rise of predatory behaviour[7]. Precisely because the elites have been appropriating more than a fair share of national wealth, increasing inequality has been hampering well-being and distorting the economy. Empirical evidence also seems to run counter to the traditional view. Recent work shows that there is a robust negative correlation between inequality and growth and that, as a corollary, less unequal countries tend to have more stable consumption and less volatile GDP[8]. Therefore, economies with some form of redistributive policies in place tend to grow faster. Emphasising rent-seeking[9] helps explain why the increase of income inequality in the past decades benefited the very highest incomes[10].

The persisting imbalance in income distribution has ended up eroding one of the major accomplishments of the post-World War Two globalisation period, the increased social mobility (be it intra-generational or inter-generational). This increase has been halted, if not reversed, in the most recent decades. A recent OECD report, aptly titled "A broken social elevator" OECD (2018) highlights not only the obvious fact that social stability crucially depends of the possibility for those at the bottom to climb the ladder, it also underlines how sustainable growth can be hampered by low social mobility, implying that many talents remain untapped[11]. Furthermore, low mobility extends beyond earnings to several other important dimensions such as

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[7] J.K. Galbraith, *Inequality and Instability: A Study of the World Economy Just Before the Great Crisis*, Oxford, Oxford University Press, 2012; J.E. Stiglitz (2013).

[8] See J.D. Ostry, A. Berg, and C.G. Tsangarides, *Redistribution, Inequality, and Growth*, IMF Staff Discussion Notes 2014/02, 2014.

[9] J.-L. Gaffard and F. Saraceno, "Répartition, Croissance et Crise", *Economie et Management* , vol. 151, April 2014, pp. 5-9; J.-P. Fitoussi and F. Saraceno, "Inégalité et Compétitivité : Quelques Considérations", *Revue d'économie Financière*, vol. 128, no. 4, 2018, pp. 77-89.

[10] T. Piketty et al. (2011).

[11] OECD, *A Broken Social Elevator? How to Promote Social Mobility A Broken Social Elevator? How to Promote Social Mobility*, OECDPublishing, 2018.

educational attainment, the type of occupation and even health outcomes. The report then proceeds to show how increasing inequalities affected human capital accumulation, a major driver of social mobility. This yielded a broken social elevator: while income mobility was a reality for many people born into a low-education background between 1955 and 1975, it has stagnated for those born after 1975. In addition, vulnerability has increased for people in the middle class (still point B of the elephant curve above). While the report refrains from saying it, this increased sense of insecurity can be seen, once again, as a major driver of the drift towards populism of large parts of the OECD countries' populations. The general conclusion of the report is that in general higher levels of inequality go together with lower intergenerational earnings mobility (an empirical fact long known as the "Great Gatsby Curve").

Territorial inequalities

A rich body of literature investigates the issue of regional disparities, especially with reference to the EU. This increasing interest has to do with the introduction of endogenous growth models in the mid-1980s and the development of models of the so-called "new economic geography" since Krugman's (1991) contribution[12]. The assumptions underlying these models allow for the reversal of the neoclassical prediction of convergence, and lead to the conclusion that faster growth may result in increasing regional disparities. From a political point of view, the success of any supra-national integration project is linked to the reduction of regional disparities, and the EU placed strong emphasis on achieving economic and social cohesion. Increased effort has been devoted to generating new data sets to understand the nature and evolution of regional disparities in the EU. Most studies rely on the information contained in the REGIO

[12] P. Krugman, "Increasing Returns and Economic Geography", *Journal of Political Economy*, vol. 99, no. 3, 1991, pp. 483-99.

data set by Eurostat. When the studied spatial units are within countries, data are most often presented by NUTS 1 and NUTS 2 territorial units according to the Nomenclature of Territorial Units for Statistics used by Eurostat. Only a few recent contributions have decomposed EU disparities to the finer NUTS 3 Level.

The main problem in the debate is that the term "disparity" refers to a multifaceted concept. The literature seems to have identified three main dimensions encompassed by the concept: polarisation, inequality, and geographic concentration. Even though inequality is by far the most important aspect, polarisation and geographic concentration are not be tossed aside lightly. The notion of polarisation is conceptually different from that of inequality, and measures of inequality are inadequate to distinguish whether regions are clustered around the average of the distribution or around two or more separate poles. Most of the studies on regional convergence tend to ignore the fact that a reduction in the cross- sectional dispersion of the distribution may be compatible with a process of polarisation into several regional clusters[13]. From a theoretical point of view, regional inequality may decline as the degree of polarisation increases[14]. In the period between 1980 and 2002, the EU witnessed a simultaneous reduction in the degree of regional dispersion and an increase in regional bipolarisation[15].

Two major developments can be inferred from the literature on regional inequalities: (1) the longstanding process of diminishing regional income disparities in Europe slowed down considerably in the 1980s. Therefore, (2) while there was (at least until the

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[13] G. Anderson, "Toward an Empirical Analysis of Polarization", *Journal of Econometrics*, vol, 122, no. 1, 2004, pp. 1-26.; J.-M. Esteban, and D. Ray, "On the Measurement of Polarization", *Econometrica*, vol. 62, no. 4, 1994, pp. 819-51.

[14] D.T. Quah, "Twin Peaks: Growth and Convergence in Models of Distribution Dynamics", *The Economic Journal*, vol. 106, no. 437, 1996, pp. 1045-55.

[15] R. Ezcurra and A. Rodríguez-Pose, "Measuring the Regional Divide", in R. Capello and P. Nijkamp (eds.), *Handbook of Regional Growth and Development Theories*, Cheltenham and Northampton, Edward Elgar, 2009.

crisis of 2008) some convergence among nations, regional disparities within the EU member states persisted or even grew.

Territorial inequality seems to be strongly related to personal income inequality, as we documented in the previous section ("The increase of inequality and the broken social elevator", p. 74). Rodríguez-Pose and Vilalta-Bufí (2005) argue that there is a link between human capital and regional economic performance in the EU[16]. Using indicators of educational stock, the matching of educational supply and labour demand, and migration, they associate the economic performance of European regions over the last few years with differences and inequalities in human capital endowment. Rosés and Wolf (2018) noticed that the pattern of regional inequality over the last 110 years follows a U-shape, and argue that it can be easily compared to the pattern of personal income inequality as documented by Piketty (2013)[17]. They find that regional inequality declined since 1900 but started to increase again around 1980, when personal income inequality also started to increase. They suggest that there is some kind of relation between the two phenomena, which may share the same causes. Rosés and Wolf's conclusion is confirmed by Iammarino et al. (2018), who identify two main factors of regional disparities[18]. The first is a wave of technological progress coupled with an expansion in world trade and a lowering of trade barriers that began in the 1970s. This wave of technological change reduced employment – for instance through automation – and has cut the cost of business-to-business trade within their value chains, making it possible for industries to become more geographically dispersed. As different skill types have increasingly become

[16] A. Rodríguez-Pose and M. Vilalta-Bufí, "Education, Migration, and Job Satisfaction: The Regional Returns of Human Capital in the EU", *Journal of Economic Geography*, vol. 5, no. 5, 2005, pp. 545-66.

[17] J. Rosés and N. Wolf, *Regional Economic Development in Europe, 1900-2010: A Description of the Patterns*, CEPR Discussion Paper 12749, 2018.

[18] S. Iammarino, A. Rodriguez-Pose, and M. Storper, "Regional Inequality in Europe: Evidence, Theory and Policy Implications", *Journal of Economic Geography*, vol. 19, no. 2, 2018, pp. 273-98.

concentrated in different places, recent trends have favoured metropolitan regions. The second factor is "the long-cycle of regional evolutionary features, consisting of place-specific endowments of people and skills, firms and industries, formal and informal institutions, capacities for innovation and their reaction to change"[19].

But there is something missing from the argument above: fiscal and social competition have already changed and are continuing to change the map of activities, while fiscal and social delocalisation lead to desertification of many territories, and the misery that comes with it. The inequalities that stem from this process are all but efficient; this is why regulation is urgently called for in these fields.

