The European Journal of Comparative Economics
Vol. 19, no. 1, pp. 3-29
ISSN 1824-2979

Unemployment and inflation in the European Monetary Union: A new approach?

Nicola Acocella*

Abstract

The paper deals first with the characters of unemployment and inflation and their trend in the EMU. Then it underlines that EMU's institutions tend to reduce inflation to a minimum, while limiting fiscal interventions at the national and the European level. The policies implemented recently represent some kind of a novel line of conduct of the EU, as they introduce a rise in the EU budget, release some constraints to national fiscal policies and foresee issuance of common bonds. Judging from these policies a legitimate question is whether the pandemic has been a game-changer, as EU interventions represent some kind of a novel line of conduct of the EU. The issue then arises whether this novelty will be followed by a retreat to the course of rules preceding the pandemic (or, worse, by disintegration of the Union) or some kind of confirmation of the new course - even a relaunch - of the EU.

JEL classification: E24, E31, F33

Keywords: Unemployment, Inflation, EMU, Next Generation EU

1. Unemployment: types, indicators and trends

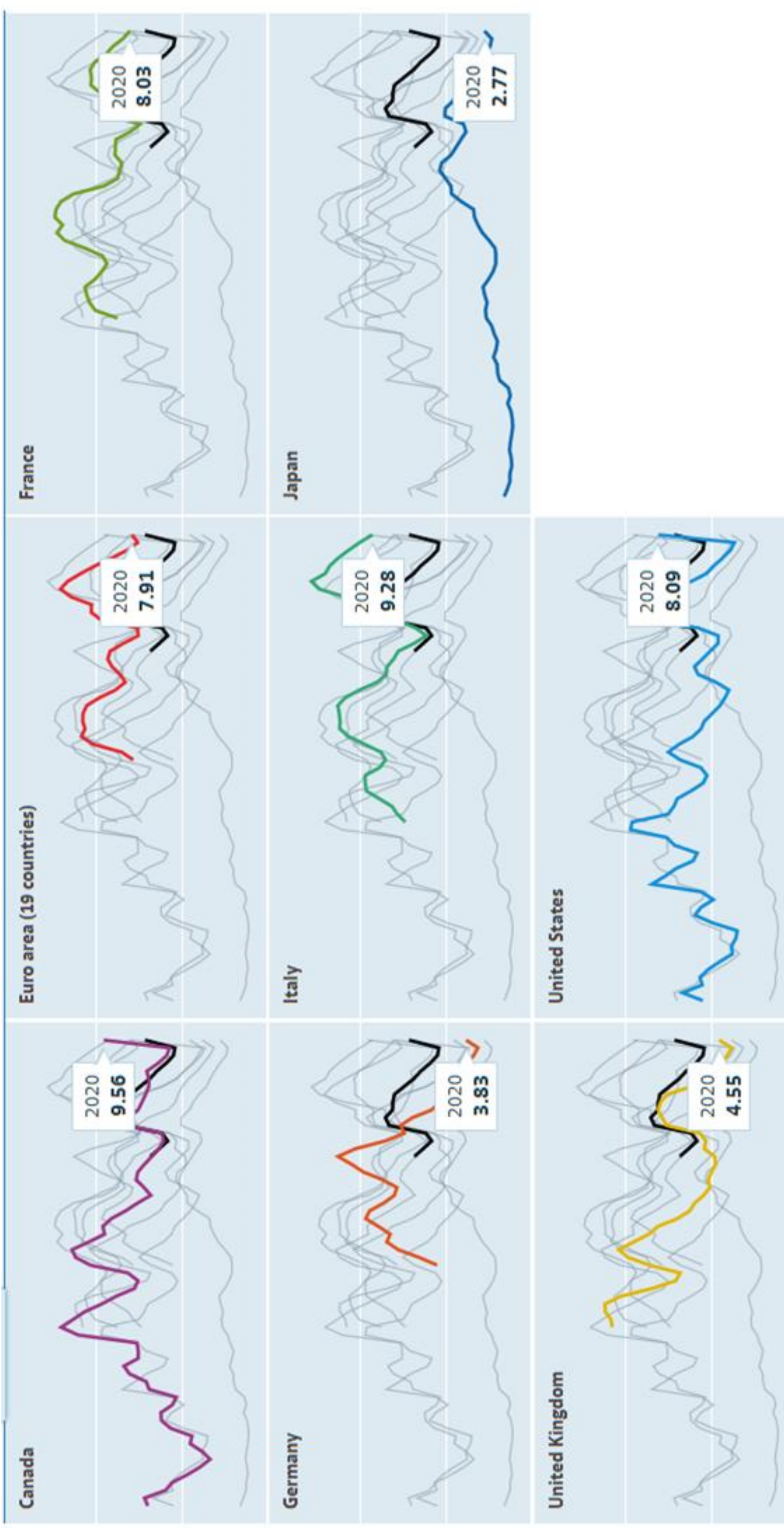
There are various types of unemployment. We do not deal with either the voluntary or the frictional unemployment.

After the Second World War, market economies experienced very different situations of employment and unemployment in the two phases that can roughly be identified: before 1973 (date of the first oil crisis) and after that date. In the pre-1973 phase, unemployment was generally in continuous decline in most countries; in the subsequent phase, on the contrary, it underwent a substantial increase until the mid-1990s. Since then it has always reduced, until 2007, when the substantial real negative effects of a significant financial crisis, the Great Recession, began, which was relatively light and short for the United States, but much heavier for the European Union, due to its fragile and unsuitable institutions (Fig. 1).

