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Capitalism, Global Change and Sustainable Development

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Slower World Growth or Global Recession with the Trade War?

Dominick Salvatore

Abstract After the slow recovery from the 2008–2009 global financial crisis, the world economy now faces even slower growth and the prospects of global recession triggered by the USA–China trade war. This paper starts by examining whether the slow growth of the world economy was due to wrong or inadequate economic policies to overcome the crisis (great recession) and return to growth, or for other reasons. Then, it examines the reasons the United States is growing faster than other advanced countries, the slowing growth of emerging market economies (and even economic crisis in some of them), and whether the world is now sliding toward a new global financial crisis and recession triggered by the current trade war.

Keywords Growth prospects · Advanced countries · Emerging market economies · Global financial crisis · Trade war · New global financial crisis

1 Introduction

After a decade from the end of the deepest global financial crisis of the postwar period, growth continues to be slow in advanced countries and falling in most emerging market economies. There is now even the risk that the world could be drifting toward a new global financial crisis triggered by the US–China trade war.

This paper examines the reasons for (1) the slow recovery after the recent global financial crisis, (2) the United States growing faster than other advanced countries (particularly Europe), (3) growth slowing in emerging market economies (with some already in crisis), and (4) the prospects of the world facing a new global financial and economic crisis—possibly even deeper than the previous crisis.

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2 Causes and Effects of the "Great Recession"

The most recent global financial crisis started in the U.S. housing sector in 2007 as a result of banks giving huge amounts of (sub-prime) loans or mortgages to individuals and families that could not afford them. When many individuals and families defaulted on their loans, U.S. banks fell into a deep crisis, which then spread to the entire financial sector in 2008 and, from there, to the U.S. real sector and the rest of the world. The result was the "Great Recession".

Contagion spread from the United States across the Atlantic because many European banks had committed even greater excesses than U.S. banks and Europe faced an even greater housing bubble than the United States (Salvatore 2010). Deep recession in all advanced countries then greatly reduced their imports from and financial flows to emerging market economies, thereby spreading the crisis to the rest of the world. Most emerging market economies (such as Argentina, Brazil, Mexico, Russia, and Turkey) fell into a deep recession, while others (such as China) faced a sharp growth slowdown.

Table 1 shows that at the depth of the recession in 2009, the percentage fall of real GDP among the largest advanced nation ranged from 2.8 for the United States to 5.6 for Germany, and it was 4.5 in the Euro Area as a whole, 2.9 in Canada, 4.3 in the United Kingdom, and 5.4 in Japan. The recovery from 2010 to 2017 was slow in all advanced nations, averaging 2.1% in the United States, 1.3% in the EU-19 or Euro Area (which even fell back into recession in 2012 and 2013), 2.0% in the United Kingdom, 1.5% in Japan, and 2.3% in Canada. Britain and Canada fared generally better than the Euro Area and Japan since the end of the crisis, with growth rates comparable to those in the United States. Japan suffered 6 recessions during the past 25 years (including in the ones 2011 and 2014).

In 2018, growth accelerated somewhat in the EU-19 and in some countries (United States, France, Italy and Spain) but declined in others (Germany, United Kingdom, Japan, and Canada) and it is forecasted to decline in 2019 in the EU-19

Table 1 Average annual percentage growth of real GDP in major advanced countries in 2009–2018 and forecasts for 2019–2020

Nation/area	Yearly average 2009	2010–2017	2018	2019[a]	2020[a]
USA	−2.8	2.1	2.9	2.3	1.9
EU-19	−4.5	1.3	1.8	1.3	1.5
Germany	−5.6	2.1	1.5	0.8	1.4
France	−2.9	1.3	1.5	1.3	1.4
Italy	−5.5	0.2	0.9	0.1	0.9
Spain	−3.6	0.7	2.5	2.1	1.9
U.K.	−4.3	2.0	1.4	1.2	1.4
Japan	−5.4	1.5	0.8	1.0	0.5
Canada	−2.9	2.3	1.8	1.5	1.9

[a]Estimates

Source: IMF (2019a)

and in all the countries in Table 1 (except Japan), but to be higher than in 2019 in 2020 (except in the United States, Spain and Japan).

3 Countercyclical Monetary and Fiscal Policies to Overcome the Crisis and Restart Growth

The United States and other advanced nations responded to the Great Recession by rescuing banks and other financial institutions from bankruptcy, slashing interest rates, introducing huge economic stimulus packages, and undertaking huge injections of liquidity (quantitative easing or QE). These efforts, however, only succeeded in preventing the economic recession from being deeper than otherwise and the subsequent recovery to be even slower than it has been.

In order to overcome the crisis, the Fed, the European Central Bank (ECB), and the Bank of Japan (as well as the central Bank of England and Canada) drastically cut their fund rate starting in 2008, so much so that by early 2014 these rates were close to zero in nominal terms and negative in real terms. These nations also conducted quantitative easing (QE) that sharply increased their holdings of private long-term assets so as to further lower long-term rates in the hope of stimulating growth (see Fig. 1). More recently, the ECB and the Bank of Japan (as well the central bank of Denmark, Sweden, and Switzerland) even introduced negative *nominal* interest rate. Such powerful expansionary policy had been not envisioned until the recent crisis.

