Luigi Paganetto *Editor*

# Yearning for Inclusive Growth and Development, Good Jobs and Sustainability

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*Editor*
Luigi Paganetto
FUET, Economics Foundation
University of Rome Tor Vergata
Rome, Italy

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# Contents

# Solving the Problem in Italy and Much of Western Europe

**Edmund S. Phelps**

**Abstract** What are the deep, structural problems in Italy—the problems that preclude a "good economy"—even if everything else goes right? Much of the problems have to do with innovation, "indigenous" and "imported." Innovation is generally necessary if people are to have gratifying working lives and rising living standards, though some kinds of innovation create a problem. How has Italy fared in this dimension?

## 1 Innovation in Italy

Long ago, several nations enjoyed an *explosion* of *indigenous* innovation (innovation originating within the nation and not imported from abroad), a large part of it *capital-saving* more than *labor-saving*: America and Britain around 1820, France and Germany around 1870—and Italy around 1950. By my calculation, Italy in that year ranked in fourth place in the big country rankings—as Italy pulled up, Germany fell back. (That surprised me because I understood the magnificent history compiled by Gianni Toniolo as concluding that the Italian economy had yet to attain sustained innovation at a good rate[1]). With that hugely fruitful innovation going on, these nations enjoyed a "golden age" from 1950 to 1970: real wages streaked ahead of wealth, leading to increased labor force participation; and the passion for new

Edmund Phelps, the 2006 Nobel laureate in economics, is director of the Center on Capitalism and Society at Columbia University. His recent books are *Mass Flourishing* (Princeton Press, 2013) and *Rewarding Work* (Harvard Press, 1st ed. 1997, 2nd ed., 2007). See also his study for Italy's Consiglio delle Ricerche, *Enterprise and Inclusion in Italy* (Kluwer Academic, 2002).

[1]Gianni Toniolo, ed., *The Italian Economy since Unification* (Oxford, 2013).

E. S. Phelps (✉)
Center on Capitalism and Society, Columbia University, New York, NY, USA
e-mail: esp2@columbia.edu



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methods and products brought high job satisfaction and consumer satisfaction.[2] (As the song goes, "I remember it well." I remember the model-building we were all doing at the RAND Corporation, the Lamborghinis in a Wilshire showroom, the Beatles, the Boeing 707s—and much more).

But these good times were losing some of their shine. Estimates by Raicho Bojilov and me at the Center on Capitalism and Society show that indigenous innovation was *gradually slowing* in Italy as well as France over the postwar period; and it was much *slower* throughout the period in Germany than it had been in its heyday under Bismarck.

Since 1970, there has been tumultuous structural change in the West:

- *First*, indigenous innovating has been markedly *slower* over the period from 1970 to 2012 in the U.S.—aside from the years of the internet boom—and also in the U.K. and France. The sharp slowdown of "imported" innovation in Italy and Spain may be caused in large part by the contraction in the importable innovations that were available in this period—not just by similar internal developments. However, these slowdowns have brought a major slowdown of total factor productivity and labor compensation, which has caused social discontent. They have thrown events into reverse: wages lag behind wealth, leading to decreased labor force participation, decreased job satisfaction and boredom borne of stagnation.

I suspect you are wondering whether there is any factual basis for these conclusions. My book *Mass Flourishing* points to *evidence* drawn from the *World Values Surveys*.[3] It shows that in 1990–91 the mean level of reported *job satisfaction* was very low in the countries suffering low levels of indigenous innovation—Italy and France, for example—and relatively high in countries with relatively high indigenous innovation—notably Switzerland, Denmark and America. Now, the same research team has found evidence from 2008 data in the *European Values Surveys* that further supports this theory.[4] It shows that among 13 economically advanced western European countries, those ranking *lowest* in reporting "high" or "somewhat high" job satisfaction—Spain, France and Italy—ranked very low in indigenous innovation as well (9th, 11th and 13th respectively) and those ranking *highest* in job satisfaction—Switzerland and Denmark—ranked very high in indigenous innovation (in 2nd place and 4th place, respectively).

- *Second*, and perhaps more serious over the near term, the *losses* of this innovation, made so fruitful because it was predominantly capital-saving, are now

[2] I came across this characterization in an op-ed suggesting that "[t]he period after the two world wars was in many ways a Golden Age." See Antar Haldar, 'Is there a future for capitalism? It doesn't have to become an uncontrollable monster,' The Independent, May 18, 2018.

[3] The data are from the *World Values Survey*. See *Mass Flourishing* (Princeton: Princeton University Press, 2013), pages 196 and 197.

[4] Data in the *European Values Surveys* are usually found in *World Values Surveys* but not in cases where American data to accompany them are not available.

accompanied by *gains* of innovation coming from the "digital economy"—in the U.S. and many other countries too. And this new innovation is much more labor-saving. (Amazon and Microsoft are good examples; I think; perhaps Google is an example of capital-saving.) It has caused major job losses in the affected factories. In regions with many such job losses, there has been a wholesale withdrawal from the labor force: America's Rust Belt in Appalachia and adjacent regions, Britain's West Midlands and France's Lorraine region.

It is interesting that the countries which have always been regarded—historically, at any rate—as "innovation nations"—are the ones that have these distressed regions, while the countries that have always been regarded as "trading nations"—Germany and Holland, for example—have not been afflicted with such regions. I have to leave it up to you to decide whether Italy fits in the first group or the second.

If Italy is suffering from the same rust belt phenomenon, the country is in a double bind: There is less of the unambiguously good innovation and more of the problematic.