* Memotef - Sapienza University of Rome, nicola.acocella@uniroma1.it

http://dx.doi.org/10.25428/1824-2979/009
First published online: 05/07/2022

Figure 1. Unemployment rate (%), various developed countries, 1960-2020

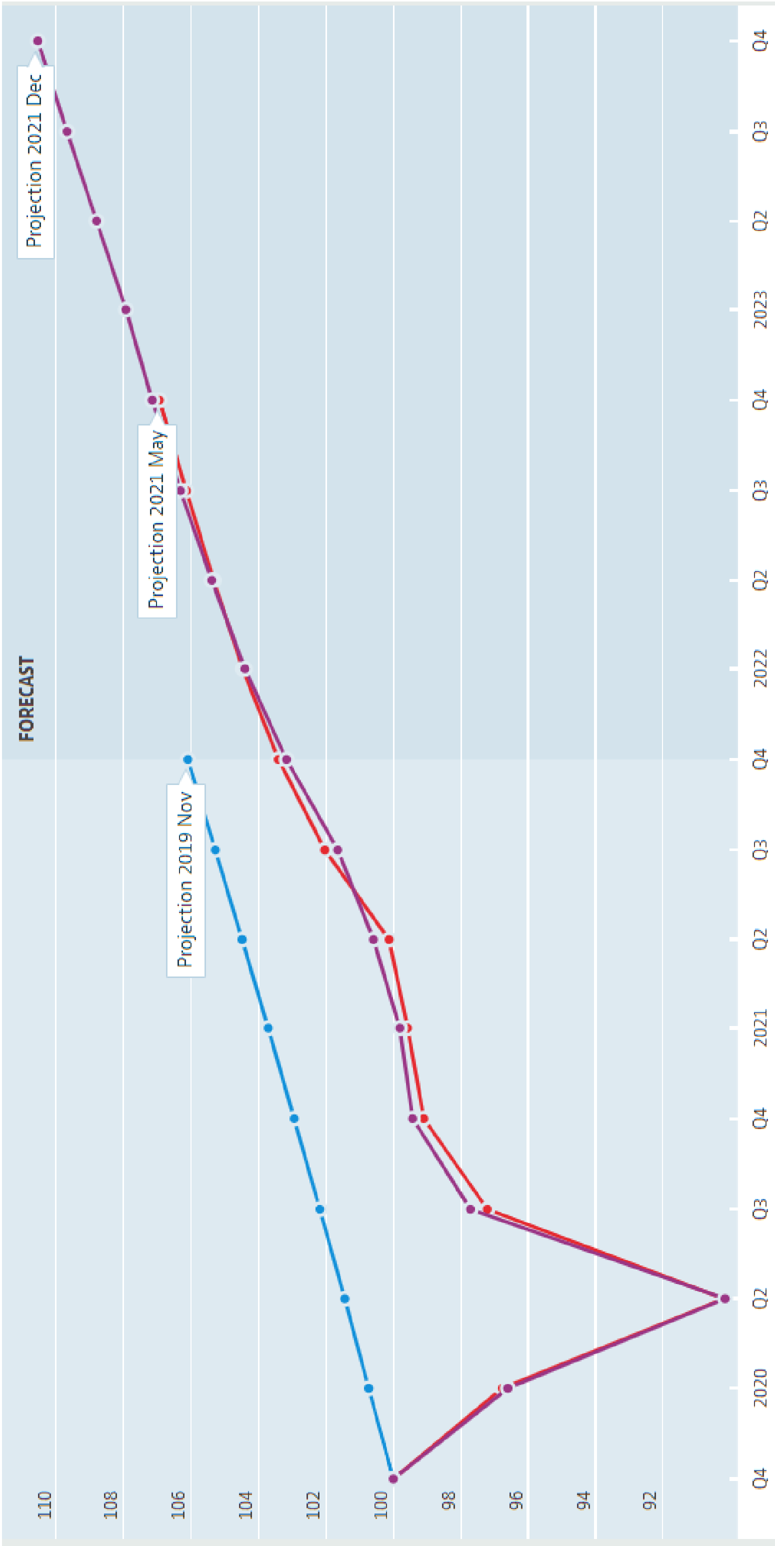


Source: OECD

In the last two years, when the effects of this recession had practically diminished and many countries had returned to their pre-crisis, or even higher, income levels, the negative effects induced by the pandemic have occurred, which have been wearing off in the last year, so much so that by the middle of 2021 growth rates have returned to the levels of the last quarter of 2019, as forecast (see Fig. 2).

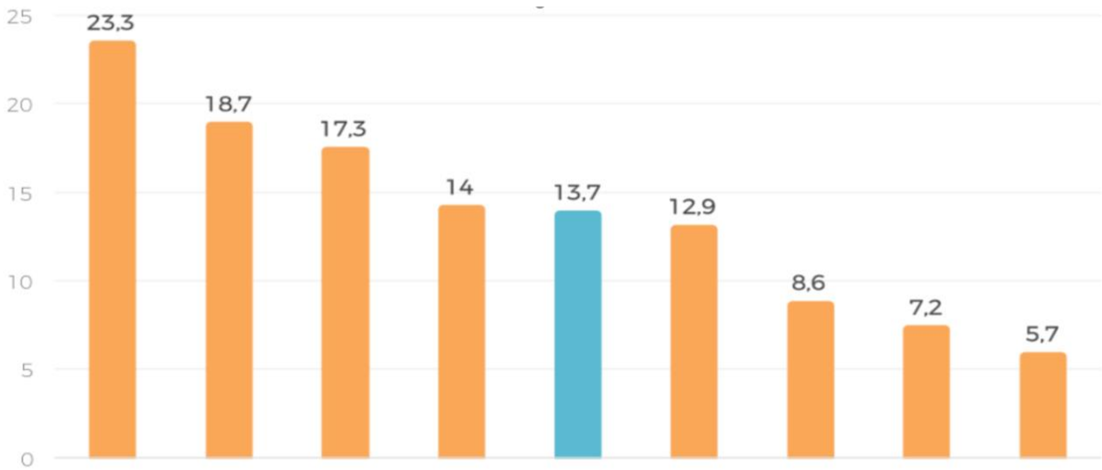
The unemployment rate is often not an appropriate measure of the phenomenon of unemployment for various reasons. In addition to situations of *hidden unemployment* and *discouraged workers* there is also a category of unemployed, called *NEETs* (from the acronym of *Not (engaged) in education, employment or training*; or the youth of the three 'no', which in Spanish is indicated as *Nini* or *Ni-ni*, from *Ni trabaja, ni estudia, ni recibe formación*). In the EU Italy showed the highest percentage of NEETs with respect to the population aged 25-30, after Bulgaria and Latvia, while The Netherlands (5.7%), Sweden (7.2%) and Germany (8.6%) had the lowest percentages (Fig. 3).

Figure 2. World GDP growth projection, 2020-2023



OECD, 2021, https://www.oecd.org/economic-outlook/

Figure 3. NEETs in some European countries (% of the population aged 25-30), 2020



