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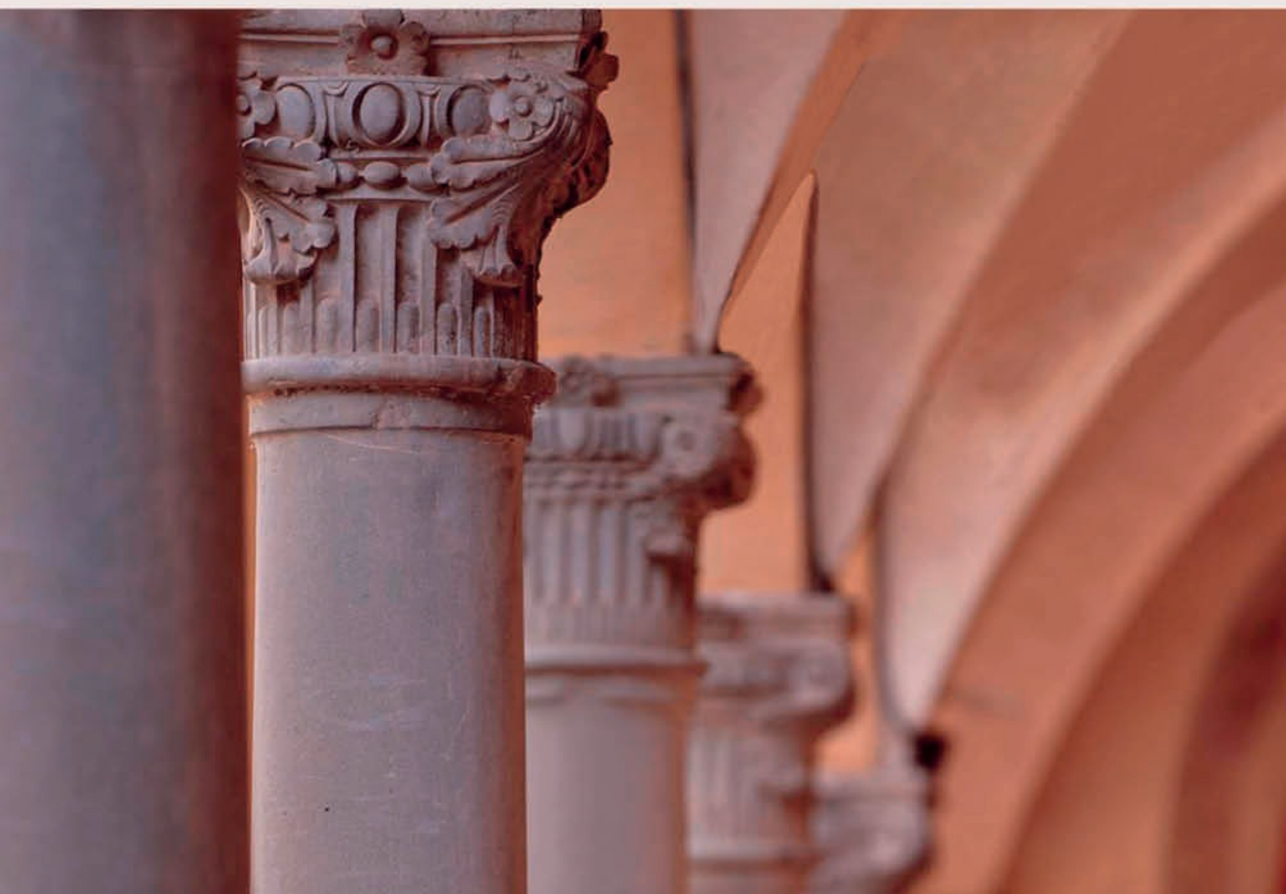
The Political Economy of Europe's Future and Identity

Integration in crisis mode

Edited by

Annette Bongardt & Francisco Torres



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Reviews

“European politicians may need to dare to take more risks” write the editors in the introduction. This rich, diverse, and well-argued book of essays by leading thinkers shines light on the priorities for taking these risks, the trade-offs to consider, and the mistakes to avoid. Anyone interested in Europe's future should read it.

Ricardo Reis
A. W. Phillips Professor of Economics. The London School of Economics.

There have been no shortages of crises for the EU to deal with as of recently. Yet, we often forget that crises are often not just a challenging test but an opportunity. The works collected in this book are a powerful testament to that: Bongardt and Torres dissect the combination of economic and institutional crises and bring together a star line-up of authors to shed light on the political opportunities to strengthen the European project even in times of crises. This is a must-read book for all those interested in understanding the evolutionary trajectory of the EU and its capacity to adapt and address to the biggest challenges of our times.

Manuela Moschella
Associate Professor of International Political Economy. Scuola Normale Superiore

---

A thought-provoking collection of creative essays by extraordinary scholars that ranges far and wide to probe the European Union’s deepening as a polity--and all the contestation that comes with it. A must read for anyone seeking to chart the future of Europe.

Kathleen R. McNamara
Professor of Government & Foreign Service. Georgetown University

The Political Economy of Europe's Future and Identity

Integration in crisis mode

Edited by

Annette Bongardt & Francisco Torres

CONTRIBUTORS

Annette Bongardt, Francisco Torres, Erik Jones, Alexandre Palma, Kalypso Nicolaïdis, Sergio Fabbrini, Vivien Schmidt, Dirk Schoenmaker, Francesco Mongelli, Stefan Collignon, Amy Verdun, Anna-Lena Högenauer, David Howarth, Lucia Quaglia, Pedro Duarte Neves, George Pagoulatos, Paul De Grauwe, Roberto Tamborini, Sebastian Diessner, Michele Chang, José Tavares, Charles Wyplosz, Waltraud Schelkle, Tomasz Woźniakowski, Nazaré da Costa Cabral, Marco Buti, Marcello Messori, Hubert Zimmermann, Daniel Innerarity, Leila Simona Talani, Maria Helena Guimarães, Loukas Tsoukalis.

Il Ratto di Europa

by Onofrio Pepe, maestro scultore e mitografo, Florence (EUI collection)

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Preface

Erik Jones

Writing in the *Washington Post* in July 2023, the director of the United States Central Intelligence Agency (CIA), William J. Burns, noted that he had lived through two 'of those rare "plastic moments" in history', when the pace of change accelerates, the old certainties crumble, and new uncertainties predominate. The first of these came at the end of the Cold War, when it was possible to imagine a world where democracy would take root alongside new opportunities for trade and prosperity. The second came more recently, with authoritarian regimes in Russia and China seeking to reshape global politics even as climate change, migration, and other challenges demand concerted attention. Threats seem more urgent than opportunities in this new climate. Hence, Burns concludes that now is a time for the United States to invest in greater intelligence and to strengthen crucial alliances.

The same argument could be made for the European Union. Those two plastic moments Burns mentions also coincide with the negotiation of the Maastricht Treaty and the rapid succession of major policy challenges running from the global economic and financial crisis through Russia's full-scale invasion of Ukraine. Now more than ever the European Union needs intelligence and alliances. However, the intelligence required is not limited to spy-craft or eavesdropping, and the alliances extend across society as well as national boundaries. The threats to be addressed require interdisciplinary solutions that stretch from the academy through the policy process and into civil society and democratic politics. Only a full mobilization of people and resources will be sufficient to ensure effective climate action, to address democratic backsliding, and to restore a rules-based in-

ternational system that offers the promise of shared prosperity while promoting human dignity and protecting human rights.

The purpose of this volume is to help address the many issues that have arisen in Europe during this more recent plastic moment. The essays touch on issues ranging from what the European Union is and does, to how it can and should be organized to tackle specific challenges relating to democratic accountability, climate change, financial instability, macroeconomic governance, violent conflict, cross-border migration, and technological disruption. These essays often focus on threats, but they present opportunities for better policymaking, greater cooperation, and wider engagement. More important, they are written synthetically and for a wider audience. The goal is not so much to push out the envelop for theoretical or empirical research as to show what practical insights academic work can offer to create a positive agenda for change.

This collection was the result of spontaneous initiative rather than a carefully planned, multi-year research agenda. As editors, Annette Bongardt and Francisco Torres decided that now is the time for action. They reached out to their scholarly network and the response was immediate and, in many ways, overwhelming – with less than four months passing from start to finish. The Robert Schuman Centre is proud to publish this collection in partnership with UCP Press. And we are grateful to Annette and Francisco for their generous commitment of time and leadership in bringing these essays together. We are making them freely available electronically in the hope that they will attract a wide audience.

Erik Jones

Director, Robert Schuman Centre for Advance Studies

European University Institute

July 2023

INTRODUCTION

What way forward for European Integration in permanent crisis mode?

Annette Bongardt and Francisco Torres

1. Introduction

Today's European Union (EU) finds itself in a permanent crisis mode – crises appear no longer sequentially and time distant but overlap and reinforce each other and even interact. If, as Jean Monnet put it, Europe will be forged in crises and as the sum of the solutions adopted for those crises, it is also true that multiple, major crises affecting the EU at the same time do not only stretch but risk to overwhelm its crisis response capacity. Yet, the EU needs to successfully address those crises to deliver results for its citizens and hold the 'club' together. There is also demand for some soul- and identity-searching, with a shared identity and values assuming special importance for facilitating collective action and leaps forward in times of crisis, such as at present, when the EU faces the need to stand by its values amidst Russia's war on Ukraine while pursuing its main objectives and its current priorities for 2019-24, most notably the European Green Deal (EGD). Both – addressing multiple challenges and a shared identity – are fundamental for making the EU more resilient to shocks and European integration sustainable (and with a purpose) over time. And they are related.

Crises may have become a part of and shaped Europe's identity. But Europe's identity is more than the result of crises.[1] It is important also to address challenges because a pragmatic or technocratic approach (not to talk of just 'muddling through') may have worked in the past but is not enough for ensuring the political sustainability of the European integration process, let alone the economic and environmental sustainability of our societies. The affirmation of Europe's identity passes not only through the domestic but increasingly also through the international dimension, as exemplified by trade *cum* climate policy, security and defence, migration policy, or digital sovereignty. Moreover, it is not irrelevant for the sustainability of the EU and its Economic and Monetary Union (EMU) what the dynamics, symbolism and politics of the model of integration that the EU is pursuing are. A reform of institutions that is too modest (and apolitical, without increased accountability) tends in general to backfire, as citizens fail to understand (and dislike) such half-hearted (technocratic) solutions without clear political objectives. Therefore, European politicians may need to dare to take more risks and engage in explaining the objectives and merits of further integration (and of European integration in general, notoriously lacking), notably which European public goods the EU should deliver. Doing so is especially important given the fact that various member state governments and mainstream European political parties, afraid of losing votes to anti-European parties, opt for mimicking populism, which is bound to only weaken them further and just reinforce populist and anti-European parties as voters always prefer the original to the copy (present-day France and Germany provide good illustrations).

In the last few years, the pandemic crisis and Russia's full-scale war on Ukraine have profoundly shaped the EU. There is a broad consensus (also among the authors in this volume) on the efficiency of the EU's response to the pandemic crisis, having acted on the lessons from the global financial crisis and the Euro Area crisis, which also led to more European integration. EMU's and EU's governance were strengthened during the pandemic crisis with the creation of new common monetary and fiscal instruments, notably the Pandemic Emergency Purchase Programme enacted by the European Central Bank (ECB) and the Next-GenerationEU (NGEU) recovery plan, an EU temporary fiscal capacity, funded by issuing common bonds, constituting a step change. Beyond that, the pandemic crisis allowed for establishing a conducive link between the short-term and the long-term policy-wise and played to the EGD's economic rationale and policy

1 For a discussion from a historical perspective of the concepts and identity of Europe, including the revival of the European ideal by politicians to heal the wounds of WWI and WWII, see Davies (1996).

priorities (Bongardt and Torres, 2022). And it came with environmental and social lessons that arguably contributed to preparedness to modify unsustainable patterns of consumption and production in line with the EGD and long-standing EU priorities (a digital, fair and sustainable economy). Undoubtedly, Europe emerged from the pandemic strengthened. Thereupon, however, supply chain disruptions, the energy crisis, the Russian war on Ukraine, together with the aggravating climate crisis, changed the picture profoundly. The EU became confronted with a security crisis but also the risk of stagflation as the result of an energy crisis that led to inflationary pressures, made worse by supply bottlenecks and firms' rent seeking. Moreover, the tendency that the EU ever more needs to stand up at the international level for its interests (already visible in a weakened international trade order) has entered a new dimension of geopolitics and power relations with Russia's invasion of Ukraine.

On the monetary front, the trade-off between price and financial stability came again to the fore, although the causes for stagflation go beyond the monetary domain (member states' energy policy options, issues of regulation and non-use of taxation at the national level to curb market distortions). That trade-off points to the urgent need for common fiscal and economic instruments in order to deepen public and private risk-sharing in the euro area. At the same time, the revision of the Stability and Growth Pact has led to a reopening of old debates (moral hazard, debt levels) and divisions among member states that show both a lack of trust and of political willingness on the part of different member states to avoid or at least to smoothen the conflict between national sovereignty and the European common interest. Even on the monetary front, the succession of crises has made it ever more obvious that EMU's sustainability does not only depend on doing away with its specific fragilities (for instance the lack of a clear role for the ECB as a lender of last resort in the government bond markets). It is also dependent on the broader EU (economic and wider) governance framework, notably on the existence of a permanent central fiscal capacity, whose importance for responding to immediate challenges and also as a mechanism of sustainable (well accepted, democratic) integration is very well illustrated in the various parts of this volume. Some common ground will need to be found, if only on the new own resources to finance the temporary NGEU and its Recovery and Resilience Fund. There is a wide range of potential European public goods across policy areas, a fact that may indicate a way forward for European integration, among which a permanent fiscal capacity. Their realization depends on whether the common interest speaks louder than member state interests (especially given the obstacle of sovereignty reservations like in the case of taxation).

On the political front, EU institutions, notably the European Commission and the ECB, and some national and international institutions, have been responding to the latest crisis developments by adapting rules and policies, which will have a positive effect in the long run. That said, reforming the wider EU regulatory framework needs the approval of member states. Yet, after some consensus created during the pandemic crisis and an initial convergence of preferences due to the Russian attack on Ukraine, there seems to be some reform fatigue and, more than that, also resistance to the need for common (substantive) responses to the current challenges that involve changes in Europe's (unsustainable) production and consumption patterns. As a result, national governments but also mainstream European political parties in the European Parliament (EP) have turned against some of the reforms proposed by the European Commission, notably (in the context of) the EGD, which are part and parcel of the European economic and social model. The latter is a key ingredient of the EU's identity (whose affirmation passes also through the digital domain). However, it can only prosper in today's more fragmented international trade arena if the EU manages to reach out and export its key values to the international level by all means available, be it through trade agreements, the Brussels effect, or other.

The idea for this volume was born out of a perception that the European Union finds itself once again at a crossroads, with its future and identity cast in doubt by a combination of crises, governance shortcomings and political divisions. At the same time, the very nature of the challenges facing the EU, notably but not exclusively the green and digital transitions, require 'more Europe' (including some central fiscal capacity) to supply those and other European public goods, among which an EU defence capability and completing a banking union. The chapters of this book provide reflections on the challenges that the EU (and EMU) is facing because of having come to live in a permanent crisis mode while simultaneously taking into consideration the EU's future and identity (sustainability).

From different perspectives and angles, contributors to this volume shed light and outline their thoughts on what are the current challenges facing European integration and what public goods the Union should provide. As put by Draghi (2023), "Europe has – until today – never faced so many shared supranational goals, (...) goals that cannot be managed by countries acting alone". Those common objectives, which require substantial European investments, feature broader issues encompassing Europe's identity and solidarity, which translate into more specific ones related to climate and the green transition, the digital transition, economic, fiscal and monetary policy challenges, or EU trade, defence, migration and artifi-

cial intelligence issues. And yet, unlike the US, the EU lacks the governance framework and at times treaty base, to address them in a coherent and effective way. For instance, at present the EU has no integrated strategy of common and national spending *cum* EU regulations, to pursue the green transition and to respond to other current and pressing challenges.

The contributions to this book are grouped into six parts.

Part I starts out with the identity and scope of the Union. It explores what makes up European identity (from different angles, such as what constitutes its soul and the contribution of solidarity among member states), that goes together with democracy and accountability (or responsiveness) of its institutions. It also addresses the division of competences and decision-making in the EU (the role of its institutions), as well as framing the chosen way forward out of the crises among possible alternatives with very different consequences.

Part II deals with what is the EU's prime contemporary challenge, climate governance and the green transition, and the ramifications of the European Green Deal (EGD), which is much more than a response to yet another crisis, in that it constitutes a paradigm change. It explains why the EU opted for the EGD, integrating the green dimension across EU (economic and all other) policies rather than having a single instrument, and why the EGD can be seen as a third building block of the EU's economic model, alongside the single market and EMU. The green transition comes with huge financing needs that still need to be met in large part while the application of climate mainstreaming across all policy areas also means that not only the single market but also external trade needs to further European objectives and address resulting trade distortions.

Part III focuses on economic governance. The discussions are centred on European public goods and collective action problems and the issues raised by an EMU that is still incomplete in its economic part. Questions asked are how European public goods ought to be supplied and administered (at the intergovernmental or the at central level) and how they could drive European integration, what the gaps and challenges for completing EMU in its economic part (notably banking union, but also fiscal and capital risk-sharing) are and what are the lessons learned from previous crises and progress made on weathering a next crisis.

Part IV turns to monetary governance, more generally to whether EMU's architecture is obsolete or still fit for purpose. It addresses efforts to overcome a birth defect of the common currency, that is, the absence of the ECB as a lender of last resort, the trade-off between price stability and financial stability, the ECB's

mandate and accountability structure, how to make EMU democratically fit for the current and future challenges (with a true dialogue between the ECB and the EP and enhanced accountability), and the ECB's 'federalist' role in implementing monetary policy.

Part V centres on fiscal governance. It examines the conflict between national sovereignty and the common interest and the role of and need for a central fiscal capacity (with its stabilization function, reform and investment support and supply of European public goods), which in turn highlights the issue of the link between national and common institutions, or vertical versus horizontal coordination of national budgets, and the effects of the various attempts to reform the Stability and Growth Pact (SGP). It also draws on the US experience and discusses how the ECB's policies and new crisis-enacted EMU/EU institutions amount to risk-pooling through re-insurance as an alternative to a fiscal union, although those developments may already translate into a new EMU/EU promising but still divisive centre of sovereignty with respect to borrowing and tax competences.

Finally, Part VI addresses different aspects of external and security dimensions, discussing the likely impact of Russia's war on European integration, the impact of US 'friendly fire', that is its new industrial (green) policy named the Inflation Reduction Act, on the EU and its internal market and the alternatives of an EU response, notably how to reaffirm its trade identity. It also analyses the EU response to international migratory flows and European digital sovereignty in light of the EU model of society, which requires establishing EU values to a global level.

In total, this book brings together 28 chapters and a postface and the rich insights from a group of scholars of European political economy and also of economics, political science, international relations, history, philosophy, and theology. Most authors happen to have been at the European University Institute in various capacities at different times, as Professors, Academic Visitors, Visiting Fellows, Max Weber or Jean Monnet Fellows, PhD students; five of them are currently professors at the EUI. The book features a Preface from Erik Jones, Director of the Robert Schuman Centre for Advanced Studies of the EUI, to whom we are most grateful for all the institutional and personal support of this project and book. We would also like to thank the authors for having swiftly responded to our call and contributed to this volume, delivering and revising their chapters so timely, at times engaging with other chapters with many good suggestions. We are especially thankful to Loukas Tsoukalis, the European political economist par excellence and one of the most knowledgeable scholars of European integration and

the European Union, for taking his time to write the Postface to this volume. His latest book (Tsoukalis, 2022), as some of his previous ones, covers the main issues here discussed and therefore we could hardly wish for a better take on the subject of our volume.

Last but not least, a word of appreciation for our two publishers, EUI Press and UCP Press, for having accepted to jointly produce the book: EUI Press for producing the eBook in open access (Creative Commons Attribution 4.0 (CC-BY 4.0) International license), to be available on the highly visible CADMUS EUI research repository, and UCP Press for producing the print copies. Special thanks are due to Giorgio Giamberini at the RCSAS/EUI, for many good suggestions and for his very timely and patient response to our many requests, and to Anabela Antunes and Margarida Appleton at UCP Press, for their prompt welcoming and readiness to co-produce the book and work on the print version during the summer.

Grotfeldshof, Neukirchen-Vluyn, July 2023

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PART I

THE IDENTITY AND SCOPE OF THE UNION

CHAPTER 1

The ambiguity, specificity, and ambivalence of living in a European union[1]

Erik Jones

1. Introduction

European union can mean a lot of different things depending on where you put the emphasis. A European union can be a union of Europeans, a union that has specific or specifically European characteristics, or a union that brings together both Europeans and European characteristics at the same time. The union itself is also ambiguous, insofar as it can reflect a sense of unity (togetherness), a set of formal institutions, or both – but leaving open the questions which came first, the feeling or the institutions, and whether the two things are reinforcing in a functional sense (Haas, 2004) or working against one-another in a post-functional sense (Hooghe and Marks, 2009).

These questions touch at the heart of the European political project. Think about the last time anyone drew Georgia onto the map of Europe or, perhaps

1 Many thanks to Veronica Anghel for timely comments and suggestions. Any errors of fact or reasoning are mine.

better, the last time anyone not from Georgia noticed when Georgia did not appear on a European map or in a list of European countries. Now ask the same question about the United Kingdom, Norway, or Switzerland. Although it is always possible to imagine situations that draw Georgia in and leave those other countries out, it is hard to deny the striking nature of the contrast. Yet somehow Georgia has a prospect for membership in the European Union that the other three countries neither have nor want, at least for now.

In a different and yet no less revealing way, think about trying to explain to people who live on other continents that liberty, equality, dignity, the rule of law, and respect for human rights are somehow specifically European values. That is a hard claim to make given Europe's colonial past and the post-colonial experience of those who live outside Europe. This is not to imply that many Europeans do not aspire to those values, but only to suggest that people outside Europe might prefer to highlight the contradictions between aspiration and practice both historically and in more recent events. The European Union's difficulty justifying its support for Ukraine's response to Russia's aggression to audiences outside Europe is only the latest example of the challenges associated with any assertion of Europe's normative distinctiveness (Milliband, 2023).

Although everyone knows what the European Union is, the idea of European union is an ambiguous construct that invites more ambivalence than many Europeans would like to admit. This observation does not have to be read as critical, particularly when you consider the alternatives. In the European Union that exists, ambiguity can be a source of strength and ambivalence is better than opposition.

2. Constructive Ambiguity

Certainly, the European Union's responses to the succession of crises since the start of the 21st Century have not brought much clarity to the notion of European union (Anghel and Jones, 2023). Admitting this does not deny the fact that Europeans have managed to do relatively well (for themselves) in the face of adversity. The European Union has held together through the divisions over the Iraq War and the so called 'global war on terror'. It survived the near failure of the Lisbon Strategy – when former Dutch Prime Minister Wim Kok admonished that the European social model is at stake – and the popular rejection of the European Constitutional Treaty. It did not collapse in the face of the global economic and financial crisis or the sovereign debt crisis that came in its wake. Instead, the European Union – represented by European Central Bank (ECB) President Mario Draghi – promised to do 'whatever it takes' to stabilize the situation.

That promise was in many ways a masterstroke of constructive ambiguity. Draghi not only succeeded in convincing market participants not to bet against the survival of the euro as a common currency, but he also managed to paper over both a sharp division between the European institutions and the member states over the conduct of macroeconomic policy, and an even deeper cleavage between North and South or core and periphery over the power relationship between creditors and debtors. Draghi's solution faced important challenges both through the impact of prolonged fiscal austerity and in the financial turmoil surrounding Cyprus in 2013 and Greece in 2015. Nevertheless, his commitment succeeded in shielding the European Union from the destructive power of global financial markets without ever having to be used or even fully articulated (Jones, 2015).

Ambiguity was a hallmark of the responses to subsequent crises as well. The European Union weathered the migration that followed the Arab spring, where German Chancellor Angela Merkel issued her own version of 'whatever it takes' – *Wir schaffen das* – but without ever generating a functional European migration policy. It did not falter when confronted with the British decision to withdraw from membership – and Theresa May's 'Brexit is Brexit' – or the election of Donald Trump as President of the United States. Of course, relations with both countries remain a work in progress and, if anything, European dependence on the United States for security has increased. The European Union persevered during the pandemic, albeit after initial stumbles, including an unfortunate moment when Draghi's successor, Christine Lagarde, appeared to take 'whatever it takes' off the table. Soon thereafter, European countries agreed to extraordinary measures that governments in powerful creditor countries previously refused to contemplate. That said, they also left open the question about whether the institutional solution is a one-off, temporary measure or a permanent change in the organization's fiscal capacity (Jones, 2020).

Even the European Union's response to Russia's expanded invasion of Ukraine has been ambiguous. Here too, Europeans agreed to measures what previously would have been unthinkable, including the use of a European Peace Facility to finance weapons purchases. They also worked in concert and at a pace that revealed the long practice they have had at crisis management. The point is only that the European Union's support for Ukraine takes place in spite of important divisions within and between member states. These divisions can be found in polling done by YouGov for the European University Institute's 'Solidarity in Europe' project and in the recurrent negotiations over sanctions on Russia and funding for Ukraine between the European Commission and Viktor Orbán's government

in Hungary.[2] Whether other member states will break ranks with the EU's policy is a constant source of concern, particularly given elections in Slovakia, political unrest in France, rising support for the *Alternative für Deutschland* in Germany, and declining support for Ukraine in Italy.

This concern over support for Ukraine in many ways mirrors concern over the rule of law and the preservation of democracy. Here too, the European Union plays an ambiguous role. As research by R. Daniel Kelemen (2017 and 2020) and others has shown, European institutions have inadvertently financed the political groups responsible for democratic backsliding, European political families have sheltered authoritarian parties, and European decision-making procedures have empowered illiberal governments with leverage they would never have outside the union. This does not sound like a constructive form of ambiguity, unless you consider the alternative. It is hard to imagine that democracy would flourish without a European membership prospect and easy to see how that membership prospect needs to translate into accession – and therefore membership – in order to be credible (Anghel and Džankić, 2023; Schimmelfennig, 2023). Just look at the Western Balkans. This is another way in which European support for Ukraine and its challenges protecting the rule of law and democracy overlap. A membership prospect for Ukraine and Moldova will only be credible if it results in faster and more consistent progress than we have seen in the Western Balkans. That explains why the enlargement process to the Western Balkans has suddenly accelerated. It is also what brought Georgia onto the European map.

3. Specific Solidarity

The ambiguity in European responses to the succession of crises that mark the 21st Century reflects the ambiguity surrounding European identity and European values. Just about anyone can find Europe on the map and most people can list at least some of the values that the people who live there claim to cherish, but that tells us very little about how Europeans see themselves and each other, how they understand the values they claim to share, and what priorities they use when facing ethical (or political) dilemmas where those values seem to come into conflict. This ambiguity is what Donald Rumsfeld underscored when he talked about old and new Europe during the run-up to the war in Iraq; it is also what Jacques Chirac implied when he admonished governments in Central and Eastern Europe for missing a good opportunity to shut up (Jones, 2004).

2 The data for the YouGov-EUI Solidarity in European project can be found here: https://europeangovernanceandpolitics.eui.eu/eui-yougov-solidarity-in-europe-project/.

We can see similar fault lines running through every crisis and crisis response. Just think about the debates about bailouts and moral hazard during the sovereign debt crisis, freedom of movement and national sovereignty with respect to migration and Brexit, individual freedom and public health during the Covid-19 pandemic, or peace and justice during Russia's war against Ukraine. Even the debate about democratic backsliding and the rule of law shows the same ambiguity in what makes a European 'European', and what Europeans cherish or believe (Anghel, 2020a). The ambiguity in crisis responses is constructive insofar as the compromises they represent ensure Europeans remain united even when they fundamentally disagree. Here again it is worth considering the alternative where Europeans not only fail to act in concert but act at cross purposes or fail to act at all.

This is where it is more important to focus on 'union' than 'European', and specifically on that feeling of togetherness that makes it possible for Europeans – as individuals, groups, and peoples – to participate in the European political project. That feeling is more specific than ambiguous. It attaches in different ways to different parts of the political project (Jones, 2012). Jacques Delors once quipped that 'you don't fall in love with a common market', but that doesn't tell how people come together around a common market. Indeed, during much of the debate about whether Britain should remain a member of the European Union, the need to maintain access to the single market was one area where both sides could agree. Where they differed was in relation to specific aspects of Europe's internal market related to freedom of movement, standard setting, regulation, competition policy, and the European Court of Justice (Jones, 2016). If the British could have chosen *a la carte* from among the various institutional provisions, it is likely they would have voted to remain.

The European Union's response was uncharacteristically unambiguous in insisting that everything is connected, and the options are binary – in or out (Laffan and Telle, 2023). That is not how the European Union functions in practice either with individual member states or even with accession countries. If that were not the case, then Sweden and Denmark would be using the euro, and Bulgaria and Romania would be admitted to Schengen over Austria's veto. Just as the European Union has responded to crises with constructive ambiguity, it has used constructive ambiguity to smooth relations across the European Union in multiple other ways. Even the location of agency within the European Union is constructively ambiguous insofar as the key decisions might be taken at different levels of political authority and by different actors using a range of different mechanisms that

run from local referendums up to intergovernmental bargaining (Anghel and Jones, 2023).

This combination of specific feelings of togetherness and constructively ambiguous institutional arrangements is the key to the European Union's resilience. To explain why, it is useful to bracket that 'feeling of togetherness' as 'solidarity' and to show how solidarity differs in specific ways from one situation to the next (Jones, 2012). Here it is easiest to start with the European Union's response to the war in Ukraine. Most Europeans feel solidarity with the government and people of Poland in this conflict because they are among the most threatened by the prospect of further Russian aggression and the disruption that comes from Russian violence in Ukraine. That solidarity does not contradict or eliminate the discomfort that many Europeans feel about the Polish government's treatment of LGTBQAI+ communities any more than it adds to the desire to invest in or compete with Polish industries. Those other feelings are disconnected from the sense of togetherness in the face of a common threat.

The feeling of solidarity in the face of the economic consequences of the Covid-19 pandemic is also different. There governments agreed to a recovery and resilience package that made explicit transfers from wealthy countries with low public debts to poorer countries with high public debts (Jones, 2020). That kind of redistribution exists in other European programmes like the common agricultural policy and the regional and structural funds. In each case, however, the logic behind the redistribution is different – and so is the expression of solidarity. Of course, it is possible to connect these things, as when the European Commission withholds regional and structural funds from Hungary in response to the Orbán government's failure to make progress in terms of the rule of law. But that institutional connection is controversial and difficult to make or enforce, particularly when the Orbán government pushes back by making connections to things like migration policy or support for Ukraine. The more everything becomes connected, the more the conflict between the European Commission and Hungary begins to look like Brexit – and that is a situation to avoid and not embrace.

On the contrary, the European political project moves forward by exploiting the specific hold that different forms of solidarity have over both politicians and the public. That way, any conflict in one aspect of the European Union, like migration, can be offset by progress made in some other aspect, like the recovery and resilience plan. Just look at the sea change in Italian popular attitudes toward Europe that took place during the pandemic. Now look at the pro-European policies of the right-wing Italian government. The migration problem has not gone away. If anything, it is likely that the combination of climate change and

violent conflict in the regions around Europe will increase the pressure of migration on Italy as a frontline state. European discomfort with the Italian far right has not gone away either. But so long as Giorgia Meloni and her Brothers of Italy continue their staunch support for Ukraine against Russia, that provides a basis for constructive engagement (Jones, 2023).

4. Accepting Ambivalence

This Italian example is not an attempt to normalize Giorgia Meloni or her right-wing government, which may eventually move toward the political mainstream, but that remains to be seen. For the moment, she remains closer to the governments of Hungary and Poland in many disconcerting respects. Other European leaders like Emmanuel Macron, Pedro Sánchez, and Olaf Scholz must feel deeply ambivalent about having Giorgia Meloni as a partner. They also must realize that finding some way to work with Meloni on issues where they can come to agreement is better than isolating her government in a kind of permanent opposition. Here the contrast between Meloni's right-wing coalition and the coalition of populist parties that governed Italy in 2018 and 2019 is instructive. So is the contrast between Italy under Meloni, and either Hungary or Poland. Simply put, it is easier for European leaders in other countries to work with a government that is looking for ways to engage with the European Union.

Giorgia Meloni is sure to experience some ambivalence of her own. So will her supporters and allies in Italy and other parts of the European Union. And so will those who line up behind extremist or non-mainstream political groups on the left and right in countries as diverse as Greece, Spain, Slovakia, Finland, and Ireland. The point to underscore is that the people who participate in this large and growing collection of voters who are disenchanted with mainstream politics are all European (Fieschi, 2019). More important their votes will have a major impact on how the European Union works as a collection of institutions. Therefore, it is vital that they be encouraged to feel a part of that union in targeted ways that address their specific concerns.

These people who are disenchanted with their governing elites do not have to fall in love with the European Union as a political project. But it should be possible to foster some feeling of being together in solving some specific problem, and then to build on that feeling by addressing other pressing concerns (Anghel, 2020b). This will not only add to the connections that unite Europeans in political terms, but also reinforce them through the diversification of sentiments –

because each expression of solidarity is different. The cumulation of these bonds may not result in a more perfect union, but it will add to the resilience of the European political project, and it will also help to prepare that project for future challenges and further enlargement.

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CHAPTER 2

On the soul and roots of European integration: purpose and metaphors

Alexandre Palma

1. Introduction

Historical realities need a purpose. When this is missing, they tend to lack the inner energies to face adversities and the creativity to engage with new challenges. The contemporary process of European construction shows precisely that. Not that there weren't always goals to be reached by this coming together of European nations. The consolidation of peace in post-war Europe and the establishment of social and economic conditions for that peace to endure were precisely a major goal that gave it, in the beginning of European integration, a clear sense of purpose. The question, though, has been, also since its beginning, if these goals were and/or are strong enough for this European project to keep making sense and, in consequence, to commit with it the European citizens. It is natural that, with time, some of these goals lose their mobilizing force. That happens too when the European project is a victim of its own successes. By overcoming some of the challenges that, for some time, gave it a certain sense of purpose, a void of meaning might be felt afterward. This has given rise to the idea that Europe needs a deeper

purpose, not so closely associated with short or medium-term institutional and economic goals. It has been argued instead that this bigger purpose ought to be derived from Europe's cultural identity.

The debate about a purpose and identity increases as the perception that the European project is going through a crisis sets in. The grounds for this perception cannot be denied, but they should, however, be contextualized. Maybe Europe had always been in crisis. That is, at the least, the view of thinkers such as George Steiner (2004) or Eduardo Lourenço (2001). To them, this crisis mode is not just an accident of Europe's current history or a consequence of the ineffectiveness of its political institutions. It is, instead, a decisive element of its own identity. Perhaps it is not by chance that the Greek myth talked about Europe (a Greek-Phoenician princess) as being abducted by Zeus, the king of all gods, illustrated by the sculpture on the first page of this volume. It is known how myths try to explain the current situation by etiologically projecting it into a time before time. The mythological stealing of Europe is then a powerful symbolic metaphor for its permanent state of crisis. In that case, Europe should learn to live in this crisis mode that determines so much of its identity, rather than trying just to overcome it. In a nutshell, 'crisis mode' is an inalienable element of the European identity, and (at least to a certain degree) the key to its historical vitality and to its cultural creativity.

This quest for purpose has also been a quest for a narrative identity for Europe (Ricoeur, 1988).[1] The linguistic elements of this are not just instrumental.[2] Perhaps the analysis of the contemporary debates about Europe is too often focused on its dogmatic identity (what Europe is) and on its historic identity (how Europe came to be). Never disregarding that, attention should be given as well to the way Europe talks about itself. While doing so, European culture actively shows and reconstructs its own identity. This is the backdrop for its current quest for purpose. That is the reason why some of its linguistic elements, such as the metaphors being used, are significant for an analysis of the current situation of the European project.

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1 Former EU Commission President José Manuel Durão Barroso (2013a) engaged also with the quest for a "new narrative for Europe": "But why, some may ask, a new narrative for Europe and why culture? [...] A new narrative for Europe not because we don't remain loyal to the *raison d'être* of the European community and the European Union; of course this remains valid. But because I think we need, in the beginning of the XXI century, namely for the new generation that is not so much identified with this narrative of Europe, to continue to tell the story of Europe. Like a book: it cannot only stay in the first pages, even if the first pages were extremely beautiful. We have to continue our narrative, continue to write the book of the present and of the future. This is why we need a new narrative for Europe".

2 I am applying to this subject the well-known principle set by Marshall McLuhan (1994: 7-21): 'The medium is the message'.

2. A body in search of its soul

A first great metaphor being used to talk about European identity and purpose comes from the anthropological realm: body and soul. A critical analysis of the current state of European political institutions underlies its use: these institutions are (or became) like bodies without souls. Taking into consideration the current sense of crisis among Europeans, one might think this is a relatively recent element in public discourse. But that is not the case. Quite the opposite, this metaphor was already being used early on. We can trace its use as far back as Robert Schuman. It was he who once stated that the European project "needs a soul (*il lui faut une âme*)".[3] More common among the European Union's 'founding fathers' was to establish a relationship between their own spiritual path and their public engagement with the European agenda. For instance, in a letter sent to Italian prime-minister Alcide de Gasperi, German chancellor Konrad Adenauer acknowledged: "We both faced our problems from the same spiritual base. We both started our political careers in a party that was both Democratic and Christian and we made sure that was clear in our actions".[4] Although there is here no explicit reference to the metaphor body-soul, the concern remains the same: the quest for a solid base for the European political project. This issue was in the mind of Europe's 'founding fathers' right from the start. On top of this inference, statements like this allow us to realize what these European politicians understood to be the 'soul of Europe'. To a higher degree than perhaps happens today, they associated it with a spiritual dimension, and even with a religious (Christian) reference. In doing so, they too were faced with some form of criticism, to which De Gasperi (2004: p. 185) answered in a quite unexpected way:

> "Recently, some have accused us and other European supporters of establishing, in the shadows, a kind of identity between Europe and Christianity or, more than that, between Europe and Catholic Christianity. Before being unfounded, this accusation is nonsensical. Allow me, however, to remember that Christianity, being a divine thing in our eyes, belongs to and is addressed to all men. To make it just a European thing would be to limit it and to degrade it".

Other layers of meaning can be found in the European appeal to the metaphor of body and soul. Besides this spiritual and/or religious element, the soul has also

3 Robert Schuman, quoted in de Gasperi (2004: p. 11).

4 Konrad Adenauer, quoted in De Gasperi (2004: p. 17).

been associated with an existential and institutional élan. That is precisely what a soul does to a body: it gives it life, motion, and reason.[5] The term 'soul' was explicitly used by another major figure within the European movement: Jacques Delors. Taking inspiration from Schuman (whom he quotes), Delors strongly associated the need for a purpose with the image of a soul: "It is necessary to give Europe a soul. [...] If in the next ten years, we are not able to give Europe a soul, spirituality, a meaning, we will have lost the game".[6] This dramatic prediction (from 1992) has been intensely quoted ever since and made Delors the great promoter of this metaphor. Three years before, though, he had already used this anthropological analogy, clearly diagnosing the need "to give more flesh (*plus de chair*) to this community and, why not, [also] a supplement of soul (*un supplémentd'âme*)".[7] In 2011, Delors would still come back to this issue, presenting it as a need for a "spiritual élan", without which "nothing great and lasting can ever be accomplished".[8] His successor, Jacques Santer, also engaged with this metaphor. He introduced, perhaps, a complementary view on it. The anthropological unity of body and soul implies that both need each other. If it is true that the European institutional body needs a soul, it is also true that the European soul is in need of an effective historical and political body. Santer promoted this complementary approach to the metaphor body-soul, namely by declaring that: "To give Europe a soul, it is not enough to recall the principles of European construction, which are reconciliation, peace, solidarity, justice, freedom or human dignity. It is still necessary to apply these principles".[9] The strength of the European soul is, therefore, also dependent on the effectiveness of its institutional body. Just as there is no living body without a soul, there's also no historical soul without a body.

Religious leaders also dealt with this metaphor, seeing in it an open door to their participation in the debates about European identity and, more important still, to critically address the secularization of European societies. They found in this element of the European authorities' discourse a bridge to something they were already arguing: a society that despises its spiritual element does not authentically promote the good of its citizens; Europe has the Judeo-Christian culture imbedded in its very identity, ignoring or renouncing it would lead Europe to

5 Triadic structure somehow related with the classic Aristotelian view on the soul.

6 Jacques Delors, quoted in Daloz (1999: p. 215).

7 Delors (1989).

8 Delors (2012).

9 Jacques Santer, quoted in Daloz (1999: p. 215).

failure or to the emergence of something that would no longer be Europe. This was also a reaction to a decrease in political influence by these communities, a consequence of the mentioned secularization of European societies. Pope John Paul II, a great European from the twentieth century and a religious leader with an acute understanding of his political role, was one of these leaders who appealed frequently to the 'soul' of Europe and did so in the context of the ecclesial project of a "new evangelization" for Europe. In his words (Pope John Paul II, 1991: p. 176):

> "Even today, the soul of Europe remains one, because, in addition to its common origins, it lives on common Christian and human values, such as the dignity of the human person, a profound sense of justice and freedom, work, a spirit of initiative, love for the family, respect for life, tolerance, the desire for cooperation and peace".

He makes here some controversial assumptions. Firstly, the soul of Europe is fundamentally one, something that seems to be challenged by numerous expressions of cultural diversities in it. Secondly, this unity derives from its common origins and from a common Christian background. If these claims by John Paul II cannot be discarded, because there are elements of truth in them, they should at the least be balanced with the acknowledgment of traces of diversity in its past history and in its current situation. The fact is that the metaphor 'body-soul' is here reinterpreted, giving it a stronger religious meaning. According to Teixeira (2004: p. 40), to Pope John Paul II, "Europe is incomprehensible without Christianity; the Church, is linked to everything that makes the glory of Europe; she is the soul of Europe". In this perspective, 'soul of Europe' does not only mean a general sense of purpose or a vitality needed by an institutional and political body. It goes deeper than that, almost being identified with Europe's religious and spiritual traditions. These are seen as key means to overcome divisions and to consolidate the European social and political processes. Therefore, according to him, "it is urgent to return to the common sources of that faith and to the same set of values that constitute [Europe's] most precious heritage" (Pope John Paul II, 1991: p. 483). This axiological or ethical dimension of Europe's soul is a recurring element in the way several religious leaders use this metaphor. That is confirmed by the way Pope Benedict XVI also took part in this discussion, clearly coupling the spiritual and ethical dimensions of Europe's quest for its soul: "In order to create new and lasting unity [in Europe], political, economic and juridical instruments are important, but it is also necessary to awaken an ethical and spiritual renewal" (Pope Benedict XVII, 2008). He too had diagnosed, before the Italian Senate (on May

13, 2004), an inner 'void' in contemporary Europe, taking even further this anthropological metaphor of body and soul: "At this time, when Europe seems to have reached the pinnacle of success, it seems like it has become empty within, paralyzed by a crisis of its circulatory system, paralyzed by a crisis threatening its very survival, which is entrusted to transplants that cannot help but alter its identity" (Ratzinger, 2005b: pp. 24-25). In either case, the metaphor of body and soul is assumed as a means to "awaken an ethical and spiritual renewal", decisive elements of Europe's contemporary "search for its own identity" (Pope Benedict XVII, 2008).

3. A project in search of its roots

Another relevant metaphor used to talk about the current European challenges, and therefore about a greater purpose of the political integration project, is taken from the organic realm. It focuses on the "roots" of European culture. This second metaphor is used, though, in a slightly different context, not so much to talk about the vitality of the current European political project but much more to raise the question of Europe's identity. The debate about European identity grew as European societies underwent significant transformations. A shift in mentalities introduced by post-War generations, with a major impact on its axiological views and life practices, social and economic globalization, that changed the role of Europe in international relations and promoted a non-Eurocentric view on the World, a decrease in birth rates and migratory fluxes, with the inevitable diversification of cultures in European soil, are amongst some of the facts that describe how Europe is changing. It is against this backdrop of change that the interest in finding and/or defending European identity has grown. It is within it that the appeal to the European "roots" has gained traction.

