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The return of fiscal policy

The new EU macroeconomic activism and lessons for future reform

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Abstract

This paper looks at the macroeconomic policy response to the Covid-19 crisis in the European Union (EU) and the prospects for long-term recovery under the Next Generation EU (NGEU) plan. It argues that, unlike what happened following the sovereign debt crisis of 2011-2012, the EU's strong and prompt response to the pandemic took more into account the lessons from the rethinking of macroeconomic theory which started after the Global Financial Crisis, including as it concerns the use of monetary and fiscal policy as macroeconomic and employment stabilizers, the impact of public investments and industrial policy on long term economic growth, and the role of labour market policies and the welfare state. It concludes reviewing the implications for the current debate on the reform of EU economic governance.

About the author

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In 2000, he became member of the Council of Economic Advisors for the Italian Prime Minister's Office. In 2002, he moved to Paris to work at OFCE, the Research Centre in Economics of Sciences-Po Paris. He is in charge of the Economics concentration of the Master of European Affairs at Sciences-Po, where he teaches international and European macroeconomics. He is member of the Scientific Board for the LUISS School of European Political Economy (SEP) and has served as a member of the Scientific Committee of Confindustria. He regularly does consulting and executive trainings. He maintains a blog on European matters and is involved in the institutional dialogue on macroeconomic policy in the EU.

Table of contents

List of Figures

Introduction

The reaction of European Union's (EU) policy makers to the Covid-19 shock was bold and timely; although they could not avoid a crisis whose dimensions made the 2007-2008 Global Financial Crisis pale by comparison, the governments' titanic effort managed, with the support of EU institutions, to mitigate the impact on incomes and employment. This came as a welcome change after the calamitous management of the sovereign debt crisis. But it is precisely the extraordinary dimension of the Covid-19 crisis that prompts the question of whether the activism of economic policy denoted a change in the mindset of EU governments and institutions, or simply was the only option available to policymakers to avoid the collapse of their economies. This working paper details the policy answer of EU countries and assesses the perspectives of the long-term recovery plans with an eye to the debate on reform of EU economic governance.

I will point out that the 2008 crisis shook up the Washington Consensus doctrinal framework, making possible an in-depth rethinking of the role of the state in the economy, from the use of monetary and fiscal policy in managing macroeconomic fluctuations to the role of public investments and industrial policy as drivers of long term growth, to even broader themes such as the role of the welfare state, labour market policies and the impact on inequality. A rethinking, however, that in the EU, and most notably in the Eurozone (EMU), was not sufficient to prevent major mistakes in managing the sovereign debt crisis that started in Greece in 2010-2011. The rethinking of macroeconomics had undermined the previous consensus, but a new one did not emerge yet (if ever it will). The Covid crisis came at a time of theoretical uncertainty, with no dominant paradigm; but contrary to the early 2010s, this time the European debate is lively: the voices preaching a return to the pre-crisis status quo are today minoritarian, although certainly not powerless. Whether the changes in the policymakers' attitude and the discussions of the recent months will eventually evolve into a more functional institutional architecture than the current one is an open question.

This paper will begin by quickly assessing the trajectory of macroeconomic theory in the past decades, showing how today, following the Global Financial Crisis, it is in a state of flux with no clear dominant paradigm. Then, in section 2, I will briefly outline the EU response to the sovereign debt crisis showing that the old consensus recipes were applied and that EU policy makers did not take stock of the debate in macroeconomics unlike what happened for instance in the US. The following sections will show how the Covid pandemics acted as a turning point. Section 3 will describe the bold and timely response to the crisis, while section 4 will be devoted to the Next Generation EU (NGEU) plan for the recovery and for the structural transformation of EU economies. Section 5 will then go through the current debate on EU reform and draw lessons (that go beyond Europe) on how to reconsider macroeconomic and industrial policies after three decades of Washington Consensus dominance. Section 6 concludes.

1 Rethinking macroeconomics after the 2008 crisis

The institutions that were put in place within the EU with the Maastricht Treaty were not born in vacuum but were strongly influenced by the macroeconomic consensus that emerged from the struggle of ideas of the post WWII period[1]. The thirty-year period after the end of the Second World War was dominated by the Keynesian theory. Keynes rejected the main result of the pre-1929 neoclassical model, namely that markets could spontaneously achieve full employment equilibrium. The essence of economic policy was, according to the British economist, to intervene in a constant attempt (fine tuning) to compensate, without claiming to replace them, for markets' inefficiencies and imperfections, to ensure macroeconomic stability and long-term viability.

The State in Keynesian economic theory and policy had a dual role: short-term cyclical regulation, aimed at sustaining economic activity and full employment in periods of slowdown (or cooling it down in case of overheating) by using fiscal and monetary policies; and more structurally, interventions aimed at increasing the "resilience" of the economy - its ability to absorb macroeconomic shocks - and to achieve trajectories of long-term growth in output and jobs at acceptable equilibria from the point of view of economic efficiency. In addition to social justice criteria, the very development and consolidation of welfare systems in the 1940s and 1950s also responded to this need: universal access to health and education, automatic stabilisers such as unemployment benefits, and (last but not least) equitable income distribution, all contributed to increasing the capacity for automatic stabilisation on the one hand, and on the other to increasing what economists clumsily call 'human capital' and therefore the economy's growth potential.

1990s: Macroeconomic policy in the closet

The crisis of Keynesian economics in the 1970s opened a new phase. From the 1980s onwards, the mainstream in economics revolved around the notion of a "natural" equilibrium, to which the economy tends spontaneously in the medium term. Within this "new consensus", even in the presence of rigidities, persistent deviations from the equilibrium will eventually exert pressure on prices that will bring the economy back to the natural equilibrium. For the theory that dominated macroeconomics in the past decades, therefore, the state has a limited role. As in the old pre-Keynesian model, structural reforms are the main policy tool: curbing monopolies (both in goods production and in labour markets), reducing the weight of the state in the economy, avoiding informational asymmetries, eliminating price and wage rigidities, all this should make it possible to remove the frictions that on the one hand hinder potential growth, and on the other amplify the magnitude of cyclical fluctuations. In this context, discretionary macroeconomic policies are not particularly appropriate; on the contrary, governments should follow clear and predictable policy rules, to reduce uncertainty and allow markets to converge more quickly to their natural equilibrium. It is therefore clear that the new consensus is rather close to the pre-Keynesian neoclassical theory. Macroeconomic policy is only effective in the short run, and only if it remains predictable thus not disturbing the normal functioning of markets whose efficiency is the main pillar of the theory. The persistent deficiencies in aggregate demand that were central to Keynes' analysis are marginal in the mainstream that emerged in the 1990s and dominated the policy landscape until at least the Global Financial Crisis of 2008[2].

[1] For details on the "struggle of ideas" on the respective role of the State and of markets in stabilizing the economy, the reader can refer to Saraceno (2017b, 2018)) and to Akerlof (2019).

[2] This intellectual framework also served as the basis for the Washington Consensus' trinity of liberalisations, privatisations and structural reforms. The Washington Consensus was already challenged by the developing economies' lost decade of the 1990s (from the social and economic impact of the shock-therapy in the former Soviet Union, to the Latin American and East Asian financial crises). But advanced economies' policy makers and academics shrugged off these major challenges until they were forced to behave differently by the home-grown Global Financial Crisis.

Within the marginal role that the consensus attributes to macroeconomic policy stabilization, monetary policy should be preferred to fiscal policy mostly for two reasons: First, it is less subject to lags in decision and in implementation; second, it can be delegated to independent and technocratic bodies that are not subject to political biases and captured by vested interests. Furthermore, monetary policy aimed at stabilizing inflation will in most cases also keep output and employment at its optimal level (what Blanchard e Galí, 2007 call "divine coincidence"), thus making any further policy intervention unnecessary. Thus, the new consensus removed fiscal policy, even in the short run, from the policy maker toolbox. Theoretical and empirical work on fiscal policy, therefore, focused on the design of "optimal" rules (Kopits e Symansky, 1998) aimed at preventing opportunistic behaviours and excessive (distortionary) influence of the government in the economy.

The New Consensus shaped the EU institutions that were put in place with the Maastricht Treaty in the early 1990s. The Treaty centered European economic governance on the rejection of active macroeconomic policies. Embracing the "divine coincidence", the ECB was given a mandate only for price stability, furthermore with considerable autonomy in pursuing it (Saraceno 2016). Furthermore, the Stability and Growth Pact (SGP) required countries to balance their budget over the cycle (i.e., making sure that surpluses in good times compensate for deficits in crisis periods), forcing countries to rely solely on automatic stabilizers to cushion economic fluctuations. Last, but not least, the EU gave the Commission a strong saying in competition policies, with the objective of favouring structural reforms and removing obstacles to the efficient working of markets.

The Consensus was not a European peculiarity, but the pressure to reduce the role of the state in the economy was particularly strong in the EU. The perimeter of the welfare state has over time been slowly but pervasively reduced[3], the role of automatic stabilisers undermined (somewhat inconsistently with the Stability Pact emphasis on their importance in absorbing business cycle fluctuations), and the cyclical regulation of the economy through macroeconomic policies sacrificed on the altar of 'market flexibility'. The elimination of fiscal policy from the policy makers' toolbox has over the years particularly affected public investment, an expenditure item politically less sensitive than current expenditure but as crucial for long-term productivity and growth as it is 'invisible' to the public (Cerniglia et al. 2021; Cerniglia and Saraceno 2020).