To conclude, it seems fair to say that the latest wave of globalisation has been accompanied by increasing inequality: (a) among individuals regarding income or wealth; (b) between capital and labour; and (c) among regions that have been hit differently by the structural changes entailed by the emergence of new economic players. We suggested in the previous section "The increase of inequality and the broken social elevator" (p. 74) that this increase of inequality, whatever dimension we consider, has a dimension that is hard to attribute to skills and marginal productivities. The rise of rent-seeking and predatory behaviour has coincided with the paramount role played by an increasingly deregulated financial sector, where the disconnect between wages and marginal productivity quickly became evident[20].

Nevertheless, this was not an inevitable process. The deepening inequalities, and the macroeconomic instability that resulted from them, were also the result of policy choices. This is what we will touch upon in the next section.

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[19] S. Iammarino et al. (2018), p. 282.

[20] J. Lindley and S. Mcintosh, "Finance Sector Wage Growth and the Role of Human Capital", *Oxford Bulletin of Economics and Statistics*, vol. 79, no. 4, 2017, pp. 570-91; T. Philippon and A. Reshef, "Wages and Human Capital in the U.S. Financial Industry: 1909-2006", *Quarterly Journal of Economics*, vol. 127, 4 November 2012, pp. 1551-609; T. Piketty and G. Zucman (2014).

The Government: Part of the Problem

The second phase of globalisation coincides with the revolution in macroeconomics that takes place when Keynesian theory, which had dominated the landscape until the mid-1970s, is challenged by a "neoclassical counter revolution"[21]. The theoretical turbulence that follows eventually settles in the late 1980s on a "New Consensus" that, despite the attention paid to the rigidities that hinder the functioning of the economy (which earned it the title of "New Keynesian" theory), takes up and develops the neoclassical theoretical framework. Starting from the 1980s the mainstream in economics is articulated around the notion of a "natural" equilibrium, to which the economy tends spontaneously in the medium term, and from which, however, it can deviate due to the work of rigidities that prevent markets from reacting optimally to exogenous shocks. These rigidities operate only in the short term: persistent deviations from the balance will end up exerting pressure on prices, whose rigidity therefore ceases in the long run.

According to the New Consensus, economic policy has a limited role. Governments should follow clear and predictable fiscal and monetary policy rules (basically stabilising prices and public debt), so as to reduce uncertainty, and allow markets to quickly converge toward the natural equilibrium. Like the old pre-Keynesian model, the theory rests on structural reforms as the main policy tool for governments. These make it possible to increase long-term growth rates by bringing the economic system closer to the ideal type defined by theory: the fight against monopolies, the downsizing of the state in the economy and the denial of any meaningful role for intermediate bodies, together with the elimination of price and wage rigidities, should make it possible to reduce the extent and duration of fluctuations in the economy around the natural equilibrium.

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[21] F. Saraceno, *La Scienza Inutile. Tutto Quello Che Non Abbiamo Voluto Imparare Dall'economia*, Roma, Luiss University Press, 2018.

The approach to economic policy, therefore, changed dramatically from the 1970s. The economic power of the elites, the paradigm shift in macroeconomics, and the conservative revolution in politics mutually reinforced each other, leading to increasingly less progressive tax systems, and to a downsizing of the welfare state[22]. The compression of the government role in Europe is particularly significant in sectors that are crucial for social mobility[23]. Eurostat data show that from 1995 to 2017 (first and last date available), general government expenditure in education as a share of GDP decreased in all the largest economies of the EU except the United Kingdom. In Italy, it dropped from 4.6% to 3.8% of GDP, but it also decreased in Spain, France, and Germany. Note that this happened as the transition towards the digital economy would have called for an increase in that ratio, and a substantial one at that.

The European institutional framework reflects the dominant theory at the time it was established. The Stability and Growth Pact was designed with the explicit objective of banning discretionary fiscal policy, and to lay the burden of adjustment on the operation of automatic stabilisers[24]. According to the Pact, EMU governments had to attain a position of close to balance or surplus in the medium term, while the deficit in any given year needed not to exceed the 3% Maastricht threshold. The Maastricht Treaty also assigns to the ECB a strict inflation mandate: "The primary objective of the European System of Central Banks shall be to maintain price stability" (art. 127), and only "Without prejudice to the objective of price stability, it shall support the general economic policies in the Community" (art.

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[22] J. Creel and F. Saraceno, "The Crisis, Automatic Stabilisation, and the Stability Pact", *Revista de Economia y Estadistica*, vol. XLVIII, no. 1, 2010, pp. 75-104; J. Hacker and P. Pierson, *Winner-Take-All Politics: How Washington Made the Rich Richer and Turned Its Back on the Middle Class*, New York, Simon & Schuster, 2010; A. Razin and E. Sadka, "The Welfare State besides Globalization Forces", NBER Working Paper Series (24919), 2018.

[23] See the already cited OECD (2018).

[24] M. Buti and G. Giudice, "Maastricht's Fiscal Rules at Ten: An Assessment", *JCMS: Journal of Common Market Studies*, vol. 40, no. 5, 2002, pp. 823-48.

2). It is worth noting that the ECB is given by the Treaty considerable independence in defining of price stability, which the ECB's Governing Council defined as a "year-on-year increase in the Index of Consumer Prices for the euro area of below, but close to 2%". While Member States retain competence on fiscal policy, and therefore on corporate tax rates, the EU has exclusive responsibility for competition policy at the European level. This was justified by spillovers (unfair support to sectors or industries in a Member State can impact other Member States), and more generally by the fact that fair competition is paramount in guaranteeing political support to EU integration (in particular the creation of the single market). Therefore, at least initially, competition policy was aimed at reducing fragmentation, not at pushing competition *per se* as in the US Competition policy in the EU rests on two pillars: the first concerns firms' behaviour, and quite classically, aims to fight collusion and eliminate abusive behaviour by firms that have a dominant position while blocking mergers that would create market dominance. The second is more interesting for the purpose of this chapter and concerns the behaviour of governments. The Treaty of Rome (1957) stipulates that "Any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market" (art. 87). State aid is forbidden whether the firms concerned are public or private, and regardless of their nationality.

Thus, in Europe, the institutions and the intellectual framework used by policy makers led to a substantial shortening of the time horizon of governments. Macroeconomic policy should be aimed at facilitating the task of markets, industrial policy would only make sure that competition could work unhindered. Defining a strategy for long term development, investing in sectors or regions in order to boost their long term growth, building infrastructure to facilitate investment and

regional development, all came to be-considered unwarranted interferences of the government in the working of markets ("picking the winners"), and as such were fought in all policy circles. The result is an inertia of European policy makers that, we maintain, goes a long way in explaining the poor growth performance of Europe before and after the crisis[25].

In a context in which the State had given up its role of regulation, financial globalisation facilitated reallocation of capital across borders. The only policy that remained available was a desperate search for competitiveness, through internal (or external, for countries outside the EU) devaluation: the reduction of corporate tax rates[26], wage compression, strong emphasis on reduced labour costs for firms, shift of the tax burden from (mobile) capital to (immobile) labour. The increased mobility of capital triggered a race-to-the-bottom tax competition. The erosion in the tax base, especially on capital, that followed tax competition, created financing problems for the welfare state, and reduced its capacity to contain the increase of inequality.

If, as has been the case for example in peripheral Eurozone countries, these structural reforms, by reducing wages and social protection, should have a negative impact on the purchasing power of households and therefore on their ability to generate demand, the partisans of reforms would argue that this effect would be largely offset by an increase in external demand: export-led growth, itself driven by gains in competitiveness.

Germany can serve as an example. The argument goes that the reforms it implemented in 2003-2005 did liberalise labour markets, and since then, except for the first years of the crisis,

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[25] J.-P. Fitoussi and F. Saraceno, "Inequality, the Crisis and After", *Rivista Di Politica Economica*, vol. 1, 2011, pp. 9-28; J.-P. Fitoussi, and F. Saraceno, "The Intergenerational Content of Social Spending: Health Care and Sustainable Growth in China", in D. Kennedy and J.R. Stiglitz (eds.), *Law and Economics with Chinese Characteristics Institutions for Promoting Development in the Twenty-First Century*, Oxford, Oxford University Press, 2013.

