Unfit for the Future: The EU Facing a Governance Challenge

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The End of US-Led Multilateralism

- The «Trente Glorieuses»: Growth for everyone and shared prosperity
  - ~~The social contract: a regulated capitalism~~
    - ~~Keynes: Virtuous interaction between State and the market~~
    - ~~Massive (public and private) investment~~
    - ~~Redistribution for efficiency~~
    - ~~Regolamentazione dei mercati finanziari~~
    - ~~Governed globalization (Gatt-WTO)~~
- The “art of the deal”. Peace and protection in exchange for trade and economic subordination
- 1980s: The end of the old world

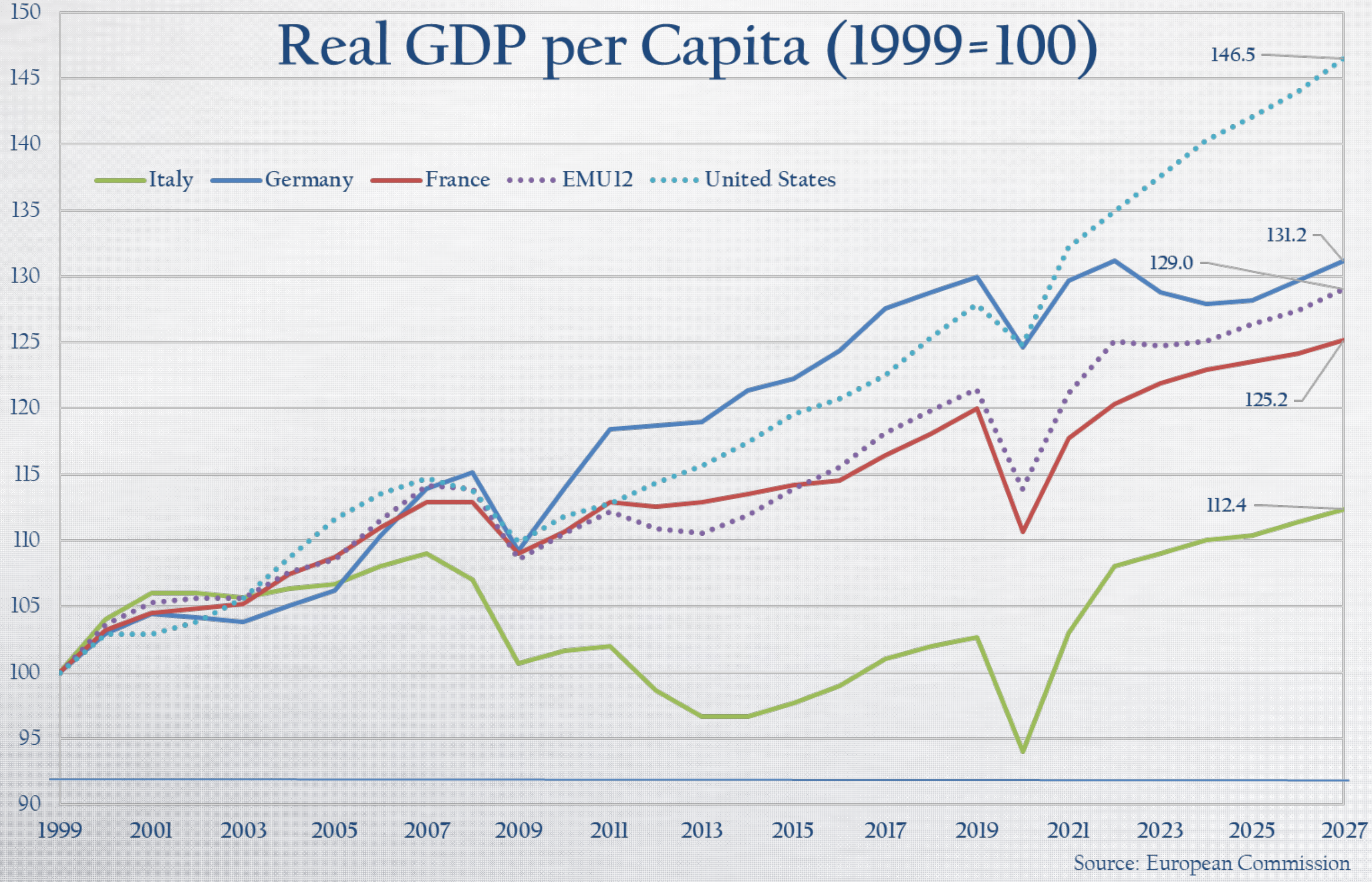
From Multilateralism to Hegemony to Competition