Reassessing the role of the State after the Global Financial Crisis

The Global Financial Crisis of 2008 shook the certainties that fed the consensus. The persistence of the recession showed the inconsistency of the claim that markets can quickly return to natural equilibrium following a shock. In 2008 and 2009, in adherence to the old Keynesian theory, monetary policy and then fiscal policy were called to the rescue of an economy that seemed unable to recover on its own. It is true that the Keynesian response was short-lived and that, especially in Europe, there was a rapid return to the fiscal discipline advocated by the new consensus. Nevertheless, economists and policy makers began to question the old recipes and in general the solidity of the foundations of the New Consensus itself. After more than thirty years of emphasis on the supremacy of markets in guaranteeing the optimal allocation of resources and fostering innovation and growth, a wide-ranging debate has begun, and still goes on, on the need to re-assess the role of the government in managing business cycles, in regulating markets and in correcting their inefficiencies. The discussion spares no dogma of the consensus[4], from industrial policy to income distribution, from capital controls to trade barriers, from taxation to the role and nature of structural reforms.

[3] Causa and Hermansen (2017) show that in most OECD countries, the insurance role of the welfare state (through, for example, unemployment benefits) has over time been reduced, leading to an increase of inequality after taxes and transfers. In some countries, assistance to the most disadvantaged categories increased, but this was not enough to reverse the trend..

[4] It is hard to give a complete list of references for a literature that grows by the day. A good starting point are the "rethinking macroeconomics" conferences animated by former IMF Chief Economist Olivier Blanchard (Blanchard 2016). The interested reader may also consult a "Rebuilding macroeconomic theory" special issue of the *Oxford Review of Economic Policy*, Volume 34, Issue 1-2, Spring-Summer 2018.

In particular, the current debate re-assesses the role of fiscal policy, that was previously relegated to a marginal role but in the past decade turned out to be pivotal for macroeconomic stabilisation[5], among other things because of the reduced effectiveness of monetary policy; as interest rates progressively converged to zero (Rachel and Summers, 2019), the latter has been constrained by the so-called zero lower bound, limiting the central bank's capacity to stimulate economic growth.

To sum up, after the years of 'market fundamentalism', the profession now seems to have returned, albeit in a confused and non-systematic way, to a broadly Keynesian conception of economic policy: an adaptive process in which, instead of delegating to supposedly efficient markets the task of converging to the best of all possible worlds, policy makers must attempt to guarantee the macroeconomic stability which facilitates investment and accumulation of knowledge and human capital, and thus stable long-term growth. The Covid-19 crisis, that forced governments to bold and improvised response to both the health and the economic emergency, did definitely wipe away the pre-2008 consensus, leaving macroeconomics in a state of flux that is likely going to last some more time.

[5] In 2012, the IMF issued a *mea culpa* on the size of multipliers. The crisis had shown that their value was much higher than estimated by the pre-crisis models used as a justification for European austerity programmes(Blanchard and Leigh, 2013). On the policy mix see the recent report published by the CEPR (Bartsch et al. 2020).

2 The Eurozone impervious to change: The sovereign debt crisis

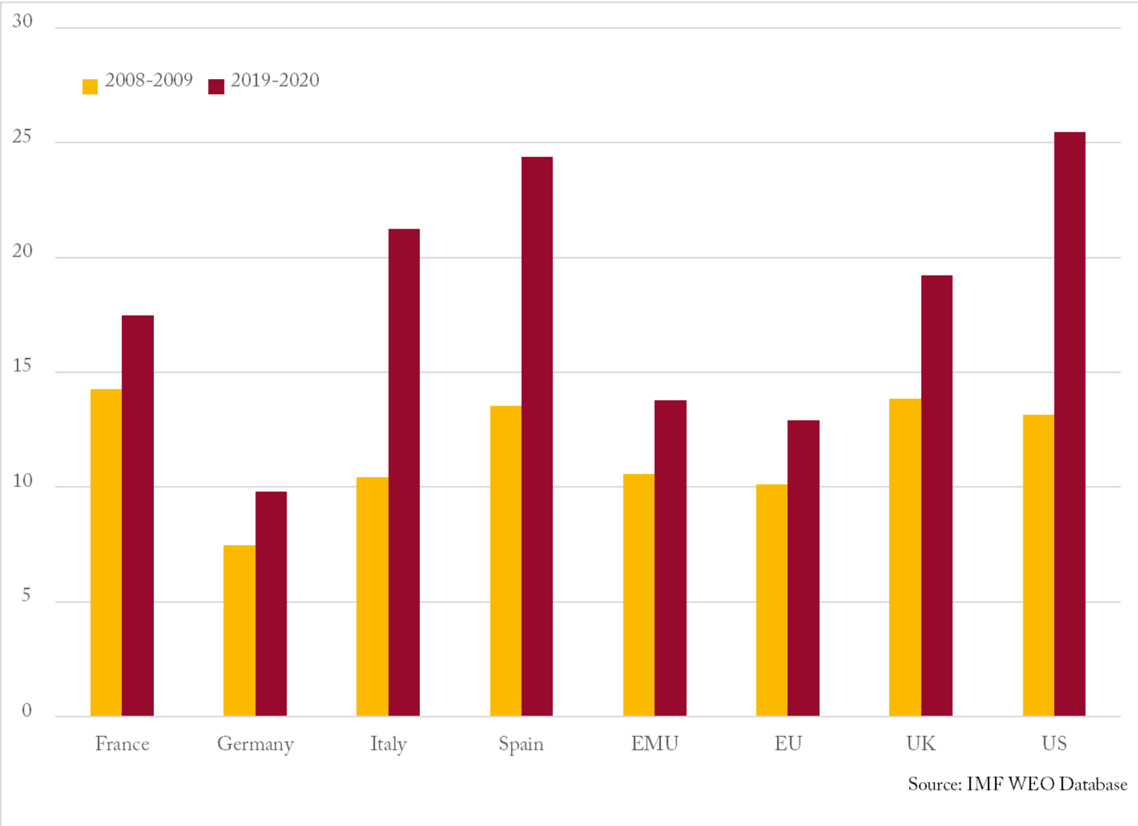
For a long time, the debate on rethinking macroeconomics had little echo in the European policy arena. On the contrary, since 2010 the eurozone crisis has been interpreted as an 'apologue of fiscal sinners', a crisis due to the indiscipline and inefficiency of the governments of some Mediterranean countries (Saraceno 2020; Tooze 2018). The austerity season of the early 2010s was a by-product of this narrative. The institutional reforms that between 2011 and 2014 followed the sovereign debt crisis (The Fiscal Compact, the Six-Pack and Two-pack sets of regulations, the ESM, the banking union) were also consistent with the apologue of fiscal sinners: taken together, those innovations in governance reinforced EU institutions' control over national fiscal policies and perpetuated the idea that structural reforms and market flexibility at the country level ("risk reduction") are in fact the main driver of convergence. To be fair, many, starting with the then ECB President Mario Draghi, have since 2014 called for more activism in fiscal policies and for a revival of public investment and domestic demand (Draghi 2014). However, these calls were carefully framed to emphasize the priority to be given to fiscal discipline (only countries with "fiscal space", defined as the respect of the Stability Pact, were supposed to implement expansionary policies). In addition, these voices remained largely unheard. One of the cornerstones of the new consensus, the separation between the natural equilibrium, determined by structural, supply-side factors, and the short-term fluctuations around it, was the last line of defence of austerity. Sure, it was argued, the adjustment imposed on the eurozone periphery had prolonged the recession, further increasing unemployment and poverty, and deepening the gap between the rich and the poor; but this was just a bitter (but necessary) medicine to be taken in the short run in order to boost growth in the long run. The empirical literature inspired by the EMU crisis has shown the fallacy of this argument beyond any doubt: prolonged recessions lead to a deterioration of the economy's (physical and human) capital, and thus of its ability to grow in the long run (for a theoretical model of hysteresis see Delong and Summers 2012). An increasing number of macroeconomists believe today that it is better to err on the "too much" side in supporting the economy during a downturn, than to let it slide in a long period of subdued growth that permanently hampers the growth potential (Blanchard et al. 2015; Fatás 2019; Fatás and Summers 2018).

3 The Policy Response to the Covid storm

Member States on the frontline

The spring of 2020 has come to reshuffle the cards. The mistakes of previous years seem to have prompted European policymakers to act quickly and well. The first dam against the pandemic wave has been erected by the governments of the member countries, which was inevitable: the EU is a union of sovereign states, that retain exclusive competency on both public health and fiscal policy. For the latter it cannot be otherwise: in accordance with the motto "*no taxation without representation*", spending and taxation decisions can only be taken at the level that is accountable to the voters.