[26] J. Le Cacheux, "La concurrence fiscale dans l'Union européenne", *Idées économiques et sociales*, vol. 154, no. 4, 2008, pp. 24-9; A. Razin and E. Sadka (2018).

unemployment has been steadily decreasing. But in fact, this is a misleading example, because the Hartz reforms were embedded in a complex institutional setting that goes well beyond labour market flexibility. In particular, an important segment of the German labour market, the one linked to manufacturing and business services, has always been ruled by long-term agreements between employers, workers, and local work councils. For these insider workers, a system of work relations was in place in which highly paid workers acquired skills through vocational training (within or outside the firm) and were protected by an all-encompassing welfare system. Vocational training created robust bonds between the firms, which had often invested substantial resources in training, and the workers, whose specific skills could not easily be transferred to other sectors or even to other firms. At the turn of the century, globalised markets coupled with the aftermath of the reunification exerted serious pressure for a restructuring of labour relations. This restructuring happened through a consensus process that did not involve the government and maintained the bond between the firm and the worker created by vocational training. The mutual interest in preserving the long-term relationship between workers and firms in the insider markets led to agreements aimed at reducing costs or increasing productivity without increasing turnover or reducing average job tenure. On the workers' side these agreements could involve labour sharing, flexibility in hours and in labour mobility, wage concessions, and reductions in absenteeism. In exchange for this, firms would guarantee continued investments in innovation, the vocational training of workers, and job security.

It is crucial to understand that the Hartz reform did not affect the insiders' market (manufacturing, finance, insurance and business, etc.), which had already begun restructuring without government intervention. The reform made the welfare system less generous, while allowing access to benefits even for workers with low earnings, thus de facto introducing incentives to low-paid jobs. Furthermore, it liberalised temporary work contracts and made more flexible a few sectors subject to competition

from posted workers (i.e. construction). The combined result of reforms and endogenous restructuring yielded a spike in part-time jobs, and an increase in employment. But it also widened the gap in earnings and in protection between workers in the export-oriented sectors and the others. Job market polarisation and a spike in inequality seem to be the price Germany paid to become a "successful" economy.

The European debate in recent years has highlighted the difficulties inherent in such a strategy. There is a fallacy of composition, because it is impossible for all countries to have a trade surplus at the same time, and thus by definition the export-led growth model is not generalisable. More importantly, it is a non-cooperative game whose end result is a compression of aggregate demand everywhere (which was already clear in the nineties)[27]. Already Keynes in 1936 and Joan Robinson in 1937 had put wage cuts, together with tariffs and the depreciation of the exchange rate, among the measures that a country could put in place to increase its market share (the policies of Beggar-thy-Neighbour), but to the detriment of other countries. And as the experience of the time showed, this could only trigger trade wars and a general fall in economic activity. It therefore seems obvious that the success of adopting an export-led growth model owes a lot to context: Germany has benefited from the robust growth of its partners to cushion the cost of reforms and enjoyed first-mover advantage, which allowed it to gain market shares. The two conditions are currently not met for the other countries in the euro area. The labour cost competitiveness argument is today the main argument put forward to justify labour market reforms that increase inequality and labour market polarisation. The problem is that, as had been the case with competitive devaluations in the past, the generalisation of wage compression has left relative positions unchanged while plunging the European economy in a deflationary environment.

[27] See P. Krugman (1996).

Last but not least, the current difficulties of the German economy underline the risks inherent in an export-oriented growth strategy. As soon as the world economy slows down (most recently because of the trade wars), the German economy and its weak domestic sector struggle to maintain momentum.

Structural reforms (mostly of labour markets), internal devaluation, deregulation, and macroeconomic inertia all stemmed from the same intellectual framework, which puts most of the emphasis concerning growth and cyclical stabilisation on market adjustments and on limits to economic policy. And they all reinforced each other in amplifying the impact of globalisation on inequality. The result has been an increasing macroeconomic instability and increasing debt[28], which eventually generated the worst financial crisis since the 1920s.

How to Go Back To Being Part of the Solution?

The global financial crisis has reopened the academic debate on the respective role of markets and governments in stabilising a faltering economy. There is now increasing agreement on the idea that the New Consensus had gone too far in limiting monetary and especially fiscal policy. But a more fundamental debate should be opened on the role of governments in ensuring long term balanced growth, especially in an increasing globalised economy. The unregulated globalisation that started in the 1970s has brought about many unsustainable imbalances, of which, as we discussed above, inequality is one of the most dangerous for the future of liberal democracies.

We therefore need to reconsider the role of the government as an actor capable of planning over the long term in order to correct distortions and to ensure stable and sustainable growth. The discussion is open on several subjects of paramount importance, and concrete policy proposals exist:

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[28] B.Z. Cynamon and S.M. Fazzari, "Household Debt in the Consumer Age: Source of Growth – Risk of Collapse", *Capitalism and Society*, vol. 3, no. 2, 2008.

1. First and foremost, action should be taken to reverse the trend towards increasing inequality. Income distribution may turn out to be the easiest lever to pull in order to fight secular stagnation. Demographic factors, or innovation trends, are hard to govern and to orient. Inequality can instead be tackled by acting on multiple levels: increasing the progressiveness of the tax system, in particular for high and very high incomes. It is interesting in this respect to follow the US debate, where a few candidates push for strong progressive taxes on both capital and income[29]. In fact, during the three decades between 1945 and 1975, the "regulated globalisation" phase, marginal tax rates were at quasi-confiscatory levels in the US, without any appreciable impact on growth (rather the opposite, see e.g. Diamond and Saez, 2011)[30].
2. Second, the focus should go back on the provision of public goods, particularly intangible ones such as education and health. Concerning social mobility, the very existence of large differences in mobility outcomes across countries indicates that there is room for policy action. The already cited OECD (2018) report on social mobility urges governments to increase investment in education, particularly at an early age, and in health and family policies; this would create a more level playing field for disadvantaged children and mitigate the impact of financial hardship on their future. The report stresses the fact that targeted programs should be privileged. This specific recommendation should be kept in mind while shaping the next European Budget. Creative European policy makers should think of a

[29] E. Saez and G. Zucman, *The Triumph of Injustice : How the Rich Dodge Taxes and How to Make Them Pay*, W.W. Norton & Company, 2019.

[30] P. Diamond and E. Saez, "The Case for a Progressive Tax: From Basic Research to Policy Recommendation", *Journal of Economic Perspectives*, vol. 25, no. 4, 2011, pp. 165-90.

"Horizon 20-27" European Commission program to finance innovative early-learning programs in disadvantaged areas.

3. Last, but not least, an effort should be made to strengthen the insurance role of the government. The trend towards reduced importance of automatic stabilisation should be reversed. Protecting low-income households from cyclical output fluctuations, coupled with active labour market policies, would reduce economic uncertainty and precautionary savings, thus stabilising output both in the short run and in the long run (through increased investment). An interesting project to be pursued is a European unemployment subsidy, to be adopted alongside existing national ones. While not flawless, a good starting point could be the Commission proposal of October 2013[31]. This would introduce solidarity between Member States, contribute to fight macroeconomic divergence, and help dampen income inequality.
4. Industrial policy in the EU should be revamped. Like in any other major economy, our policy makers should set strategic priorities in terms of investment and incentives towards the goal of technological progress and long-term growth. It seems especially utopian to rely exclusively on market forces and on free competition to steer our economies towards the green transition. While it is far from sure that European champions as proposed by Germany and France are the best strategy to pursue, it is encouraging that on the heels of the Alstom-Siemens merger rebuttal the debate continues on European industrial policies. To avoid tax competition and non-cooperative behaviours, the European Commission should rethink its role. From watchdog of free competition, it should transform itself into a forum

[31] European Commission, "Strengthening the Social Dimension of the Economic and Monetary Union", Communication from the Commission to the European Parliament and the Council COM-690 (October 2nd), 2013.

of coordination among Member States, especially but not only with regards to EU-wide industrial policies (such as the ecological transition).

5. Rethinking industrial policy should also focus on territorial inequality. Past discussion was polarised between two extremes of either privileging efficiency, and hence clustering and economies of scale (a trend that has dominated so far); or at the opposite focus on "equity", implementing policies to spread economic activity. Iammarino et al. (2018) proposed a third approach, which they label "place-sensitive distributed development policy"[32]. Such an approach would consist not in trying to fight agglomeration of activity, nor to try to make it convenient for existing economic activity to move to poorer regions; but rather to invest in the institutions of these regions ("distribute open ended" capabilities") in order to make them appealing to "second generation" innovators, who are often the key of success for new technologies. Once again, given that the spatial distribution of wealth often crosses national borders, the right dimension for such policies is the European one. The role and effectiveness of cohesion funds should be reassessed in this perspective.

