Mario Draghi: Sovereignty in a globalised world

Speech by Mr Mario Draghi, President of the European Central Bank, on the award of Laurea honoris causa in law from Università degli Studi di Bologna, Bologna, 22 February 2019.

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It is a great honour to be speaking here today at the University of Bologna.

As Europe’s oldest university, it has been at the heart of education and learning in Europe for over 900 years. It has a long history of welcoming students from across the continent, including Thomas Beckett and Copernicus. Erasmus studied here in 1506, and the University of Bologna is today a leading participant in the student exchange programme that bears his name.

The Erasmus Programme is one of the many examples of the benefits of the close cooperation within the European Union that enjoy widespread popularity. But we know that other elements of European integration are more contested today.

At the root of this debate is the inherent tension between the clear gains of economic integration, and the cooperation that is necessary to bring it about, which can sometimes be politically difficult to achieve or explain. I would like to argue that, in many ways, this tension is illusory. Rather than taking away countries’ sovereignty, the EU offers them a way to regain it.

This does not mean we need the EU for everything. But in the face of globalisation, the EU is more relevant than ever today. As Jean Monnet said, “we need a Europe for that which is essential … a Europe for what nations cannot do alone.”

Sovereignty in an interconnected world

On the whole, European citizens appear to welcome the benefits brought about by economic integration through the EU. The free movement of people, goods and services – that is, the Single Market – is routinely seen by citizens as the EU’s most positive achievement. In the euro area, 75% of people are in favour of the euro and Monetary Union, and 71% of Europeans support the EU’s common trade policy.

Yet at the same time, public attitudes towards the EU’s political structures seem to be hardening. Average trust in the EU stands at 42%, down from 57% in 2007. This decline has taken place against the backdrop of a general loss of faith in public institutions. Trust in national governments and parliaments has dropped to just 35%.

This tension between economic integration and political cooperation is fuelled by a powerful belief that there is an inherent trade-off between EU membership and the ability of countries to exercise sovereignty. In this way of thinking, if citizens want to be able to exert more control over their destinies, they have to loosen the EU’s political structures. But this belief is wrong.

It is wrong because it conflates independence with sovereignty.

True sovereignty is reflected not in the power of making laws – as a legal definition would have it – but in the ability to control outcomes and respond to the fundamental needs of the people: what John Locke defines as their “peace, safety, and public good.” The ability to make independent decisions does not guarantee countries such control. In other words, independence does not guarantee sovereignty.

Countries that are completely shut off from the global economy, to take an extreme but instructive example, are independent but not sovereign in any meaningful sense – often relying on external food aid to feed their people. Yet being connected through globalisation also
increases the vulnerability of individual countries in many ways.

They are more exposed to financial spillovers and to the aggressive trade policies of foreign states, while increased competition makes it harder for states to coordinate with one another to enforce regulations and set standards so as to achieve their social goals. This restricts their control over domestic economic conditions.

In this environment, countries need to work together to exercise sovereignty. And this applies even more within the EU. Cooperation within Europe helps protect states from external pressures, and it helps enable their policy choices.

**Working together to protect**

Globalisation has profoundly changed the nature of global production and deepened the ties that exist between countries. Cross-border holdings of financial assets are now around 200% of global GDP, compared with about 70% in 1995. Foreign trade has increased from around 43% of global GDP in 1995 to about 70% today. And around 30% of foreign value added is now created through global value chains.

At the global level, this process has been driven not just by policy choices, but in large part also by technological progress. Businesses have capitalised on the advances in transportation, telecoms and computing that make it easier to trade globally and fragment production.

Previous policy decisions and geographic proximity make the EU by far the most important trading area for European economies. The majority of world trade takes place within three main trading blocs – the EU, the North American Free Trade Agreement (NAFTA) and Asia – and though linkages have grown between those blocs, they remain relatively closed to one another. The ratio of extra-regional trade to GDP in these regions is below 15%.

The EU is the most integrated of these blocs. Two-thirds of EU countries’ trade is with other Member States, compared with about half for the NAFTA region. Around 50% of euro area cross-border financial holdings are from other euro area countries. Practically speaking, this means that Italy exports more to Spain than to China, and more to Austria than to Russia or Japan. In 2017, German direct investment in Italy was five times higher than that of the United States.

