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"EURO SUSTAINABILITY": FIVE POLICY PROPOSALS TO MAKE THE EURO SUSTAINABLE FOR THE EUROPEAN ECONOMY

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***Abstract**. The provided economic analysis and the economic policy proposed in this article are the natural verifications and continuations of a research that was started with the author's described theory in Single Currency, Economic Development and Local Economies. A Critical Analysis of the Economic Policy of the Euro (1998). He emphasized the presence of important critical factors on the Economic and Monetary Union (EMU) which, if not solved, would undermine its existence; however, the importance of EMU's policy was not questioned. This article offers a sustainability strategy of the Euro, called a "push investment approach," which provides complementary public and private investment, strengthens the euro area governance and gradually eliminates the Maastricht criteria. Furthermore, the policy makes the Euro sustainable for all the acceding countries, constitutes development as well as the competitive factor and it is not critical to enterprises.*

***Keywords:** Euro, governance, Maastricht criteria, EMU policy, sustainability.*

1. Introduction

The economic analysis and the proposals in this article are the natural continuation of a research path that does not follow the mainstream thinking, which originates from the theses described by the author in the book he published in 1998, titled Single Currency, Economic Development and Local Economies. A Critical Analysis of the Euro Economic Policy. This paper, while not questioning the political importance of the realization of the EMU and the existence of some unquestionable advantages not only of an economic nature, highlighted how the introduction of the euro represented a starting point and not the arrival of a complex and articulate integration process. In addition, the book emphasized the existence of certain important critical factors on the path to establishment of the EMU, which, if not resolved, would have to undermine its very existence.

Indeed, in the text, it was pointed out that the economic policy guidelines followed since the end of the nineties left only the solution of the structural nodes of the European economy:

[1] The views expressed in the article are strictly personal and do not necessarily involve the Ministry of Economic Development.

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> If in the short term they can be overcome, by restrictive economic policy, in the long term, while the economic status quo remains and in the absence of structural policies, the expected parameters can hardly be maintained by all Member States. This will create strong tensions within the system, with the back up of rising inflation pressures and interest rates in some countries (Capuano 1998, p.23).

In the book, the point is further discussed:

> In particular, if the analysis moves from the European context to the Italian context, where the return targets, especially the debt side, compared to European partners are very ambitious and of longer duration, the danger is to bring the economy to an asymmetrical growth path with respect to the European economic cycle curve. The consequence is that future economic policy choices made by the EU go to sign and intensity in the opposite direction to Italy needs. (Capuano, 1998, p.32).

And so it was.

More generally, the single currency, in our view, was not just the introduction of a monetary policy instrument to make comparisons and transparent prices for goods and services between the participating countries (currently only 19 of 28 the EU countries have adopted the euro), but, above all, a concrete response to the economic, financial and political imbalances, created by the liberalization process of capital movements since the nineties with the abolition of the Glass-Steagall Act under the Clinton Presidency.

The problem is that only the euro was not enough and turned out to be a necessary but not sufficient condition without the common management of the economy and the currency, de facto delegating the function of countries subject to financial markets, the negative effects of which will recur cyclically, not least those relating to the crisis started in 2007 and not yet fully completed.

The economic governance deficit, coupled with monetary policies that are particularly inspired by monetary policy, have done the rest. Today, in order to ensure the sustainability of the euro in all the participating countries and to make the single currency a vehicle of growth and economic stability, it is necessary to modify and strengthen the economic governance mechanisms underlying the creation of an optimal monetary area (Mundell 1961), which will be proposed and described in the last part of the article.

2. Wrong economic policy

The introduction of the euro was built on economic policies that were based on the excess of both budget (a deficit/GDP ratio equal to or less than 3% and a public debt ratio equal to or less than 60%) and monetary virtues (maintaining inflation within a 2% target), which led to the recognition of the low GDP growth rates, interest rates and inflation rates and high rates of unemployment as a forced step toward the realization of the

EMU. With a "classic conception of the role of the state budget in economics, relegated to mere public financier and with no stabilizing and/or anti-cyclical function," as stated in the book. (Capuano, 1998).

