Parliamentary Dimension

romania2019.eu

Romanian Presidency of the Council of the European Union

Session III: The Economy of the Future.

Is There a Need for Reform of the Economic Model?

- Background note -

Economy of the Future and the Fourth Industrial Revolution

The economy of the future will develop within the context of the 4th industrial revolution, leading us to a new technological frontier through artificial intelligence and a wide application of software. The digital economy will revolutionize every economic sector with a transversal transformative effect. The revolution of artificial intelligence and the Internet of Things will most likely bring great productivity advantages. There is a great opportunity to spread prosperity to billions of people, but there is also the risk of creating even more injustice and inequality. In other words, in terms of the technological revolution management, history is not necessarily a clue for much optimism. A recent study by LSE[1] reveals that the Internet increased inequality, people with higher education and higher income earned the highest advantages and multinational corporations were able to grow strongly due to massive tax evasion.

Therefore, the expectations are great, ranging from visions of paradise, where all the problems of humanity will be solved, to visions of hell, where our creation will become an existential threat. There is a risk that the "winners take all" paradigm will triumph and then we will have a very small number of winners and a large number of losers. However, this is not an implacable destiny. The outcome will decisively depend on the way in which the earnings will be produced and distributed, namely it will ultimately depend on the political options. Economic and political institutions will dictate the outcomes and not the technology itself.

From historical point of view, the world has constantly become more prosperous, working less to produce such prosperity. As a rule, this process should continue. The natural effect of technological innovation is the increase in the living standards. Robots are meant not to destroy, but to enhance the value of human labor.

The need for public policies for channeling automation for the humans' welfare seems

[1] Alexander J. A. M. van Deursen, Ellen J. Helsper. The Third-Level Digital Divide: Who Benefits Most from Being Online?

beyond discussion. However, the "optimists" believe that they must be left free in order to create a higher balance even after the monumental failure of the markets that caused the 2008 financial crisis. Nevertheless, a certain dose of "pessimism" may be needed, which would recommend a collective action for controlling the rate and the type of innovation. Beyond economy, this is a philosophical and ethical issue. Maciej Kuziemski asked a profound question[2]: "What makes human beings human? Is it the pursuit of hyper-efficiency – the Silicon Valley mind-set? Or is it irrationality, imperfection, and doubt – traits beyond the reach of any non-biological entity?" Otherwise, not the people's jobs are in danger, but the humanity itself, Robert Skidelsky[3] points out.

Going beyond new technological frontiers characterizing the fourth industrial revolution raises an issue that constantly accompanied the history of capitalism: the relationship between the market and State. By reducing the marginal costs of a wide range of services to zero, digital development and artificial intelligence provides the opportunity to move certain areas to a collaborative economy, where activities for profit and non-profit activities can co-exist. Moreover, in some areas, data collection and analysis allow the achievement of optimal results due to making decisions and planned resource allocation at a central level.

Sine die Postponement of the Economic Paradigm After the 2008 Crisis

While the Great Depression during the '30s led to Keynesian economics, which replaced the previous laissez-faire mind-set, and the stagflation of the '70s led to Friedman's monetarism, which replaced the Keynesianism, the Great Recession did not lead to a similar intellectual paradigm shift. As a rule, major shocks led to fundamental changes in the role of the State and markets, objectives of macroeconomic policy and role of central banks. However, this is not what happened this time. The 2008 financial crisis represented a monumental market failure after a period of increasing inequality in many countries and deterioration in the relationship between capital gains and labor. However, the political decision-makers have hardly questioned the relative roles of the government and markets. The current economic model focuses on structural reforms that are synonymous with market liberalization, tax and charges cuts and deregulation of labor markets.

However, the cognitive errors of the macroeconomic conceptual framework were identified before the crisis. The Great Moderation paradigm, which predicted the disappearance of the major recessions, that was dominant before the crisis, was based on three major assumptions: 1. The monetary policy is able to stabilize the economic cycles by itself by pursuing a stable inflation, 2. The tax policy plays a secondary role, being reduced to automatic stabilizers and 3. The

[2] Maciej Kuziemski is a policy fellow at the School of Transnational Governance at the European University Institute.

[3] Robert Skidelsky, Professor Emeritus of Political Economy at Warwick University and a fellow of the British Academy in history and economics, is a member of the British House of Lords.

financial regulation does not influence the macroeconomic policy.