You may be interested in knowing what I believe Italy and other countries must try to do to reverse the decline of the good innovation. I have written some pages suggesting measures that state and society could take. The most thorough presentation is in the 8½ pages at the close of my book *Mass Flourishing*—pages 316–324. Society must cultivate in students and young people an eagerness and capability to innovate.

Further, society must stop vested interests and corrupt officials from blocking or discouraging new product or methods—at least those not judged against the public interest.

It is clear now that such a revitalization of the economy might have the "side effect" of giving a boost to the problematic innovation—the innovation that drives down wages to a lower growth path. As a Chinese proverb says: "Beware that you get your wishes!" Is there a way out of this conundrum? It appears so, once we understand the dynamics of labor-saving innovation.

In a couple of theoretical models that Hian Teck Hoon and I built over the past year or more, a single, purely labor-saving innovation—more precisely, a single innovation that adds a bunch of robots to workforces in the way a wave of immigration adds workers to workforces—would drive down the wage rate. But the resulting increase in the capital stock would pull the wage rate back up to where it had been before the robots came.

And the bulge of profits on private capital and the rise of tax revenues appear to be enough to compensate for the dip in wage rates. Perhaps the lesson to draw is that the nation's safest strategy is to take measures to slow the procession of robots that arrive to do the kind of work done by the humans.

My conclusion from all this is that Italy as well as America, Britain and France must take all reasonable measures to boost the dynamism of their economies while they also take steps to ensure that the influx of technologies proceeds sufficiently slowly so that wage rates and employment of the affected workers can be cushioned through government compensation paid for out of the rising tax revenues.

*The euro, growth and employment* I do think from time to time about other issues in the West. We have all been hearing for a very long time the contention that Italy has a serious problem with the euro—whether or not there is also a problem of deficient innovation that is independent of any currency problem.

I think we should be skeptical about these claims. (My friend Stefano Micossi once congratulated me for being skeptical about everything.) But it is impossible for the proponents—all of them highly reputable economists—to prove their claims *beyond any doubt.* So we should take seriously their arguments.

There is the *slow recovery* claim and the *slow growth* claim. The former claim is that Italy could depreciate its currency in pre-euro times and now it can't. Of course, one of the arguments *for* the institution of a common currency was that it would put an end to devaluations and resulting inflations. (I heard other arguments from Robert Mundell and Tommaso Padoa Schioppa. I also had conversations with Dominick Salvatore.) One might wonder why the Italians are not grateful that the euro has averted the need for a catastrophic depreciation.

The complaint against the euro that we hear is that the *lack* of a devaluation has been a drag on the speed of recovery in Italy after it hit bottom following the global financial crisis. The recent book by Mario Baldassarri, *The European Roots of the Eurozone Crisis*, is perhaps a definitive source.[5] The data in FRED, a standard source of G7 data, show that Italy's so-called employment rate, seasonally adjusted, climbed from its low in July 2010 of 56.6–58.2 % in October 2017. That is a slow speed of recovery, to be sure. But if the euro is at fault, we should expect to see a poor result also in France and Spain. In France, the same employment rate climbed from its low of 63.9% in October 2010 to 65.2% in October 2017. The speed of recovery there is also poor. But in Spain, the employment rate climbed from its low of 56.0% in April 2012 to 61.6% in October 2017. This is a much faster speed of recovery. Some other countries in the Eurozone also show a relatively speedy recovery: Holland climbed fast from its low of 64.5–67.2% and Portugal—bless its heart—has exploded from its bottom of 59.3–68.9%.

Denmark also sprinted back to normal. Tentatively, I would lay all or most of Italy's poor performance to structural causes. We do not know how Italy would have performed had it chosen to operate with a flexible exchange rate.

There is also a theoretical point to be made: although Keynesian theory has a well-deserved place in understanding the initial employment effects of a contractionary shock, it is implausible to attribute a weakness of employment to a decrease of aggregate demand more than a dozen years ago. Nominal wages and prices ultimately adjust. Start-ups find openings.

The slow growth claim is that the overvaluation of Italy's currency has brought *slower growth* in Italy since the advent of the euro in 1999. I wonder: Is the euro the cause of that deceleration? My great colleague and dear friend, Joseph Stiglitz, points out that from 2000 to 2016 the eurozone GDP has shrunk noticeably relative to the US GDP—if my arithmetic is right, from 88.5 to 80.0%. But until 2005 or so,

[5] Mario Baldassarri, *The European Roots of the Eurozone Crisis,* (Palgrave, 2017).

the US was enjoying the extraordinary rapid growth brought by the buildout of the internet. Furthermore, this relative shrinkage of the eurozone countries ought to be compared with what happened to the relative size from, say, 1985–2000. We need to recall that in the 1980s there was the deep "slump in Europe," which Jean-Paul Fitoussi wrote about in our book *The Slump in Europe*[6]*:* The European slump was deeper and longer than the slump in the U.S., so Europe was losing ground in the '80s—long before the euro. And it lost still more ground in the 1990s when, as I noted, the US began to develop the internet. We called it the second Great Depression!

However, the heart of the matter is whether the euro is the cause of still slower *productivity growth* in Italy—and, by the same logic, France and Spain too. I would note that the estimates by Bojilov and me show gradual *slowing of indigenous innovation* in Italy in the '50s, again in the '70s and again in the mid- '90s—with no further slowing whatsoever after 1999 till the last year, 2011.