Europe has profited a great deal from this integration: it is estimated that the Single Market raises GDP in the EU by around 9%, taking into account both the direct trade and competition effects. But as countries become more interlinked, they also become more exposed to volatile capital flows, unfair competition or discriminatory actions – and this necessitates greater protection for their citizens.

That protection, which EU countries have created together, has allowed them to garner the benefits of openness while limiting, to some extent, its costs. The EU’s common structures and institutions contain spillovers, ensure a level playing field and prevent unjust behaviour – in other words, they respond to the needs of citizens and allow countries to exercise sovereignty.

Thus the Council and the European Parliament set common rules for the whole EU, the Commission ensures they are observed, and the European Court of Justice (ECJ) provides for judicial protection if they are violated. In the euro area, European banking supervision and the Single Resolution Mechanism help to contain the effects of financial instability.

In this interconnected environment, seeking independence from EU institutions presents complex trade-offs. Countries either have to accept rules decided by others to ensure continued access to the European market, which gives them less control over decisions that affect their citizens’ interests; or they have to disentwine themselves from their most important trading partners, which gives them less control over their citizens’ welfare.
If trade barriers were to be reintroduced within Europe, it is estimated that GDP would be about 8% lower in Germany and 7% lower in Italy.\(^8\)

The case for working together to enhance sovereignty also applies to the relationship between the EU and the rest of the world. Few European economies are sizeable enough to withstand spillovers from large economies or to leverage power in external trade negotiations. But cooperating at the EU level increases their potential to do so.

The EU accounts for 16.5% of global economic output,\(^9\) second only to China, which gives European countries a large domestic market to fall back on in the event of trade disruptions. EU trade makes up 15% of world trade,\(^10\) compared with around 11% for the United States, providing the EU with significant weight in trade negotiations. And the euro is the world's second-most traded international currency, which helps insulate the euro area economy from exchange rate volatility.

Indeed, around 50% of extra-euro area imports are now invoiced in euro,\(^11\) which reduces the pass-through of exchange-rate volatility to import prices. That in turn allows monetary policy to focus more on euro area economic developments rather than having to react repeatedly to external shocks.\(^12\)

For all these reasons, being outside the EU might lead to more policy independence, but not necessarily to greater sovereignty. The same is true of the single currency.

Most countries would no longer benefit from local currency invoicing, which would exacerbate the effects on inflation if they undertook large exchange rate devaluations. And they would be more exposed to monetary policy spillovers from abroad – not least from the ECB itself – which could constrain their domestic policy autonomy. In recent years, Denmark, Sweden, Switzerland and central and eastern European economies have been affected by spillovers from our policy measures.\(^13\)

In fact, spillovers from larger economies were one reason why the euro was created in the first place. Under the European Monetary System that preceded the euro, most central banks had to follow the policy of the Bundesbank. After more than a decade of disappointing, if not devastating, experiences, it was deemed preferable to regain monetary policy sovereignty by launching the single currency together.\(^14\)

**Cooperation and economic policy**

The second way in which globalisation constrains sovereignty is by limiting countries’ capacity to set laws and standards that reflect their social goals.

Global trade integration tends to reduce that capacity, because as production fragments through value chains, there is a greater need for countries to agree on common standards. Those standards are mostly set not within the World Trade Organization, but by large economies with dominant positions in the value chain. Smaller economies tend to end up as rule-takers in the international system.\(^15\)

Global financial integration can likewise reduce individual countries’ power to regulate, tax and uphold labour standards. Multinational firms can influence national regulations through the threat of relocation, as well as arbitrage tax systems by shifting income flows and intangible assets across jurisdictions. There can also be incentives for countries to use labour standards as a tool of international competition – the so-called “race to the bottom”.

This makes it more difficult for countries to enforce their core values and protect their people. It also leads to corporate tax bases being eroded, which makes it harder to finance welfare
OECD analysis, for example, estimates global revenue losses from tax avoidance to be in the range of 4% to 10% of corporate income tax revenues. These effects occur when countries are not large enough to exercise regulatory power against mobile capital or cross-border firms. But it is harder for this to happen at the level of the EU, since it represents a market that companies can ill afford to leave. Having regulatory power at the EU level enables EU countries to exercise sovereignty in the areas of taxation, consumer protection and labour standards.

First, the EU gives its members the capacity to prevent multinationals from avoiding corporation tax by exploiting loopholes or extracting subsidies. This is a complex area, but some recent progress has been made on this front. New European rules have entered into force this year to eliminate the most common corporate tax avoidance practices. And while the ECJ recently ruled against the Commission in a tax exemption case, it also recalled that special tax deals between multinationals and individual countries can constitute illegal state aid, which the Commission has the right to examine.