There seems to be a second difference in the use of this metaphor. While 'body and soul' is used in a reasonably balanced way both by political and religious actors, the appeal to the European 'roots' seems to be more frequent in the public discourse of religious leaders. Not that some traces of it cannot be found in statements of public office holders or even of renowned scholars. Former European Commission President José Manuel Durão Barroso, for example, talked about a European "aspiration for unity", which he saw "at the very root of European culture" (Barroso, 2013b), and Francis Fukuyama (2018: pp. 85-86), when dealing with the political impact of a worldwide quest for identity, describes contempo-

rary Europe as being "largely secular societies with Christian roots".[10]

This metaphor seems further used and developed by religious leaders. Such is the case, once again, of John Paul II and Cardinal Joseph Ratzinger (later Pope Benedict XVI). Firstly, this catholic leadership, here taken just as an illustration of this metaphor use, interprets the 'European roots' as its 'spiritual roots', as can be seen in the following quote (Pope John Paul II, 2003: 7):

> "I would like to mention in a particular way the loss of Europe's Christian memory and heritage, accompanied by a kind of practical agnosticism and religious indifference whereby many Europeans give the impression of living without *spiritual roots* and somewhat like heirs who have squandered a patrimony entrusted to them by history".

This diagnosis is very much in line with the observations that also contextualized the appeal to the 'European soul'. The highlighting of this spiritual element almost unites these two metaphors. They become almost two different means that stress the same idea. Due to that, there is no wonder if, with regard to the 'European roots', we can also find prophetic statements claiming about the 'roots' what is said about the need for a 'soul' or an 'élan'. For example, in programmatic pronouncements such as these: "The new Europe needs to rediscover its ultimate roots"; "Europe, as you stand at the beginning of the third millennium, *open the doors to Christ! Be yourself. Rediscover your origins. Relive your roots"* (Pope John Paul II, 2003: 21). Here too, one can see how the spiritual understanding of the 'European roots', in these religious actors' mind, leads to a Christian interpretation of this metaphor.

Secondly, this metaphor is also interpreted in cultural terms. This second element is not so relevant when talking about the 'European soul' as it is when talking about its 'roots'. 'Roots' become a reference to European history, to its heritage, which is deeply dependent on the religious and/or Christian contributions to it. These catholic European leaders never ceased to bring it into public debate:

> "Multiple are the cultural roots that have contributed to reinforce the values just mentioned: from the spirit of Greece to that of Roman law and virtue; from the contributions of the Latin, Celtic, German-

10 It is interesting to take notice of how Fukuyama too grounds his critical analysis of the current claim for identity on the "soul", namely on *thymos* that Ancient Greeks considered a part of it.

> ic, Slav and Hungarian-Finnish peoples, to those of the Jewish culture and the Islamic world. These different factors found in the Jewish-Christian tradition the power that harmonized, consolidated and promoted them. By acknowledging this historical fact in the process leading to a new institutional order, Europe cannot deny its Christian heritage, since a great part of its achievements in the fields of law, art, literature and philosophy have been influenced by the evangelical message. Not giving in to a temptation to be nostalgic or to be content mechanically to repeat past models, but being open to the new challenges emerging, Europe will need to draw inspiration with creative fidelity from the *Christian roots* that have defined European history" (Pope John Paul II, 2002: 4).

The immediate context of this pronouncement is of utter importance because it helps understand not only the meaning given to the metaphor 'European roots' but also to understand why this theme became so important for some religious actors. In the aftermath of the Laeken European Council (2001), the European Convention started the discussion and drafting of a European Constitution. The question if Christianity should have been mentioned in its preamble pushed these ecclesial leaders to take part in this discussion. Reacting against those who refused any explicit reference to Christianity in this essential document for the future of European institutions, they argued passionately in favour of the acknowledgment of the religious and Christian roots of Europe. On the one hand, John Paul II recognized a plurality in the European roots. A meeting of peoples and cultures helped create Europe as we know it. But, on the other hand, according to him, it was the 'Jewish-Christian tradition' that allowed for an integration of such diverse elements, in order to generate what has become Europe and the European culture. Therefore, even if the European roots are culturally diverse, Jewish-Christian culture historically plays in it an absolutely unique role or, in other words, it is a more decisive element of European identity than all those other cultural contributions.

J. Ratzinger (2005a: p. 352) echoed this same view. For him it was clear that Europe was going through a "stress test", a crisis mode that could be described with this organic metaphor: "A tree without roots withers". This test resulted from the contemporary clash of two European sub-cultures, one in which the Human being sees himself as a product of his own making and the other in which all things are viewed as gifts from a divine Creator (Ratzinger, 2005a: pp. 345-346). This was also a stand taken by him in the context of the debate about the

European Constitution.[11] As a matter of fact, in his view the resistances to any explicit reference to Christianity in the document were not grounded on respect towards other religious communities, but on a rationalist perspective that denies all forms of openness to transcendence. He tried, above all, to demonstrate how those ancient roots are not dead and are still needed for the future. This was a way to deal with the suspicion that his claim was essentially nostalgic of a Europe that no longer exists, one in which all the continent was Christian and that saw life through Christian eyes. To him, any "historical observation also implies something about the present, since to mention roots is also to point to residual sources of moral guidance, and so to something that constitutes the identity of this thing called Europe" (Ratzinger, 2005a: p. 348). Roots mean, therefore, the present relevance of European history, of its legacy and heritage, so deeply influenced by Christianity. In fact, as Ratzinger (2005a: p. 353) put it, "we need roots to survive".

4. Some concluding remarks

In the use of this metaphor, something seems to be missing though: the fruits of Europe. This would be a logical counterpart to 'roots' within this organic analogy. Perhaps a more detailed analysis of these debates might come to the conclusion that what might be considered the fruits of Europe is already being contemplated, even if the word is not being used. Anyway, this absence is meaningful. By 'fruits' I mean the current concrete manifestations or effects of the European culture(s). The European identity is not something to be found only in previous ages. It is also something that is dynamically showing and transforming itself today. In consequence, this European quest for itself supposes looking not only at its own foundations, as important as they are, but also at its contemporary realizations. This would allow for a more comprehensive analysis of these fundamental aspects of the European culture, assuming that cultural identity is not just some-

11 "Let us take a closer look at this contrast between the two cultures that have marked Europe. This contrast has surfaced in two controverted points of the debate about the Preamble to the European Constitution: shall the Constitution mention God? Shall it mention Europe's Christian roots? Some say that there is no need to worry, since article 52 of the Constitution guarantees the institutional rights of the Church. However, this means that the Churches find room in European life only in the realm of political compromise, but that when it comes to the foundations of Europe, their actual substance has no room to play any formative role. The arguments given for this clear "No" are superficial, and it is clear that, rather than indicating the real reason, they in fact cover it. The claim that mentioning Europe's Christian roots would offend the feelings of the many non-Christians who live in Europe is unconvincing, since what we are dealing with is first and foremost a historical fact that no one can seriously deny": Ratzinger (2005a: pp. 348).

thing to be found in the past (in its roots) but also something lively showing its strength and capacity to adapt and answer to new situations today. It would as well allow for a more dynamic narrative framework for the European culture, enriching the debate and, in consequence, the thought about these issues. It would, ultimately, help understand how religious and/or Christian elements are still decisive to European identity. These fruits might no longer be immediately perceived as being religiously and/or Christianly inspired, but perhaps they are. Religion, especially in secularized societies, tends not so much to disappear (as at first glance it might appear) but rather to take new forms and manifestations.[12] This means that there are several 'religious and/or Christian fruits' that just are not being perceived as that. If so, then all the talk about the religious and/or Christian roots of European culture(s) would no longer be under the suspicion of being nostalgic or anachronistic. At the same time, this would help religious communities overcome a defensive attitude towards some of the social and political developments in contemporary Europe.

The two great metaphors here highlighted confirm at least two things: Europe is in an intense quest for itself; and Europe has at its disposal a rich linguistic set of tools. Both put into words the current form of the European recurrent 'crisis mode'. They show not only what is happening today, but also show that, like in its past, it is through crises that Europe has always found its way. The former witnesses its recurrent sense of crisis and demand for purpose. The latter shows its cultural richness and intellectual vitality. But these two are intertwined. There is no purpose to be found outside the way we express it. Purpose has to have some logic, that is, some *logos* (word). There are no metaphors disconnected from reality. Metaphors use what there is and is known to us to express or explain something else. The two metaphors considered here – 'body - soul' and 'roots (- fruits)' – show also that Europe acknowledges the need for non-materialistic goals and strives to know what they might be. There is no reason not to see its religious and spiritual heritage as an asset in this European enterprise.

12 This raises another interesting question: Is it possible to keep producing these fruits (religious and/or Christian) disconnected from their roots? Is there not a risk of, after some time, losing that capacity?

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CHAPTER 3

Democratic respect in times of crisis: The case of the NextGenerationEU fund

Kalypso Nicolaïdis

1. Introduction

Crisis may generate policies that open new political vistas, pushing back the limits of the possible, or on the contrary policies that constrain our collective agency, giving defenders of the existing order a pretext on which to seek to consolidate it (White, 2022). To ask under what conditions are crises horizon-expanding instead of horizon-shrinking is not to ask whether politicians and policy makers manage to "solve" a given crisis, or in the period examined in this book, a series of crises, but rather whether the manner in which it is solved opens up new transformative possibilities that had not been imagined before (Nicolaïdis, 2022).

I believe that the so-called perma-crisis that has come to characterise the EU in the last 15 years has offered horizon-expanding potentials that will only be actualised through bold moves and a general ethos of what I refer to here as 'demo-

cratic respect'. I define democratic respect as an attitudinal disposition by which decision-makers engage in politics and policy shaping as a function not only of the "public interest" as they so conceive but as a function of the public's claim to self-government. This understanding sets out to overcome the a-priori tension between responsiveness and responsibility posited by Mair (2005) popularised by Juncker's infamous "we know what is to be done, we just don't know how to get re-elected when we do it". In contrast, an attitude of democratic respect sees the tension not as essential feature of the political landscape but rather as endogenous to the way decisions are approached and taken.

As discussed in several chapters in this book, the NextGenerationEU fund (NGEU) was conceived by the European Commission and the member states as both a way to absorb and "emerge stronger" from the economic shock created by the COVID-19 pandemic and a mechanism to operationalise a renewed commitment to European public goods, including the European Green Deal (Bongardt and Torres, 2022). Through its centrepiece, the Recovery and Resilience Facility (RRF) the EU has raised funds by borrowing on the capital markets and issuing bonds on its behalf that it makes available to its member states to implement reforms and investments to "make their economies and societies more sustainable, resilient and prepared for the green and digital transitions" as well as "address the challenges identified in country-specific recommendations under the European Semester framework of economic and social policy coordination". And in addition, it helps implement the REPowerEU plan to address socio-economic hardships and global energy market disruptions caused by Russia's invasion of Ukraine.

Here, I revisit the design and operation of NGEU as a test case for the effective expression of democratic respect and offer a normative justification for two ways to operationalise this ethos: the democratic panopticon and demoicratic deliberation.

2. NGEU Fund: Three Shifts

As I have argued elsewhere (Nicolaïdis, 2022) we ought to consider the potential opened up by the NGEU not just as the material injection of funds but rather as both a potential trigger and an expression of three (incomplete) shifts in EU policies with important implications for the EU polity and the question of democratic respect.

First is what we can call ‘deference with purpose’. Considering that relations between states are characterised by an ever-shifting balance between mutual deference and mutual interference, crises tend to lead to new equilibria between the two that may or may not be enshrined in new rules. In this sense, the EU is constantly revisiting Europe’s Westphalian bargain, which simultaneously enshrined sovereign recognition and therefore deference, and its conditionality and therefore interference, reminding us that states’ recognition of each other’s autonomy tends to be predicated on their *droit de regard* inside each other’s realm, as a function of mutual trust.

As we witnessed first and foremost in the case of Greece, the Euro-crisis will be remembered as a moment when EU institutions presided over a radical jump in asymmetric mutual interference allowance under the cover of debt. Such asymmetric interference combined in effect the traditional creditors conditionality playbook à la International Monetary Fund (IMF) with the much more far-reaching core competences of the EU. And this “great merger” turned the shared polity into the kind of enforcer which hitherto had been a role reserved for agents like the IMF, with the caveat that the IMF is both externally and temporarily involved.

Against this backdrop, the NGEU on the other hand, can be seen as a shift of the pendulum back to deference, based as it is on a bottom-up process of national commitments. In order to access the funds, the member states need to present ambitious investment programmes which integrate the digital and climate transition imperatives. The Commission allocates budgetary envelopes to the member states which generate their own distribution key between projects. To be sure, EU monitoring and its concurrent emergency break is still part of the equation, but linked not only to financial solvency but to the country’s continued contribution to shared purposes.

The second shift is more tentative and has to do with the modes and extent of accountability associated with the first shift. It may be premature to say that horizontal interference between states has been replaced by accountability *all the way down* at the domestic level bolstered by transnational networks. Here the mutual engagement which accompanies the sharing of funds extends beyond the diplomatic realm, taking place under the implicit auspices of the public sphere and the interconnected democracy spaces of the member state. At stake is indeed the question of whether the agency regained by EU institutions in the wake of the Covid-19 pandemic can be put to work for democratically-chosen ends.

Last but not least, and connectedly, the third shift has to do with the political-economic underpinning of the second shift, namely the nature of the funds at stake at the first mutualisation of debt in the EU, which in itself has key implications in democratic terms. This can be summarised in three stages: *"no spending without taxation*," "n*o taxation without representation*" and *"no representation without participation"*.

1. *"No spending without taxation*": the NGEU cannot escape the old imperative that new debts are bound to imply new responsibilities. There will be mighty political fights in the future which will unfold in the public arena, including on whether the spending will be covered by old or new taxes, how to balance EU fiscal autonomy with national fiscal primacy, the distributional implications for richer and poorer member states and most fundamentally, to what extent EU-wide taxes ought to mirror EU-wide benefits – from European taxation of digital multinationals, the «GAFA» (Google, Amazon, Facebook, Apple) for the benefit of EU-wide digital infrastructures to a carbon border tax so that the EU Emissions Trading System (ETS) does not result in competitive distortions facing EU firms in international trade (Bongardt, 2023, this volume). After all, the new taxes will bear important implications for each European citizen, even if on corporations and/or at the border, given fiscal crowding out, induced inflation, and so on. The core democratic tensions between considerations of distributional fairness and electoral savviness are bound to be at play. In all of these ways and more, the hike in taxation opened up by NGEU, even if at the EU level, will have crucial democratic implications.

2. *No taxation without representation*. Although extensive monitoring and reporting mechanisms have been put in place to support the Recovery and Resilience Fund (RRF) it is not clear how democratic they might be. They provide benchmarks to the public on how the funds are used in different countries according to alternative criteria of output and outcome, collated in databases such as the research infrastructure FENIX. But there is no such data at the micro project level.

3. *No representation without participation.* This is indeed the broader context in which the unfolding of NGEU takes place, a context where the EU increasingly recognises that participatory democracy is no longer a mere appendix to representative institutions but deserves an eco-system in its own right. Under this premise, the spending of the funds needs to be scru-

> tinized by any actor who wishes to and is able to do so, thus bringing to bear the wealth of collective intelligence in deploying the EU's resources. The general public, the media and the organisations involved in formal and informal activism may stand at the end of long chains of scrutiny, but they are the ultimate stakeholders in the kind of democratic control called for by such an ambitious programme. Unfortunately, beyond being informed on their country's or region's performance of specific targets, monitoring does not extend to the project level whereby the public would be granted the means for granular assessment of 'where the money goes'.

How then can we envisage to address the triple democratic challenge raised by these three shifts?

3. The democratic panopticon: Democratic respect through radical transparency

I have suggested elsewhere (Nicolaïdis, 2021) the idea of subverting the ominous idea of Bentham's surveillance panopticon to herald the creation of a *democratic* panopticon, whereby decision-makers, like Bentham's prison inmates, will be effectively compelled to regulate their own behaviour under the assumption that citizens might be watching at least some of the time, their power both visible and unverifiable. Publicity takes the place of surveillance, a way to guard the guardians, and social control becomes control by society, not of society. In effect, what we should be advocating in the age of the internet and widespread literacy is a kind of monitory democracy on steroids, as one element of a broader democratic ecosystem in the EU. The implementation of the NGEU may serve as the testing ground for such a democratic panopticon. Forget *la revolution permanente*, long live *la participation permanente*.

But could NGEU serve as the test case for such a democratic panopticon in the EU? To be sure, there has been attempts in this direction with regards to the Common Agricultural Policy.

When it comes to classical electoral representation, it is fair to say that much depends on the vigilance of national parliaments themselves. In short, the NGEU offers two modes of scrutiny: First, a policy mode where country programmes are assessed and audited on the basis of performance-based criteria, gathered in an aptly named FENIX data base where disbursement follows investment performance. Second, an ethical mode based first and foremost on national systems

which control ex-post for fraud or conflict of interest, monitored by the Commission (see ARARCHNE data base). On both counts, this gap in reimbursement opens up the potential for expanded scrutiny since assessing whether funds have been spent appropriately tends to require time. But how democratic has this scrutiny been until now or is likely to be? Have governments published the data in accessible ways? What is the optimal democratic division of labour in the process?

These questions vary depending between two different moments in the RRF cycle:

a. The *ex-ante* approval process of the spending plans where one would expect a primary (budgetary) role for national parliaments to mitigate the risk that executives both be judge and party. Up to now however, and while every country operates under a different tradition of parliamentary control, such scrutiny has generally been wanting. Some argue that national parliaments cannot be involved in the details of every sectoral allocation but need to set budgetary priorities and overall rules of conduct (in Italy for instance the parliament added an obligation to channel 40 per cent of the funds to the South). Is this sufficient? How should this process relate to electoral cycles? What happens with a change of government in the middle of the procedure? Should the European Parliament (EP) fill the gap of time consistency?

b. When it comes to the execution of the plans through procurement and specific projects, questions of scrutiny become all the more critical. To what extent should control remain mainly retroactive as it is today? The current process emphasizes targets and the role of national control and audit system (CAS) which needed to be in place before the plans (rooted in national legislation and the structural funds machinery). In theory the EU acts as a power of enabler, allowing for instance parliaments to hold hearings and ask the CAS agency for detail. But what kind of data is made available to them? On what grounds can they assess projects? Should the EP be given a greater role to assess performance on top of the Commission's more narrow or technical assessment of outcomes based on milestones and targets? And if the EP's role is to introduce greater political judgement in these assessments, should it not work closely with national parliaments?

Clearly, most national parliaments are having a difficult time discharging this democratic oversight function. This is why the third leg of our democratic call stands on the premise: no representation without (citizens') participation.

Yet, when it comes to participation from civil society and the public at large, the democratic deficit is even wider. To be sure, even if degrees of transparency vary between member states, and between different levels of government, no member state seems to have embraced the idea of radical transparency to enhance the legitimacy and efficacy of the funds. To counter this state of affairs, the project labelled "the recovery files project" initiated by the Dutch company "follow the money", has gathered journalists from about 20 member states to conduct their own assessment and transparency advocacy. As they point out, even the European Court of Auditors has recognised that it does not have enough resources to scrutinise properly. An early mover, the *Coalición Pro Acceso* and the Open Generation EU Platform have publicly called on the Spanish government to open the files. And the Helsinki committee in Hungary has demonstrated risks of government-led corruption in its preliminary reports, nepotism, with EU moneys often used to subsidise political messaging against EU. More generally, social partners across countries have started to question on what grounds country strategies can assess what is 'incomplete reforms' (as in judiciary, pensions, labour markets, tax) which were traditionally negotiated with social partners and stakeholder.

The compass for such a journey has an old democratic pedigree: inclusion. In some ways, the process of deepening the reach of democracy remains the same as it has been, namely a series of struggle to expand the franchise, to include more citizens under its tent. This time around, it is a franchise that does not necessarily express itself through the right to vote in periodic elections, but rather through widespread inclusion in the political process in all its forms, including the process of allocating the biggest funding drive ever available in the EU. We need no less than a democratic panopticon to ensure that those funds are allocated fairly.

4. Deliberative Citizens' Assemblies

The other side of the coin of democratic control goes beyond the idea of monitory democracy to advocate a control of these funds by Citizens' Panels or local assemblies whose members are selected by lottery to be involved in decision-making. Such a demarche in phase with a decades-long tradition of participatory budgeting, has already been experimented with regard to how cohesion policy funds get prioritised and spent (see Cantabria in 2021-22). And indeed, many citizens across Europe are engaged in democratic innovations at the local and national levels. At the EU level, the Conference on the Future of Europe (CoFE), 2021-2022, has opened a window of opportunity by offering a fascinating experiment with its

four Citizens' Panels that each brought together 200 people selected by lottery from across 27 member states to deliberate in 24 languages for around six days. The European Commission has since continued commissioning Citizens' Panels to inform its policy making processes in 2022-2023.

The time has come to make a qualitative step forward, to move the needle on the EU's democratic paradigm and open up a path for EU institutions to give people genuine voice and power in shaping EU-level decisions. A standing EU Citizens' Assembly could connect everyday European citizens (directly to one another, and not only through their institutions). By existing on an on-going basis with rotating members it could avoid arbitrariness and cherry-picking on when and how such assemblies are convened, while at the same time opening up the promise for learning over time. Such an assembly in turn could meet in different configurations, including to monitor the spending of European funds at local level. In other words, citizens assemblies can serve here as the main vehicle against state capture and corruption. When funds are distributed on the scale engineered by the NGEU, there is little doubt that such citizens' empowerment would bolster the EU.

5. Our demoicratic imagination

Whether this triple shift is actually at work remains to be seen but I believe that it has to do as much with our political imagination as with the constellation of economic interests that have been directing the combined hands of the market and the state involved in delivering NGEU. Put simply, what is at stake with the NGEU is whether it will serve as a conduit for the reinvention of Europe's greatest asset in the face of the global autocratic onslaught: democratic authorship and the collective intelligence that comes with it.

This appeal to our democratic imagination rests on a simple diagnostic regarding public opinion in the EU. Scholars like Virginie Van Ingelgom (2014), Catherine De Vries (2018) or Sarah Hobolt (Hobolt and De Vries, 2016) have demonstrated that 'the median European' is neither Eurosceptic nor Europhile but that Europeans tend to be integrationist in substance and sovereigntist in method. They approve of 'more Europe' to address crises like a pandemic, but also of more decentralised, local engineering of crisis response. In this spirit, we need to manage democratic interdependence between its member states all the way down, progressively promoting norms and processes that connect national democratic conversations horizontally supported but not captured vertically by Brussels.

This is what I mean when I say that the EU can be understood as a 'demoicracy' in the making, a union of peoples who govern together but not as one, where a shared political identity resides with the empowerment of national democracy by the centre and with caring about what happens in our respective national or subnational democratic space, spaces that are becoming increasingly politically vulnerable to each other. For sure European demoicracy is unstable and vulnerable, given the centrifugal and centripetal forces of bureaucratic centralization and populist renationalization that feed each other's justificatory narratives. But this makes the challenge all the more appealing.

Such a demoicratic vision of what the EU is about, I believe, is much more ambitious than the dream of those who advocate making it ever more state-like, ever more centralised and harmonized (or 'federal' in the traditional way). A demoicratic union is the most ambitious reading of what European integration is about: deep horizontal mutual recognition through democratic agency to allow for togetherness among utterly diverse peoples. The paradox of this EU third way is thus: the most densely institutionalised cooperation among states in the world, yet between the most deeply entrenched nation-states in the world.

We have long bemoaned the fact that something is clearly missing in European politics in times of crisis. If a demoicratic order is about process rather than *finalité*, this process has neither been linear nor uncontested, owing in part to the tension between the messianic logic that has prevailed in the EU since its inception (Weiler, 2012) and a more open-ended demoicratic ethos and praxis. Traditionally erected on the two separate pillars of indirect (intergovernmental) and direct (supranational) electoral democratic legitimacy, the EU is evolving into a transnational democratic system relying for its evolving legitimacy on multifaceted representation, deliberation and participation which the label of 'demoicracy,' seeks to capture (Lord and Magnette, 2004; Lord et al., 2022). But demoicrats can differ on the interrelationship between three types of transformative dynamics which shape the novel transnational order on which a demoicratic EU builds: (i) the transformation of the European state system away from a classic regional order of sovereign states; (ii) the transformation of nation states into member states; (iii) the transformation of a diplomatic contract through intergovernmental EU treaties into a democratic contract within and between the peoples of Europe. In theory at least, this third transformation is underpinned by the transformation of national societies through processes of horizontal Europeanisation. Such a three-pronged 'transformative' logic unfolds in contrast with the 'mimetic' logic behind endeavours to build a continental state - at least in so far as it remains open-ended.

Democratic respect is the more critical part of a demoicracy, as participating states must abide by the commitment to make their citizens author the laws that apply to them, thus putting national modes of authorisation of EU decisions and rules at the centre. If the EU is primarily accountable to its demoi, not just to their states, "when governments make commitments to one another about their future behaviour, they simultaneously need to be responsible and accountable to their domestic populations in order to retain their political legitimacy" (Bellamy and Weale, 2015: 259). If the demoicratic legitimacy of the Union starts with whether the EU polity takes roots in the democratic practices of the member states, the Euro crisis has exposed the insufficient effort made by national institutions to channel citizens' participation in European affairs and to allow for adequate controls over collective decision-making. EU accountability implies that every national democratic public, and not just their governments have the last word on EU law that matters most.

The key to EU demoicracy is to focus on the various channels of democracy from below, empowering both formal and informal civil society to make good on the Lisbon Treaty's provision on participatory democracy (Liebert, Gattig and Evas, 2016). To counter democratic disaffection and the fragmentation of the European public sphere we also need to move beyond voting and other traditional rights associated with citizenship (Van Reybrouck, 2018). A demoicratic ethos explores a 'right to participate and deliberate' jointly with citizens from other states, beyond traditional models of representative democracy which cannot achieve direct democratic interaction and debates across national or metropolitan polities and citizens in Europe. A demoicratic research agenda explores new ways of linking representation and participatory process in the EU context, thus interrogating the meaning of 'representation' itself.

In this regard, the EU's Conference on the Future of Europe was a greatly valuable demoicratic experiment. Its use of European Citizens' panels demonstrated that transnational deliberative processes can be effective in enhancing the kind of mutual knowledge and entanglement called for by a sustainable demoicracy (Alemanno and Nicolaïdis, 2021). The demoicratic case is strong for democracy-through-sortition (Sintomer, 2023) at the EU level that would lead to substantive powers for transnational citizens assemblies, whose workings would empower citizens and civil society organisations through their deliberative, monitory and mobilising functions. More broadly, CoFE has opened a new window of opportunity for reflection on new kinds of political agency and interaction between citizens, political elites and bureaucracies to bring the deliberative wave, which

has so far concerned only the local/national (Chwalisz, 2019) to the next level as a crucial way of managing democratic interdependence. Hence, we need to ask how the twin challenges associated with mere changes of scale and with the transnational character of deliberation can be combined (Vergne, 2013). Accordingly, the EU could offer a new space for citizens' empowerment by refining modes of multilingual and transnational communications for a radically renovated European demoicratic public sphere (Evas, Liebert and Lord, 2012).

6. Conclusion

Crisis can be the harbinger of radical change. If the NGEU was to be the trigger to set out a process of genuine public accountability, there would be hope for the EU to stand out in the landscape of democratic experiments not by claiming to be 'more advanced' than the rest of the world, but by investing in scaling up the kind of participatory and digital democracy that has burgeoned around the world from the national or subnational level to the transnational, and from the vertical to the horizontal. In this spirit, I have tried to suggest how effective democratic control of NGEU will in the years connect taxation, representation and participation in a genuine attempt to do away with the kind of state capture that has given democracy a bad name in our turbulent era.

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CHAPTER 4

Brussels in hard times: the EU's executive deficit[1]

Sergio Fabbrini

1. Introduction

Since 2009 the European Union (EU) has seen a sequence of crises which have rocked its very institutional structure. It is noteworthy that 2009 was also the year that the Lisbon Treaty, the last of the treaties approved, came into force. The idea with that Treaty was to close the long and troubled period of the EU's institutional consolidation exemplified by the major enlargement in 2004-2007. So, while the Lisbon Treaty thought it had completed the consolidation stage, the crises reopened it. In August 1954 Jean Monnet said something which became an unchallengeable truth in pro-European thinking, i.e., "Europe will be forged in crises, and will be the sum of the solutions adopted for these crises." The EU has certainly responded to the crises, proving itself reactive and resilient. However, its responses have also highlighted the weakness of its system of governance, in terms of effectiveness and legitimacy. The representational deficit in the EU has long been discussed, in reality the crises have shown that the EU has a governability deficit. Here, I will proceed as follows. I will set out the institutional context that was formalised in Lisbon, then I will analyse the crises which followed, to then

1 Thanks to the editors for their comments to the previous version.

discuss their consequences for the EU. I will conclude with some considerations on the EU's executive deficit.

2. Who decides in Brussels?

Before looking into the crises of the last 15 years, it is necessary to specify the institutional context in which they were faced. The EU which emerged from the Lisbon Treaty is a hybrid or composite institutional system, within which there co-exist differing decision-making approaches which are sometimes distinct and sometimes overlap (Fabbrini, 2015). It was with the 1992 Maastricht Treaty that the EU internally institutionalised different decision-making regimes (or pillars). With Maastricht a form of dual governance takes shape, a supranational one for regulatory policies of the single market and an intergovernmental one for strategic policies, traditionally close to the heart of national sovereignty (core state powers as security, foreign affairs and defence, home affairs and political asylum, fiscal policy; Genschel and Jachtenfuchs 2014), which became common policies after the end of the Cold War. Although the 2009 Lisbon Treaty abolished the pillar structure, it preserved the decision-making differentiation.

In supranational governance, which was prefigured in the Single European Act of 1987, the European Commission monopolises legislative initiative, while the Council of ministers (hereinafter, the Council) and then (since 1979) the European Parliament have the power whether or not to approve (with differing majorities among them) the proposals (regulations and directives) put forward by the European Commission, with the European Council of heads of government called on to intervene only when disputes emerge on politically sensitive issues. This decision-making regime was enhanced by various Treaties approved after 1992, up to becoming, in the 2009 Lisbon Treaty, the ordinary legislative procedure (Dehoussse, 2011). Instead, in intergovernmental governance, decisions in core state policies are rarely of a legislative (but, rather, political) nature and are taken on the bases of the initiative by one or other national government (rather than by the European Commission). The decision-making process is controlled by the Council and (particularly) the European Council, with the European Commission acting as a secretariat and the European Parliament side-lined (it is informed of the decisions taken but rarely has the chance to approve or sanction them) (Bickerton *et al.* 2015). With the various enlargements, that of the 1990s and above all the 'big bang' in 2004 and 2007, intergovernmental governance became the preferred decision-making strategy of national governments, also in

areas not strictly related to core state powers. The enlargements not only increased the differences among the member states, but above all brought within the EU states that were jealous of their national sovereignty or were committed to re-establishing themselves as such (after having their sovereignty taken away by Soviet domination) (Larsen 2021).

Thus, the nationalism of the new states that joined the EU as from the 1990s strengthened the intergovernmental approach which, in its turn, fed nationalism. Inside intergovernmental bodies, national interests were protected by the power of veto granted to each national government, a condition that guarantees the small but also the large member states. France has always had an intergovernmental predisposition, but so too did post-1990 Germany. That unification blunted the supranational culture predominant in the country up to then, since intergovernmental governance ended up increasing Germany's decision-making influence as a demographically larger country with a stronger economy. So, with Maastricht, a structural differentiation was created within the EU, which makes Monnet's phrase problematic. As Anghel and Jones (2023: 767) noticed, "any argument that Europe is forged through crisis is unlikely to tell us much about what Europe is or where it may be headed". Indeed, it is necessary to specify which form of governance is favoured by the solution adopted for the crisis in question. The latter can in fact lead to an acceleration of the integration process in either a supranational or intergovernmental direction (Fabbrini and Puetter, 2016). But, of course, this will depend also on the crises to be faced.

3. Monnet and the crises

Not all crises are equal (Lehene, 2022). They differ in terms of their nature, magnitude, but above all their 'cognitive construct' (Schmidt, 2015). Despite reflecting empirical phenomena, crises are socially and politically constructed by constellations of actors successfully mobilizing ideas congenial with their own interests. I will consider here crises that occurred in policy fields where national governments had a competence's pre-eminence over supranational institutions, had different impact on member states and had different consequences for the predominant paradigm of public policy. These differences can be traced to two distinct types of crises, distributive (in the 2010s) and constitutive (in the 2020s).

Distributive crises are considered such because they impact relations among member states, regarding the costs to be met for managing or resolving them, but do not call into question the main paradigm to handle them. This is the case of the

sovereign debt crisis and the migration crisis in the first half of the 2010s. Despite both crises having a distant external origin (the former followed the global financial crisis, the latter the degeneration of the Syrian conflict), they were finally interpreted as endogenous (due to the policy choices of some member states), asymmetric (hitting some member states more than others) and reinforcing the predominant policy's paradigm. The sovereign debt crisis rocked the Eurozone, based on a single currency and distinct national budgetary policies, although the latter have been highly regulated to ensure their compliance with precise macroeconomic parameters, or, as put by Bongardt and Torres (2022: 283), hit an EMU left incomplete in its economic part. The sovereign debt crisis was eventually interpreted as due to the fiscal profligacy of the debtor member states (Carstensen and Schmidt 2018). This led to a further regulation, in the form of new legal measures and new intergovernmental treaties (inside and outside the EU), to prevent conduct entailing moral hazard by those member states. The dominant policy's paradigm was confirmed: it was a national responsibility to deal with the crisis. At its turn, that solution generated a deep division within the Eurozone (Matthijs and Blyth 2015). A similar interpretation emerged with the migration crisis in 2015-2016, caused by the arrival of over one million Syrian refugees in Europe (Genschel and Jachtenfuchs, 2018). The migration crisis, with its related asylum policy implications, hit more the member states willing to open their borders to the refugees (as Germany) than those opposing that policy (the countries of the Visegrad Group, Poland, Hungary, the Czech Republic, and Slovakia). Indeed, that latter group argued that the crisis was triggered or accelerated by the openness of the welcoming member states, using the institutional tools of their competence's pre-eminence for containing its consequence. The division between member states was cooled by sub-contracting the management of the refugees to a non-EU member state as Turkey. In this case too, the dominant paradigm in migration policy was not called into question (Guiraudon, 2018). A paradigm based on the pre-eminence of national governments in managing immigration, a pre-eminence symbolised by the Dublin rules, on the bases of which it falls to national governments to take responsibility for the external defence of national borders, despite internal borders having been abolished by the Schengen Agreement.

The constitutive crises of the 2020s (such as the pandemic which exploded in 2020 and the Russian aggression against Ukraine in 2022) have instead been interpreted as a blow to the structure of the EU and did not solely alter the power relations among member states. In these two cases too, interpretations have been advanced claiming national responsibility for dealing with them, but the empirics of the crises helped those constructing a different interpretation of them. They

were finally interpreted as exogenous (since no member state could be considered responsible for their occurrence), symmetrical (even if they had contingent asymmetrical effects) and requiring a different paradigm for handling them. Once constructed as symmetrical and exogenous crises, it would have been implausible to deal with them through the national responsibility's paradigm. Those crises have called into question the policy models which organised the material constitution of the EU as such. The pandemic showed the inconsistencies in the healthcare security model based on member states' responsibility to guarantee protection of their citizens from epidemics (Schmidt, 2020). The war waged by Russia showed the inconsistencies in the growth and defence model adopted by EU member states with the end of the Cold War. In just one night, the Russian leadership wiped out the efforts of European countries (Germany in particular) to appease and trade with that country, efforts which were driven by significant economic interests. The post-Cold War approach of 'peace through trade' had enabled Germany to enjoy low-cost energy with which to support its national industry, thus making their products competitive on international markets (specifically the Chinese market). Despite the Russian annexation of Crimea and some eastern areas of Ukraine in 2014, Germany (but not only she) had continued to rely in industrial terms on two authoritarian regimes, Russia for energy and China for markets (Dempsey, 2022). Indeed, some national governments (led by the French one) have argued, regarding Germany's dependency on Russian gas, that the energy crisis was due to that country's irresponsible policy, highlighting therefore the distributive consequences of that policy. Following this view, the crisis can be conceptualized as partly endogenous and with asymmetrical effects (hitting Russia's dependent member states more than those who are not). If the paradigm of 'national responsibility first' has been challenged by the pandemic, the economic consequences of the Russian invasion of Ukraine could bring it back again (at least partially). As if that were not enough, the Russian war showed also that the EU had no military defence system of its own, despite the rhetoric about its strategic autonomy, depending fully on the Americans through NATO (Bergman and Besch, 2023). The EU also found itself without a European defence industry, a sector which was fragmented owing to jealousy among the various member states.

4. Taking decisions in hard times

How have the crisis pressures (Ferrara and Kriesi, 2021) affected the established models of decision-making within the EU? In all the four crises considered, national governments could claim a competence's pre-eminence relatively to supranational institutions. Indeed, in both the distributive and the constitutive crises, the European Council proposed itself as the main crisis manager, although that role varied significantly. In the distributive crises, the European Council had the monopoly over decisions, with the support of the economy and finance ministers of the Eurozone or Eurogroup (in the case of the sovereign debt crisis) or of the Justice and Home Affairs Council (for the migration crisis). Those two crises, especially the first, led to the strengthening of intergovernmental governance, also thanks to the intergovernmental treaties agreed outside the EU. Nonetheless, intergovernmental governance created more problems than solutions (Fabbrini, 2019). A decision-making regime based on unanimity cannot handle crises which need immediate and efficient responses (Fossum, 2020). Indeed, during the financial crisis, the European Council was criticised for decisions which were 'too little and too late'. When a decision implies the unequal distribution of costs and benefits, then the deliberative nature of intergovernmental governance disappears, to give way to more Weberian power relations (in the case of the financial crisis, of creditor countries over debtor countries). Finally, an intergovernmental decision which produces redistributive effects, without the European Parliament being able to take part in the decision-making process, is inevitably perceived as illegitimate by those who pay the consequences (the citizens of the debtor countries). Indeed, the solution adopted for the sovereign debt crisis triggered a populist reaction in almost all the debtor countries, delegitimising the Eurozone system overall (Hopkins, 2020).

With the pandemic, after the crisis was successfully constructed as exogenous and symmetric, the intergovernmental approach struggled to take hold. Moreover, some national (the German chancellor) and European leaders had personally experienced the destabilising effects of that approach (an example of policy learning). As no one could be held responsible for it, the crisis was framed as a common threat which required a common response. That response arrived through divisions, implying different narratives on the crisis, between coalitions of member states (Fabbrini, 2023), although divisions constrained the answer to the pandemic also in established federations as the US (Fiorina, 2023). The European Council had to accept, if not to solicit, a more active role by the European Commission. Due to

the rising costs for vaccines generated by competition among states to buy them, the European Commission had to step in as the sole agency for their purchase, thus lowering their cost. Given the interstate divisions generated by the need to support the various national economies, it was necessary to acquire new resources for the recovery and resilience of national economies through NextGenerationEU (NGEU). A program consisting of loans and grants (guaranteed by the budget of the EU and those of its members states as well as by own new resources, so far only the plastic tax) managed by the European Commission and the Council, under the supervision of the European Council yet deprived of the power of veto. The constrained supranationalism of NGEU was however contained, in terms of time (the program will end in 2026) and logic (the resources acquired are distributed to member states and not used autonomously by supranational institutions). Thus, with the pandemic, the EU was given a temporally limited and ad hoc fiscal capacity (F. Fabbrini, 2022), unavailable for facing new challenges.

Challenges that came with the Russia's aggression against Ukraine. National governments did not give up their decision-making supremacy but, also in this case, they had to rely on action by the European Commission to find some common ground. The European Council approved ten packages of economic sanctions against Russia, despite repeated vetoes by the Hungarian government delaying their implementation. The European Council reached agreement to refinance the European Peace Facility funding which is needed to buy arms to then send to Kyiv or to reimburse national governments for sending their arsenal to Kyiv. With the war continuing, however, differences among member states resurfaced. The need to reduce the dependence on Russian gas led to divisions on how (and whether) to control its price. Taking advantage of the temporary suspension of the regulation which prohibits state aid, some national governments intervened with policies to support companies and citizens, a necessary choice which, however, accentuated the differences among countries which had fiscal space for manoeuvre and other countries restricted by high public debt. Also, the military assistance for Ukraine ended up having distorting effects. Some member states sent old munitions to Kyiv but then asked to be reimbursed as if they were new (Finland claimed 100 percent of the reimbursement based on new purchase prices, Latvia claimed 99 percent under those terms, Lithuania 93 percent, Estonia 91 percent, France 71 percent and Sweden 26 percent). Moreover, facing competition among national governments to buy new armaments, with the massive rise in the costs of military materiel, the European Council had to ask the European Commission to become a common procurement agency for those armaments, thus negotiating lower costs with the companies that make them, although the European Defence Agency claimed that role too.

But, above all, the Russian war showed the unpreparedness of the EU and its member states to face a military threat. The Russian war highlighted the lack of European defence, despite the Permanent Structured Cooperation on Security and Defence (PESCO), envisaged by Articles 42(6) and 46 as well as by Protocol no. 10 of the Treaty on European Union or TEU. Just consider that, one month after the Russian invasion (March 2022), the EU approved a Strategic Compass, proposed by the High Representative for security and defence policy, which envisages the mobilisation of a European rapid deployment force of just 5,000 soldiers. National governments considered that it was possible to continue to free-ride on American military protection to guarantee the security of European citizens. When, in the following months, various national governments finally set themselves the goal of investing in defence, they invested in national and not European defence, with the result of exacerbating the asymmetries among the various national defence capabilities. Think for example of the approval (in June 2022) by the *Bundestag* of 100 billion Euro to be spent on defence. Certainly, it was a *zeitenwende* in German defence policy (which implied emending the Fundamental Law) (Scholz, 2023), but it was not a step towards a supranational EU defence system. Indeed, it is likely that Germany's asymmetric rearmament will arouse inevitable concerns in other European countries, which will be hard to control through intergovernmental coordination. In short, the crises highlighted the incongruence of a union 'governed' by 27 national governments. Intergovernmental governance was unable to identify a common interest in both distributive and constitutive crises. After all, national governmental leaders were elected to promote the interests of their own country and not of the EU.

5. Conclusions

As soon as the Lisbon Treaty came into force in 2009, the EU had to face a series of crises which shook the institutional structure formalised by that Treaty. Contrary to the expectations of its internal and external opponents, the EU survived those crises, showing that it has sufficient institutional resilience. However, contrary to the opinion of its internal and external supporters, the EU showed that it was equipped to react rather than to act. Exploded in policy fields with a pre-eminent competence of national governments (as fiscal, migration, health and military and industrial security policies), those crises were initially addressed through the European Council. However, the latter has shown to have a limited effectiveness when dealing with the political implications of both distributive and constitutive crises. If the European Commission is controlled by the bicameral legislature (the

Council and European Parliament), the European Council is instead not subject to checks and balances at the level at which it acts. Its members take decisions in an accountability vacuum (Fabbrini, 2021). In fact, despite individual national leaders having the confidence of their respective parliaments or electorates, the European Council as an executive is not controlled by a legislative institution (the European Parliament) operating at the same level. The EU's executive deficit consists of the absence of a single executive institution endowed with the capabilities and legitimacy to act, in its turn controlled by a bicameral legislature legitimated by European citizens and by member states. The Union must not become a 'state', but it cannot do without a government, to guarantee its external security and its internal functioning. In other words, to face hard times. If Europe's coming of age (Tsoukalis, 2022), then it would require new clothes.

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CHAPTER 5

What future for the European Union: Forward via progressivism, backwards with neo-liberalism, or off the rails with populism?