- 1980s, the end of the old world
  - Great "Moderation" and the end of Redistribution: Inequality
  - The myth of market efficiency: deregulation
- The United States continues to benefit from the system (the Washington Consensus), which with the end of the USSR from cooperative becomes hegemonic
- The 2000s: the toy breaks down
  - Polycrisis (from GFC to geopolitical disruption)
  - The arrival of China
- The US does not win anymore and starts to opt out
  - Common thread of all administrations since 2000
  - Trump accelerates the tendence that was already there

Europe at a Crossroads

- The geopolitical challenge
  - The end of multilateralism. Competition with "friends" and foes (not a Trump Phenomenon)
  - China and the BRICs
  - Military expenditure
  - Dependency (energy, military, etc.) as vulnerability
- The Structural Transformation
  - Ecological and digital transitions
  - Inequality and social capital deterioration
- These challenges are grafted onto a structural problem of the European economy

The Growth Gap



Why the divergence? The Letta and Draghi Reports

- A structural growth deficit that is due to a **productivity** gap
- Weak leadership in digital technologies (AI, cloud, semiconductors)
  - Only 4 EU tech firms in global top 50 by revenue. No unicorns
  - Skills mismatch and shortage in digital and tech competencies
- **Fragmentation**
  - Fragmented Single Market limits scale and innovation
  - Absence of a true Capital Markets Union hinders private funding
- Excessive and overlapping **regulation** slows down innovation
- **Strategic dependency** for raw materials and tech infrastructure
- EU lacks a coordinates industrial and investment strategy
  - R&D investment insufficient and poorly targeted
  - **Public and private investment largely insufficient**

What Draghi doesn't say: the doctrinal roots of the European decline

- 1970s Oil shocks, stagflation, and the crisis of Keynesian theories
- 1990s, *The New Consensus*: Markets are **fundamentally efficient**
  - The economy fluctuates around a **natural equilibrium** that it can achieve without help from economic policy
  - **Structural reforms** (eliminating market imperfections) are the main tool for growth and resilience
  - **The only role for macroeconomic policy**: nominal stability
    - Monetary policy needs to keep inflation expectations on hold
    - Fiscal policy must avoid crowding out private spending
    - Monetary and fiscal **Rules** allow policy to be predictable and not disrupt markets

EU Institutions did not Age Well

- The EU institutions were created in the 1990s. Therefore, they embed the New Consensus **market optimality** doctrine. Besides **reforms,** not much to be done
  - **Fiscal Policy**: the Stability and Growth Pact requires budget balance over the cycle: no discretionary policy
  - **Monetary policy**: strict inflation targeting for the ECB
  - Strong emphasis on **competition** (level the playing field!)
    - Very strong focus on the abuses of dominant position and rents
    - Doctrine on State aid and distortion of competition
    - The consequence: the death of industrial policy
- The polycrisis challenges the New Consensus: **"Rethinking Macroeconomics"**
- Europe nevertheless remains impervious to this process: The **fiscal profligacy narrative** to address the sovereign debt crisis.
- But the rest of the world does not wait…

The World does not Wait: “New” Industrial Policy

Cherif, R., F. Hasanov, and X. Li (2024) ‘A “True” Industrial Policy for Europe is a Technology and Innovation Policy’, in Cerniglia F. and Saraceno F. (eds), *Investing in the Structural Transformation: 2024 European Public Investment Outlook*. Cambridge: Open Book Publishers.

Aiginger, K., Rodrik, D. ‘Rebirth of Industrial Policy and an Agenda for the Twenty-First Century’ *J Ind Compet Trade* 20, 189–207 (2020).