It goes without saying that in the current environment of pressure on public finances, improving the provision of public goods, strengthening the welfare state, and implementing industrial policies would require an increase in public expenditure. This is the re-empowering of the State and of its capacity to raise resources lies at the core of our policy proposals. Fiscal reform will be the defining issue of the next decade, in terms of reducing inequality and endowing the State with the means to pursue long-term policies. Of course, taxation of very mobile factors is not an easy task, and it becomes almost

[32] S. Iammarino et al. (2018).

impossible in an environment of fiscal competition. It is not coincidental that a handful of countries, the usual suspects, are blocking a European Commission proposal to instate a Common Consolidated Corporate Tax Base, or CCCTB (Candau and Le Cacheux, 2018)[33]. This is a pressing issue, as it pertains in particular to the taxation of multinational companies (in particular those whose assets are mostly intangible, like Google or Amazon), which today are estimated to transfer at least 40% of their profits to tax havens. The principle of CCCTB is taxing based on the quota of revenues, employment, and factors other than fiscal residence. While it is impossible to arrive at a consensus among all countries on such a principle, the Independent Commission for the Reform of International Corporate Taxation ICRICT (2019) shows that if a few of the largest OECD economies were to implement such a principle unilaterally, the incentive for tax optimisation by large multinationals would be strongly reduced[34]. This would be a Copernican change which would constitute a major step forward towards a fair tax system and would give the state the means to pursue its other objectives.

The set of proposals and issues outlined above call for a renewed role for economic policy. This also means that in Europe, we need a change in the political and economic culture that dominated the European construction since the Maastricht Treaty before we begin to implement specific economic measures.

So far, our recommendations have remained in the technical realm, but we believe that the real problem lies beyond: it is philosophical and political. Philosophical because the idea of the existence of a meta-institution, the market, which is supposed to discipline policies better that any government, takes us

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[33] F. Candau and J. Le Cacheux, "Taming Tax Competition with a European Corporate Income Tax", *Revue d'Economie Politique*, vol. 128, no. 4, 2018, pp. 575-611.

[34] ICRICT, *International Corporate Tax Reform: Towards a fair and comprehensive solution*, October 2019.

back to the market vs. democracy debate. The doctrinal foundation of European Economic Policy is to be found in rational expectations, real business cycles theory, and a doctrine which claims that the role of the state should be minimised. Hence the supremacy of rules. It is also philosophical, because facts seem to be utterly unimportant. The victory against inflation, which was considered as the condition *sine qua non* to build a good economy, ended in the worst crisis since 1929. And on a similar note the elites do not seem to realise what most sensible economists (such as Olivier Blanchard) are putting forward, namely that the battle against public debt, if it is won, would lead to a bigger catastrophe. But the problem is also political because governments have lost trust of the people and do not seem to have the courage to propose a new vision. Unless such a vision is put forward, the increase in protest that we have seen may mark the beginning of a new era of authoritarian capitalism.

5. Euro and Economic Governance: National Priorities and Quest for Stability

Lorenzo Codogno

Why Is Economic Governance So Crucial for the EU/Eurozone Outlook?

In the age of rising populism and nativism throughout the European Union (EU) and globally, designing proper economic governance that allows the EU to address its collective action problem, advance integration and deliver relative to citizens' expectations has become of paramount importance.

The EU/Eurozone has moved from crisis to crisis over the past ten years. The outbreak of the economic and financial crisis in 2008-2009 was effectively just the first leg of a series. Initially, it was all about global economic and financial contagion and spillovers into domestic activity. The banking sector suffered severely from the international financial turmoil due to specific domestic business weaknesses, which then resulted in widespread state aid intervention to save the banks across the EU. Then a second leg followed, with the Greek crisis, which was shadowed by shocks in many other Member States either through their banking sectors or public finances. The public debt ratio sharply increased in many countries, government bond spreads widened, and interbank markets closed. The

policy reaction was frantic as EU governance was not prepared and designed for crisis management. In 2011-2012, another leg developed, this time specific to Italy. The widening of government bond yield spreads produced a quasi-credit crunch. Eventually, accommodative monetary policy and Draghi's "whatever it takes" contributed to preventing a further rise in government bond yields and a downward spiral in the economy. Debt overhang and fallouts of the balance sheet recession prevented any significant economic recovery after that. Another leg developed again with the Greek crisis in 2015, while Italy was close to engineering a new one in 2018. Over the past decade the EU has always been in crisis mode.

Despite considerable advances in crisis response mechanisms, banking union and the economic governance framework, more than ten years of problems left their scars in terms of reform fatigue and lack of trust among Member States. Moreover, the financial and economic crisis produced permanent damage to the growth potential[1] of many economies. Unemployment rose sharply in many Member States, social uneasiness started to rise and with it also new political phenomena, which were global but also had some specific EU characteristics.

The current EU governance as it stands remains in the middle of the road, and such unfinished job leaves the whole European integration project vulnerable. The need for further political and economic integration is hindered by real risks of disintegration, e.g. Brexit but also other potential "exits", and by growing requests for returning sovereignty to Member States in key policy areas. The EU unique status as a rule-based "supranational organisation" becomes increasingly at odds with non-cooperative nationalistic behaviours and mistrust. Faced with pressing domestic problems, European leaders often find it more convenient to postpone addressing EU/Eurozone challenges, while most of the times the latter were also at the root of their domestic problems.

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[1] In economics, potential growth refers to the highest level of real gross domestic product (potential output) that can be sustained over the long term.

Following the initial impulse to reform and advance EU/Eurozone integration, the process has increasingly met with political opposition, and the reform momentum has been lost, which paradoxically is one of the main avenues to make the EU/Eurozone in a condition to provide concrete answers to the legitimate demands of citizens.

The still-not-properly-functioning Economic and Monetary Union (EMU), combined with the sluggish and unequal growth and the lack of assertiveness on the global scene, provides the best culture ground for the rise of populist, Eurosceptic and nationalist movements and parties. Failure to deliver and meet people's expectations becomes in itself a way to generate a vicious circle, with disappointed voters channelling their resentment toward populist movements wishing to undermine EU competencies and policies, further reducing the EU's ability to deliver.

Breaking the vicious political circle taking place in Europe means also having the political courage to complete economic and political integration. This chapter tries to describe the state of the European project by looking at two economic strands, i.e. the fiscal framework and the Macroeconomic Imbalance Procedure, as the EU enters into a new political term, following the European elections on 26 May 2019, with a new European Parliament and a new Commission.

Fiscal Framework: Any Hope for a Different Policy Mix?

The controversial decision of the Governing Council of the European Central Bank (ECB) to introduce another package of easing measures in September 2019 opened a big debate. The plea to use fiscal policy by former ECB President Draghi[2], even supporting cross-border fiscal transfers, was not well received by all observers. For instance, six prominent former central bankers

[2] Interview with the *Financial Times* on 29 September 2019, and previous similar remarks at the regular press conferences of the European Central Bank.

published a memorandum criticising ECB monetary policies, saying they have been unsuccessful and probably aimed at bankrolling indebted governments[3]. Is the fiscal framework in the EU attuned with the evolving needs, and especially the need to achieve a different policy mix amid constrained ECB policies?

It is thus crucial to assess the extent to which European leaders and institutions can respond to this call by delivering a more expansionary fiscal policy. Before that, it is useful to recap the changes in the EU fiscal framework since the crisis.

The culprit was probably elsewhere, but part of the blame for the government debt crisis in the EU, and especially the Eurozone, went to the public finance profligacy of some countries before the crisis, or at least their inability to build-up adequate fiscal buffers in good times. Thus, it called for a strengthening in the institutional architecture of which the Stability and Growth Pact (SGP) was an essential part.

The SGP is the reference for the fiscal governance in the EU. Its introduction was linked to the adoption of the euro to ensure that debt levels remain sustainable as a matter of "common interest" and as a complement to the independence given to the ECB. Maintaining so-called "monetary dominance" means avoiding the central bank being forced to change monetary policy to facilitate sovereign financing. This risk has become even higher following the crisis and the current constraints to monetary policy.