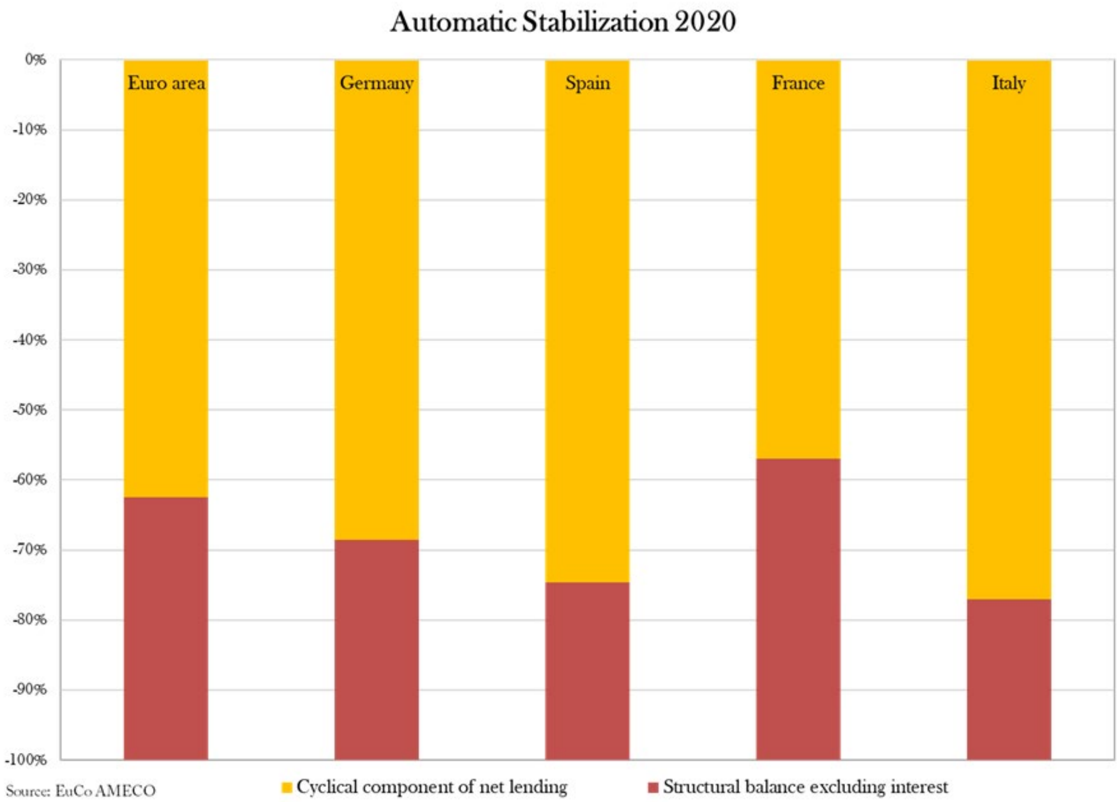
Figure 1: Change in government gross debt to GDP, Global Financial Crisis vs Covid. Selected EU Countries



In addition, to cope with the health emergency, states have injected huge resources into the economy to support businesses' liquidity, to limit the fall in labour income, and to provide guarantees aimed at keeping credit flowing to the productive sector. In almost all European countries, the measures were extended and renewed as the economic effects of the pandemic unfolded; as we write (March 2022), these measures have been mostly withdrawn despite the omicron wave raging as limitations to economic activity have been almost entirely lifted. The effect of these measures on public finances was immediate; debt and deficits exploded (figure 1), and in most EU countries they will continue to rise in 2021. Interestingly, and despite its

downsizing mentioned above, the welfare state played an important role. Most of the fiscal support to the economy came from automatic stabilization (figure 2). This is quite different from countries with different institutions, such as the United States, and should be a cautionary tale. Faced with the many stimulus plans (announced but yet to be made into laws) by the Biden administration early in 2021, many claimed that the European Union has been left in the hay once again and has renounced to support its economy. In truth, such a claim does not take into consideration the crucial differences between the two systems. Of course, the figures of the American measures are staggering. However, they include actions that have already been incorporated into European countries' national welfare systems. US fiscal policy is mainly made up of discretional measures, while the European one leaves a major role to automatic stabilizers.

▶ Figure 2: Cyclical and structural net lending



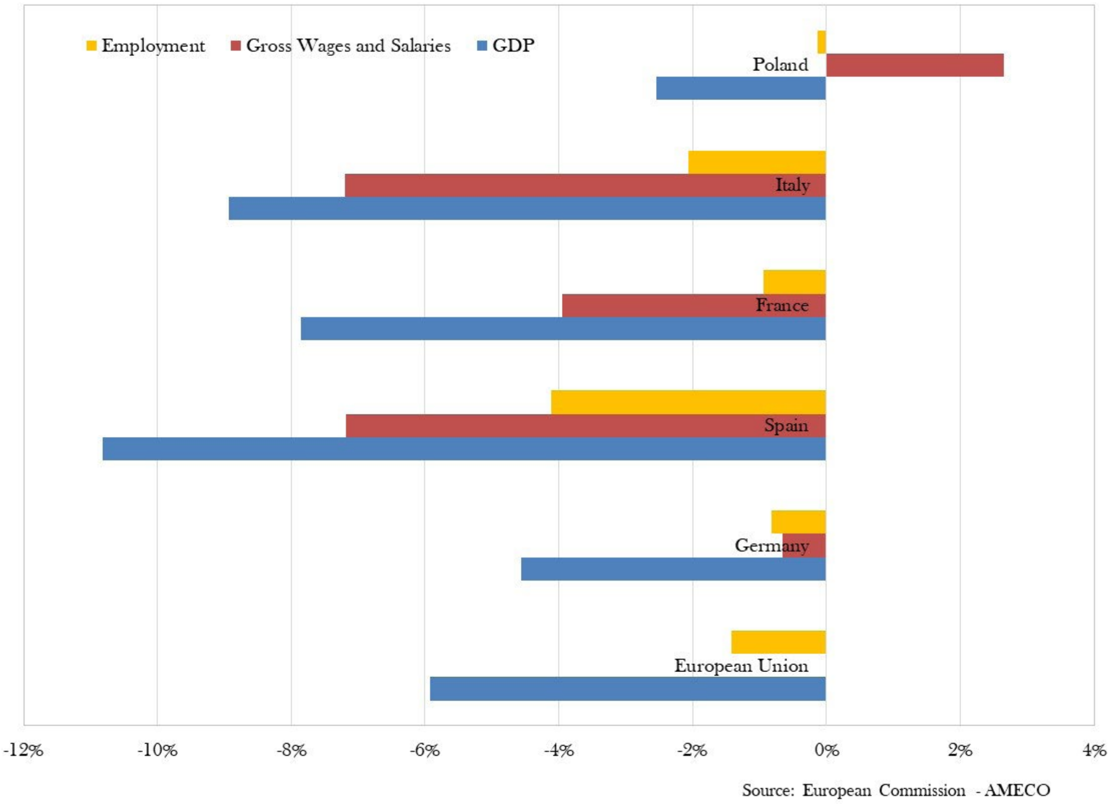
In most European countries support to labour markets and incomes took the shape of job retention (JR) schemes. For example, thanks to the *activité partielle* introduced in France in April 2020, 70% of the gross wage of displaced workers (including in the service sector) was paid by the government (see OECD 2020). Job retention schemes were unprecedented and hugely popular among potential beneficiaries. In the case of France, again, requests for support amounted to over 50% of employees and in the end 33% were covered. During the Global Financial Crisis, the number had been 1%. In general, just weeks after the beginning of the pandemics, job retention schemes supported about 50 million jobs across the OECD, about ten times as many as during the Global Financial Crisis of 2008-09. According to the OECD (2020), "*The unprecedented use of JR schemes has helped contain the employment and social fallout of the COVID-19 crisis and avoid massive layoffs. Concerns over the potential negative effects of JR schemes, which arise in ordinary times, were initially of secondary importance. In particular, the risk of devoting public resources to support jobs that employers would have retained anyway was limited because restrictions in business activity during confinement heavily*

reduced sales and hence financial resources in many firms across almost all sectors. In ordinary times, JR schemes can also impede the reallocation of workers to more productive firms. But this risk was also limited during the lockdown period, given the hiring freeze and the pervasive impact of government-imposed restrictions and physical-distancing measures on all firms, independently of their pre-crisis performance.".

The difference between the two crises is striking. The only EU country that resorted to job retention schemes in 2008 had been Germany (and even in that case, to a scale not com[6]parable with 2020). The relative success of the German labour market after the Global Financial Crisis did push other countries to follow that path in 2020. In fact, this was an explicit recognition that labour markets have specific dynamics that cannot be neglected. The stability of labour relations is crucial for the continuity of investment, including in human capital. While the pre-crisis consensus prescribed flexibility of labour markets, the Global Financial Crisis showed that the capacity to engage in long-term relationships with workers is key, together with stable flows of financing, in guaranteeing adequate accumulation of capital. The German labour market is a very good case in point. Contrary to the conventional wisdom, that sees the Hartz reforms as heavy and far-reaching liberalizations, an important segment of the German labour market, the one linked to manufacturing and business services, is still ruled by long-term agreements between employers, workers, and local work councils (for details see Carlin and Soskice 2009). For these "insider workers", a system of work relations is in place, in which highly paid workers acquire skills through vocational training (within or outside the firm) and are protected by an all-encompassing welfare system. Vocational training creates robust bonds between the firms, that often invest substantial resources in the training, and the workers, whose specific skills could not easily be transferred to other sectors or even to other firms. The strength of this institutional setting has been apparent at the turn of the century, when globalized markets coupled with the aftermath of the reunification, exerted a serious pressure for a restructuring of labour relations. This restructuring happened through a consensus process that kept untouched the bond between the firm and the worker. The mutual interest in preserving the long-term relationship between workers and firms in the insider markets, led to agreements aimed at reducing costs or to increase productivity without increasing turnover or reducing average job tenure. These agreements could involve on the workers' side labour sharing, flexibility in hours and in labour mobility, wage concessions, reductions in absenteeism. In exchange for this, firms would guarantee continued investments in innovation and in the (vocational) training of workers, and job security. Job retention schemes aimed at the same objective: preserving work relations while the economy was frozen by lockdowns and supply side disruptions, so as not to disperse the within firm human capital that would be necessary for the rebound.