All the criticisms, as shown in the work, would have led to economic effects, particularly in the southern countries of the EU, that were very negative, as was then the case. The negative effects resulting from the construction of the euro as described above are those which essentially underestimated two particular macroeconomic aspects (Stigliz 2016; De Grauwe 2017).

The first is an issue of asymmetry, of competitive imbalances between the member countries. In the absence of external devaluation, all the rebalance had to be made with the adjustment of wages and relative prices (an internal devaluation): they had to, or should, grow in Germany instead of the Mediterranean countries.

The second is an asymmetric shock problem: the whole euro area has a shortage of demand.

The school case that is considered when it comes to understanding the benefits inherent in creating a fixed exchange area or monetary union is the possibility of asymmetric shocks in the exogenous variables of the countries involved. An example is given by an asymmetrical variation in demand, which occurs in one or more countries, but not in all of them, in which case only two countries are considered as part of a hypothetical currency area: the demand for certain goods produced in a country (country A) may increase, while it could decrease the demand for goods produced in another country (country B). In the absence of a fixed exchange rate regime, an increased demand for country A's assets would have to change the exchange rate, leading to the depreciation of the country B's currency and the country's currency appreciation, avoiding the rising unemployment in Country B (or the deterioration in the trade balance), which would otherwise be affected by the diminished demand for goods produced in its territory. Of course, this adjustment cannot take place in the presence of fixed exchange rates or, indeed, monetary union arrangements.

The adjustment could then be achieved by a variation of wages and prices – if they were flexible. In the absence of such a flexibility, the only solution for avoiding the consequences of the shock would be a shift of production factors.

As for price changes, (flexibility of prices and wages) is not enough to consider them a remedy. In fact, it would be necessary for the economies of the two countries to become closely integrated from the commercial point of view: in this way, a small decrease in the prices of goods produced in country B would lead to a sharp increase of their demand.

Another element that may facilitate an optimal currency area is the actual presence of a fiscal federalism system, useful for mobilizing resources from the most advantaged areas to those most disadvantaged.

A consequence of the considerations made is that a currency (or monetary) area is

optimal if asymmetric shocks are rare or absent, or if prices and wages in the various countries are very flexible, or if the economies of the two "groups" of countries (strong and weak countries, as in the EU) are very integrated, both as regards the presence of strong commercial opportunities and the possibility of displacement of productive factors. Alternatively, an efficient fiscal federalism system could make monetary integration more desirable.

In fact, we may recount what has happened in the recent years: in Italy and other countries of Mediterranean Europe, it was tried to reduce wages through structural reforms (a labor market reform etc.), while the same was not done in Germany (in 2000 wages increased of 2%), nor the latter took any charge of expansionary policies that would support the demand. On the contrary, it increased the German trade balance surplus (in 2016, it was 9% of GDP) due to the surge in exports in the recent years.

Other mistakes, this time of governance, have been committed in the first fifteen years of the euro's life.

In response to the crisis, it has adopted the Fiscal Compact (the Stability Treaty approved on March 2, 2012) and the ESM (European Stability Mechanism), which are treaties under international law, not Community law. On this last point, we want to make a reflection that comes from the recent debate on the concept of the "two-speed Europe," a concept relaunched in early 2017 by the German Chancellor Angela Merkel.

In the background of the debate on the different speeds on which European policies ought to be set, i.e., on the common commitment, more or less effective in completing the EMU, two approaches can be found – one concerning the technical rules and the discipline system and the other related with powers and political discretion. Both approaches focus on the role played by the European Stability Mechanism (ESM): on the one hand, you want to have the ESM as a technocratic body with discipline and autonomous powers over national budgets (the German position); on the other, it is believed that it should be developed into a real and effective European Ministry of Finance (the EU Commission position), and we would add a European Minister of Finance, while the ministry itself would be structured in order to prevent and combat problems and economic downturn that could inflict damage throughout the Eurozone, with its own budget and financial autonomy (for example, fed by a tax on financial transactions). The last one is our proposal, with the establishment of a real economic governance of the euro and not of the European Monetary Fund.