At present, the economists are practically in consensus that the three assumptions of the Great Moderation were insufficient, if not completely wrong, especially the third assumption. However, the macroeconomic model remained virtually unchanged after the crisis. The IMF conference held in April 2015, *"Rethinking Macroeconomic Policy",* was suggestively and agnostically named "*Progress and confusion."* Progress, because the errors of the old model were identified, but confusion, because the direction of the new model is unknown. In practice, the macroeconomic policy is still based on the three assumptions. Paul Krugman[4] tried an explanation: *"the existing macroeconomic model is good enough to allow governments to work and prevent a new Great Depression.*" Nevertheless, Robert Skidelsky contradicts him, noting that the economists failed to give an answer to certain key questions before and after the crisis: 1. Why did the "New Keynesian" school of thought (a fusion between the neoclassical economics and Keynesian economics) not recommend measures for preventing the collapse between 2007 and 2008? and 2. Why were the rehabilitated Keynesian policies between 2008 and 2009 quickly abandoned in favor of fiscal austerity?

[4] Paul Krugman is an American economist who is currently Distinguished Professor of Economics at the Graduate Center of the City University of New York, and a columnist for The New York Times. In 2008, Krugman was awarded the Nobel Memorial Prize in Economic Sciences.

Although many good ideas are circulated in the academic environment and not only there, the inertia is very big. Martin Wolf[5] suspects the power of special interests: ("vested interests")." "Today's rent-extracting economy, masquerading as a free market, is, after all, hugely rewarding to politically influential insiders." In his book, "The Price of Inequality", Joseph Stiglitz[6] draws the attention over two vicious circles that mutually maintain each other: concentration of the economic power and concentration of political power.

The Economic and Monetary Union in the Trap of the Dominating Economic Model

The intellectual influence of the Great Moderation concept, that configured the dominating economic model, was decisive in setting-up the institutional architecture of the Economic and Monetary Union, initiated by the Maastricht Treaty.

At the Economic Forum from Brussels, 11 May 2011, Servaas Deroose, deputy general manager of DG ECFIN of the European Commission said: "According to the Great Moderation paradigm, fiscal discipline, in combination with low and stable inflation are necessary and sufficient conditions for overall macroeconomic stability. The Maastricht Treaty

[5] Martin Wolf is chief economics commentator at the Financial Times, London. He was awarded the CBE (Commander of the British Empire) in 2000 "for services to financial journalism".

[6] Joseph Stiglitz is an American economist, public policy analyst, and a professor at Columbia University. He is a recipient of the Nobel Memorial Prize in Economic Sciences (2001).He is a former senior vice president and chief economist of the World Bank and is a former member and chairman of the (US president's) Council of Economic Advisers.

laid down the architecture of EU economic governance in reflection of the main tenets of the Great Moderation paradigm. The crisis has seriously questioned validity of the Great Moderation. The crisis represented a revelation. It has seriously questioned the validity of the Great Moderation paradigm. The Maastricht assignments are still valid for the EU, but they need to be strengthened and complemented with new elements".

The response to the crisis and the first reform elements were based on three pillars:

1. *Ad-hoc* crisis resolution measures ("*crisis resolution"*) that were based on the implicit assumption that the irrational exuberance from before the crisis was caused exclusively by debtors, especially public debtors, completely exonerating the creditors;
2. Consolidation of the fiscal discipline, that was based on the assumption that the main cause of the crisis was the fiscal indiscipline of the state and not a monumental error of the markets;
3. Structural reforms oriented towards the liberalization of the markets of products and services and the flexibility of the labor markets that were based on the assumption that the crisis was produced, first of all, by a supply shortage and not by a demand shortage.

Pillar 2 and 3 were integrated in the framework of the new invented European Semester that proposed an *ex ante* coordination of the budgetary and economic policies of the member states, replacing the previous *ex post* coordination.

The first proposals were made in 2012-2013, but the EMU reform was outlined only after the 2014 elections for the European Parliament and set-up of the new European Commission that placed the EMU among the 10 big priorities.

On 15 July 2014, the candidate for the presidency of the European Commission, Jean-Claude Juncker, presented, in front of the newly elected European Parliament, political orientations for the future European Commission. Here is what he said about the EMU reform: "I also propose that, in the future, any support and reform programme goes not only through a fiscal sustainability assessment, but through a social impact assessment as well. The social effects of structural reforms need to be discussed in public and the fight against poverty must be priority. I am a stronger believer in the social market economy. It is not compatible with the social market economy that during a crisis, ship-owners and speculators become ever richer, while pensioners can no longer support themselves."