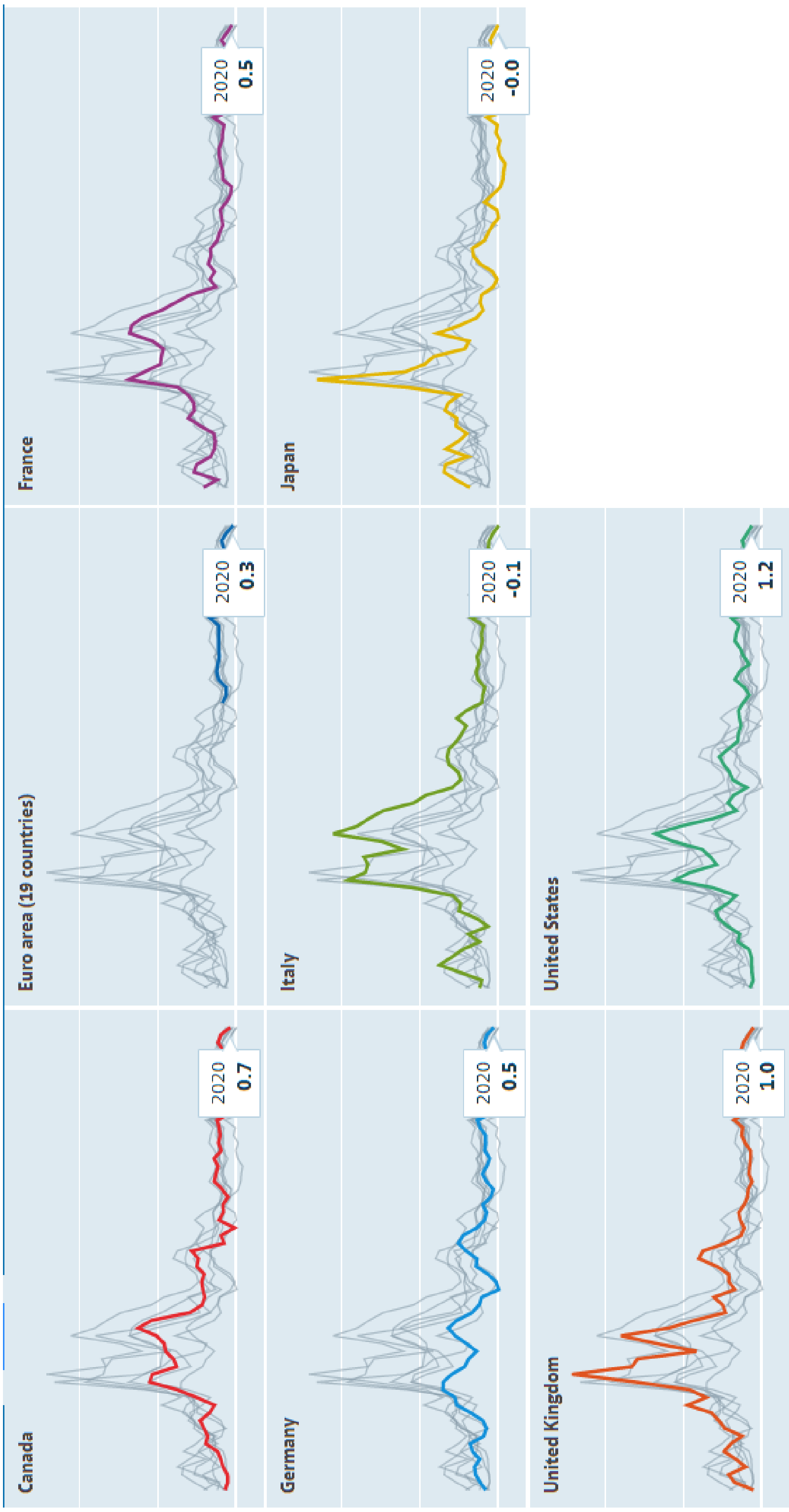
Source: Eurostat
Note: From left to right the figure shows data for: Italy, Greece, Spain, France, the EU, Poland, Germany, Sweden, The Netherlands.

2. Types, trends, causes and effects of inflation

It is well known that the term 'inflation' usually indicates a sustained increase in the general price level and, therefore, the loss in value of the currency. The types of inflation are numerous, ranging from creeping inflation to hyperinflation. It can derive from excess demand, lack of supply – on the one side – and pressure of costs (especially, wages), on the other.

Post-war inflation underwent very different trends in developed and underdeveloped countries. In some of the latter - for example, in the Latin American countries - there are normal situations of galloping inflation or even hyperinflation, which, moreover, do not necessarily generate a collapse of the currency and the need to replace it, that is to find another instrument capable of performing monetary functions. Within the developed countries, apart from the immediate postwar period, inflation normally had a creeping character until the oil crises (1973 and 1979). In the following years, and also as a consequence of them, the phenomenon showed an almost generalized tendency to accentuate up to the 1980s, without ever assuming, however, the characteristics of hyperinflation (Fig. 4).

Figure 4. Inflation rates (%), various developed countries, 1960-2020



Source: OECD

After the Second World War, not only was the reduction in prices not accompanied by the onset of the recession (which happens rarely), but there were even situations in which stagnation of demand and inflation were present together (hence the term *stagflation*). The reader can usefully combine the data reported in Figures 1 and 4 and will note that after 1973 in many countries there has been a simultaneous increase in unemployment and inflation. Even in the first decade of the new century - and in particular in 2007-2008 - there has been a notable increase in the price of oil, but this has not produced stagflation effects.

Reducing inflation can become an economic policy objective for two essential reasons:

a) the fear that an uncontrollable phenomenon of hyperinflation could be triggered;
b) the weakening of the social conflicts related to it.

The economic and social costs of galloping inflation and hyperinflation are certainly more relevant. In such situations, first the transparency in the functioning of the relative price mechanism that underlies the allocation of resources is reduced and distortions and inefficiencies are created. In extreme cases of hyperinflation, there is even the risk that the economic system will have to do without the advantages deriving from the use of money, which could no longer perform its proper functions as a unit of account, an intermediary for exchanges and a store of value. In fact, the continuous and significant changes in the absolute level of prices associated with galloping inflation cause relative prices to vary continuously, thus making the calculations of convenience necessary for the efficient use of resources difficult. In addition, the social and political costs of inflation should be noted. In fact, we can remember, first of all, that Hitler's rise to power was due to various factors, to which inflation and unemployment that had hit Germany hard in the 1920s and early 1930s are by no means unrelated. The memory, then, of German hyperinflation is at the basis of the desire - in some cases, the obsession - of the Germans for monetary stability.

3. The policies against unemployment and against inflation in particular in the EMU

3.1. Policies against unemployment in general

First of all, it is necessary to distinguish policies that tend to reduce unemployment from those aimed at mitigating its effects, while not affecting its level, or doing it little. Of the first kind are the maneuvers of aggregate demand through fiscal or monetary policy or even the devaluation or depreciation of the exchange rate, which increase the foreign component of aggregate demand. On the other hand, unemployment benefits tend to a large extent to reduce the negative effects of unemployment, although they can act to some extent to reduce their level, because they automatically lead to an increase in public spending, other items being equal, when a falling demand and rising unemployment take place (acting as *automatic stabilizers*). A negative effect of the unemployment benefit can derive from the possibility that the unemployed person is satisfied with the subsidy, giving up an active job search. This would be absolutely harmful and would run counter to the purpose of the subsidy. To avoid this effect, it is necessary that the subsidy is limited in time or linked to the job search. One possibility is that it will cease after a certain period of time or if the worker turns down a series of jobs. Obviously, the appropriateness of the positions offered to him with respect to the characteristics of the worker should be carefully evaluated, before depriving him of the allowance.

Another important distinction alludes to the different policies that tend to attack the different causes of unemployment. Thus, if the indicated policies are recommended for cyclical unemployment, resulting from the scarcity of aggregate demand, structural unemployment requires other policies, which rather affect the structure of the economy: retraining policies, policies tending to accentuate geographical mobility (such as availability of affordable housing), policies that improve the circulation of information.

3.2. Policies against inflation in general

Also policies against inflation must be calibrated according to the types and causes of inflation. Thus, if this arises from excess demand or is cost-push, restrictive fiscal and monetary policies are indicated. To better understand how inflation is affected by acting on aggregate demand we can say that, according to the Phillips curve, as the unemployment rate increases (due to the reduction in demand), lower employment pushes down the prices of factors of production and wages, thus reducing prices and inflation. Conversely, a low unemployment situation pushes wages upwards by indirectly reducing the final price of products and services and the rate of inflation. From a macroeconomic point of view, the curve suggests that it is always possible to make an economy work at low unemployment rates, as long as one accepts price growth (i.e., inflation) and, conversely, that one has to accept higher unemployment rates, if inflation is to be curbed. In fact, it is possible to avoid this dilemma (high inflation or high unemployment) if one has two instruments at the same time, such as fiscal policy and *incomes policy*.

Monetary policy and macro-prudential regulation can be used in particular against credit inflation. Restrictive monetary policy reduces the quantity of money in circulation, raises the interest rate and thereby reduces the demand for credit. Macro-prudential policy establishes criteria of prudent administration of an anti-cyclical nature (for example, an increase in liquid reserves during phases of expansion and their reduction in crisis phases), aimed at avoiding excessive credit concessions and, with this, a systemic crisis.