Vivien A. Schmidt

1. Introduction

Over the past few years, the EU has been subject to a compounding of crises which have affected just about everything. With regard to European economic governance alone, the decade of the 2010s was defined by the eurozone crisis, with belt-tightening austerity and structural reforms that were slowly eased over time, and suspended in 2020. In 2020 came the Covid-19 health pandemic, with its expansive measures to shore up the economy while protecting peoples' lives and livelihoods, followed by the inflationary pressures engendered by restarting econ-

omies with broken supply chains, and then the energy crisis linked to the Ukraine war. And throughout has been the on-going existential crisis related to climate change, with the uncalculatable costs linked to increasingly hot summers, intense forest fires, and rising seas. How the EU responds to the challenges driven by these crises will determine its future.

The main question is: Will the EU stand together? Will it come up with new unified EU level responses to invest in the EU's future, including new industrial policy and investment vehicles to combat climate change and social inequality while responding to the security risks? Or will the EU and the member-states at best muddle through? For the answer much depends upon which of the current three '*big ideas*' wins out. Will the EU move forward via *progressivism*, backwards with *neo-liberalism*, or off the rails through *populism*?

What are these three big ideas, very briefly? Progressivism brings with it attention to the existential problems of today, and attempts to fix them with bold answers. This necessarily implies a shift away from the long-time obsession with debt to emphasize investment, building on the example of the temporary Resilience and Recovery Fund, with its focus on the green transition, the digital transformation, and addressing social inequality. In contrast, a return to the neo-liberalism that has oriented the last forty years of economic thinking, with its focus on market solutions, a limited state, and debt-reduction, means a return to the failed governance of the Eurozone crisis, with austerity and without the investment vehicles necessary to confront the EU's many challenges. Moreover, the negative spillovers from such economic governance will lead to the further rise of populist anti-system politics, in particular on the extremes of the right. Their nationalist, us-versus-them rhetoric, combined with climate-change denialism, welfare chauvinism, and attacks on the institutions of liberal democracy, will make cooperatively developing solutions to the EU's many crises ever-more difficult.

This chapter begins with a brief review of the EU's economic governance and its problems since 2010, then turns to ways in which proponents of each of these big ideas might respond to on-going problems: beginning with progressivism, followed by neoliberalism, and ending with populism.

2. EU economic governance since 2010

The EU's response to the Covid-19 pandemic in 2020 represented a great leap forward, particularly in contrast to its response to the Eurozone crisis beginning in 2010 (Schmidt, 2020b). Solidarity replaced austerity with the creation of the temporary EU level debt instrument of the NextGenerationEU (NGEU), with its 800bn euro Resilience and Recovery Fund (RRF), focused on the green transition, the digital transformation, and social inequality. Moreover, the European Semester itself changed from top-down negative conditionality to a bottom-up positive conditionality, with more carrots and fewer sticks.[1]

The pandemic response was a tacit acknowledgement that the emergency politics related to Eurozone crisis responses had not been fit for purpose. 'Governing by rules and ruling by numbers in the Eurozone' engendered what I have called "Europe's crisis of legitimacy," which negatively affected public perceptions of Eurozone governance in terms of the economics, politics, and procedures (Schmidt, 2020a). With regard to the economics, the lack of policy effectiveness plus the resulting poor general economic performance put output legitimacy (as outcomes) in question. This in turn led to major political fallout, as shown by the decline of mainstream parties and the rise of populist anti-system challengers, suggesting that input legitimacy (as political responsiveness) was equally in jeopardy. In terms of the eurozone's rules-based, numbers-targeting governance, moreover, throughput legitimacy (as efficacy, accountability, transparency, inclusiveness and openness) was also very much up for grabs.

Put another way, the emergency politics involved in eurozone governance raised questions about the legitimacy of supranational executive authorities' governing activities in times of crisis, and in particular whether ensuring effective outcomes (output) can make up for the temporary suspension of political responsiveness (input) and accountable procedures (throughput) (Schmidt, 2022a). The evidential test for this is whether supranational actors in the midst of emergency politics can make up for what they lack in traditional coercive state powers with their rhetorical power to legitimize their actions during times of emergency and to normal-

1 Negative conditionality required rapid fiscal consolidation to meet the deficit and debt criteria of the Stability and Growth Pact along with structural reforms focused on deregulating labour and cutting the welfare state, or face enhanced surveillance procedures by the Commission and the threat of sanctions. Positive conditionality involves RRF grants (carrots) for green, digital, and social projects proposed by countries in exchange for structural reforms focused on attacking national economic vulnerabilities and administrative hindrances as well as promoting social 'fairness'.

ize them afterwards (Kreuder-Sonnen and White, 2022). From the Eurozone crisis of the 2010s through the Covid-19 pandemic of the early 2020s, the contrasting experiences of the ECB as opposed to the European Council and the European Commission are revealing. Whereas the ECB's increasingly expansive monetary policy through emergency bond-buying measures continued to be ratcheted up during the two crises, and was generally normalized as (output and throughput) legitimate, the emergency measures of the European Council and the European Commission were not. After the initial reinforcement of the rules and numbers of the Stability and Growth Pact (SGP) in the first years of the Eurozone, incremental rollbacks began, first in 2012 by reinterpreting rules and recalculating numbers 'by stealth,' without admitting it, and then by 2015 acknowledging increasing flexibility (Schmidt, 2020a and 2022a). But the suboptimal rules remained until the Covid-19 crisis, at which point the rules were suspended, a temporary EU level debt fund agreed, and solidarity won over austerity.

The question confronting the EU today is: Will it go back to the *status quo ante* of the fiscal rules and leave the temporary RRF as a one-shot emergency investment? Or will it alter the rules and develop new EU level debt vehicles capable of responding to the EU's current challenges, by taking the necessary steps towards a more sustainable, equitable and just transition while tackling inequality and precarity? Before Feb. 24, 2023 and the Ukraine war, the future looked rosy. But it is now less certain, given a renewed economic crisis related to high energy prices and the growing cost of living tied to inflation, with a war that could go on for a very long time, and divisions among the member states on how to move forward.

3. Moving forward with progressivism?

Progressives offer a plethora of proposals for solving the EU's current economic governance problems. These centre on the push for permanent EU level debt and reformed fiscal rules, with an enhanced role for the state to address the risks with regard to sustainability, social issues, security and energy. The sustainability risks are largely focused on ensuring the greening of the economy and digitalizing society, already the target of the temporary Resilience and Recovery Fund. But it is clear that much more would be necessary here, given the size of the required investments on climate, let alone security. The United States, with investment initiatives such as the CHIPS Act and the Inflation Reduction Act (IRA), has deemed it necessary to invest in innovation, banking on its multiplier effects with regard to spurring private sector investment in the climate transition and renewable energy.

But the EU so far, instead of meeting the challenge with its own investment initiatives, has done little more than complain about the unfair competition and about European companies relocating to take advantage of US subsidies.

Even before the current US initiative, however, many had called for permanent EU level debt that could provide investment funds for all member states on a regular basis (e.g., Cornago and Springford, 2021; De Angelis et al., 2022; Schwarzer and Vallée, 2020) or, given continued resistance to EU level debt by Germany and the 'frugals,' 'temporary just transition funds' targeting green and productive reforms and investments (Sustainable Finance Lab, 2022). Such an EU level debt mechanism could also be used for solidarity purposes through a range of innovative EU funds targeting the EU's socio-economic needs, including unemployment (Enderlein et al., 2012), refugee integration (Schwan, 2020), 'just mobility' focused on brain drain (Hasselbach, 2019); early childhood investment (Hemerijck, 2023); or even a guaranteed (basic) minimum annual income (Lonergan and Blyth, 2018).

Beyond this, progressives see the reform of the fiscal rules as of the essence. They have called for them to be permanently suspended, to be replaced, say, by a set of 'fiscal standards' to assess sustainability in context (Blanchard et al., 2021) or by a 'Golden Rule' in which public investments beyond those that are part of NGEU should not be counted toward deficits or debt when deemed to benefit the next generation (e.g., investments in education and training, greening the economy, digitalizing society, and improving the physical infrastructure) (Bofinger, 2020). Others have called for revising the mathemetical models and statistical instruments of the fiscal rules in order to go beyond GDP for assessment of fiscal stability, such as by factoring in sustainability and well-being indicators (Hafele et al., 2023).

The Commission's proposal for reform of the fiscal rules suggests a moderated version of the numbers-based rules of the Stability and Growth Pact, with longer time periods for meeting the numerical targets and more country-specific sensitivity in the application of the rules to encourage 'national ownership.' But the Commission made no related proposal for a permanent EU level debt facility, or for the use of the 'golden rule' to exempt national investment, seeing little agreement coming from a divided Council, with Germany back in the frugal camp. It was also cognizant that Treaty change would be difficult given that the restrictive rules and numbers of the SGP are written in so many different places in the Treaties and legislation (Jones, 2020). As a result, despite the more user-friendly nature of the reform, highly indebted countries are likely to find themselves without the 'fiscal

space' to invest in the ways necessary to assure sustainable growth, and would arguably find themselves subject to belt-tightening austerity were they not to meet their debt-reduction targets. Only an EU level debt facility would be able to address these problems. But for the moment, much to the disappointment of the progressives, it does not appear to be in the cards, largely because of what appears to be the resilience of neo-liberal ideas.

4. Going backwards with neo-liberalism?

The minute inflation reared its head as the Covid-19 pandemic was abating, neo-liberal ideas came back with a vengeance. Fiscal hawks started talking about the need to address excessive deficits and debts incurred during the crisis. The ECB began raising interest rates to dampen inflation, seeing wage rises (rather than supply chain issues or corporate price hikes to maintain profits) as the main culprit. And the 'frugals,' now again including Germany, called for bringing back the full force of the Stability and Growth Pact rules and numbers in order to ensure that all member states tightened their belts and paid down deficits and debts. They also opposed any permanent EU level fund, seeing it simply as 'more debt' as opposed to investment in a more sustainable future. The contradiction here, of course, is that neoliberal obsession with debt cannot be reconciled with the EU's commitment to dealing robustly with the threat of climate change and addressing inequalities, not to mention the increased security risks, all of which require massive investments.

Any full-fledged return to neoliberal economic governance means that little may be done to fix the problems resulting from neo-liberalism having gone too far, such as hyper-globalization, the financialization of everything, and the offshoring of manufacturing to the global south. It is doubtful that the current patches to the system such as the OECD-recommended 15 per cent tax on global platforms and some reshoring of manufacturing will be enough. And for the moment, the EU has yet to dedicate major resources (beyond the RRF) to address climate change in an effective manner, despite lots of 'blah, blah, blah' (as Greta Thunberg would say). Moreover, public services have languished, with cutbacks in particular in peri-urban and rural areas, which helps explain the *gilets jaunes* in France, and votes for the AfD in Germany. Beyond this, the ever-increasing shift to the regulatory state, with technocrats in charge, has served to hollow out democracy. This has especially been true for the EU, where decisions once taken at the national level by political actors have now moved up to the supranational level,

leaving citizens increasingly alienated by the resulting national 'politics *without* policy' as a counterpart to the EU's 'policy *without* politics' (Schmidt, 2006). The accompanying general dissatisfaction with their governments once the Eurozone crisis hit has led to a concomitant decline in mainstream parties accompanied by the rise of populist challenger parties, now making for 'politics *against* policy' or even 'politics *against* polity' in the case of Brexit. At the EU level, moreover, this increasing polarization 'at the bottom' has led to politicization from 'the bottom up' in the Council as well as increasing politicization or 'policy *with* politics' at the top, among EU institutional actors (Schmidt, 2020a). Neoliberal economic policies at the EU as much as the national level, in short, has a lot to do with the rise in populist anti-system politics.

5. Going off the rails with populism?

To explain the rise of populism, and the dangers it poses for the EU and its member states, it is useful to think in terms of the discursive construction of discontent, with reference to the "4M's," message, messenger, medium, milieu (Schmidt, 2022b). Neo-liberalism *redivivus* would reinforce the *milieu* in which populism thrives—including the socioeconomic problems of people feeling left behind, the socio-cultural fears about loss of status, and the politics of 'Take back control,' as in Brexit. This is turn would add fuel to populists' *messages,* expressed in an anti-elite, us-versus-them, post-truth style. These fan the flames of racism by presenting peoples' fears of migration as undermining national identity and security; of climate denial by counterposing peoples' concerns with the 'end of the month' with elites' focus on the 'end of the world'; and of respect for human rights by denying equal protections for LGBT+ on grounds of protecting 'family values'. Such messages are expressed by the *messengers* who, as charismatic populist leaders with an aura of authenticity claim to speak for 'the people' while often repudiating the intermediating institutions of liberal democracy. Moreover, such messengers diffuse their messages through the *medium* first of the social media, in echo chambers that serve to attract and radicalize followers, and then the increasingly polarized traditional media.

In the past few years, populist leaders have been able to win elections in country after country in Europe, becoming major parties of opposition, joining coalition governments, and even leading them. And the more they gain power, the more they have been able to set the agenda at the national level. At the EU level, moreover, the more populists there are in government, the more difficult it will

become for the member states in the Council to engage in the cooperative decision-making necessary to respond to the EU's economic governance challenges—not to mention what may come to pass if the extremes were to gain a windfall on the European Parliament elections of 2024.

6. Conclusion

Which of these three alternatives, progressivism, neo-liberalism, or populism, are most likely futures for the EU? For the moment, it appears to be a toss-up. Let us hope that progressivism will move the EU forward. But this depends a lot on whether neoliberalism takes us backwards with regard to economic governance in the short term. If it does, then the EU is indeed likely to go off the rails with populism. For the moment, the future still looks progressive, but for how long remains in question.

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PART II

CLIMATE GOVERNANCE AND THE GREEN TRANSITION

CHAPTER 6

The Green Deal – futureproofing Europe

Dirk Schoenmaker

1. Introduction

The European Green Deal is a great, and much needed, political achievement to face the ecological challenges. These ecological challenges are multi-fold: climate change, biodiversity loss, biochemical flows (phosphorus and nitrogen) and green water shortages. The Green Deal is a comprehensive policy package addressing the transition to renewable energy, a circular economy and regenerative agriculture producing healthy food. Moreover, the European Commission (2020) recognises that this transition is only possible with appropriate social policies to ensure a just transition.

The Green Deal helps to futureproof Europe. Interestingly, the Green Deal policies set more ambitious targets than governments do at the national level. This raises the question of the political economy of the Green Deal: how has it been possible to adopt such an ambitious and comprehensive package? This chapter explains that it is a combination of voter preferences and a window of political opportunity in 2019.

Economists tend to argue for strong government policies (notably a carbon tax) to achieve the public good of sustainable development. This chapter argues

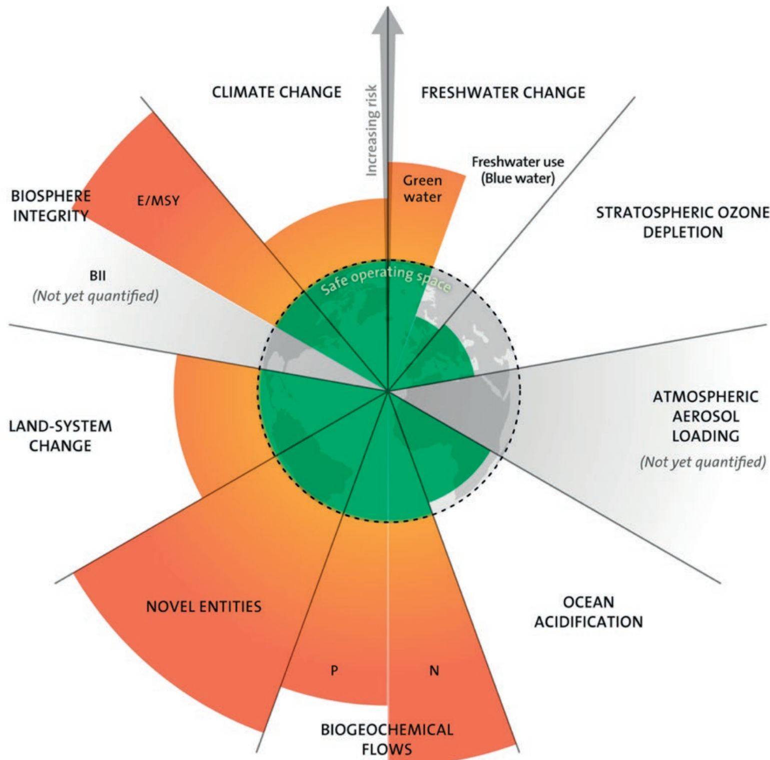
that this is not sufficient. First, the leading economic paradigm needs to change from market economics to green economics. Second, governments cannot do it on their own. All parties should act, in a complementary way, to achieve sustainable development. This chapter reviews the different policy dimensions: international trade, fiscal and monetary.

2. Need for the Green Deal

The planetary boundaries framework of Steffen *et al.* (2015) defines a safe operating space for humanity within the boundaries of nine productive ecological capacities of the planet. The framework is based on the intrinsic biophysical processes that regulate the stability of the Earth system on a planetary scale. The green zone in Figure 1 is the safe operating space, orange represents the zone of uncertainty (increasing risk) and dark orange indicates the high-risk zone.

Applying the *precautionary principle*, the *planetary boundary* itself lies at the intersection of the green and orange zones. To illustrate how the framework works, we look at the control variable for climate change, the atmospheric concentration of greenhouse gases. The zone of uncertainty ranges from 350 to 450 parts per million (ppm) of carbon dioxide. We crossed the planetary boundary of 350 ppm in 1988, with a level of 420 ppm in early 2023 and currently adding at a rate of around 2.5 ppm every year. The upper limit of 450 ppm is consistent with the goal (at a fair chance of 66 per cent) to limit global warming to 2° Celsius above the pre-industrial level and lies at the intersection of the light orange and dark orange zones. At the current rate of emissions, the upper limit of 450 ppm may be reached around 2035.

Figure 1 – The planetary boundaries



Source: Azote for Stockholm Resilience Centre, based on analysis in Wang-Erlandsson *et al.* (2022), Persson *et al.* (2022) and Steffen *et al.* (2015).

The current linear production and consumption system is based on extraction of raw materials (take), processed into products (make), consumption (use) and disposal (waste). Traditional business models centred on a linear system assume the ongoing availability of unlimited and cheap natural resources. This is increasingly risky because non-renewable resources, such as fossil fuels, minerals and metals, are increasingly under pressure, while potentially renewable resources, such as forests, rivers and prairies, are declining in their extent and regenerative capacity. Moreover, the use of fossil fuels in the linear production and consumption system overburdens the Earth system as natural sink (absorbing pollution).

With this linear economic system, we are crossing planetary boundaries beyond which human activities might destabilise the Earth system. In particular, the planetary boundaries of climate change, land-system change (deforestation and land erosion), biodiversity loss (terrestrial and marine), green water shortages, biochemical flows (nitrogen and phosphorus, mainly because of intensive agricultural practices) and novel entities (plastics) have been crossed (see Figure 1). A timely transition towards an economy based on sustainable production and consumption, including use of renewable energy, reuse of materials and land restoration, can mitigate these risks to the stability of the Earth system.

3. Politics of the Green Deal

Traditionally, the socialists, Christian democrats and liberals form the largest parties in the European Parliament. In the 2019 elections for the European Parliament, the greens gained more votes and emerged as fourth party. When the European Council, upon proposal of French President Macron, had appointed Ursula von der Leyen to become Commission president, it was all but clear that she could assemble the necessary votes in the European Parliament. The fact that she had not been a Spitzenkandidat in the run-up to the European elections pitted her against the Parliament, which wanted to establish that principle, and also against part of her own party, which had seen its Spitzenkandidat being vetoed by the European Council. She had to reach out for support across political parties and climate was the principal unifying theme. Shortly after the election of the Commission, on 28 November 2019, the Parliament declared a climate and environmental emergency in support of net zero GHG emissions by 2050 (Bongardt and Torres, 2022). The European Commission invited a majority coalition of socialists, Christian democrats and greens to support its policy programme. To secure a deal with the greens, the European Commission embarked on an ambitious green policy programme, the European Green Deal.

The overarching aim of the European Green Deal is for the European Union (EU) to become the world's first "climate-neutral bloc" by 2050, with at least 55 per cent less carbon emissions by 2030 compared to 2019 levels (European Commission, 2019). In addition to climate, the European Green Deal comprises a circular economy action plan and a farm to fork strategy (for healthy food and nature-positive agriculture). A key component of the Green Deal is the social component to ensure a just transition (European Commission, 2020). The Just Transition Mechanism addresses the social and economic effects of the transition,

focusing on the regions, industries and workers who will face the greatest challenges, and includes funds for investment in new development and retraining workers from industries that are phased out. The aim is to protect workers and not jobs.

The European Green Deal is part of the global Sustainable Development Goals (SDG) agenda. The SDGs form the world's business plan for a greener, more inclusive and sustainable future (UN, 2015). The SDG agenda is set by the United Nations, which suggests that the SDGs are the main responsibility of governments. However, there is growing recognition that all parties have a moral responsibility to contribute to achieving a sustainable future. We have a joint responsibility for the stewardship of our planet (Schoenmaker, 2020).

4. Economics of the Green Deal

The underlying economic paradigm shapes the design of policies. In market economics, the economy is considered as a self-contained "structure of production, distribution and consumption of goods and services within a given country or region" (Mitchell, 1998: p.84). Ecology and/or sustainability are missing from the economy's definition. This idea can be seen as the preanalytical vision of market economics (Daly, 1996): it excludes sustainability from the framework of analysis, which makes it challenging to solve sustainability problems if it is not a part of the system.

The central yardstick for measuring progress in market economies is GDP growth. At the societal level, utility maximisation translates into increasing GDP per capita as the argument for economic growth as a reflection of society's perceived underlying values. Market prices are the correct reflection of economic actors' subjective valuations of products and services. Hence, the way to aggregate all different kinds of preferences can be done by the monetised value from market transactions.

Market economies centralise markets as an interaction mechanism, being the most efficient and therefore delivering optimal value (Debreu, 1959). They declare market exchange as the natural state, often referring to the invisible hand of Adam Smith. But market economics does not provide for the maintenance of the 'commons' for current and future generations.

Green economics follows different dynamics than market economics (Schoenmaker and Stegeman, 2023). In market economics, the intersection of supply and demand leads to transactions. The resulting clearing or market price reveals the

scarcity of the good and service. By contrast, scientists model climate change, biodiversity losses and freshwater shortages as boundaries, which should not be trespassed. The interaction mechanism for green economics is regeneration to preserve ecosystems. As the economy is a sub-part of the broader Earth eco-system, this suggests that economic activity has to take place within the planetary boundaries (Daly, 1996). The ecological constraint should thus be included in production and consumption functions (Dasgupta, 2021).

Recognising the ecological constraint, the European Commission (2019) has adopted the Green Deal as the cornerstone of its economic policies. The Green Deal has been endorsed by the European Council and the European Parliament. The EU political bodies are the prime mover on green policies. Where does this leave other operators in the economy, such as companies, financial institutions and central banks? The ecological constraint is relevant for all economic operators. While market economics simply equates demand and supply to set prices and facilitate transactions, green economics starts with the ecological constraint and from there operates in the most efficient way.

The driving forces of internalisation of environmental externalities raise the question of the appropriate division of labour between the various players: government, investors, companies, consumers and civil society (Schoenmaker and Schramade, 2023). The role of these players is complementary. Each can make its own contribution. A major challenge is avoiding the waiting game, where one player (for example, a company considering the adoption of a low-carbon technology) waits for another player (for example, the government contemplating raising the carbon tax) to act.

5. International dimension

In market economics, trade is an efficient way to optimise the gains from comparative advantage. Economic operators have a comparative advantage over others in producing a particular good if they can produce that good at a lower relative opportunity cost. Trade barriers, including cross-border tariffs, are seen as inefficient.

But green economics wants to make the ecological constraint binding. The EU carbon tax (as part of the EU Emissions Trading System) is about €100 per tonne CO_2-equivalent in early 2023.[1] This carbon tax is far higher than in other regions,

1 Technically speaking the EU ETS is based on permits (quotas). It is a market-based instrument (as quotas are marketable) and works through the price mechanism. The price for ETS permits can be seen as a carbon tax.

which may lead to relocation of carbon-intensive production (the so-called carbon leakage). The European Commission (2022) has therefore introduced the carbon border adjustment mechanism (CBAM) to reconcile the EU's climate and trade interests. CBAM introduces a cross-border tax – in proportion to a product's carbon intensity – for imports. In that way, a lack of a foreign carbon price is neutralised. In this way, the EU imposes its climate policies on its trade partners by CBAM, which is basically a cross-border tariff.

The key challenge is to see CBAM as the start of making an international coalition with like-minded regions and countries on climate policy. Non-EU producers can deduct the carbon price paid for the carbon used in the production of the imported goods in a third country. Effective carbon taxes at similar levels in other countries thus reduces CBAM to zero.

6. Fiscal dimension

During Covid19, the EU created the NextGenerationEU fund as the EU's €800 billion temporary recovery instrument to support the economic recovery from the coronavirus pandemic and build a greener, digital and more resilient future (European Council, 2020; 2022). The explicit aim is thus to futureproof the EU. In this way, the EU linked the short-term needs of the pandemic crisis with the long-term needs of the European economy. The EU raised the funds for NextGenerationEU on the capital market by issuing EU bonds.

The centrepiece of NextGenerationEU is the Recovery and Resilience Facility – an instrument that offers grants and loans to support reforms and investments in the EU Member States for a total of €800 billion. The EU provides funds to Member States in line with their national Recovery and Resilience plans – the roadmaps to reforms and investments aimed to make EU economies greener, digital and more resilient.

While many countries also supported their economies during Covid19, the EU stands out for making funds available on the condition that investment would support the green and digital transition. That highlights the central theme of this chapter: the European Commission has made green policies the cornerstone of its overall policy framework rather than just relying on the EU carbon tax as a single policy instrument to achieve the green transition. The European Commission recognises the complementarity of the various policy instruments to accelerate the green transition. Bongardt and Torres (2022) consider the Green Deal as a third building block (in the making) of a sustainable European economic model, alongside the Single Market and Economic and Monetary Union (EMU).

7. Monetary dimension

The ECB plays an important role in the economy. At the meta level, the ECB, like any central bank, aims for sustainable development of the economy. This means healthy development of the economy in the long run. Sustainable development is usually discussed in impact terms. The starting point is a requirement to do no harm by avoiding negative impact. The ECB should thus at a minimum avoid negative impact by correcting a biased allocation in monetary policy towards high-carbon assets (Schoenmaker, 2021). At a more ambitious level, the ECB can also look for positive impact (in its monetary policy role) to move the economy within planetary boundaries.

Schoenmaker (2021) derives two main conditions for greening monetary policy. These conditions are a general approach (not supporting particular companies or sectors) and a broad asset and collateral base. The latter is important to avoid distortions in the transmission of monetary policy to the economy: monetary policy should ideally get in all the cracks of the economy. To satisfy both conditions, Schoenmaker (2021) proposes a tilting approach for a central bank's direct asset holdings (related to official reserves or asset purchases under quantitative easing) and collateral holdings (related to monetary policy operations). The basic idea of the tilting approach is to shift the composition of the ECB's asset and collateral portfolio towards low-carbon assets. The ECB can do that by increasing the allocation to low-carbon and transitional assets and at the same time reducing the allocation to high-carbon assets. This allocational approach is in line with green economics, which recognises the need to move the allocation to the ecological constraint.

Coordination between the fiscal and monetary authorities is needed to come to an 'appropriate' carbon tax for the euro area. What is the optimal fiscal-monetary policy mix? On the monetary policy side, the institutional framework of the ECB allows, in principle, for adoption of the monetary policy stance most appropriate for the euro area as a whole, taking into account the fiscal policy stance for the euro area as a whole (Orphanides, 2017). In the case of the transition to a low-carbon economy, this means the lower the carbon tax, the stronger the low-carbon allocation in monetary policy (and the higher the tax, the looser the low-carbon allocation). It should be noted that fiscal policy (i.e., setting the carbon tax) and regulatory policy under the Green Deal are far more powerful in mitigating climate change than any monetary policy low-carbon allocation can ever be.

8. Conclusions

The European Parliament elections in 2019 are at the core of the European Green Deal. The increased vote for the Greens supports the European Commission's flagship policy.

The European Commission has integrated the green dimension across its economic policies rather than relying on the single instrument of a carbon tax (the centrepiece of market economics). Importantly, investments from the €800 billion NextGenerationEU have been made conditional on greening the economy. That is a very powerful policy approach to futureproof the EU. The European Green Deal can be seen as a third building block of a sustainable European economic model, alongside the Single Market and EMU.

Finally, the ECB is also redirecting its asset and collateral base for its monetary policy operations towards low-carbon companies. The allocational approach, as part of the green economics paradigm, is gaining ground.

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CHAPTER 7

The financing of the green energy transition[1]

Francesco Paolo Mongelli

1. Introduction

Climate change is increasingly affecting ecosystems, our society, and the economy. Scientists have long presented daunting evidence that climate trends and warming dynamics are worsening at an accelerated pace and, consequently, physical risks are on the rise (IPCC, 2022; UNFCC, 2022). A global policy response – to keep global warming well below 2°C by 2100, but preferably below 1.5°C, above pre-industrial levels – was enshrined in the 2015 Paris Agreement. However, progress by governments in reducing domestic carbon emissions is thus far slow and uneven. While progress in mitigating climate change entails wide-ranging changes to virtually all sector of human activity, the focus of this paper is on the transition of the energy sector, which accounts for about 70 per cent of today's global greenhouse gas (GHGs) emissions.

On the real economy side, many steps for the green energy transition have become clearer in recent years: a sustainable transformation of economic structures is needed. We know what to do technically and industrially, as well as how to

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1 I am grateful for comments from Fabio Tamburrini, Ariana Gilbert-Mongelli, Laurent Abraham, and Ettore Dorrucci. I am responsible for any error and omission and the views might not represent those of the European Central Bank (ECB). An earlier and longer version of this chapter is in Mongelli (2023).

foster decarbonization. Moreover, renewable sources of energy are getting cheaper because innovation is advancing rapidly[2]. Nevertheless, substantial hurdles remain, such as the availability of sufficient critical climate minerals (including rare earths), the sharing of technologies globally, and the time it takes to scale up climate-related investments.

On the financial side, a key question is: how much might the green energy transition cost and how could it be funded? There is a broad consensus that a massive commitment toward "green investments" is needed. Yet, according to the International Renewable Energy Agency (IRENA, 2022), only a few global estimates exist, and several features of this discussion are just emerging. The Intergovernmental Panel on Climate Change (IPCC, 2022) report flags that there is no agreed definition of climate finance. Thus, available estimates should be welcomed but also treated with prudence as they are not necessarily comparable. Underlying assumptions and approaches might vary widely: e.g., about aims (1.5°C vs 2.0°C) and time horizon (2030 versus 2050).

This chapter explores some selected features of this debate. It is organized as follows. Section 2 presents several classifications of green investments. Section 3 reviews recent estimates concerning sustainable financing needs. Section 4 brings in social discount rates. Section 5 reviews the actual available sustainable financing. Section 6 presents some final remarks, new approaches and perspectives. Considerations stemming from disorderly scenarios and exacerbated climate risk premia are left out. This chapter does not present definite conclusions and isolates some trade-offs.

2 See IEA (2022), Renewables 2022, IEA, Paris https://www.iea.org/reports/renewables-2022.

2. Not all green investments are equal! Some may be "unproductive," yet are indispensable

Green investments can be classified either in terms of the technologies employed or their environmental objective. In recent years, combined renewable power technologies have started dominating the global market for new electricity generation capacity. In 2020, 260 GW of solar photovoltaic (PV), wind, bioenergy, hydropower, and other solar sources were installed, exceeding by fourfold fossil fuels and nuclear new electricity generation (IRENA, 2022). This encouraging process must be complemented by additional types of green investments including higher energy conservation and efficiency efforts, the electrification of end-use sectors, rising production and direct usage of clean hydrogen and synthetic fuels, and rising diffusion of bio-energies and carbon capture and storage (CCS). Each of these strands of the green energy transition raises its own challenges and has its specific financing needs.

In an effort by the financial sector and regulator to reduce information asymmetries and dispel doubts of greenwashing, a common approach has been to exactly define criteria to identify economic activities that are environmentally sustainable, which could in turn support capital allocation towards those investments. The degree of granularity in the identification of specific types of green investments will likely continue to increase. An example of this quest for clarity is the EU "Taxonomy" of Sustainable Finance (Regulation 2020/852). This tool aims to help investors, companies, issuers and project promoters to navigate the transition to a low-carbon, resilient and resource-efficient economy (European Commission, 2020). To qualify, green investments must satisfy diverse requirements. For example, investments must make a substantial contribution to one of six environmental objectives: 1) climate change mitigation; 2) climate change adaptation; 3) sustainable use and protection of water and marine resources; 4) transition to a circular economy; 5) pollution prevention and control; and 6) protection and restoration of biodiversity and ecosystems. Furthermore, the investments must not significantly harm the other five objectives and must meet minimum social safeguards such as the UN guiding principles on business and human rights. Presently 35 activities are included in the EU Green Taxonomy and more are expected to be

added over time.[3] A widely commented drawback of such approaches, unless they explicitly account for intermediate categories (for so called "transition finance"), is that their strictly binary nature may prove excessively restrictive, excluding from the definition of sustainable investments a large portion of economic activities which, while falling short of the identified criteria, might still benefit the green energy transition.[4]

Green investment can also be classified in terms of their broad macroeconomic implications. Green investment classifications differentiate between two criteria, i.e., whether green investments are "productive" versus "unproductive", and whether they are "additional" or "non-additional". Productive investments raise the productive capacity of the economy, usually understood in the economic literature in terms of total factor productivity. Investments in solar, wind, smart-grids, hydrogen generation, energy dispatchability, and so on qualify as productive, to the extent that their economic returns exceed their cost of capital. However, faced with the occurrence of climate related physical risks: e.g., from climate disasters (heatwaves, storms, floods, and fires) as well as chronic phenomena (higher average temperatures, land erosion, droughts and desertification), a broader set of green investments will be required for adaptation purposes and to safeguard lives, properties and the completion of the green energy transition. Some examples include barriers against flooding, forest management, building shelters, and cooling factories. These outlays contribute to Gross Domestic Product (GDP) during construction but are unproductive in the conventional economic understanding of the term, even though they protect other existing productive capital. Concerning the second criterion, a green investment is "additional" if it adds new flows to total investment expenditures. Instead, non-additional green investments might simply displace other investments, as other expenditures are reduced, resulting in a net zero effect on total investment and aggregate demand.

The combination of the above classifications and criteria yields different effects on aggregate green investments and the green energy transition.[5] Victor (2022)

3 For a critical appraisal of the EU's Green Finance Taxonomy see Torres (2023, this volume). He argues that it become denatured when gas and nuclear energy were singled out and made subject to the Taxonomy Complementary Climate Delegated Act in which those sectors were classified as 'green' in the transition.

4 NGFS (2022), Enhancing market transparency in green and transition finance.

5 "The real challenge of financing a green transformation will be paying for green investment that generates environmental and social benefits not captured in market prices, and which offer little or no financial return to the private sector" (Victor, 2022).

observes that only a subset of the thirty-five activities listed in the EU Green Taxonomy qualify as both "productive" and "additional" and thus might generate a genuine market return. These include, "clean or climate-neutral mobility" which are EVs (3 out of 35), whereas eight out of thirty-five activities encompass a mix of productive and non-productive activities such as increasing the recyclability of products. The remaining twenty-four activities are classified as non-productive (e.g., protecting the environment from the adverse effects of urban and industrial wastewater discharges).

Summing up, not all "green" investments are the same! Several types, dimensions, and strands of green investments exist and might display varying synergies. The intertemporal dimension is also complex. The balance between productive and unproductive green investments as well the possible rate of financial returns might shift over time: a seemingly unproductive investment when assessed in the short term could prove a high social return when assessed over a longer time horizon. A critical aspect is that investment in the green energy transition represents a public good that might be underprovided. The public sector will need to step up to enable and crowd-in private investments. This pertains to investments with very high multipliers such as in research and development (e.g., pioneering research on nuclear fusion, semiconductors, energy storage and conservation, and so on), education and reskilling of existing and new work forces, and infrastructures (e.g., grids and energy storages).

3. Sustainable green financing needs to support the green energy transition

There is a growing understanding that the transition to a green energy system will require unprecedented global investments. IRENA (2021) predicts that the energy transition alone will require at least a doubling of global annual investments (Figure 1), distinguishing:[6]

- The Planned Energy Scenario (PES), which is the benchmark based on governments' current energy plans reflected in Nationally Determined Contributions (NDCs). PES already contains a green energy shift, but is insufficient to achieve the Paris 2015 climate goal; and

6 IRENA collects data on all forms of renewable energy (https://www.irena.org/). It is a platform for international cooperation and supports countries in their energy transitions.

- The 1.5°C Scenario (1.5-S), which instead captures the more ambitious energy transition pathway aligned with the 1.5°C climate target based on known and scalable technological solutions.

IRENA estimates that in the more ambitious 1.5°C Scenario USD 131 trillion of cumulative green funds will need to flow into the energy system over the period up to 2050 (at a higher pace initially up to 2030 and declining thereafter). Thus, the annual average is about USD 4.4 trillion. This is equivalent to about 5 per cent of global GDP and 20 per cent of the Gross Fixed Capital Formation in 2019. Between now and 2050, over 80 per cent of this USD 131 trillion total, must be invested in the green energy transition. As a background, the International Energy Agency (IEA, 2021) estimates that "To reach net zero emissions by 2050, annual clean energy investment worldwide will need to more than triple by 2030 to around $4 trillion".[7]

At the same time this represents a 33 per cent increase in energy investments plus a redirection of 25 per cent of already planned energy investments! Energy investments unfold on a continuing basis. Current plans under the Planned Energy Scenario already envisage cumulative investments of about USD 98 trillion by 2050. This already represents a near doubling of annual energy investment, which in 2019 amounted to USD 2.1 trillion. Substantial funds will flow towards modernisation of energy infrastructure and meeting growing energy demand. There is a USD 33 trillion difference but USD 24 trillion of planned investments in the PES will have to be redirected from fossil fuels to energy transition technologies between now and 2050. Shares of source of financing also shift over time and across scenarios.

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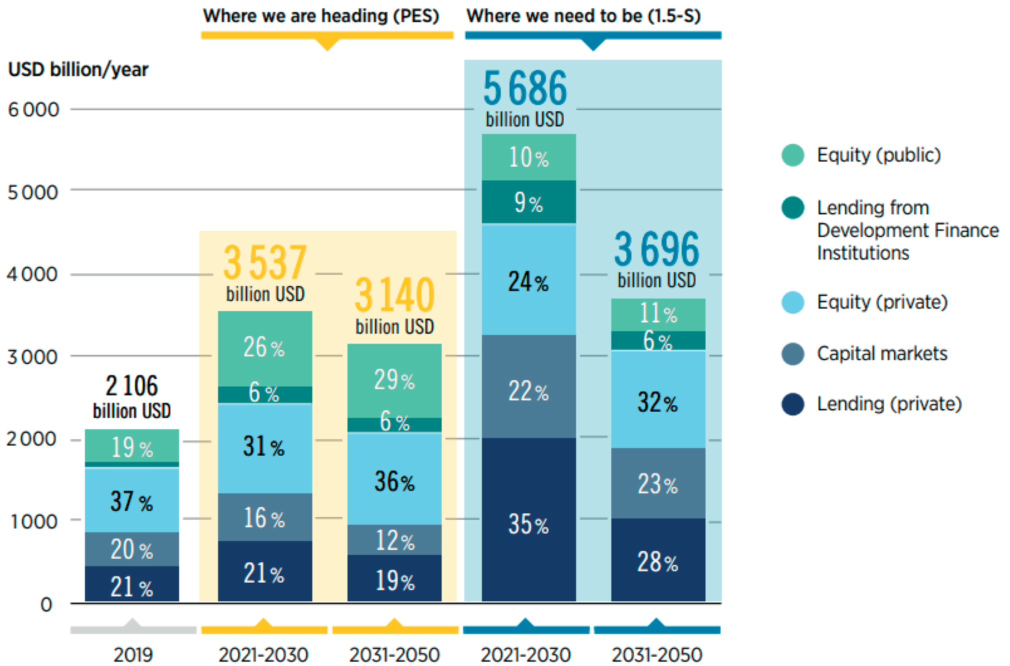
7 See https://iea.blob.core.windows.net/assets/deebef5d-0c34-4539-9d0c-10b13d840027/NetZeroby2050-ARoadmapfortheGlobalEnergySector_CORR.pdf

Figure 1 – Historical and projected annual energy investment needs



Source: IRENA (2021).

A similar, but higher, set of estimates of green investments exists. McKinsey estimates that reaching the goal in the Paris Agreement, i.e., net-zero GHGs by 2050, will require about USD 275 trillion of cumulative global investments in real capital over the next three decades (McKinsey, 2022). This requires an ever-higher commitment to green investments.[8] It implies that annual spending on physical assets for energy and land-use systems in the Network for Greening the Financial System (NGFS) Net Zero 2050 scenario would rise to about USD 9.2 trillion annually, or about USD 3.5 trillion more than today (Figure 2). Moreover, USD 1.0 trillion of spending would need to be reallocated from high to low emission assets.

8 The stock of real capital that enables the functioning of the economy includes infrastructure such as roads, railways, harbors, and airports; water and sewage systems; power plants, refineries, pipelines; and buildings and equipment (Victor, 2022).

The European Union (EU) produced granular estimates of its investment needs in the context of the impact assessments of its Fit-for-55 policy package. Table 1 presents some recent estimates of EU-wide investment needs. The estimates are what is needed in terms of green investment over the 2021-2030 period to reach the Fit-for-55 objectives in comparison with averages over the previous decade. The breakdown shows that in some sectors, e.g., power grids, the needs quadruple compared to the previous 2011-2020 decade.

Table 1 – Average annual investment needs in the energy system and for transport, historical trend 2011-2020, and Fit-for-55 policy scenario 2021-2030, (EUR 2022, billion)

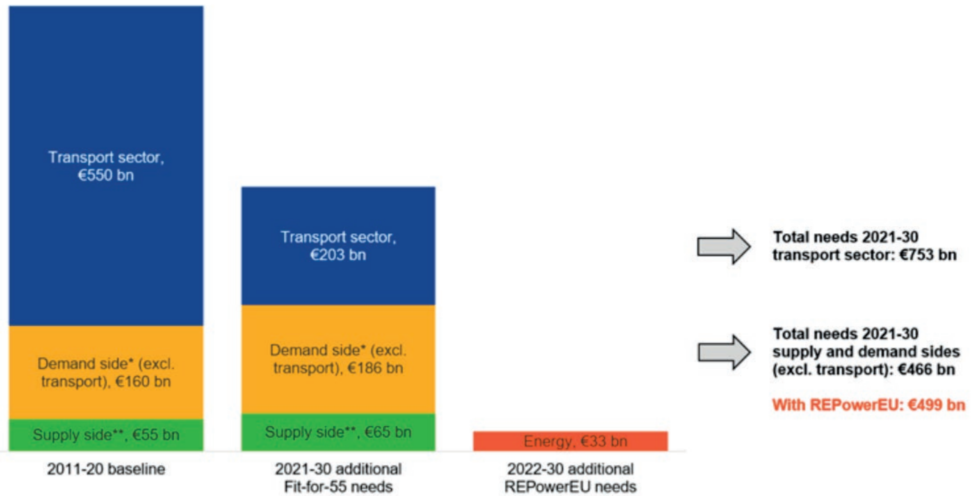
Sector	2011-2020 (annual)	Fit-for-55 policy scenario 2021-30 (annual)	Difference (annual)
Supply side	**55**	**148**	**+93**
Power grid	15	55	+40
Power plants, incl. boilers and new fuels	40	93	+53
Demand side	**160**	**339**	**+178**
Industrial sector	12	34	+22
Residential	102	202	+100
Tertiary	46	103	+56
Total (Energy System)	**215**	**487**	**+272**
Transport sector[95]	549	754	+205
Total (energy and transport)	**764**	**1,241**	**+477**

Source: European Commission Staff Working Document with a recent proposal for a Net Zero Industrial Act included updated estimates at https://single-market-economy.ec.europa.eu/system/files/2023-03/SWD_2023_68_F1_STAFF_WORKING_PAPER_EN_V4_P1_2629849.PDF. Transport includes investment in vehicles and recharging and refuelling infrastructure. It does not include investment in infrastructure such as road or railways.