[6] The internal labour market dynamics were compounded by wide ranging offshoring of activities, that contributed to keep production costs down helping the build-up of massive current account surpluses.

▶ **Figure 3: Percent changes in GDP, employment, and incomes in 2020. Selected EU countries**



Despite its huge cost, the colossal effort by European governments has borne fruit, and everywhere, at the peak of the crisis in 2020, incomes and employment have fallen significantly less than GDP (Figure 3). It is interesting to notice in this respect, that the rebound at the end of 2020 was faster in the US, where JR schemes were not implemented. Nevertheless, employment levels did not recover the pre-pandemics levels yet, while in EU countries the so-called "Great resignation" did not materialize. More research will be needed to investigate the impact of JR schemes on labour market dynamics in the short and in the medium term.

The European support to member states

During the first response phase European institutions acted as guarantors of the member countries' efforts. In March 2020, the ECB opened a protective umbrella by launching a vast temporary programme of government bond purchases (the *Pandemic emergency purchase programme*, PEPP), which in December 2020 was extended until the spring of 2022. Through successive upgrades the program went from €750 billion to a new total of €1,850 billion. Besides its size, it is notable because for the first time the ECB adopted a flexible approach to the self-imposed capital keys[7]: contrary to previous Quantitative Easing (QE) programs, the ECB did not buy bonds according to rigid ratios at each period, thus supporting more member states in immediate need (such as Italy and Spain); only at a latter moment it rebalanced the purchases,

[7] The capital keys forced bond purchases within the Quantitative Easing programme launched in 2015 to be proportional to countries' shares in the ECB capital. The Governing Council adopted them to dispel doubts of core Eurozone countries worried that QE would imply debt mutualization through central bank purchases.

so that at the end of the program, in March 2022, the capital keys will have been respected. The massive bond purchases contributed to keep sovereign interest rates down while deficits soared. Nevertheless, it is worth remembering, as the program nears to its end, and the ECB needs to navigate between temporary price increases, market expectations and geopolitical tensions, that together with central bank purchases it is the secular excess savings over investment that have kept (and will likely keep in the next few years) interest rates low and debt sustainable (Blanchard 2019; Summers 2016), as it will be discussed later.

The European Commission also acted quickly to support member countries. First, it activated the suspension clause of the Stability Pact, that will not be reinstated until 2023 (if it ever will; we will discuss the reform of European fiscal rules in section 0); then, it eased state aid rules so as not to hamper countries' fiscal efforts to support the sectors most affected by the pandemic.

European institutions also engaged in immediate financial assistance to Member States. In March 2020, the Commission made available €37 billion from the EU budget to finance urgent expenditure (mostly related to health care). In the meantime, with the Council it put together two loans schemes. The first, a €240 billion (2% of EMU GDP) pandemic line within the European Stability Mechanism (ESM) lending for health-related expenditure (from equipment to training of medical personnel to vaccines). The second is a newly created instrument, the €100 billion *European instrument for temporary Support to mitigate Unemployment Risks in an Emergency* (SURE). The working principle for the two instruments is the same: European institutions borrow at favourable rates and transfers the funds to member countries, which can therefore save on interest expenses. If the ESM pandemic line did not take off, SURE was highly demanded and in autumn 2020 it started lending; as of January 2022, it had committed €94 billion and disbursed €90 billion to 19 countries[8]. Last, but not least, the European Investment Bank (EIB) introduced a Pan-European Guarantee Fund to focus mostly on small and medium-sized companies with the capacity to lend up to €200 billion.

[8] There has been heated debate, especially in some countries, on the ESM pandemic line. Its failure to attract borrowers can probably be traced to the ESM nature: a sovereign bank created to pursue Eurozone financial stability and capable of imposing macroeconomic conditions to the countries it assists. Even if the pandemic line has lighter conditions, countries accessing it could at least in principle be forced into adjustment programs.

▶ 4 Towards the recovery

If Europe's role in the short term could only be limited to support member countries (as was done quite effectively), things change if we look beyond the emergency. As we are slowly putting the crisis behind us, we must tackle the challenges that the pandemic will inevitably leave behind. This means providing the 'global public goods' that are essential for a strong recovery in the long term, such as the transition to sustainable growth, the revival of public investment, digitalisation, and the rethinking of our welfare systems. Not even the largest European countries can hope to meet these challenges alone: the greater effectiveness of coordinated investment, economies of scale, and externalities are all factors that militate in favour of policies conducted, or at least financed and coordinated, at the European level.

This is what inspired the *Next Generation EU* (NGEU) program, which supplements the €1 trillion 2021-2028 European budget with a €675 billion 'Recovery and Resilience Facility' (RRF) and other extraordinary mechanisms, for a total of €750 billion. There has been much discussion about the innovative aspects of the instrument: it is the first time that the Commission issues debt for such significant amounts, to finance a vast investment programme that should reconcile the exit from the Covid crisis with the Union's long-term programmes (green growth, digitalisation, social cohesion).

In addition, resources are allocated to Member States not according to the usual keys, but according to the needs linked to the costs of the pandemic and to the severity of the crisis; this creates some sort of transfer among countries (risk sharing) that had so far been fiercely opposed by Germany and other so-called “frugal” countries (The Netherlands, Austria, Finland). It has been pointed out by many that Italy, usually a net contributor to the budget, will be a net beneficiary of the Recovery and Resilience Facility. Debt will be repaid starting in 2028 (until 2058), hopefully with European resources such as a Carbon border tax. If no progress is made on this side, each country's contribution to the EU budget will have to increase (of quite a modest amount).

Member countries had to prepare Recovery and Resilience programs following strict guidelines both on the destination of funds, such as at least 37% of investment in the green transition and 20% in digitalization, and on the definition of targets and milestone to facilitate ex-post assessment (European Commission 2020). The Recovery and Resilience programs were submitted in the Spring 2021 and approved by the Commission and by Council; after an advance paid in August 2021, the remaining funding will be granted after the Commission has verified respect of the milestones and compliance with the requirements.

Next Generation EU: A radical change but not yet a Hamiltonian Moment

There is little doubt that with Next Generation EU we are in the presence of a radical change: for the first time in its history, the Union is making a joint effort to boost recovery and growth, and the principle of debt mutualisation, albeit temporary, has been accepted. What makes the agreement even more significant is the position of Germany, which had never before agreed to introduce elements of risk sharing into European policies and which, this time, has put its full weight behind the Commission's initiative from the outset (Saraceno 2021). Nevertheless, the enthusiasm of those who speak of a Hamiltonian moment – i.e., of a founding act for a federal Europe - is not entirely justified, as we are still very far from a genuine common fiscal capacity.

Germany's historic green light was conditioned by the one-off nature of the NGEU, which does not take over existing debts (contrary to what the US Treasury did with Alexander Hamilton in 1970, for the debts of the American states after the War of Independence). Moreover, except for the plastic tax, there is not agreement

among Member States on the other common sources of revenues currently discussed (that would make it possible to avoid an increase in the contributions of the member states to the European budget), such as the taxation of multinationals, the Tobin tax, the carbon border tax. Remember that Hamilton financed the servicing of the newly created federal debt with customs tariffs and an excise duty on whisky and other spirits, the first U.S. federal tax. Finally, the Facility operates by transferring resources for investment programmes that will nevertheless remain national, as the Union does not currently have a spending capacity comparable to that of a federal state (Creel et al. 2020). Therefore, a truly European investment program is very far from being reality yet.

Lastly, the question of conditionality may become a problem. It was legitimate, indeed necessary, to introduce constraints on the allocation of funds, precisely because of the principle that NGEU is a joint effort aimed at common goals. This conditionality is to be welcomed because it will ensure the overall consistency of national plans and their compatibility with the work program that the Von der Leyen Commission has put in place in late 2019. Nevertheless, the conditions for accessing funding also require abiding by the "country specific recommendations" that the Commission addresses to Member States in the framework of the European Semester. Some fear that these may become, in a near future, a tool to condition access to funding to macroeconomic adjustment programs that would have no justification other than to perpetuate a concept of "permanent austerity" that still has too many partisans in Europe despite the disastrous performance during the sovereign debt crisis.

However, highlighting the grey areas of the Next Generation EU should not lead to neglect its innovative aspect, nor to forget that the EU has been effective in the face of the pandemic, supporting member countries in their emergency effort and launching a common programme to govern recovery in the medium term.

A tool for structural transformation

Only a few studies so far have attempted to assess the short-term macroeconomic impact of Next Generation EU, and they all concur that it will not be extremely large. Watzka and Watt (2020) only look at the grant component and, assuming it all goes in investment, they find a modest but significant impact on European annual GDP, of the order of 0.3% for each year of the programme (2021-2026). Other studies (e.g., Codogno and Van Den Noord 2020 and Pfeiffer et al. 2021)) find similar values. In all studies, the Eurozone average hides a very heterogeneous distribution between countries, with the Member States most affected by the pandemic, and the poorest ones in particular benefiting from a larger increase in production and employment than core countries. This is not surprising, given that peripheral countries have suffered major disruptions and have a larger share of the program's funds. In particular, Pfeiffer et al. (2021) focus on spillover effects between countries, arguing that individual countries' assessments overlook the fact that countries also benefit (through increased exports) from the stimulus of trading partners. The authors estimate that this spillover effect adds, on average, one-third to the direct impact of NGEU spending. The increase in GDP over the period 2022-2026 reaches over 4% in Greece, about 3.75% in Bulgaria, Croatia, and Romania, and about 3% in Italy and Portugal.