I would interpret these very preliminary findings as suggesting that real, not monetary forces, are at work in the West. I feel that future data will show even slower indigenous innovation in the U.S., the U.K. and France leading to a *further* slowdown of productivity and investment throughout the West. Certainly, the increased weakness in investment and real wage rates is apparent.

If that is so, the West must address the need not for a new monetary system but for a revival of the spirit of innovation. That is needed if the West is to regain the prospering and flourishing of its Golden Age.

[6]Jean-Paul Fitoussi and Edmund Phelps, *The Slump in Europe: Reconstructing Open Economy Theory*, (Basil Blackwell, 1988).

# Trump's Challenge to the World's Liberal Economic and Trade System

Dominick Salvatore

**Abstract** The unexpected election of Donald Trump to the Presidency of the United States in 2006 has led to major changes in U.S. economic and trade policies in the first 2 years of the new administration in Washington. Some of these policies, both domestic and international, are very controversial and represent a major break with the past, and they have already had a major impact on the U.S. and on world economies.

This paper examines the reasons for the slow recovery and growth in the United States after the recent global financial crisis and "great recession", the domestic and international policies actually adopted by the Trump administration to stimulate U.S. growth, and the effect of those policies, on the United States and the rest of the world.

## 1 Policy Proposals by Candidate Trump

At different points during the course of the presidential campaign, Trump promised a reduction in the U.S. corporate tax rate from 35 to 15%; a reduction in the number of personal income tax brackets from seven to three of 10, 25, and 35% (with the top rate down from 39.6%); and increase infrastructure investments (of about \$1 trillion), as well as a major increase in military expenditures.

Trump also promised to reduce and change domestic regulations by rolling back of parts of the Dodd-Frank Act of 2010 (aimed at preventing future banking crises), repealing of the Affordable Care Act or Obamacare, and rolling back many of the regulations introduced during previous administrations.

On the international front, Trump promised to reform or drop out of international trade agreements and increase trade protection. Specifically, Trump promised to renegotiate NAFTA, which he called "the worst trade deal in history", drop out of the Trans-Pacific Partnership (TPP), put the Transatlantic Trade and Investment

D. Salvatore (✉)
Department of Economics, Fordham University, Bronx, NY, USA
e-mail: salvatore@fordham.edu



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Partnership (TTIP) on hold, impose import tariffs to reduce the huge U.S. trade deficits, drop out of the Paris Climate Accord, restrict illegal immigration, and expel or repatriate illegal immigrants who committed serious crimes while in the United States.

Trump expected his policies to accelerate U.S. growth from the anemic yearly average rate of 2.1% since crisis to 3.0–4.0% per year in the future, and to significantly increase U.S. manufacturing output and employment by sharply cutting U.S. huge bilateral trade deficits by imposing import tariffs, especially on China. Most economists, however, anticipated a growth rate more likely in the range of 2.3–2.5% because the United States was close to full employment and the growth of the labor force was not likely to increase very much. Furthermore, the rising government debt resulting from tax cuts and the increase in infrastructure and military expenditures would lead to inflationary pressure and higher policy rates, which would discourage private investments and lead to capital inflows and a dollar appreciation dollar—all of which would dampen U.S. growth.

The future U.S. growth could also be slower than anticipated by Trump because of the slower growth of emerging markets because higher U.S. interest rates would slow or reverse capital inflows to these countries and could also lead to a debt crisis in the many emerging market economies that are highly indebted in dollars. More U.S. trade protectionism could also lead to a trade war with China, which would slow down its growth and, as a result, dampen the growth rate of other countries. Slower growth in China and other emerging market economies would then lower U.S. and world growth in the highly interdependent and globalized world of today. The inherently slower growth in Europe would also dampen U.S. and world growth.

## 2 Domestic Economic Policies Adopted by the New Administration and Their Effects on U.S. Growth

During 2017 and 2018, Trump was able to adopt many of the policies that he had promised on the campaign trail, but not all. On the taxation front, the Trump administration passed a tax reform bill that lowered the federal corporate rate from 35 to 21% (rather than to 15% that he had originally sought). At the same time, personal income tax brackets were reduced from 7 to 4 of 10, 25, 35, and 37% (instead of the three brackets of 10, 25 and 35% that he had promised). Trump was also able to obtain funding for more infrastructure investments and the military, but not as much as he promised because of the very large increase in budget deficits and national debt that they would entail.

On the domestic *regulatory* front, the Trump administration rolled back parts of the Dodd-Frank Act of 2010, reduced many regulations imposed during the 8 years of the Obama and of previous administrations, and repealed the individual mandate that required every employee to have health care, but he did not succeed in repealing the Affordable Care Act or Obamacare as a whole (as he promised to do during the presidential campaign). Trump was also prevented (for the most part) by the courts from taking measures to stop illegal immigration and to expel and repatriate illegal immigrants who had committed serious crimes while living in the United States. Also, Trump was able to get only partial financing to build his wall on the Mexican border to stop illegal migration.

At this point, it should be safe to say that most of the policies advocated by candidate Trump, and those actually passed or promised by the Trump administration in its first 2 years of operation, are aimed at increasing the growth of the U.S. economy ("putting America first") and bring it back to the higher growth trend that prevailed prior to the 2008–2009 global financial crisis and "great recession".

Despite the policies adopted so far and promised for the future by new administration, many economists and the markets expected the U.S. potential and actual growth rate to rise only to 2.3% (at most to 2.5%) per year in the near and medium term, which would not be much higher than the 2.1% rate that the United States averaged from 2009 to 2016. Several reasons were advanced for this.