The European Commission has estimated the public and private climate-related investment needs in the EU over the period 2021-30 at €466 billion on average per year (Figure 2). This excludes the sustainable conversion of the transport sector (e.g., electrification and hydrogen). As a proof that such projections progress, in 2022 a new initiative – REPowerEU – has been adopted in the wake of Russia's aggression against Ukraine. It identifies additional €33 billion of annual green investments needs over the period 2022-30 in order to diversify European energy supplies, save energy and produce additional clean energy (Panetta, 2022). It is

expected that between 20 and 25 per cent of such green investments will need to be funded by the public sector.

Figure 2. EU climate and energy security investment needs (average annual needs over 2021-30)



Sources: Panetta (2022) and ECB staff calculations based on Commission estimates of Fit-for-55 and REPowerEU investment needs. Captures public and private investments recalculated in EUR billions at 2022 prices (thus the small difference with Table 1 values).

Public finance frameworks are likely to come under severe strains. There is a growing discussion about the possible mismatch between 'climate investment needs vs fiscal space'. This discussion has started in EU member states because several countries have high public debt levels (made worse by the Pandemic). Given the existential threats from climate change and the need to launch the green energy transition, should the EU finance the climate transition as a "European public good"?[9]

9 See Panetta (2022) and Buti et al (2023). With reference to the IEA's (2022) green investments estimates (about 3 per cent of global GDP): "*Not all of this has to be done through government budgets, of course. Indeed, most will and should consist of private investment. But governments are responsible for making that happen. If they can crowd in six euros of new private investment for every euro they put in in incentives or investment of their own, they would still need to raise public spending by 0.5 per cent of GDP*" (Sandbu, 2023).

The balance between public and private financing of the green energy transition might shift. There has always been complementarity between, on the one hand, publicly funded research and development, public infrastructures and public goods and services and, on the other hand, private initiatives (seeking financial returns). As we prepare for a protracted stream of higher green investments in the decades to come, this ratio might need to be revisited: governments are ultimately responsible for making the green energy transition happen. In this context, some commentators have argued that the "sheer scale of the physical infrastructure that must be revamped, demolished or replaced is almost beyond comprehension. Governments [...] will have to lead this new Marshall Plan"[10].

Summing up, protracted green financing on an unprecedented scale is required. Financing of the scale just mentioned must be both public and private-sourced, well-coordinated and sustained. Resources for public investments might in part originate from proceeds of carbon pricing (i.e., the carbon tax, the emission trading schemes (ETS) and excise taxes) but they will need to be complemented by additional public financing sources. Will global public finance frameworks be ready to face such a massive investment need both domestically and internationally?[11] Green investments for climate mitigation will compete with outlays such as reducing distortionary labour taxes, compensating for natural disasters, and adaptation to reduce the impact of physical risks and also respond to environmental degradation.

10 Financial Times, "The energy transition will be volatile", by Derek Brower, Amanda Chu and Myles McCormick June 29, 2023.

11 Stronger policy effort needs to go into finding the right frameworks to do that, both domestically and internationally. Even the most comprehensive ETS currently existing would not generate sufficient revenues to finance the public investment needed.

4. Discounting future net benefits

What about the trade-offs between costs and benefits from undertaking decisive climate adaptation and mitigation policies? Investments supporting the green energy transition might have very long time-horizons. The impact of lengthy time-horizons on the financing needed to implement the green energy transition necessitates an assessment of the costs versus benefits:

- Costs of the green energy transition projects and investments might be largely perceived as clear and present, and also might be quite heterogeneous. Such massive costs might crowd-out other outlays, will have to be shared and coordinated internationally, and will need to be sustained for decades;
- Benefits from the green energy transition might instead accrue after a prolonged period, even very far-off in the future. The benefits might also be uncertain, uneven across types of sustainable investments, and heterogeneous across countries and regions, more so than in the case of traditional public and private investment decisions.[12]

Several dichotomies emerge. As a starting point, a crucial aspect for evaluating the merit of undertaking long-term climate change-related investments pertains to how to discount their future streams of expected benefits in comparison with a stream of costs. The financial literature has formulated the concept of a social discount rate (SDR) that is a rate of interest used to calculate the present value of future benefits or costs. More generally, in the context of climate policies, the SDR facilitates calculating the net present value (NPV) of adaptation and mitigation investments, as well as the social cost of carbon (SCC).[13] Moreover, experts also warn that the net returns of climate projects might often not be immediately measurable in financial terms (profits) but rather might be defined on different grounds, for example, by reducing and or capturing GHG emissions. Given a whole array of challenges, some types of climate related investments might not be appealing for the private sector. Such dichotomies could become important stumbling blocks.

12 The consensus is that costs of slowing and reversing climate change will be dwarfed by long-term benefits such as general health improvements thanks to cleaner air that reduces mortality rates and morbidity from local air pollution, as well as helping to increase output, financial stability, and biodiversity (Adrian et al., 2022; IMF WEO, 2020; IPCC, 2022).

13 The SCC captures the economic damages associated with emitting one additional ton of carbon dioxide into the atmosphere and is used to inform policy decisions as well as the design of carbon pricing mechanisms.

Estimates of social discount rates vary widely. The choice of the SDR can depend on several criteria, including ethical and intergenerational considerations, the rate of return on alternative investments, and the rate of economic growth. A lower social discount rate places a greater value on future benefits and costs, while a higher social discount rate places a greater value on present benefits and costs. Hence, the SDR enables the evaluation of the trade-off between present and future consumption (Gollier et al., 2014; Bauer et al., 2021). The theoretical and empirical literature presents a wide range of approaches and estimates of the SDR. For example, the Intergovernmental Panel on Climate Change (IPCC, 2022) has used discount rates ranging between 1 per cent and 5 per cent in its assessments of the impacts of climate change. Nicholas Stern (2022) postulates a discount rate of zero per cent, whereas Giglio et al. (2021) observe that real estate is exposed to both consumption and climate risk and therefore the term structure of discount rates is downward sloping, reaching 2.6 per cent for payoffs beyond 100 years. Instead, Dietz et al. (2018) postulate that the "climate beta" is positive and close to unity for long maturities.

Summing up, the dichotomy between asymmetric (perceived) costs and benefits is complex. Moreover, there is a need to address the very long-term discounting, especially because the green energy transition will require very ambitious investments whose net benefits might be uncertain for a long period. The discussion thus far has addressed the typology of green investments as well as the estimates of the overall financing needs over long-term horizons. These assessments of the "demand for green financing" to implement the green energy transition are intimidating (but indispensable to achieve the Paris 2015 climate goal). The next section turns instead to the "supply of green financing" to implement the green energy transition, such as: equities, bonds, loans, and lending from developmental financial institutions.

5. Sustainable finance available to scale up green financing

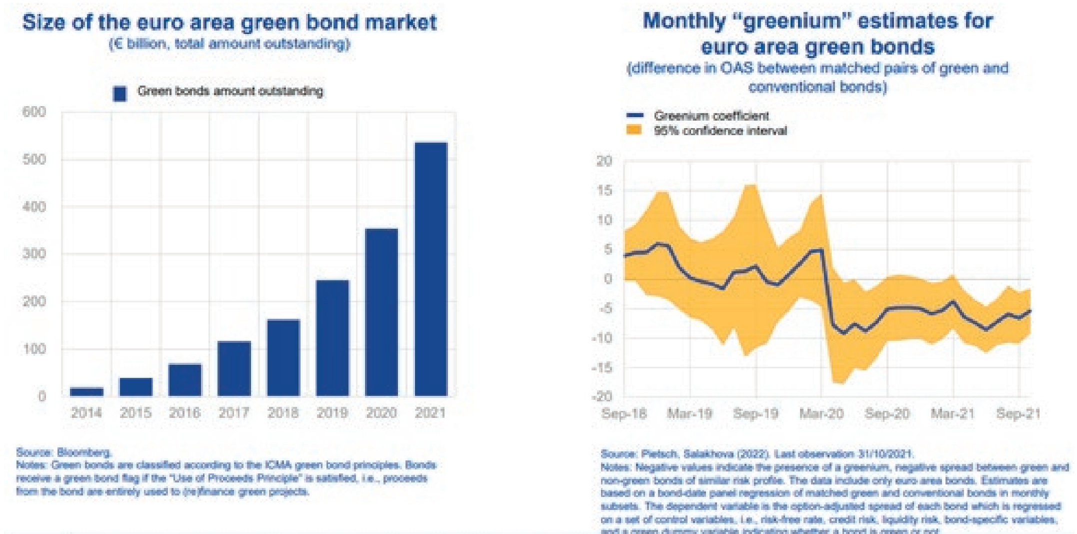
Private funds might originate from diverse sources including self-financing by firms, green loans by banks and other financial institutions, and issuance of green securities (IRENA, 2022). Green financing holds the greatest potential for funding the green transition and the green energy transition. Yet, at some basic level, some crucial channels and mechanisms of the green financing are still unclear: e.g., what is the value added of green financing? How does it work? More evidence of its tangible economic benefit compared to conventional finance is needed. Evidence regarding the effectiveness of sustainable finance in increasing the amount, or lowering the cost, of capital for sustainability purposes is currently mixed.

The EU has spearheaded initiatives to raise both awareness and confidence in the areas of environmental standards, social standards, and corporate governance. These are well known with their now ubiquitous acronym ESG stemming from the abbreviations of E (environment), S (social), and G (governance). The EU initiatives include a set of regulations such as the EU Green Taxonomy, the Sustainable Finance Disclosure Regulation (SFDR), and the Corporate Sustainability Reporting Directive (CSRD), furthering the scope of the EU Capital Market Union (Schnabel, 2022).

The physical green transition versus the financial green transition is complementary but might not always be perfectly aligned. Such disclosures of information on the greenness of economic activities are increasingly stigmatizing non-sustainable carbon-intensive securities and firms, potentially reducing their access to financing (e.g., sustainable bank loans, bonds, and equities). The size of European green bond markets is rising steadily (see Figure 3 LHS panel). Thus, greater disclosure of information/transparency is encouraging investors to redirect their investment toward green/sustainable projects. The latter face a lower cost of funding, known as the 'greenium' (see Figure 3 RHS panel).[14] Green finance might increase the efficiency of capital markets to the extent that it allows a better match of investors' preferences for sustainability. But it also segments financial markets, hence decreasing the liquidity of each segment.

14 Yet, at present, evidence on the greenium is far from conclusive. The greenium is anyway too small to compensate for higher fees and costs of issuance.

Figure 3. Size of the euro area green bond market and greenium



The Network for Greening the Financial System has put forward diverse climate scenarios with different environmental, social, economic, and financial implications (NGFS, 2021). Two extreme examples are the "*orderly*" scenario versus the "*too little, too late*" scenario. We embrace here the first scenario, one which accommodates systematic decarbonization and a green energy shift. Efforts will also need to accommodate and raise acceptance for necessary divestment from fossil fuel assets and securities. Not a small task given the considerable weight of high-carbon equities and bonds in financial markets (Howard, 2015). Howard also cites a global movement soliciting various institutions (e.g., universities, pension funds, charitable foundations, NGOs, local authorities, and others) to divest from coal, oil, and gas companies for both moral and financial reasons.

Summing up, more recent advancements in the ESG area and the EU Taxonomy provide a framework to guide an orderly divestment process. Instead, in the "too little, too late" decarbonization scenario, carbon-intensive securities might be stranded which entails significant financial losses potentially disrupting the energy transition.

6. Some final remarks, including new approaches and perspectives

Estimates of the financing needed for the green energy transition vary widely but are all considerable. Green finance will need to be supported by additional national and regional estimates under comparable assumptions. The current pace of actual flows toward green initiatives, as well as tilting of portfolios, is less clear on a global scale, but will also need to pick up rapidly. The scale of the climate challenge is vast, and the accompanying financing needs to sustain a green energy transition faces a variety of risks. Several new approaches and perspectives are emerging.

Investment funds, pensions funds and insurances might need to absorb very long-term climate related securities supporting the green energy transition efforts. Public and private insurances might have to absorb and share rising climatic risks (not discussed here) while the green energy transition supports the path to net-zero.[15] Concerning the mitigation of stranding risks, Fanizza and Cerami (2023) propose a market solution to enhance the role of the financial sector in supporting the green transition. This operates by developing a secondary market for "brown exposures" in order to allow banks to dispose more quickly of stranded assets thereby increasing their capacity to finance green investments.

Let us change perspective and assume that most countries would greatly benefit from the green energy transition: what then? A radically new approach – associated with Coase's bargaining and contracting theory – would be to pursue the highest possible net social benefit from a large reduction in CO2 emissions arising from the replacement of fossil fuels with renewable energies. For example, the intertemporal net economic gains of phasing out coal and facing investment costs to build replacement renewable energy and compensate for opportunity costs of coal, could be around USD 85 trillion (cumulatively until 2050) adopting an average social cost of carbon of USD 80/tCO2 (Adrian et al., 2022). Net benefits are distributed across countries and most countries would benefit from a global coal phase-out even without any compensatory cross-country transfers. Yet, richer countries need to offer sufficient funding to develop renewables and compensate for the opportunity costs of a loss of cheaper coal energy during the transition (Adrian et al., 2022).

15 See the joint staff paper on the climate insurance gap by the ECB and the European Insurance and Occupational Pensions Authority (ECB and EIOPA, 2023).

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CHAPTER 8

EU trade policy and climate change[1]

Annette Bongardt

1. Introduction

The European Union (EU), one of the world's largest economies and deeply integrated in global markets, is in a prime position with respect to trade.[2] Being an open economy and defender of free trade and self-assumed global climate leader only increases the importance of the development of trade. External trade is not only important for EU economic growth and prosperity, even more so as an exit strategy in a crisis context. It is also critical for the EU's identity that trade serve also wider EU objectives by leveraging its weight in global trade to shape an open and fair global trading system and make sustainable development and combatting climate change central to its trade policy. Those EU objectives are very much in tune with current challenges to global trade.

1 Research for this study was conducted at the Research Center in Political Science (UIDB/0758/2020), University of Minho / University of Évora, supported by the Portuguese Foundation for Science and Technology and the Portuguese Ministry of Education and Science through national funds.

2 The EU is the world's largest trading bloc, ranking first in inbound and outbound international investments, and the top trading partner for 80 countries (the US for about 20) and the most open economy to developing countries (https://policy.trade.ec.europa.eu/eu-trade-relationships-country-and-region/eu-position-world-trade_en).

Climate change is the consequence of economic activities (non-sustainable consumption and production patterns), which include the carbon footprint of international trade. The need to address this biggest market failure (Stern, 2007) is grounded in basic economics.[3] International coordination efforts to limit global warming to sustainable levels (Kyoto and Paris Climate Agreements) exist but are hampered by non-binding commitments and the non-existence of a worldwide carbon price to make all polluters internalize environmental costs as to change behaviour. The EU committed to climate neutrality by 2050 with intermediate targets for a conducive trajectory (European Green Deal), with carbon pricing (the EU Emissions Trading System, ETS) being the chief instrument. This regional approach to combatting climate change may result in competitive distortions facing EU firms in international trade.

This chapter considers how the EU addresses this dilemma in a trade policy context that has also changed, characterised by a weakened multilateral trade order and challenges on various fronts to the increasing economic integration that the world economy has become accustomed to over the last decades.

2. The importance of EU trade policy in a changed context

The EU, a staunch defender of free trade and multilateralism, faces a weakened multilateral trade governance set-up and new realities in the international economic system that affect its external trade.

The multilateral approach to trade-rule making and even trade dispute arbitration has suffered setbacks. Multilateral trade rules have not evolved in step with the global economic integration of markets and its accompanying phenomena while World Trade Organization (WTO) trade rule arbitration can no longer be taken for granted.[4] Furthermore, the integration of world markets over the past three

3 For a discussion, see Bongardt and Torres (2022a).

4 Ever since the aftermath of WWII, the General Agreement on Tariffs and Trade (GATT), which was succeeded by the WTO, were the principal vehicle and forum for opening up world trade and dealing with trade disputes. The multilateral approach had been rather successful in doing away with conventional trade barriers in successive negotiation rounds but started to encounter increasing difficulties in concluding multilateral agreements and to set new rules collectively (requiring unanimity of its 164 member states). In recent times, even the WTO's smooth functioning in regard to multilateral trade rules has been cast in doubt (issue of nomination to trade dispute arbitration panels). Countries are thus more exposed to power relations in international trade.

decades or so had brought about manifold phenomena of internationalisation beyond traditional goods trade (such as trade-related services, direct and financial investments, or intellectual property rights), which are only partly covered by multilateral rules under WTO jurisdiction. In this setting, bilateral and regional trade agreements in general and deep trade agreements in particular have been proliferating.[5] The very deepening of preferential trade agreements beyond traditional trade policy, encompassing areas like competition, investment, and intellectual property right protection has driven globalisation (Laget et al., 2019).

In recent times various shocks (notably the Covid-19 pandemic, which erupted in the beginning of 2020, and Russia's full-scale invasion of Ukraine in early 2022) have exposed the vulnerabilities of established globalisation patterns, especially so regarding supply chains and food supply, energy dependency, or access to critical raw materials. In their wake, geopolitics made a re-appearance and globalisation patterns are being reconsidered (cost advantages versus resilience) in light of risks. Issues that have arguably been present more in the background for long (benefits and costs of international trade and their distribution, labour and environmental issues, also climate change) have also become highlighted.

As a result, a new global map of economic relationships started to take shape as of 2021, redrawn by shifting value systems and alliances, in which geopolitics increasingly influences the global economy (Lagarde, 2022).[6] Aiyar et al. (2023) draw attention to the world now facing the risk of policy-driven geoeconomics fragmentation and to the costs of fragmentation. Multilateral cooperation is called for also in this setting notably also in the area of climate change, as a necessary public good for the international economic system to function (Gaspar and Amaglobeli, 2021). Addressing this chief challenge requires the internalisation of environmental costs via carbon pricing also in international trade (Gaspar and Amaglobeli, 2023).

Summing up the challenge for the EU, von der Leyen (2023) contends that the risk of trade wars and the return of confrontational politics is among the global risks that the EU faces, but that climate change requires an immediate transition to a green economy. In fact, stepping up climate action should be among the priorities to preserve the benefits from global integration and multilateralism in the

5 Bilateral and regional trade agreements have surged from about 50 in 1990 to about 300 in this millennium (Fernandes et al., 2021a).

6 In three ways: prompting shifts from dependence to diversification, from efficiency to security, and from globalisatioan to regionalisation.

face of multiple shocks (Georgieva, 2023). According to Lagarde (2023), Europe should be a leader and not a follower in writing the next chapter of globalization and has the capacity to do so.

Against that background, the EU's stance has been to continue pursuing multilateral cooperation and an open trading order while fragmentation along trading blocs has raised the importance of trade policy and of making its internal market work towards efficiency and EU treaty objectives, that is, the EU (economic, social and environmental) model.[7] Addressing the climate crisis provides a test case for its resolve.

3. The nature of deep trade agreements and their potential to shape global trade

Preferential trade agreements may be seen as a second-best option to multilateral arrangements and/or as one affording a more tailored response to globalisation. For the EU, they also offer an opportunity to further its objectives in international trade.

The reason is that deep trade agreements go much beyond the tariff cutting that is the object of conventional free trade agreements, in terms of breadth (scope) of issue areas but also depth (complexity) (Mattoo et al., 2023). They are important determinants of international trade patterns, global value chain integration and welfare, and as such shape economic development. WTO multilateral rules are still at the basis of regional agreements, but where they are absent deep trade agreements establish new trade rules. The implication is that their very details matter for evaluating welfare implications (Fernandes et al., 2021a).[8] By involving regulatory and other non-tariff measures, they also get into what were formerly exclusively domestic policy domains (Lamy, 2020). One of the welfare-relevant

7 For a discussion of the economic principles behind environmental protection and the need for internalization on efficiency grounds, see Bongardt and Torres (2022a). For a discussion of environmental protection as values see Pelkmans (2021).

8 As Fernandes et al. (2021b: 2) put it, the economists' traditional approach to evaluate (preferential) trade agreements, based on the creation of market access, is inadequate to capture the complexity of policy areas that are covered by deep trade agreements. Economists (and not only) need to take a more differentiated view and account for the fact that specific policy areas and provisions in trade agreements have consequences, not all of them beneficial. A similar point has been emphasized by Rodrik's work, notably that economists have also failed to contribute to a full picture on trade, tending to emphasize gains from trade and not to discuss more complex consequences such as the distribution of benefits and the impact of regulation (Rodrik, 2018).

areas that deep trade agreements may cover is the environment and/or the climate domain.

The proliferation of preferential trade agreements in this millennium has resulted in more regional integration in the world economy centred around major trading blocs, the EU being a case in point. EU trade policy has ever more opted for preferential trade agreements, which are increasingly deep and comprehensive trade agreements. Recent crises have reinforced regionalisation further, as countries have adopted measures to protect their economies and societies from their fallout or, more generally, from perceived geopolitical risk (such as, in the case of the EU, de-risking from China, trade sanctions against Russia).

That said, there remains a necessity for economic cooperation to assure the provision of public goods. Challenges (pandemic preparedness, sustainable development, climate change) facing the international economic system, whose resolution requires cooperation beyond the narrow trade domain, call for collective action still in this decade (Gaspar and Amaglobeli, 2023). Creating and extending global governance has however to reckon with political opposition from private and public actors. As Frieden (2023) points out, the issue playing out in this second globalisation is democracy (different from the first globalisation prior to WWI, which was otherwise as deep).

While the rise of preferential trade agreements may be seen as a response to a global trading order in retreat, it affects global trade, for two main reasons (Mattoo et al., 2023). The first is that deep trade agreements increasingly set trade rules, which are about establishing economic integration rights (goods, services, labour, capital, ideas).[9] They have been growing in terms of policy areas and complexity in general terms, most among developed countries.[10] Secondly, there has been a regionalisation of trade (preferential trade agreements being centred around the EU, the US and Japan), with trade agreements being most similar within those blocs (although there is similarity in regard to about half of the contents also across blocs).

9 The term trade agreement is hence somewhat misleading.

10 As Fernandes et al. (2021a) put it, doing so regional trade agreements have run away with the international trade agenda.

The EU, too, has come to, initially reluctantly, embark on an increasing number of bilateral and regional international trade agreements.[11] It has been very successful, concluding an ever-increasing number of deep and comprehensive free trade agreements. On the other hand, this trade policy achievement sits uncomfortably with the difficulties that it has been experiencing with respect to ratification.

As for why that may be the case, one should note that the rules established in bilateral or regional deep trade agreements matter as they feed back into the European economic and social model (Bongardt and Torres, 2023). Deep trade agreements – which establish economic integration rights and enforcement rights that have recently also come to feature welfare-related areas such as the environment and labour – impact welfare through an international spillover effect. (Mattoo et al., 2023). Yet, with economic integration within the EU and its internal market being more profound than what the Union grants to third countries in free trade agreements, the EU faces the risk that the latter may interact with and put downward pressure on European environmental and social standards. After all, the very logic of deep trade agreements is doing away with non-tariff barriers (once tariff barriers are already low). Establishing those economic integration rights for third parties necessarily implies beyond the border measures extending into domestic regulation and enforcement to ensure implementation.

Explanatory factors also include the shift from EU exclusive to divided sovereignty for trade issues, meaning that some relevant competences are decentralized. In legal terms, any trade agreement that is qualified as mixed (covering also specific areas of member state competence) rather than EU-only may enter into force before full ratification also by all member states but only provisionally and in a limited way (still the case of the EU-Canada Comprehensive Economic and Trade Agreement, CETA); its fate is subject to uncertainty in the meantime. It becomes void if a single member state (or region, if applicable) does not ratify it. Splitting up a trade agreement allows for getting around the role of member states in ratifying the trade section part but that involves negotiating separate trade and investment and political and cooperation agreements. The Commission has adopted this approach already in the recently concluded EU-Chile agreement and proposed it for the politically contentious Mercosul and Mexico agreements (Blot, 2023). Moreover, judging by the case of CETA, the EU is undertaking some efforts

11 By summer 2021, the EU had some 130 trade agreements – in place (77), pending (24) or in the process of being adopted or ratified (24) or being negotiated (5). As a result, up to 40 per cent of EU external trade is governed by bilateral and regional agreements (Blot and Kettunen, 2021).

to address (avoid) possible contestation a priori, notably by increasing transparency and making new generation free trade agreements more progressive in terms of objectives (Leblond and Viju-Miljusevic, 2023).

As bilateral agreements receive greater scrutiny (Blot, 2023), the reaction to or contestation of EU free trade agreements will be informative as to the EU's capacity to pursue a trade agenda that is supported by European society and member states and regions. For the EU, the challenge comes down to balancing the economic integration rights it grants to third parties in deep trade agreements with ensuring that the EU's regulatory model delivers on the EU model.[12] What Rodrik (2014) refers as the delicate balance in globalization poses an even larger challenge for the EU, as its own delicate internal balance could be potentially upset by the effects of new generation free trade agreements.

4. On the implementation of EU objectives through trade: towards a more active EU trade policy

As EU trade policy has moved away from normative free trade and multilateralism, it has been embracing (more openly) a more active trade policy and pushing for EU objectives (Couvreur, De Ville, Jacobs and Orbie, 2023; Blot, 2023).

EU trade policy had already undergone several modifications over the years in support of EU objectives, which went in parallel with a growth of bilateral

12 Rodrik has long pointed to the existence of a paradox in globalization, warning that if pushed too far globalization would undermine its own institutional foundations. Bongardt and Torres (2022a) argue that this is even more the case for the EU, where the resulting external balance impacts a delicate internal balance. The reason is the EU's regulatory model. In the EU's internal market, the functioning and acceptance of regulation rest on preference convergence: harmonization if there is preference convergence, mutual recognition where there is not. However, the notion of similarity that makes mutual recognition (that is, systems competition) possible is already stretched within the EU. In the end, the issue is to what extent systems competition via deep trade agreements could come to undercut those areas which are key components of the EU model and whether competence distribution in the EU (when involving member states and/or regions) provides a sufficient safeguard in the case of divergent preferences.

trade agreements.[13] The Commission's (2021) most recent trade policy strategy complements the European Green Deal (EGD), in that it aims at reinforcing the EU's capacity to act as a global champion of open, rules-based trade that is sustainable and fair.[14] It includes efforts to reform the WTO, strengthen the EU's regulatory impact and implement and enforce trade agreements, ensuring a level playing field for EU economic actors. It led to a new approach to EU trade agreements (European Commission, 2022) to promote green and just growth through a strengthening of the implementation and enforcement of Trade and Sustainable Development (TSD) chapters.[15]

The TSD review and action plan have been called a turning point for European trade agreements (Blot, 2023). First, because trade policy is to be brought in line with EU (climate) policy (Sustainable Development Goals, the EGD) and external commitments (2015 Paris climate agreement, ILO conventions). Second, for the first time, there are concrete enforcement mechanisms in partner countries and a more tailored (rather than the previous one-size-fits-all) approach. TSD commitments will be strengthened in new agreements as is enforcement, with commitments binding and the possibility of sanctions in case of non-compliance.[16] On the downside, applicability is limited to future negotiations and ongoing ones as appropriate.[17] Despite shortcomings, the Review fortifies the EU's position as a global leader with respect to integrating sustainability in trade policy.

EU trade policy has switched to an active stance also in other areas. The EU's new Carbon Border Adjustment Mechanism (CBAM), which is to start operating in autumn 2023, is the world's first carbon tariff. It is a milestones, as a trade instrument but also in terms of EU climate policy, as another EU-level instrument

13 The Global Europe Strategy (European Commission, 2006) affirmed that EU trade agreements were to complement the EU's growth and employment strategy (the Lisbon Agenda, which already included climate targets) through an external dimension. In 2015, EU trade policy was put also at the service of European values and principles such as high social and environmental standards (European Commission, 2015). Still, according to Felbermayr (2016) the EU's more active policy of negotiating bilateral trade agreements became guided by economic objectives rather than by political affinities and by objectives.

14 See also Schoenmaker (2023, this volume), Torres (2023, this volume) and Bongardt and Torres (2022b).

15 As put by Innerarity (2023, this volume), "Europe has every right to demand the universalisation of its criteria if it believes them to be appropriate, even if they are to its advantage. The fact that certain values serve its own interests does not necessarily delegitimise them".

16 TSD chapters had already been systematically included in recent, modern EU free trade agreements, aiming at putting to good use the leverage of trade and investment issues with respect to EU objectives (European Commission, 2018).

17 The case of the Mercosur agreement illustrates the difficulties associated with amending existing ones.

next to the EU Emissions Trading System (ETS). The ETS and the CBAM are complementary: the CBAM provides a necessary external dimension that allows European carbon pricing to function in the absence of a global carbon pricing arrangement.[18] The EU's trade stance has also become more assertive in other respects. It gained a new trade defence instrument. With the so-called anti-coercion instrument, the Commission now places emphasis on defensive aspects against third parties, labelling its former stance as naïve (the example given is China, which was not successfully domesticated by multilateral rules) (Couvreur et al., 2023).

Not only trade instruments, but EU regulation may have a trade dimension, too. The objective of sustainable global value chains calls for an internal, complementary policy dimension, which is where the EU's due diligence regulation comes in (Rudloff, 2022). Nonetheless, in a now more fragmented global economy, it remains to be seen to what extent the EU manages to continue to benefit from the so-called Brussels effect (Bradford, 2020), by means of which EU regulation is applied in global markets.

The jury is also still out on the impact of the United States' Inflation Reduction Act (IRA) on the EU. IRA is an US industrial strategy that incentivises the green transition. Its emphasis on subsidies for local production means that it triggers market distortions that pose a significant challenge for the EU, not least because it could put at risk the good functioning of the EU's single market.[19]

5. Conclusion

There is a strong economic case for addressing climate change, which also poses a chief challenge for international trade. The EU, an important global actor on both the trade and climate change agendas, has taken on the challenge of a carbon-neutral economy domestically, through its European Green Deal. It has also resorted to a more active trade policy. With the world's first carbon tariff, the CBAM, the EU protects the main vehicle of its climate policy, the ETS, in an international trade context. The recent Trade and Sustainable Development (TSD) review brought trade policy in line with climate objectives. New EU trade agreements are to promote sustainability objectives through more effective and enforceable TSD

18 To compensate certain firms exposed to international competition, the ETS has been allocating some emission quotas for free, which contradicts the polluter pays principle.

19 For a discussion of IRA, see Guimarães (2023, this volume).

chapters. The shift to welfare-related commitments in trade agreements is also significant because it may help address the issue of political contestation of EU trade agreements on the grounds that they put at risk the European model. That said, their details will be crucial.

Time will tell whether the EU manages to condition globalisation in today's changed context in line with its objectives and values or whether economic integration rights granted to third countries put pressure on the European model and with it, the sustainability of the European integration project.

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CHAPTER 9

The European Green Deal at the core of the EU's and EMU's sustainability

Francisco Torres

1. Introduction

In more recent times the European Union (EU) has faced a succession of crises, of which the Covid-19 pandemic (which erupted in the beginning of 2020) and Russia's full-scale invasion of Ukraine (in early 2022) have been the latest. The pandemic crisis prompted a strong (government policy) response. This fact can be explained by the nature of the crisis and by policy learning during the previous crises and in their aftermath (Buti and Papaconstantinou, 2021; De Grauwe and Ji, 2020; Quaglia and Verdun, 2022). Also, there was a functioning banking sector, which has led to a swifter rebound in economic activity, whereas the combination of the two in turn prevented a new sovereign debt crisis (De Grauwe and Ji, 2020; De Grauwe, 2023, this volume). Europe thus came out of the pandemic strengthened, yet it had barely time to recover from an extraordinary effort and was, as a result, still in a rather fragile condition to respond to the next crisis, triggered by Russia's war on Ukraine (Jones, 2022). That said, on their part, EU institutions, notably the European Commission (less so member states), have played an important role also throughout the latter crisis.

Nonetheless, EMU's sustainability was again cast in doubt. This time the destabilizing situation was the result of successive delays in implementing the green – notably energy – and digital transitions, made much more acute by the effects of Russia's aggression on Ukraine. In the wake of the Ukraine crisis, by the end of 2022, high stagflationary risks had created major challenges for the good functioning (avoiding financial fragmentation/instability) and sustainability of EMU. There was a need for monetary and fiscal action within the appropriate EU (and also global) governance framework. It includes a role for world major central banks in engaging in close coordination of their actions to avoid excessive tightening of monetary policy (from July 2022 to June 2023, the ECB has increased its interest rate on the main refinancing operations by 400 basis points, from 0 to 4 per cent) with avoidable output and employment costs while credibly combatting inflation expectations. Fiscal policy also has a very important role to play, notably in improving the composition of public expenditure to turn around debt dynamics and speeding up the green and digital transitions (Buti et al., 2022).[1]

One can hence argue that the succession of crises has made it ever more obvious that EMU's sustainability does not only depend on doing away with its own specific fragilities but that is also dependent on the broader EU (economic and wider) governance framework. Of course, the EU has faced and weathered crises before, but what is new is that crises have come not only to overlap but being intertwined. It follows that to be effective, policies more than ever need to address them simultaneously in a coherent and holistic way. Conversely, failure to push ahead with the climate agenda "will not only complicate the task of central banks, but will pose grave risks to economic stability and global well-being" (Gopinath, 2022). The ECB acknowledges that to finally implement that long-due EU priority would not only make the economy greener and less dependent on unreliable partners, but it would also reduce the risk of energy inflation (Lagarde, 2022).[2] It follows that governments should correct incentives and price in the negative

1 Garicano (2022) argues that instead of reforming the Stability and Growth Pact (SGP), the EU should establish a new European Climate Investment Facility, given that the EU's current fiscal framework has failed to fully deliver long-term discipline and facilitate a countercyclical fiscal stance. This new facility would provide grants and loans to fight climate change until 2050, when the Union must reach net zero emissions. At the same time, an independent European Fiscal Agency would assess the good standing of member states to access this new facility. On the importance of a central fiscal capacity, see also Buti and Messori (2023, this volume).

2 Attempts to reduce the risk of supply shocks (volatility) through the diversification of global trade and help boost potential output around the globe also need to englobe correcting market distortions by pricing in environmental damage and avoid (again) short-termism (Bongardt, 2023, this volume; Bongardt and Torres, 2023).

effects of carbon more effectively.[3]

2. The EGD as a third building block in the making of EU economic governance

The European Green Deal (EGD), presented in December 2019 by the von der Leyen Commission, is an expression of entrepreneurial spirit. It commits the EU to a profound change in policy direction towards more sustainability, namely to achieving a carbon-neutral Europe by 2050. It thereby gives rise to another qualitative change in European integration, after the single market and EMU, also Commission initiatives, had already shifted a trade-led to a European regulatory model and added a monetary union to the (still incomplete) economic union side. Both the single market and EMU enhanced economic sustainability, promoting efficiency through the competitiveness rationale in the single market and the (mostly but not exclusively microeconomic) benefits of a single currency. The EGD further enhances these goals, bringing in environmental sustainability and making climate neutrality a priority, and by including sustainability in the competitiveness rationale (now denominated 'competitive sustainability'). It is hence not least due to efficiency considerations that climate and biodiversity need to be integrated into economics and be included in production and consumption functions and decision-making (Dasgupta, 2007 and 2021). As for EU-level coordination, and as the European Commission (2019b) and the ECB (2021a; 2021b) acknowledge, the chief rationale resides in avoiding negative spillovers from non-internalized environmental degradation into the single market and EMU. The European Commission has recognised the ecological constraint and adopted the EGD as the cornerstone of its economic policies (Schoenmaker, 2023, this volume).

There are two principal reasons why the EGD has the potential to become another building block of the EU economic governance. First, it is built on EU sustainability thinking that had been evolving over time, representing its (logical) culmination, as economic efficiency reasoning *per se* requires that environmen-

3 As put by Heemskerk, Nerlich and Parker (2022), this becomes easier as the pressure on fossil fuel prices subsides. Pricing in would also offer governments revenues to support the necessary green investments, a win-win situation. Cutting counterproductive subsidies is of course another.

tal effects be accounted for, too.[4] The EGD gives consistency to what had been a piecemeal approach (Bongardt and Torres, 2013). Second, the EU could only ever hope for truly politically sustainable European integration if it put economics at the service of the EU integration project by adopting a wider sustainability perspective, also in regard to addressing its governance fragilities (Begg *et al*., 2015; Nicolaïdis, 2019; Bongardt and Torres, 2022a and 2022b). However, the EGD as a building block of the EU's economic model is still in the making. The implication is that in this initial phase it is still fragile (not consolidated) put to test in a crisis context when crises should be addressed through its lens.

The EGD's objectives follow up on the European economic (growth) agendas (Lisbon and Europe 2020 strategies, both forward-looking and with long-term horizons for reforms), in that the European economy and society are to become sustainable by transforming potential threats (climate and environmental challenges) into economic opportunities and by making the transition just and inclusive.[5] The principal (and revolutionary) novel feature is the EGD's imposition of an overarching sustainability lens – climate neutrality – to all policies and policy areas and on the economy and society. The EGD is hence a change of paradigm like the single market and EMU, but unlike those it did not come with treaty change nor with new competences for the Union. The (steep) challenge that lies ahead is to bridge long-term goals with consistent policies and actions in the shorter term with a view to climate and environmental mainstreaming. Implementation of its ambitious objectives thus hinges on putting to good use the existing EU economic governance framework, most notably climate and energy policies, and on incremental change.

The EGD made a multitude of policies and instruments that had previously lacked coherence and a holistic approach subject to its climate law. It can build on some important previous developments, among which that environment policy and instruments – notably the creation of the EU-level European Emissions Trading System (ETS), a cap-and-trade instrument – had been brought ever more under an efficiency rationale since the internal market and in light of the EU's global climate leadership role. The ETS has fed back into internal policies

4 The crises have also had an impact on trade, calling for internalizing negative external effects from productive activity like pollution. Yet, if negative externalities are not priced in, there is a difference between private cost (market price) and social (opportunity) cost, which leads to excess consumption and production (an economic inefficiency).

5 For a comprehensive analysis of Lisbon and Europe 2020 strategies see Bongardt and Torres (2020b).

and member state targets.[6] However, it had lacked an external dimension. In the absence of a worldwide carbon trading system or equivalent carbon pricing, an effective EU ETS risks creating a competitiveness disadvantage for certain European firms. The recognition of this fact led to the EU gaining another EU-level environment policy instrument, the carbon border adjustment mechanism (CBAM), to start operating in autumn 2023. The two – the ETS and CBAM – are interrelated: while the CBAM will also bring in revenue it is foremost about correcting competitive trade-related distortions (so-called carbon leakage) at the EU-border, brought about by EU climate policies, thereby protecting the economic and political viability of the ETS and the EU's treaty-based polluter pays principle.[7]

With climate and sustainability promoted to an overarching rationale, all other policies need to be coordinated and legislation revised to fall in line with the EGD's holistic sustainability objective and carbon emission targets. Climate policy (hard law) together with climate mainstreaming may create a constraint that helps to align other policy areas. International commitments, above all the 2015 Paris Climate Accord, add (self-imposed and voluntary) external constraints.

The EGD's legislative agenda is ongoing. Still, it has already brought about several important changes. First, the Commission came to enshrine and adopt a wide (economic, social, environmental) sustainability lens already in the Annual Sustainable Growth Strategy 2020 (previously denominated Annual Growth Strategy). It emphasizes the multi-faceted role that environmental policies can play in regard to a sustainable economic recovery and employment growth, through resource efficiency and the circular economy but also others like environmental fiscal reform, including shifting the tax burden from labour (a good) onto environmental pollution (an inefficiency); Second, and although the EGD had drawn on – essentially unchanged – soft governance through the European Semester process, the climate law and climate and energy regulation work as constraints; Third, the EGD gained the extra financial component that it had initially

6 The ETS is a market-based instrument with efficiency properties. Its good functioning hinges on an adequate carbon price and a competitive market setting. Subject to a cap to total emissions, the carbon price reflects relative scarcity (supply and demand). Carbon trading provides economic agents with an incentive to abate emissions and invest in more environmentally efficient equipment. The ETS was to become broader and more effective in its 4th phase (2021-2030), as part of the Fit-for-55 package (European Commission, 2021.

7 On the CBAM, see also Bongardt (2023, this volume). In December 2022, EU legislators reached agreement to equalise the price of carbon paid for EU products operating under the ETS and the one for imported goods. The levy will be launched on 1 October 2023. To avoid double protection of EU industries, the length of the transition period and the full phase in of the CBAM will be linked to the phasing out of the free allowances under the ETS..

lacked. The EU's response to the pandemic crisis gave rise to (substantial) funds earmarked for fostering the green transition as part of the Recovery and Resilience Facility (RRF) while it simultaneously hardened soft governance by introducing reform conditionality. In addition, the Recovery Fund, set up as a temporary institution, will be repaid through new EU own resources. Those are geared towards European public goods (environmental protection and other) and will create some EU fiscal capacity[8] that, together with other dynamics in favour of sustainability at the EU level (monetary, financial, energy and trade policies), as discussed in Bongardt (2023, this volume) and Schoenmaker (2023, this volume), and also the national and local levels, not only allow the EU to reinforce its environmental policy (through EU taxes or the CBAM) but also imply an advance in economic and political integration.

Last but not least, the EGD has the potential to contribute beyond environmental sustainability also to the sustainability of the European integration process as such. To the extent that it curbs negative spillovers and promotes synergies and European public goods, the EGD feeds back into and complements the qualitative changes that the single market and EMU made to EU economic governance and contributes also to economic and political sustainability. In sum, this third building block of EU economic governance could foster democratic participation (Nicolaïdis, 2023, this volume) and is part of what Loukas Tsoukalis (2022) refers to as Europe's coming of age.

3. Does the 'crisis mode' contribute to reinforcing the EGD and to EU's and EMU sustainability?

Crises in the EU prior to the pandemic had deflected from the climate issue by pushing more short-term issues to the fore.

The 2008-09 financial and the 2010-13 sovereign debt crises are cases in point. Although sustainability and green growth were already objectives of the EU's economic agendas, the EU largely wasted the opportunity for a green crisis exit.

8 As pointed out by Cabral (2022; 2023, this volume) the EU has now 'a new centre of sovereignty on the fiscal/budgetary front, with respect to borrowing and tax competences'. Such a change re-balances EMU, contributing to a more efficient policy mix. Buti et al. (2022) and Buti and Messori (2023, this volume) put forward investment and reforms for sustainable growth as a carrot in the proposed new fiscal framework.

Still, financial restraints notwithstanding, that would have been feasible through existing instruments (regulation), with a view to incentivising sustainable behaviour and investment (Bongardt and Torres, 2016).

In the pandemic crisis, which allowed for establishing a conducive link between the short-term and the long-term and played to the EGD's economic rationale and policy priorities (Bongardt and Torres, 2022b), the same did not happen. The pandemic crisis has been made to work towards reinforcing the EGD. Policy responses could build on policy linkages, such as synergies between addressing climate change and Covid-19 (causes, policies) and also complementarities (digital transition). Environmental and social lessons arguably contributed to preparedness to modify unsustainable patterns of consumption and production in line with the EGD and long-standing EU priorities (digital, fair and sustainable economy).

The European Commission, which regained its leadership somehow lost to the European Council in the previous (financial and sovereign debt) crises, realized that the EGD could be framed as an exit strategy for the pandemic crisis (European Commission, 2020b). The EU's efforts to ensure a future-oriented sustainable, even, inclusive and fair recovery were therefore centred on the EGD and on investment.[9] In addition, the EU's response to the pandemic also supplied resources – in fact, the EU's largest ever stimulus package. A large part of the recovery funds became earmarked for a green transition (European Commission, 2020b).