In all the studies the value of impact (i.e., short-term) multipliers, while positive, is not really macroeconomically significant. Far from being a surprise, this is consistent with the nature of the programme, whose main objective is to boost potential long-term growth through the financing of investment and reforms. These will be the metrics to assess whether the programme will have been a success.

5 The Challenges Ahead

The response of EU governments and policy makers to the Covid pandemics was bold and timely. Not only they did shield to the best of their capacities the economies from the pandemics; they also quickly designed a tool for the medium-term transformation of the economy centred on public investment and active government involvement. The question remains, as the two crises in a decade prompted a debate on EU reform, whether this activism is here to stay or whether it was just the product of the exceptional shock that hit the economy in 2020. This debate goes beyond Europe, of course, as the "Maastricht blueprint" has been seen in many countries as the path to growth and stability; an obvious example is of course the CFA franc Amato and Nubukpo 2020; Masson 2019). Furthermore, the shifting lifting lines in Europe have had an impact in multilateral forums already. The G20 finance ministers and central bank governors meeting of Riyadh, Saudi Arabia, in April 2020, took an unprecedented and quite proactive stance to fight Covid, which would not have been possible without a different approach from Germany.

Market risk sharing is not and cannot be enough

Following the Global Financial Crisis, the slider between the state and the market has shifted back towards the centre: many economists today have no problem recognising a role in macroeconomic stabilization for monetary and (especially) fiscal policies. In fact, the first twenty years of the single currency and the sovereign debt crisis have shown that markets cannot be relied upon for absorbing macroeconomic shocks and ensure long-term convergence. On the contrary, they sometimes row in the wrong direction. That was evident during the Eurozone crisis, when destabilising capital flows deepened the structural differences among the members of the eurozone, increasing asymmetry of shocks. However, it was also evident during the first decade of the single currency, when excessive capital flows from the core to the periphery of the Eurozone, and misallocation of expenditure in the latter, contributed to large current account imbalances and the build-up of net foreign liabilities. Far from being benign, as some at the time argued (Blanchard and Giavazzi 2002), these imbalances eventually led to capital flights out of peripheral EMU countries and to the sovereign debt crisis. Therefore, no matter how hard individual countries may push their reform efforts, exclusive reliance on markets will necessarily be unwarranted: part of the burden of adjustment following whatever exogenous shock may hit the economy must necessarily fall on the shoulders of public policies. In fact, Farhi and Werning (2017) show how the presence of externalities makes it impossible a full stabilization through market forces, even when capital markets are complete. Responsible investment that minimizes risk through portfolio diversification is beneficial to the saver as well as to the financial system as a whole, which will be stable and more resilient. This is a typical positive externality and, as it always happens in these cases, savers do not incorporate into their choices the positive effects of diversification on other savers, at home and abroad. Therefore, they do not differentiate their portfolio in a socially optimal way, and stabilization/insurance cannot be not complete. In this case, the existence of a fiscal stabilization mechanism can lead to greater international diversification of portfolios, and thus to "internalize" the benefits of risk sharing through markets. A fiscal transfer mechanism, in other words, would be useful not only because of the direct impact on the stabilisation of asymmetric shocks, but also because it would make market risk sharing more effective. Market and government risk sharing therefore would be complementary. In light of this theoretical result, the empirical findings by Alcidi et al. (2017) are not surprising[9]: even in the United States, a monetary union characterized by strong flexibility and high factors' mobility, macroeconomic policies (in particular risk sharing operating through the federal budget) play a central role not only during crises but also in normal times.

[9] Their results confirm the seminal ones by Asdrubali et al. (1996) and Sachs and Sala-i-Martin (1991). Dullien (2019) recently argued that this stream of literature likely underestimate the role of Government risk sharing; therefore, the results by Alcidi et al (2017) should be seen as a lower bound.

The coronavirus crisis makes it even more evident that only real mutual insurance mechanisms, typical of a federal budget, could make it possible to guarantee stability and growth by operating alongside (and sometimes in place of) market adjustments. Of course, the federal budget cannot exist without a federal state, and it is obvious that the United States of Europe is today little more than a chimera. Yet, the existence of an ideal solution, however utopian, serves as a benchmark against which to assess the desirability of the many reform proposals that are discussed: any institutional change that acts as a surrogate for a properly federal structure must be encouraged as a means to ensure convergence.

As the consensus in macroeconomics shifts away from the emphasis on markets as the main drivers of both short-run macroeconomic stabilization and investment for long-term growth, the lack of fiscal capacity in the EMU becomes blatant. The European budget and within it structural funds represent a tiny fraction of EU GDP, and they only serve (somewhat successfully in some cases) the objective of catching up of lagging regions. No central capacity for short-term countercyclical stabilization exists in the EU, nor in the Eurozone. At the same time, the EU fiscal rule strongly constrain member states, that need to balance the structural budget and *de facto* can only let automatic stabilizers play. Even if the European fiscal rules never yielded actual sanctions in spite of the numerous infringements, for the first twenty years of existence of the single currency their very existence was capable of constraining governments' action through peer pressure and a general reprobation attached to fiscal policy activism (Fitoussi and Saraceno 2008).

The absence of a fiscal capacity, be it at the centre or at the Member State level, has over time been compounded by a loss of consistency of the EU framework. The European treaties are consistent with a social contract that gives importance to the insurance role of the government through the welfare state; a system in other words, where automatic stabilization plays an important role. In the US, on the contrary the social contract gives a low weight to the insurance role of the government. Coherently with this democratic choice, discretionary macroeconomic policies in the US are active to smooth income fluctuations. In other words, two equally legitimate and consistent systems can be designed: one in which a marginal role for the welfare state is compensated by active discretionary fiscal and monetary policies (the US); or a European treaty-consistent one in which constraints to discretionary policy go hand in hand with a role for automatic stabilization. Creel and Saraceno (2010) show nevertheless that the EMU has gradually evolved towards an inconsistent framework, dismantling its social insurance system, while it tightened the constraints to macroeconomic policies.

A well-functioning common currency needs to resolve the inconsistency and endow itself with appropriate tools for implementing fiscal policies. The remainder of this section will explore some possible avenues to that end.

A central fiscal capacity

Looking at the experience of the United States, the most effective way to endow the eurozone with the capacity to implement fiscal policy is to create a fiscal capacity at the central level. Next Generation EU could be a first step towards such a European fiscal capacity. Hopefully European countries will be able to use the Recovery Facility to revive the economy, channel the resources efficiently into a green and digital transition that can no longer be postponed and transform the Union into a dynamic knowledge-based economy. The success of the NGEU package could pave the way for a discussion on the next step, the creation of a permanent fiscal capacity. It would not be the first time that temporary instruments have acted as icebreakers and led to innovations in European governance. The Recovery Facility possesses (albeit at an embryonic stage) the characteristics of a federal-type ministry of finance: its own borrowing capacity, a (prospective) ability to finance itself from its own resources, an allocation of resources that combines the needs of individual countries with the pursuit of common goals such as the ecological transition and digitalisation. Speculative attacks on sovereign debt, and the risk of free riding by national governments, so feared by the "frugals", would be greatly reduced if the eurozone were to equip itself with such an instrument.

While it would be a first best in terms of efficacy (for example in dampening asymmetric shocks), a central fiscal capacity would be quite difficult to put in place, even abstracting from the scepticism of some Member States worried by the possibility of free riding and moral hazard. The creation of a European capacity to tax and spend would require finding a solution to several interconnected problems: how to ensure the accountability in front of voters (once again, *no taxation without representation*), the coexistence of "federal" instances with local ones, division of tasks and determination of accountability across various levels of decision-making. These are all difficulties that could be swept away by the creation of a truly federal fiscal policy body, an option that nevertheless will most likely remain non-viable for the foreseeable future. In the absence of a political union, the creation of a central tax-and-spend capacity will need to be thoroughly weighted and framed in the appropriate legal framework.

While waiting for the political conditions for a permanent Recovery fund to be reunited, a possible surrogate of a federal budget could be represented by a European unemployment benefit scheme, which has been discussed since the 1990s at least (among the many proposals, see e.g., Andor 2016). The scheme could be designed in different ways. A common feature of all proposals, including the one by the European Commission (2013), is that the European subsidy would supplement the national benefits in case of large deviations in the unemployment rate from a country-specific reference value. Hence, it would be a contingent scheme that would intervene only in the event of significant shocks, and it would be additional to, and not a substitute for, national benefits. This feature is crucial in a non-federal system because it would leave to the social contract within each country to decide how much and for how long to protect workers from unemployment. No country would be able to take advantage of the scheme to abolish or reduce the level of its benefits and replace them with support from the EU. Attempts to simulate the stabilisation capacity of such a mechanism reach two conclusions: first, the effect in terms of GDP stabilisation would be limited at the European level but significant for individual countries, which is not surprising since the mechanism is specifically designed to absorb asymmetric shocks; second, as it should be, the stabilisation capacity increases with the severity of the shock. The European unemployment benefit system could be designed in such a way that it does not lead to permanent transfers, for example by introducing clawback mechanisms that would automatically adjust the contributions of individual countries. Such a contingent scheme, designed to absorb asymmetric shocks, could then be complemented by a permanent version of SURE, allowing the Commission to borrow to finance the European benefit in case of common shocks.