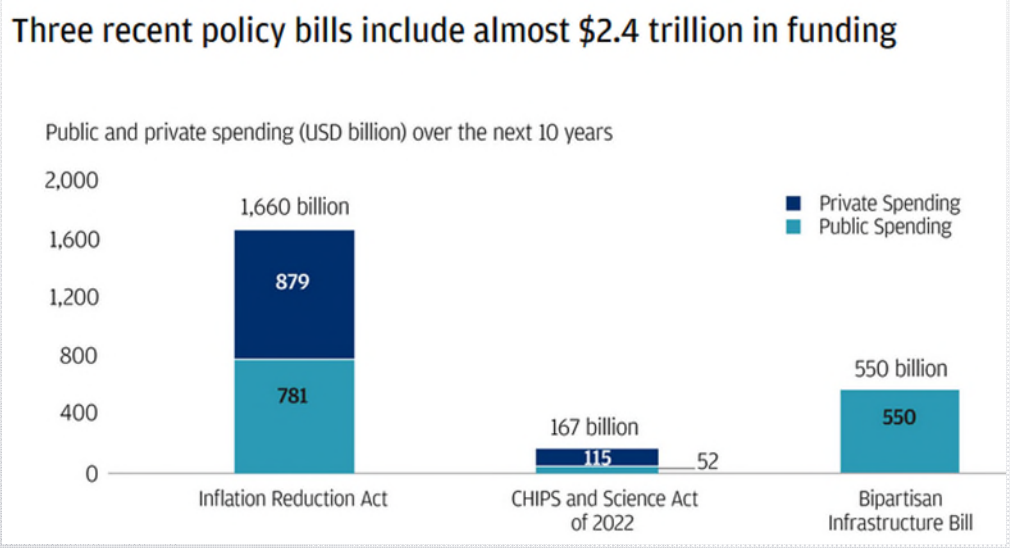
- Industrial policy is much more than competition policy or “European Champions”
- **Multidimensional policy**: taxes/incentives, regulation, trade and competition policies, monetary policy, finance, regional policies, investment
- Mazzucato’s **Entrepreneurial State** that accompanies and, more importantly, shapes markets
- Examples:
  - Incentives to facilitate entry into high value-added sectors
  - Selective and temporary protection
  - Attention to bottlenecks and stable demand flows (demand pull)
  - (fiscal policy) certainty for private investment
- Back to the 1960s?

US Industrial Policy: The case of IRA

- *Inflation Reduction Act* (August 2022). Part of a package aimed at reindustrializing the US:
  - CHIPS and Science Act, which dedicates funds toward cutting-edge R&D,
  - Infrastructure Investment and Jobs Act
- More industrial policy than inflation reduction
  - Subsidies for:
    - Production of clean energy sources (wind, solar) - uptake of electrical vehicles (EVs) - carbon sequestration - production of renewable fuel - clean manufacturing -heat pumps
    - Demand-pull measures that allows these technologies to reach market maturity
- Innovative features
  - US input requirements
  - Long lasting financing
  - Significant part of the burden on (large) corporates: 15% minimum corporate tax
- Uncertain cost (in the range of $400 to $1,200 billion)

The EU's Green Strategy. ~~Maybe~~ not Wrong, Certainly Incomplete

- Europe moves mainly with regulation. Not necessarily a problem (on the contrary!), but without investment…
- *IRA+Infrastructure Act+Chips Act*: about $1400 billion (NGEU: €750)
- If we regulate and others invest, they are the ones who will come out on top.
- Transition and reindustrialization need to go hand in hand
- The EU also needs a multidimensional strategy



No Blood Bath: Green Public Investment is Better than you Think

Batini, N., et al (2022) 'How Big Are Green Spending Multipliers?' in Cerniglia F. and Saraceno F. (eds), *Greening Europe. 2022 European Public Investment Outlook*. Cambridge: Open Book Publishers.

- Estimate multipliers for different categories of expenditures
  - Every dollar spent on key carbon-neutral or carbon-sink activities can generate more than a dollar's worth of economic activity ($\frac{\Delta GDP}{\Delta Exp} > 1$)
  - Multipliers associated with spending on renewable are larger than fossil fuel energy investment ones (1.1-1.5 versus 0.5-0.6)

→Stabilizing climate and reversing biodiversity loss are not at odds with continuing economic growth.

Green Jobs or no Jobs?

OECD (2025), *Employment and Skills Policies for the Green Transition: Review of International Good Practices*

- Modest net job change, but **major reallocation** across sectors/regions
- 20% of OECD workers are in "green-driven" occupations that will grow or be significantly modified.
- **Displacement** from high-emission industries **is costly**: 24% larger earnings losses over six years compared to other displaced workers.
- Strong **skill mismatch risks**, particularly for low-skilled workers who face harder transitions across sectors
- Uneven **distributional effects** (across regions, sectors, and skill levels)

→ ***The importance of accompanying the structural transformation with proactive policies***

The Challenge of Defence

Cepparulo, A. and P. Pasimeni (2024) ‘Trends in Defence Spending in the European Union’, in Cerniglia F. and Saraceno F. (eds), *Investing in the Structural Transformation. 2024 European Public Investment Outlook*, Cambridge, UK: Open Book Publishers.