Likewise, the current security crisis, triggered by Russia's war on Ukraine, also had the potential to support the European Green Deal narrative and bring the green transition forward (Bongardt and Torres, 2022a). In the EU, sovereignty reservations have held back energy policy as far as energy sources (member states' energy mixes) are concerned. Yet, the war and its fallout have led, at least initially, to some preference convergence that has allowed for a larger consensus on the need to exit faster from fossil energy sources *cum* accelerating renewables. Visegrad countries toned down their criticism of the EU's climate policy once the Commission labelled the push for renewables, energy efficiency and emissions reductions as 'security policy'. At their March 2022 Versailles summit, EU leaders agreed to phase out dependency on Russian gas, oil and coal imports as soon as possible. In the wake of Russia's aggression against Ukraine, the RRF became the EU's chosen vehicle also to strengthen its strategic autonomy by diversifying energy supplies and ending the Union's dependency on imported Russian fossil fuels. In 2022,

9 https://ec.europa.eu/commission/presscorner/detail/en/ip_20_940

the new REPowerEU plan provided additional grants, allowing member states to add a new chapter to their national recovery and resilience plans as to finance key investments and reforms in line with its objectives.[10]

The ECB, in the monetary domain, has joined the European Commission in advancing the EGD as a third building block of the EU economic model. It has pledged to align its policies with the Paris climate objectives as quickly as possible, so that all the actions that it takes in the pursuit of its primary mandate will contribute to the greening of the euro area economies and not undermine incentives to accelerate the green transition (Schnabel, 2022). Its strategy review also depicts some entrepreneurship, as it enables the ECB to consider more deeply how it can continue to protect its mandate, strengthening the resilience of monetary policy and its balance sheet in the face of climate risks (ECB 2021a, 2021b).[11] The existence of climate externalities implied that the ECB had "to reconsider the notion of market neutrality", as "in the presence of market failures, adhering to the market neutrality principle may reinforce pre-existing inefficiencies that give rise to a sub-optimal allocation of resources" (Schnabel, 2021). The argument is reinforced by Schoenmaker (2021), who shows that tilting the asset and collateral framework towards low-carbon assets (without undue interference with the transmission mechanism of monetary policy) reduces carbon emissions in the ECB's corporate and bank bond portfolio by over 50 per cent.

As argued in Torres (2013), the ECB derives its legitimacy not only from delivering price stability, but also (its wider output legitimacy) from acting as a guardian of EMU objectives, doing "whatever it takes to preserve the euro" and guaranteeing the sustainability of EMU as such. The internalization of the need to contribute to reducing the costs of the green transition and help to ensure price stability in the long run has therefore come to be part of the main strategic objectives of the ECB. That is why the ECB has engaged with work on climate change, aiming at better managing climate-related risks, supporting the green transition in line with the EU's net-zero objectives and fostering wider action from others (Lagarde, 2022).[12] As put by Isabel Schnabel (2023), "concerns that persistent higher interest

10 See https://www.consilium.europa.eu/en/press/press-releases/2023/02/21/eu-recovery-plan-council-adopts-repowereu/.

11 See also Schnabel (2021; 2023) and Lane (2022). Preunkert (2022) provides an excellent analysis of why and how climate change has moved to the centre of the ECB's agenda.

12 Supporting the green transition is not a sign of dominance (see for instance Reis's, 2022b, types of dominance – table 1) preventing the ECB from lowering inflation. See also Reis (2022a) and Schoenmaker (2021).

rates (monetary tightening) may discourage efforts to decarbonise (and thus increase the risks of "climateflation" and "fossilflation" affecting price stability) must be taken seriously – they expose a potential dilemma directly relating to the central bank's primary mandate of price stability, that cannot be ignored even on legal grounds". The ECB had already taken part in wider economic policy debates, such as on structural reforms. Supporting the green transition, it has brought in climate change into the debate and the discussions about its own course of action (and mandate).

In the end, to deliver price stability the ECB needs to take into account all factors affecting inflation and climate change is one of them.[13] Besides the primary objective of keeping prices stable, the ECB's secondary objectives, notably contributing to a high level of protection and improvement of the quality of the environment, are fundamental to ensure not only environmental sustainability but also the sustainability of the process of European integration and the very survival of EMU.

4. Like EMU before, the EGD is attracting fierce political opposition

Russia's aggression on Ukraine led to the REPowerEU programme to accelerate the shift to renewables in the EU, yet the jury is still out on its net effect on the green transition. In an initial phase, securing energy supplies became a paramount concern. National governments invested in fossil-fuel infrastructure, reopening coal-fired plants and constructing liquefied natural gas terminals, which may lock in the usage of carbon-intensive fuels. Adding to that, the provision of energy price subsidies does not only contribute to higher public deficits, but it also masks the price signals given by changes in relative prices, which are however needed to incentivise lower consumption of fossil fuels, behavioural changes and greater investment in green technology (Heemskerk, Nerlich and Parker, 2022). Under-pricing fossil fuels, as many governments in the EU have been doing, leads to overconsumption and global warming (Gaspar and Amaglobeli, 2023), prolong-

13 Frank Elderson (2023), member of the ECB's Executive Board, goes even further: "Our economy relies on nature. Thus, destroying nature means destroying the economy. Preventing the former is in the realm of elected governments as nature policymakers. We as ECB have to take nature-related risks into account in the pursuit of our mandate". As stressed by Dasgupta (2021): "(…) in recent decades eroding natural capital has been precisely the means the world economy has deployed for enjoying what is routinely celebrated as 'economic growth'".

ing non-sustainable consumption and production patterns and worsening global heating. The effects of all those misguided actions are to risk hindering the green transition whereas what is needed is an intensification of that process in order to reduce the costs of the transition and help to ensure price stability in the long run.

In a second phase, powerful vested interests, in various sectors – among which the German car and energy industry and the French nuclear sector – have been seizing on the crisis and its possible more immediate consequences (energy supply shortages, price hikes) as an opportunity to attempt to delay the EGD or even scrap it altogether. Of course, the implementation of the EGD's objectives is complex as it involves a whole legislative agenda to revise all EU policy areas as to ensure conformity. Member states have not shied away from trying to weaken it or take out pieces of the puzzle, even crucial ones (such as on channelling private funds to the green transition, transport or biodiversity), putting the achievement of targets and timings at risk.

Let us consider a bit more closely some recent examples that illustrate inconsistent behaviour on the part of member states. The EU Green Finance Taxonomy to guide investments towards sustainability, enacted through a delegated act, was seriously denatured when gas and nuclear energy were singled out and made subject to a separate Taxonomy Complementary Climate Delegated Act, in which they were classified as 'green' in the transition (driven by the particular interests of Germany in gas and France in the nuclear sector).[14] In December 2022, Germany set a dangerous precedent by withholding its final agreement on the already agreed (also repeatedly by Germany) end of the combustion engine by 2035. Not justified on efficiency grounds and for the sake of a symbolic win for one specific party in the government coalition the German government was prepared to undermine trust in the political reliability of the country and the EU policymaking process. In June 2023, France followed suit by threatening a last-minute blocking of the approval of the EU's revised renewable energy directive, if hydrogen from nuclear sources was not considered renewable. The European Commission was forced to put forward an additional declaration acknowledging the role of nuclear energy,

14 After neither the Council nor the European Parliament (by absolute majority) objected to the Taxonomy Delegated Act, it entered into force on 1 January 2023. The new EU regulation classifies gas and nuclear energy, with high emissions from fossil gas and radioactive waste, as 'green'. It will therefore provide an incentive away from genuinely sustainable renewable energies, such as wind and solar power.

which Germany also came to back.[15]

'Collusion' between France and Germany (despite the Greens, who are however in minority in the government coalition), with various other member states, has also led to severely weakening the EU Biodiversity Strategy (*Financial Times*, 2023), an important element of the EGD, which called for binding targets to restore degraded ecosystems. Even the amended (weakened) version of the law was rejected by the environment committee in the European Parliament.[16] In sum, out of electoral concerns but also in the name of resisting to change an unsustainable modus vivendi and production patterns (car, agricultural, nuclear sectors), various member states and established European political parties are ever more contesting the EGD (most recently on 'red tape' overregulation reasons). In this case, populist parties are following, not leading, the political opposition to the EGD but obviously it will be them who will capitalize on those short-sighted political stances, as is arguably already the case both in France and Germany. Moreover, those actions risk undermining the very EGD and, with it, EMU and the internal market.

5. Conclusion

The EGD, as a building block of EU economic governance in the making, is crucial to implement policies in a coherent and holistic way so that they are effective and the process of European integration sustainable (also from a political point of view). While an initial convergence of preferences made the EGD possible, the revision of all policy areas in line with the objectives and a conducive trajectory is proving a major challenge, above all because member state policies and actions are not consistent with the long-term policy objectives they had subscribed to in the first place. On the upside, EU institutions, notably the European Commission and the ECB, and some national and international institutions, have been re-

15 Interestingly, it was President Macron who had proposed Ursula von Der Leyen, who is also a member of the EPP and a German citizen, for President of the European Commission. She had to reach out to MEPs from other political groups (not counting with the support from the MEPs from Germany) to be elected in the European Parliament and the EGD is her own initiative. She has shown herself as a determined reformer and defender of the EU's common interest and therefore, as already before in Germany, has attracted fierce opposition from her own political support basis.

16 Marking a new development in EU politics, a majority of MEPs in the EP seemed to have turned against (a crucial pillar of) the EGD. Still, in the plenary vote on 12 July 2023, MEPs did not follow party discipline and approved the (albeit weakened) law. European interest prevailed over party politics and populism.

sponding to the challenge by adapting rules and policies, which will have a positive effect in the long run. However, they also depend on the wider EU regulatory framework, for which the European Commission needs the approval of member states. Yet, national governments of some member states, most notably France and Germany, once considered the engine of European integration, and some mainstream European political parties have been turning against the EGD giving in to vested interests (and electoral tactics). Those policy stances are not only bound to feed Euroscepticism and backfire, but they undermine the EGD, EMU's sustainability and, in consequence, Europe's future and identity.

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PART III

ECONOMIC GOVERNANCE

CHAPTER 10

Public goods and the neo-republican approach to European integration

Stefan Collignon

1. Introduction

Where do we stand with European integration? After the Euro crisis, Covid pandemic, and the war in Ukraine, Europe faces new challenges that have a major impact on its governance. Unfortunately, the debates about Europe's future remain trapped in sterile debates about sovereignty and national identities, while the evidence for collective action problems mounts. A profound rethink is needed.

Ideas on European integration can be traced back to the founding fathers of the European Union. After the second World War, setting up the United States of Europe was popular. Altiero Spinelli drafted the Ventotene *Manifesto for a Free and United Europe* in 1941 and initiated the European Federalist Movement. He held the institution of nation states responsible for two World Wars and continuing conflict in Europe and favoured a European Federation with its own sovereignty (Spinelli and Rossi, 2016). Conservative confederalists resisted this transformation of sovereignty as they favoured intergovernmental cooperation. Inspired by General Charles De Gaulle, they only accepted voluntary agreements

between states based on unanimity decision making.[1] Jean Monnet, the founder of the Committee for the United States of Europe, traced a compromise between these positions by adopting a neo-functionalist approach to integration with the gradual transfer of sovereignty in specific functional areas.[2] This proved the most successful path leading from the European Coal and Steel Community to the customs union in the European Community, the Single Market Act and finally the Treaties of Maastricht and Lisbon laying the ground for monetary union and strengthened democratic control by the European Parliament.

Today, the European Union is codified in the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU). This is a haphazard creation of negotiated compromises. The Treaties define the competences of member states and European Union institutions but without following the logical structure that would prevent inefficiencies, collective action problems, and governance failure. The obstacle for a clear constitutional structure is the concept of sovereignty based on states to which "people belong". I will propose an alternative approach based on public goods and their ownership by citizens. I call this the neo-republican approach.[3]

1 The idea of a European confederation was first articulated by the Nazi foreign minister Ribbentrop in 1943 with the intention to preserve German dominance over militarily conquered states in Europe (Brunet 2014). In 1960 General De Gaulle used the concept of confederation to protect French autonomy and the sovereignty of states caught between the American and Soviet superpowers. He spoke of the debate over European integration as a battle between two "visions" of Europe: the "utopian myths [of] supranational power"' on one side and a "confederation" in which no sovereign state could be "exposed to the possibility of being overruled on any economic matter... and therefore in social and sometimes political matters" (Moravcsik, 1998). The notion was picked up by President Mitterrand after the fall of the Berlin Wall and is still influential today with Macron's European Political Community for an enlarged EU (Moulin, 2022).

2 For the theory of neofunctionalism, see (Haas, 1964).

3 I must emphasise that the conceptualisation of the Republic by public goods deviates from traditional views of republicanism. For the foundations of my approach see: Collignon (2002). Further elaborations in Collignon (2004; 2007) and Collignon and Paul (2008); see also: (Besson and Martí, 2009). For the ancient concept of Republicanism see: Pettit (1997) and Bobbio and Viroli (2003). Ulrike Guérot (2016) combines several political concepts of old republicanism and modern democratic theory which leads her to speak of the European Republic as utopia, while I argue that it is already a reality based on existing public goods.

2. European public goods

In the process of integration an increasing number of European public goods has been created. The notion of "goods" includes services and policies which are services to citizens. They generate externalities that are costs or benefits to third parties that arise from other parties' activities. Public goods are defined by externalities which are partially or fully non-rival and non-exclusive benefits or costs for the individuals who are the owners of these goods and the reach by which they affect all members of a group. What matters for determining the reach is who is affected by policies, not on the identity of the group. Thus, the costs and benefits of local public goods reach only a small circle of citizens; national public goods affect all citizens of a state; and European public goods affect all European citizens.

Supplying public goods requires joint decisions. Private markets cannot provide them because externalities inhibit the price mechanism. How such joint collective decisions are taken defines the governance of public goods. Given their public nature, a clear assignment of spending (demand) to cover the cost of production (supply) is not possible. Hence, a public authority must define the quality and quantity of public goods and ensure that all members of the group contribute to the funding of necessary resources. In systems of multilevel governance, citizens who are the owners of public goods delegate decision-making competences to governments over which they exercise democratic controls. When the scope of the democratic control matches the reach of public goods, the governance is efficient and the collective decisions are legitimate. Yet, the nature of externalities determines not only the scope, but also the effectiveness of governance.

3. The nature of externalities

Positive or negative externalities arise when it is not feasible to exclude group members from the potential enjoyment of the public good or when joint efforts are required to provide its supply. The condition of *non-excludability* creates "jointness in demand". The condition of jointness in supply is called *non-rivalrousness*. Goods are private, when access is excludable, and supply is rivalrous. They are public when they are non-excludable, or non-rivalrous, or both.

Combining these two dimensions yields four groups of goods. Figure 1 shows the matrix for classifying some European public goods according to these criteria. The nature of public goods generates very distinct dynamics and incentives for

their provision and management and has therefore consequences for the competencies and responsibilities of governance.

Private goods are excludable and rivalrous. They are efficiently supplied by markets that ensure that their consumption depends on the payment of a price that covers the cost. The pricing mechanism balances supply and demand by excluding those from the market who are not willing or able to pay for the costs. With perfect competition, the price mechanism is efficient and there are no externalities. The European internal market has created the conditions for a very large range of private goods.

Pure public goods are non-excludable and non-rival. Anyone has access to use them and they require cooperation for their supply by a critical number of users. However, the efficiency of their provision is undermined by free riding when some group members seek advantages but avoid sharing the burden of costs. Because free riding generates negative externalities, the efficient supply of such goods requires that they are administered by a central authority that has the power to enforce fair burden sharing. In a democracy such authority is subject to democratic control by the members of the group, i.e., by the citizens affected by the public policies. This ensures that the scope of externalities is coherent with the group of affected persons, so that their preferences are determining relevant policy choices.

Club goods are impure public goods. They yield benefits for all members of the community, but their supply requires contributions from the collective. Because they are non-rival in supply while access can be restricted to members, free riding is avoided. Members who are not willing to play by the rules exclude themselves from their benefits. Because the externalities are positive in aggregate (positive sum game), the interests of club members *converge*.[4] Given the logic of the positive sum game, member states will cooperate voluntarily. Intergovernmental cooperation will work, because member state governments can use the benefits to increase their own legitimacy with voters. Cooperation problems arising from asymmetric information can be solved by soft guiding rules or by an impartial institution (like the European Commission) that ensures the transparency of compliance.

Common resource goods exist, where the supply of public goods is rival, because the resources required for supplying them are limited. That creates *rivalry* in a zero-sum game and an incentive to reap benefits at the expense of other members.[5]

4 The technical term is *strategic complementarities*. See Cooper and John (1988).

5 The technical term is these goods are subject to *strategic substitutabilities*. See Cooper and John (1988). Such common resources are often underpriced and lead to the "tragedy of the commons" (Hardin, 1969).

The interests of policy makers *diverge*[6] and distributional conflicts generate negative externalities which impede voluntary cooperation and generate collective action problems. For this reason, only a central authority can ensure the effectiveness of collective decisions and enforce compliance with policies in the interest of all. Hence, common resource goods require more centralised forms of governance than club goods. As in the case of pure public goods, the legitimacy of such authority is preserved when the scope of decision making is coherent with the externalities of the public goods. Because the euro is a common resource and limited in supply by the ECB, the European integration process has taken a new quality since the Maastricht Treaty.

All public goods are prone to collective action problems (Olson 1971). Positive externalities are an incentive for group members to cooperate, but if the group is very heterogeneous in size or interests, *cooperation may stop before the optimal amount of public goods is provided*. This is called the collective action problem. Individuals may seek to reduce their own contribution while reaping the benefits of the actions of other group members. The resulting lack of resources will cause the undersupply of public goods. The temptation of free riding and how to avoid it is therefore the core challenge for the provision of public goods. With the enlargement of the European Union, problems of collective action, preference heterogeneity, and policy gridlock have become the major cause for governance failure.

6 The traditional example is fishing: the stock of fish is limited, but access to fishing is unlimited (unless regulated). In the Euro Area, money supply is limited by the central bank, but all European commercial banks have access to euro liquidity.

Figure 1 – Typology of public goods

	Rivalrous	**Non-rivalrous**
Excludable	private goods	club goods
	all tradable goods bought and sold in markets for a price	*Four freedoms, Education, Public health, Fighting crime (Police co-operation), Asylum, Digital rights, Social policies, Industrial policies, R&D,*
Non-excludable	common resource goods	pure public goods
	the Euro, Central bank liquidity, Budgetary policy (SGP), Public debt, Migration, Climate change avoidance, Fisheries, Regional policies, fighting corruption	*Foreign and security policy, Military command, Judicial system, Financial stability, Public infrastructure, External border control, Competition policy, Common Agricultural Policy, Trans-European networks, Energy security*

4. The governance of European public goods

The incentives implicit in club goods were the main driver behind Monnet's method of integration and the process of European integration since WWII. The necessity to create a stable framework for sustaining these goods has also generated pure public goods. Becoming a member of the European Community meant sharing in the benefits of economies of scale, first in the customs union, then in the large single market with the free flow of goods and services. The price for accession was conformity with the common rules and regulations, but the rules themselves were the result of intergovernmental agreements. Such agreements determined the balance of costs and benefits for member states, but all members had an interest to cooperate because they wished to access the overall benefits.

The Maastricht Treaty has changed this dynamic, and the system of governance has not been adapted and made coherent. The creation of the euro has established money as the hard budget constraint for all members of the Euro Area. The European Central Bank supplies money for the single market and is bound to keep it scarce to ensure price stability. Previously, exchange rate movements

provided space for soft monetary policies and diverging inflation rates. The resulting market distortions undermined the functioning of the single market, and the uncertainty created by exchange rate volatility slowed down investment and economic growth.[7] In accordance with Monnet's neofunctionalism, the monetary union was the logical complement to the creation of the single market. However, with money as the hard budget constraint, new European common resource goods have appeared. In the monetary union, access to financial markets is non-excludable for all borrowers, including governments, but the limitation of money supply, by which the ECB ensures the hard budget constraint, has created rivalry for accessing financial resources. This is particularly salient for fiscal policy which raises the financial resources for public goods. Rivalry for resources has made compromises and agreements between member states increasingly more difficult. The effect is gridlock in European public decision making (Crombez and Hix, 2015). A centralised European authority could overcome the gridlock by imposing efficient solutions. But that raises questions for the legitimacy of such decisions.

5. The legitimacy of the European republic

The EU bases the assignments of competences for governing European public goods on the principle of subsidiarity, but this is not helpful. Article 5 TEU says that "Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the member states, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level". The assignment is purely procedural and has no substance. However, the article would make a lot of sense if "scale" would be defined by the scope of externalities. But even this criterion is not dealing with cooperation failure. The subsidiarity principle needs to define "effects" as referring to the efficiency of decision-making, which means it needs to be augmented by the distinction between impure public goods. The logic of public goods requires different forms of governance for club goods and common resource goods. The first can be efficiently administrated by intergovernmental agreements; the latter need a centralised decision-maker to be effective.

7 Padoa-Schioppa and Emerson (1987); Collignon (2002a).

There remains the question of what lends legitimacy to the conferral of competences to the European Union. What makes the next step of setting up centralising institutions for the governance of European public goods so difficult is the concept of sovereignty. For confederalists, the state, and the state alone, is sovereign. It can delegate the administration of specific tasks to some subordinated institution, but it keeps the ultimate power.[8] Citizens belong to the state, i.e., the state is owner of citizens and not the other way round. In the neo-republican theory that I propose, citizens are the owners of public goods.

The Latin wording for public goods was *res publica*. A Republic is a bundle of public goods, and insofar the bundle generates specific externalities, the Republic is itself a public good. It is a generic term. Ownership, however, remains individual-based. Given the different reaches for public goods, an individual can simultaneously be the owner of a private, a local, a national, and a European public good. In a democracy - not all republics are democratic - citizens have equal rights to exercise control over the decisions relating to their public goods. They express their preferences and interests through the election of representatives who administrate their public goods. These procedural rights invest citizens with their sovereignty and render the public choices legitimate.

The neo-republican interpretation of sovereignty is different from traditional theories of democracy that claim the existence of a single *demos* either nationally as in the confederalist or supranationally as in the European federalist model. The *demos* is the source of democratic legitimacy of nation states.[9] Yet, the word stands for the imagined homogeneity of economic and political preferences and cultures that does not exist in reality. Real societies consist of individuals with many conflicting ideas, beliefs, and preferences. When these invdividuals have the same rights to choose their representatives for policymaking, we call them citizens. The fantasy of a homogeneous *demos* reflects the holism which Karl Popper (1995) identified as constitutive for closed societies. This holistic interpretation of democracy has become an obstacle to the creation of an open and integrated

8 In German legal discourses, EU member states are called *Herren der Verträge* (Lords of the Treaty) – a notion that speaks volumes about the conservative roots of German constitutionalism. See Große Hüttmann and Wehling (2008).

9 Theories of "demoi-cracy", i.e., of rule by a plurality of *demoi*, do not overcome the fallacy of imagined homogeneity. *Demoi* is the plural of *demos*. Nicolaïdis (2012) argues that "the treaties seem to accept the fact that the European Union is based on the mutual recognition of *identities* and not their merger" (my emphasis).

European Union.[10]

The efficient governance of European public goods must reflect the interaction of club goods with pure public goods and common resource goods. Club goods can be governed by intergovernmental cooperation. But the rivalrousness of common resource goods and the non-excludability of pure public goods require some form of centralised decision making. For subordinate institutions like the European Central Bank this has already been recognised by the Maastricht Treaty, where the legitimacy for monetary union was derived from the limited objectives of monetary policy and from the Treaty on European Union which had been agreed by sovereign states. However, the new challenges that the EU faces today, such as conducting optimal economic and fiscal policies to cope with shocks, the ecological and digital transition, the protection of the common external border, the design of a European foreign and security policy, etc., require a new set of institutions with a stronger base of legitimacy. Because many of them have qualities of pure public or common resource goods, they are unlikely to be governed efficiently by intergovernmental structures under the prevalence of national sovereignty.

The Lisbon Treaty does not clearly assign competences for decision making to specific public goods. It is therefore not functional for the new challenges that await Europe when it needs to enlarge the range of public goods and the number of its members. The neo-republican approach lays the ground for a liberal-democratic constitution for the European Union that would improve the legitimacy and effectiveness of Europe's governance. It derives the multiple levels of governance from the reach of public goods and the scope of externalities, and it assigns the degree of centralisation in response to the nature of externalities which determine the likelihood of cooperation between member states.

The logic of the European Republic implies that citizens, not states are the owners of public goods. Hence, a centralised decision-making institution can only claim to be legitimate when it can act as the representative of all citizens concerned. The Lisbon Treaty provides the tool for that through the ordinary legislative procedure, but this procedure does not apply to many common resource goods, especially in the field of fiscal policy. The European Republic builds on the existing structures of democratic representation through the European Parliament and assigns the ordinary legislative procedure to all common resource goods.

10 The conservative interpretation of demos constituting a democracy – rather than a democratic republic – has been put forward by the German Constitutional Court. See BVerfG (2009 and 2020) and Grimm (2009).

A new treaty could create the efficient governance for the bundle of European public goods that constitute the European Republic. The revision of the *Treaty on European Union* with the purpose of improving the coherence between public goods and their governance is the *conditio sine qua non* for sustaining the benefits European citizens desire.

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CHAPTER 11

Still an asymmetrical EMU? Closing the gap between the 'E' and 'M' in EMU

Amy Verdun

1. Introduction

Ever since the start of the project to create an economic and monetary union (EMU) in the European Union (EU)[1] the question has been, how should it be designed? From the 1960s until the 1990s and indeed beyond there was a need for 'parallelism' between economic union on the one hand and monetary union on the other. What are these two concepts and how has the EU managed (or not) to close the gap between the two? Is it still an asymmetrical EMU (Verdun 1996)? What lies ahead?

From the early days of the Barre Plans, the Werner Report (Commission of the European Communities, 1970), even the MacDougall Report on the role of public finance in European integration (Commission of the European Communities, 1977) that drew heavily on fiscal federalism literature, there was mention

1 This essay uses the term 'European Union' (EU) even in those occasions when strictly speaking the entity had different names (European Community or European Communities for instance).

of needing to go beyond collaboration in the monetary domain, i.e., also on economic and fiscal matters. The authors of the Werner Report mentioned the need for a "centre of decision for economic policy" to be an authority on par with the EU supranational monetary authority. The Delors Report was, however, unable to decide how to solve the conundrum of developing both the 'e' and the 'm' of EMU and also referred to as "parallelism" (Committee for the Study of Economic and Monetary Union, 1989). In the Maastricht Treaty, however, the decision was to focus on creating a single currency and an EU-level central bank, but it was less clear what would be done on the 'economic' or 'fiscal' side of things. The background reports to EMU prepared by the Commission services focused on a very small common budget to use for automatic stabilisers and for redistribution (Verdun, 2000).

Some have argued that the sovereign debt crisis has been so intense in the EU because of the incomplete institutional design of EMU. In addition to the above-mentioned asymmetry between economic and monetary union, a second asymmetry emerged between those in the 'core' and the 'periphery' (Howarth and Verdun, 2020). The countries in the 'periphery' suffered much more from the sovereign debt crisis than did those in the 'core' (Matthijs and McNamara, 2015). At the height of the Greek crisis, there was no common safe asset (a Eurobond for instance) that this member states could draw on to refinance its debt (Jones, 2010). In the wake of the sovereign debt crisis, the so-called European Semester was set up to seek to coordinate macroeconomic policy-making through a mechanism that resembled the open method of coordination (Verdun and Zeitlin, 2018; D'Erman and Verdun, 2022). New steps were considered in the so-called Four Presidents Report (Van Rompuy, 2012) and the Five Presidents Report (5PR) (Juncker, 2015). These included more activity on banking supervision and Banking Union (Howarth and Quaglia, 2016; see also Högenauer, Howarth and Quaglia, 2023, this volume). Furthermore, at the time, with the prospect of the United Kingdom (UK) leaving the EU after the referendum of 23 June 2016, and a desire to celebrate 60 years of European integration, the EU issued three reports about the EU that built on these two presidents reports.[2] In so doing the Commission reflect-

2 The European Commission (2017a) White Paper on the 'Future of Europe' (which contains reflections and scenarios for the EU27 by 2025) that came out on 1 March 2017 builds on the path including the target date of 2025 which corresponds to the third stage mentioned in the 5PR. The report on 'Completing EMU' that also came out in spring 2017 (European Commission, 2017b) also builds on the 5PR and the 'Reflection paper on the deepening of the Economic and Monetary Union', that came out on 31 May 2017 (European Commission, 2017c) suggest that the 5PR has been incorporated into the next steps of Commission planning (European Commission, 2017b: 26).

ed on what the next steps might be (European Commission, 2017a, 2017b and 2017c). These considered the various possible next steps without making political choices which ranged from very little cooperation (nothing more than the single market) to a fully-fledged Treasury. If we know what it is that we are looking for, why is it so difficult to achieve?

2. Fiscal federalism in the EU

The challenge with the 'e' of EMU is that it refers first and foremost to taxing and spending. The EU still does not possess a large capacity to do so. Traditionally it was able to spend around 2 per cent of all EU public spending. To make a significant change it would require either changing the treaty or being creative within the current constitutional boundaries (no taxation without representation). In addition, there are a few other important factors. Other dimensions that are important in this regard include the green transition (see for instance Part II of this volume) and banking union; capital markets union; and the European Stability Mechanism (ESM) (see Part III of this volume). Thus, in addition, the 'E' in EMU is also able to progress without taxation and transfers. Economic policy coordination, most recently the European Green Deal (EGD) that has following previous agendas, with its overarching sustainability lens, introduces the ecological constraint (Schoenmaker, 2023, this volume; Torres, 2023; this volume) into the economic (and monetary) policies and in this way also develops some of the 'E' of EMU.

Let us consider the integration process whereby some of the public resources would be collected at the EU level and spent at that level. Early scholars of European economic integration emphasized that European integration should be seen as likely going through stages. Scholars such as Tinbergen (1954), Balassa (1961), Corden (1972a and 1972b) Curzon Price (1974) and Machlup (1977) identified these stages as starting with a Free Trade Area, Customs Union through to a Common Market, a Monetary Union, a complete Economic Union and possibly a more deeply integrated Political Union. More recently, the idea that these stages may need to be followed in sequence, or are irreversible, has been let go of. Nevertheless, it is useful to see these stages as analytical tools (Verdun and Tovias, 2013). If we compare the EU to a federal state, the most advanced form of integration is the stage in which EU supranational institutions would take on more of the role of a federal government. Why is this stage so difficult?

Comparing the EU with a federal state, taxing and spending are done at both levels. For instance, in the situation in Canada, which is one of the most decentralised federations (Bird, 1990; Kincaid 2019) both levels have the ability to tax and spend and who does what is spelled out in the constitution. Furthermore, the higher level can also distribute among the member states to 'equalise' (Béland, Lecours, Marchildon, Mou and Olfert, 2019). Since the creation of the federal nation, that Canada has been since 1867, federal and provincial powers have been divided. The provinces can tax and spend and make laws that are specific to the province; the federal level takes care of overarching expenses. There are funds that provinces can use from the federal level thereby obtaining transfer payments.

The EU is not a state. Even compared to decentralised fiscal federal Canada, the EU polity is not a federal state even if it has some federal features (Verdun, 2015; 2016). Nevertheless, it is still changing. The challenge for scholars is to figure out what it is and where it is going (the so-called question about its finalité). The EU has been making inroads in that direction. Political scientists and lawyers from different perspectives have highlighted various features, in the EU constitutional setup and its modes of governance, that give reason to consider the EU coming closer to being considered a federation and seek to make comparisons with theory and practice (see inter alia Nicolaïdis and Howse, 2001; Menon and Schain, 2006; Tömmel, 2010; Schütze and Tridimas, 2018; Larsen, 2021).

3. Identity and representation

The challenge of course is that there should be no taxation without representation. In the past, there have been plans to consider the optimal amount of fiscal federalism. These were, for instance, spelled out already in the late 1970s, in the MacDougall Report (Commission of the European Communities, 1977), and in the One Market, One Money Report (Emerson et al., 1992) and the Commission background studies that considered the need of having a centralised monetary authority but a decentralised fiscal authority (European Commission, 1993a and 1993b). If there is more supranational spending of funds at the EU level there will need to be political representation. Today the EU is set up with an executive and a legislative which are democratically elected. But the challenges of the setup are that the political platforms are indirect at best.

The citizens vote for the European Parliament (EP) once every five years. The results of those elections inform the composition of the European Commission – the executive of the EU. The EU governance model works a bit different-

ly than national models. In the EU citizens are often unable to identify exactly the platforms of the parties. Some of these political parties will focus on national rather than European issues during election campaigns. Voters have also treated European elections as less important. In some cases, voters may even take the opportunity of the elections to cast a protest vote (De Vries, 2018). For these and other reasons scholars have labelled EP elections as 'second-order' elections (even though this situation is not the same across time and space[3]). Finally, the transmission belt between the vote in the EP and the policy agenda of the Commission is quite indirect. There had been an attempt to set up a *Spitzenkandidaten* system to rectify this tenuous link, but for numerous reasons that system did not stick (Christiansen, 2016). In the aftermath of the 2019 elections, for instance, the Commission set up an ambitious agenda to advance a European Green Deal (EGD). This agenda was in response to societal pressures as well, the outcome of the elections, and to revive European integration (Bongardt and Torres, 2022; see also Torres, 2023, this volume.).

Another challenge in the EU context is the weak public debate. Many of the public discussions in the EU context are national in orientation. European citizens identify mostly nationally whereas only a few citizens identify with the EU as their main identity (Fligstein, Polyakova, Sandholtz, 2012). Having multiple identities (national and European) however, does not necessarily undermine support for the EU. Research suggests that it is part of the party of building a stronger European identity (Hooghe and Marks, 2009). It does however mean that when EU citizens are directing their political attention they are often focused on the national level. Voters usually consume news that concentrates on national issues. They expect national political elites to solve problems. It means that the day-to-day activities of the EU have remained largely outside the public purview of EU citizens (Hurrelmann, Gora and Wagner, 2016).

This phenomenon of national orientation is reinforced by how education is organised in the member states. Education is a national (or regional) competence. It means that member state authorities determine how much EU-knowledge is taught in schools. The result can be divergent because any member states may determine how much European integration is taught in primary and secondary schools if at all. The results are quite diverse. Many will emphasize peace and

3 For instance, turn-out increased in 2019, which scholars took as a sign that there may be an end to the trend of ever-lower turnout, hinting at a process of normalisation of the EP elections (Gattermann, de Vreese, van der Brug, 2021). Furthermore, some smaller parties may take the EP elections more seriously than some mainstream parties (Bartels, 2023).

economy; but others will focus on different ideological and social aspects (Sakki, 2010). Many citizens are not fully aware of EU competences and the potential that the EU can bring. For these reasons and more the public space is not as well developed at the EU level. Kalypso Nicolaïdis has identified this multiple-demos phenomenon and given it the term 'demoicracy' – meaning that the EU has a multitude of demoi (Nicolaïdis, 2004; see also Nicolaïdis, 2023, this volume).

4. Recent developments

The COVID-19 pandemic generated a symmetric shock to the EU that demanded a response to the challenge at the EU level. The European Central Bank and the European Commission were fast to propose new avenues of support (Quaglia and Verdun, 2023). The European Council reinforced this need by setting up a Recovery and Resilience Facility (RRF), developing temporary financial support at the EU level backed up by the EU budget (NextGenerationEU). The choice for a new entity (RRF) rather than developing further the European Stability Mechanism (ESM) that had been used during the sovereign debt crisis was to avoid the negative stigma felt by some from those times. Moreover, some felt that the crisis generated by COVID-19 was affecting all member states whereas the ESM was set up for euro member states (Schilin, 2023; Zagermann, 2024).

Some politicians, among others German Chancellor Olaf Scholz, have argued that this development of temporarily using the EU budget to provide member states with grants and loans to offset the economic effects of the COVID-19 crisis constitutes a 'Hamiltonian moment' (Fabbrini, 2022).[4] The major innovation is that after a number of years of failing to find a common debt instrument, the EU now found a compromise in which the EU centralised budget would be used. Although experts agree that there is a good chance that this experimentation may lead to a more solid institutional structure in the future (Begg, 2023) others have been more sceptical about comparing Europe's path to that of the US and argue that Europe will need to find its own path (Issing, 2020; Howarth and Quaglia, 2021). Political elites do not necessarily agree to what instruments would be needed to help one another or what solidarity may mean in this regard (Della Posta and Schure, 2020). Many observers do agree, however, that some development of public goods is needed and that new ideas are required to come up with the next steps (Tsoukalis, 2022; Buti and Messori, 2023, this volume).

4 The reference here is to US Secretary of the Treasury, Alexander Hamilton, who had allowed the US to take on the debt of former colonies and so convert them to debt of the federal union (Calhoun, 2020).

Following closely on the heels of the effects of the COVID-19 pandemic has been the rise in inflation that popped up in mid-2021 followed by the outbreak of a full-scale invasion of Ukraine. These developments were responded to by the EU taking a stronger leadership role in foreign policy and military action (even if falling short of becoming involved directly). The EU also decided to further strengthen the European Green Deal thereby reaffirming its commitment to the green transition but also adding a need to become less dependent on Russian oil and gas.

5. Conclusion

The 'e' of EMU is still underdeveloped. One of the reasons for this state of affairs is that the EU needs to expand the political structure as well to ensure the democratic principles of no taxation without representation is adhered to. The EU is thus faced with a creativity issue. As we have seen, the EU is not exactly structured the same as other federal states, but it still has made a good bit of development in that direction. Making another step towards a higher share of EU-level taxing and spending would require either changing the treaty or being creative within the current constitutional boundaries. When plans are drawn up authors are aware that it requires political will to proceed. It is not clear whether this political will is there. There are numerous pressures that make it difficult for the EU to make institutional changes. Until that time it is difficult for the EU to make bold steps towards a larger formal taxing and spending in the EU.

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CHAPTER 12

The challenge of completing banking union

Anna-Lena Högenauer, David Howarth, Lucia Quaglia

1. Introduction

In the aftermath of the 2007-8 international financial crisis, most European Union (EU) member state governments accepted the need to reinforce EU bank regulation.[1] These governments sought to avoid the future necessity of taxpayer funded bank bail-outs. In 2012, euro area national governments also agreed to create Banking Union. They were motivated by an immediate need to stabilize the Spanish banking system, large elements of which were dangerously close to collapse (Quaglia and Royo, 2015). There was also the broader goal of safeguarding financial stability – particularly in the euro area periphery – and tackling the sovereign debt-bank doom loop, in which fragile national banks held growing amounts of sovereign debt, while the sustainability of a number of national public debt loads was increasingly questioned.

The Banking Union that has been constructed over the past decade has involved a number of elements (Donnelly, 2018; Epstein and Rhodes, 2016; Howarth and Quaglia, 2016; Nielsen and Smeets, 2017). These include the improved supervi-

1 This chapter is a condensed and modified version of Högenauer et al. (2023).

sion of banks through the Single Supervisory Mechanism (SSM); the establishment of the Single Resolution Mechanism (SRM), the partial mutualization of national resolution funds into the Single Resolution Fund run by the Single Resolution Board, and adoption of rules for the resolution of banks to encourage bail-ins by bank shareholders, rather than bail-outs by governments; an EU-level support mechanism for bank recapitalization via the European Stability Mechanism (ESM), which was to act also as a financial backstop to the Single Resolution Fund. By contrast, a European Deposit Insurance Scheme (EDIS) was initially mentioned as one of the key pillars of Banking Union, it was then set aside, even though there was an agreement to enlarge deposit guarantee funds at the national level. The EDIS proposal was re-launched by the European Commission in 2019, but made little headway. Underpinning Banking Union, is the so-called 'single rulebook' — a single set of harmonised prudential banking rules that apply throughout the EU, not only to Banking Union member states.

Banking Union represents one of the most important developments in European integration since the launch of Economic and Monetary Union (EMU). Yet the design of Banking Union agreed between 2012 and 2014 was a messy compromise among EU member states seeking to rebuild confidence in European banking sectors in the aftermath of the international financial crisis and in the midst of the euro area's sovereign debt crisis. A decade after the launch of Banking Union proposals in June 2012 and fifteen years since the outbreak of the worst international financial crisis since the late 1920s, the design of EU bank regulation, supervision, support and resolution remains hotly contested, in both academic and policy-making circles.

In this chapter, we highlight two main issues that need to be addressed in order to strengthen Banking Union: first, its incomplete institutional design and, second, the difficulty encountered in applying the different elements of Banking Union to loosen sovereign-bank ties. By bringing together the main findings of the papers, we also tease out some important lessons that can be drawn from the first decade of operation of the main pillars of Banking Union, namely: banking supervision, resolution, deposit guarantees, and the banking 'rulebook', which are discussed, in turn, in the following sections.

2. The successful – but less-than-single – Single Supervisory Mechanism

Banking supervision within the SSM remains far from single. The ECB supervises the euro area's largest banks using national rules while national supervisors retain significant autonomy in the supervision of smaller institutions. Thus, the most obviously supranational element of Banking Union – the SSM and the transfer of significant supervisory powers to the ECB – retains very clear national elements. Yet there are ongoing efforts to construct a common supervisory culture within the SSM – that is, the adoption of very similar, if not identical, supervisory practices, standards and methodologies (Božina Beroš, 2023; Lautenschläger, 2018).[2] The ECB has pursued ongoing efforts to reduce the number and restrict the scope of options and discretions available to national supervisors.

The SSM can also be praised for its comparatively transparent, accountable and effective operation. Through a comparative assessment of the transparency of the ECB, Högenauer (2023) concludes that ECB supervision is more transparent and accountable than that of national level banking supervisors, reflecting the success of the supranationalisation of bank oversight and the greater distance from national political sensitivities. Quaglia and Verdun (2023) argue that the ECB-SSM Supervisory Board reacted promptly and forcefully to the pandemic-related economic and financial crisis (Quaglia and Verdun, 2023). The ECB jumped into the vacuum that emerged, as neither the member states nor the other EU institutions were able to act quickly as they needed time to come up with a major collective response. Yet, the ECB's entrepreneurship in relaxing supervisory rules during the Covid-19 pandemic might also be considered pragmatic policy making in exceptional circumstances. Donnelly (2023) argues that in its supervisory policy, the ECB had to juggle conflicting goals of risk reduction and the encouragement of lending which was so vital in the context of the pandemic and the euro area's post-pandemic future. While the SSM was designed to reduce risk by limiting national supervisory forbearance, during the pandemic the continued provision of credit was equally important. Indeed, in 2023, the European Court of Auditors found that the ECB itself was too lenient with banks with regard to their management of credit risk (ECA, 2023).

2 These efforts to construct a common supervisory culture in the SSM mirror what is happening in the European competition policy domain (see Bongardt and Torres, 2022).

3. The holes in Europe's bank resolution regime

The second pillar of Banking Union concerning bank resolution is less robust than the first supervisory pillar and the vagaries of national politics continue to undermine the construction of a credible resolution regime in Banking Union. The SRM and the Bank Recovery and Resolution Directive were supposed to harmonise bank resolution in Banking Union, but this happened only to a limited extent. The institutional model chosen for the SRM meant that resolution partly remained a national competence for small domestic banks. For banks under direct ECB supervision as well as cross-border banks, the resolution was to be managed by the SRB through a convoluted decision-making process (see Kudrna, 2016) and for a number of years without the backing of a substantial Single Resolution Fund. Consequently, there was considerable national variation in the way in which national authorities dealt with ailing banks in Banking Union, in particular concerning the important question of 'who pays' (Quaglia, 2019).

Moreover, some observers have argued that some (notably larger) member states can get away with exploiting the loopholes in the Bank Recovery and Resolution Directive, while others might have more difficulty doing so (Asimakopoulos and Howarth, 2022). Both Italian and German governments have intervened to ensure that EU resolution rules were not applied, including for smaller regional banks which could otherwise be resolved without major contagion for the rest of the banking system. The European Commission approved both the German bailout of NordLB and the Italian bailouts of Monte dei Paschi and two Veneto banks, thus in effect undermining the applicability of EU resolution rules (Moschella and Quaglia, 2019; *Financial Times*, 2019). In these cases, EU authorities bowed to political pressure from national governments and allowed them to sidestep the requirement of bail-in by bondholders prior to bail-out by taxpayers.

To reinforce the EU's resolution regime, some observers and policymakers have further argued for a more consistent resolution mechanism that applies to a larger range of banks, including small and medium-sized institutions (Villeroy de Galau, 2021). The current regime also fails to ensure the provision of sufficient liquidity in resolution. The divergence in member state bank bankruptcy regimes continues to undermine the consistent application of EU resolution rules.