Second, the EU offers much greater possibilities to defend consumers’ values and ensure that they are treated fairly within the European market. This has been visible in the EU’s ability to enforce its values concerning privacy through the General Data Protection Regulation. It has been visible too in EU regulations to bring down mobile phone roaming charges for consumers within Europe, or to ensure that they cannot be charged more for cross-border payments in euro within the EU than they would be for national transactions.

The third advantage is that countries have the possibility to coordinate within the EU to defend social protections without imposing trade restrictions. Through the Charter of Fundamental Rights, EU law has reduced the possibility of unfair competition from jurisdictions with laxer labour laws. And it has also helped raise labour standards within the EU. A case in point is the European Directive on Part-time Work in 1997, which reduced certain forms of discrimination that were still in place in 10 of the then 15 EU Member States, including Italy. OECD analysis finds that, over time, the introduction of equal treatment laws was associated with an increased likelihood of people being awarded permanent contracts.

The same protections do not exist at the global level or are much weaker in other regional trading blocs such as NAFTA. The history of the United States itself illustrates the difficulty of aligning the approaches of individual states to improve working conditions. In the early 20th century, there was a growing concern in several US states about the lack of a social safety net, especially for the elderly. But individual states feared that providing social security would impose, in the words of the time, “a heavy tax burden on the industries of the state that would put them at a disadvantage in competition with neighboring states unburdened by a pension system.”

The lack of coordination created a severe underprovision of social security, which was exacerbated by the Great Depression. In 1934, half of the population over 65 were in poverty. This was only resolved through the passing of the federal Social Security Act in 1935, which enabled states to coordinate in providing social security.

In a similar way, the EU provides a powerful coordination function that allows countries to achieve goals that they could not realise alone. And the EU is able in turn to export some of its
standards globally.

The EU is the top trading partner of 80 countries, compared with just over 20 for the United States. That allows the EU to insist on higher labour and product standards abroad via trade agreements, as well as protecting local producers at home. The recent trade agreement with Canada, for example, protects 143 European geographic indications.

The EU also has regulatory power that goes beyond trade agreements. As exporters to the EU must meet its standards, economies of scale result in the application of those standards to production in all countries. This is known as the “Brussels effect”. In this way, the EU de facto sets the global rules across a wide range of areas.

All this gives EU countries another unique capacity: to ensure that globalisation is not a race to the bottom on standards. Rather, the EU is able to pull global standards up to its own.

Institutions and rules

In an integrated regional and global economy, the case for European countries to work together to exercise sovereignty is clear. But while many would agree on the need for cooperation, views differ over how best to organise it.

Some would argue that looser, more transactional cooperation led by national governments is sufficient. And there are indeed several historical examples of successful agreements being forged by the coming together of willing states. Where all parties benefit equally, loose cooperation can be sustainable. One such example is the Bologna Process, which has helped align higher education standards and ensure mutual recognition of university degrees across members of the Council of Europe.

But it is also clear that in cases where cooperation is more necessary, the conditions for loose cooperation would not hold. Spillovers between larger and smaller economies are typically asymmetric. Coordination problems arise because there are incentives for countries to free-ride or to undercut one another. In these instances, deeper modes of cooperation are essential to align countries’ interests.

The EU has thus far employed two methods of governance to facilitate cooperation. In some cases, we have invested common institutions with executive power – such as the Commission for trade policy or the ECB for monetary policy. In others, executive power remains with national governments, with cooperation through common rules, such as the framework for fiscal and structural policies.

These areas of economic policy were considered too specific to the situation of individual countries to be entrusted to a common body. It was felt that the only possible form of governance was for countries to exercise national sovereignty, thereby respecting their own specific set of circumstances. A rules-based approach was seen to be the only solution that was consistent with this vision. But it is worthwhile to reflect on how successful this choice has been.

For the cases where executive power has been invested with institutions, most would agree that the institutions have performed relatively well. Trade policy has been effective in opening up access to new markets: the EU has in place 36 free trade agreements, compared with 20 for the United States. Monetary policy has successfully fulfilled its mandate.