Public finances' sustainability and investment: Reforming fiscal rules

The discussion on the creation of a fiscal central capacity, or at least of a joint stabilization mechanism, rages among academics and policy-makers; nevertheless, it is still quite far from becoming a priority in the European political agenda. On the contrary, the next few months will see a heated debate on the reform of the Stability and Growth Pact. It would be simplistic to say that European fiscal rules forced the season of austerity after 2010. This was the result of a vision that traced financial instability and the debt crisis back to the profligacy of southern Eurozone countries, whereby, with or without the existing fiscal rules, European countries would have walked that path anyway. Still, the institutions for European macroeconomic governance were consistent with that turn to austerity and, as demonstrated by the management of the Greek crisis, provided the appropriate instruments to pressure even the most recalcitrant governments.

The activation of the suspension clauses of the Stability Pact in March 2020 was motivated by the pandemic that was just starting; however, the Commission had already, just a few weeks earlier, opened a consultation process on the reform of the rules; an assessment which was based on a surprisingly severe assessment of the existing framework[10]. The Commission finally took on board the criticisms that had been unanimously voiced by independent economists for several years: (a) the current framework was overly complex,

[10] European Commission, 'Communication on the Economic Governance Review', February 5, 2020; The communication took on board the recommendations of the European Fiscal Board (2019).

arbitrary, and difficult to enforce; (b) the rules allowed to control deficits, but much less debt, which was the true threat to public finances' sustainability; (c) public investment, which is generally easier to reduce than current spending, had been penalised at least since the Global Financial Crisis; (d) finally, the Commission acknowledged for the first time that the current framework was pushing many governments to implement procyclical fiscal policies, reducing spending when the economy was slowing down (particularly between 2010 and 2013). In short, between the lines the Commission acknowledged that European rules had made fiscal policy a factor of instability rather than stabilisation.

The consultation process was suspended by the Covid emergency, but in the early Summer 2021 Commissioner Gentiloni relaunched it, while announcing that the Stability Pact suspension clause would remain activated at least until all of 2022. It is highly likely that the existing rules will be replaced before they come back into force, especially in light of the geopolitical developments of the Spring 2022. The Commission is expected to table a proposal in the fall of 2022.

The reform process comes at a moment in which public investment is at the centre of the stage. The gap in public capital is evident in European countries as well as in other advanced economies and is compounded by the future needs related to the ecological and digital transition. A big push in public investment was the most notable feature of the recent coalition agreement in Germany: The Green Party managed to obtain an acceleration of the exit from fossil fuels, brought forward to 2030 (from 2038) when 80% of the electricity supply will have to be ensured by renewable energy. This will require colossal public investment (estimated at least 450 billion euros over the next ten years, see Dullien et al. 2020). The discussion on European fiscal rules, therefore, inevitably intersects with the revived body of literature on the impact of public investment. Going into the details of this research is beyond the scope of this paper (for a detailed review see Durand et al. 2021 and the meta-analysis of Gechert and Rannenberg 2018). Nevertheless, the main results can be summarized as follows: (a) public investment multipliers tend to be lower than current expenditure ones as it concerns their immediate impact, but are larger over the medium-to long run. (b) All fiscal multipliers are much larger in case of economic downturns and negative output gaps; a result long known (see, e.g. Creel et al. 2011) but blatantly overlooked during the EU austerity phase of 2010-2014. (c) Multipliers are larger when monetary conditions are accommodative (either with a proactive central bank or at the zero-lower-bound). (d) Last, but not least, the multiplier is smaller in open economies due to leakage. A well-known textbook effect, which calls for economic policy coordination and for privileging joint cross-border investment programs such as Next Generation EU.

Considering the revival of public investment in the academic and in the policy agenda, it is not surprising that most reform proposals (for a few examples, see Dullien, Paetz, et al. (2020) Darvas and Wolff 2021 and Giavazzi et al. 2021) revolve around one form or another of a Golden Rule of public finances similar to the one introduced in the UK by the Chancellor of the Exchequer Gordon Brown in the 1990s, and applied until 2009 (for details, see Creel et al., 2009). The key idea is to constrain current expenditure (either by balancing it with current revenues or by an expenditure rule linking it to GDP growth), while financing public capital accumulation with debt (the increase in liabilities would be in fact matched by an increase in assets). Investment expenditure, in other words, would be excluded from deficit calculation, a principle that is timidly applied already in the "flexible approach" adopted by the Commission since 2015 (European Commission 2015). Such a rule would stabilize the ratio of debt to GDP, it would focus efforts of public consolidation on less productive items of public spending and would ensure intergenerational equity (future generations would be called to partially finance the stock of public capital bequeathed to them). Last, but, especially in the current situation, not least, putting in place such a rule would not require treaty changes.

The golden rule is not a new idea, and in the past it has been criticized (see e.g. Balassone and Franco, 2000) on the ground that it introduces a bias in favour of physical capital and penalize certain expenses, for example education and health care, that - while classified as current - are crucial for future growth. This criticism, however, can be turned into a strength, by making the choice as of whether a specific expenditure item is useful for future growth, a political one. The idea is to abandon the accounting definition of investment in favour of a functional one: investment should be whatever increases the material or immaterial public capital stock. Dervis and Saraceno (2014) and Saraceno (2017a) propose that at regular intervals,

for example in connection with the European budget negotiations, the Commission, the Council and the Parliament could find an agreement on the future priorities of the Union, and make a list of areas or expenditure items (regardless of whether they are classified as current or capital) exempted from deficit calculation for the subsequent years. Joint programs across neighbouring countries could be encouraged by providing co-financing (for example by the European Investment Bank). This "augmented" Golden rule would in fact mark the return, on a European scale, to industrial policy, a political and democratic determination of the tools to mobilize for reaching the EU long-term growth objectives. The entrepreneurial State (Mazzucato 2013), through public investment, could once again become the centrepiece of a large-scale European industrial policy, capable of implementing tangible as well as intangible investment. Waiting for a real federal budget, the bulk of investments would remain responsibility of national governments, in deference to the principle of subsidiarity. But the augmented Golden rule would coordinate and guide them towards the development and the well-being of the Union as a whole.

Dervis and Saraceno argue that the implementation of a golden rule of this kind would serve the purpose of focusing on the nature and quality of public spending in relation to the growth objective. It would also force European policymakers to have a periodic and transparent discussion on the investment needs of their economies, and to coordinate policies as part of a process that would increase participation, cohesion and legitimacy in the Eurozone. Ducoudré et al. (2019) further note that the EU already has a process, the European Semester, that so far has been mostly geared towards monitoring fiscal discipline of Member States, overlooking the role of coordination. An increased role of political negotiations in determining the objectives of the EU and the contributions of individual States might happen within the European Semester that would therefore finally become the macroeconomic policies' coordination device that the EU has been missing.

Whatever reform proposal will eventually gather the consensus of EU governments, it is essential to protect national public investment from the injunctions of European fiscal rules if European countries are to support the public investments needed to boost their economies and face the challenges of climate change and digitalization. It is likely that the Commission will converge towards a reform proposal that excludes at least part of investment expenditure from the deficit calculation, including expenditure related to the ecological transition and the Green Deal (the Commission's proposal could resemble the proposal made by Darvas and Wolff 2021). This is welcome news. Yet this "green" Golden rule would narrow (rather than extend it to social capital) the definition of investment; therefore, its inception might not provide the fiscal space that Member States will need to face the challenges of the next decades.

Managing public debt: From solvency to sustainability

The response to the pandemic has led to a massive increase of public debt across advanced and emerging economies (IMF 2021). This will be compounded by the massive investment needs of the next decades. How to manage such a large stock of debt and minimize its potential threat to global financial stability, will be one of the challenges of the next decade.

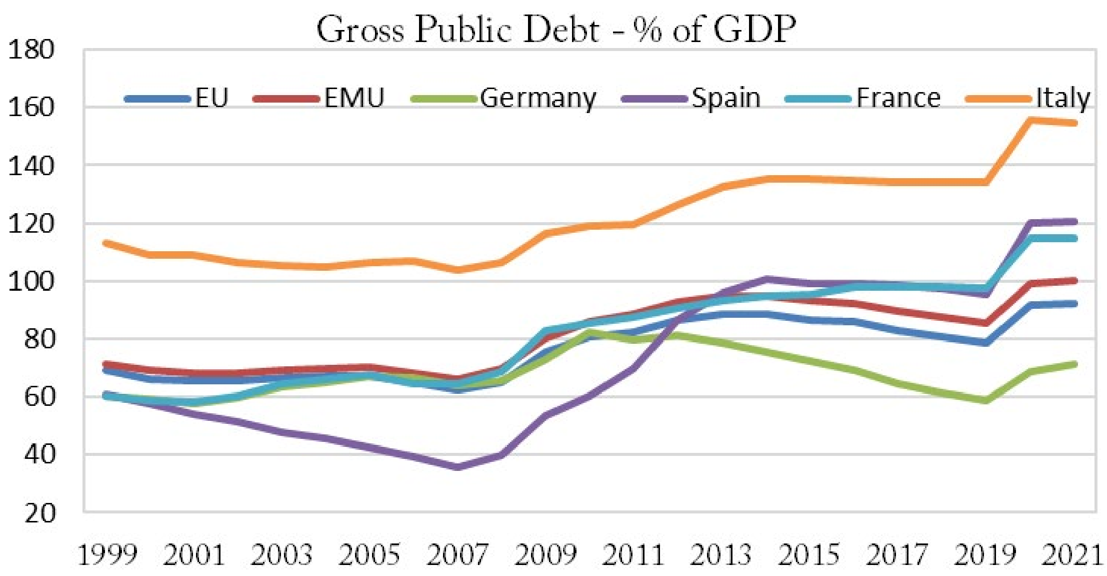
In past sovereign debt crises, the debate was dominated by the idea that governments need to ensure the sustainability of public finances by keeping revenues in line with expenditures and by repaying past debt, as any good household would do, in order not to mortgage the future of its children. This narrative was the economic (when not moral) support of austerity policies. Nevertheless, historically very few governments have repaid their debt. The good household narrative is flawed because it neglects the perpetual nature of the government that can indefinitely refinance its debt as long as it is capable to service it (i.e., pay the interest). Said differently, a government, contrary to a household who eventually will come to the last period of its life and repay its debt, does not need to be solvent (Eichengreen et al. 2021).