For supply-side inflation, both incentives to increase supply and contractions in demand are indicated, but the former require time to produce their effects. Cost inflation can be avoided through incomes policies, which establish rules relating to the increase in wages and profits, such as, for example, that wages can vary only to the same extent as labour productivity and that the prices of finished goods must not rise (that is, that firms' profit margins do not vary), as happened in Italy in the early Nineties.

Finally, imported inflation can hardly be regulated by import containment policies (duties, physical restrictions, devaluation of the national currency), which would increase the price of imported goods. It can be blocked or indirectly reduced through policies of contraction of aggregate demand (as was the case with inflation deriving from the 1973 and 1979 oil crises) or the incomes policy.

3.3. The policies against unemployment and inflation in the EMU

3.3.1. Support for imbalances before the crisis

The specific characteristics of the EMU (also known as the Eurozone or EZ) institutions, compared with those of the USA, make it possible to explain the different phases of the financial crisis in the two regions. For the USA, one cannot really speak of institutional shortcomings. It is true that wrong economic policies were adopted before the crisis, such as deregulation and inaccurate financial supervision, which facilitated the crisis itself, and that, in addition, there was also some error in the management of the crisis. However, on the whole, the US institutional framework made it possible to fight the crisis better than that of the EZ. In general, and apart from fiscal policy, the absence or weakness of several common institutions in the EZ contributed to nourishing the factors underlying the private debt crisis. We refer to the absence of robust common policies in fields such as financial regulation, wage policy and regional and industrial policy. Financial regulation would have prevented the accumulation of excessive credit and debt positions. Wage policy would have imposed an appropriate regulation of wages and prices, linked to productivity trends, preventing, on the one hand, real competitive devaluations of the German kind and, on the other, the continuous appreciation of the real exchange rate in peripheral countries. A common regional policy coordinated with industrial policy would have facilitated a healthier and higher growth of the peripheral economies than that actually achieved, but would have required a much higher EU budget. All these policies were opposed as manifestations of an excessive role of the government, contrary to the spirit of the Union and, for many countries, a submission to the EU of the last effective policy tools member countries were in control of. Thus, the absence in the monetary union of a common and active governance in numerous fields and the persistence of diversified economic systems largely contributed to explaining the real imbalances that have emerged. Furthermore, fiscal imbalances arose or increased as a result of a generally deflationary environment and policies. Asset price bubbles resulting from capital inflows into peripheral countries partially moderated the effects of this deflationary environment. They lasted until 2007, which may partially explain why policy makers in these countries did not take long-term action to reduce imbalances, in particular those deriving from the differences with the central European countries in terms of productivity dynamics. The system of signals adopted at the

European level for local public decision makers was then imperfect, i.e. it did not make the signs of a possible crisis evident for the operators involved and the doctrine tended to justify the absence of corrective interventions by national governments. In addition to the absence of common and coordinated actions aimed at overcoming differences and imbalances, common policies of a passive nature were also introduced, such as the limitations on fiscal policy with the *Stability and Growth Pact* (SGP) and the Fiscal Compact, with evident negative effects on countries' ability to overcome these imbalances. It is true that stringent fiscal policies could stimulate the introduction of long-term reforms, but this can only happen in certain circumstances, such as availability of information to citizens and the proper functioning of the political process. Furthermore, this solution allows to achieve only a second best result, with respect to the case of using appropriate common policies, of the kind mentioned above. Finally, isolated policies implemented by peripheral countries could conflict with the positions of other countries which in the Union have based their growth strategy on exports to other member and external countries.

It can thus be explained why Germany also suffered from the crisis, not only in 2009, but also afterwards. The European institutions were a straitjacket for the implementation of reforms by national economic policy makers, imposing constraints, not only on monetary action, but also on fiscal action with the aforementioned result of inducing national authorities to satisfy those constraints in the simplest way, namely by cutting public investment, which, however, reduced potential output.

3.3.2. Crisis management

The mismanagement of instruments on both sides of the Atlantic is undeniable, as has been said. But this has more to do with current policies than with institutions. Once again a comparison with the USA may be useful as to the specific role of the latter in binding political interventions. In this country there are few limits on the side of the institutions in a short and medium term perspective, given that the Fed does not have a conservative mission and there is a fiscal union. Even in this country, however, some limits to an expansionary fiscal policy stemmed from the ceiling on the absolute volume of debt, which President Obama found difficult to increase on at least two occasions, in 2012 and 2013. This ceiling limited the possibility of extending the fiscal expansionary fiscal stance, with the result of a discretionary boost by the federal budget that was (moderately) negative or uncertain. The roof has its roots in the different views, one conservative and the other liberal, which divide American society and which could have a negative impact in a longer term perspective. Even more important than the existence of a debt ceiling could be in the medium term the effects of the creation of bubbles deriving from unconventional monetary operations.

As for the EU, even stricter limits on fiscal action derive from the constraints already mentioned. The European institutions have not only fuelled the crisis, but have severely limited current policies, making them unable to counter the crisis when it occurred or even to reduce its effects. After the first signs of the transformation of the private debt crisis into a public debt crisis, the SGP - once again, therefore, a passive and inactive fiscal policy - also contributed to the accumulation of public debt in most of the peripheral countries, Portugal, Ireland, Italy, Greece and Spain (PIIGS), and the consequent speculative operations that aggravated it, immediately after the first signs of the public debt crisis. A limited but timely intervention by a federal government such as the US would have prevented the plunging of the financial position of these countries. In addition, the Fiscal Compact has further limited the expansive fiscal action, mandatorily requiring debt reduction. Only the 'deep pockets' of the ECB prevented a significant increase in the deficit and debt in Germany. However, the fiscal policies required from the peripheral countries, resulting from the absence of a common (and expansionary) fiscal policy - and confirmed by the attitude of the central European countries during the crisis - overloaded the deficit and debt of the entire EZ.

In addition to formal institutions and specific policies, mention must finally be made of the value judgments that supported them, since these have certainly contributed to the actual attitudes of European policy makers in the face of the crisis. A principle underlying both the interventions to react to the public debt crisis and the reform of the EMU institutions, in particular to strengthen the SGP and impose bail-in (i.e. recapitalisation), has been that of punishment, especially by the markets, to reduce moral hazard and ensure compliance with the rules. Think of how much the bail-in rule can aggravate the situation: holders of securities issued by banks will try to hedge themselves whenever they fear bankruptcy, with the result of activating a mechanism of illiquidity and crisis. Or think of the vicious circle between harsh austerity plans in peripheral countries and an increase in the premium for the risk of insolvency and therefore an aggravation of this risk, due to the higher weight of the debt service for interests. A 'carrot and stick' system coupled with the debt restructuring of countries like Greece would have been more effective, paving the way for a relaxation of the austerity plan. Another value judgment underlying the management of the crisis was certainly that according to which debt is equivalent to a fault and that not only deficits and debt must be avoided, but also the burden of reducing imbalances must fall mainly or exclusively on 'debtor' countries.