But for the areas that use a rules-based approach, some shortcomings have been revealed. The fiscal rules have provided a framework for assessing fiscal policies but have at times proven difficult to enforce and hard to explain to the public. In the area of structural policies, the Country Specific Recommendations have had a limited impact, with less than 10% of recommendations
being substantially implemented each year.[33]

The disparity between the outcomes of the two methods does not stem from any difference in the quality of European and national authorities. Instead, it is a consequence of the inherent difference between rules and institutions. There are two reasons why institutions have proven superior.

First, rules are generally static and require countries to adhere to specific actions, whereas institutions are required to achieve prescribed objectives. Rules therefore cannot be updated quickly when unforeseen circumstances arise, whereas institutions can be dynamic and employ flexibility in their approaches. That distinction matters hugely when underlying parameters and economic relationships change – as they often do. The distinction also matters for citizens, who ultimately care most about the results of economic policy rather than the actions taken by governments.

The ECB’s monetary policy during the crisis is an example of the greater flexibility of action afforded by an institution-based approach.

The ECB was faced with a range of challenges that few could have predicted when our mandate was defined. But the Treaty combines our mandate for price stability with discretion over the tools we could use to achieve it. This allowed us to deploy a range of unconventional policy tools to ensure that inflation remained in line with our aim. Neither operating monetary policy according to a fixed rule nor restricting ourselves to conventional policy tools would have sufficed.

Discretion and flexibility in the use of our tools helped to strengthen our credibility. Flexibility and credibility were, in this instance, mutually reinforcing.

By contrast, rules lose credibility if they are applied with discretion. Rules will be undermined if countries find reasons to circumvent them or rewrite them as soon as they bind. But circumstances will always arise which were not foreseen at the time the rules were written and which call for flexibility. In the case of rules, there is an inevitable trade-off between credibility and flexibility.

This is why there are always tensions when it comes to economic policies that follow the rules-based approach. But the transition to an institutions-based approach requires trust between countries. And trust is based on strict compliance with the existing rules, but also on the ability of governments to reach mutually satisfactory compromises when the circumstances call for flexibility and to explain them adequately to their citizens.

That transition nevertheless remains necessary.

The European Commission’s recent initiative on the international role of the euro provides a further example of the need to move from the current framework of various laws and ad hoc rules to a system based on harmonisation and institutions. Rising trade tensions and the growing use of sanctions as an instrument of foreign policy have meant that the laws of the United States are increasingly being applied outside its jurisdiction. This takes the form of penalties for societies outside the United States and the prevention of access to the US payment system and is based on the central role played by the US financial system and the US dollar in global trade.

Several European governments believe that this situation could be mitigated by increasing the international role of the euro. But if markets are to entertain the possibility of an enhanced role for the euro, we need to consider what the conditions are that underpin the dollar’s dominance. The list is long, but the fact that the dollar is an expression of an integrated capital market is certainly one of those conditions [34] For the EU to meet that condition – which, at this stage of its development, is more achievable than others – would require a complex programme of legislative and institutional harmonisation, which however could be put in place in short order.
The second reason why an institutional approach can help produce better outcomes is that institutions and their actions can be subject to more clearly defined democratic control. Precisely because those institutions are invested with a mandate and defined powers, it is possible to make a more direct link between decisions and responsibility.

The EU already has many channels through which its citizens can exercise democratic control, via national authorities in the EU Council and Members of the European Parliament, who hold EU institutions accountable on behalf of the people who elected them. In fact, for the first time on record, a majority of Europeans now feel that their voice counts in the EU.\[35\]

It is to be hoped that accountability arrangements to hold EU institutions in check continue to be strengthened, because the perception of the legitimacy of their actions depends on it. The role of the European Parliament is vital here. Of the institutions with a democratic mandate to exercise control, it is the only one with a European perspective.

The European Court of Justice provides a second avenue of democratic control. Its role in ensuring that EU institutions are following their mandates becomes all the more important in the absence of a European government.

Adherence to the judgments of the ECJ is a necessary condition of the rule of law. Consistency and uniformity in the interpretation of EU law across 28 Member States are the bedrocks of EU law as an effective and autonomous legal order.\[36\] A basic function of the law is to stabilise expectations by providing a reliable foundation upon which citizens and companies can organise their activity and plan for the future.\[37\] And such predictability and certainty is especially important for Economic and Monetary Union today.

**Conclusion**

In today’s world, technological, financial and commercial interlinkages are so powerful that only the very largest countries are able to be independent and sovereign at the same time, and even they cannot do so entirely. For most other nation states, including the European countries, these two characteristics do not coincide.