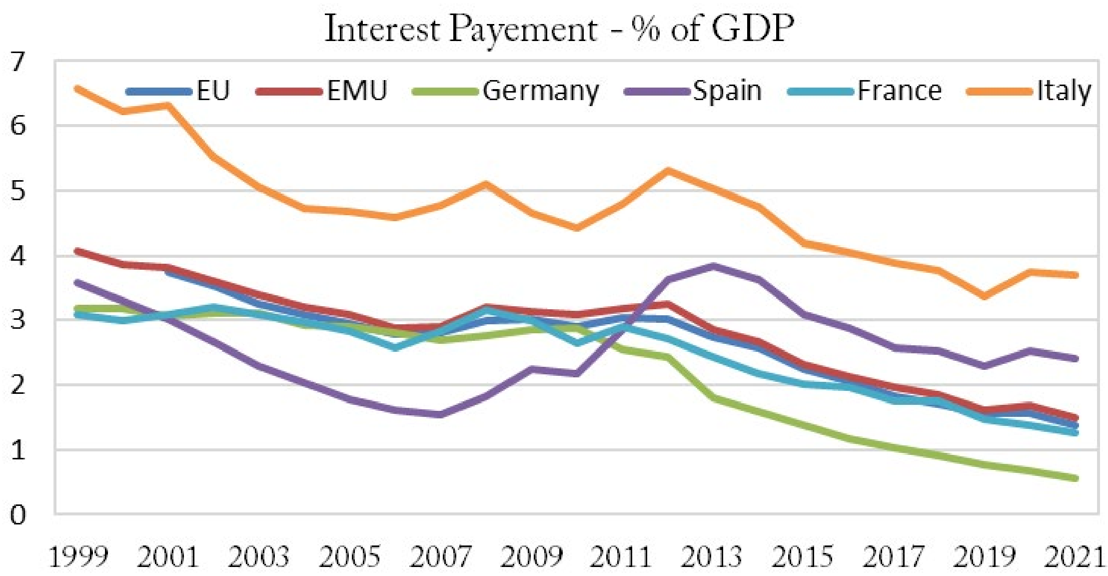
Therefore, what matters for governments is sustainability, i.e., the capacity to service the stock of debt, that crucially depends on the interest rate it pays and on its capacity to generate resources (the growth rate of the economy). A notable feature of advanced economies in the past decades, has precisely been that

interest rates have been generally lower than growth rates, thus avoiding explosive debt paths even in the presence of persistent government deficits (Blanchard 2019).

Since the beginning of the nineties, nominal interest rates have fallen significantly in almost all industrial countries; more importantly, they have fallen to a greater extent than inflation. The result is a fall in real interest rates that has helped alleviate the debt burden. The apparent rate, the ratio of interest expenditure to public debt, has fallen despite a major increase in debt; this has shown in a drop of the interest payment to GDP ratio, and it happened not only in virtuous countries but also in those where public finances are most fragile (Figure 4).

▶ **Figure 4: Debt and interest payments as % of GDP**





Source: European Commission - AMECO

Recent literature has leaned on this long-term trend on the one hand to try to understand its reasons, on the other to try to evaluate its persistence. In a standard theoretical framework, the natural interest rate leads to the equilibrium of savings and investments at the level corresponding to full employment; its downward trend therefore indicates, in general terms, a context of excess of the former over the latter. This rate is estimated by many economists to be zero or lower for the majority of advanced economies, which since 2009 at least have been in a situation of zero lower bound (Rachel and Summers 2019; Ragot et al. 2016). What are the reasons for this chronic excess of savings (which in fact is another way of saying that there is a chronic shortage of demand)? Since the late 1980s, and even more so since the early years of this century, world savings have increased significantly. The reasons for this increase are manifold, from the recent increase in uncertainty and financial instability to the aging of the population, passing through the increase in inequality (which redistributes incomes to those who save the most) and the increase in private debt (which pushes to increase savings to meet future payments). In advanced countries, this increase in savings has been accompanied by a significant reduction in investment. Firstly, as we saw above, public investment; then, to an almost equal extent, private investment, the decline of which can be traced back to the slowdown in productivity (Gordon 2016)[11], the financial fragility of companies, the uncertainty that has compressed the "animal spirits". True, the decline in investment is a phenomenon linked only to advanced countries, and globally it has been offset by the boom in emerging and low-income countries. However, the savings of the latter, in search of "safe assets", have mostly been directed towards the financial markets of advanced countries, helping to widen the gap with investment, and, therefore, the deflationary trend against which central banks have been fighting for at least a decade.

Inflation, and central bank interest rates: Much ado about nothing?

Starting from the spring 2021, with the post-pandemic recovery, inflation in both the US and the eurozone increased well beyond the 2% central banks' target. These, however, did not rush into a policy reversal. The Fed is preparing for a gradual tightening in 2022, and the ECB has no plans to raise rates until 2023[12]. This caution is mainly explained by the belief that the spike in inflation is temporary and specific to some sectors. As the economy rebounded after the pandemics, in early 2021, on one side confidence returned; and on the other a part of the large mass of savings accumulated in 2020 (partly forced and partly precautionary) has poured into the markets in the form of demand for consumption or investment by firms. The fiscal stimulus plans, especially in the United States, compounded this increase in private demand. Nevertheless, supply has struggled to follow demand. First, during the pandemics there were bankruptcies and destruction of productive capacity, although minimized by public aid. Then, even for companies and sectors in which the activity has continued, the pandemic has disarticulated the production process. Supply chains have deteriorated with the crisis and need to be rebuilt when not outright reinvented; this created sectoral bottlenecks that slow down the recovery and contribute to the temporary surge in inflation (Celasun et al. 2022). In addition, the pandemic has created new needs (for example related to smart working) to which the offer is adapting with difficulty; think of the semiconductor sector for which production fails to adapt quickly to the explosion in demand. These distortions have had an impact on energy and commodity markets and the production and delivery of some industrial goods, whose price increases have in turn contributed to inflation and sectoral bottlenecks (Celasun et al. 2022).

In short, we are still far from the smooth functioning of the markets before the pandemic, which should not be surprising given the nature and violence of the shock that has hit the world economy. However, there is no reason to believe that the distortions and bottlenecks we are witnessing will lead to a permanent

11 This "supply side" secular stagnation view does not make unanimity; for a contrarian view see for example Phelps (2013).

12 As I write this paper (March 2022), the war in Ukraine is provokin a spike in energy prices and a downward revision of growth forecasts. The central bank normalization strategies will certainly be affected by these developments.

increase in inflation. First, because the institutions that favoured the de-anchoring of expectations and the price-wage spirals of the past are not in place anymore (no European country has today a mechanism to index wage increases to inflation). If anything, besides temporary wage hikes in some countries or sectors, we still see wages that barely keep up with productivity growth. Second, while it is almost certain that the organization of production processes and the sectoral distribution of activity that will emerge at the end of this adjustment phase be somewhat different from those we are used to,. nothing tells us that there will be persistent inflationary pressures in this new world. On the contrary, all the forces that have compressed inflation in recent years are bound to weigh as much if not more than before: macroeconomic and geo-political uncertainty, an ageing population, growing inequality and wage compression, precariousness in labour markets, the growing burden of debt (public and private), the slowdown in technical progress and innovation. All this has pushed in the past, and will push in the future, to an increase in savings rates and to stagnant investment. The current low interest rate environment is likely to continue.

Solving the trade-off between fiscal discipline and risk sharing

The overall favourable conditions for debt financing and sustainability do not mean that there are no longer any constraints on the increase in debt in individual countries. Even if the general environment is likely to remain one of low rates and cheap money for the next decade, EU countries may find themselves sanctioned by markets, either because of unsound management of public finances or because of speculation and financial markets turmoil. This is why it is important that rules effectively reconciling fiscal discipline with renewed fiscal space (as discussed above) are complemented by tools aimed at protecting Member Countries by unwarranted market pressure. The crucial trade-off for a monetary union is between fiscal discipline and the efficiency with which they manage to *collectively* interact with financial markets. It is a question on the one hand of minimising moral hazard, and on the other of finding a cooperative or at least coordinated way of accessing capital markets by leveraging not on the default risk of individual states, but on that of the monetary union as a whole. In the eurozone this trade-off has so far not been solved, so that we have the paradox of a strong and stable currency coexisting with a persisting risk of market runs on sovereign debt. With Mario Draghi's (2012) "whatever it takes" speech, followed by the Quantitative Easing bond purchases programme started in 2015, the ECB took on the role of insurer of individual countries' solvency; but this came at the price on one side of strong political tensions between the "frugals" and the ECB itself; and on the other side of constraints to the bank capacity to carry on "normal" monetary policy: as I write (March 2022) while deciding the appropriate stance to confront inflationary pressures and to deal with geopolitical instability, the ECB cannot abstract from the impact of its actions on the yields of peripheral eurozone countries' sovereigns.

