EUROPE IN IDENTITY CRISIS

The Future of the EU in the Age of Nationalism

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

ISPI

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Edited by Carlo Altomonte and Antonio Villafranca
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Introduction

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

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

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

In a nutshell, the EU appears to be in an identity crisis. Its chances to survive hinge upon its ability to deliver at home and abroad, without abandoning its values and principles but rather adapting and relaunching them in the new international context.

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

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

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

The evolution and rationale behind today's trade war between Washington and Beijing are at the core of Niclas Frederic Poitiers' analysis in chapter 3. Specific attention is devoted to the effects of the trade war on the world economy and particularly to the implications of a potential disintegration of the WTO on the EU and its member states. The author suggests viable options for the EU to secure its own interests in a time when the multilateral approach to trade seems increasingly under attack.

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

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

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

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

Giampiero Massolo
ISPI President

1. A Revived EU Identity in the Age of Nationalism

Carlo Altomonte, Antonio Villafranca

Defining the EU's Identity

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

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

[1] D. Acemoglu, P. Aghion, and F. Zilibotti, "Distance to Frontier, Selection and Economic Growth", *Journal of the European Economic Association*, vol. 4, pp. 37-74, 2006.
[2] A. Sapir et al., *An Agenda for a Growing Europe: Making the EU System Deliver,*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Hubs and Spokes: The External Dimension of the Identity Crisis

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[19] Deutsche Welle, "Russia's parliament votes to unplug internet from world", 16 April 2019.

[20] The Diplomat, "China's Cybersecurity Law: What You Need to Know", 1 June 2017.

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

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

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

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

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

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

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

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

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

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

The internal identity of the EU is defined by its ability to achieve both economic growth and socio-economic cohesion. In the current state of affairs, these dynamics are inevitably affected by economic globalisation and asymmetric multipolarism. On the one hand and as already discussed, globalisation contributes to the emergence of inequalities, both at the territorial level and across societies, due to the sluggish reaction of welfare systems to international trade shocks[22]. On the other hand, the asymmetric power play currently taking place at the international level also risks hampering internal cohesion within the EU, due to the different exposure of countries to economic ties with China, or other idiosyncratic shocks (e.g. the different economic impact of sanctions against Russia on Member States' exports)[23].

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Conclusions: Handling the EU Identity Crisis

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

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

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

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

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

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

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

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

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

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

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