First, the $1.5 trillion Trump tax cut is likely to contribute to an increase in the U.S. budget deficit to above $1 trillion in a few years. This would lead to higher market rates, which would discourage private investments and thus U.S. growth. Secondly, the higher corporate profits resulting corporate tax cuts is likely to be used by American corporations more for stock buybacks and for higher savings by high-income individual than for higher investments. Thirdly, higher U.S growth cannot be achieved because the United States is or seems to be already at or near full employment. Fourthly, and as pointed out by many economists during the presidential campaign, the rise in U.S. rates are also likely to lead to more capital inflows to the United States, a stronger dollar, and to less capital flows to emerging markets, and possibly to even lead to a new financial crisis in those emerging market economies that are highly indebted in dollars. All of this is likely to cut growth in emerging market economies and, as a consequence, to also dampen the growth of the rest of the world, including the United States.

In fact, according to the International Monetary Fund (IMF), real U.S. growth was actually 2.2% in 2017 (see Table 1) which, on average, was not higher than for the other G-7 countries. Table 1 also shows that U.S. growth was substantially higher in

**Table 1** Growth (%) of real GDP in G-7 countries, 2009–2018 and projections for 2019–2020

| | Yearly average | | | | | |
|---|---|---|---|---|---|---|
| Area/Nation | 2009 | 2010–2016 | 2017 | 2018 | 2019 | 2020 |
| United States | −2.8 | 2.1 | 2.2 | 2.9 | 2.6 | 2.2 |
| Japan | −5.4 | 1.5 | 1.9 | 0.7 | 0.8 | 0.7 |
| Germany | −5.6 | 2.0 | 2.5 | 1.4 | 0.7 | 1.1 |
| United Kingdom | −4.3 | 2.0 | 1.8 | 1.4 | 0.8 | 0.9 |
| France | −2.9 | 1.2 | 2.3 | 1.5 | 1.3 | 1.3 |
| Italy | −5.5 | 0.0 | 1.6 | 0.8 | −0.2 | 0.5 |
| Canada | −2.9 | 2.2 | 3.0 | 2.1 | 1.9 | 1.9 |

Source: IMF, January 2019 and OECD, March 2019

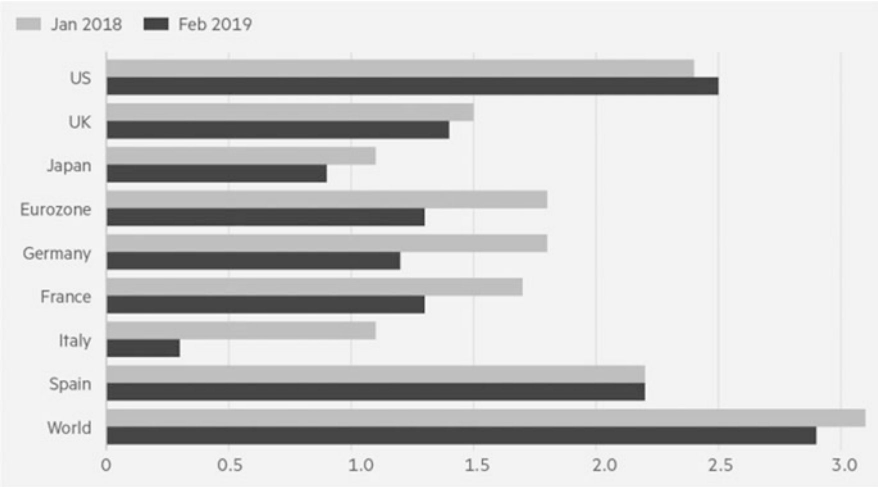


**Fig. 1** Revised Growth Projections for G-7, Eurozone, Spain, and World in February 2019 with Respect to January 2018. Source: "The ECB Must Reconsider Its Plan to Tighten," *FT*, March 6, 2019, p. 11

2018 than the U.S. growth in the previous decade and much higher than growth in the other G-7 countries. OECD for projections for 2019 and 2020 show that growth will slow down in all G-7 countries, but with the slowdown being less for the United States than for the other G-7 countries. Furthermore, during 2017 and 2018 the number of new jobs created in the United States has been much higher in proportion to its labor force and the U.S. rate of unemployment of 4% was less than half of that in the other G-7 countries (except for Germany). Thus, we can conclude that the new administration in Washington was able to stimulate the growth of the U.S. economy, increase job creation and reduce the unemployment rate in relation to the previous administration and to the other G-7 countries, but not by as much as Trump had predicted. Figure 1 shows the sharply reduced growth rates projected by the OECD for the G-7 countries (other than the United States) and the Eurozone from January 2018 to February 2019.

We must also keep in mind that the projected growth rates for 2019 and 2020 shown in Table 1 are based on the implicit assumption that the trade policies of President Trump will not trigger an all-out world trade war. Also, to the extent that the higher growth rate of the United States in 2018 and projected higher growth rate for 2019 (even if lower than in 2018) was due primarily to the reduction in U.S. taxes in regulations by the new administration—these are liberal rather illiberal national economic policies, which are likely to stimulate U.S. growth even in subsequent years.

# 3 International Policies Adopted by the New Administration and Their Effects on the U.S. and the World

More dramatic and momentous are the international (trade) policies promised and actually adopted by Trump administration. On the presidential campaign trail in 2016, candidate Trump promised that as President he would renegotiate international trade agreements and negotiate directly with major U.S. trade partners bilaterally in order to force them to eliminate foreign protection against U.S. exports and provide as equal access to their markets as they have in the U.S. market.