Advanced nations also used powerful expansionary fiscal policy to fight the recession and restart growth, which led to huge budget deficits and government debts. Table 2 shows that the U.S. budget deficit as a percentage of GDP was 2.9 in 2007, reached the high of 13.1 in 2009, before falling to 3.2 in 2015, and then rising to 3.8 in 2017 and 4.3 in 2018. In the Euro Area, comparable figures were 0.6, 6.3,

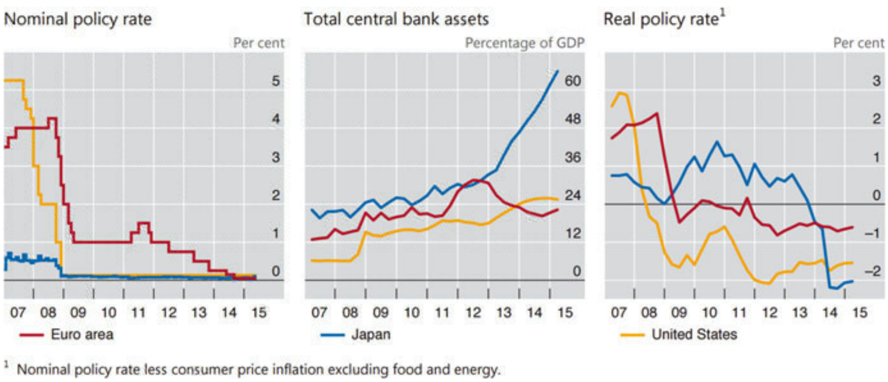

Fig. 1 Nominal and real policy rates, and holdings of Total Central Bank Assets: Euro Area, Japan and United States, 2007–2015 (Source: BIS 2015)

Table 2 Budget deficits as percentage of GDP in major advanced countries, 2007–2019

Nation/area	2007	2009	2011	2013	2015	2017	2018	2019[a]
United States	−2.9	−13.1	−9.3	−4.1	−3.2	−3.8	−4.3	−4.6
Euro Area	−0.6	−6.3	−4.2	−3.1	−2.0	−1.0	−0.6	−1.0
Germany	0.3	−3.0	−1.0	−0.1	0.8	1.0	1.7	1.1
France	−2.5	−7.2	−5.2	−4.1	−3.6	−2.7	−2.6	−3.3
Italy	−1.5	−5.3	−3.7	−2.9	−2.6	−2.4	−2.1	−2.7
Spain	2.0	−11.0	−9.6	−7.0	−5.3	−3.1	−2.7	−2.3
United Kingdom	−3.0	−10.7	−7.5	−5.3	−4.2	−1.8	−1.4	−1.3
Japan	−2.1	−10.4	−9.4	−7.9	−3.8	−3.2	−3.2	−2.8
Canada	1.8	−3.9	−3.3	−1.5	−0.1	−0.3	−0.4	−0.6

[a]Estimate
Source: IMF (2019b)

Table 3 Government debt as percentage of GDP in major advanced countries, 2007–2019

Nation/area	2007	2009	2011	2013	2015	2017	2018	2019[a]
United States	64.0	87.0	99.7	104.8	104.7	106.2	105.8	106.7
Eurozone	64.9	78.4	86.6	91.6	89.9	86.8	85.0	83.6
Germany	63.6	72.6	78.6	77.4	70.8	63.9	59.8	56.9
France	64.4	82.9	87.8	93.4	95.6	98.5	98.6	99.2
Italy	99.8	112.5	116.5	129.0	131.6	131.3	132.1	133.4
Spain	35.5	52.7	69.5	95.5	99.3	98.1	97.0	96.0
United Kingdom	42.2	64.1	80.8	85.2	87.9	87.1	86.9	85.7
Japan	183.0	201.0	222.1	232.5	231.6	235.0	237.2	237.5
Canada	66.8	79.3	81.9	86.2	91.3	90.1	90.6	88.0

[a]Estimate
Source: IMF (2019b)

2.0, 1.0, and 0.6. In the United Kingdom, it was 3.0 in 2007, reached the high of 10.7 in 2009, but then fell to 4.2 in 2015, 1.8 in 2017 and 1.4 in 2018. In Japan it was 2.1 in 2007, reached 10.4 in 2009, with 3.2 in 2015, 3.2 in 2017 and 1.4 in 2018. Canada had a budget surplus of 1.8 in 2007, a deficit of 3.9 in 2009, 0.1 in 2015, 0.3 in 2017 and 0.4 in 2018.

Table 3 shows that as a percentage of GDP, U.S. debt rose from 64.0 in 2007 to 87.0 in 2009, and it was 105.8 in 2018. Comparable figures were for the Euro Area 64.9,78.4, and 85.0. In 2018, it was 59.8 for Germany, 86.9 for the United Kingdom, 90.6 for Canada, 96.8 for France, 97.0 for Spain, 132.1 for Italy, and 237.2 for Japan.

As pointed out earlier, however, such powerful monetary and fiscal countercyclical policies only prevented the crisis from being deeper, but not to return to the higher pre-crisis growth levels in the large advanced countries. Although U.S. growth after the crisis was generally higher than in the EU-19 as a whole and of most large advanced nation individually, it was lower than that after of all the previous postwar recessions (see Salvatore 2018).

4 Slow Recovery in United States but Faster Than Europe's

Although the U.S. recovery after the recent crisis was the slowest than after all its post-war recessions (see Salvatore 2016), it was faster than in Europe (see Fig. 2). The figures shows, however, that Europe's growth problem started much earlier (in the 1990's) than with the recent crisis, but it became even worse as a result with the crisis (i.e., the diverge from U.S. growth became even worse after the crisis).

But why was the Great Recession so deep and the recovery so slow in the United States and other advanced countries? One important reason is that the Great Recession was triggered and accompanied by a banking and financial crisis, and experience indicates (Reinhart and Rogoff 2009) that this type of crisis is much more difficult and usually takes much longer to overcome than a purely economic crisis because it is usually accompanied by heavy deleveraging by the banking sector. But there are also other more specific reasons that made this recovery and growth so slow.