At the basis of the SGP is the Maastricht Treaty, which enshrines as its primary fiscal goal to maintain sound public finances. In the Treaty, the threshold of 3% for public deficit

[3] "There is broad consensus that, after years of quantitative easing, continued securities purchases by the ECB will hardly yield any positive effects on growth. This makes it difficult to understand the monetary policy logic of resuming net asset purchases. In contrast, the suspicion that behind this measure lies an intent to protect heavily indebted governments from a rise in interest rates is becoming increasingly well founded. From an economic point of view, the ECB has already entered the territory of monetary financing of government spending, which is strictly prohibited by the Treaty". As published in J. Randow, "Memorandum on ECB Monetary Policy by Issing, Stark, Schlesinger", *Bloomberg News*, 4 October 2019.

on Gross Domestic Product (GDP) and of 60% for debt on GDP were simple conditions to maintain debt sustainability, although the underlying assumptions on real GDP growth and inflation now appear to have become somewhat obsolete. They were aimed at avoiding excessive deficits and debts, monetary financing and financial repression, any "free-riding" and any form of bail-out. On 17 June 1997, a resolution of the European Council[4] paved the way for the SGP, underlining "the importance of safeguarding sound government finances as a means to strengthening the conditions for price stability and strong sustainable growth conducive to employment creation". It also said that it was "necessary to ensure that national budgetary policies support stability-oriented monetary policies. Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3% of GDP". This simple budget rule would have allowed Member States to let automatic stabilisers work symmetrically over the cycle while maintaining the deficit within the 3% limit. Later on, also an escape clause was introduced for extraordinary adverse cyclical conditions. The framework was nevertheless criticised as it focused too much on headline targets, and thus it was perceived as "stupid"[5], ignoring unanticipated changes in cyclical conditions or situations out of the control of Member States.

In 2005 both France and Germany failed to comply with fiscal rules and the Commission did not step up the Excessive Deficit Procedure (EDP). Instead, the Pact was revised to introduce the concept of "structural balances", i.e. estimates based on country-specific elements such as potential growth, the output gap, as

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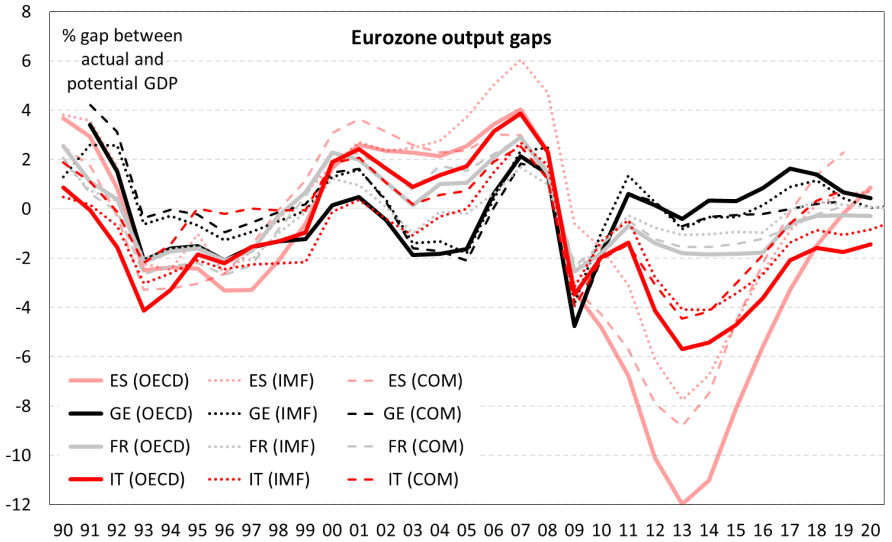
[4] Resolution of the European Council on the Stability and Growth Pact, Amsterdam 17 June 1997, (97/c 236/01).

[5] Former President of the European Commission Romano Prodi said "I know very well that the stability pact is stupid, like all decisions which are rigid. […] The pact is imperfect. We need a more intelligent tool and more flexibility", interview with *Le Monde*, 17 October 2002.

well as future costs associated with the ageing of the population. This increased its economic relevance but also the uncertainty of estimates. Uncertainty increased massively following the considerable shock to the economies coming from the financial/economic crisis, which made estimates of potential growth, and thus output gaps, much more difficult[6] (Figure 5.1). Despite that, the reform was able to reduce pro-cyclical elements in national fiscal policies somewhat. Moreover, with the reform, the emphasis shifted from "fiscal outcomes" to "fiscal efforts", to better reflect the changes in the fiscal balance due to discretionary measures, taking into account the relevant margins of error.

Fig. 5.1 - Eurozone output gaps



Source: Thomson Reuters Datastream, OECD, IMF, European Commission, own calculations.

Commission, IMF, and OECD output gap estimates for four Eurozone countries

[6] Various international institutions and research centres had substantially different estimates of potential growth and the output gap for the EU countries, and estimates became subject to sizeable revisions. As a result, structural balances became an increasingly controversial gauge of the underlying budget position.

Nevertheless, once the 2008-2009 crisis breaks out, it became apparent that over the years fiscal rules had not been sufficiently tight to allow a fast convergence to the country-specific Medium-Term Objectives (MTOs)[7] and that the level of the debt ratios was somewhat neglected in implementing rules. Although fiscal policies were not at the root of the crisis, the so-called "Six Pack" (2011) and the "Two Pack" (2013)[8] strengthened the toolkit for economic and fiscal surveillance. Fiscal rules were tightened, and indicators broadened to make sure the MTO was reached with the shortest possible delay, and thus allow public finances to be in a relatively "safe zone".

An expenditure rule was introduced, together with a debt reduction benchmark to complement existing rules. The "expenditure benchmark" was introduced to make sure that any extra spending not consistent with economic growth were to be financed by new permanent tax revenues. The concept of "debt-reduction at a satisfactory pace", embedded in the Maastricht Treaty signed in 1992, was operationalised and linked to a debt-based EDP. The aim was to ensure an annual reduction of about 1/20th of the difference between the actual debt level and the 60% threshold with the introduction of a complex debt benchmark derived from backward and forward-looking components.

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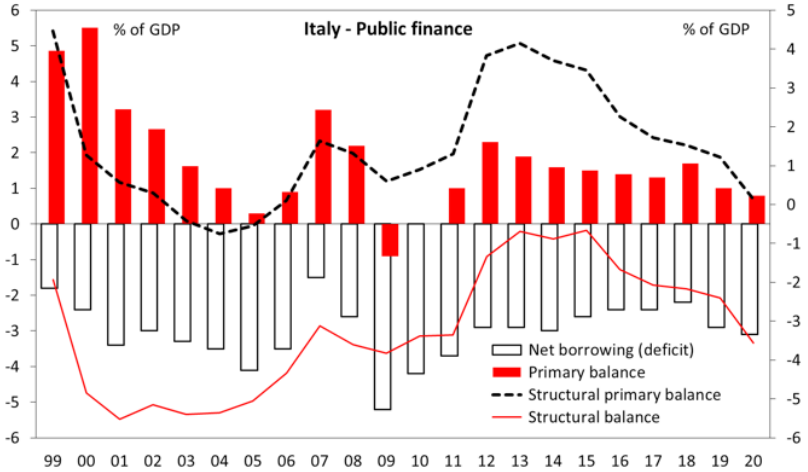
[7] MTOs are set as long-term deficit-to-GDP targets to ensure sound fiscal health. They take into account the need to achieve sustainable debt levels while ensuring governments have enough room to manoeuvre and a safety margin against breaching the EU's fiscal rules.

[8] The Six Pack included: (1) changes to the preventive arm of the Stability and Growth Pact to strengthen the surveillance of budgetary positions and the surveillance and coordination of economic policies, (2) changes to the corrective arm of the Pact speeding up and clarifying the implementation of the excessive deficit procedure, (3) details of possible sanctions for the effective enforcement of budgetary surveillance in the euro area, (4) strengthen national budgetary frameworks by introducing specific requirements on national budgetary frameworks. The "Two pack" included: (1) common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States, and (2) a surveillance framework beyond the SGP for euro-area Member states experiencing or threatened with serious difficulties with respect to their financial stability.

The European Semester was strengthened, and the dialogue with Member States reinforced to achieve more ownership of the process. It also made the whole practice homogeneous and consistent throughout the EU, and especially the Eurozone. The Eurozone dimension received more attention over time, but it never became prominent due to fundamental opposition by some Member States. Although being of technical nature, the strengthening of the European Semester produced a significant procedural leap forward.