- Weak growth/expenditure correlation (except for R&T)
- Spending composition for EU countries: High share of personnel
- Low domestic productive capacity
  →low multipliers
- Defence as a Global Public Good + Economies of scale + duplication/fragmentation + externalities → **EU level is preferred**
- More a question of what/how than of how much
- Crowding Out?
  - SAFE: low-interest loans + exemption clause for defence spending → No need to cut other expenditures
  - I wouldn't be so sure!
  - In 2029 the exemption clause will expire and debt will have increased. Under the SGP, cuts to expenditure will have to be made. I accept bets on what will be cut…

The Colossal Investment Needs…

- We begin with the Draghi Report and then:
  - Reconfiguring value chains because of trade wars and instability
  - Defence
  - Accelerating climate change

- For **Public Investment** we are talking about a figure between 5 and 600 billion per year (3% -4% of EU GDP)

Create Fiscal Capacity for Industrial Policies

- Industrial policies for strategic autonomy
- The broad objective needs to be the creation of **fiscal space**
- Two possible ways:
  - Create **fiscal capacity at the center** and constrain Member States (the US model)
  - Keep most of fiscal policy national and **radically reform the fiscal rule**

The First Best: A European Central Fiscal Capacity

Buti, M. and M. Messori (2022) ‘A Central Fiscal Capacity in the EU Policy Mix’, *CEPR Discussion Paper Series* DP17577(October).

- A European central fiscal capacity (CFC) should be endowed with the classic roles of fiscal policy
  - Stabilization
  - Enhancing structural change
  - Global public goods
- The CFC is more efficient than national policies on the three counts
  - Lower Pressure on Member States with demand shocks
  - Supporting reforms and provision of public goods in the case of supply shocks (avoid stagflation)

First best, True. But How Realistic?

- The issue of resources: the taxation of multinationals is one of the central topics of the coming years.
- Attention to the democratic deficit
  - To whom does the European Minister for Economic Affairs answer?
  - Make sure that checks and balances exist, even at the price of some cumbersomeness of the mechanism
- Furthermore: **is it realistic**? European Elections + French crisis + German Crisis, + Return of fiscal hawks + Political fragmentation = No political space for EU common projects (

→ We need to turn to national governments: a well functioning fiscal rule

A Functioning EU: Squaring the Circle

- An (almost) impossible trinity
  - Endow Member States with fiscal space to carry on investment and industrial policy
  - Protect them from market pressure in a fragmented sovereign debt market
  - Guarantee fiscal discipline
- The only way to escape the trilemma is to **implement a comprehensive reform**: Piecemeal inconsistent changes have doomed Europe
- Two pillars for a reformed EU governance
  - A new fiscal rule
  - A European Debt Agency

Pillar I: A New Fiscal Rule.

- Reform of the Stability and Growth Pact: Despite the flaws, the **2022 Commission proposal** was a significant step forward:
  - Medium term approach to debt sustainability
  - Scenarios (DSA), not strict constraints + Country ownership debt reduction paths
  - Use measurable variables: expenditure rules
- **Objective: be able to use fiscal policy guaranteeing sustainability**
- Then came the political process. The Commission proposal transformed in an empty shell. Debt Sustainability analysis and medium-term programs still exist, but:
  - Deviations trigger safeguard clauses → yearly debt reduction objectives
- **Back to the old SGP philosophy: debt reduction is, again, the final objective**