The most important of these is that advanced nations faced a sharp decline in labor productivity after the recent global financial crisis. Table 4 shows that while U.S. labor productivity increased at a yearly average of 2.4% in 1999–2006, it rose by only 1.1% in 2007–2015. Comparable figures (in percentages) were, respectively, 1.8 and 0.7 for Japan, 2.4 and 0.1 in the United Kingdom, 1.5 and 0.5 for the Euro Area, and 1.9 and 0.6 labor for the European Union of 28 (EU-28).

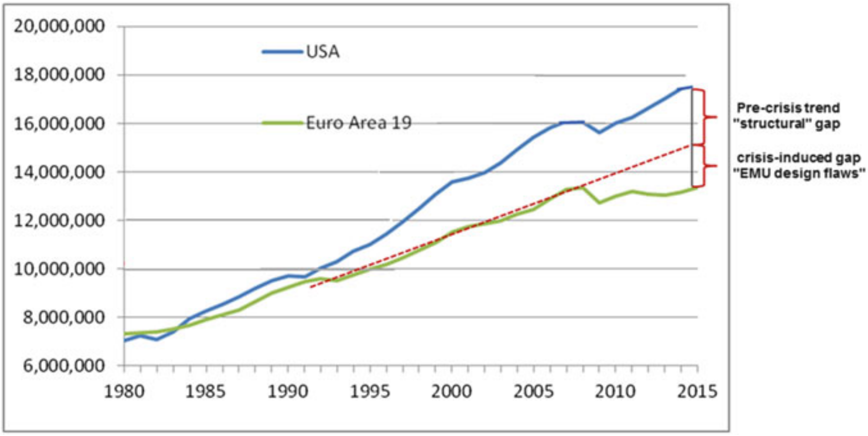

Fig. 2 The Euro Area growth crisis goes far back, but became worse after the global financial crisis (Source: Conference Board 2016)

Table 4 Growth of labor productivity, average percent per year, 1999–2015

	US	Japan	UK	Euro Area	EU-28
1999–2006	2.4	1.8	2.4	1.5	1.9
2007–2015	1.1	0.7	0.1	0.5	0.6

Source: OECD (2016)

Another reason for slower growth (and less job creation) in the United States and other advanced countries was outsourcing. Most multinationals from advanced nations, in their effort to minimize production costs, transferred a great deal of production (and jobs) to emerging market economies, especially China, during the past decade. This started before the recent global financial crisis but it rapidly accelerated afterwards. Growth was also discouraged in advanced nations by high taxes, overregulation and policy uncertainty—again, more so in Europe that in the United States and the United kingdom (as shown in Fig. 2).

5 Why Is Growth Slower in Europe Than in the United States?

Overregulation and excessive welfare benefits are generally regarded as the primary reasons for the slower growth in Europe than in the United States (Salvatore 1998, 2007, 2017). Europeans expect their government to take care of them from birth to death. They have guaranteed vacations, free health care, free education, practically guaranteed jobs, and high unemployment benefits. All this kept the European growth rate much lower than growth in the United States during the past two decades and landed Europe into a deeper recession and a weaker recovery than the United Stares (Salvatore 1998, 2004). Japan is in a similar situation.

Overregulation and high taxes lower efficiency, increases the cost of doing business, and slows growth. Figure 3 shows that the cost of doing business in the Euro Area (EA) is about almost four times higher than in the United Kingdom and seven times higher than in the United States. The Doing Business (DB) Indicator includes the following ten indicators: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency. Since the cost of doing business in the Euro Area is much higher than in the United Kingdom and the United States, the Euro Area is less efficient, less competitive internationally, and grows more slowly than the United Kingdom and the United States. Italy stands out among the large Euro Area countries as being more overregulated and having higher welfare costs—and thus experiencing slower growth since 2008 than other large European countries (see Fig. 4).

6 Growth Slowdown or Recession in Major Emerging Market Economies

After their spectacular growth during the past decade, growth also slowed down in emerging market economies (Klein and Salvatore 2013). The economic crisis in emerging market economies started as a result of contagion as the recession-afflicted

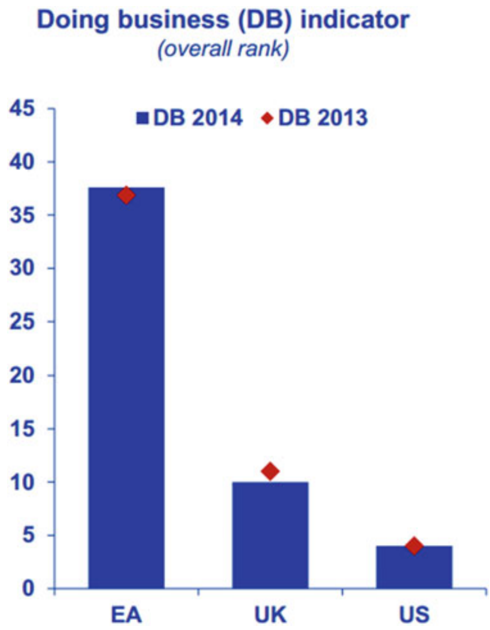

Fig. 3 Doing business indicator (Source: World Bank 2016)