This must be added to the different bargaining weight of debtor and creditor countries and the incredible asymmetry of the Macroeconomic Imbalances Procedure (MIP) in implying the pre-eminent commitment of deficit countries in cutting current account deficits.

In short, the responsibility for the crisis in the EMU is largely due to the inappropriate institutions for an area that is too heterogeneous in terms of growth and inflation, as well as to the different orientations and interests of the various countries. An area with no federal government and whose only - or main - common policy is that of a conservative central bank can cope with shocks of the kind and extent of those that hit Europe only at the cost of a depression. This difficulty in responding to the crisis in a similar area was recognized in its infancy by the then president of the ECB, Trichet. Changing institutions could therefore also be in the interest of surplus countries, but only if we ignore the influence of the value judgments mentioned above.

Turning to the difficulties of managing a crisis when interest rates have reached the lower limit of zero, it must be said that in this case new problems arise. Indeed, shocks similar to those that generate an increase in costs and that imply changes in inflation and production in opposite directions (when interest rates are free to move) can instead lead to a fall in both variables at the ZLB. Indeed, the combination of the ZLB with the debt deflation channel can amplify the restrictive effects on economic activity. The absolute need arises from this to move the economy away from the ZLB.

3.3.3. The flaws in the institutional design more in detail

These can be summarized as shown below.

1. The institutional framework tends to be deflationary and incomplete.
2. This framework is lacking due to the absence of appropriate mechanisms. In particular, the rebalancing mechanisms are lacking, being entrusted to the

markets, which lack appropriate signals and are often highly imperfect. This is particularly true of the markets that should ensure rebalancing in a monetary union in the absence of a fiscal union, namely the labour markets. These markets are highly segmented across countries and reflect different national regulations. Differences in real interest rates and the freedom of capital movements between countries have also contributed to issuing erroneous signals to national policy makers about the true state of the economy.

3. There are no rebalancing mechanisms such as those operating in a gold standard regime, in which temporary and limited devaluations were possible. For the reasons mentioned above, they cannot be replaced by imperfect and segmented markets.
4. In some cases, such as for the ECB, given its conservative nature, the existing rules (such as the SGP, the Fiscal Compact and the MIP) have constrained the action of European bodies and countries in their policies before and after the crisis ('a sin of commission'). In other cases, such as for structural and current account imbalances or financial regulation, the rules did not ('a sin of omission').
5. The policies implemented by the EMU bodies seem to be guided and constrained not only by an inadequate institutional architecture, but also by the visions and interests of the dominant countries. Think of the speculative practice (called *carry trade*) used by German banks that bought securities with higher interest rates in peripheral countries as of 2008 when spreads began to rise significantly and also the strategy followed by Germany (but not only by it) to face the Greek crisis. For that particular country the strategy can be interpreted as the result of the links between government, banks and non-financial companies, which form a veritable vertically integrated industry in that country.
6. Policies and institutions facing the test of the Great Recession.

In section 3.3.4 we are going to deal with the first question in more detail.

3.3.4. The deflationary bias

This bias may have arisen from what we said earlier about the ECB, PSC, Fiscal Compact and, most importantly, the MIP.

The purpose and nature of the ECB have been considered extensively so far. We have also talked to some extent about the policy it carries out in practice, but something needs to be added. The ECB has on the whole acted in a manner consistent with its main target, avoiding an inflationary and deflationary environment, although the fight against deflation has met strong opposition within it. In fact, it can be understood how the interpretation of the role of guardian of monetary stability has been very faithful since its establishment, due to the need to ensure the new bank a reputation that could not derive solely from the legacy of the Bundesbank. As mentioned, even during the crisis, it overestimated the risks of inflation.

Moreover, only with delay and with fierce opposition from the Bundesbank, did it cope with the financial crisis by resorting to the same unconventional measures used elsewhere, by the Fed and other central banks. Finally, the ECB has tended not to directly support national governments during the crisis, which can be understood in light of both the institutional constraints that prevent it from granting credit of last resort and the fear of generating even deeper conflicts within its governing bodies. The real problem is that it behaves like 'a driver ready to use the brakes', but who notoriously does not use the 'accelerator' (Bibow, 2006: 13). Fiscal policy also confirms this restrictive stance of monetary policy, as has been said several times.

Finally, the existence of unresolved asymmetries between the different countries - which before the crisis fuelled external imbalances - while reducing the deflationary environment in the peripheral countries (but issuing erroneous signals about the state of their economies), translated after the crisis into a very powerful deflationary bias, due to deleveraging, as is well known since the days of Irving Fisher and John M. Keynes. The mechanism can be illustrated as follows: a consumer or a company that have to reduce their debt will decrease consumption and/or liquidate assets. The increase in savings will reduce demand, production and income. Selling the assets will reduce their prices, creating new insolvencies and the need to de-leverage. Both actions will defeat the private sector's attempt to decrease its debt, creating a deflationary spiral, which can only be interrupted by a reaction from the public sector to increase its spending and take on private debt. The deflationary rebalancing imposed on peripheral countries - practically denying or limiting the expansionary role of their public sector - could have been avoided indirectly if the countries in the center had expanded their public budgets or raised wages or reduced their current account surplus. The cost of this missed option was very high, in aggregate and equity terms. In particular, the weakening of the European Social Model (ESM) due to the policies adopted, by limiting the action of automatic stabilizers, has further reduced the ability to cope with the financial crisis. Furthermore, by imposing structural reforms aimed at reducing public wages and budgets, the solutions have tended, on the one hand, to cure (some) symptoms of the crisis, not its causes; in fact, the imbalances in the EZ depend both on the restrictive policies of demand and wages implemented by the surplus countries and on the structural inefficiencies of the peripheral countries, which are reflected in particular in the lower dynamics of their productivity. On the other hand, the imposition of supply-side reforms has in some cases aggravated the crisis, at least at some point, due to low demand. It is well known that similar situations cannot be coped with by acting in the opposite direction, at least in the short term, because the effect of supply-side policies is to simultaneously reduce the level of prices and demand. These policies also tend to lower the potential output. Conversely, structural reforms can only be effective if demand is stimulated.

Thus, the risk, glimpsed by someone before the establishment of the EMU, of a deflationary bias deriving from the Maastricht criteria materialized. This has also caused a trend towards secular stagnation, in the same way that it loomed in the 1930s as a result of the deflationary policies adopted by European countries attempting to remain in the Gold Standard.

At this point we must discuss the roots of the deflationary bias of EMU institutions and policies. They are indeed numerous. An important factor is the pre-eminent role of Germany and its traditional adversity to inflation, but the role of erroneous theories that preach expansionary austerity, low multiplier values and similar ideas should also be emphasized. Finally, there is the role of vested interests in favour of the growth of the financial sector and which have influenced the action of the ECB and the formulation of political solutions for the financial crisis, in particular as regards the policies of Greece.

4. New trends and obstacles

In the period 2014-18, new trends seem to have emerged in the EZ. First of all, there has been a recovery that has affected the GDP of the main countries and in some cases - what is even more noteworthy - of some peripheral countries, such as Spain. For the first time since 2009, the decline in income in Greece has stopped and there has also been an increase.

As we have seen, employment has also grown and unemployment has fallen in all major countries. These new trends are mainly the result of expansionary monetary policy, while fiscal policy has generally remained neutral. Also, like Janus's other face of the recovery, deflation turned into inflation in 2016, partly due to rising oil prices.