As President, Trump dropped out of the Trans-Pacific Partnership (TPP), put the Transatlantic Trade and Investment Partnership (TTIP) on hold, forced the renegotiation of NAFTA, and imposed hundreds of billion of dollars of tariffs on U.S. imports of steel, aluminum and other products on most its major trade partners, and threatened to impose a 25% tariff on automobile imports from Europe, Japan, China and other nations if they did not eliminate their restrictions on U.S. exports. Trump even threatened to drop out of the World Trade Organization (WTO) if it continued to fail to enforce the rules of the liberal world trading system, created after World War II under U.S. leadership.

The most dangerous U.S. trade dispute, however, is with China, which came to a head in 2018 when the United States imposed tariffs on hundreds of billions of dollars on U.S. imports from China because of the alleged (1) systematic stealing of U.S. technology on a grand scale by Chinese companies, (2) illegal subsidies given by the Chinese government to some its large companies, (3) requirement that U.S. and other foreign firms enter into joint ventures and transfer their technology to Chinese companies as a condition for allowing U.S. and foreign firms to operate in China, and (4) China's over-expansion of its production capacity of many products (such as steel and aluminum) and then dumping the excess production on the U.S. and world market.

After China did not heed U.S. demands to eliminate its unfair trade practices against U.S. firms and trade, the United States imposed initial import tariffs on $50 billion of Chinese exports to the United States in June 2018. When China retaliated by imposing tariffs of its own on an equal amount of U.S. exports, the United States "double up" in July by imposing a 10% import tariffs on an additional $200 billion of Chinese exports (and threatened to increase the tariff rate to 25% if China did not change its ways). Since China imported less than $190 billion of goods and services from the United States in 2017 (as compared with over $520 billion of its exports to the United States), China could not possibly retaliate in kind, but China threatened to retaliate with other form of protection against the United States. Thus, there was the making of a trade war at the end of 2018, which would be very damaging and costly not only for the warring parties but for the world as a whole.

Trump claimed that its initial tariffs on Chinese exports to the United States were essentially "countervailing duties" or a defense against Chinese protectionism and therefore did not justify China's retaliation—and that is why Trump "doubled up"

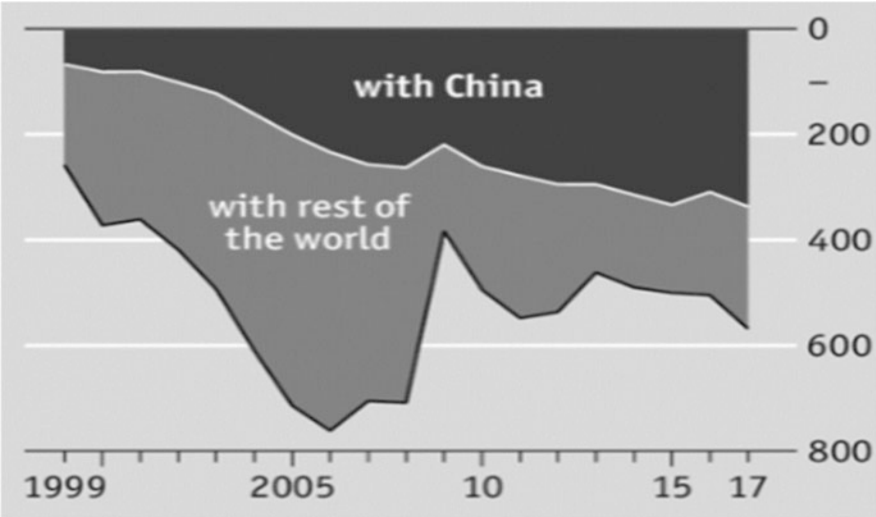


**Fig. 2** U.S. Trade Deficits in Goods and Services with China and the World, 1999–2017. Source: U.S. Bureau of Economic Analysis, 2018

when China retaliated. Also, Trump did not use the WTO to force China to drop its trade restrictions against U.S. firms and exports or authorize the United States to impose countervailing duties on Chinese exports because the WTO seemed unable or unwilling to enforce the rule of the trade system over the years. Thus, the U.S. "defensive" protectionistic trade policies under Trump undermined the WTO and risked a very damaging trade war. At this writing (February 2019), the United States and China have resumed trade talks in the hope of avoiding a full-fledged trade war. Although this is not the first challenge to the liberal postwar world trade system (see Salvatore 2009), it does represent the by far the greatest challenge and danger to actually lead to its collapse.

## 4 Is the World Trading System Biased Against the United States? Are U.S. Trade Policies Justified?

As Fig. 2 shows, the United States has had large and unsustainable trade deficits for more than a decade and more than half of U.S. trade deficits are now with China. While the United States has trade deficits with many countries, the fact remains that a single country (China) is now responsible for more than half of U.S. trade deficits. Also to be pointed out is that China's trade surplus with the European Union is much smaller in relation to the EU's GDP than with the U.S.