→The New Stability Pact is just the old one version 2.0

An Investment-Friendly Fiscal Rule

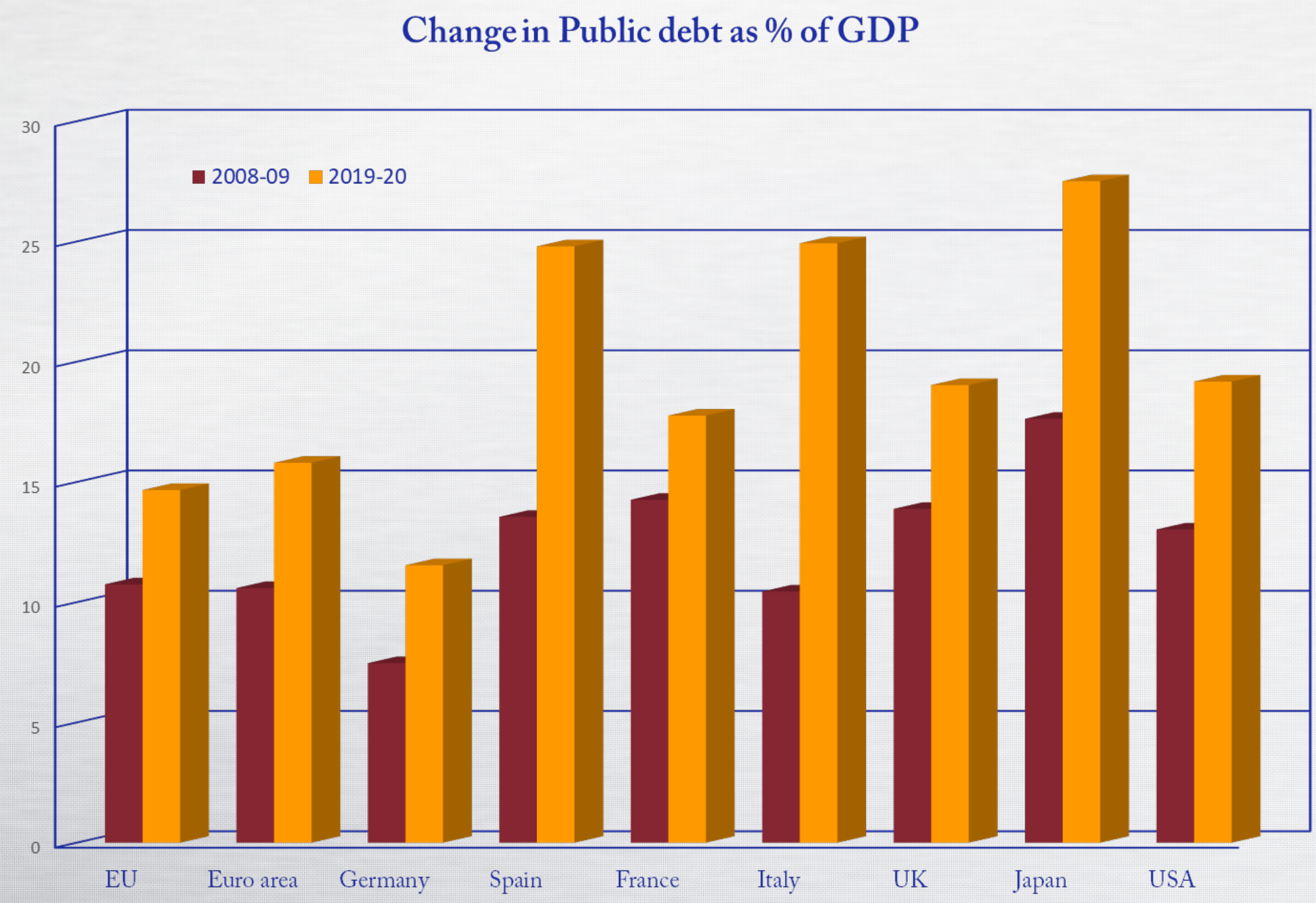
- In view of the investment needs, the ideal is a "**Golden rule**": Balance the current budget over the business cycle
- Advantages:
  - $\frac{Debt}{GDP} \rightarrow \frac{K_g}{GDP}$
  - Intergenerationally fair
  - The burden of fiscal consolidation falls on current expenditure
- Criticisms:
  - It introduces a bias on physical capital
  - Public investment is a slippery concept (risk of creative accounting)
- These weaknesses can nevertheless be turned into strengths: Shift from **an accounting to a functional definition of investment** and make the definition of public investment a ***political issue***

An Augmented Golden Rule

Saraceno, F. (2017) 'When Keynes Goes to Brussels: A New Fiscal Rule for the EMU?', *Annals of the Fondazione Luigi Einaudi* 51(2): 131–58.