However, initiatives to strengthen cohesion and decision-making in the monetary union are lacking, leaving a division between countries (especially peripheral ones) that would like to share more macroeconomic risks and those (of the center) that want to maintain a prudential conduct and ensure compliance with the restrictive rules also by others, in particular in terms of sovereign debt. As a result of this, among other things, the process of strengthening the banking union is incomplete.

The coronavirus has imposed a crossroads on Europe. The various countries of the Union have acted in no particular order both in the adoption of measures to combat the pandemic and in fiscal interventions. In contrasting policies, each country has for a long time adopted its own policies for the containment of infections, staggered in the timing of the regulation and not connected with those of the others (for example, by unilaterally suspending the freedom of movement of people, by introducing bans on the export of some products such as material and machinery useful for medical treatment). This was partly due to the different timing of the infections and partly to the well-established habit of 'self-service' in Europe.

Since March 2020, the European Commission effectively suspended freedom of movement in the Schengen area, recommending avoidance of non-essential foreign travel and closure of the EU's external borders to non-EU citizens. From 3 June 2020 all these restrictions were removed and from 15 of the same month the restrictions on travel to and from the EU countries, the Schengen area and the United Kingdom fell. This led to the second and third wave of the pandemic.

The caution with which the Commission has moved is partly explained by the fact that the size of the flows of people between the various European countries is so high as to prevent, or at least advise against, limitations. In fact, the number of frontier workers residing in the countries of the Schengen area was around 1% in 2018, and even more than 5% in Slovakia and 2.7% in Luxembourg. In addition, residents in one of the countries in the area made about 320 million trips with an overnight stay in another EU country, more than 39 million (12%) of them for business purposes (Meninno, Wolff, 2020). Perhaps the position taken by the various countries in the initial phase of the epidemic is also partly justified by the difficulty of understanding its extent and consequences at that stage. And similar attitudes partly explain the different timing and modalities of the restrictions introduced in the various countries. However, it is difficult not to blame the indiscriminate inward and outward movements abroad (as well as the reduction of precautions in contacts) for the significant increase in contagions in European countries since August 2020.

Bénassy-Quéré, Weder di Mauro (2020b) proceed by scenarios, with reference to the evolution of the pandemic in Europe. In the most optimistic one, there would be only a few new infections, easily faced on the epidemiological level and without heavy negative consequences from an economic point of view for the private and public sectors. The intermediate scenario envisages further outbreaks and contagions at the regional level, which require additional contrasting measures, with uncertain effects on economic balances. The worst scenario arises from the inability to sufficiently deal with contagions and coordinate actions among the various countries, with a very high probability of financial, social and political crisis, even with the possibility that the unity of the EZ and perhaps also of the European Union are threatened, unless an appropriate strong reaction in these fora is taken. The reality of the evolution of the pandemic in Winter 2021-2022 tends to oscillate between the second and the third scenario.

As for the contrasting economic measures, the orders of magnitude of the fiscal policies decided in each country range from about 1% of the GDP of the Mediterranean countries to 2% of France and Denmark, up to 8% of Germany. The resources to be invested in public health are partly linked to the state of the public accounts of the various countries. They certainly do not depend at all on the extent of the infections.

However, the deficits needed to cope with the pandemic and the resulting accumulation of debt will require further measures to reduce spending and/or increase revenues to repay the accumulated debt (Cochrane, 2020).

With regard to common interventions, monetary and credit policies were first adopted, implementing a new unconventional monetary policy program, in particular with the purchase of public debt securities of the euro area countries (*Pandemic Emergency Purchase Program*, PEPP, a program initially worth € 750 billion). At the beginning of June 2020 the European Central Bank announced an increase of 600 billion of the PEPP, and on 10 December one of €500 billion, bringing the total of the program to 1,850 billion, and the extension of the same to the end of March 2022, therefore beyond the initially planned date of December 2020. The reference interest is zero and that on bank deposits with the ECB is -0.50%, again in order to not induce them to deposit their liquid assets with the central bank and stimulate banks' lending.

The operation was not bound to a division of the acquisitions of the securities of the various countries proportional to their share of capital in the ECB, in order to counter the action of speculation on the spreads. The banking systems of the various countries have also been refinanced, which has allowed, on the one hand, the maintenance of public securities held by the banks and, on the other, the financing of the private sector, also facilitated by the granting of state guarantees on bank loans to businesses.

The doubt arose that it could not meet legal requirements, but Grund (2020), found it 'legal, compliant and suitable' for the ECB mission.

Therefore, the policies adopted by the ECB do not seem, and should not, be influenced by the ruling with which on May 5, 2020 the German Constitutional Court - in contrast to a previous decision of the Court of Justice of the European Union - criticized the expansionary policies of 2015, calling on the Bundesbank not to join such interventions. The ruling created considerable embarrassment, but it does not appear to have influenced the strategy adopted by the ECB, as can be seen from the reactions of its main bodies. The expansionary monetary action will most likely continue for the future, keeping inflation forecast until 2029 at a level below 1%, well below the limit set by the ECB for the medium term (Claeys, 2020), even if it has risen to above 2% as a consequence of the strong growth of output in 2021.

With regard to macro-prudential policy, temperaments could be introduced to the new accounting standards in relation to expected losses and in the calculation of troubled loans for the assessment of the soundness and capital requirements of banks. Similarly, some capital requirements for banks could be eased (Bénassy-Quéré, Weder di Mauro, 2020b). In a partially different sense argues Angeloni (2020). In a period in which credit systems are undergoing the impact of the epidemic in various ways - with the need for higher loans to customers and, at the same time, the growth of 'non-performing loans' (NPLs) - the need of capital can be of the order of 200 billion euros in Europe. There is therefore the need to avoid poor management of micro- and macro-prudential policy instruments and a shrewd strengthening of existing institutions, for example, with the possibility of increasing the authority of these institutions for liquidation procedures of banks in difficulty.

Apart from the interventions of the monetary authorities and macro-prudential policy, new credit measures have been introduced at the Community level. As for the ESM, the details of the financing were only clarified in early May 2020. On the occasion of the epidemic, it was specified that conditionality relates only to the object of expenditure (medical and health care), and not to the adoption of other measures to reorganize the existing public debt (which should be suspended until the end of 2022), which would otherwise have slowed the use of the Mechanism by heavily indebted countries such as Italy. The loans have a term of ten years and a rate of 0.1% is applied to them. If we consider that the interest rate on Italian 10-year BTPs was 1.83% at the beginning of May 2020[1], recourse to the ESM became convenient for Italy, as it ensured a lower financing cost of 1.73 % per year. On a loan of up to 36 billion, the savings would have been higher than 600 million euros per year (Accademia dei Lincei, 2020). However, it should also be noted that access to the Mechanism by a country could imply a reduction in its credibility and therefore an increase in the cost of other loans.

The ban on state aid to companies has also been suspended until the end of 2021. The EU Commission can authorize state support for: 1) direct subsidies and tax breaks aimed at meeting urgent liquidity needs up to € 800,000 per company; 2) state guarantees on bank loans; 3) public loans at subsidized rates; 4) aid to banks to finance businesses; 5) short-term export credit insurance; 6) support for research and

[1] However, in 2021 this rate has decreased.

development against Coronavirus; 7) deferral or suspension of taxes; 8) income support for employees.