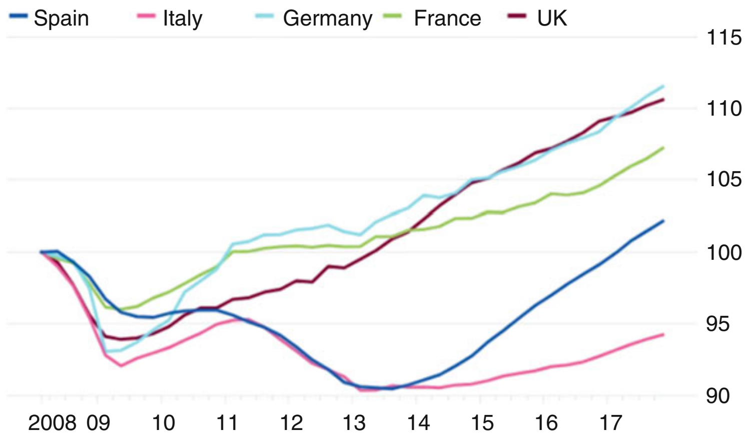

Fig. 4 Real GDP Growth in Italy, Spain, France, Germany and U.K, 2008–2017 (Source: OECD 2018)

advanced nations sharply cut imports from and the flow of investments to emerging markets during the recent global financial crisis. This was one reason for the decline in China's previous spectacular growth. While India's growth held up, the average annual percentage growth of real GDP in other large emerging countries (those in the G20) has been very slow (with exception of China, India and Indonesia—see Table 5).

Table 5 Average annual percentage growth of real GDP in emerging countries in G20 in 2009–2018 and forecast for 2019–2020

Nation/area	2009	2010–2017	2018	2019[a]	2020[a]
China	9.2	8.0	6.6	6.3	6.1
India	8.5	7.3	7.1	7.3	7.5
Russia	−7.8	1.9	2.3	1.6	1.7
Brazil	−0.1	0.4	1.1	2.1	2.5
S. Africa	−1.5	2.0	0.8	1.2	1.5
Korea	0.7	3.5	2.7	2.6	2.8
Indonesia	4.7	5.5	5.2	5.2	5.2
Mexico	−4.7	3.2	2.0	1.6	1.9
Argentina	−5.9	2.4	−2.5	−1.2	2.2
Turkey	−4.7	6.8	2.6	−2.5	2.5
S. Arabia	−2.1	4.0	2.2	1.8	2.1

[a]Estimates
Source: IMF (2019a)

The slowdown in China's growth rate from 2010 to 2017, however, was also the result of its effort to restructure its economy toward more internal demand and from a manufacturing to a service economy, rather than relying on continued export growth and on heavy domestic investments as in the past (the former because it was no longer sustainable and the latter because of the setting in of the "dreaded" diminishing returns). In the process, China's demand for primary commodity imports from other emerging markets (especially from Brazil and many African countries) also declined sharply. This caused an even greater growth slowdown in other emerging market economies than the decline resulting from the recession in advanced countries.

As the demand for their primary exports declined, the currencies of emerging markets sharply depreciated or were devalued, thus making the servicing of their previously accumulated heavy financial debt and dollar borrowings of over $6 trillion by 2018 unsustainable. Emerging market economies also experienced large net financial outflows, which exacerbated their economic problems even more. Thus, Brazil faced recession with a decline of real GDP of 3.5 in 2015 and 2016, Russia faced even more economic difficulties as a result also of the wars and the economic sanctions imposed on it, and Argentina and Turkey also faced an economic crisis.

The economic crisis in most emerging market economies would have been even deeper had they not been operating under some form of exchange rate flexibility or had not devalued their currencies (which cushioned to some extent their reduction in exports) and had they not also entered the crisis with more foreign exchange reserves accumulated during the commodity boom of the previous decade.

7 The U.S. Trade War with China

The United States started a trade war with China in order to force China to end its unfair trade practices. The *White House Office of Trade and Manufacturing Policy* published a study (June 2018) providing evidence on “How China’s Economic Aggression Threatens the Technologies and Intellectual Properties of the United States and the World” by engaging in: (1) systematic stealing U.S. technology on a grand scale sponsored by the Chinese government, (2) providing illegal subsidies to some of its large companies to overcome foreign competition, (3) requiring U.S. and other foreign firms to enter into joint ventures and transfer their technology to Chinese companies as a condition 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.

China was admitted to the World Trade Organization (WTO) in 2002 on the condition that it would gradually move toward a market economy over time and follow WTO’s trade rules. That did not occur. China took full advantage of the opportunities of, more or less, free access to other countries’ markets but it did not allow equal access to foreign companies in the Chinese market. Clearly, China “gamed the system”. Over the years, China promised several times to change its ways, but it never did and does seem willing to do so. 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 try to pry open the Chinese market to U.S. companies, end Chinese steeling of foreign technology, and ending all its other unfair trade practices, so as to establish a level-playing field in international trade and economic relations.

The U.S. accusation that China is not following WTO rules seems to be mostly true and is more or less believed also by the European Union, Japan and Canada. 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.

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 international trade theory postulates that trade deficits are caused (result) from gross *domestic* macro imbalances, specifically from the United States spending much more than it saves, with the excess reflected in its trade deficit. Trump used import tariffs primarily as a weapon to force its trade partners, especially China, to open their markers and reduce their protectionism against the United States to the lower U.S. level.

The United States (Trump) believes that it is fair and appropriate to protect itself by imposing “countervailing duties” on China’s exports to the United States, just as it would be prescribed by the WTO rules—and without allowing China to retaliate (as it occurred when the United States imposed a 25% import tariff on $50 billion of Chinese exports to the United States in July–August 2018). However, the United States did take China to the WTO and this allowed China to immediately retaliate. The United States then "doubled up" by imposing a tariff of 10% on another $200 billion of Chinese exports to the United States in September 2018 (raised to 25% in June 2019—and China again immediately retaliated). The stage was thus set for a full-fledged trade war. In fact, the United States has indicated that on October 1, 2019 it will impose a 15% tariff on a subset of the remaining $300 billions of Chinese exports to the United States, and then to the whole $300 billion on December 15. The United States also prohibited its high-tech companies to sell advanced semiconductors and other high-tech products to Chinese firms and from acquiring or invest in high-tech U.S. companies.