All these changes were embedded into the European Semester, and the "Two Pack" called for independent national fiscal watchdogs to increase ownership of the process and, supposedly, public monitoring and dialogue. However, complexity inevitably increased and with it, the difficulty in explaining the behaviour and decisions of European institutions to ordinary citizens.

Fig. 5.2 - Italy's decline in the structural primary balance since 2014



Source: Thomson Reuters Datastream, European Commission, own calculations.

Italy's main fiscal variables according to estimates by the European Commission

Another more subtle shift in the EU fiscal framework happened when the Juncker Commission took office in late 2014. Since then, the Commission has started to favour a more flexible interpretation of the Stability and Growth Pact (sealed by a decision of the Council in February 2016), to reduce some pro-cyclical features of the rules and enhance their economic meaning. During the crisis years, the need to capture the diversity of economic circumstances became particularly pronounced, with a more sophisticated but also more complex set of considerations. More specific clauses were designed to favour investment activity, and allow the introduction of structural reforms with short-term budgetary costs. In 2017, the Commission also introduced the so-called "margin of discretion" as a further way to allow extra flexibility when deserved. However, the problem remained implementation by Member States. A high-debt country like Italy, in the preventive arm of the Pact, recorded effectively no fiscal effort in 2014-2019, if measured by the change in the structural primary balance (Figure 5.2).

The implementation of the rules by the Commission became thus less mechanical and more open to political considerations, and thus also exposed to criticism by a number of Member States. Together with increased complexity, also came the feeling of distance of EU institutions from citizens. Finally, some may also argue that the credibility of the rules has been undermined by repeated "flexible interpretations"[9] to the point that the whole framework now needs to be reconsidered.

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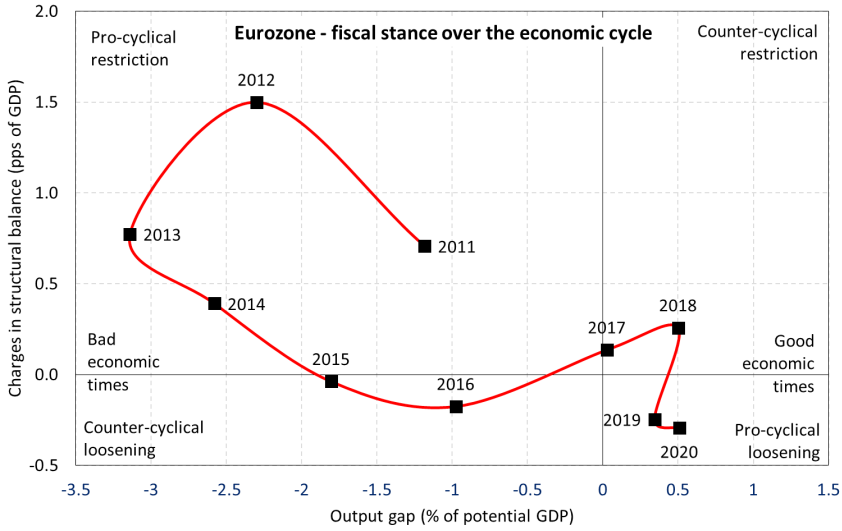
[9] For a description of these episodes, see C. Martinez Mongay and M. de Manuel Aramendia, in "Issues in fiscal policy. The EU fiscal rules during the Juncker Commission", forthcoming in "The Euro 2020", Foundation for Financial Research and ICO Foundation, Madrid 2020. There are four main episodes: (i) the extension in 2015 of the 126(7) Council recommendation for France; (ii) the decision adopted in 2016 concerning the fines associated to the stepping up of the EDP for Spain and Portugal; (iii) the implementation of flexibility under the preventive arm for Italy; (iv) the rejection and subsequent negative opinion on the 2019 DBP of Italy in the autumn of 2018; and the (v) implementation of the debt rule in the case of Italy.

There have been so many important innovations over the years, and time has now come to evaluate their performance. Most countries were in EDP at the outset of the crisis. Eventually, all countries went out of the procedure by 2018, with Spain being the last. A bird-eye view of this period suggests that most of the fiscal consolidation happened courtesy of lower interest rates and the recovery in the economy. There has been little structural adjustment in the underlying factors or any significant re-composition in revenue and expenditure. The quality of public spending has not improved either, with public investment cutbacks over the years almost everywhere. Finally, there has been pro-cyclicality, especially in countries that in the early stages of the crisis went under severe financial market pressure (Figure 5.3). However, past policies would become broadly neutral if these countries were netted out from the whole Eurozone.

Fig. 5.3 - The Eurozone fiscal stance has been pro-cyclical since the crisis



Source: European Commission, AMECO, Thomson Reuters Datastream, own calculations.

Eurozone structural balances vs output gaps

There have been many analytical efforts and academic studies over the years to assess the performance of the EU fiscal framework. Moreover, the possibility of reviewing it was first officially raised in the Five Presidents' Report in June 2015, and then further discussed in the Reflection Paper by the European Commission in May 2017, and finally in the roadmap for deepening Europe's Economic and Monetary Union in December 2017. Probably the best summary of the main findings of the whole discussion, including recommendation on how best to revise the fiscal framework, can be found in a report by the European Fiscal Board on the "Assessment of the EU fiscal rules, with a focus on the 'Six Pack' and 'Two Pack' legislation" published on 10 September 2019[10]. This study was commissioned by the President of the European Commission in January 2019. The assessment of the effectiveness of fiscal rules was done following three main criteria: (1) ensuring the long-term sustainability of public finances; (2) stabilising economic activity in a counter-cyclical fashion; and (3) improving the quality of public finances.

The conclusions of the Report is that these reforms "have moderately advanced sustainability". However, they "have been unable to significantly reduce pro-cyclical elements in national fiscal policies and to improve the quality of public finances". The main recommendation, in line with growing consensus, is to focus on one single anchor, i.e. "the longer-term evolution of the ratio of public debt to GDP", and one main instrument, i.e. "the expenditure benchmark". Also the European Fiscal Board was of the view to replace some of the piece-meal elements of flexibility introduced over the years, with "a general escape clause", the use of which "should be embedded into a clearer demarcation than in current practice between analysis and the political arguments that will occasionally have to override it". Moreover, the Report made a strong point on simplicity: "The

[10] European Fiscal Board, "Assessment of the EU fiscal rules, with a focus on the six and two pack legislation", 10 September 2019.

growing complexity of the functioning of the Stability and Growth Pact has become problematic, raising questions about transparency, equal treatment among countries, and communicability to the public".

In a nutshell, here are the key policy recommendations.

- New rules, i.e. getting rid of the deficit rule and instead relying exclusively on a more straightforward medium-term debt ceiling and a limit on net primary expenditure growth for a period of three years, adding an all-encompassing escape clause triggered on the basis of independent economic judgement.
- Golden rule for public investment by allowing Member States to voluntarily top-up expenditures on EU projects co-financed by them beyond their national commitments. These could then be deducted from the calculations of the expenditure benchmark.
- A full-time Eurogroup President, to enhance the ability of the informal Eurogroup body to govern Eurozone fiscal matters, police the national budgets, and help to implement the overall fiscal stance.
- Abolishing reverse qualified majority voting[11], as it contributed to making the Commission politicised and fiscal surveillance increasingly on a bilateral basis at the expense of multilateral peer review.
- Independence of DG ECFIN; experts of the Directorate-General for Economic and Financial Affairs should play a more independent role in setting the fiscal targets and assessing whether the Member States meet fiscal goals, allowing occasional political decisions to overrule the technical assessment.
- A different kind of sanctions. Sanctions introduced during the financial crisis in case of breaching the rules have been politically difficult to enforce. Instead, access

[11] Under the current fiscal rules, most sanctions are applied unless a qualified majority of countries overturns them.

to European funds for counter-cyclical policies (to be developed) would be denied if the country is not in compliance.

- A seven-year cycle, which effectively mirrors the multiannual financial framework (MFF) for the EU's long-term budget, to better coordinate public accounts and investment projects. High-debt countries would commit to reducing their debt, while low-debt countries would commit to increasing growth-enhancing government expenditure, and especially those that have positive cross-border spillovers.

Longer-term, the Report looked at ways to reconcile EMU deepening with the heterogeneity of the Eurozone, even by recognising diversity "by collective negotiation of country-specific debt targets for the longer run".