A major document that laid out practically the reform trends was the Five Presidents' Report of June 2015. It was preceded by the Analytical Note, signed by Jean-Claude Juncker, Donald Tusk, Jeroen Dijsselbloem and Mario Draghi, presented at the informal European Council of 12 February that, among others, provided a diagnostic of the crisis. Four crises are identified, that preceded or took place after 2008: the financial crisis, the crisis of the sovereign debts, crisis of competiveness and crisis of markets. Two findings are significant for what was to be proposed after several months, the Five Presidents Report. The first one, at the competitiveness crisis: “Several Eurozone countries did not use the boom period to tackle existing rigidities in product and labor markets. By contrast, deep-rooted vulnerabilities did not allow the supply side to catch-up with demand”. The second, at the crisis of the markets: “While the Maastricht Treaty was based on the assumption that market discipline would be a key element in preventing a divergent development of the Eurozone economies and their fiscal positions, with increasing government bond interest rates having a signaling effect, this was not the reality of the Eurozone from 1999 to 2008.”

This diagnosis can be synthesized through two main ideas:

1. The main cause of the crisis was the supply shortage, from where the need for structural reforms to remove the restrictions on the business environment, thus stimulating the increase in supply;
2. Market discipline is interpreted as an ability they have to monitor the governments’ fiscal discipline. It is a reversal of classical wisdom: not governments are the ones to intervene through anti-cyclical policies to temper the pro-cyclicality of markets, but vice versa, markets have to put an end to anti-cyclical behavior (market discipline), to the pro-cyclicality of government policies.

This diagnosis was essential in putting the EMU reform in the current trend, with a focus rather on market discipline, understood as the supervision of fiscal discipline and structural reforms to stimulate supply, leaving secondly the risk sharing.

After the Five Presidents' Report, there were several initiatives and proposals from the European Commission, including the Reflection Paper on the Deepening of the Economic and Monetary Union of 31 May 2017. A period of intellectual effervescence followed, in which politicians and economists all the same presented political views and analyses such as that of President Macron at the Sorbonne on 26 September 2017, Finance Ministers of Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, The Netherlands and Sweden on 6 March 2018 or the 14 German and French economists in January 2018. Important for the portfolio of ideas and the positioning of political actors were the Franco-German meetings, especially the Meseberg meeting in June 2018, as well as the Eurogroup meetings.

In summary, the current EMU reform implies a gradual and conditioned process towards a common budget / common fiscal capacity:

1. Establishment of buffer areas at national level, namely strengthened fiscal discipline;
2. Structural reforms to increase the resilience of national economies to enable shocks to be absorbed by national markets; This is the main significance attributed to “convergence”;
3. Risk sharing through start-up markets;
4. Risk sharing by public tools in the end: common budget / fiscal capacity after the first three conditions are met and

only for very high shocks without permanent fiscal transfers.

Opinions are shared on the common Eurozone budget. The discussion is mainly about the goal of this budget and its size.

In Eurogroup's press release, an institution negotiating the possible budget instrument for the Eurozone, of 4 December 2018, they said, among other things: "As regards the instruments for competitiveness and convergence, France and Germany proposed an architecture for the Eurozone budget, which would be part of the EU budget. Its size would be determined by the heads of state and government in the context of the Multiannual Financial Framework (MFF)." and "The possible features of a stabilisation function were also discussed, including the unemployment insurance scheme. We did not reach a common view on the need and design of such a function. Technical discussions continue."

The Euro Summit of 14 December 2018 authorized Eurogroup "to work on the design, modalities of implementation and timing of a budgetary instrument for convergence and competitiveness for the Eurozone." The Eurozone's joint budgetary stability function has been abandoned for the moment.

Guidelines for Debate / Questions:

1. *Is the 4th Industrial Revolution compatible with the current economic model?*
2. *The opportunities offered by the near-zero marginal costs of the digital economy: the "uberization" of the economy vs. socialization of the economy*
3. *"What makes human beings human? Is it the pursuit of hyper-efficiency – the Silicon Valley mind-set? Or is it irrationality, imperfection, and doubt – traits beyond the reach of any non-biological entity?"*
4. *The economic model before the crisis remained virtually unchanged. Is this model compatible with sustainable growth, inclusive or it needs to be reformed? If it needs, in what direction?*
5. *The right diagnosis of the financial crisis is essential for setting-up the future economic model. What is the main cause of the crisis, supply shortage or demand shortage, excessive deregulation of markets or the fiscal indiscipline of states?*
6. *How should the relationship between the market and the state evolve? What are the limits of the markets?*
7. *What should be the role of fiscal policy in the future for macroeconomic stabilization?*
8. *The Eurozone, as it is now configured as institutions and policies, produces divergence rather than convergence. What should be the main trends of the EMU reform?*
9. *For making Eurozone functional, balance is necessary between the European solidarity and the responsibility of the Member States. What should be the main instruments of EU economic and social solidarity and what should be the main policies defining the responsibility of states?*
10. *What functions should the possible common budget of the Eurozone fulfil? What should be the size of this budget? Could it finance European public goods*