The United States also took or threatened protectionist trade action against other trade partners. Under President Trump, the United States dropped out of the Tans Pacific Partnership (TPP), put the Transatlantic Trade and Investment Partnership (TTIP) on hold, forced the renegotiation of NAFTA on Canada and Mexico, 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 reduce their tariffs on U.S. exports to U.S. levels. 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 or unwilling to enforce its trade rules. But by so doing, Trump seriously undermined the WTO and is risking unleashing a new global economic crisis.

The correct U.S. trade policy would have been and should be to convince the other major trading nations that China's non-market trading practices 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 (and without permitting China to retaliate). This policy would have a greater chance of China's accepting to change its ways in international competition and trade, and end the trade war.

8 Will the U.S. Trade War with China Lead to a New Global Crisis and Recession?

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 exports of the United States, China, Europe, and 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, and the world as a

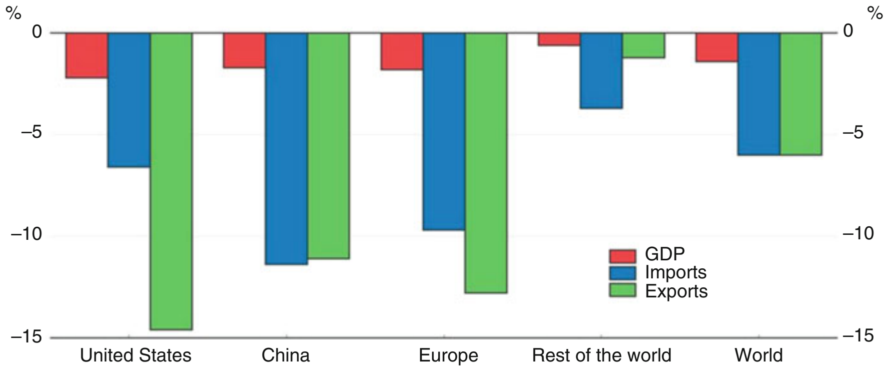

Fig. 5 Effect on GDP, Imports, and Exports of an Increase in Trade Protection by the United States, Europe and China that raises trade costs by 10% (Source: OECD 2016)

whole. The figure shows that the U.S. GDP would fall more than in other nations and areas. Imports would fall the most in China and Europe, while exports would fall more in the United States and Europe (for the result of another similar simulation exercise, see Salvatore and Campano 2018).

Of course, an all-out trade war would very likely be much more economically damaging than indicated in Fig. 5 because the tariffs on U.S.–China trade have increased much more than the 10% assumed in the OECD simulation shown in Fig. 5. In fact, U.S. tariffs on Chinese exports to the United States rose from 3.1% in January 2018 to 24.3% in November 2019 and Chinese retaliatory tariffs on U.S. export increased from 8.0 to 25.9% over the same time period. On the other hand, trade tariffs on the rest of world trade have not increased.

A more recent OECD (2019) estimate indicates that the U.S–China trade restriction imposed so far (from July 2018 through August 2019) would cut 1.0 percentage point of growth in China over the next 2–3 years, 0.7 of growth in the United States (thus lowering its growth from the forecasted rate of 2.3% in 2019 and 1.9% in 2020 to 1.7 and 1.3, respectively), and from and 0.6 growth of the world as a whole. But if the trade war progresses and intensifies (as it seemed likely in fall 2019), the economic harm in terms of the reduction in world growth could be much higher, especially if other nations were drawn into the trade war.

The U.S.–China trade war is almost certain to also worsen other economic weaknesses present in the world economy today. These are: (1) the excessive total indebtedness in the Chinese economy, now in excess of 275% of its GDP, (2) emerging markets' total indebtedness in dollars, which now exceeds $6 trillion and in the face of an appreciating dollar, (3) the new financial bubble arising from nominal interest rates near zero in the United States, Britain and Canada and negative in Japan, the Euro Area (and Denmark, Sweden and Switzerland), thus leading inflated stock markets and also investors, in search for returns, to undertake "excessively" risky investments, and (4) discouraging world consumption and investments.

Each of these weaknesses or dangers could in fact trigger a new global financial crisis and recession on their own even without the trade war, but in the current trade war situation they could lead to “a perfect storm” (i.e., a deeper global financial crisis deeper than the previous one) at a time when most advanced nations have fewer (and less effective) monetary and fiscal policies tools to deal with it.

The United States and China are now (October 2019) engaged in intensive negotiations to avoid an escalation in trade protectionism and worsen the 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.

9 Conclusion

After the generally slow recovery from the recent global financial crisis and great recession, the world is again in danger of sliding into a new crisis triggered by the present U.S.–China trade war, which could be even deeper than the previous crisis because of other current weaknesses in the world economy. The hope is that reason will prevail by ending the trade war and correcting the other weaknesses and dangers currently facing the world economy, not only to avoid another global financial crisis but also to return to the faster world growth that prevailed before the recent crisis.

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European Solidarity as a Way to Face Globalization and as an Antidote Against Populism

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Abstract Two opposite positions are facing each other in the euro area. The first one, originating in southern Europe, is based on the observation that the adoption of the euro favored northern economies, allowing them to have persistently high trade surpluses at the expenses of the southern ones. The second position, originating in northern Europe, focuses instead on the risks that the citizens of those countries would incur to cover the high debt of southern countries. Such opposed positions, however, ignore the deep reasons that led European countries to start the process of economic integration, of which monetary integration is a relevant part. In view of what precedes, a market-financed euro area-wide investment plan to be agreed, monitored and even administered by representatives of northern governments, should be acceptable to them and would support the southern ones in their endeavor of risk reduction.