Figure 3 then shows that the United States has lower tariff rates than its principal trade partners, especially China and South Korea. This means that other nations are

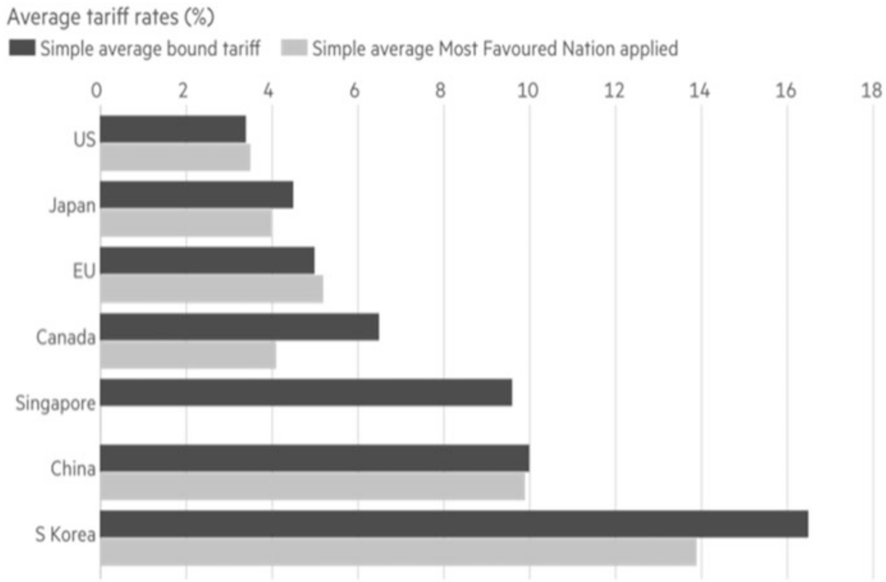


**Fig. 3** U.S. Average Tariff Rates (%) Were Lower than in Other Trading Nations in 2017. Source: World Trade Organization, 2018

more protectionistic than the United States, but (as we discuss later) the higher tariffs of most U.S. trade partners are not the cause of U.S. trade deficits (as some U.S. government officials believe).

In addition to China, President Trump also singled out Germany for its unfair trade practice of having an excessive total trade surplus of nearly $300 billion in 2018, which is of similar in magnitude to that of China, a much larger country. In fact, Germany's trade surplus is 8–10% of its GDP (as compared to China's less than 3% of its GDP). And therein lies the problem since according to the (soft) rule of the International Monetary Fund (IMF), nations should not generally have a trade surplus in excess of 3% of GDP. The reason is that an excessive trade surplus by one nation may mean some other nation(s) may have an excessive and unsustainable trade deficit and, according to IMF rules, the burden of adjustment must be symmetrical and fall on both nations, and not only on the deficit nation(s). Since Germany is one of the largest exporter of automobiles to the United States, President Trump is threatening to impose a 25% duty on all automobiles exported to the United States.

The greatest complaint of unfair trade practices is, of course, directed at China. In June 2018, the *White House Office of Trade and Manufacturing Policy* published a study providing evidence on "How China's Economic Aggression Threatens the Technologies and Intellectual Properties of the United States and the World" by China engaging in: (1) systematic stealing U.S. technology on a grand scale sponsored by the Chinese government, (2) providing illegal subsidies to some its large companies to overcome foreign competition, (3) requiring U.S. and other foreign

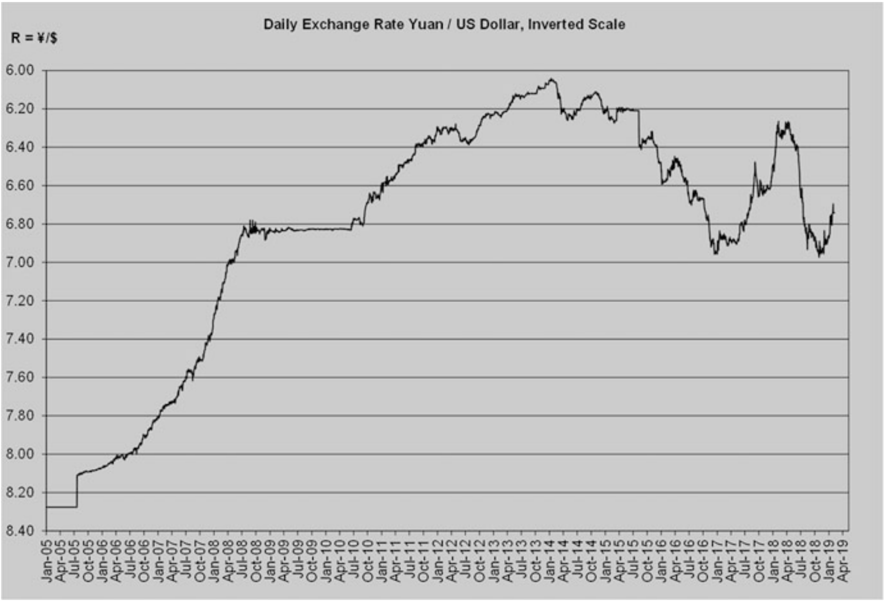


**Fig. 4** Daily exchange rate of the Yuan/Dollar from January 2005 to January 2019. Source: Calculated by the Author from IMF data

firms to enter into joint ventures and transfer their technology to Chinese companies as a condition for allowing them to operate in China, and (4) engaging in the over-expansion of its production capacity of many products (such as steel and aluminum) and then dumping the excess production on the U.S. and other world markets.

An additional argument is that China deliberately keeps its currency (the RMB or Yuan) undervalued with respect to the dollar in order to stimulate its exports and discourage its imports from the Unites States. However, since 2005, the yuan's exchange rate has, more or less, reflected market forces rather than being determined by the Chinese government and central bank as previously done. As Fig. 4 shows, the yuan actually appreciated with respect to the dollar from October 2010 to January 2014 when China was still growing very fast, but then it depreciated afterwards when China's growth sharply declined. If anything, there is evidence that China's central bank intervened in the foreign exchange markets to prevent a further depreciation of the yuan so as not give an additional reason for the United States to accuse China of trade protectionism. In fact, the United States has recently stopped accusing China of "exchange rate protectionism".