These are all very sensible proposals, but the Report met mixed feelings among finance ministers. Some want to be able to continue to delay unpalatable fiscal adjustments and thus want to retain somewhat opaque procedures, which provide them with some leeway. Others are afraid that a revision would produce an even more flexible interpretation of the rules, which may undermine fiscal discipline. Finally, many believe that reforming the fiscal framework is not a matter of priority and that rules are already working reasonably well. This seems to produce a convergence of interest for inaction.

The Report of the European Fiscal Board was presented to ministers at the informal Ecofin meeting in Helsinki on 14-15 September 2019, and the proposed simplification of fiscal rules, to make them more transparent and predictable, was backed by EU finance ministers. Also, the idea to focus on medium-term debt anchor and the expenditure benchmark as operational rule seemed broadly accepted. However, it was said that more work is needed before any change is agreed, and especially there was a clear desire not to reopen a discussion on existing legislation if not sure whether there could realistically be an agreement on

any new shape. The European Commission will make its proposals by the end of 2019, as part of a scheduled review, and then the debate at committee level will start. Reviewing fiscal rules is also in the mission letter to the new Commissioner Gentiloni to achieve "a more growth-friendly fiscal stance in the euro area and stimulate investment while safeguarding fiscal responsibility".

Beyond official statements, however, the impression is that of a deadlock. Despite some agreement on the need for simplification of rules, European countries seem unable to build any form of consensus in favour of the view that fiscal stabilisation is a collective responsibility within the Eurozone, as suggested by the European Fiscal Board already in 2017 and by many others. Building up any form of fiscal capacity remains the most controversial step. It is indeed difficult for fiscal rules to act as a substitute for more coordination of fiscal policies and a central fiscal capacity or other features of a deeper Economic and Monetary Union. Reconciling debt sustainability and economic stabilisation remains therefore very challenging.

The so-called Budgetary Instruments for Convergence and Competitiveness (BICC) should not be considered as the first step towards a centralised fiscal capacity as they are not designed as countercyclical tools. They are financing instrument aimed to support both structural reforms and public investment in the form of grants (i.e. direct financial contribution), with a national co-financing rate of 25%. In June 2019, the Eurogroup agreed on the main features of the BICC for euro area, and for ERM II Member States on a voluntary basis. The Euro summit and the Eurogroup will give strategic guidance on the key reform and investment priorities for the convergence and competitiveness of the euro area and will review these priorities annually. The priorities will be reflected in a strengthened Euro Area Recommendation. A minimum national co-financing rate will be required and set as a percentage of the total cost of the investment and reforms. The amount of the support that a Member State can benefit from will be determined based on the cost estimate on specific proposals which should consist

of "packages of reforms and investment, linked to the national reform programme and compatible with the national budgetary process". Allocation will be based, for at least 80% of the funds, on population and inverse of GDP per capita.

As the instrument will be part of the EU budget, it gave rise to hopes it could become *in nuce* a sort of centralised fiscal capacity. However, the allocation of funds within the EU budget is supposed to be only about 0.1% of Eurozone GDP, and the instrument is not designed as a counter-cyclical tool. While indeed a positive device for structural reforms and investments, the BICC is a false dawn for Eurozone fiscal capacity[12].

As a result, at this stage, there are only three possible routes.

First, without changing existing Treaties or any substantial variation in the current policy framework, the Commission with the support of European leaders could try to achieve a better policy mix, through policy coordination. This would imply exploiting all possible fiscal space currently available at the national level and use maximum flexibility allowed by the rules.

This, however, would inevitably put any such European public finance decisions on a collision course with Germany's internal debt brake policy, the *Schuldenbremse*, and its budget policy, the *Schwarze Null*. More likely, Germany (the Netherlands, and possibly others) will introduce policy initiatives to make room for additional fiscal expansion, such as funds dedicated to infrastructure or green investment[13], instead of going for outright

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[12] See Eurogroup press releases on 14 June 2019 and 10 October 2019, and statement of the Euro Summit, 21 June 2019.

[13] In Germany, there have been calls for the introduction of a fund supporting climate policy related investments, mainly supported by the Green party, or alternative requests for investing to soften the impact of the ageing population (*Deutchlandsfonds*). As of writing, this does not appear to have led to any concrete policy action. Moreover, the *Klimapaket*, a broad based policy package announced after the summer introduced a number environmental initiatives, but now major new funds were brought to life leaving aside an old climate fund ("EKF" established in 2010), which contained €4.5 billion (about 0.1% of German GDP) at the end of 2018, that will be used for the financing of some of the measures in the package. In the Netherlands, King Willem-Alexander confirmed in a speech

fiscal expansion. Finally, it is not even clear whether moving within the boundaries of existing rules would produce enough policy space to allow the ECB to gradually "normalise" current policies, bring interest rates back into positive territory and allow proper transmission though the banking channel without risking to hinder the ability of banks to expand credit.

Second, European leaders and the Commission could agree on a suspension of rules. The existing Regulation[14] provide for a possible "waiver" from any adjustment in case of an "unusual event outside the control of member States […] which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole". This is a sort of nuclear option, which could be activated only in extreme situations. It would probably take another severe recession or a substantial external shock (US trade sanctions?) to move in that direction. In any case, there would be no guarantee that Member States faced with the opportunity to go for fiscal expansion would take advantage of that possibility, as the trade-off between stabilisation policies and debt sustainability would become an important issue, especially in high-debt countries.

Finally, Eurozone leaders may decide to introduce a Euro-wide central fiscal capacity, together with a safe asset, to allow the economic area to activate counter-cyclical policies and alleviate the zero-lower bound constraints on monetary policy[15].

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to both houses of Parliament in September 2019 that the government would set up a national investment fund early in 2020. The aim of the fund will be to help the economy expand in a sustainable way for the next 20-30 years by strengthening the country's earning capacity, focusing investments on specific projects meeting tightly formulated criteria in the sphere of knowledge development, innovation and infrastructure. Finance Minister Hoekstra said that the fund may involve "tens of billions of euros over the longer term" and then press releases suggested about €50 billion. Projects for this "future fund" will be detailed in early 2020.

[14] Regulation (EC) 1466/97.

[15] See L. Codogno and P. van den Noord, "The rationale for a safe asset and fiscal capacity for the Eurozone", LEQS, the LSE 'Europe in Question' Discussion

This would be the most controversial and politically difficult move. It could only be achieved as part of a grand bargaining that makes a significant step towards economic and fiscal integration.

Macroeconomic Imbalances: Ownership of Reforms and a Roadmap for the Future

In the post-crisis environment, the "Six Pack" also introduced the Macro Economic Imbalance Procedure (MIP)[16] to prevent and correct external and internal macroeconomic imbalances. Convergence in nominal interest rates following monetary union produced a sharp increase in cross-border capital flows and the formation of large external imbalances in some Eurozone Member States. Capital inflows led to credit-fuelled growth, which in turn produced private sector over-leverage, asset over-valuation, increased wages, and loss in cost competitiveness. External and internal imbalances were closely linked and were at the root of the crisis. This called for strengthened monitoring and governance changes.

The MIP established an annual monitoring cycle, as part of the European Semester and in parallel with the fiscal side (SGP). It also introduced a corrective arm, i.e. the Excessive Imbalance Procedure (EIP), which so far has not been launched. Thematic focus was strengthened, and Country-Specific Recommendations (CSRs) made more binding through the link to the procedure. The monitoring of the implementation

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[16] The "Six Pack" included: (1) prevention and correction of macroeconomic imbalances: it lays out the details of the macroeconomic imbalance surveillance procedure for all Member States, (2) enforcement action to correct excessive macroeconomic imbalances in the euro area. Regulation EU 1176/2011 and EU 1174/2011.

of structural reforms was boosted, as well as technical assistance to Member States in need.

The annual monitoring cycle starts with the publication of the Alert Mechanism Report by the Commission, which assesses the economic situation within the EU countries on the basis of a screening device, a scoreboard of indicators. Indicators cover both internal and external imbalances, including private sector leverage and government debt, price and cost developments, and current account balances. This is followed by in-depth reviews carried out by the Commission for those countries whose situation warrants more analytical and policy attention. The review concludes whether "excessive imbalances" exist and their severity. The annual CSRs, proposed by the Commission and then approved by the Council, spell out the actions required to address imbalances, taking into account that, unlike decisions on taxation and government spending, the correction of imbalances are often not directly under the control of the government.