Keywords Globalization · Populism · Risk reduction · Risk sharing · Fiscal austerity · Investment plan

1 Introduction

The euro area crisis was ignited by the Greek shock and seemed to prove that the northern fear of a southern fiscal profligacy, dating back to the beginning of the process of monetary integration, was fully justified (although such a conclusion ignored the fact that until the beginning of the crisis, public finances of the countries mostly affected were in relative good shape or at least were giving signs of convergence). Still, fiscal austerity was imposed in order to redress the situation, although it was only thanks to the reassurance coming from the ECB, acting de facto as a lender of last resort, that the crisis came to an end.

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A different view results from a southern perspective, arguing that northern countries are benefitting from the rigidity provided by EMU, since their trade surpluses do not find any automatic compensatory mechanism to balance them.

Both perspectives seem to lead to the conclusion that creating the EMU was not appropriate and that it would be in the convenience of southern countries to leave and in the convenience of northern countries to let them go.

This conclusion, however, ignores the deeper reasons that are behind the creation of EMU, which is part of the wider project of European integration.

If northern countries want the southern ones to redress their fiscal situation, thereby reducing risk, as the current fiscal rules would oblige them to do, then, considering their self-interest in not disrupting the whole project of European integration, they should be willing to accept some degree of risk sharing in order to counterbalance the negative effects of risk reduction, for example in the form of the market financed euro area wide investment plan proposed by Della Posta et al. (2018).

2 Euro Area Crisis, Austerity Policies and the Stabilizing Role of the ECB

The euro area crisis is usually attributed to public debt imbalances (this is also why it is often defined as “sovereign debt crisis”, to distinguish it from the “global financial crisis” that preceded it). This is a debatable conclusion, though, especially considering the role also played by private debt, by current account imbalances and by self-fulfilling expectations, ignited not only by the sudden discovery of the higher than expected Greek public deficit and debt, at the end of 2009, but also by the “Deauville declaration” with which in October 2010 Angela Merkel and Francois Sarkozy acted as “scaremongers of first instance” (the opposite of what a “lender of last resort” should be doing in order to reassure the markets), thereby fostering rather than extinguishing the crisis.

Moreover, before the crisis the public debt-to-GDP ratio had been gradually decreasing in all euro area countries, and it was rather low in Spain and Ireland (respectively about 40% and 20%). It is only after the Greek crisis and after the bursting of the housing bubble in some countries (Spain and Ireland, where the bubble was induced by an excess of private debt made possible also by the capital inflows from northern countries, particularly France and Germany), that public debt had to be increased in order to bail out the private one.

In the case of Portugal, instead, the problem had not to do with a house bubble, but with current account imbalances (also present in the case of Spain, Ireland and Greece), once more resulting from an excess of consumption made possible on one hand by the capital inflows attracted by the higher interest rates and the perception of a rather low risk in southern countries, and on the other hand by the rigidity characterizing monetary unions and preventing any automatic adjustment of the current account imbalances (this point will be further addressed below).

Be that as it may, being the crisis attributed, by Germany and other northern European countries, to public debt imbalances, namely being it believed to be fundamentals-driven (the main economic fundamental to be monitored, however, being public debt and not the private one), the proposals for its resolution have been based mainly on the imposition of fiscal austerity policies, in order to adjust such imbalances.

The counterproductive effects of those policies had been immediately recognized by many observers (including Krugman 2010), who had applied the basic Keynesian model to conclude that with their adoption the public debt to GDP ratio would have increased rather than decreased because of the contractionary effect they would have had on GDP, the denominator of the public debt-to-GDP ratio.

As a matter of fact, as De Grauwe and Ji (2013) had promptly shown, the public debt-to-GDP ratio did not fall, and in fact it kept increasing, in spite of fiscal austerity

It is undeniable, then, that rather than thanks to fiscal austerity, the crisis came to an end only when the ECB stepped in and reassured the markets by acting, eventually, as a "lender of last resort". This happened with the famous Draghi's "whatever it takes" speech (accompanied by the prompt adoption of the unlimited Outright Market Transactions program), that reduced dramatically the interest rate on public debt.

Such an ECB role, however, like any other form of implicit or explicit fiscal solidarity, had been denied that far, following too literally the prescriptions of the Maastricht Treaty, with the motivation that doing otherwise would have risked providing the wrong incentives to the market. This is why the little Greek fire was allowed to grow (an image that I am borrowing from Paul De Grauwe), putting at risk the whole of Europe.

The role of incentives is well-known in economics and their importance cannot be discarded. It should be also recognized, however, that there are instances in which they may play a rather limited role, for example if divergences are structural rather than dependent on the deliberate actions of agents. This is the case, for example, when countries differ in labor or market institutions, or when the public debt that they have inherited is larger than that of other countries, thereby implying the need to impose higher taxes (especially when considering the indirect ones, like VAT) to repay it. This would undermine the domestic competitiveness since, in such a case, countries belonging to a monetary union would be characterized by different inflation rates, in spite of the same monetary policy being run in the area by the common central bank. Another instance is when countries have a different productive structure and the process of economic specialization based on comparative advantages has implied concentrating in a sector whose productivity increases less than that of other sectors. A further problem exists if, as argued above, no self-stabilizing market mechanisms are allowed to be in place by the system that has been adopted.