A federal treasury would be an obvious, as well as today politically unrealistic, solution to the trade-off. In its absence, however, it is possible to think of a "synthetic treasury", issuing Eurobonds to then finance member states while maintaining a differentiated treatment according to the credit risk of each of them. Amato et al. (2021) give all the details on the working of such a *European Debt Agency* (EDA), while Amato and Saraceno (2022) develop its policy implications. In a nutshell, the EDA would issue bonds on financial markets and use them to finance Member States with perpetual loans, freeing them from refinancing risk. To avoid free riding and irresponsible behaviour, the instalments paid by Member Countries would be based on fundamental risk, and on compliance with fiscal rules (whose monitoring would remain with the Commission); the EDA therefore would only deal with the pricing of payments, while the somewhat political task of allocating Member States to different risk classes would be the exclusive competence of the Commission and of the Council.

By issuing a common bond that would be a (badly needed) European safe asset, the EDA could act as a key factor in reducing systemic uncertainty, thus stabilising market expectations on overall debt sustainability. In the meantime, it would align the cost of debt with the 'fundamentals' of each Member State, so it could allow the adoption of rules giving to states more leeway, without sacrificing neither fiscal discipline at the national level nor the financial stability of the Union.

While the idea of an EDA may seem at first sight quite unorthodox, it has several characteristics that may make it politically viable. The first and more important is the absence of mutualization, that would de facto eliminate incentives to free ride or moral hazard[13]. The second is that substituting the ECB in financing the Member States it would facilitate the normalization of monetary policy, that could go back to its core business. Then, the bonds issued by the EDA would constitute a safe asset and help the Euro acquire a role in line with the economic power of its economy. Last, but not least, the EDA could be designed to support and efficiently manage public debt with any type of fiscal governance, be it (as discussed above) a central fiscal capacity or a renewed role for national fiscal policies. In a complex (political and institutional) setting like the European one, this seems an important point in favour of the proposal.

A broader role for the ECB

The process of rebalancing the respective role of markets and government in managing the economy cannot leave out a rethinking of monetary policy. The review of the monetary policy strategy announced in July 2021 (European Central Bank 2021) finally dispels the technocratic illusion that monetary policy could be conducted with only the objective of price stability in mind. Since the 2008 crisis it has been evident that the choices of the ECB had implications that, for better or for worse, went far beyond inflation. Although cautiously, the new strategy implicitly formalizes the non-technocratic role of the ECB (Islam and Saraceno 2015).

As we have seen, The ECB statute dates to the period when the consensus in macroeconomics postulated that a central bank should only address inflationary risks and that these were related to the quantity of money in circulation. Within this framework, growth and convergence (e.g., between euro area economies) were the prerogative of supposedly efficient markets that from the public sector would only require an appropriate environment: stable prices to avoid surprises, public finances under control, structural reforms to limit distortions that hindered the efficiency of markets. These beliefs underpin the European institutional architecture based on a limited interaction between monetary and fiscal policies, an independent central bank, and a constant emphasis on controlling inflation in the tradition of the German Bundesbank. This is why for most of the twenty years of existence of the single currency, economic policy has had an asymmetrical behaviour and a fundamentally deflationary impact on the economy: always ready to tighten at the slightest sign of overheating and much less reactive in case of a slowdown.

The 2008 crisis challenged the consensus, and it became evident that stagnant prices and deflation are as pernicious to growth as excessive inflation, but much harder to fight. If, to cope with excessive price increases, the central bank can always increase rates and curb aggregate demand, to combat the tendency to stagnation and deflation it is constrained by the zero lower bound. This is why in recent years all central banks have had to resort to unconventional policies such as massive purchases of securities or the provision of long-term liquidity to the banking sector); and that is why central banks have invoked (sometimes, as in Europe, implored; see the already mentioned Draghi Jackson Hole speech, in 2014) the help of fiscal policies.

All the major central banks have in the recent past reassessed their strategies noting that, as we saw above, deflationary risks in the coming years will persist. Recently the US Fed adopted an average inflation rate target that requires it to pursue an inflation target above 2% after a period in which it has been consistently lower. The ECB has not been so radical[14]: it dropped the old target of inflation below, but close to, the (impassable) ceiling of 2%, to adopt a symmetrical targeting whereby inflation can remain above (but close to) 2% following periods of stagnant growth and prices. While it is true that an average inflation target would have been a more marked departure from the old strategy, the adoption of a symmetrical objective should contribute in the future to reducing the structurally deflationary stance of monetary policy. The ECB's change

[13] The reader should be aware that the design of the rule would be of paramount importance. Giavazzi et al. (2021) also propose a Debt Agency, for managing exclusively the Covid debt. Their scheme, nevertheless, does not avoid debt mutualisation for the part of the debt taken over, while it creates risks of instability for the remaining national debts (the so-called juniority effect); it is therefore much less viable in the current political environment.

[14] For a thorough analysis of the (mostly) macroeconomic impact of the strategic review, see Reichlin et al. (2021)

of direction is further reinforced by the abandonment of the monetary aggregates' growth target. This is a technical point, which is also made irrelevant by the fact that in the past the objective has often been disregarded without too much stress. However, the symbolic significance of dropping it is important, since the focus on monetary growth targets is a legacy of a monetarist period in which prices and the quantity of money were believed to be strongly correlated, giving the central bank alone the task of controlling inflation. Today, the ECB joins other central banks in recognizing that the link between the quantity of money in circulation and inflation is tenuous and that to bring inflation to the targeted levels requires cooperation between monetary and fiscal policies.

The latest sign of the formalized "politicization" of European monetary policy is the abandonment of the so-called market neutrality, which required not to use valuations other than the effect on inflation in deciding the types of securities to purchase. From now on, the ECB will contribute to a European green industrial policy by embedding the threats to financial and price stability into its policy analysis and by favouring purchases of "green" bonds aimed at financing investments in the ecological transition. Again, it is not the first nor the most daring of central banks to have embarked on a green strategy (see Bank of England 2021 for a bolder approach) and there is little to be expected in terms of macroeconomic or structural impact. However, the change of perspective is radical and must be emphasized.

The ECB strategic review simply formalizes a change in the bank's objectives and instruments that has *de facto* already happened since the sovereign debt crisis, when in several occasions the central bank had to stretch its mandate to make up for the inertia of EMU governments (Saraceno 2016). Of course, it would have been preferable to embrace in full the lessons from the past, and that the ECB opened a discussion on abandoning inflation targeting in favour of a dual mandate (Friedman 2008; Saraceno 2013)[15]. Nevertheless, with the strategic review the fiction of a technocratic monetary policy has been definitively abandoned. In the future, the monetary policy stance will be determined by a political balancing act within the ECB itself and in coordination with government's fiscal policies.

[15] The ECB could not adopt a dual mandate simply through a strategy review. For that, a Treaty change would be needed. However, the bank could have put the issue on the table and opened the debate with the Council and with the Commission.

Conclusion

The Covid-19 crisis turned around the economic policy debate in Europe. Guiltily clinging to the old consensus, during and after the sovereign debt crisis, European policymakers had opened up as little as possible to the debate raging among economists on the role of economic policy as an engine of macroeconomic stabilization and long-term growth as well as on the best institutional set-up for the single currency. The pandemic swept away those hesitations. In the Spring of 2020, in a matter of a few weeks the EU introduced instruments for common crisis management and for boosting the recovery that could, if successful, lead to a reorganisation of European public policies (especially macroeconomic policies) quite different from the one that showed so many shortcomings during the sovereign debt crisis. Interdependence and the need for risk-sharing mechanisms are now becoming obvious, even in Brussels and Berlin, in fields such as health, public investment, the ecological and digital transition and the management of asymmetric macroeconomic shocks.

The debate on rethinking macroeconomics is far from settled, but a consensus is emerging on the fact that fiscal policy is back in town. Today, as we discussed above, EU institutions do not provide room for it, thus being clearly at odds with the *esprit du temps*. To equip European countries with a stronger "collective" fiscal capacity to react to shocks and foster growth and convergence, different paths can be taken. It can be decided to create such a fiscal capacity at central level, providing the EU governing bodies with a spend-and-tax capacity to be put at the service of countercyclical expenditure, investment, and favouring convergence; if that choice were made, individual states would be unburdened, and fiscal rules might not be much looser than they are today. Such a choice would follow the model of the United States (and in general of federal states), where individual states have strict balanced budget constraints, but the federal government uses the fiscal lever actively and without constraints other than market pressure. The alternative would be to remain in a setting quite like the existing one, with limited spending capacity and revenue collection at central level. In such case, nevertheless, a radical overhaul of the Stability Pact would be needed, to provide Member States with the fiscal capacity needed for macroeconomic regulation and investment. The most promising solution would be, as argued above, the introduction of an augmented golden rule, protecting tangible and intangible public capital. As this working paper tried to show, both choices have pros and cons, and which way will the EU go will eventually depend on political equilibria. What is clear is that fiscal policy needs to make it back in the toolbox of European policy makers.

The last, but not least important, message of this essay is that the return of fiscal policy needs to be framed within in a major overhaul of EU institutions. Better and more credible fiscal rules, the joint management of debt through a Debt Agency capable of minimizing borrowing costs while keeping government accountable and a less technocratic ECB would be parts of a consistent and renewed system of macroeconomic governance capable of providing space for policy action while avoiding instability and opportunistic behaviour.

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