The moral that is derived from these years of single currency life is that, paradoxically, the content of the Maastricht Treaty, while being criticized, has been violated by worsening its content in a restrictive sense since the application of Regulation 1466/97, with which the European Council, on a proposal from the Commission, has imposed an acceleration that led to the introduction of the euro without even respecting the provisions of the Maastricht Treaty.

3. The Negative Effects of the Euro's Economic Policy

Starting from the second half of 2010, the debate, academic and not only, has been enriched with new reflections and considerations. On the one hand, the G20, held in Toronto, underlined that rich countries should "at least" halve public deficits by 2013; on the other hand, the US Congress could block the new stimulus program, proposed by President Obama. Keynesian-based economists, such as Krugman, claimed that the transition to austerity was to be regarded as a colossal error and attributed certain official statements as apparently "coming from Herbert Hoover's Speech Collection" (Krugman 2010).

On the contrary, several pre-neoclassical orientation economists belonging to the so-called academic mainstream followed the thesis that an articulated austerity program, implemented with spending cuts and budgetary rigors, would not have caused any depression and could even stimulate the economy (an expansive fiscal rigor). A possibility that had long been pointed out by Giavazzi and Pagano (1990; 1996), Alesina and Ardagna (2010), Alesina, Giavazzi, Barbiero, Favero and Paradisi (2015).

After 2010, all major western economies, primarily those in Europe (including Germany), have detected deceleration, one such that could evoke the risk of a relapse in depression (a double dip) – a risk actually manifesting itself in many countries including Italy. In response to these cyclical events, a lively and in-depth debate emerged that centered on the effects of austerity policies, in particular those imposed, in a very strict manner, in Europe on certain countries that were found to have difficulty in financing sovereign debt.

In the past, the *Theory of Expansive Rigor* had lost much of its appeal following the criticism of the method and substance, made by some scholars working within the International Monetary Fund (IMF). For the methodological aspects, it was first criticized for the incorrect identification of fiscal consolidation periods, which caused the distortion of the conclusions, underestimating the depressive effects and overestimating the expansive ones.

Indeed, with the correct identification of periods and with reference to the remediation policies undertaken by 15 advanced economies during the 1980-2009 period, the IMF (2010) analysis easily come to the conclusion that *fiscal consolidation typically has a depressive effect* on production and employment. These effects were partially mitigated by robust interest rate cuts by central banks and, above all, by substantial devaluations (Stigliz 2016).

For Italy, the macroeffects of this "economic policy disaster," which occurred after the euro, have been devastating: from 2007 to 2013, the Italian economy has lost almost more than 10% of its GDP and 25% of its industrial production, which has left more than 3 million citizens unemployed with an unemployment rate of between 12% and 13%, and the youth unemployment rising over 40% (source: ISTAT - 2017).

By looking more closely at the substance of the issues, we consider that the first criticism came to the restrictive budgetary policies.

After more than 15 years after the introduction of the euro, another 2014 study by the International Monetary Fund has been dedicated to "forecast errors on growth" and "fiscal multipliers." It has attracted the attention of economists and the media. The "fiscal multiplier" is, in fact, one of those tools around which scholars are divided into opposing schools and is responsible for the practical orientation of the economic policies of governments.

Famously, the *fiscal multiplier* measures the intensity with which the income (or GDP) of a country reacts to fiscal policy and is one of the lintels of Keynesian theory. For Keynesians, the fiscal multiplier is typically greater than 1: the reduction in public spending (or fiscal increases) of 1 euro causes a reduction in income of much more than 1 euro and vice versa.

Since the introduction of the euro in 2002, as we have previously described, Europe has been subject to austerity, i.e., more taxes and less public spending. Yet public debts have risen more where the application of the cure has been more severe. In many countries, it has been engaged in a perverse mechanism: implementing restrictive tax policies, depressing economic activity and generating unemployment, even with a lower tax revenue (linked to lower income), aggravating the internal macroeconomic scenario (Blanchard and Leigh 2013).