In addition, the European Investment Bank (EIB) has created guarantee funds for bank loans to companies with an endowment capable of supporting loans for a total of 240 billion euros. The funds should be financed by EU member countries according to their participation in the Bank's capital. Various funds were then set up such as SURE (*Support to mitigate Unemployment Risks in an Emergency*) and other funds for a total of 540 billion euros. SURE is a new instrument that should give temporary support to reduce the risk of unemployment in emergency situations and could raise up to 100 billion on the market through a system of guarantees by member countries to finance member countries in difficulty (European Commission, 2020a). In addition, the EIB will set up a pan-European guarantee fund to support European workers and businesses affected by the pandemic crisis, and finally the agreement to channel support through the ESM has been confirmed. In July 2020, the so-called '*Recovery Fund*' was also defined. It has been renamed *'Next Generation EU'* (European Commission, 2020b). With this newly created fund, the European Commission intends to raise up to 750 billion on the market, giving long-term funds as a collateral made available by a (temporary) increase in the European budget 2021-2027 up to 2% of GDP (therefore doubling the current amount of the budget) for a value of 1,100 billion over the seven years, from new direct contributions (for 390 billion) and greater guarantees from member countries. The funds will be repaid against future budgets, not before 2028 and not after 2058. Coverage will be offered by new EU own resources, such as the *Environmental Emissions Trading System*, new corrective border levies for products that involve excessive carbon emissions and other resources such as a financial transaction tax on certain transactions and derivatives. On the objectives of the Fund there have been those who understand it as aimed at short-term purposes, that is, as a tool to support the economy. But various considerations lead instead to favouring those of a structural nature (see in particular Pisani-Ferry, 2020). Moreover, we can add that the long-term, generational objectives transpire from the same denomination.

It should be noted that the disbursement of funds is conditional on the preparation of detailed spending programs and that after the payment of the first 10%

the European Commission will exercise controls on the use of funds and on the initiation of reforms.

The use of these funds was allocated by the European Commission to countries with greater difficulties, Italy and Spain in the lead, to carry out investments and reforms necessary for recovery. The reason why the Mediterranean countries, also supported by France, have advocated this tool is that, unlike the others, these are resources that are partly very long-term loans, with rates lower than those of national bonds, and partly non-repayable. The main recipient will be Italy, which will receive 208.8 billion (of which 81.4 through non-repayable subsidies and 127.4 in loans). Spain will receive a total of €140 billion (72.7 of which non-repayable), France 39 billion, Greece 31.5, Portugal 26.1 and Germany 23.6.

The estimated effects on GDP are more favourable in the peripheral countries, Greece and Portugal first, and a little less for Italy.

The so-called 'frugal' countries (i. e., Austria, Denmark, Finland, Netherlands, Sweden) have objected to the ratification of the Treaty for some months. Consequently, there has been a delay in the arrival of the first loans until Summer 2021. However, it should be noted that, for some, the payments from the budget for the next seven years cannot be materially disbursed in 2021 or 2022, if not in minimal part. According to Darvas (2020), which takes up statements from the European Commission, the disbursement of 3/4 of the funds will have to wait until 2023. According to Giovannini et al (2020), the disbursements for the loan component will be higher in 2022, while the peak of non-repayable grants should occur in 2024. Therefore, the various governments will be forced to intervene, anticipating the funds of the Next Generation EU.

Among other measures, the Next Generation EU provides funds equal to 31 billion euros for the recapitalisation of companies, which should mobilize private resources to support economically viable companies in the sectors, regions and countries most affected by the pandemic. Through the leverage effect, 300 billion euros should be raised. In reality, this intervention, while focused on a well-founded need, that of the recapitalisation of companies, appears insufficient in the face of their growing debt.

Access to funds is not conditional on compliance with the SGP (which, however, is suspended until the end of 2023) nor obviously on the adoption of 'structural reforms'. The disbursement of funds is subject to the presentation by individual countries of national spending plans that will be evaluated by the Commission and approved by the Council with a qualified majority, i. e., with the vote of at least 15 countries representing no less than 65% of the population. The approval will be accompanied by 'country specific recommendations' (CSR). These will in fact constitute the reference for the evaluation of national spending plans, with particular attention to reforms that improve the potential for growth, employment and economic and social resilience. From interviews released by the competent authorities, the various countries could be required to guarantee policy guidelines such as to ensure the recovery of the economy in a reasonable period of time, the sustainability of the public debt, an improvement in coordination between the different layers of government, the strengthening of health and education and distance learning through digital tools, the improvement of the efficiency of the judicial system and the public administration, the support of the vulnerable groups most affected by the crisis and of small and medium-sized enterprises and innovative ones, the reduction of unemployment and increased investment in the green economy and digitalisation.

The times within which the use of funds must be made are important, as there is a risk, as noted by Perotti (2020), of a hasty, rash and patronizing identification of the projects to be carried out with their use.

The EU's ability to ensure growth by stimulating productivity and innovation will have important effects on the attractiveness of the area for investment and on strengthening the rating of the weaker areas, which could positively affect supply of safe assets by the EZ, thus increasing the role of the euro as an international currency (Claeys, Wolff, 2020).

Measures that are halfway between monetary and fiscal ones are represented, among other things, by the 'money dropped from the helicopter' (helicopter money), consisting of the opening of an irredeemable credit by the ECB to governments or by direct purchase at the issuance of public debt securities and their immediate cancellation or the conversion of such securities into irredeemable securities. Many objections would probably arise against such an intervention, starting from the one according to which it would be precluded by the independence of the ECB and by the existing rule that prohibits direct financing by governments or by the fact that it would generate inflation.

The first of these objections can be overcome, because the exceptional nature of the situation requires an adaptation of the existing rules, as happened for the purchase of public securities on the secondary market. In addition, the ECB could decide independently to follow such a policy. The second objection has no basis, given the existing lack of aggregate demand and the need to activate public spending to increase income and employment (Galì, 2020).

As for expansionary fiscal policies in the strict sense, first of all – as said - the SGP was suspended, which allows individual member countries to adopt significant expansionary fiscal policies financed in deficit.

It would also be desirable to transform part of the national debt into European debt (Eurobonds or similar), to reduce the ratio of public debt to GDP, which is particularly high - or destined to become so - in some countries such as Greece and Italy. The advantages of issuing this form of mutualized debt are many. Among them, the lack of dependence on market ratings (i.e., assessments) of the reliability of sovereign debts and their variations, the reduction of spreads for the most indebted countries, which would thus reduce their exposure to the financial market and the possibility of banks using Eurobonds to diversify their portfolios, often burdened with lending to domestic securities.

Further initiatives could concern: 1. the creation of a single European institution to be entrusted with the competences of national institutions, such as the ministries of health, in the event of an epidemic involving more than one country; 2. enhanced cooperation, to carry out a European investment project financed by securities and destined to specific investment fields (for example, bio-medical research, transport infrastructures, information technologies, creation of a level-playing field, i.e. equal access to the market, in this case through a level playing field). In the longer term, it would finally be necessary to devise a European industrial policy that not only identifies priority sectors in which to invest, but that also favours aggregations between European companies, for example in the energy, telecommunications and bio-genetics sectors, strengthening European research platforms useful for innovative medium-sized enterprises and start-ups, on the model of CERN (*European Center for Nuclear Research, Conseil européen pour la recherche nucléaire*), ESA (*European Space Agency)* and EMBO

(European Molecular Biology Organisation). Then, various trans-European infrastructures could be enhanced (Accademia dei Lincei, 2020).