- The Golden Rule **as an instrument** for industrial policy
  - Periodic democratic assessment about the needs in capital (physical, human, intangible). for example, after EU elections
  - Council, Commission and Parliament jointly decide what items of public expenditure **(tangible or intangible)** are EU priorities, and can therefore be excluded from deficit figures
  - Countries implementing joint projects could be given incentives (EIB loans?)
- A democratic and systematized version of the SAFE and the defence escape rule
- Of course, this does not come for free. **Debt will increase →** The need for a second Pillar

Pillar II - (Large) public debts are here to stay



Source: European Commission AMECO

Managing public debt: move from solvency to sustainability

- States are perpetual, debt can be rolled over
- Focus should move from paying debt to service it (Blanchard 2019)
- Favourable macroeconomic environment:
  - Chronic excess savings (secular stagnation)
  - $g > r$ globally

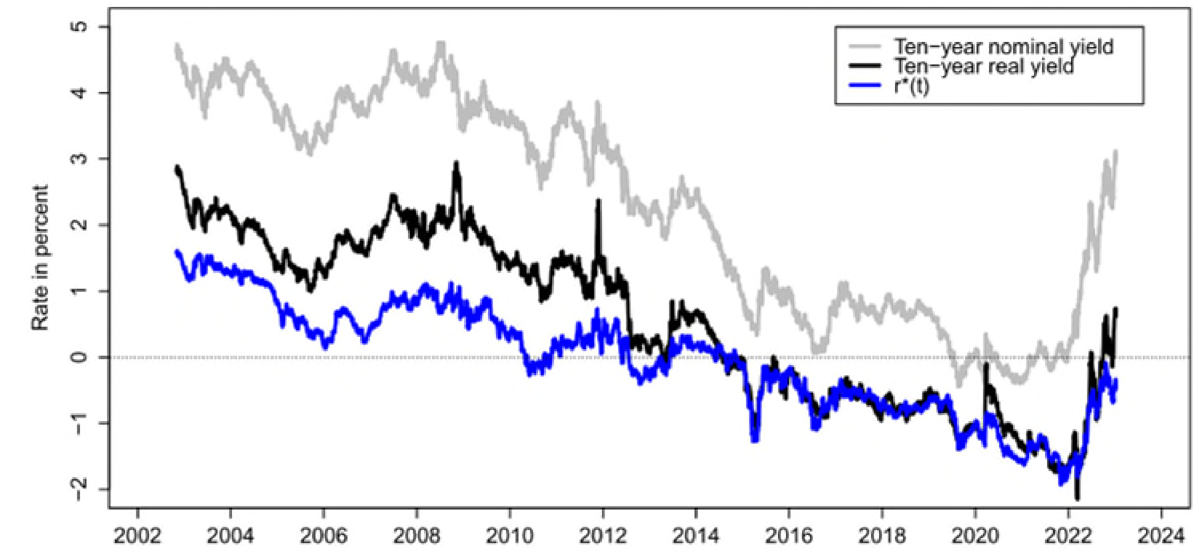
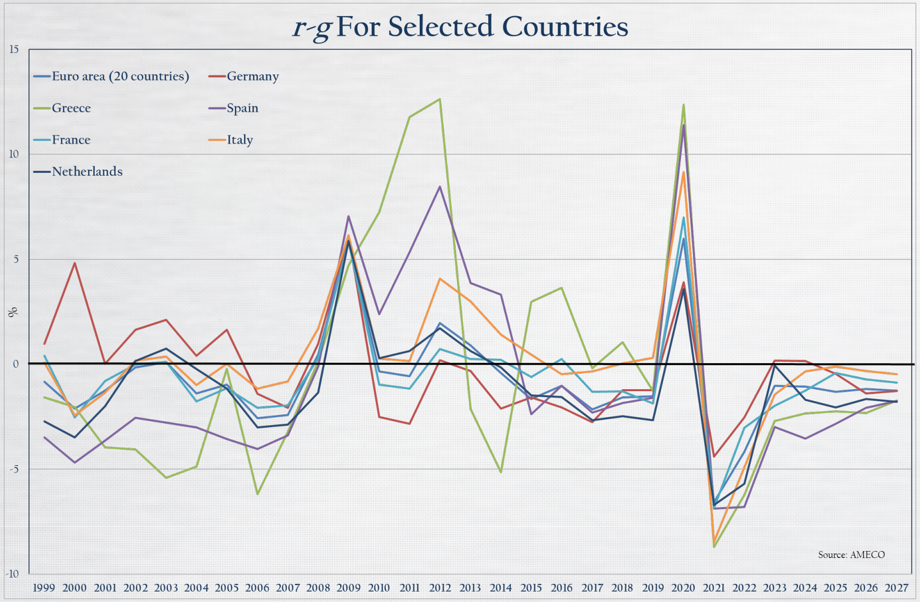