The U.S. trade problem with China came to the forefront in 2002 when China was admitted to the World Trade Organization (WTO) on the condition that it would gradually move toward a market economy over time and follow WTO's trade rules. This did not happen. China took full advantage of the opportunities of, more or less, free access to other countries' markets but it did not allow equal trade to foreign companies in the Chinese market. In other words, China "gamed the system". Over the years, China did promise several times to change its ways, but it never did (nor does it seem willing to do). This set the stage for President Trump imposing higher and higher import tariffs on more and more Chinese exports to the United States. The purpose was (and is) to pry open the Chinese market to U.S., try to end Chinese steeling of foreign technology, and ending all the other unfair trade practices, so as to establish a level-playing field in international trade and economic relations.

## 5 Are U.S. Trade Policies Justified? What Trade Policies Should the United States Have Adopted?

The U.S. accusation that China is not following WTO rules that it had agreed to follow upon joining the WTO and this is harming (taking advantage of) its trade partners, especially the United States, seems to be mostly true. One result is that (as we have seen) China is now responsible for more than half of the U.S. trade deficit. Of course, there is no theory that postulates that a nation needs to balance trade bilaterally. But when one nation (in this case China) is responsible for more than half of the total trade of the very large and unsustainable trade deficit of the biggest (and very competitive) economy in the world (the United States)—clearly something is wrong.

Thus, it would be fair and appropriate for the United States to protect itself by imposing "countervailing duties" on China's exports to the United States, as allowed and prescribed by the WTO rules, and this would not allow China to retaliate and respond in kind with duties of its own on U.S. exports (as it occurred when the United States imposed a 25% import tariff on $50 billion of Chine exports to the United States in June of 2018). But the United States chose to act unilaterally by not bringing China to the WTO (as required by WTO rules) for adjudication and very likely authorize the United States to impose calibrated countervailing duties on Chinese exports to the United States. Thus, the United States, itself, also did not follow WTO rules, and this allowed China to soon retaliate with import tariff on an equivalent amount of U.S. exports to China. When the United States then "doubled up" by imposing a tariff of 10% on another $200 billion of Chinese exports to the United States (with the threat of increasing that tariff to 25% if China did not change its ways), the stage was set for a full-fledged trade war between the United States and China, which would probably involve other nations, as they would be forced to chose sides.

But, as we have seen earlier, this was not the only unilateral protectionistic trade action taken or promised by the United States in 2017 and 2018. The United States also threatened protectionist trade action against many other U.S. trade partners. As we have seen, the United States dropped out of the TPP, put the TTIP on hold, forced the renegotiation of NAFTA on Canada and Mexico, and imposed hundreds of billion of dollars of tariffs on U.S. imports of steel, aluminum and other products on most its major trade partners and threatened to impose a 25% tariff on automobile imports from Europe, Japan, China and other nations if they did not eliminate their restrictions on U.S. exports. Trump even threatened to drop out of the World Trade Organization (WTO). Trump acted unilaterally because of his strong belief that the WTO was unable and unwilling to impose that its trade rules be respected. But by doing so, Trump seriously undermined the WTO and is risking a world trade war, which would seriously damage the entire world.

Thus, the United States unilaterally imposed import tariffs on most of its major trade partners in order to induce them to change their ways and provide as open trade access to U.S. goods and services as they enjoy in the United States. Of course, Trump was told that import tariffs on Chinese and other nations' exports to the United States would not reduce the U.S. trade deficit because trade deficits are caused (result) from gross *domestic* macro imbalances, specifically from the fact that the United States spends much more that it saves, and this excess is reflected in its trade deficit. Specifically, U.S. invests much more than it saves, and this excess becomes the U.S. then in a trade deficit. Trump, thus, used import tariffs primarily as a weapon to force its trade partners to open their markers reduce their protectionism against the United States.

The correct U.S. trade policy, however, would have been and should be to convince the other major trading nations that China's non-market trading harms them all, not just the United States, and convince them to jointly bring China to the WTO, where legal proof of China's transgressions would be presented, which, if proved true, would lead the WTO to sanction the joint legal imposition of countervailing duties on China. This policy would have a greater chance of China's accepting to change its ways in international competition and trade, and avoiding a trade war.

Figure 5 provides an OECD simulation scenario that shows the effect of an increase in trade protection by the United States, Europe, and China that increased trade costs by 10%, and the resulting percentage deviation in the GDP, imports, and

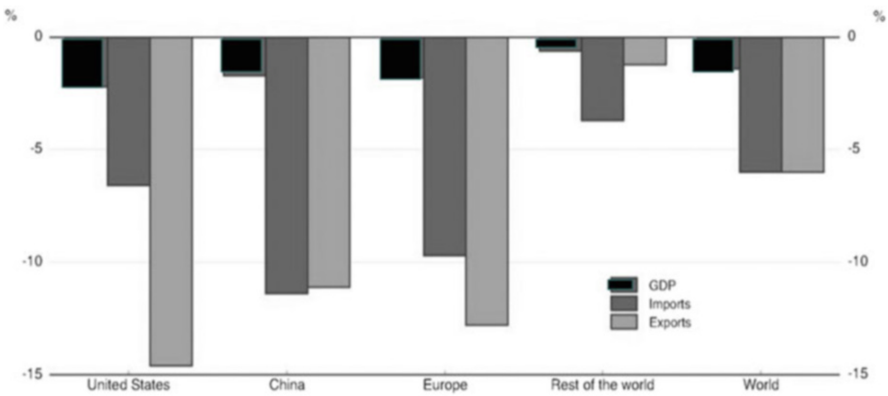


**Fig. 5** Effect on GDP, imports, and exports of an increase in trade protection by the United States, Europe and China that raises trade costs by 10%. Source: *OECD Economic Outlook*, No. 2, 2016

exports of the United States, China, Europe, the rest of the world. The simulation exercise shows that GDP, imports, and exports would fall by various percentages with respect to the baseline in all countries and areas or groups of countries. Figure 5 also shows that the U.S. GDP would fall more than in other nations and areas. The reduction in imports and exports would be much greater than the reduction in GDPs, especially for the United States, Europe and China. Of course, an all-out trade war would very likely be much more economically damaging (see Salvatore and Campano 2018).