3 Opposing Views on the Way EMU Should Be Run: Exit EMU, Risk Reduction or Risk Sharing in EMU?

3.1 Exit EMU from a Southern Perspective

A quite wide spectrum of economists of southern euro area countries, both of a progressive and a conservative orientation (in Italy, for example, including names like Alberto Bagnai, Domenico Mario Nuti and Paolo Savona, just to list some of the most well-known of them) observe that the adoption of the euro has coincided with the relative impoverishment of their countries and with the enrichment of the Northern ones, therefore arguing that their countries should leave EMU, which is for them a sort of straightjacket that does not allow them to operate freely and that forces them in a subordinate role vis-à-vis the northern ones.

This is a long standing argument, that was raised already when the European Monetary System was created. After the fall of the fixed exchange rates system created in 1944 in Bretton Woods, European currencies started fluctuating widely against each other, thereby disrupting the otherwise intense intra-European trade. The late Marcello de Cecco also observed, however, that an additional effect of floating exchange rates within Europe would have been the appreciation of the German mark vis-à-vis the other European currencies. As a matter of fact, the economic strength of Germany would have attracted capital from the rest of the world, thereby appreciating the D-Mark and reducing its commercial competitiveness. Moreover, any German competitive advantage over its trading partners, resulting in a trade surplus, would have created the automatic conditions for rebalancing the situation through the appreciation of its currency, as it was the case when the "rules of the game" in the Gold Standard were not infringed by Britain's sterilization policies. Joining a fixed exchange rate system, then, this was the argument made by Marcello de Cecco, was in the full interest of Germany, since it allowed that country to avoid the appreciation of the D-Mark that would have prevented the accumulation of current account surpluses. The same is true, of course, for the adhesion to a monetary union, which is an extreme form or irrevocably fixed exchange rates.

German economists and citizens, then, should consider the role played by the mechanisms described above if they want to understand the true origins of the current account deficits of most southern euro area countries and, as a result, the origins of their persistent current account surpluses.[1]

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[1]When discussing the role played by the European Monetary System, however, it also needs to be recalled that, according to an old argument introduced by Giavazzi and Pagano (1988), the German monetary discipline might have helped reinforcing the anti-inflationary credibility of follower countries, including Italy, so as to contribute to the reduction of their inflation rate. Such a conclusion, however, is subject to several caveats and discussions that cannot be reported here but that should be considered.

3.2 Exit EMU from a Northern Perspective

The appeal signed by 154 German economists and published in the Frankfurter Allgemeine Zeitung on May 21, 2018 against Macron's proposal to transform the European Stability Mechanism to a permanent European Monetary Fund in order to be able to absorb future economic shocks, goes in the opposite direction.[2] The most prominent of those signatories are Hans-Werner Sinn, former president of the Ifo Institute, and Jürgen Stark, former member of the European Central Bank executive board. Their views are also in line with the position expressed by another well-known German economist like Bernd Lucke, who has been among the first ones to interpret and represent the German sentiment of fear of the mutualization of southern public debt. A similar fear characterizes the appeal signed in March 2018 by eight northern euro area countries (Finland, Denmark Sweden, Lithuania, Latvia, Estonia, Ireland and The Netherlands).

The northern view resulting from those documents only focuses on the risk they face to be asked to pay the debt of southern countries. This is why they encourage the states that are not capable to keep their accounts in order to leave EMU and to make this possible they suggest to set up a procedure to be followed by insolvent countries to quit the euro.

This position might convey the idea that they do not fear the risk that some countries may be leaving the euro area. What is not clear, however, is whether they would be willing to accept the risk that such an exit process involved more than just an outsider country like Greece, and whether they are well aware of the effects and implications this would imply in terms of the overall process of European integration.

One possibility is also that they rely on the fact that a deflagration of the European Union might not be in the interest of follower countries either, since this would mean to have to cope with a newly isolated and strong Germany, precisely what European countries wanted to avoid when EMU was created.

3.3 Risk Reduction and Risk Sharing (Namely Fiscal Solidarity) in EMU and the Benefit for Northern Countries of Being Part of It

Opposite, although less radical positions are those that, at least in principle, do not question the participation in EMU, although they subject it to the fulfillment of either risk reduction (to be performed by southern countries) or risk sharing (to be provided by the northern ones).

[2] https://www.faz.net/aktuell/wirtschaft/konjunktur/oekonomen-aufruf-euro-darf-nicht-in-haftungsunion-fuehren-15600325.html?utm_term=0_10959edeb5-f3892c4dc9-189813013&utm_campaign=f3892c4dc9-

Risk reduction is required by northern countries, arguing that if South and North have to remain together in a monetary union, the former has to behave properly, not expanding public finances in the implicit hope of a northern bail out. Such risk of fiscal profligacy is something that has been present in the debate from the very beginning of the process of monetary unification, namely from the Delors Report (Delors 1989).

It is far from clear, though, why risk reduction should only apply to budgetary issues. This is what has emerged after 2010, with the adoption of the European Semester, according to which a whole set of potential macroeconomic imbalances has to be monitored by the European Commission. As a matter of fact, not only fiscal divergence might represent a potential risk for EMU, but also any other indicator of competitiveness divergence could. Introducing labor market reforms in an uncoordinated manner (a clear example being the German Hartz reforms) or adopting a preferential fiscal treatment in favor of foreign companies, also creates a divergence within EMU, which increases the risk of a long run unsustainability. The latter case, for example, in which countries act the facto as free riders (this is the case of Ireland and the Netherlands, for example), produces the paradoxical result of strengthening the public finances of the countries adopting such fiscal measures, while weakening the public finances of the countries not adopting them, whose revenues will be decreasing and creating an equally disruptive trade divergence within EMU because of the competitive advantage it gives them.