4. The missing European Deposit Insurance Scheme

The third pillar of Banking Union, the EDIS, has escaped agreement for over a decade. Further, there remains considerable variation across national deposit guarantee schemes which is permitted by the EU's Deposit Guarantee Scheme Directive revised in 2014. Countries (notably, Germany and Austria) with existing institutional protection schemes — that covered a range of potential interventions from bail-out to deposit insurance and resolution funds — were allowed to maintain these schemes. In Germany, in particular, there was a long track record of using these schemes to provide bail-out funds to struggling public law banks, both the regional *Landesbanken* and smaller savings banks. German savings banks have persisted in their opposition to the creation of an EDIS. Their influence in relation to local, Land and federal governments has ensured ongoing German government opposition to the mutualisation of national schemes (Cassell, 2021; Howarth and Quaglia, 2018).

Debates are ongoing on the necessary construction of both EDIS but also the ESM as a backstop to the Single Resolution Fund. In turn, these reforms are often presented as essential to tackle the sovereign debt-bank doom loop and to contribute to wider financial stability (Amtenbrink, 2023). For many observers, the establishment of European level financial support mechanisms is of vital importance to weaken ongoing pressures faced by national governments to bail-out national banks. Some observers and policymakers though accept that intractable German opposition to the creation of an EDIS requires the further harmonization of national deposit guarantee schemes, and the consideration of alternative mechanisms, including a liquidity support system among national deposit guarantee schemes (Villeroy de Galau, 2021).

5. The 'single' yet diverse banking rulebook

The EU 'single rulebook' for banks is often presented as the foundation stone of Banking Union, supporting its pillars. Yet important structural weaknesses remain in this foundation, notably because EU legislation adopted over the past decade has continued to allow member states significant divergence in the form of 'options and national discretions' (ONDs). Indeed, several proposed reforms

designed to strengthen the EU's regulatory framework and reduce the number of ONDs, thus decreasing the size of loopholes for banks, met the determined opposition of a number of EU member state governments and powerful bank interests. Two notable examples of the use of ONDs by member states and the problems that they have generated concern rules on capital requirements and the definition of non-performing loans (NPLs).

The Capital Requirements Directive adopted in 2013 (CRDIV) was to transpose elements of the international Basel III agreement on bank capital standards in the EU. However, the directive allowed member state governments significant margin of manoeuvre in the precise rules on capital and liquidity adopted at the national level. Governments sought legislation that better reflected the structures of national banking systems and system-wide characteristics of bank capital and thus placed less constraint on national banks (Howarth and Quaglia, 2013). Subsequently, in 2019, the EU adopted a legislative package referred to as CRDV, which was designed to implement the so-called Basel IV agreement in the EU. The main immediate objective of these reform attempts was to force banks to hold increased loss-absorbing capital and liquid assets. The broader objective was to make banking safer, to diminish the systemic effects of losses resulting from high-risk bank activities, and to reinforce the ability of supervisory authorities to monitor effectively these activities. At the same time, there were parallel efforts by some member state governments to water down EU bank capital requirements, which were seen as too 'costly' for banks, or at least to prevent their reinforcement (Noonan et al. 2015; Fleming and Arnold 2021). The debate on desirable EU capital requirements continues (see, for example, Holzmann et al., 2021).

A second example of the use of ONDs in the national implementation of EU legislation concerned the adoption of common definitions, measurement and rules for the management of NPLs. The ECB's preparatory analysis for its 2014 Asset Quality Review of the euro area's largest banks identified major differences in the way bad loans were recognised and classified. Indeed, the Asset Quality Review published in October 2014 revealed significantly higher NPLs than what the banks had previously disclosed (IMF, 2015; Gren et al., 2015). There was rapid progress towards a common definition of NPLs and the ECB was successful in forcing euro area banks to reduce NPLs. However, following the creation of the SSM, there were a number of provisions on the management of NPLs which allowed for considerable member state margin of manoeuvre, allowing persistent divergence (EBA, 2021; ECB, 2021).

While divergence persists among the supervisory authorities and banks headquartered in Banking Union member states, this divergence is greater for those EU member states that remain out of Banking Union. The ongoing divergence between Banking Union and non-Banking Union member states, which are nonetheless still subject to the EU's single rulebook for banking, also undermines the construction of Banking Union itself, as the governments of non-Banking Union countries continue to seek regulatory and supervisory arbitrage for competitive advantage (Ban and Bohle, 2020). While many elements of the EU's single rulebook constrain the potential for this arbitrage, it is clear that the sovereign-bank ties in Central and Eastern European countries not in Banking Union remain strong (Piroska and Epstein, 2023). Without significant further convergence, the ongoing pursuit of arbitrage is inevitable.

6. Conclusion

The construction of Banking Union – both its supranational and intergovernmental elements – is an important achievement in the history of European integration. Nonetheless, we point to a number of lacunae in this chapter. The SSM has operated in a broadly effective manner over the past decade – even in times of crisis. However, the SSM remains less than single. There are holes in Europe's resolution regime because it has only partly been supranationalised, it has a rather convoluted decision-making process, the Single Resolution Fund is of insufficient size and resolution processes in member states remain influenced by national political considerations. The EDIS is often presented as a much needed missing pillar of Banking Union, whereby the strategy to promote further supranationalisation in this field has sought to combine 'risk sharing' by eventually pooling resources at the EU-euro area level and 'risk reduction', for example, by dealing with bank NPLs in the member states (Nouy, 2018). Finally, the 'single' yet diverse banking rulebook remains a hindrance to the effective operation of both the SSM and SRM.

The challenge of reinforcing euro area financial stability can be described as a collective action problem. Most, if not all, member state governments are subject to national political pressures to undertake regulatory and supervisory arbitrage and to support their national banks (Epstein, 2017). However, all the elements of Banking Union allow for ongoing government intervention and thus fail convincingly to tackle this collective action problem. Tackling the moral hazard for both banks and governments that resulted from these ties had been a major motivat-

ing factor for the establishment of Banking Union. The supranationalisation of control over both the supervision and resolution of banks was supposed to mitigate if not eliminate altogether this kind of moral hazard (Pierret and Howarth, 2023).

More generally, the design and management of Banking Union is torn in different directions, further creating the potential for member state government intervention in national banking systems. The weaknesses of the institutional design of Banking Union and rule implementation must therefore be acknowledged. Banking Union resembles an unfinished cathedral. Given its problematic architecture, there remain important stability risks. Member state governments retain excessive margin of manoeuvre in a number of respects thus exposing both EU institutions and Banking Union more generally to accusations that, when push comes to shove, member states will do what is politically expedient.

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CHAPTER 13

Risk-sharing in the Euro Area

Pedro Duarte Neves

1. Introduction

The unprecedented adverse shocks that hit the Economic and Monetary Union (EMU) one decade ago – commonly referred to as the *public sovereign crisis*, the *double-dip recession*, or simply as the *euro area crisis* – contributed to the identification of insufficiencies in the design of EMU.[1] This chapter stresses the benefits in progressing in three different, but complementary, areas: creation of a fiscal capacity, completing the Banking Union, and completing the Capital Markets Union. Effective action on these three dimensions will increase risk-sharing in the euro area and, as a result, resilience of the economy and a reinforced capacity to absorb asymmetric shocks.

1 Constâncio (2018) proposes an order of priorities to improve the design of the EMU.

2. Risk-sharing in the euro area: stylized facts

The concept of risk-sharing refers to the idea that economic agents try to smooth out their levels of consumption (and investment) over the business cycle. This chapter addresses income risk-sharing in the euro area, defined as the capacity of an economy to absorb – through different cross-border smoothing channels – idiosyncratic adverse (i.e. country-specific) shocks. The literature (Nikolov, 2016; Leandro et al., 2016; Cimadono et al., 2018; Cimadono, 2022) assumes that risk-sharing within a currency union takes place through three main channels (one public and two private):

i. The *fiscal channel*, or the public channel, smooths out the effects of economic shocks through fiscal transfers between participating countries (between those that are affected by a negative shock and those which are not);

ii. The *credit channel* operates via cross-border saving and borrowing from financial intermediaries, mainly from banking credit. Cross-border banks are less exposed to the local economy, as they can compensate losses made in recession-hit regions by gains in other geographies;

iii. The *capital channel* corresponds to the possibility of economic agents to have access to income flows from other countries, through internationally diversified investment portfolios. Capital market integration fosters the geographical diversification of funding sources and strengthens private risk-sharing.

Empirical evidence on the functioning of the EMU over the last 15-20 years allow us to identify the following stylized facts on risk-sharing in the euro area.[2]

Stylised fact 1: There is a reduced risk sharing – both public and private – in the euro area when compared with the US

The three risk-sharing channels have been able to smooth around 60 to 80 per cent of income shocks in the US, whereas that numbers decreases to 20 or, at most,

2 See for instance Draghi (2018).

40 per cent in the euro area.[3] The message is clear: a large proportion of shocks remains unsmoothed in the euro area.

A part of the explanation has to do with the lack of fiscal risk sharing in the euro area, as its contribution to income smoothing is negligible. This result may be, over the next years, challenged by the functioning of the NGEU (the NextGenerationEU), but for the time being it clearly illustrates the lack of a fiscal stabilization function in the euro area. Instead, in the US the fiscal channel plays a reduced, but visible, role.

The most noticeable difference between the two economic spaces corresponds, however, to the role of the private risk-sharing channels in the US – both the capital and the credit channels – which exceed, by 2 to 3 times, the corresponding figure for the euro area. Deepening financial integration is one way to increase risk-sharing in the presence of adverse economic shocks.

Stylised fact 2: There was a lack of progress in financial integration in the euro area since the pre-Global Financial Crisis (GFC) position

The European Central Bank (ECB, 2020 and 2022) presents two composite indicators of financial integration in the euro area by combining information from the most important financial markets (money, bond, equity, and banking markets). These indicators provide a quantification of financial integration through cross-border price differentials (the *price-based* indicator) and cross border investment lending (the *quantity-based* indicator), as measured by bond holdings, equity holdings, and interbank.

Financial integration increased since the introduction of the euro, reaching their all-time highs in the mid-2000s just before the GFC. Both indicators have declined sharply during the sovereign debt crisis, starting to recover by 2013. Currently they stand close (or below) the pre-GFC period, indicating the lack of progress in financial integration in the euro area. This result holds regardless the relevant progress in the design of EMU, through the creation of the Banking Union and the efforts to build a capital markets union (CMU).

The same message is provided by the *cross-border finance indicator* produced by the Association for Financial Markets in Europe (AFME, 2022) to quantify intra-EU and intra-euro area capital markets integration. This indicator displayed

3 See Nikolov (2016), Leandro et al. (2016) and Cimadono (2018).

an upward trend up to 2007, which was reversed in the following 10 years. The indicator has recovered over the last 5 years but has not yet reached the mid-2000s figures. The lower cross border private equity investment and M&A activity – which have been increasingly undertaken at domestic level – have constituted the driving factors of the indicator.

Stylised fact 3: Financial integration is not resilient under financial adverse shocks

The resilience of financial integration[4] – how persistent financial integration proves to be in the face of adverse shocks – is also a key dimension in an economic and monetary union. As mentioned above, the degree of financial integration in the euro area registered a marked decline in the period 2007-2012. Cimadono et al. (2018) highlight the dissipation of the credit channel during the sovereign debt crisis. This channel functioned in a pro-cyclical way – increasing borrowing abroad in good times and repayment of the loans in bad times – by adding, rather than by reducing, volatility in the financial cycle, that is functioning more as an amplifier than a mitigator of the adverse economic developments.

The same did not happen in the recent COVID-19 adverse shock: the decline in the indicators of financial integration induced by the beginning of pandemic was reversed relatively quickly, reflecting the prompt policy measures by governments and the ECB. The COVID-19 shock – contrarily to the double-dip recession in the euro area – does not qualify for a financial adverse shock, as fiscal and monetary authorities acted promptly and effectively (see Chang, De Grauwe and Torres, 2023, this volume).

These stylized facts indicate very clearly that there is a significant potential for strengthening risk-sharing within the euro area. Deepening public and private risk-sharing in the euro area would create conditions for a more resilient financial system and more favourable conditions for the preservation of financial stability. The US/euro area comparison on the relative importance of risk-sharing indicates three areas of possible progress in the design of EMU: creation of a macroeconomic stabilization function in the euro area (a fiscal capacity), completion of the Banking Union, and the effective promotion of a Capital Markets Union.

4 The ECB (2022) explains that financial integration tends to be more resilient against shocks the higher the following ratios of intra-euro area cross-border (i) long-term to short-term debt securities holdings, (ii) equity holdings to debt securities holdings, and (iii) retail bank lending to interbank lending.

3. Increasing risk-sharing through the fiscal channel: creation of a fiscal capacity in the euro area

There is a very complete empirical assessment of the possible functioning of a fiscal capacity in the euro area (Carnot et al., 2017; Bénassy-Quéré et al., 2018; Arnold et al., 2018; and Stráský and Claveres, 2018). All these studies illustrate the effective contribution of a fiscal macroeconomic stabilization function for increased risk-sharing among member states. In addition, they also suggest that a well-designed fiscal capacity would not imply permanent transfers within the euro area (see also Buti and Messori, 2023, this volume).

These four empirical studies identify many reasons that justify the need for a reinforced public risk sharing channel in the monetary union. First, for varied reasons, the current fiscal framework in the euro area does not have capacity to absorb large asymmetric shocks: (i) national fiscal stabilizers do not manage to smooth large economic shocks; (ii) there are limits to discretionary policy within the Stability and Growth Pact; (iii) cross-border spillovers are too small to be effective. Second, the existence of a macroeconomic stabilization function in the euro area would contribute to a more effective management of public policies: (i) a fiscal capacity facilitates a better mix between fiscal and monetary policies in the event of an area-wide shock; (ii) a fiscal capacity would play an important role in terms of macroeconomic stabilization in a situation in which monetary policy interest rates face an effective lower bound; and, (iii) a fiscal capacity would complement – rather than functioning as a substitute – financial integration.

The development of a fiscal capacity for the euro area requires the assessment of many critical aspects: the size of the budget; the definition of ex-ante conditionality to have access to the fund; the scope of the fiscal capacity, in terms of the nature (asymmetric vs symmetric) and the size (large vs relatively smaller) of economic shocks; the definition of the trigger mechanisms to access the fund; and the definition of options to reduce the risk of permanent transfers within the euro area. Neves (2020) provides a comparative assessment of the four studies mentioned over these dimensions.

4. Increasing risk-sharing through the credit channel: completing the Banking Union

The banking union was initiated in 2012 in response to the euro area crisis (see also Högenauer et al., 2023, this volume). It constitutes the most important adjustment in the framework of the EMU since the creation of the euro, intended to break the vicious 'bank-sovereign loop'. This banking union should be based on three pillars: the supervisory (the Single Supervisory Mechanism), the resolution (the Single Resolution Mechanism), and the deposit guarantee (the European Deposit Insurance Scheme, or EDIS) pillar.

The first two pillars were successfully developed, even if some insufficiencies remain. In particular, the prudential supervisory function has contributed in a decisive way to a well-capitalized and more resilient euro area banking sector. Unfortunately, the third pillar – which should stand as one the very first priorities of euro area governments – has not progressed at all.

There are many good reasons to develop the EDIS. First, it is important to have a uniform level of depositor confidence. Depositors must be awarded similar protection across the common currency area. The existence of an EDIS contributes to level playing field and mitigates the risk of competitive distortions at the EU level.

Second, a uniform level of depositor confidence across the euro area is an essential line of defence to reduce market fragmentation and the risk of bank runs in stressful moments, therefore reinforcing the conditions for the preservation of financial stability. Most national deposit guarantee schemes do not have sufficient resources to deal with large local shocks; in the case of a large pay-out, most of them would be depleted and would need a national backstop (loan) from the national government. The existence of an EDIS mitigates the risks of market fragmentation and of the vicious 'bank-sovereign loop'.

Finally, the existence of an EDIS would align control (as supervision and resolution are decided at the euro area level) and liability (as it is a national responsibility to guarantee deposits).

The lack of this common backstop constitutes one important vulnerability for the functioning of the euro area financial system. The completion of an effective Banking Union requires a fully mutualized EU deposit guarantee scheme, as

a key contribution to reinforced resilience, reduced market fragmentation and increased risk sharing in the euro area.

5. Increasing risk-sharing through the capital channel: completing the Capital Markets Union

The full benefits of having a single currency require a well-functioning capital markets union. Financial integration increases financial resilience, as investments – in debt and equity – are decided irrespective of home country considerations. Scaling-up market-based financing in the EU is a very natural way forward in a predominantly banking-based economy.

Capital markets have developed nationally and are not sufficiently integrated, therefore being far from an effective single market. Moreover, capital markets must become deeper (both on debt and equity) and more accessible for start-ups, small and medium-sized firms. The CMU is a very relevant project for the euro area; unfortunately, the progress since the 2015 Action Plan – designed as a gradual progress based in small steps – has been very poor.

A successful CMU would increase the relevance of the capital channel in smoothing out adverse shocks, increasing private risk-sharing. The CMU project is also highly relevant for economic growth as it provides conditions for a liquid market of both debt and equity, boosting the opportunities for innovation and productivity. Non-banking financial intermediation (like venture capital) tends to provide a relatively more promising contribution to innovation and productivity than banking financing.

This chapter recalls three reinforcing actions that could contribute to an effective CMU.

First, a successful CMU requires a (much) larger retail investment participation. This can be achieved by multiple means. The supply-side could contribute by the development of truly pan-European financial products. Just as an example, the Pan-European Personal Pension Product (PEPP)[5] could (i) boost voluntary

5 The European Insurance and Occupational Pensions Authority (EIOPA) has developed a remarkable work in the design of the PEPP, which corresponds to a paradigm shift: the PEPP has been designed as simple, transparent, cost-effective, digital, and portable pension product. Moreover, the PEPP draws on learnings from behavioural science.

retirement savings in the EU, (ii) facilitate labour mobility within the EU, (iii) be effective in countries where the 2nd and 3rd pillars are not well developed, and (iv) help closing the pension savings gap. On a broader perspective, product design could benefit from reinforced transparency and communication through (i) radically simpler consumer disclosures, and (ii) be fit for the digital age, engaging a non-financially literate audience. On the demand side, financial literacy initiatives[6] – which are developing consistently across EU members – should be important to build consumer trust in capital markets.

Second, the very successful experience of the single supervision mechanism for the banking sector could be extended as well to pensions, insurance, and financial markets in general through a fast progress in supervisory convergence within the EU. Supervisory convergency has ranked as a top priority for both EIOPA and the European Securities Markets Authority (ESMA) over the recent years. This means (i) common rules and common regulatory policies, (ii) harmonized application of rules in a manner proportionate for risks, (ii) effective enforcement, and (iv) development of a harmonized macro-prudential framework for the non-banking sector, therefore supporting level playing field for market participants regardless of where they are located. This requires stronger powers for EIOPA and ESMA and, possibly, evolution towards two new pan-European sectoral supervisors.

Third, it is necessary to achieve progress in reducing fragmentation through legal changes. Improving withholding tax procedures for cross-border financial activities could contribute to overcome barriers to intra-EU cross-border investments. Insolvency frameworks, which differ markedly across the EU, play a crucial role in the functioning of the economy, this being particularly important in the current situation of high non-financial private debt for both corporates and households. A move towards convergence on insolvency frameworks – based on sound economic principles and adoption of best practices – could also contribute in a significant way to the success of the CMU.

An effective CMU it is very relevant for supporting robust growth – in particular, in the current stage of green and digital transition (see Part two of this book) – and a more resilient and inclusive economy, contributing in a decisive way to higher risk-sharing within the euro area.

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6 The European Supervisory Authorities (ESAs, 2023) published a report on national financial literacy initiatives on digitalization outlining good practices that can be seen as reference practices to increase the effectiveness of this type of initiatives.

6. Conclusion

In the recent past, the euro area economy has remained very resilient in the face of successive adverse shocks (the pandemic, the energy crisis, disruptions in the supply chain, the Russian invasion of Ukraine). Past episodes of financial stress recommend, however, to reinforce risk-sharing in the euro area, therefore contributing to a more predictable, steadily growing, and resilient economy. This chapter suggests possible ways to make the three risk-sharing channels – the public, the credit, and the capital channels – more effective in the euro area.

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CHAPTER 14

EMU and the crisis: A story of highly incomplete integration

George Pagoulatos

1. Introduction

Economic and Monetary Union (EMU) represented a giant political leap towards closer European integration. It also represented a leap of faith in terms of the economic underpinnings ensuring its economic sustainability. The EMU was “a post-modern construction defying the laws of gravity”, as Tsoukalis (2003: 150) had pithily put it. However, the asymmetric architecture of EMU (a common, centralized monetary policy but decentralized economic policies) rendered it fragile in the face of an extreme shock. A number of well-established inherent weaknesses underlay its functioning.

2. EMU's structural deficiencies and policy errors

EMU's weaknesses derived from the fundamental structural asymmetry of a single currency and centralized monetary policy coexisting with decentralized economic policies, whose coordination largely relied on soft instruments, leading to macroeconomic, structural, and external imbalances. No centralized fiscal policy function or fiscal capacity existed. The European Central Bank (ECB) was bound by an exclusive and rigid mandate for price stability. Fiscal rules under the Stability and Growth Pact (SGP) were both too rigid and insufficiently observed, leaving insufficient space for countercyclical fiscal action; at the same time, no robust mechanism existed to ensure that good times are being used to generate primary budget surpluses for fiscal sustainability. And then there was the lack of any national government control over the euro, celebrated upon inception as a guarantee against fiscal dominance over ECB monetary policy, whose downside, however, is that it renders national public debt akin to having borrowed in a foreign currency. This resulted in an inherent vulnerability to a liquidity crisis (governments being unable to guarantee they can repay all bondholders at maturity) generating the potential of a liquidity crisis unfolding as a self-fulfilling prophecy (De Grauwe, 2011 and 2023, this volume). And more.

Such deficient architecture, coupled by erroneous policies at EU and national level, generated the large current account deficits and external over-indebtedness in the Eurozone periphery that led to the 2010 crash. Policy errors included not just the fiscal derailment of the Greek economy, which in 2009 posted a primary budget deficit in the area of 10 per cent of GDP; they also included the neglect of credit and housing bubbles in Ireland and Spain, which fed the inordinate expansion of the non-tradable sectors at the expense of tradables and exports, all of which translated into the looming current account deficits that were followed by the sudden stop in private sector financial inflows and the subsequent crash.

All such EMU construction defects notwithstanding, the final crash was far from inevitable. The Economic and Monetary Union had the potential to operate as a positive sum arrangement for all, had it been followed up by the appropriate national and Eurozone-wide policies. For the Southern economies, mired by weak currencies, inflation, higher deficits and higher borrowing costs, accession to the single currency brought a positive disciplining effect. Inside the euro, lower interest rates facilitated public and private sector borrowing, for good and for bad.

Much of it went to productive investment in infrastructure and the improvement of human capital, contributing to gains in productivity. More, however, ended up financing consumption, financial and real estate bubbles (Chang et al., 2020). These underlay the external imbalances, the build-up of current account deficits in the periphery, which culminated into the crash (Baldwin and Giavazzi, 2015; Pagoulatos, 2020).

When the debt crisis transpired, starting from Greece, it demonstrated a vicious quality of spreading across national borders, and across sectors, from the sovereign to the banking sector and vice versa. The debt crisis dispelled the overoptimistic expectation of an 'impossible trinity' upon which EMU had been founded: no bailout, no Euro-exit, no sovereign default of a Eurozone member state. Not all three could hold in the face of such an extreme shock; and they did not, in a Eurozone lacking any sufficient crisis-resolution mechanism for Eurozone member states. No integrated EU-level mechanism existed to mutualize the response to risks emanating from the (liberalized but short of a consolidated EU-level supervision) banking sector, spreading to one or more member states. And at the same time, no effective resolution mechanism existed to provide liquidity to distressed sovereigns, manage contagion risk and safeguard Eurozone financial stability.

Vulnerability in the face of an EMU crisis pointed to a lack of sufficient stabilization instruments and a structural inability to engage in sufficient risk sharing inside the Eurozone. This could be implemented through either of three channels: the monetary channel, the fiscal channel or the private sector financial channel (see also Neves, 2023, this volume). Jean Pisany Ferry (2012) has observed another 'impossible trinity' within the Eurozone: national banking systems, strict no-monetary financing, no co-responsibility over public debt, are three principles whose simultaneous coexistence renders the Eurozone fragile.

None of the three aforementioned channels could be properly activated under the existing institutional architecture. The monetary financing of any member state's public debt is prohibited under the Treaties. Financial sector risk-sharing (as it unfolds in more perfectly integrated economies like the US) is forestalled by the lack of sufficient financial integration inside the single currency area. And federal fiscal transfers are not part of the EMU constitutional contract, as well-illustrated by various chapters in Part V of this volume.

3. Lack of collective will to complete EMU

Needless to say, risk-sharing has always confronted resistances. The canonical counterargument postulates that no risk sharing can happen if not preceded by risk reduction. The response to that is that risk sharing itself would lead to risk reduction and in any case the two should go hand in hand (see Bénassy-Quéré et al., 2018). Sceptics have not been convinced.

Yet, for lack of sufficient collective will to institutionally complete an imperfect monetary union, collective political survival instinct has devised imperfect substitutes to fill part of the gap. The European Central Bank applied quantitative easing after 2015, purchasing copious quantities of government bonds and private sector paper on the secondary market. When the Covid-19 pandemic broke, the ECB extended its program even further by adding a new Pandemic Emergency Purchasing Program (PEPP). Quite importantly it attached no conditions to the latter, extending it to include government paper that was still below investment grade, such as Greek government bonds. Thus, these ECB initiatives represented a gradual but steady strengthening of its policy instruments. Starting from a timid Securities Market Program in 2010, the ECB subsequently introduced the Outright Monetary Transactions (OMT) program under the landmark "whatever it takes" statement of July 2012. The assertiveness this program emitted was so convincing that the markets never dared to challenge the ECB. OMT was never applied, as its activation would have required the bailed-out government to subscribe to an ESM conditionality program, yet it was effective in reducing Italian and Spanish spreads. Then launching proper quantitative easing (Public Sector Purchase Program, PSPP) in March 2015 provided the effective backstop of potentially unlimited purchasing of government bonds through the secondary market, even of the type that could not be targeted to any distressed sovereign but directed indiscriminately to all Eurozone governments of investment grade, according to their capital key. And culminating with the PEPP, the boldest of all its monetary interventions, as mentioned above. Still formally short of direct monetization of government deficits, still distinct from what other central banks could do, but approximating their impact.

Then risk-sharing through the financial channel. Financial markets, rather than fiscal transfers, are seen as implementing most risk-sharing in federal unions. Regional shocks can be offset through cross-ownership of productive assets between countries, facilitated by developed capital markets. Income shocks are offset through consumption smoothing via lending and borrowing in the in-

ternational credit markets. As an issue developed by the European Commission (2017), integration of capital and labour markets helped cushion the blow of only about 10 per cent of asymmetric shocks in the Eurozone versus 50 per cent in the US. EMU up to the Eurozone debt crisis had been constructed upon a single financial market that only existed in name. When the debt crisis broke, financial fragmentation carried the day. Monetary accommodation by the ECB was not translated into lower borrowing costs for the financial and banking systems of the periphery. In central banking jargon, the monetary transmission mechanism was broken. The launch of the (still incomplete) banking union after 2012 has aimed to address such fragmentation. So does the ongoing process of the capital markets union – another uphill struggle aimed to render, among others, the single currency area more resilient to financial shocks and to facilitate the convergence of national economies.

Finally, risk sharing through the fiscal channel was even harder to implement, given in this case the formidable political obstacles. To be sure, permanent federal-type fiscal transfers have never been part of the EMU intergovernmental social contract. Such transfers operate as mechanisms of risk-sharing, macroeconomic stabilization, and inter-state redistribution in real federal economic unions, from Germany to the United States. A fiscal stabilization function and fiscal capacity for countercyclical reaction to asymmetric shocks (EU Five Presidents, 2015; European Commission, 2017; Buti and Carno, 2018), has been often proposed but consistently resisted. When President Macron set out to promote such instruments, Chancellor Merkel responded with total lack of enthusiasm, which led to the underwhelming Meseberg agreement. A "budgetary instrument for convergence and competitiveness" was adopted by the Eurogroup in 2018; the instrument was subsequently equipped with negligible firepower, adding insult to irrelevance. Notably, the Eurogroup statement of December 2018 (all the existing hindsight of the crisis notwithstanding) clearly stated that "possible features of a stabilisation function were also discussed, including the unemployment insurance scheme", but no agreement was reached.

4. Integrating by doing

The unexpected pandemic of 2020 offered the innovation impetus that a prolonged Eurozone debt crisis had failed to generate. The SURE instrument, granting low-cost credit to finance the protection of jobs affected by Covid-19, devised to cushion the effects of the pandemic shock on jobs, operated as the EU-wide un-

employment insurance scheme which many economists and progressive political forces had been calling for since the beginning of the Eurozone crisis. Most importantly, the Recovery and Resilience Fund operated as a second investment budget for the entire European Union, disbursing not just loans but subsidies directed to the most vulnerable and investment hungry EU economies. While falling short of the famous "Hamiltonian moment" for the European Union, it has proven the EU's resourcefulness in devising crisis-reaction strategies, and its existence, even if "one-off", has established a precedent whose importance cannot be disputed.

Several of the deficiencies of the EMU structure have been addressed during the Eurozone debt crisis, albeit in an incomplete manner. The project has been likened to seeking to fix the engine of an airplane during its flight. Perhaps surprisingly, the airplane did not crash – the Eurozone survived intact and a disorderly catastrophic default of any Eurozone economy was averted (Greece defaulted but in an orderly manner and within the euro). Still, the cost of the operation was a highly procyclical set of policies, accentuating recession and unemployment, generating toxic sociopolitics, leaving behind legacies of fragility that the European Union was later forced to address. And address it did, by directing the largest (in GDP percentage terms) investment support from the Recovery and Resilience Fund to the economies which (starting from Greece) had been left with severe vulnerabilities from the Eurozone debt crisis, vulnerabilities including high unemployment, lack of fiscal space, and a large public debt/ GDP.

5. Conclusion

By raising the stakes of EU failure, the Covid-19 crisis operated as a reform accelerator. The joint reaction demonstrated that the EU maintained its survival instinct, drawing on the political capital invested in its preservation. Nonetheless, EMU remains incomplete. Consecutive reform attempts have been frustrated by country coalitions that resist movement towards further risk-sharing (through the fiscal, financial or monetary channel) or deny any further transfer of national autonomy.

There are ways out of the EMU straitjacket, and some have unfolded in practice (Pagoulatos, 2021). One is formally deferring the rules, such as the formal suspension of the Stability and Growth Pact following the 2020 pandemic. Another is saying things without doing them, as with sanctions for exceeding national budgetary limits never enforced, or instituted rules left to be ignored (such as the unwisely instituted Fiscal Compact). A case of that is also the 'whatever it takes'

statement, a statement so powerful that it generated its desired effects without having to be applied. A third strategy is doing things without saying them. Common debt issuance to finance a fiscal investment stimulus provided by way of grants (not just loans) to the economies in need is an important demonstration of risk-sharing through the fiscal channel, and it was implemented in the framework of NextGenerationEU not the Eurozone crisis. Some degree of integration, through all three channels (monetary, financial and fiscal) has taken place through actions that cumulate to a substantial acquis, even if they fall short of a formal completion of the Economic and Monetary Union. Progress notwithstanding, the agenda of EMU deepening remains wide open.

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PART IV

MONETARY GOVERNANCE

CHAPTER 15

The end of Eurozone fragility?

Paul De Grauwe

1. Introduction: Fragility of the Eurozone

The eurozone is a fragile construction. Governments of the member countries of the monetary union issue bonds in a currency, the euro, over which they have no control. It is as if each of these governments issue debt in a foreign currency. Like the Argentinian government when it issues bonds in dollars, a currency that this government does not control (Eichengreen et al., 2005).

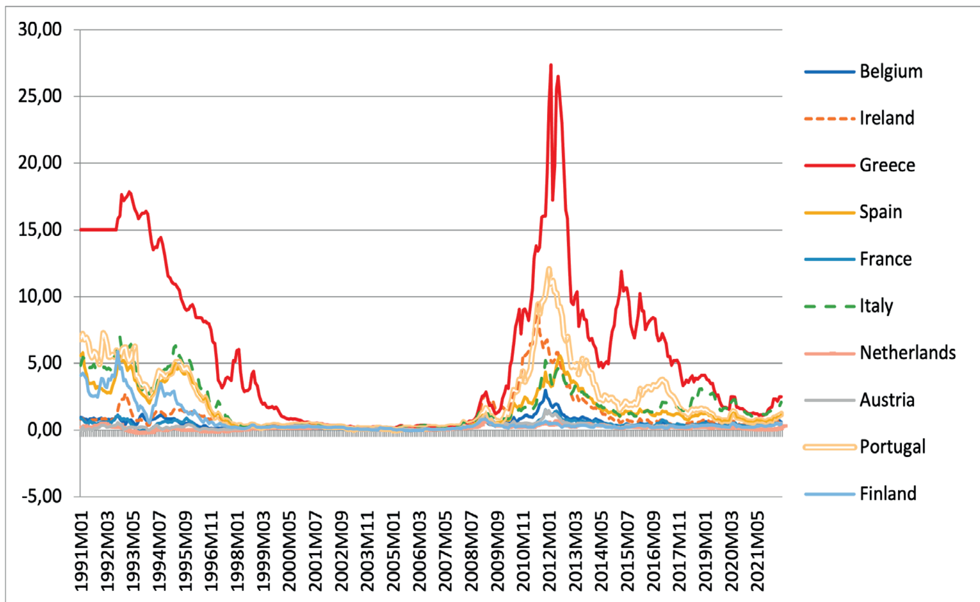
As a result, the governments of a monetary union cannot give a full guarantee to the bondholders that they will have the necessary liquidity to pay them out at maturity. The risk that governments can run out of cash in a monetary union creates the potential for self-fulfilling liquidity crises: investors who are afraid that the government may run out of cash, panic and massively sell that government's bonds, thereby precipitating the liquidity crisis they were afraid of. Such a crisis may force the government to default on its debt (De Grauwe, 2011; Beirne and Fratscher, 2012; De Grauwe and Ji, 2013; Aizenman, et al., 2013; Montfort and Renne, 2013).

Fixed exchange rate systems suffer from a similar credibility problem: central banks promise to convert the domestic currency into a foreign currency at a

fixed price. This promise lacks credibility because the central bank may not have enough foreign currency to honour this promise. This can set in motion a self-fulfilling speculative crisis forcing the central bank to devalue or to stop pegging the exchange rate.

The sovereign debt crisis that erupted in 2010 led to massive increases in the spreads in the sovereign bond markets of the Eurozone (Figure 1). The crisis was overcome when the ECB understood that it belongs to its responsibility to provide lender of last resort support in the government bond markets in times of crises. With the announcement of the OMT programme, which was a promise to buy unlimited amounts of government bonds in the secondary markets, the ECB stopped the crisis.

Figure 1 – 10-year Government bond spreads (relative to German government bond yield)

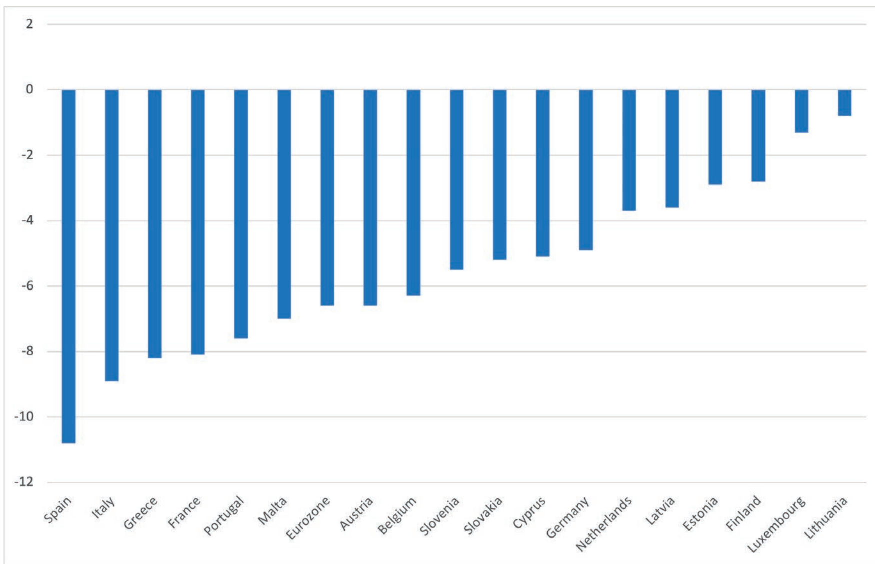


Source: Eurostat

2. The pandemic of 2020-21

When the pandemic erupted in 2020 there was a risk that the huge shock that hit the Eurozone countries would trigger a new sovereign debt crisis, especially since the high-risk countries in the periphery also appeared to have suffered significantly larger negative effects on their GDP than low-risk countries (see Figure 2).

Figure 2 – GDP growth during 2020 (per cent)



Source: Eurostat

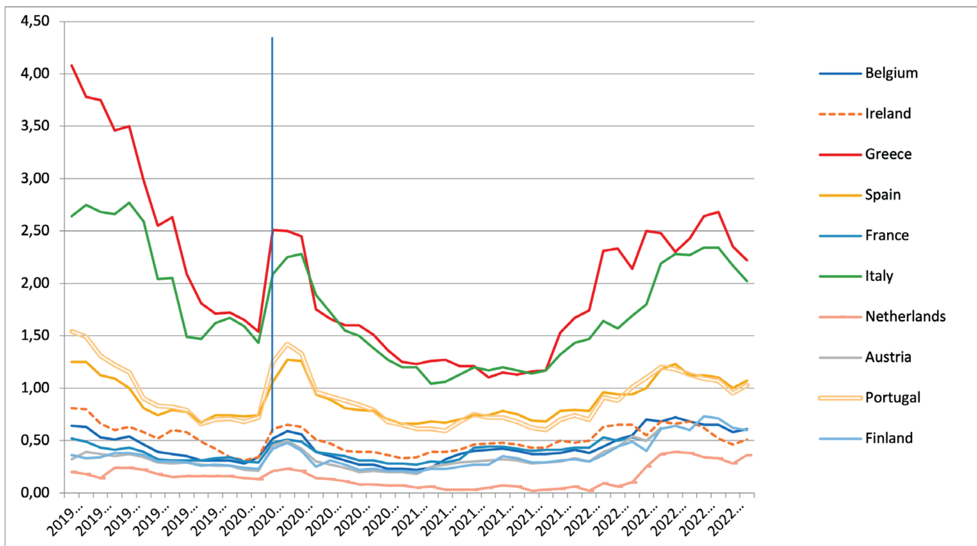
The sovereign debt crisis did not happen. In fact, apart from an early hiccup in the yields of Italy, these yields continued to converge further (see Figure 3 which shows a segment of Figure 1) so that at the end of September 2021 the spreads were even smaller than before the eruption of the pandemic (see Candelona et al., 2021).

How did this remarkable result come about? The new governance of the Eurozone that emerged after the sovereign debt crisis of 2010-12 allowed the European policymakers to use new instruments of stabilization. As a result, the fragility of the Eurozone was significantly reduced thereby making it possible to avoid self-fulfilling crises in the government bond markets. The new instruments that achieved this result were both monetary and fiscal.

On the monetary front there was an important innovation: The ECB's Pandemic Emergency Purchase Programme (PEPP) announced during 2020. This was a programme of large-scale government bond purchases by the ECB. The innovation of this programme was the absence of conditionality. While the OMT programme was linked to an austerity programme by governments receiving aid, the PEPP programme was stripped from any such austerity requirement. This was a remarkable intellectual reversal of the ECB policy towards support of the government bond markets.

A second major policy innovation was a fiscal one. The European leaders decided in July 2020 to set up a recovery plan, the NextGenerationEU (NGEU) which was funded by the issue of common bonds. This common spending programme helped to create further confidence in the future of the Eurozone. It signalled that the future path of the monetary union would be one involving further steps towards a budgetary union. This was the second reason why the Covid-shock did not lead to a sovereign debt crisis.

Figure 3 – Government bond spreads (10-year), 2019-22



Source: Eurostat
Note: the vertical line shows the start of the pandemic

3. Today's challenge: Will the surge in inflation lead to a new Eurozone crisis?

The surge in inflation creates two dilemmas for the ECB. The first dilemma is the traditional one that every central bank, including the ECB, faces after a supply shock. This dilemma can be described as follows. The negative supply shocks that occurred during 2020-22 raised the cost of production, led to a surge in inflation in most countries and to a reduction of output. This stagflation is at the core of the dilemma faced by the central bank. Whatever it chooses, the outcome will be painful: if it fights inflation by raising interest rates, it may produce a recession; if it does not raise interest rates for fear of creating a recession, it may make inflation permanent. Most central bankers have elevated inflation as their primary objective so that it looks likely that they are willing to risk a recession to fight inflation.

The second dilemma is the one the ECB, as a central banker of a monetary union, faces (in addition to the one just described). This second dilemma can be described as follows. When the ECB raises the interest rate this has very different effects on the long-term bond rates of the different member countries. This can be seen from Figure 3. The ECB started to raise the interest rate during 2022. This interest raising strategy triggered increases of the spreads, especially those of Italy and Greece that were close to 1 per cent at the start of 2022, but moved upwards during 2022 in the 2.5 to 3 per cent range. Further increases in the interest rate triggered by the ECB's desire to fight inflation could lead to an explosion of the spreads and risk creating a new sovereign debt crisis.

Thus, the second dilemma the ECB faces is one between fighting inflation at the risk of creating financial instability in the Eurozone; or fighting financial instability at the risk of losing the battle against inflation. An equally uncomfortable dilemma as the first one.

There is a way out of this dilemma in two ways. Both, however, create new discomforts. The first way out consists in a commitment by the ECB to provide unlimited amount of liquidity to countries experiencing liquidity crises. In fact, in July 2022 the ECB announced a new programme, the 'Transmission Protection Programme' (TPI) which does exactly that: providing liquidity to governments experiencing liquidity crises. However, when used, this will create additional liquidity in the system which will interfere with the central bank's desire to fight inflation. The ECB will therefore have to withdraw liquidity from the system by selling government bonds from low-risk countries (Germany, Netherlands, Finland). As

a result, the ECB will increasingly accumulate high-risk government bonds at the expense of low-risk government bonds. This may create uncomfortable political problems when countries like Germany and the Netherlands resist this.

There is a second potential way-out from this dilemma. This consists in allowing inflation to increase above the self-imposed target of 2 per cent. Several academic economists have argued that 2 per cent is too low a target and that a target range of 3 to 4 per cent would be more appropriate (see Blanchard, 2010; Ball, 2014; and De Grauwe and Ji, 2017), mainly because it would make it less likely that central banks get trapped in the zero-lower-bound syndrome that has made monetary policies so ineffective for so long.

Raising the inflation target would not eliminate the dilemma but it would make it less constraining thereby reducing the probability of future crises. This way-out from the dilemma, however, would trigger similar uncomfortable political problems as the previous one.

4. Conclusion: Prospects for the future

Since the sovereign debt crisis of 2010-12 a new governance of the Eurozone has emerged. This governance was strengthened even further during the pandemic when both new monetary and fiscal instruments were created. This has made it possible for the Eurozone to withstand the major economic disruptions brought about by the pandemic. But a new risk has emerged which is inflation and the need to fight it with drastic increases in the interest rates.

Will the need to fight inflation with higher interest rates again reveal the fragility of the Eurozone? There is a fundamental contrast between the Eurozone and standalone countries, i.e. countries with their own central bank. In a standalone country the central bank faces one sovereign which always prevails in times of crisis. There can be no doubt that in a standalone country the central bank will have to provide liquidity when the government faces a liquidity crisis.