It could be argued that macroeconomic imbalances have declined over the years, with only three countries in "excessive imbalances" since 2018, although in 2019 the number of countries experiencing imbalances of any sort increased to 13 from 11. The recorded improvement was mainly related to the gradual economic recovery rather than policy action. According to the European Commission analysis and other empirical studies[17], compliance with MIP recommendations has been rather weak, and it has worsened over the years. Implementation of policy actions is an even more delicate area, as not only legislated measures but also their effective implementation matters.

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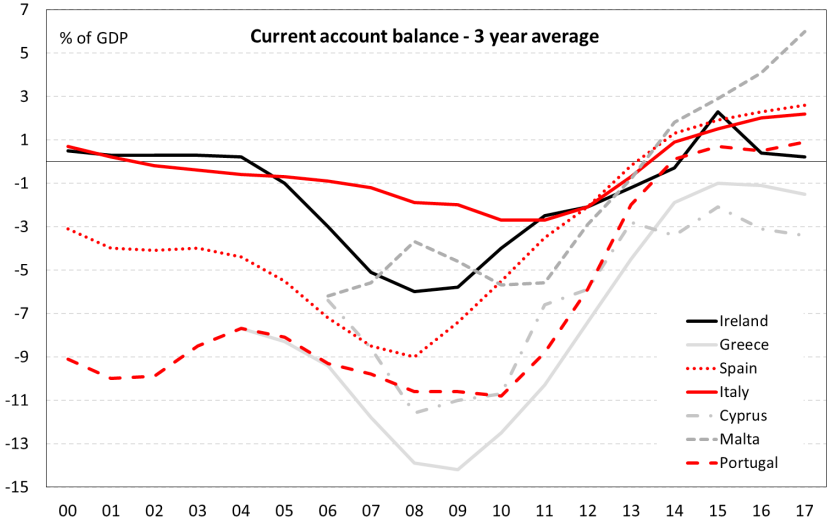
[17] See for instance, European Commission, *The Macroeconomic Imbalance Procedure: Rationale, Process, Application: A Compendium*, Institutional paper no. 039, 2016; B. Pierluigi and D. Sondermann, "Macroeconomic imbalance in the euro area: where do we stand?", ECB Occasional Paper Series, no. 211, 2018; K. Efstathiou and G.B. Wolff, *What drives national implementation of EU policy recommendations?*, Bruegel Working paper no. 4, 2019.

Fig. 2.4 - Current account adjustment in the periphery of the Eurozone



Source: Thomson Reuters Datastrem, Eurostat, own calculations.

Current account balances for selected Eurozone economies since EMU

Lack of compliance has various reasons. A first reason relates to the fact that only two imbalances have significant macro relevance, well above all the others, i.e. high debt-to-GDP levels, and outsized current account deficits/net international investment positions, and these two are the most difficult to tackle in the near term. A second reason is the asymmetric correction of macroeconomic imbalances indicated by the procedure (e.g. different thresholds for current account balances depending on whether they are in surplus or deficit) and by countries, with the troubled ones having reduced their deficits, while surplus ones having done very little to address the issue (which sometimes was not even perceived as an issue). To some extent the asymmetric adjustment in current account balances is also linked to the cuts in public investments, which resulted from low-quality fiscal adjustment across Europe.

There have also been some areas of weakness in the procedure itself. It was launched in 2011 with some intrinsic ambiguities. First, the MIP overlaps with SGP procedures as indicators such as the level of debt ratios are the focus of both procedures. Second, the ambiguity partly refers to the links to social and labour indicators included in the scoreboard, which serve as broad policy objectives but have only a feeble connection with macroeconomic imbalances. It was the result of the involute dialogue among the Commission, the Council and the European Parliament when the "Six Pack" regulation was written in 2011, which produced a Christmas tree of broad policy objectives. Third, there was some ambiguity on what the procedure was supposed to do and the sometimes weak links with economic literature. In fact, sometimes the procedure was addressing effects instead of underlying causes. Fourth, the procedure is a way to identify imbalances that jeopardise the functioning of the EU/Eurozone, but it is not clear whether the aim is to force countries to do what is best for their own economy, or to protect the rest of the EU/Eurozone from any fall-out, or both. Fifth, there is a suspicion that it is more a way to strengthen and make more binding the fiscal recommendations, i.e. the SGP, rather than addressing a different stream of vulnerabilities.

Finally, the direction of travel is not completely clear. Should the aim of the European project be full fiscal/economic/political integration sometimes into the future, macroeconomic imbalances would look differently. The assessment would take into consideration divergent patterns of sectoral specialisation, which in turn contribute to producing different productivity growth rates and current account balances, implying co-existence of different industrial and economic structures and a different pace of employment creation and output generation within different countries. All this would not matter much in a fully integrated area. Sectoral specialisation with the Eurozone would be a positive phenomenon to enhance potential growth and employment. However, in the long run, the literature suggests that sectoral composition also has a substantial impact on

TFP growth. Therefore, it would mean different growth rates and output trends across member states, and within certain limits, imbalances should be expected as a by-product of greater product and services market integration. Instead, the MIP reflects the idea that imbalances are country-specific, and that countries are treated as they were stand-alone entities[18]. Finally, there is no clear distinction between broad policy objectives and intermediate targets, which are more under the control of policymakers[19].

The recommendations of the European Fiscal Board for the way forward of the MIF include: "(i) using MIP to its full potential, including the excessive imbalances procedure (EIP); (ii) enhance communication with Member States and ownership; (iii) increasing transparency of the process by advancing analysis (i.e. forward-looking indicators), specifying more detailed policy actions and setting a more realistic timeframe for implementation of recommendations; (iv) increasing credibility by clarifying the criteria and process for classifying imbalances; (v) aligning Member States' recommendations with the euro-era ones; and (vi) linking the MIP with fiscal surveillance". These are all workable suggestions. As for the fiscal side, the Commission will put forward proposals by year-end, and then the discussion will start. The impression is that European leaders are not eager to step up the reform, as this would also mean intrusion into their domestic policy turf.

It is not sure whether countries identified with imbalances have also experienced an open discussion among the relevant policymakers and the broader public. Anecdotal evidence suggests that the attention was higher in the early years of MIP and that the momentum for public discussion has abated since

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[18] See L. Codogno, speech at the concluding policy panel "Perspectives on European growth: One currency, several growth models?", DG ECFIN Annual Research Conference on "New growth models in Europe", Brussels, 21 November 2011.

[19] L. Codogno, G. Odinet, and F. Padrini "The Use of Targets in the Lisbon Strategy", *Rivista di Politica Economica*, Issue I-III, January-March 2009, pp. 3-21.

then. The spreading of the debate on imbalances and policy actions beyond the close cycle of policymakers and government officials remains a significant challenge for the success of the overall strategy. Political acceptability and ownership of reforms facilitate the implementation and avoid the risk of backlashes. It is only once the broader public understands the rationale behind the recommendations, and that produces awareness about the need to prevent and correct imbalances, that the strategy can truly be considered a success.

Conclusions: Roadmap Still Missing, Ownership Is Key

As the EU approaches to review the "Six Pack" and the "Two Pack", which are key cornerstones of the EU economic governance, there is still no clear support on the ultimate goal of the European project.

Many documents tried to open a broad debate on the future of Europe and get the necessary political support. It started with the so-called Four Presidents' Report "Towards a genuine Economic and Monetary Union" in June 2012. It then moved to the Five Presidents' Report in June 2015, then to the "White Paper on the Future of Europe" by the European Commission in March 2017, and the "Reflection Paper on the Deepening of the Economic and Monetary Union" prepared by the European Commission in May 2017, and finally in the roadmap for deepening Europe's Economic and Monetary Union in December 2017.

These report never met full-hearted backing by European leaders, and many aspects remain highly controversial. A fully agreed roadmap would inform the more near-term decisions on changes to the EU/Eurozone economic governance, and thus help broader public support on the substance and the objectives of the whole endeavour. In fact, ownership of the European integration process remains the weak link.

Without shared and agreed-on ownership of the integration process, the EU/Eurozone remains in the middle of the road, without a clear sense of direction, vulnerable to exogenous and endogenous economic shock, but also and more importantly, to a political and social backlash.

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