This perverse effect would easily be explained on the basis of Keynesian theory. If the multiplier is greater than 1 (as claimed by the Keynesians), to solve the debt problem, one should do exactly the opposite of the austerity policies: one should reduce taxes and increase public spending, in particular for investments, because the multiple growth of the derived income would then generate the additional tax revenue, which is needed to remedy public finances.

On the contrary, most recent European economic policies have been inspired by the *Theory of Expansive Restraints*, according to which the multiplier does not exist or, if it exists, is very modest: according to this approach, fiscal policy does not have any significant impacts on the GDP. For this school of thought, consumer and investor decisions are not just related to their current income, but also to the available income that is expected in the future.

So, if taxes are increased today, it is expected that they will be reduced tomorrow, because the debt has shrunk. Individuals, therefore, do not react to rising taxes by reducing their consumption, as the Keynesians have argued, and demand and income remain unchanged or even increase. In theory, too strict austerity policies can therefore be pursued without causing particular recessionary effects.

So far, European economic policies have been based on this hypothesis, namely on the assumption that the multiplier was less than 1: economic policies in particular were

set on the assumption that for each 1% cut in the public deficit, the GDP would be reduced by less than 0.5%.

In this regard, the IMF estimated that in the 2010-2011 period, the multiplier was actually 1.5: the recessionary impact of austerity policies was three times greater than expected.

Another recent example of the wrong approach to European economic policy this time concerns the levels of sustainability of public debt. A paper written in 2010 by two Harvard professors, Carmen Reinhart and Kenneth Rogoff, seems to give scientific and irrefutable bases to fiscal austerity policies. Becoming the "Bible" of the European Union's economics experts, though fundamentally wrong in its conclusions, also because of a banal – yet so clamorous – calculation error in the Excel spreadsheet used to conduct their elaborations (T. Herndon, M. Ash and R. Pollin 2013).

The study by Reinhart and Rogoff assumed that countries with over 90% public debt were destined for nothing – or even negative economic growth. Although the two authors were merely suggesting a correlation between the two parameters without giving any proof of the cause-effect relationship and without providing irrefutable recipes, their conclusions were acritically accepted to support austerity measures in both Europe and the European Commission, in such a way that in February 2013, the former EU Economic Commissioner Olli Rehn made the following statement: "It is widely recognized, on the basis of serious academic research, (Reinhart and Rogoff – 2010) that public debt, when over 90%, tends to have a negative impact on economic dynamism, leading to low growth for many years. That is why a consistent and calibrated fiscal consolidation remains necessary in Europe."

Even on the question of inflation control and, more generally, on the currency stock in circulation (one of the five parameters provided for in the Maastricht Treaty), it has been unfortunately confirmed by the economic reality.

In fact, the ECB has not consistently respected the target of 2% inflation in the area (in recent years, the main problem is deflation due to the low growth and the certainly not high inflation rates). The same could be said for the amount of currency M3 (which includes all other financial assets that, like the currency, can serve as a reserve of value).

The damage that has produced deflation in countries like Italy with a high public debt[2] are devastating: 1% less inflation for the Eurozone means for Italy to have an extra surplus of a further 1.3% budget just to achieve the same goals.

Since the target being of 2% but with an inflation that is close to zero, it costs Italy 2.6% of its GDP to reach the same target, which could only be achieved if only the ECB's objectives were met. In fact, to reduce debt and make it sustainable in the medium term,

[2] We must remember that the Italian public debt is steadily growing and has exceeded the 133% threshold in terms of GDP with an absolute value of 2 235 billion euros in around 2016. Recalling that in 2002, the first year of the "epoch Euro," it was set at 101% of GDP.

it would take more than 5 years with an inflation of over 2%. Even the IMF confirms that in a context of deflation or low inflation, the debt is out of control.