The United States and China are now (February 2019) engaged in intensive negotiations to avoid an escalation in trade protectionism and a possible trade war, but even if an accord were reached, strong international trade controversies are likely to recur, especially between the United States and China, unless the WTO were reformed and strengthened and the world returned to the rule of law in international economic and trade relations and to a liberal economic and trade system.

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# Populism and European Integration: Diagnosis and Policy Response

**Marco Buti and Karl Pichelmann**

**Abstract** This paper offers a perspective on how to address the current populist charge against European economic integration. The first section provides a back mirror view on the economic and political issues that have marked the last few decades. While some of these issues, such as the intensification of global economic interaction were expected, few foresaw the extent to which the forces of "globalisation" would widen economic and political divisions within Europe and globally. The second section looks ahead, attempts to distil the defining challenges that we face, and sets out a perspective for EU economic policy over the next 5 years. In terms of economic policy priorities, the EU's ability to support the resilience of its economy and convergence in living standards will depend on its ability to deliver in three main areas: (i) growth and productivity, (ii) deepening the Economic and Monetary Union and (iii) ensuring that it acts as a Union that provides opportunities, empowers and protects.

## 1 Scrolling Back: The Big Picture

Over the last decade, the EU has well maintained its strong role in the international economy, weathering major global shifts. Despite (i) the rise of the BRICS, particularly China (ii) the impact of technological change greatly enhancing interconnectivity and (iii) its internal crisis in the euro area following the great recession, Europe remains an important player in the world economy. Although small in population, the EU remains rich per capita, with an open market, competitive firms, highly educated work force, investment-friendly environment and a stable currency. The EU has negotiated comprehensive trade deals with important partners and the Single

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M. Buti (✉) · K. Pichelmann
DG Economic and Financial Affairs, European Commission, Brussels, Belgium
e-mail: Marco.Buti@ec.europa.eu; Karl.Pichelmann@ec.europa.eu



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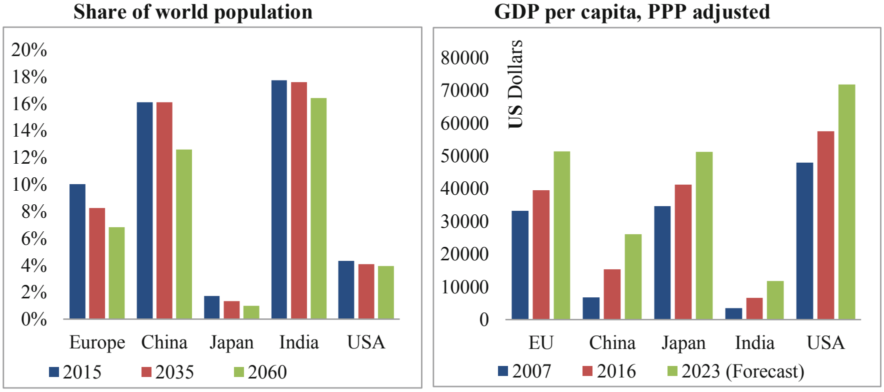


**Fig. 1** The economic weight of the EU—small in population, but rich per capita. Source: UN World Population Prospects (right Fig.) and IMF WEO (left Fig.)

Market with its 500 million people is the most highly integrated economic area in the world and a major destination for foreign investment. Europeans enjoy overall standards of living that are among the highest in the world with prosperity broadly shared among its people as inequality, albeit higher than 30 years ago, is still relatively low by international standards (Fig. 1).

Despite this positive picture, the benign view of the benefits of globalisation has underestimated some related side effects. "Globalisation" as a catch-all for increasing trade, global supply chains, financial integration and capital market liberalisation has been economically beneficial. At the same time, it should be acknowledged that critics of globalisation do have a point. Concerns about the negative impact on inequality and claims that it adversely affects fundamental socio-political values, such as national identity and sovereignty, should not be casually dismissed. Indeed, the post-1990 wave of globalisation and market integration has differed in many respects from previous episodes. First, it extended well beyond the traditional spheres of trade in goods to services, in particular unbridled liberalisation in finance, and to harmonisation of regulations behind the border such as investment rules, product standards, patents and copyrights etc. Secondly, it strongly interacted with skill-biased technological progress raising interconnectivity, thereby supporting off-shoring, relocation and outsourcing of economic activity and the build-up of integrated value-added chains. Thirdly, dynamic agglomeration and network effects have accentuated the spatial divide in the location of economic activities, with laggard regions increasingly at risk of falling in stagnation traps. And, obviously, the emergence of the BRIICS, in particular China, has been a game-changer in the world economy. Increased trade has been a by-product of these developments, but the main defining features have been financial globalisation and the creation of flexible mobile international production networks configured according to international cost arbitrage, including taxation and other aspects of national regulatory autonomy.