The European Union is the institutional framework that has allowed the Member States to be sovereign in many areas. It is a shared sovereignty, which is preferable to none at all. It is a complementary sovereignty to the one exercised by individual nation states in other areas. It is a sovereignty that Europeans like.

The European Union has been a political success built within the international order that emerged after the Second World War. It has been a faithful interpreter of the values of freedom, peace and prosperity on which that order was founded.

The European Union has been an economic success because it has provided an environment in which the energies of its citizens have created widespread and lasting prosperity founded on the Single Market and protected by the single currency. The last decade has dramatically highlighted the shortcomings of national policies and the need for cooperation to evolve both within the EU and beyond.

A long global economic crisis, unprecedented migration flows and inequality exacerbated by large concentrations of wealth resulting from technological progress have given rise to rifts in a political and economic order that was thought to be set.

Change is necessary, but there are different ways of bringing it about. One prospect is that age-old ideas that have shaped most of our history are revived, such that the prosperity of some cannot be achieved without the poverty of others; international and supranational organisations lose their relevance as places for negotiating and finding compromise solutions; the affirmation of
the self, of the identity, becomes the first requirement of every policy. In such a world, freedom and peace become accessories which can be dispensed with as needed.

But if we want these values to remain essential, fundamental, the path is a different one: adjusting existing institutions to change. This process of adjustment has so far encountered resistance because the inevitable national political difficulties always seemed to be above such need. This reluctance has resulted in uncertainty about the capacity of institutions to respond to events and has strengthened the voice of those who want to pull down these institutions.

There should be no doubt: this adjustment will have to be as deep as the phenomena that revealed the fragility of the existing order, and as vast as the dimensions of a geopolitical order that is changing in a way that is not favourable for Europe.

The European Union wanted to create a sovereign where there was not one. It is not surprising that in a world where every point of contact between the great powers is increasingly a point of friction, the external challenges to the existence of the European Union become increasingly threatening. There is only one answer: recovering the unity of vision and action that alone can hold together such different countries.

This is not only a hope, but an aspiration based on political and economic advantage. But there are also internal challenges that have to be faced, which are no less important for the future of the European Union. We need to respond to the perception that it lacks equity, between countries and social classes. We need first to listen, and then to act and explain.

So, unity and equity are needed, above all, as a guide for policymaking in Europe.

I would like to recall in closing the words of Pope Emeritus Benedict XVI in a famous speech held 38 years ago:

“To be sober and to do what is possible, and not to claim with a burning heart the impossible has always been difficult; the voice of reason is never as loud as an irrational cry… But the truth is that political morals consist precisely in resisting the seductions of magniloquent words… It is not moral the moralism of adventure… It is not the absence of all compromise, but the compromise itself that is the true moral of political activity”.[38]

Footnotes

[5] There is some debate as to whether technology will evolve in the future in ways that make global value chains less important. Technologies such as 3D printing or robotics could allow the local production of many more goods. Some scholars find that technological change has so far only mildly slowed offshoring, while others see a more significant reversal ahead. See Koen De Backer, K., Menon, C. Desnoyers-James, I. and Moussiegt, L. (2016), “Reshoring: Myth or Reality?”, OECD Science, Technology and Industry Policy Papers, No 27, OECD Publishing; and Baldwin, R. (2016), The Great Convergence: Information Technology and the New Globalization, Harvard University Press.


This scenario assumes a counterfactual in which trade reverts to WTO-rules, and applies Most Favoured Nation (MFN) rates as tariffs on goods. For non-tariff barriers, it relies on estimates calculated for trade between the EU and the US. See in’t Veld, J. (2019), op. cit.

As measured by PPP-adjusted GDP.

Excluding intra-EU trade.

For further details, see ECB (2015), *The international role of the euro*, Frankfurt am Main, July.


See European Commission, “New EU rules to eliminate the main loopholes used in corporate tax avoidance come into force on 1 January”, press release, Brussels, 30 December 2018.


REGULATION (EU) 2016/679 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation).

COMMISSION IMPLEMENTING REGULATION (EU) 2016/2286 of 15 December 2016 laying down detailed rules on the application of fair use policy and on the methodology for assessing the sustainability of the abolition of retail roaming surcharges and on the application to be submitted by a roaming provider for the purposes of that assessment.