A permanent central fiscal capacity should be constituted, in order to consolidate and institutionalise the innovations contained in the Next Generation EU, more specifically: to finance EU public goods – particularly in the green economy and digital transformation - and to facilitate the adjustment of member states towards a solid and sustainable fiscal position; to manage macroeconomic shocks and eliminate regional imbalances; to finance the new challenges in terms of, on the one side, climate changes and energy transition and, on the other, the low growth rates and the recurring crisis (Blanchard et al., 2020; Amato et al, 2021; Buti, 2021; Buti, Messori, 2021; Bordignon, Pisauro, 2021; Feàs et al, 2021; Varoufakis, 2022).

5. Conclusions

Judging from the policies implemented recently, a legitimate question is whether the pandemic has been a game-changer, since EU interventions represent some kind of a novel line of conduct of the EU.

The issue arises now whether this novelty will be followed by a retreat to the course of rules preceding the pandemic (or, worse, by disintegration of the Union) or some kind of confirmation of the new course - even a relaunch of the EU.

Some shortcomings of the policies that have been chosen must be indicated. First, the Recovery Fund is considerably diluted with respect to the original Franco-German proposal. In addition, the loan element has had a rather limited attraction, due to the current low market interest rates. However, the attraction will certainly increase in the near future, due to the restrictive monetary policy that almost certainly will be implemented to face the current inflation: the ECB has not changed its policy rates, maintaining them at the zero level, but it has envisaged to raise them in the near future, as the current inflation rate threatens its main statutory goal, i.e. a 2% medium-term rise in inflation. Passing to other EU policy instruments, it must be considered that a high emphasis has been placed on the success of the Next Generation EU. It must be considered that, in case of its failure, the prospect could be one of disintegration of the EU, given the pivotal role that has been assigned to it to address the many EU failures.

On the side of the optimistic scenario, one must say that effective implementation of the reforms can not only abate the epidemic, but also allow structural transformations capable of increasing the growth rate and face the recurring crises, particularly deep in the EU.

There are indeed reasons for supporting both scenarios. Many authors and myself are undecided whether the recent policies represent a foundational Hamiltonian moment in the life of the EU or just a transactional and time-limited Marshall plan.

References

Accademia Nazionale dei Lincei (2020), *La crisi Covid e la possibile svolta per l'Unione Europea*, Documento della Commissione Covid-19, https://www.lincei.it/sites/default/files/documenti/Commissioni/ANL_Comm_Covid-19_la_crisi_covid_9maggio2020.pdf

Amato G. *et al.* (2021), 'The new European fiscal framework: how to harmonise rules and discretion. A contribution to the Commission Review of the EU Economic Governance Framework', *Astrid Paper*, 81, December

Angeloni I. (2020), *Beyond the Pandemic: Reviving Europe's Banking Union*, CEPR Press, London

Askenazy Ph., Chevalier M., Erhel C. (2015), 'Okun's laws differentiated by education', *Document de Travail CEPREMAP*, 1514, https://pdfs.semanticscholar.org/070d/d14a6226216d918b60533539537d76b91e90a.pdf

Bénassy-Quéré A., Weder di Mauro B. (2020a), eds., *Europe in the Time of Covid-19*, A CEPR Press VoxEU.org eBook, CEPR Press

Bénassy-Quéré A., Weder di Mauro B. (2020b), 'Europe in the Time of Covid-19: A New Crash Test and a New Opportunity', in A. Bénassy-Quéré, B. Weder di Mauro (2020a), eds.

Bibow J. (2006), 'Europe's quest for monetary stability', *International Journal of Political Economy*, 35(1), 24-43

Bibow J. (2020), 'A Euro Treasury: Essential, and rather straightforward', in M. Buti, G. Giudice, J. Leandro, eds., *Strengthening the Institutional Architecture of the Economic and Monetary Union*, A VoxEU.org Book, Cepr Press

Blanchard O., Leandro Á., Zettelmeyer J. (2021), 'Redesigning EU fiscal rules: from rules to standards', *Working Paper*, 21(1), Peterson Institute for International Economics, February

Bordignon M., Pisauro G. (2021), 'On Reforming the EU Fiscal Framework. A contribution to the European Commission Review of the EU Economic Governance Framework', *Astrid Paper*, 82, December

Buti M. (2021), *The Man Inside. A European Journey through Two Crises*, Milan: Bocconi University Press

Buti M., Messori M. (2021), *The search for a congruent Euro area policy mix: vertical coordination matters*, VoxEU.org

Claeys G. (2020), 'The ECB in the COVID-19 Crisis: Whatever it takes, within its mandate', *Monetary Dialogue Papers*, Study for the Committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg, June

Claeys G., Wolff G. B. (2020), 'Is the COVID-19 crisis an opportunity to boost the euro as a global currency?', *Policy Contribution*, 11/2020, Bruegel

Cochrane J. H. (2020), 'A Fiscal Theory of Monetary Policy with Partially-repaid Long-term Debt', *NBER W. P.,* 26745, February

Darvas Z. (2020), *Next Generation EU: 75% of grants will have to wait until 2023*, Bruegel.org, 10 June, https://bit.ly/2WnYImE

De Grauwe P. (2021), *Euro Area fiscal policies and capacity in post-pandemic times*, European Parliament.

European Commission (2020a), *SURE, Supporting Member States to help protect people in work and jobs*, SURE Factsheet, 2 April.

European Commission (2020b), *Europe's moment: Repair and Prepare for the Next Generation*, Brussels, 27.5, COM (2020) 456 final.

Feás E. *et al.* (2021), 'A proposal to reform the EU's fiscal rules', *Elcano Policy Paper*, December

Galí J. (2020), 'Helicopter money: The time is now', in A. Bénassy-Quéré, B. Weder di Mauro (2020a), eds.

Giovannini A. *et al.* (2020), 'The fiscal implications of the EU's recovery package', *ECB Economic Bulletin*, 6.

Grund S. (2020), *Legal, compliant and suitable: The ECB's Pandemic Emergency Purchase Programme (PEPP)*, Hertie School, Jacques Delors Centre, 25 March

Istat (2020), *Il mercato del lavoro. Una lettura integrata*, Roma: Istat, 2020

Meninno R., Wolff G. (2020), 'As the Coronavirus spreads, can the EU afford to close its borders?', *VOX CEPR Policy Portal*, Voxeu.org, 28 February, https://bit.ly/3jc2qtl

OECD (2021), https://www.oecd.org/economic-outlook/

Perotti R. (2020), 'Gli aiuti di Bruxelles all'Italia. Quei conti che non tornano', *la Repubblica*, 29 May

Pisani-Ferry J. (2020), 'European Union recovery funds: strings attached, but not tied up in knots', *Policy Contribution*, 2020/19, Bruegel

Varoufakis Y. (2022), 'How the Euro divided Europe', *Project Syndicate*, Jan 20