In the eurozone the ECB faces 20 sovereigns none of which has authority over the ECB. None of these governments can force the ECB to provide liquidity in times of crisis. This creates uncertainty about future liquidity support in a monetary union. There is thus a fundamental credibility issue about the willingness of the ECB to be a lender of last resort in the government bond markets. This will continue to make the Eurozone a fragile construction.

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CHAPTER 16

Is the European Central Bank an Integration Agency?

Roberto Tamborini

1. Introduction

The unprecedented systemic shocks that hit the European Economic and Monetary Union (EMU) in its second decade, namely the 'Europeanisation' of the 2008–9 global crisis, and later the COVID-19 pandemic followed by the global inflation, raise a few existential questions in view of the future of the European Central Bank (ECB). Has the ECB had to act as an integration agency of EMU, and will it have to act likewise in the future? Does this role of the ECB trespass the limits of its mandate? If the ECB has to retrench within the limits which institution is going to replace it?

2. The EMU trilemma

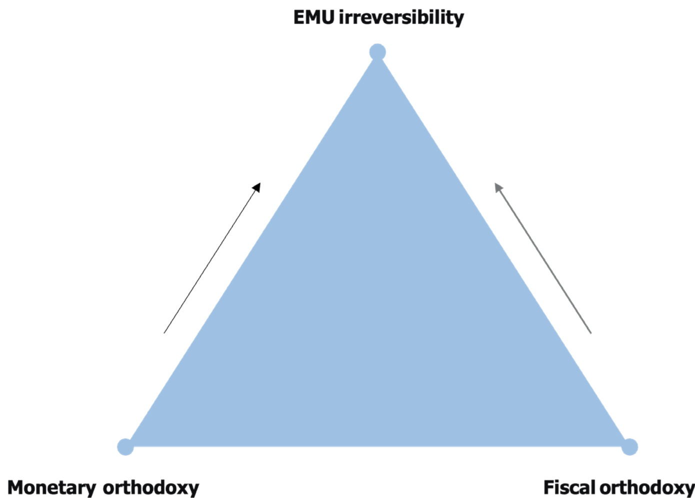
The EMU was laid on three pillars: 1) *the irreversibility of membership* (the conversion rates between former national currencies and the euro are said to be "irrevocably fixed"), 2) *monetary orthodoxy* (the priority of price stability and the ban on

financing sovereign debts), 3) *fiscal orthodoxy* (governments of member countries maintain fiscal sovereignty, subject to deficit and debt constraints and market discipline).

The systemic shocks mentioned above witness what Della Posta and Tamborini (2022) have dubbed the 'EMU trilemma': only two of its three pillars can be preserved (see Figure 1). When EMU integrity is in jeopardy, it can only be saved if either monetary orthodoxy or fiscal orthodoxy (or both) are relaxed.

Della Posta and Tamborini (2022) frame the trilemma in a fiscal target-zone model of EMU, where public debt is hit by stochastic shocks and governments under monetary and fiscal orthodoxy are willing to abide by their commitment to debt stability only up to an upper bound of their feasible fiscal effort. Shocks large enough push the stabilisation fiscal effort beyond the feasibility constraint, in which case a government would opt for default on debt service and breakup of EMU membership - similarly to the abandonment of an exchange-rate agreement.

Figure 1 – The EMU trilemma



A key trigger of this scenario is investors' understanding that governments can, at best, commit themselves to debt stabilisation within a band of fiscal sustainability. Indeed, credibility, in ordinary language, has two meanings: deliver on what has been promised, and promise what can be done. Hence setting to governments the unconditional commitment to debt stabilisation is non-credible as it may not pass the test of the feasibility constraint. As investors anticipate that the upper bound of the fiscal feasibility band is not defendable, the system becomes more fragile in that self-fulfilling run-ups to the upper bound are triggered, smaller debt shocks can be absorbed by governments, and breakup becomes more likely.

As the authors show, for EMU to be truly irreversible ramparts for extraordinary times are necessary beside regulations for ordinary times. The former may consist of no-breakup devices that, under given circumstances, suspend and replace either monetary orthodoxy (e.g. central bank's intervention for sovereign debt stabilisation) or fiscal orthodoxy (e.g. central fiscal support). When properly designed, these devices enhance the resilience of the system. First, larger shocks can be accommodated within the fiscal feasibility boundaries. Second, a 'no-breakup premium' keeps interest rates lower.[1] Third, monetary and fiscal devices are synergic: the activation of both reduces the extent of activation of each.

The events in the aftermath of the Great recession and the pandemic can by and large be read in terms of the EMU trilemma. In both cases, the initial defence of the twin orthodoxies led to the brink of EMU dis-integration. In the course of the acute sovereign debt crisis of the early 2010s, temptations of 'exit' gained ground. European governments and institutions struggled to combat them (though initially some shored them up). The financial and currency markets began to price the risk of redenomination, i.e. the risk of a country's exiting the euro and reverting to its national currency (Di Cesare et al., 2012; De Santis, 2015). The move of the ECB into the unchartered territory of 'unconventional monetary policies', represented by the arrow on the left-hand side of the triangle in Figure 1, was key to the rescue of EMU integrity (Wyplosz, 2014). Whether, and the extent to which, monetary orthodoxy was trespassed remains highly debated. No doubt, there was large and unprecedented recourse to unconventional tools including purchases of sovereign bonds on secondary markets which, though practiced by other central banks, conflicted with well-established interpretations of the ECB's mandate as testified by the disputes with the German Constitutional Court (see e.g. Siekman and Wieland, 2014; Brunnermeier et al., 2016: Part III; Schnabel, 2020).

1 This would make the sovereign debt of EMU members more similar to that of stand-alone countries according to the distinction drawn by De Grauwe (2012).

On the fiscal front, on the other hand, the budgetary rules and fiscal consolidation plans were tightened up, not only in the countries with the highest default risk, and a string of reforms of the Stability and Growth Pact (SGP) was implemented between 2010 and 2012. The result was a contradictory mix of economic policies which contributed to the protracted stagnation of the 2010s, a decline in the confidence in the EMU and the strengthening of anti-Euro movements.[2]

The disastrous economic consequences of the arrival in Europe of the COVID-19 pandemic in early 2020 were initially tackled, once again, by the ECB alone. Frankfurt relaunched its quantitative easing measures with a specific Pandemic Emergency Purchases Programme (PEEP), largely targeted to sovereign bonds, as early as March 2020. The fiscal response at the Union level was hesitant. National governments and the Commission decided to temporarily suspend budgetary rules, as is provided for by the SGP in the presence of exceptionally adverse events, while it was increasingly clear that leaving the capacity for plans of public health, social relief and economic recovery to each single country's 'fiscal space' would rapidly increase the risk of collective catastrophe (e.g. Baldwin and Weder di Mauro, 2020). Lengthy and tense intergovernmental negotiations followed until July 2020, when a large scale EU fiscal plan was launched (*NextGenerationEU,* NGEU) encompassing significant 'heterodox' elements such as raising financial resources via the issue of EU bonds (the arrow along the right-hand-side of the triangle in Figure 1). Whether this seed of EMU fiscal capacity will take hold or will remain a once-and-for-all episode is an open issue, as testified by the debate about the reform of EMU fiscal governance preceding the reactivation of the SGP (European Commission, 2022; Buti et al., 2023).

3. Why is EMU entrapped in the trilemma?

The rationale for the creation of the euro was popularised by the metaphor of the 'inconsistent quartet' coined by Tommaso Padoa-Schioppa (1982). As the process of European economic integration was gaining momentum, he warned that the four cardinal points of free trade, free mobility of capital, a system of fixed exchange rates and autonomous national monetary policies were incompatible. "The circle cannot be squared: one element has to be surrendered in order to avoid any inconsistency" (p. 7). The inconsistency became blatant with the collapse of

2 See Tamborini (2015) and Orphanides (2020) for overviews. A rich literature has investigated the relationship between the EMU crisis and the surge of euro-sceptic or openly anti-euro movements and parties: see, e.g. Tosun et al. (2014) and Guiso et al. (2016).

the European Monetary System (EMS) in September 1992. Somewhat paradoxically, that event accelerated the process towards the single currency, vindicating Padoa-Schioppa's claim that the EMS "was not enough" and that a complete monetary union was needed, with monetary sovereignty being "the element to be surrendered" in order to resolve the inconsistent quartet. The events of the 2010s witness that EMU, as it was conceived, was not enough either.[3]

By now an extended literature has highlighted the flaws inbuilt in the EMU institutional design. In the first place, it was the product of the cultural climate prevailing in the 1980s and 1990s when the belief in the self-regulating and self-propulsive forces of free markets was pervasive, the confidence in the efficiency and effectiveness of fiscal policies on GDP and employment levels was low, the restriction of the perimeter of the public sphere was compelling, and monetary policy was seen as a universal panacea for macroeconomic stability. In the second place, the conception of EMU was deeply conditioned by political-economic factors specific to Europe and its history, creating the grounds for a battle of ideas and interests at the same time (Brunnermeier et al., 2016; Gros, 2021).

At the centre of the battleground was the choice between the 'monetarist' *vs.* 'fiscalist' path towards the EMU.[4] The former, associated to France, put the monetary union first as a catalyst of the integration process that would have followed, much in Jean Monnet's spirit of integration as a sequence of push and pull phases. The latter, attributed to Germany, viewed the monetary union as the crowning of deeper integration of economic structures and harmonisation of institutions, including the creation of a common fiscal core. If the 'monetarist' approach prevailed in the runup towards the euro (as France and others were, with some reason, increasingly worried about the Bundesbank's noncooperative monetary hegemony), the 'fiscalists' got a revenge on two fronts. First, the triple onus of stabilisation, coordination and integration was entirely shifted onto the fiscal shoulders of national governments within the boundaries dictated by the

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3 As a matter of fact, one can find some analogies between the two crises of the EMS and of the EMU. Corsetti et al. (2020) point out four of them: costly adjustments of fundamental divergences, poor policy coordination and cooperation, exposure to self-fulfilling speculative attacks, and lack of a backstop to the integrity of the system. Yet, whereas this last deficiency in the case of EMS was mitigated by the escape lane of realignments, or outright exit, in the case of EMU no easy escape lane is open, which may transform the euro in a 'trap' (Sinn 2014). Notably, Corsetti et al. (2020) also argue that the countries involved in the EMS collapse recovered more successfully and rapidly than at the time of the EMU crisis, not only thanks to currency devaluations, but also because national central banks and governments found ways to support their banking systems and sovereign debt markets that have been partially precluded in EMU.

4 These two different approaches have also been labelled 'monetarist' or 'institutionalist' and 'economist' or 'gradualist', respectively. See Bongardt and Torres (2022: 220-226).

SGP. Second, the ECB scope of action was restricted to the single mandate of price stability detached from any other responsibility for possible spillovers (negative as well as positive) from monetary policy to the integration/integrity of EMU. Through the lenses of the crisis of the 2010s one might argue that the 'monetarist' acceleration was indeed too hasty. On the other hand, one might also object that the strong resistance against common fiscal institutions even in the face of existential threats to EMU integrity witnesses that the 'fiscalist' path to the creation of the euro would in all likelihood have been endless.

Once the monetary integration process was put on track, the postulate of separability between monetary policy and the other dimensions of integration soon appeared precariously based. In that phase, the dominant issue was 'one size does not fit all' (e.g. Dornbusch et al., 1998; Buti and Sapir, 1998; Bofinger and Mayer, 2007). EMU-wide stabilisation policy was, in principle, entirely a matter for the central bank despite it being common knowledge that the latter is not fully up to the task in a monetary union when shocks are asymmetric, i.e. hitting the various member countries to different extents and/or in different directions. Confidence that the system would nonetheless be resilient to dis-integration forces, keeping the ECB's strict mandate and separation postulate uncontaminated, rested on a mixture of theoretical presumptions and empirical extrapolations.

First, there was optimism about the adequacy of the 3 per cent room for cyclical deficit/GDP ratios as stabilisers of asymmetric shocks. Its basis was largely empirical, resting on the past experience of countries when, however, they also could avail themselves of independent monetary policy and adjustable exchange rates (Buti and Sapir, 1998). Scepticism was instead already prevailing with regard to the internal consistency of the SGP with more general principles (Buiter et al., 1993; Kenen, 1995; Feldstein, 1997). The SGP envisaged only one type of externality, namely excess debt and/or deficit by one or more countries jeopardising the Union's financial stability and generating debt monetisation pressure on the ECB or transfers between member states to save one or the other from default. It ignored the macroeconomic externalities of unilateral changes in the fiscal policy implemented by a single country (especially a large one) in a continent where trade is intense and value chains are increasingly integrated.

Second, the conception of monetary policy and of the role of the ECB was debtor to the advent of the 'New synthesis' between neo-classical and neo-Keynesian ideas, emerged from the macroeconomic quarrels of the Seventies and Eighties (Goodfriend, 1997; Blanchard, 2000). Monetary policy was grafted onto models of self-regulating and self-stabilising markets except for some price stickiness giving

rise to temporary real effects of aggregate demand shocks to be stabilised by appropriate, rule-based, changes in interest rates. Among the critical postulates of these models was the efficiency of financial markets, the same also underpinning their role as watchdogs of fiscal discipline in EMU (Leijonhufvud, 2007; Stiglitz, 2014). A corollary of this postulate was that price stability would also ensure financial stability, and consequently the denial of the need for central banks to have explicit financial-stability targets (Bernanke and Gertler, 2001). As Stiglitz wrote later, "To me, the strangest aspect of modern macroeconomics was that central banks were using a model in which banks and financial markets played no role" (2014, p. 9).

4. Monetary policy and EMU integrity

As recalled above, these fault lines yawned in EMU, not as a consequence of asymmetric shocks, but in the aftermath of the first large systemic shock of 2008-09, imported from the US through financial markets, when it became blatant that the blueprint on how to govern and keep the whole system together was largely incomplete (De Grauwe, 2013).[5] A line of defence of the existent regulation apparatus pointed the finger to (some) member states for their lack of fiscal discipline, reform inertia, uncorrected macroeconomic divergences. If any responsibility was to be charged onto the rules was their lax, not rigid, enforcement. Be that as it may, once the dis-integration ignited by financial markets process was in progress, could the ECB remain safely nestled into its statutory neglect for the integration process beyond price stability?

In order to answer to the previous question, it is worth quoting the whole passage of the speech of the then ECB President Draghi (2012) containing his celebrated 'whatever it takes' promise.

> [...] we think the euro is irreversible. And it's not an empty word now, because I preceded saying exactly what actions have been made, are being made to make it irreversible. But there is another message I want to tell you. Within our mandate, the ECB is ready to do what-

5 In the words of former ECB President Trichet (2015): "From my perspective as President of the ECB, I remember clearly the huge uncertainty about where we were and which direction we should head in. I remain convinced that had central banks across the globe in the advanced economies not come together to chart a course out of the crisis, the outcome could have been a repeat, if not worse, of the '30s [...] At the same time, in the euro area, the crisis revealed major deficiencies in its governance, ranging from the refusal by some member states to comply with the fiscal rules of the Stability and Growth Pact to a benign neglect of the major divergences in price and cost competitiveness, from the absence of a crisis management and resolution framework, and, finally, to the lack of a banking union".

> ever it takes to preserve the euro. And believe me, it will be enough. There are some short-term challenges, to say the least. The short-term challenges in our view relate mostly to the financial fragmentation that has taken place in the euro area. Investors retreated within their national boundaries. The interbank market is not functioning. It is only functioning very little within each country by the way, but it is certainly not functioning across countries. And I think the key strategy point here is that if we want to get out of this crisis, we have to repair this financial fragmentation (p. 2).

It was not by chance that the leeway for the ECB's modification, not only of its operation tools from 'conventional' to 'unconventional', but of its interpretation of the scope of its statutory duties to include EMU integrity explicitly, was provided by the nexus between monetary policy and financial stability. One reason was worldwide. After the earlier consensus that price stability was a necessary and sufficient condition for financial stability collapsed with the global financial crisis, central bankers' conventional wisdom was turned upside down.

A second reason was more specific to EMU, namely the incompleteness of the financial integration mechanisms and institutions, in particular those devoted to micro- and macroprudential regulation (ECB, 2021). As the self-regulatory hypothesis of financial markets has been set aside, the interconnections among the regulation of individual intermediaries (microprudential), the regulation of the intermediaries as a system (macroprudential), and the monetary macro-policy has come to the forefront. An accurate design is necessary to the effect that the three levers are moved consistently. The quest for 'narrow' inflation targeting by the ECB is hardly consistent with the resistance towards further supranational devolution of micro- and macroprudential regulation.

5. Concluding remarks

Since Draghi mentioned 'fragmentation' as a major impediment to the proper functioning of monetary policy in the pursuit of its mandate, the ECB pedagogy about its various 'unconventional' programmes, up to the creation of the new Transmission Protection Instrument (TPI) in July 2022, has hinged on financial stability, and prevention of fragmentation, as a precondition for price stability (Schnabel, 2020 and 2021; ECB, 2021 and 2022). The post-pandemic surge of inflation has made this approach more, rather than less, cogent in order to come to terms with the trade-offs between price and financial stability.

Criticisms of the statutory consistency of the ECB's engagement in defence of EMU integrity have been countered not only on legal, but also on economic-theoretic grounds (ECB, 2021). As far as the latter are concerned, the point is that the way the world has changed in the last three decades has made the foundations of EMU architecture obsolete, and the underlying political-economic equilibrium untenable. The sooner the EMU trilemma is addressed and resolved leaving politics and dogmatism aside, the better.

In this perspective, let me conclude with the words of Brunnermeier et al. (2016) where they argue that "for extreme adverse events, excessive emphasis on individual liability is counterproductive; in such circumstances the solidarity principle should dominate. The European community thus needs a discussion of the extent to which it is willing to assume tail risks for its members. A commonly acceptable cut-off needs to be identified, agreed upon, clearly communicated, and enforced in future crises" (p. 117). The alternative to this endeavour is reformulating the treaties with explicit and regulated exit procedures from EMU.

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CHAPTER 17

On the monetary dialogue between the European Central Bank and the European Parliament: From monetary monologue to dialogue – and beyond?

Sebastian Diessner

1. Introduction

This essay traces the evolution of the communication between the European Central Bank (ECB) and the European Parliament (EP) over the past 25 years of Monetary Dialogues between the two supranational institutions. The essay begins with a reflection on the political problem of central bank communication. It then sketches out three distinct phases of ECB-EP relations over time. The main contention is that ECB communication with the EP has started, and should continue, to move from a one-way street to a multi-way street, in the interest of further improving the democratic credentials of EMU.

2. The political problem of ECB communication with the European Parliament

The political conundrum of ECB communication with the EP stems from the inherent tension between the central bank's far-reaching legal independence, on the one hand, and the normative requirement for accountability in representative democracies, on the other (Amtenbrink and van Duin, 2009; Baerg and Cross, 2022; Bongardt and Torres, 2022: ch. 10; Grünewald and van 't Klooster, 2023; Schonhardt-Bailey, 2022). While central bank independence and accountability are often portrayed as 'two sides of the same coin' (cf. Braun, 2017; De Grauwe, 2022), with the latter seen as the 'necessary counterpart' to the former (ECB, 2023), this is only true to some extent in the case of EMU. In particular, it hinges on a distinction between different *types* of accountability, which we might refer to as formal versus substantive accountability (Jourdan and Diessner, 2019: 6-7). Formal accountability merely entails an *ex post* answerability by the central bank for its policy actions, whereas substantive accountability also entails the ability to threaten or issue the central bank with sanctions and rewards (Sibert, 2010; Koop and Reh, 2019). While a high degree of *formal* accountability is generally reconcilable with a high degree of independence, there arguably exists a trade-off between *substantive* accountability and the ECB's statutory independence (Diessner, 2018): the former can only be increased at the expense of the latter, at least in theory (Dawson et al., 2019).

In practice, the issue is less straightforward still. Although the European Treaties enshrine the ECB's independence and stipulate that it shall not 'seek or take instructions' (TFEU Art. 130), this leaves open two vexing questions nonetheless. First, does 'no instructions' amount to 'no coordination'? And second, does not *taking* instructions imply not *giving* instructions either? Due to the vagueness of the ECB's mandate (De Grauwe, 2022), the answers to both questions have remained a matter of interpretation over the past two decades (Diessner and Genschel, 2021; Quaglia and Verdun, 2023: 645). While the ECB has been adamant not to be taking any instructions on its own monetary policy-making, recent research has shown that the central bank has not shied away from formulating and at times even enforcing instructions for euro area governments itself, including in the areas of fiscal policy (Diessner and Lisi, 2020) and structural reforms (Braun et al., 2022), raising awkward questions for its perceived legitima-

cy (see also Chang, 2023, this volume; Fontan, 2018; Jones, 2009 and 2013; Macchiarelli et al., 2020; Schmidt, 2020).

The adequate forum for debating and resolving these tensions has been and continues to be the Monetary Dialogue between the ECB president and the European Parliament's Committee on Economic and Monetary Affairs (ECON) as the main supranational political counterpart of the ECB.[1] How, then, has the relation between the two institutions evolved over the past 25 years? And how can it be expected to evolve in the future?

3. Three stages of ECB communication with the European Parliament, 1998-2023

3.1 1998-2008: ECB-EP communication as a one-way street or 'hearing but not listening'

The first period of ECB communication with the European Parliament broadly corresponds to the first decade after the inception of the Monetary Dialogue in 1998, on the initiative of former MEP and ECON Chair Christa Randzio-Plath (European Parliament, 1998).[2] While the ECB has been perceived to be modelled 'largely' on the German Bundesbank (Schmid, 1997), what is less appreciated is the fact that the supranational central bank also appears to have been influenced by the views of its predecessor in terms of democratic accountability – namely, that central bank independence should preclude extensive accountability and policy coordination (Tucker, 2018).[3] During one of his first appearances before the European Parliament, for example, ECB president Wim Duisenberg pushed back against proposals for creating a 'macroeconomic dialogue', stressing that "such a dialogue should be clearly distinguished from any attempts to coordinate policies

1 Note that the Single Supervisory Mechanism (SSM) Regulation has created a separate accountability framework for the ECB's banking supervision-related tasks in 2014, known as the Banking Dialogue (Fromage and Ibrido, 2018; Högenauer, 2023; Högenauer et al., 2023, this volume; Maricut-Akbik, 2020). Another area of interest that lies beyond the scope of this essay is the democratic accountability of national central banks in the Eurosystem towards their national parliaments (Högenauer and Howarth, 2019). For new light on this long-standing blind spot in research on EMU, see do Vale and Malherbe (2023).

2 This section draws substantively on Diessner (2022; 2023) and a presentation given at SCEUS in 2022.

3 This mantra appears to hold sway until today: in a recent comparison of accountability arrangements among national central banks, the Bundesbank scored the lowest (do Vale and Malherbe, 2023: 13-19).

ex ante" (Duisenberg, 1999; see Braun et al., 2022). Instead, the ECB's approach to democratic legitimation became one of *ex post* answerability – or in Duisenberg's own half-joking words to MEPs: "I will fully inform you *after* the event" (Adams and Osborn, 2001, emphasis added). In another infamous exchange during one of the ECB's regular press conferences, the president also ventured to suggest that when it came to political contestation of the ECB's monetary policy, the central bank preferred to "hear but not listen" (Duisenberg, 2001).

In sum, it seems fair to say that substantive democratic accountability played a subordinate role for the ECB during the first years of EMU.[4] Duisenberg's successor Jean-Claude Trichet sought to build on these foundations by making the ECB's price stability target the be-all and end-all of debates about its monetary policy-making (cf. Claeys and Domínguez-Jiménez, 2020). During his exchanges with ECON, for example, Trichet "frequently stopped technical questions by referring to the ECB's mandate", which meant that debates "covered broad macroeconomic issues and remained more superficial" (Collignon and Diessner, 2016: 1305; see Diessner, 2023). This state of affairs would change eventually, if only partially, after the Eurozone crisis.

3.2 2009-2019: ECB-EP communication as a one-and-a-half-way street or 'silence and voice'

As the ECB's responsibilities widened in response to the Eurozone crisis, so did the central bank's attempts to improve the perception of its democratic accountability (Heidebrecht, 2015). This manifested itself in a 'strategic partnership' between the ECB and the ECON Committee (Torres, 2013), with exchanges becoming reflective of a 'more emancipated' accountability relationship between the two institutions and with Trichet's successor Mario Draghi displaying an increased "willing[ness] to answer even hypothetical questions" by MEPs, at least compared to his predecessors (Collignon and Diessner, 2016: 1305; see also Diessner, 2023). The longer the crisis dragged on, however, the more the ECB found itself confronted with a political pushback that saw MEPs use their 'political voice' to press the central bank on EMU's sluggish recovery and persistently high unemployment (Ferrara et al., 2022; Schmidt, 2020).

4 In a now-notorious exchange between Willem Buiter and the ECB's first chief economist Otmar Issing, the former bemoaned that it was "do[ing] no good either to the European Parliament or to the ECB to have the President of the ECB walk all over the MEPs" (Buiter, 1999: 207; cf. Issing, 1999; de Haan and Eijffinger, 2000).

The ECB's advocacy for structural reforms across EMU member states is a case in point here. While the central bank has been calling on national governments to implement reforms since its very inception, this advocacy gained a new quality throughout the crisis, as the ECB also obtained reform *enforcement* powers through its participation in the Troika (Braun et al., 2022). Before long, a political backlash ensued: the EP launched several inquiries into the handling of macroeconomic adjustment programmes by the Troika institutions, while President Draghi repeatedly faced critical questions from MEPs about the ECB's insistence on reforms. In 2016, he eventually had to concede in front of the Monetary Dialogue that it was "certainly not in the ECB's mandate to suggest specific structural policies and agendas to different countries" (Draghi, 2016). Soon after, the ECB's two-decade push for structural reforms came to an end, and the central bank went all but silent on the subject in its public discourse (Braun et al., 2022).

The structural reform saga can serve as an illustration of how ECB-EP communication has moved to what we might call a one-and-a-half-way street – away from a monetary monologue and towards a more genuine monetary dialogue, so to speak. Another recent example of this tendency is the ECB's discourse on climate action and the greening of its operations, which was co-created by a coalition of 'green' central bankers and like-minded MEPs (Deyris, 2023; Massoc, 2022; Quorning, 2023; Siderius, 2022; Thiemann et al., 2023). However, silence or voice on politically thorny issues like structural reforms or climate action can arguably hardly be enough for substantive accountability in and as of themselves.

3.3 2020-2023: ECB-EP communication as a multi-way street or 'ECB listens, but to whom?'

In response to the above challenges to its accountability and legitimacy, the ECB has ramped up its communication strategy in recent years, including and especially towards the general public (Gardt et al., 2021) rather than towards the European Parliament. In addition to a stronger presence on social media (Ehrmann and Wabitsch, 2021), the central bank has organized a series of 'ECB Listens' events that were intended to inform its monetary policy strategy review of 2020, which had to be postponed by a year due to the COVID-19 pandemic (see Begg, 2021). Beyond such outreach activities towards the wider public, however, a perennial question remains in terms of how to further improve the interactions between the ECB and the EP. Several adjustments to the structures and to the practices of the Monetary Dialogue could help foster a more genuine 'back-and-forth'

between the ECB president and the ECON Committee (Jourdan and Diessner, 2019). Recent proposals have included the creation of a sub-committee dedicated to holding the ECB to account as well as a European Credit Council to deliberate macroeconomic policies, an enhanced use of the EP's resolution on the ECB's annual report, or new mechanisms to provide the ECB with guidance on how to deliver on its secondary mandate, for example (ibid.; Béres et al., 2021; de Boer & van 't Klooster, 2021; Monnet, 2023).

A first step in this direction could be to start talks about an inter-institutional agreement (IIA) between ECON and the ECB, as recently promoted by the Socialists and Democrats (2021) and by the Greens/EFA in the EP (van 't Klooster and Grünewald, 2022). As of February 2023, the ECB now appears to have committed to participating in such a process (Tinagli, 2023). Importantly, however, the existence of an inter-institutional agreement does not automatically make a difference for how the ECB is held to account by the EP. This is exemplified by the fact that the Banking Dialogue – for which an agreement has been in place since the beginning in 2014 – and the Monetary Dialogue – for which an IIA has not been put in place until now – are perceived very similarly by the actors involved, with the processes and contents of both dialogues having become increasingly alike over time (Akbik, 2022; Akbik and Diessner, 2023). As such, negotiating and concluding an IIA arguably only make sense if it results in further improvements in the structures and practices of the Monetary Dialogue along the lines of the above or other recent proposals, instead of codifying the *status quo*. What has become evident over the past 25 years of ECB-EP relations is that the way forward in EMU should be toward a multi-way street – not solidifying a one-and-a-half-way nor moving back to a one-way street – if the monetary union is to be made democratically fit for the next 25 years and beyond.

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CHAPTER 18

Legtimizing central bank independence under the post-Maastricht framework

Michele Chang

1. Introduction

The creation of the European Central Bank (ECB) coincided with the ascendance of a professional and academic consensus regarding the need for independent central banks to control inflation. Economies with independent central banks like the US and West Germany fared better after the recession following the oil shocks of the 1970s. When negotiations for economic and monetary union (EMU) took place, an independent central bank modelled after the West German Bundesbank became its centrepiece.

Since the introduction of the euro over two decades ago, the euro area has weathered numerous crises that give pause to the original Maastricht deal. This essay considers 1) the assumptions made at Maastricht that allowed for the creation of the world's most independent central bank; 2) how over a decade of economic and financial crises have cast doubt on those assumptions; and 3) why one should reconsider the logic behind independent central banks, given the EU's experience.

2. The Maastricht framework's assumptions

The Maastricht Treaty granted the new European Central Bank a high degree of independence, as "neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body" (Article 130 TFEU). Price stability was set as the primary mandate of the ECB (Article 127.1 TFEU) and the Treaties limited its accountability to reporting requirements (Article 284.3 TFEU). The ECB later voluntarily agreed to an inter-institutional agreement with the European Parliament for what became known as the Monetary Dialogue, in which the ECB answers questions from the European Parliament on a quarterly basis (see Diessner, 2023, this volume).

Why did the Maastricht Treaty give its central bank quasi-constitutional independence? In Europe, as elsewhere, central bank independence had taken hold as necessary for price stability. Central banks were portrayed as technocratic actors despite the political ramifications of their decisions (Kirshner, 2003). Price stability acquired the status of a public good when it became enshrined as the primary mandate of the ECB. Other central banks have dual mandates, for example, like the Federal Reserve's pursuit of price stability and employment. The ECB, on the other hand, had a hierarchy of policy objectives with price stability taking precedence, followed by the secondary objective "to support the general economic policies in the Union" (Article 119.2 TFEU). With the focus on its primary objective, the ECB had a policy objective that was easy to monitor and was given a high degree of independence to use its policy tools (interest rates and open market operations) to pursue it.

Several key assumptions, therefore, were made (in Europe and elsewhere) when developing euro area governance that rationalized independent central banks as necessary to achieve price stability. Significantly, the central bank did not make economic policy choices (which would be under the competence of governments, not technocrats). These assumptions promoted a narrative of independent central banks as technocratic actors rather than political actors whose policies had redistributive consequences.

First was the assumption that price stability could be pursued independently of other policies like fiscal policy and financial regulation and supervision and

act as a disciplinary force. Rather than having the central bank react to developments in the fiscal or financial realms, governments would adjust to monetary policy, thereby ensuring monetary dominance. Indeed, central banks served as a check on government excess – a key economic argument used in favour of independent central banks was the incentive of governments to run deficits to gain political support (Kydland and Prescott, 1977; Barro and Gordon, 1983). Central banks, along with markets, would operate as a disciplinary force on governments that might run excessive deficits, with the central bank using monetary policy to counteract inflationary fiscal policies. Government bond yields also would react to government imbalances, creating further market incentives for member states to adhere to the Stability and Growth Pact (SGP) rules that removed the need for fiscal risk sharing through a common budget.

The second assumption of the Maastricht Treaty was that market discipline (strengthened by the SGP rules) would prevent the type of speculation that had become endemic during ERM years, eliminating the need for central bank intervention and allowing it to focus on its narrow mandate. Indeed, Pisani-Ferry (2013: 9-10) noted the general agreement that "within a monetary union, balance of payments would become as irrelevant as they are across regions within the same country". In the absence of expected balance of payments crises, the euro area countries were no longer eligible to use the facility providing medium-term balance of payments assistance, with the European Commission proposing that any such loans be obtained via capital markets or financial institutions (European Commission, 2001). Moreover, the no bailout clause of the Maastricht Treaty (Article 125 TFEU) prohibits euro area member states from taking on the debts of other member states. It was also presumed to encourage market discipline of member states. Similarly, the Basel 2 accords prominently placed 'market discipline' as its third pillar that would "contribute to a safe and sound banking environment, and supervisors require firms to operate in a safe and sound manner" (Basel Committee on Banking Supervision, 2004: 175). At the European level, member states rejected the creation of integrated financial supervision despite the expectation that monetary union would spur financial integration. Instead, the EU relied on the cooperation of national regulators and supervisors through the Lamfalussy Process. Some but not all euro area central banks also served as national financial supervisors, and the EU made the successive Basel accords into EU law.

Finally, the Maastricht Treaty assumed that monetary union would promote further economic convergence among euro area member states. Indeed, the prior decades of exchange rate cooperation under the European Monetary System con-

tributed to greater exchange rate stability, lower inflation, and lower interest rates. The Maastricht treaty contained convergence criteria to ensure greater economic homogeneity among the member states in preparation for a single monetary policy. Academic research supported the idea that monetary union could promote stronger trade links, thereby leading to the correlation of business cycles (Frankel and Rose, 1998). If the euro area resembled an optimum currency area, the ECB's interest rates would be suitable for the region as a whole and would not generate redistributive effects, lending justification to the argument of central banks as technocratic actors working for the benefit of the euro area. Indeed, market discipline had been an important component of driving convergence under the Exchange Rate Mechanism (Chang, 1998).

In summary, these three assumptions justified an independent central bank with minimal accountability requirements. Thanks to the narrow mandate and ability to influence government policies (with the help of markets), the ECB would be free to pursue price stability for an increasingly homogeneous euro area without needing a corresponding fiscal union or financial union.

3. Learning from experience: Moving from crisis to crisis

The 2008 global financial crisis ushered in an extended period of economic crises for the euro area that exposed the fallacy of assumptions made in the Maastricht Treaty. The crisis demonstrated the ramifications of a monetary union with only one strong pillar (monetary union) combined with the weakness of national co-operation in fiscal and financial matters. The euro area responded to the euro crisis by creating an emergency loan facility (the European Stability Mechanism), a banking union (still incomplete), and by the strengthening of fiscal rules.

In contrast to the assumption of market discipline, markets did not react to economic differences prior to the global financial crisis and then overreacted relative to such differences afterwards, responding to political expectations at least as much as to economic conditions (Chang and Leblond, 2015). The ECB assumed a very prominent role, as did other central banks, and became 'the only game in town' when it came to crisis management (El-Erian, 2017). This included a gradual expansion of its policy toolkit to include unconventional monetary policy.

In contrast to the assumption of economic convergence, divergence between the northern and southern economies increased after the introduction of the euro. The common monetary policy of the ECB therefore had the effect of depressing demand in countries like Germany and stoking it in countries like Ireland and Spain, fuelling housing and construction in the latter that laid the ground for a second crisis within the euro area. The sovereign debt crisis made clear that internal imbalances still mattered within a monetary union, as they contributed to sudden stops of capital and had implications for the economic competitiveness of economies.

As these assumptions unravelled, the ECB had to deviate from its focus on monetary policy as a tool for price stability. First, the development of unconventional monetary policy to deal with the successive crises included quantitative easing (QE) programmes that massively inflated the ECB's balance sheets with government bonds. Second, the policies pursued by the ECB arguably came into conflict with its price stability mandate. The German Constitutional Court argued that the ECB had undertaken economic policymaking with its quantitative easing programme, though ECB policies were upheld by the Court of Justice of the European Union (2015, 2017).

While the ECB's programmes may have been legal, they were not seen by all as legitimate. The economic crises fuelled inequality and populism, much of it directed at the ECB (Macchiarelli, Monti, Wiesner and Diessner, 2020). Although the ECB significantly increased its transparency to assuage concerns (Fraccaroli, Giovannini and Jamet, 2018), its increased prominence after the successive economic crises has made it a target and led to questions about the legitimacy of an independent central bank. Moreover, the recent expansion of ECB interests to include areas like climate change further stretches the initial logic of its independence.

4. Reconsidering independence

In 2022 rising inflation in Europe (and the US) led to sharp criticism of central banks. While the ECB's unconventional monetary policies in response to the euro and Covid-19 crises were controversial, they took place during a period of very low inflation so the ECB could continue to claim that it followed its mandate. As inflation climbed to record heights in the euro area (9.2 per cent in December 2022, compared to the ECB's target of 2 per cent), central banks hiked interest rates to stem inflation. The ECB began raising rates in July 2022, 4 months after the Federal Reserve concluded that rising inflation was more than a transitory phenomenon due to pent-up demand post-Covid lockdowns and rising energy prices after Russia's invasion of Ukraine and raised its interest rates.

The ECB's interest rate adjustments (7 interest rate rises between July 2022 and May 2023) constitute the fastest monetary tightening in its history. Moreover, it has wound down its QE programmes. The ECB's Governing Council decided to stop new asset purchases under the Asset Purchase Programme (APP) as of 1 July 2023 but would still reinvest the principal payments made on maturing securities. As of March 2023, the Governing Council decided to not reinvest all of the principal payments and allow the APP portfolio to decrease. As for the Pandemic Emergency Purchase Programme, the Governing Council ended net asset purchases as of the end of March 2022 but continued reinvestment of maturing principal payments until at least the end of 2024.

The unwinding of the ECB's balance sheet poses risks for euro area financial stability. The ECB has been a major buyer of euro area government debt for nearly a decade, and these purchases "contributed decisively to the reduction of euro-area sovereign spreads and the dispelling of sustainability risks" (Alberola-Ila, Cheng, Consiglio and Zenios, 2022). While the ECB's willingness to do 'whatever it takes' staved off bigger crises and possibly saved the euro area, it also undermined market discipline (Ojala, 2021) and turns the Maastricht logic on its head.

The ECB has exhibited remarkable flexibility in the face of the assumptions behind the Maastricht model breaking down. Nevertheless, no substantial changes have been made to the ECB's status as a highly independent central bank whose independence is predicated on its ability to achieve a single objective (price stability) that is easy to monitor and does not impinge on policy areas under the competence of member states. Instead, the ECB relies on the accept-

ance of its interpretation of its policies as compliant with its mandate. The ECB made frequent references to the monetary policy transmission mechanism to justify its policies. For example, ECB President Mario Draghi (2012) justified Outright Monetary Transactions through this mechanism: "we need to be in the position to safeguard the monetary policy transmission mechanism in all countries of the euro area. We aim to preserve the singleness of our monetary policy and to ensure the proper transmission of our policy stance to the real economy throughout the area".

5. Conclusion

The ECB's policies have been justifiable. Their consistency with the ECB's mandate and accountability structure, however, should be reconsidered considering the many lessons learned since the signing of the Maastricht Treaty. The inability of member states to reach agreements during the euro crisis left the ECB as the only actor that could operate with sufficient speed and credibility. But (over-) reliance on the ECB has strained its credibility and its legitimacy, and this has been damaged further by its inability to control price stability. It would be highly unlikely that the member states would open the Treaties to revise the ECB's independence. Alternatively, they could improve the ECB's accountability structure further, particularly under the framework of the ECB's secondary mandate. The member states could further buttress euro area governance through the completion of banking union and creating more fiscal tools so that the ECB would not be needed as the euro area's main fire fighter. The Maastricht framework is approaching its breaking point.

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CHAPTER 19

The ECB´s monetary policy as federalism: An excursion

José Tavares

1. Introduction

In this article we argue for an alternative view of monetary policy conducted in the Eurozone where, in spite of its shortcomings, discussed, for instance in Wyplosz (2016), ECB´s policy can be seen as "federalist", that is, conducted decidedly at the central level but appropriately weighing its impact on different national jurisdictions. We first conduct a short discussion of monetary policy as "federalism". We present results from an empirical exercise that unravels the proximity of ECB´s interest rate policy to different counterfactual national monetary policies. Maybe surprisingly, the ECB´s estimated weighing of economic fundamentals displays the characteristics of sensible policy-making, federalist in nature.

2. The Political Economy of Monetary Policy

The fiscal federalism view points to different criteria that add to the benefits of endorsing a centralized authority. The presence of significant spillovers across jurisdictions that cannot be intermediated by market forces, that is, non-pecuniary spillovers. One may argue that, in an economic space with tight trade and financial integration that may apply to an apology for a common currency and common monetary policy. One possible interpretation of the Greek citizenry resistance to exiting the Euro during the sovereign debt crisis is the acknowledgment of such benefits. A second criterion for joint decision-making by a central authority is the existence of economies of scale. Certainly, the reputational and symbolic benefits of a common currency are, by nature, sensitive to scale. A third criterium rests on the relative unimportance of information asymmetries in favour of the local authorities. Hard to imagine that a common monetary policy can be aware and, especially, respond differently to different local conditions relying on the use of a very limited set of common policy instruments. Finally, not only the factual, economic conditions, may differ across jurisdictions, the political preferences of the citizenry may not be the same. Again here, it is hard to think of a uniform monetary policy as responding to diverse and changing political preferences.

Certainly, monetary policy conducted at the ECB level may suffer from a "one size fits all" syndrome, devaluing or ignoring economic and political idiosyncrasies. On the other hand, the practice of economic and political governance of the EU may have add legitimacy to a common, "federalist" monetary policy, due to both its efficacy and its ability to summon citizen support.

First and foremost, in a context of protracted decisions in the fiscal and political front, monetary policy emerges as a decisive and comprehensive instrument for policy-making. It is well documented how the timing of monetary and fiscal policy differ, the latter acting with a larger decision and implementation lag. The diligence and overall impact of monetary policy in stabilizing the economy become especially salient in the wake of the sovereign debt crisis. It is no exaggeration to remember the scent of "end game", played between Greece, unable to fulfil its debt commitments, led by at least a few politicians willing to toy with default and Euro exit, on the one hand, and a stream of creditor countries dependent on the credibility of the Euro, and justifiably fearing a Greek exit from the common currency. The possible unleashing of a domino effect involving other debtor econ-

omies could spell the end or the beginning of the end for the European currency. As acknowledged today, the ECB's role in bringing the sovereign debt crisis to final moderation cannot be exaggerated. The then President of the European Central Bank, Mario Draghi, stated, among other: *"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."* The words are extremely pointed as far as power to act: ready to do, whatever it takes, it will be enough. The prompt to act, how far it will go, when will it stop. They are also remarkable in terms of signalling institutional, if not personal, will to act: our mandate, believe me. Our mandate, believe me. It is necessarily one of the most effective political speech excerpts in the history of addressing expectations. The policy move was, in the same run, institutional and idiosyncratic, steeped in words and amazingly effective in its handling of expectations and communication of policy resolve.

Second, it may have come to salience in citizen's views of European policymaking, how common monetary policy and fiscal federalism may be *de facto* substitutes. It is worthwhile to recall how the consensus was, at the time, that the crisis could only be overcome through the increase in the fiscal depth of the Eurozone, including an increased common budget and the assumption of a fiscal federalist objective for the EU, on the one hand, or the inevitable breakup of monetary union and the fall of the Euro. The first, as we easily realize, had only minor developments, fiscal union or even fiscal federalism still a mirage no country wants to discuss in substantial terms. As for the Euro, it survived the crises, and it did so through a more active stance of the European Central Bank, *de facto* and, as seen above, by decisively modelling expectations. The low likelihood that EU spending will ever come to match, or even approach the magnitude of national budgets, suggests the difficulty of using fiscal policy at the EU level as a timely response to business cycle fluctuations. The actions of the ECB during the sovereign debt crisis also added to its legitimacy as it became clear its rigid statutes in what concerns the response to the real economy were not an obstacle to meaningful policy-making in a real crisis.