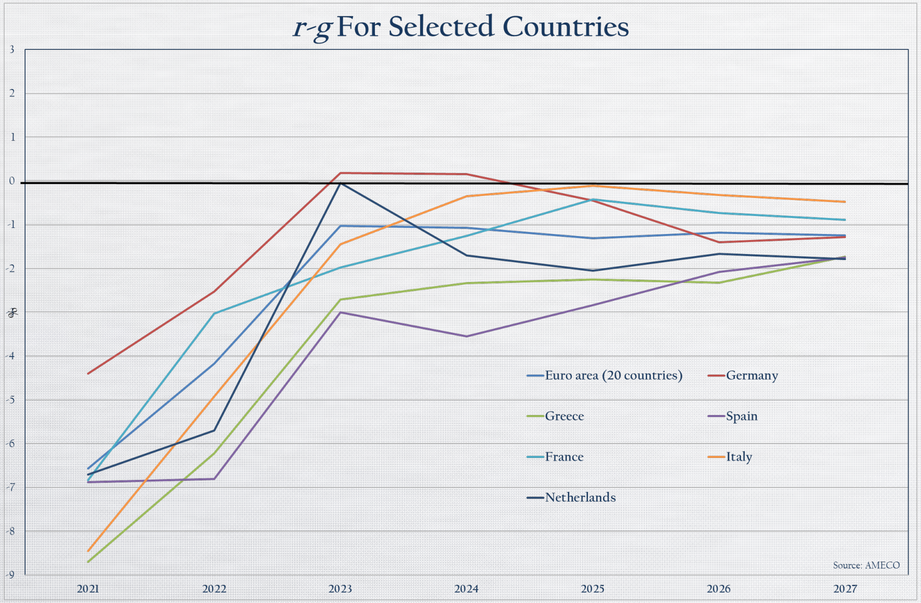
Figure 1: **Long-Term Nominal and Real Yields and an Estimate of r***

Christensen and Mouabbi (2024) 'The Natural Rate of Interest in the Euro Area: Evidence from Inflation-Indexed Bonds', *NBER Working Paper* 2024–08(March).

Debt: Unsustainable?



- Solvency is not a global issue
- It may be for individual countries, though



Pillar II – A European Debt Agency

Amato, M., E. Belloni, P. Falbo, and L. Gobbi (2021) 'Europe, Public Debts, and Safe Assets: The Scope for a European Debt Agency', *Economia Politica* 38(3): 823–61.

- While global debt sustainability **is not** an issue, individual countries may be subject to **pressure from fragmented markets**

→ We need to erect a diaphragm to protect member countries:

- Without systemic risk/financial markets' instability (avoid *refinancing risk*)
- Guaranteeing fiscal discipline (keep *fundamental risk*)
- **Avoiding debt mutualization**

- A European Debt Agency
  - **Borrows on markets**
  - Perpetual loans to countries
  - Idiomatic pricing of installments reflects fundamental risk as assessed (by the Commission) through debt sustainability analysis and compliance to fiscal rules. ***States' fiscal accountability is guaranteed: No risk sharing!***

Reigniting Europe's ambition

- The two reforms together would make it possible to:
  - Free the hands of states for industrial policy
  - Through the Augmented Rule:
  - Transform investment into a political and not a technocratic issue
  - Through the EDA:
    - Protect governments from market pressure
    - Ensure the sustainability of public finances

- Incidentally, they would make it possible to:
  - Restore the ECB autonomy
  - Reduce the fragmentation of EU sovereign debt markets
  - Provide markets with a safe asset alternative to the dollar

A Gloomy Conclusion.

- The old world (tie the hands of the State! be frugal!) is still very much present in Europe
  - The reaction to inflation - The reform of the Pact - Public Investment.
- Europe is not endowing itself with the instruments to face the challenges of transition and sustainability.
- While we look backwards the world is not waiting. After EVs and solar cells, in what other sectors will we be outpaced by China?
- The end of the Franco-German engine
- **The only way out: a comprehensive reform: Reopening negotiation on the Stability Pact and creating an EDA**

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