So, what should be considered in the economic evaluations is the nominal GDP, not the real GDP: in the context of deflation/low inflation, the nominal GDP falls dramatically, and the weight of public debt actually becomes unsustainable.

In this regard, it is entirely incorrect and wrong to note that the Italian government's return plan, submitted in January 1998 provided for a reduction in public debt from 124% to 60% after 15 years in terms of GDP (in the two-year period 2015-2016, this ratio was 135% (source: ISTAT)), basing its estimates essentially on two parameters: stability and/or the presence of strong regional imbalances (both *pro capite* GDP and unemployment) and the differentiated growth rates in the European Union (since 2000, the growth rate in Italy was the lowest in the euro area). Since the beginning, it has made the constitution and the maintenance of monetary union fragile, the instruments used to reduce the imbalances; therefore, the Maastricht criteria, as was already seen since 1993, have been totally inadequate and tightened, in a restrictive sense, by Regulation 1466/97.

De facto, they have merely nominal and financial convergence parameters, which represent imperfect substitutes for a European regulation of taxation between the Member States. Moreover, the "real" parameters were neglected altogether. The consequence of this was the attainment of short-term convergence and not long-term economic cohesion, as the absence of the second undermines the duration of the first: in practice, the philosophy of stability prevailed over the philosophy of development.

This also meant an inability to find alternative solutions and be more favorable to employment in order to better distribute the sacrifices imposed by the disinflationary logic between wages and profits, between the employed and unemployed, between the strong regions and the weak regions.

In practice, the objectives and instruments of economic policy, pursued at that time for the construction of the EMU and developed in the recent years, especially in Italy, have accelerated the realization of a growth path tending to zero, unbalanced, which resulted in a further increase of unemployment and an increase of the regional North-South gap.

These are the main macroeconomic effects observed in the 15 years of the euro, dictated, above all, by the incorrect economic policy choices that were wrongly considered to be prone to sustainability of the euro.

The weak points of those choices could be summarized as follows:

1. It underlined the economic-social costs of the medium-term period that the member countries are supporting for entry into and stay thereafter in the euro;
2. Market forces have been insufficient and/or inadequate, starting from a situation of imbalance, to bring the economy on a path of more balanced development, the growth of the differentials between strong and weak areas having not diminished – yet, indeed, they have increased;

3. The effect of this approach was to create more wealth in the medium term, but with a very high concentration ratio in the rich regions, marking a stronger split between the "central areas" and "peripheral areas," which, in the long run, has caused a slowdown in growth in the same prosperous regions and asymmetric shocks in the countries with a higher concentration of weak and/or depressed areas.

4. Policy Proposals for the Foreseeable Future

After analyzing economic effects of euro, in the last part of the article, we will try find proposals to make the euro sustainable. However, this represents the past. Some economists (Sapir 2012; Stigliz 2016; De Grouve 2017) and institutions (IMF, 2017) agree that the euro governance needs to be changed. What can be done in the near future for the euro to become an opportunity for stability and growth for the euro area, and to make the single currency sustainable for all economies and not a source of low growth, unemployment, social disadvantage and poverty for large and weak sections of the European population, particularly in Southern Europe?

The likely change, of course, to revitalize economic development will only take place when a continental-scale strategy is set up, which has its core role in increasing the propensity to invest in the "Europe system."

A strategy that complements both public and private investment, strengthens the governance of the euro and gradually eliminates the Maastricht parameters, all in accordance with the economic policy line that we could call the "investment push approach" to make the euro sustainable for all participating countries and be a factor of development and competitiveness and not a critical issue for the MicroSMEs.