Risk sharing is required instead by southern countries, arguing that if South and North have to remain together in a monetary union, the latter should acknowledge and give back to the former at least part of the advantage gained with the creation of the monetary union.

As a matter of fact, the euro area crisis itself would have been avoided by the application of fiscal solidarity, that has been exerted only at a later stage, and only being subject to conditionality in order for northern European countries to be reassured of not being exploited by the southern ones.

If the two perspectives reported above—the northern and the southern one—are brought to an extreme, the conclusion would be the one presented in the previous section, namely that southern countries that are not capable to provide the required risk reduction or that are going to lose from their participation in EMU because of the permanent competitive advantage that export countries have, should leave EMU.

4 The Need for a Comprehensive View: Risk Reduction and Risk Sharing

In my view both extreme positions make the mistake of looking at only one aspect, assigning to it an exorbitant weight that overcomes all other aspects and reasons for the creation of the euro, that should be considered instead in order to have an overall, balanced view on being part of EMU.

Those reasons might have to do, for example, as recalled above, with the high inflation rate of the 1970s and part of the 1980s, that was reduced also with the help (although not without costs, as the rational expectations theories of those days would have suggested instead) of the fixed exchange regime that had been adopted, and that set the adhering countries on a sustainable path of credibility. Needless to say, it is easy today to forget about inflation, given its current low level.

Similarly, we have forgotten the consequences of exchange rate volatility for an economic area open to trade and characterized by many different currencies and in which the suspect of "beggar thy neighbor" policies induce competitive devaluations and produces a spiral of retaliatory measures. Would that problem disappear if we leave the euro? May be that this is the case, since after all world trade operates under a flexible exchange rate regime. The intensity of such trade, though, is much higher in Europe. Not to mention that we came to the conclusion that we need intra-European trade and open commercial relationships, in order to keep away war and the phantoms of the past.

Maybe even more importantly, we have forgotten that the euro was part of a larger design, aiming at the political unification of the European continent. True, that might have been risky (as the Italian politician Carlo Ripa di Meana observed in discussing the project of EMU: "It is not the European Union that creates money but money that should be creating the European Union: it's a risky game"), but the final objective of a European Union, after the dramas of two world wars, as Altiero Spinelli and the other authors of the Ventotene Manifesto had dreamed, was the main ideal motivation behind it and the previous moves, the creation of the customs union in 1957 with the Treaties of Rome and the adoption of the Single European Act in 1987 had shown that the neo-functionalist approach had been giving good results.

Finally, behind the beginning of the process of European integration, and indirectly behind EMU, then, there is the need for European countries to cooperate to better resist the pressures of globalization and protect their citizens, being aware that this would only be possible by joining forces and by sticking together.

Still, in order to reap a (limited) advantage (or to avoid incurring a limited loss), both northern and southern countries criticize EMU by focusing on a single aspect and by neglecting the risk to ignite the breakup of the process of European economic, monetary and political integration, which would be a much worse and potentially disruptive conclusion.

In other words, this implies the risk to play a prisoner's dilemma game, in which both northern and southern European countries do not resist the temptation to play alone in the hope to reap a small benefit, not realizing that by doing so they will end up in a Pareto inferior equilibrium.

5 Negative Implications of Austerity Policies and the Need for an Investment Plan

The austerity policies that have been applied in order to solve the "sovereign debt" crisis have implied a dramatic fall of investments—the only expenditures that can be cut easily by policymakers interested to preserve an electoral consensus without receiving any objections or complaints on the part of those who would have benefitted from them, namely the voiceless future generations.

Most crises of the past, however, have been put to an end by following an opposite route: economic growth has been pursued in order to reduce the public debt-to-GDP ratio, thanks to the beneficial effects of the Keynesian multiplier, so that even if the numerator would be growing further, the denominator would grow even more. This has been the case, after World War II, in Britain with its 240% public debt-to-GDP ratio, or in the USA, where GDP growth has been the key element to stabilize and make public debt sustainable.

The least that this may imply is that the austerity policies followed by southern euro area countries, should have been supported and partially compensated in a cooperative environment in order to avoid the GDP fall of fragile countries that would nullify their effort, by expansionary domestic policies to be undertaken by the northern euro area members. Such a compensatory (not necessarily direct, through fiscal transfers from North to South countries, but also indirect, through higher internal absorption—consumption, investment, government expenditure—that would have favored a rebalancing of North-South current account divergences) would be fully beneficial because it would increase the GDP growth of the most fragile countries, so that the public debt/GDP ratio will surely decrease. Since this was not done, no surprise that the Greek paradox emerged, implying that not only austerity policy imposed a heavy social cost (that became apparent also in the mortality rates, as documented in the literature), but the public debt to GDP ratio did not fall, due to their contractionary effect on GDP growth.

It could still be understood that this would be hard to accept by citizens who speak another language, have a different religion, different traditions, culture and history, and different beliefs, although this signals clearly that they do not feel being all Europeans.

What is harder to understand, though, is the fact that solidarity if not accepted even if its cost would be close to zero. As a matter of fact, Germany and other northern euro area countries would only be required, following for example the proposal of the adoption of a euro area wide investment plan made by Della Posta, Marelli and Signorelli, to join forces with the southern euro area ones and issuing European bonds to collect the necessary financing on the international markets. As a matter of fact, the guarantee by euro area countries would be sufficient to attract market capital, so as to enjoy a high leverage effect. Moreover, still according to the proposal made by Della Posta et al. (2019), for example, investments would be selected, administered and monitored by the countries who provide a guarantee on them. Such a solidarity would imply neither a financial nor a monetary sacrifice,