The highlights of this approach could be summarized in 5 proposals, all linked to each other:

1) A gradual elimination of the Maastricht parameters;

A less rigid and "accountancy" view of the achievement of the criteria and their progressive elimination, replaced by a rigorous approach, which: a) follows "return trends" and not the absolute values of indicators and their sustainability in terms of GDP and aggregate savings (public and private) with a particular reference to the sustainability of public debt, also in relation to private debt; b) permanently sterilizes, in an automatic form, from the cyclical factors and the investment component in the calculation of the public deficit in terms of GDP, effectively de-seasonalizing values, focusing only on the structural components and current deficit spending. The same Maastricht Treaty is clear on this point. On the contrary – a rigid fixing of the parameters is an "interpretation" given by the Bundesbank in the 1990s, with all the consequences of the case, above all as a condition for the participation of the German economy in the euro.

2) An establishment of an European Fiscal Policy (EFP);

In order to gradually eliminate the Maastricht parameters, it is needed to establish a common fiscal policy that is not the sum of the fiscal policies of the member countries. In the perspective of a "federal" European budget, which is based on the US model and favors the reduction of fiscal pressure and investment (Enderlein, Linder, Calvo-Gonzales, Ritter 2005). Today, for example, the ordinary VAT rates range is between the 15% of Luxembourg and the 25% of Denmark. This creates the "tax dumping," which is very negative for competition between companies.

3) A Minister of European Finance;

The appointment of a "European finance minister" to manage the common fiscal policy and the Community budget, so as to also allow the gradual elimination of budgetary parameters that have "improperly" filled up a lack of governance.

4) An amendment of the ECB Statute;

The rebalancing of the monetary powers of the European Central Bank, the creation of a "political body" for the management of EU economic policy and the change of the ECB's statute on the FED model – all this must be done not only to safeguard from inflation, but to also have growth and development goals. In fact, the will of the Community legislator of that time, as well as giving the rightful autonomy of the ECB from political authorities as provided in Article 105 of the Maastricht Treaty, was the exclusive maintenance of price stability, the primary and priority objective for the monetary function and pursued through the government of liquidity. This is an approach that in the medium- to long-term severely limits the potential of ECB intervention and remains as counterproductive to the goal.

5) An exchange policy with "flexibility grids";

An exchange rate policy with the euro "tied" to a substantial parity with the US dollar, providing the "flexibility grids of change" on the old ECU model (Jaen 1990; Hahn 1992; European Commission 1997), as compared to major world interest currencies (other than the US dollar, yen, renminbi and the British pound). In this way, the ECB could make possible devaluations with more or less swing, considering the euro's central parities when compared with other currencies (+/- 2.25% or +/- 6%), depending on the phases of the economic cycle. The objective is to provide an additional tool for the ECB's monetary policy, to discourage speculation and to foster the macro and micro internationalization processes of the European economy and its MicroSMEs. Additionally, a control mechanism can be provided with a "divergence indicator" to avoid past mistakes and, above all, to promptly intervene in exchange ratios.

An important financial impetus to this strategy could be given by the following actions:

1. By using some of the 100 to 200 billion US dollars (depending on the estimates) from the "surplus" reserves (estimated at around 5% of the Community's GDP) of the European Central Banks as a result of the introduction of the euro, partly to be used to reduce public debt;
2. By channeling private savings, free from the reduction of public debt, toward project financing;
3. By reducing the weight of the Common Agricultural Policy (CAP), which still holds weight in the Community budget of about 40% for a sector with an average GDP of around 2%, giving priority to development policies.

This change of route would give greater economic and monetary stability to the European Union, but, at the same time, would create conditions for a more balanced growth among the Member States, because it would consider not only convergence, but economic cohesion as well; therefore, it would result in the sustainability of the euro for all member countries and in a growth factor for the MicroSMEs, particularly those that want to internationalize.

Only in this context and in these conditions will the Euro have any sustainable impact on the European economy, with more growth and employment proportional to its potential. Moreover, it will turn from a problem of some countries (Southern Europe) into a great opportunity of development for all the states, not just Germany and its "satellites."

On the contrary, we will assist the dissolution of the euro, with strong negative impact for the whole European economy and not just for the countries of the Southern Mediterranean, with rising interest rates, inflation and unemployment, with capital flight and the condemnation of the "secular" stagnation of the European economy over the other "driver" economies of the world.

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