Thirdly, there is the looming and important issue of democratic accountability. Monetary policy is, by nature and common example, a realm where expertise trumps political accountability, and the sensible advocacy of central bank independence as key policy conduct just reinforces the distance between monetary policy and citizens' concerns. In the European Union, this "democratic distance" may take second place to other facts that lend legitimacy to monetary policy. The first is that policy, at the EU level, is not only feeble in the amount of fiscal re-

sources it summons, but the political instance of decision-making, the European Parliament, is itself recurrently associated with an important "democratic deficit". Further, in a political and economic system, the European Union, where genuine sharing of symbols is a scarce commodity, the use of a common currency across borders is a powerful and invaluable reminder of union and commonality that may have no match elsewhere, certainly not in the fiscal area. As shown, for instance, in Guiso et al. (2014), even in the wake of deep economic crisis, the popularity of the common currency is higher than of other European institutions, this in spite of the difficulty, underlined in Issing (2005), that an institution like the ECB faces when delivering and communicating a common policy to a diverse set of constituencies.

In sum, for symbolic but also for efficacy and expediency reasons, heightened through the experience of the sovereign debt crisis, monetary policy may have accumulated some of the features of "federal" policy-making that will be hard to match by other EU policy areas. The "institutional loneliness" within which the ECB acts, that Bongardt and Torres (2022) allude to, may actually be an asset within the context of multi-level governance complexity that characterizes the European Union.

3. Country Weights in ECB´s Interest Rate Policy: An Exercise

In a recent paper, Pereira and Tavares (2019), we conduct a specific empirical exercise that may add evidence to the "federalist" workings of monetary policy by the ECB. Using quarterly data between 1996 and 2016, We provide quantitative evidence that informs the debate on the responsiveness of ECB policy to varying national economic circumstances. We start by estimating the counter-factual country-specific interest rates that national Central Banks would likely have put forward were they to follow the same pattern of policy behaviour observable prior to adhesion to the Euro. To obtain these counterfactual interest rates, we model each national central banks' reaction function in the period before introduction of the euro, and then estimate what the likely response would be to the country's post-euro macroeconomic fundamentals. Then, using the observed ECB reference interest rate, we estimate the country weights implicit in the ECB's conventional monetary policy. Thus, country-specific weights are computed from the difference between the ECB's reference interest rate and an estimated counterfactual interest rate for each of the EMU11 countries. Anchored in the seminal

contribution of Clarida et al. (1998) on monetary policy rules, we explore the robustness of our results to five different Taylor rule specifications. Our results show Germany, Belgium and the Netherlands associated with the largest weights, and Greece and Ireland with the smallest. More interestingly, the weights of the larger economies are smaller than what would be suggested by their respective shares in European output and population. The results change minimally when the crisis period is compared with the period before. In sum, while weights differ across countries, they do not seem to unduly weigh larger economies.

In sum, unravelling the black box of decision-making at the ECB; we find that the estimated country weights behind the ECB's interest rate policy presents characteristics close to those expected to guide a federal policy-making institution:

1. all units are weighed in policy-making;
2. larger units tend to be weighed more heavily, but less so than their economic or population weight would suggest;
3. these weights are robust to different estimation procedures and largely invariant for the exposure to the sovereign debt crisis period.

4. Conclusion

In conclusion, we argue, based on our discussion and on our empirical exercise, that it is sensible to discuss the role of the ECB in conducting monetary policy as that of an institution with at least some "federalist" characteristics, from the scale economies and the symbolic value of common policy-making to the estimated balanced weight of the various national interests. It remains to be seen whether other European institutions will be able to add responsiveness, effectiveness and weighed balance of diverse interests in way that further and more explicit federalism arises in the European Union landscape.

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PART V

FISCAL GOVERNANCE

CHAPTER 20

SGP reform: one step forward, but the circle is still not squared

Charles Wyplosz

1. Introduction

The Stability and Growth Pact (SGP) was suspended at the beginning of the Covid pandemic, to allow euro area member countries to face the unusual budgetary needs of a historical event. The suspension comes to an end in December 2023. It was understood that this period of nearly three years would be used to reform the pact. After protracted discussions with governments, the Commission has issued a proposal in November 2022 (Buti et al., 2022). In late April 2023, the German Finance Minister registered a view that is at variance with the Commission's proposal (Lindner, 2023). Shortly afterward, the Commission presented a new version of the proposal that largely restates its earlier one (European Commission, 2023).

2. How to square the circle?

The SGP is meant to square a circle: fiscal policy is a national prerogative, rooted deep in each member country's democratic institutions, while fiscal discipline is a common goal vital to the functioning of the euro area. In countries that fail to deliver fiscal discipline, the SGP is meant to constrain the fiscal institutions. Until now, it has worked through overseeing national fiscal policies on a yearly basis, with the Commission issuing warnings and requests based on the formal 3 per cent and 60 per cent of GDP limits set for the budget deficit and the public debt. When these recommendations were binding, member countries could disregard them without fearing politically unacceptable sanctions. They did so by objecting to making fiscal policy procyclical, or by making promises for the next years that would not be delivered, or by announcing actions that would not occur as promised. This has led the Commission to become both stricter and more flexible over time. Some changes have aimed at tightening its surveillance, by specifying more rules and by getting deeper in budget numbers. Other changes were meant to make the pact more flexible by accepting special excuses and by spreading over time the required adjustments.

3. Limits of the SGP

The SGP's history is not a happy one. It was suspended in 2003 when the area's two largest countries, France and Germany, were running budget deficits. This embarrassing decision – which triggered a formal complaint to the European Court of Justice – led to a first reform adopted in 2005, whose purpose was to introduce some flexibility. Then, in 2010 came the debt crisis, which started in Greece and spread to Ireland, Portugal, Spain and Cyprus. Collective support was provided to these countries, Spain excepted, through the newly created European Stability Mechanism. In 2012, a second reform was adopted to strengthen the pact, with a view of ensuring that deficits be closed during years of solid growth. Just before the pandemic, there was widespread agreement, even in official circles, that the SGP was not delivering on its objective of achieving fiscal discipline and needed to be fixed (Pench et al., 2018; Thygesen et al., 2020).

A large literature has explored the pact's shortcomings and suggested a wide array of changes. Although there is no agreement on both issues, a few observations are fairly consensual:

- The deficit and debt target ceilings of 3 per cent and 60 per cent of GDP, respectively, are arbitrary and inapplicable to many countries.
- The pact that emerged from the successive reforms has become far too complex.
- Complexity has led to a heavy bureaucratic process without making the pact any more effective.
- The power of the pact was meant to derive from the threat of sanctions, but no sanction has ever been applied.
- There is lack of ownership by member countries. Fiscally undisciplined countries complain about interference in national sovereignty, fiscally disciplined countries complain about a soft implementation of the pact's constraints, and both blame "Brussels".

4. The Commission's reform proposal: one step forward

The pact operates on a yearly calendar. During the so-called Spring Semester, member governments submit to the Commission the parameters of their forthcoming budgets along with forecasts of the implications in terms of deficits and debts. The Commission scrutinizes these detailed documents and makes observations, which can include requests for limited changes or for serious reconsideration. Repeated non-compliance can lead to a government being put under close supervision, potentially leading to sanctions.

A key difficulty is that the budget outcome will depend on the economic situation expected to prevail during its execution. Good years tend to reduce deficits/increase surpluses, with the opposite situation in bad years. One problem is that forecasts are inaccurate. Another problem is that calling for lower deficits in bad years results in procyclical fiscal policies. The combination of these two problems opens up much room for disagreements between each government and the Commission. This undermines the implementation of the SGP and all but precludes the imposition of sanctions.

The problem is much deeper, however. It is generally – but not universally – admitted that countercyclical fiscal policies are desirable. This calls for tightening the budget in good years and for letting deficits deepen in bad years. Over time,

a judicious dosage of surpluses and deficits can drive the public debt to a level deemed compatible with fiscal discipline. Indeed, this is the concept of debt sustainability. Thus, a few years of deficits are fully compatible with debt sustainability provided that they are followed by years of adequate surpluses. Put differently, the year-by-year approach of the SGP, is ill adapted to the use of countercyclical fiscal policies by member countries.

This is why the 2012 reform includes a 'preventive arm' designed to achieve medium term objectives (MTOs) that each government must agree upon with the Commission. This is fine but, again, when it is used year after year, it beats the purpose. We need to look at several years ahead, beyond the current business cycle. That means making forecasts, which will inevitably be found to have been wrong.

The new proposal takes a step forward by going the other way around in time. The procedure involves deciding first where the debt should be in four, possibly seven years. Moving backward, we can find a succession of annual budgets that takes the debt to its target. This is exactly how the SGP should work. The beauty is that there is not just one path of budget outcomes that deliver the right debt level, but an infinity of paths. That means that if expected conditions call for fluctuations of the upcoming budget balances, this is fine as well. A forthcoming slowdown warrants some deficits, possibly large ones, say for a couple of years, to be compensated later on by surpluses. True, there is the serious question of whether a government can make a commitment over several years (will it still in power?), whether it will try hard enough to deliver, and what happens if it does not. This is the old challenge of squaring the circle.

5. Limits of the Commission's reform proposal

Over the years, the Commission has refined its ability to contain efforts to circumvent the SGP. Much of its attention has been concentrated on the Spring Semester. Tailored to the yearly implementation of the SGP, this procedure does not fit the new medium-term approach now proposed by the Commission and, yet it is retained and amplified.

A key advantage of the medium-term approach is that it recognizes that annual fluctuations of budget balances matter little for debt sustainability. It would have seemed natural to deemphasize the year-by-year surveillance procedure that the Commission has built over nearly a quarter of a century. Obviously, it is reluctant

to do so. One reason is that it still needs to closely follow what is happening to national budgets during the interim and, if need be, to sound the alarm bell when a government strays away from the agreed path.

Another reason is that the Commission may not want to dispose of its previously accumulated surveillance know-how. That would be understandable if it were without adverse consequences, but it is not. It perpetuates the tradition of laying new rules on top of old rules, a recognized cause of harmful complexity (Pench et al., 2018). It muddles the significance of the shift to a medium run approach. It also elevates internal Commission procedures to the rank of targets. This is exemplified by the key role now attributed to the expenditure benchmark, meant to substitute for the cyclically adjusted budget balance. As argued in Wyplosz (2023), the expenditure benchmark, which was designed as a check on the cyclically adjusted budget balance as part of the annual adjustment process, combines a poorly designed cyclically adjustment with an arbitrary target. This confusion is bound to undermine the reformed pact.

Another serious limit is the determination of the path of future budget balances that lead to a desired debt level at the four-year horizon, or seven-year in some cases. This involves two decisions and several assumptions. First, what should the medium-term debt target be? Since the official 60 per cent target is unreachable for many countries, another target must be set, which is a challenging task. Too much or too small ambition would make the whole process meaningless. Second, as noted above, there is an infinity of future budget balance paths that can reach the chosen target. To compute any of these paths, assumptions must be made about the future interest and growth rates over the upcoming four years. Well aware of these difficulties, the Commission proposes to make all these calls: "the **Commission** will issue a country-specific '**technical trajectory**'. This trajectory will seek to ensure that debt is put on a plausibly downward path or stays at prudent levels, and that the deficit remains or is brought and maintained below 3 per cent of GDP in the medium term" (European Commission, 2023). This contrasts sharply with the oft-stated objective to restore country ownership of the pact. One would expect that member governments make the last call on a such a major political commitment, after reaching an agreement with the European Council. Such a procedure would also buttress transparency, another oft-stated objective of the reform.

6. Why the circle will not be squared

The conflict between national sovereignty and common interest is unavoidable. Any reform proposal must take steps to minimize it, but it cannot be eliminated. The latest proposal is useful as it moves away from the year-by-year approach that repeatedly failed because it was technically misleading, the source of conflicts between member countries and the Commission. But the implicit solution to the basic conflict is to enhance the power of the Commission to the point where member countries have little or no bargaining power to disagree.

The German government reaction shows how challenging the situation is. Lindner (2023) makes two main points:

- The proposal moves away from the one-size-fits-all that used to underpin the SGP.
- The proposal gives too much leeway to the Commission and should instead rely on non-negotiable quantitative constraints, such as a mandatory annual reduction of the public debt.

These two points are what make the Commission's proposal promising, moving away from the arbitrary rules of the original SGP. The second point also confirms a mistrust of the European Commission, which is seen as too flexible in the face of spendthrift governments. Paradoxically, the German government shares the Commission's aim of reducing national fiscal sovereignty in favour of the common interest, but they part company when it comes to drawing lessons from past failures of the pact. The German government considers that spendthrift governments have exploited every space for flexibility to escape the pact's constraints. It wants to establish binding quantitative rules that are not open to negotiations with the Commission. The Commission recognizes that strict binding rules are not applicable because they are blind to the prevailing economic and political conditions. Instead, it wants to be given the power to impose 'clever' constraints on spendthrift governments. Neither view is likely to succeed because they both ignore national fiscal sovereignty.

This conflict between national sovereignty and common interest can be seen under the familiar image of sticks and carrots, which economists see as setting adequate incentives. The German government believes in sticks – which it calls binding quantitative rules – with no carrots. The Commission proposes to hold the power to constrain spendthrift governments (the sticks) but also to offer

carrots in conditionally expending the horizon to seven years and other technical adjustments to the expenditure benchmark, which means trading off some flexibility against what it considers as 'good' spending (on climate change and productive public investment, among others).

A more promising avenue is to enhance the carrots and to move the sticks to the national level. The debate overlooks a crucial question: why are some governments systematically fiscally disciplined while others are systematically fiscally undisciplined? The answer is well-known: some countries have adopted long ago national institutions that are designed to make fiscal discipline compulsory. There is no one-size-fits-all institution in this respect. As observed by von Hagen et al. (2007), adequate institutions depend deeply on the local political regime. It is a matter of checks and balances, whereby the government is domestically constrained by laws, procedures and supervisory bodies.

This idea was actually taken up by the 2012 reform of the SGP as it required each country to establish an independent fiscal policy council that would 'tell the truth' about fiscal discipline. Unfortunately, the requirement was vaguely phrased, allowing governments reluctant to see their power domestically limited to establish powerless councils. Yet, a few other countries have accepted such limitations and achieved fiscal discipline, as explained in Beetsma et al. (2019). Effective national institutions are the key to eliminate the conflict between national sovereignty and the common interest. The problem is that Germany is not prepared to trust foreign domestic institutions while the Commission considers that it is the proper institution. At the same time, the spendthrift countries could single-handedly take steps to build their own solid arrangements, but they do not seem to, which confirms lingering suspicions. Clearly, the circle will not be squared this time around.

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CHAPTER 21

When all else fails: European re-insurance of member states[1]

Waltraud Schelkle

1. Introduction

By 2023, the EU has gone through 15 years of almost uninterrupted crises. It started with the North Atlantic financial crisis in 2008, which morphed into its sovereign debt phase with the Euro Area (EA) crisis in 2010. This reached its turning point in 2012 but lingered on until mid-2015 with a renewed escalation related to Greece's third bailout programme. In that same summer, a refugee crisis erupted, partly due to a large number of Syrians who fled the war that President Assad waged against his own people, partly due to EU-internal disagreement over how to address this recurrent hard policy problem. This unedifying image has almost certainly tipped the Brexit referendum in favour of the Leave vote in June 2016; the much anticipated membership crisis of the EU did not materialise, however. The slow recovery was then rudely interrupted by the Covid-19 pandemic that the EU

1 Research for this chapter was supported by the European Research Council under Synergy Grant ERC_SYG_2018 Grant no. 810356, for the project SOLID – *Policy Crisis and Crisis Politics. Sovereignty, Solidarity and Identity in the EU post 2008*.

for once shared with the rest of the world. The Russian invasion of Ukraine has led to another surge of refugees but this is less salient than the cost-of-living crisis, fuelled by pent-up demand and supply chain interruptions from the pandemic as well as the bounty of liquidity with which central banks tried to tide economies over wave after wave of severe disruptions since 2008.

So far, so familiar. The EU responded with a whole battery of reforms and new institutions. It is arguably underappreciated what an achievement it is to pull this off in terms of overcoming collective action problems (Rhodes, 2021; Schelkle, 2017). But do these new institutions add up to anything or is it just muddling through, preparing the ground for another crisis (Jones, Kelemen and Meunier, 2016)? This chapter argues that a system of re-insurance has emerged, i.e., insurance that covers the excess loss of severe member state crises, which could sink these primary insurers, here: national welfare states. The system emerged not because it was designed that way but because it is what governments with very different views of inter-state solidarity can agree on. This is not institution building of the second-best, lowest-common denominator variety. It is potentially a genuine functional and political alternative to a fiscal federation, not its weak imitation.

2. Why re-insurance?

In economics, re-insurance is a risk exchange between insurers. Re-insurance is different from co-insurance in that only the excess loss or tail risk is covered, not a share of any (normal) risk that materialises (James, 2013: 9-11). Primary insurers, such as those who sell home content and life insurance, want to cede the risk of excess loss, e.g. in the case of a major earthquake in a region where their business is concentrated. The excess loss occurs under the exceptional circumstance of highly correlated risks where all their clients are affected at the same time, their homes heavily damaged and lives lost. From the primary insurers' point of view, it is often insurance against becoming insolvent when such a disaster strikes.

The national (welfare) state is a primary insurer of resident individuals. And just like a private insurer in an earthquake, the nation state can get overwhelmed when catastrophic risks materialise, such as a systemic financial crisis or a pandemic. Membership in the International Monetary Fund (IMF) is a form of taking out re-insurance, which materialises in the form of adjustment programmes that also protects other members against negative collateral damage. But, until recently, the IMF could only come in when a shock had led to capital flight in a balance of payments crisis. The IMF's resources are also too small when relatively wealthy countries, like those in the EU, are affected. Equally, a fiscal federation can act

as re-insurer, for instance provide federal disaster relief when a hurricane hits a member state. This is different from co-insurance, such as a federal top-up of the state unemployment insurance scheme paid in normal times.

For a union of nation-based welfare democracies like the EU, re-insurance has at least three advantages that go beyond economics.

1. It requires much less institutional convergence of welfare state schemes than federal co-insurance. The assessment of excess loss, triggering a payment for instance if unemployment rises over 20 per cent of the workforce, does not require to harmonise the coverage of previous earnings or the eligibility criteria. It is therefore much less intrusive and disruptive than constructing a federal fiscal system out of 27 different fiscal systems and welfare states.

2. Relatedly, moral hazard should be much less of a concern. Risk-taking in the knowledge that downside risks can be socialised is contained by the very fact that the losses up to the excess have to be borne by the primary insurer. So, if a country wants to be generous to its unemployed, it has to find its own fiscal means for 19.9 per cent of unemployed residents.

3. Re-insurance can take many forms, it does not have to be fiscal. Given the limited fiscal capacities of the EU level, it is quite important. Lending-of-last-resort by central banks can provide re-insurance to financial markets and thus reduce the amount fiscal authorities have to spend on recapitalising banks and compensating losers of bank failure. Micro-prudential regulation can allocate the losses from failure of foreign bank subsidiaries in a member state such that the member state where the banks have their headquarters share in the (excess) loss.

Risk pooling through re-insurance can thus be an alternative to co-insurance on which fiscal federations are based and is arguably more in line with the state of political integration in the EU.

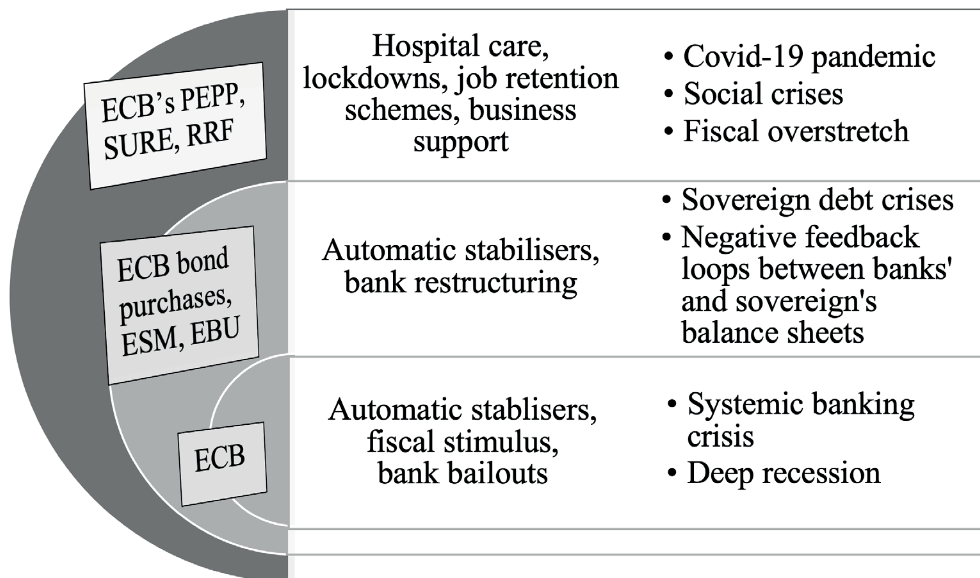
3. How does the system work?

This section illustrates how the emergent system of re-insurance works. It started with a systemic financial crisis, which was cumulative and self-reinforcing. This can bring down entire economies if not stopped, the biggest and wealthiest included. Lending of last resort by central banks was deployed on an unimaginable scale that included a whole swap arrangement between central banks. Too much reliance

on monetary re-insurance became untenable with the Euro Area crisis, because the cumulative effect spilled over from banks **to** sovereigns (so-called doom loop). The European Central Bank (ECB) then insisted that some fiscal capacity be created, the European Stability Mechanism (ESM) for bailing out sovereigns as well as for restructuring national banking systems. Elements of the later European Banking Union (EBU) can also be interpreted as re-insurance, and again, it was the ECB that requested it. During the pandemic, the re-insurance character of EU support became quite explicit with a back-up scheme for national job retention schemes, the temporary Support for mitigating Unemployment Risks in an Emergency (SURE). SURE and the Recovery and Resilience Facility (RRF) soon afterwards stretch the notion of re-insurance since they are pre-emptive, paid out before disaster strikes. But in contrast to economics, political economy can also highlight the differences between re-insurance as a public good and as a private service, which does allow to extend the notion to the pre-emptive use of re-insurance.

The following figure gives a stylized image of the EU's, not only the Euro Area's, system of re-insurance.

Figure 1 – System of re-insurance, primary insurance and major crisis concerns



Reading Figure 1 from right to left, the long stretch of crises in the EU started in 2007-8 with a bank run, more precisely: a run on banks from banks in wholesale markets. The fire sales drove down asset prices, drawing more and more banks into the maelstrom. While governments supported the automatic stabilisers of the budget[2] with additional fiscal stimulus and bailed out failing national banks, only central banks with their deep pockets and instruments that can be mobilised quickly can come to the rescue of a systemic financial crises. Their re-insurance to financial markets was crucial to keep payment flows and thus national and international trade going even as banks did not want to hold claims on each other. Financial markets completely failed to act as primary insurers of household wealth, from the portfolios of the rich to the savings of the less well-off.

The financial crisis prepared the ground for negative feedback loops in a sovereign debt phase, which was specific to the Euro Area crisis (De Grauwe, 2023, this volume). By fighting the financial crisis and the ensuing recession, governments had weakened their balance sheets; in turn, banks had weak balance sheets but also held a lot of government bonds and even more from their own government than before the crisis (so-called home bias). The doom loop of weak(ening) bank and government balance sheets could start either way. In the case of Greece, the sell-off and, ultimately, default of government bonds weakened the Greek banks that required them to be rescued with credit from the ESM; in Ireland, it was the weak banks that sank the government soon afterwards. In the Euro Area, the prohibition of buying bonds directly from the issuing government meant that the doom loop could not be stopped straight away. Bonds had to be sold to banks first and held there for a time before the ECB could buy them. Foreign banks were not willing to buy bonds of certain countries, so governments leaned on domestic banks to buy their bond issues, making the home bias ever worse. Again, only central banks with their deep pockets could intervene quickly and provide re-insurance of financial markets and governments. The latter, extending re-insurance to governments through their asset purchases, was a breakthrough, even if provided at the beginning only in pre-committed amounts which did not reassure investors.

As five countries got trapped in a doom loop (Schelkle, 2017: 193-196), governments became ever more reluctant to clean up their banking systems, for fear that more public debt, contingent liabilities and bad bank assets could raise alarm

2 Automatic stabilisers are items on the revenue side, such as the income tax, and on the spending side, notably unemployment insurance, that are responsive to the business cycle and make the budget balance move counter-cyclically.

in their bond market. This made the ECB a lone firefighter, in danger of providing extraordinary amounts of liquidity indiscriminately because it could not force governments to recapitalise and restructure national banks more resolutely (Mabbett and Schelkle, 2019). It argued hard for a bailout fund in 2010 and got eventually the ESM. This bailout fund, with a lending capacity that is three times larger than the maximum that the IMF ever lent to sovereigns at a particular point in time, came with hard conditions for sequential disbursements. Again, it did not consistently reassure bond investors that the fiscal re-insurance for the European monetary union and its members was reliable. It is against this background that Draghi's famous 'Whatever it takes' speech was so powerful.

The ECB also lobbied hard for the EBU with Euro Area-wide supervision and resolution capacity that started in 2014. It was particularly interested in a resolution capacity for insolvent banks. Like a European Deposit Insurance Scheme, it is, in principle, a useful element of the system. Both are conceived as re-insurance for member states when their national schemes are overstretched. However, Germany was singularly opposed to the EBU and obstructed the usefulness of the Single Resolution Mechanism and reneged on an agreement to introduce the deposit scheme. This is rather puzzling because both schemes would make the banking industry share in the cost of producing this public good.

The refugee crisis and Brexit were political, not financial-fiscal crises. But financial markets became nervous each time and forced the ECB to continue extraordinary monetary measures that kept real interest rates negative. The Covid-19 pandemic, however, threatened livelihoods quite directly, through loss of life and severe illness, damage to business, employment and education. Governments had to increase hospital capacities and buy medical equipment but also provide income and credit support to businesses and households during lockdowns. The ECB announced immediately a Pandemic Emergency Purchase Programme (PEPP) that kept interest rates of government borrowing low and took out all restrictions as regards buying the most distressed bonds. SURE provided re-insurance for national unemployment insurance but with a twist: its cheap loans incentivised member states to use their funding for job retention schemes during lockdown. For the EU, this had the advantage of being self-terminating when lockdowns ended.

But it was also clear that ever more credit support for the primary insurers would not be of much help in the case of governments whose creditworthiness had greatly suffered from a long crisis decade. Moreover, Troika programmes had made the ESM toxic. Its contingent credit line for pandemic-related expenditures

was rejected explicitly by Italian and Spanish governments as stigmatising even though no conditionality was attached (Schelkle, 2021). Hence the need for an alternative.

The RRF broke truly new ground. It provided grants to the tune of more than 3 per cent of EU GDP on average, and a slightly higher amount of loans (which most countries did not take until the Ukraine war). It targets countries that were poorer to begin with and/or particularly hard hit by the pandemic. At least for those who suffered a deeper recession than others, the re-insurance element is clear: while forward-looking to recovery, it is assessed on the basis of damage suffered. As usual, re-insurance here wants to allow an economy to return to its growth trajectory, if possible even on a higher one – hence, governments had to submit detailed reform and investment plans. The political intervention here is clear: the stipulation tries to placate the opposition to such largesse and presumably ensure that next time the main beneficiaries will be in a better position to help themselves (Rutte, in Valentino 2020). The second R, for Resilience, stands for this transformative re-insurance that was given in anticipation of a predictably difficult recovery; above all, it signals a political compromise.

4. A better alternative?

Risk pooling through re-insurance can be an alternative to co-insurance on which fiscal federations are based. It is less demanding in terms of institutional adaptation required, which is crucial in a union of diverse welfare states. It is also politically more acceptable for members that resist creating a budgetary union but acknowledge that integrated markets can be a source of systemic risks and interdependence through spillovers, for which some safety nets of last resort are required. And it can use the whole arsenal of instruments at the EU's disposal, which is much better developed in the regulatory and monetary than the fiscal domain. These three reasons can explain why governments with very different views on the future of the EU can agree on some form of re-insurance scheme.

I have argued that it works now increasingly as a system. Monetary policy can act swiftly and provide relief to governments' public debt management as well as to banks playing their role for payments and credit in the Euro Area. Swap arrangements can extend this to non-Euro members. But on its own, easy money maintains too many unviable banks and incentivises speculative investments. Fiscal authorities need to be given room for manoeuvre for more targeted action but not all may have the capacity. Re-insurance can protect them against bond market panic

but also enable them to rebuild their economies and perform primary insurance roles.

One may still argue that re-insurance is a politically weak substitute for a fiscal federation: it comes in only after all else failed. Institutionalised co-insurance in fiscal federations, by contrast, creates strong bonds between different levels of government and harmonised entitlements project community and identity. Possibly. But there is also evidence that co-insurance creates rivalry between the state and federal level, e.g. for credit claiming when a crisis is solved. States' free riding on federal capacity is another notorious problem in some fiscal federations, blaming the centre for accumulating so much debt while relying on and simultaneously obstructing its stabilisation efforts.[3] These political incentives make the functional imperative of fiscal federalism much less compelling. Moreover, established federations like the United States do not break apart because of these rivalries. But this would be a real threat in the EU, which has not (yet) reached the same status of being taken for granted. Political developments that are conducive to permanent co-insurance take time and trying to force them with functional imperatives may even backfire.

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3 Inspired by the work of Jonathan Rodden (2005), Alexander-Shaw, Ganderson and Schelkle (2023) provide evidence for these federal-fiscal rivalries in the U.S. during the Covid-19 pandemic, in contrast to the EU with its weak centre.

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CHAPTER 22

Building an EU central fiscal capacity - lessons from US history[1]

Tomasz P. Woźniakowski

1. Introduction

This chapter puts forward that a central fiscal capacity in a multilevel government may emerge as a result of a threat which must be tackled by the supranational or federal level of government, and that the taxation needed for such a capacity should be agreed on simultaneously with the agreement on the spending side. In the case of the EU, the new 'own resources' were behind the NextGenerationEU (NGEU), the EU's financial response to the Covid-19 pandemic. The spending was expected to trigger taxation, the new 'own resources', at some point in the future. By contrast, in the US, both revenue and spending sides of the federal budget were agreed on at the same time. As a result, the Constitution of 1787

1 I am grateful to Andrea Capati, Annette Bongardt, Marco Buti, Sergio Fabbrini, Odysseas Konstantinakos, Francisco Torres and Tiziano Zgaga for their comments on earlier versions of this chapter. The usual caveat applies. The research presented in this chapter was financed by the Polish National Agency for Academic Exchange (NAWA) under the Bekker Programme (project number: BPN/BEK/2021/1/00370).

clearly specified the types of policies the Union could conduct and the types of taxes it could impose to finance those policies (Wozniakowski, 2018).

This chapter builds on literature comparing the US with the EU[2], scholarship on the EU financial response to the pandemic[3], federalism literature[4] and my recent monograph (Wozniakowski, 2022). The aim is to shed light on a paradox of fiscalization, leading to a fiscal bargain – the fact that in order to tax less, the states must give a power to tax to the union. Granting the federal/supranational level of government an adequate tax power may lead to an overall increase in tax revenues. In the case of the EU, those revenues may be then spent on European public goods (EPG) or countercyclical policies in times of crisis. By linking fiscalization, that means an independent tax power, with spending capacity on a public good at the hands of member states there may be a fiscal bargain. This is because less revenues would be needed at the member state level: some part of public spending would be the responsibility of an EU level, paid from revenues coming from taxes unavailable for many member states due to tax competition. In this way, EU taxes, such as taxes on carbon emissions by businesses, the revenues of large internet companies, financial transactions (such as trading in shares) or on business profits could even restore a basic fiscal justice and, in fact, are overwhelmingly supported by the citizens, as the results of a YouGov survey in 11 member states among 11,000 citizens show (Maduro and Wozniakowski, 2020). Therefore, to tax less at the national level, some part of the tax power needs to be shifted to a higher level of government. Such an EU fiscalization does not imply harmonized tax rates. What it does imply, though, is a central budget based on an EU tax power, and not on contributions from the members states. Such a capacity could be used not only for transfers to member states, as is largely the case with the NGEU, but to supply European public goods (such as: common investment in the field of energy, the creation of a European hydrogen bank, EU rules on critical raw materials, and a European sovereign fund to support trans-European projects aimed at strategic innovation) or other functions such as stabilization or reform and investment support as Buti and Messori argue (2023, this volume).

2 Bordo et al. (2011), Egan (2015), Eichengreen (1990), Fabbrini (2007), Gaspar (2015), Georgiou (2021), Henning and Kessler (2012), McKay (2001), Riedel (2018), Sargent (2012), Schelkle (2017), Schütze (2009), Wozniakowski and Maduro (2020) and Zgaga (2020).

3 Buti and Fabbrini (2022), Buti and Messori (2022), Bongardt and Torres (2022b), Costa Cabral (2023, this volume); Fabbrini (2022), Genschel and Jachtenfuchs (2021) and Gordon (2022).

4 McKay (1999), Riker (1964; 1975) and Hinarejos and Schütze (2023).

2. European polycrises: three threats, different European responses

Fiscal integration can take two forms (or instruments): *capacity*, that is an independent source of revenue at the supranational/federal level as a result of a fiscalization process; or *regulation*, where the supranational/federal level of government regulates the fiscal policies of the states (Genschel and Jachtenfuchs, 2013). Fiscalization is defined as "a process through which a certain level of government (supranational/federal/central) expands its power to raise its own sources of revenue, and in so doing decreases the level of vertical fiscal imbalance" (Wozniakowski, 2022: 10), meaning that fiscalization would decrease financial dependence of the EU on the member states, as the EU would have its own adequate tax power.

During the Eurozone crisis the EU enhanced its fiscal regulation, in the form of an annual cycle of policy coordination and surveillance, the European Semester, and created mechanisms of quasi-fiscalization in the form of various lending mechanisms, such as the European Stability Mechanism. In turn, the EU response to the Covid-19 pandemic, in the form of a one-off financial mechanism (NGEU) linked these two instruments of fiscal integration. This recovery fund introduced both grants and loans, the latter of which had been the sole component of previous EU lending mechanisms. By linking the allocation of funds with the implementation of the European Semester's country specific recommendations (CSR), it made the transfer capacity – as the NGEU funds would not be spent by the EU itself but would be transferred to the member states – dependent on the regulation instrument of fiscal integration. Regardless of all the differences between the EU financial responses to the Eurozone crisis and the pandemic crisis, the logic of the NGEU is similar to the logic of the Eurozone crisis response, as both represent strong regulation (and quasi-fiscalization in the form of various lending mechanisms), as the EU still lacks adequate tax power (Zgaga, 2023).

The EU has a borrowing capacity, as the European Commission can borrow funds on the financial markets in order to lend to the member states, but no significant tax power that could generate adequate revenues to pay for common public goods. The new own resources such as a national contribution based on the amount of non-recycled plastic packaging waste, the so-called plastic own resource, or the Carbon Border Adjustment Mechanism (CBAM), whose Regulation was signed by the EU co-legislators on 10 May 2023, would not generate enough revenues to change the logic of the EU financing. For instance, the CBAM

is expected to generate around 10 billion euros annually, which constitutes just a few percentage points of the annual EU budget, already inadequate to supply EPGs. So far, the third threat the EU has been facing, constituted by Russian imperial ambitions, has not been perceived by the member states as large enough to trigger the creation of an EU central fiscal capacity.[5] Consequently, a European equivalent of a federal fiscal union does not exist, despite the emergence of various financial 'mechanisms' or 'facilities'.

Similar dynamics were at play in the US, just before the Constitution of 1787 was ratified.[6] The creation of a federal fiscal union with federal tax power (mainly the tariff, sometimes called impost or custom duties) would affect the budget of the State of New York the most, as the two thirds of its state budget in 1780s came from the state tariff. However, this state finally gave a green light to the new federal tax power – including the federal tariff – because this new power was linked with the federal obligation to ensure security from external enemies. New York lost the most from the introduction of the federal fiscal union – it could not levy the most lucrative source of revenue – but at the same time it gained the most as it was the state which benefited greatly from the new federal Union as a security provider. The State of New York was initially against fiscalization (it vetoed a proposal for a federal tariff in the 1780s and the majority of the elected members of its ratification convention were Anti-Federalists) but was finally convinced to ratify the Constitution. Similarly, some of the sceptical EU member state governments may be convinced to support the creation of an EU fiscal capacity. The key is to link this new central fiscal capacity with a spending side of the new EU budget or a new EU public policy, such as common defence (see Buti and Messori, 2023, this volume for more examples).

5 The existence of NATO, the experience with European alliances during the World War II and the fact that no EU member states are directly involved in the war may be part of the explanation. As discussed below, even in America it took several years after the war – and an internal rebellion against state taxes levied to pay for the war loans – to agree on a federal fiscal union.

6 As I showed in my book (Wozniakowski 2022).

3. The American experience in creating a central fiscal capacity in response to a common threat

Fiscalization in the US came about as a result of an internal threat in the form of social rebellions against unpopular direct taxes at the state level, which were imposed by most states in the mid-1780s in order to pay off the War of Independence debt. As the Union during the war could not tax but only borrow, the fiscal burden fell on the states which decided to pay off the war-debt using direct taxes, payable in cash. This led to revolts, such as the Shays' Rebellion which broke out in Massachusetts in 1786. When the political elite saw that those rebellions might lead to the fall of the Union, they initiated the fiscalization process. After a long public debate, the text of the Constitution – as presented in Philadelphia in 1787 – with a federal taxing clause[7], was ratified by the states. One of the crucial reasons which allowed for the ratification by the most anti-federalist states, such as New York, was the nature of the new federal tariff. As the tariff rates would be unified throughout the states it was expected to generate more revenues. Moreover, once the most expensive public policy at that time, the common defence, would be shifted to the federal level, the fiscal needs of the states would diminish. Indeed, the revenues from the tariff increased 600 per cent within a decade (1785-1795), once this source was shifted to the federal level, as there was no tax competition between states anymore (Edling and Kaplanoff, 2004: 739). Furthermore, the tariff was expected to generate enough revenues to pay for federal responsibilities, and that was the case until the outbreak of the Civil War in 1861 – during the first seven decades of the existence of US, the custom duties generated 85 per cent of federal revenues, and "between 1863 and 1913, customs duties provided 49 per cent of total federal revenues, internal revenue 42 per cent, while other sources (including land sales) came to 9 per cent of total revenue" (Wozniakowski, 2020: p. 5). Nevertheless, having a federal, or supranational, tax power over a variety of sources, means that no single industry would be taxed too heavily. As Alexander Hamilton argued in The Federalist nr 35: "Suppose, as has been contended for, the federal power of taxation were to be confined to duties on imports, it is evident that the government, for want of being able to command other resources, would

7 "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States", Section 8, US Constitution.

frequently be tempted to extend these duties to an injurious excess" (Syrett, 2011: 477).

Some taxes, like the tariff in the US case, or the taxes on the profits of multinational companies in the EU case, can only be effectively imposed at the highest level of government, as otherwise inefficient, due to the race to the bottom, tax competition would ensue, which is currently the case of the EU where a sovereignty reservation applies to tax matters, as explained by Bongardt and Torres (2022a). Just like the tariff at the end of the 18th century US was imposed effectively once the federal government took it over, with a significant increase in revenues arising from this source, the tax on large corporations can only be effectively levied at the EU level, with a potential for a similar rise in revenues and more tax fairness.

4. Conclusion

This chapter puts forward first, that tax power is not a zero-sum game – granting a tax power to the EU, while ensuring its parliamentary legitimacy, does not necessarily mean that overall tax revenues would diminish. Second, the revenues from an EU central fiscal capacity could be spent directly by the EU. The tax power should be agreed on simultaneously with a strictly defined spending power – or the public policy area to which the revenues arising from the tax power would be devoted. Hence, the tax power should not be granted for its own sake, especially at the level higher than a nation state, such as the EU. Instead, such a power should be used to provide some important common goods such as countercyclical policies in times of crisis or European public goods, such as common defence, which could boost the support for the European project among its citizens.

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CHAPTER 23

The state-mimicking method and the alternative budgetary union in the E(M)U[1]

Nazaré da Costa Cabral

1. Introduction

A typical budgetary union, either involving unitary or federal states, relies on the assumption that public revenues and expenditures and the respective legal powers are distributed between the different layers of governments existing in those states. Typically, one could conceive of three layers of government, with the top level being the central government, the intermediate corresponding to the state or regional government and the lower level being the local or municipal government. A budgetary union assumes that despite the (stronger or weaker) financial decentralization towards the intermediate and lower-level governments, the central budget plays a pivotal and unifying role in the country when undertaking the sov-

1 The opinions expressed in this article are the author's alone and do not represent any position or point of view of the Portuguese Public Finance Council.

ereignty apparatus in the fiscal domain and embodying, through that, the macroeconomic stabilizing function of the state as a whole (recall, in this regard, the seminal contribution on fiscal federalism by Musgrave, 1959). The upper limit of the budgetary union corresponds to the political borders of the (national/sovereign) state.

Unlike (conventional/national) states, the E(M)U is marked by disjointed sovereignties (affecting the aforementioned stabilization function), in the sense that the location of the abovementioned sovereign powers is not a single and unique entity (that should in a standard fashion be the E(M)U as the top level), but rather they are sliced and distributed among two different layers – monetary policy relies on EMU itself (the central government for the purpose of this analysis), while fiscal/budgetary policy, including the respective instruments of sovereignty – e.g. the creation of taxes and the treasury function – remain with lower level governments (the member states) that in this matter maintain their characteristic sovereignty.[2]

In this chapter, I will present and describe the 'State-mimicking' method, which is in fact the pragmatic policy-oriented approach that has been developed over the years by the E(M)U[3] as a way to address the implications arising from these disjointed sovereignties. In particular, such a method has been marked by the implementation or proposal for innovative budgetary prototypes that intend, in turn, to imitate conventional budgetary aggregates (e.g. revenues) or the budget as a whole. The standard predicates of a budgetary union are therefore adapted or twisted to give rise to a heterodox, alternative Budgetary Union in the E(M)U.

2. Predicates of a typical budgetary union

Let me start then by introducing the three main predicates that are supposed to be found in a budgetary union regardless of the political nature (federal or unitary) of the State (assuming liberal democratic countries):

2 Bongardt and Torres (2022a) address this issue when referring to the EMU as being unbalanced in its monetary and economic spheres (pp. 236-239).

3 I will use the acronym E(M)U when I am indistinctly considering the Economic and Monetary Union (EMU) and the European Union (EU) as a whole. For certain analytical purposes it is not interesting to make such a distinction, but whenever required, the distinction will be made.

a) Common to all levels of government existing in that State: typical budgetary instruments and institutions

In principle, all levels of government are assigned typical (and classical) budgetary instruments and legal and institutional provisions ensuring the rule of law in the budgetary field, in particular the principle of the separation of powers (Table 1).

Table 1 – Typical budgetary instruments and institutions

Typical budgetary instruments	Rule of law institutions (in particular the principle of the separation of powers)
Budget (organized, approved and executed according to budgetary principles, e.g. annuality, universality and unity) Budgetary technical devices (e.g. appropriations, allocations, programmes) Accounting instruments Expenditures (current and capital) Revenues (e.g. tax revenues) Borrowing/debt/bonds Budget as a 'citizens' budget', i.e. tax revenues proceed directly from legal persons (individuals and corporations) and expenditure payments have them as main actors (e.g. social benefits, subsidies), despite transfers to other subsectors.	The power to approve the budget and taxes: legislative assemblies (unicameral or bicameral systems) The power to propose and to execute the budget: executive bodies The power to control budget execution: administrative or parliamentary bodies and courts – e.g. court of auditors

Source: Created by the author

b) Distribution of powers/competences between different layers of government: assignment of functions and revenues and the imposition of budget constraints

Despite differences between countries (each experience of fiscal decentralization has its own idiosyncrasies) the fact is that a certain normative pattern (identified on theoretical grounds by the 'Fiscal Federalism theory'[4]) emerges with regard to either functions (expenditure) assignment or revenue assignment. In particular, Musgrave (1959) claimed that the objectives of income redistribution and macroeconomic stabilization should be mostly assigned to the central government, whereas the 'heart of Fiscal Federalism' (that is, relating to decentralization) should remain with the allocation branch. Regarding revenue assignment, three orders of financing can be distinguished: i) Tax revenue assignment and/or tax powers (the legal competence to create taxes and their main elements); ii) Transfers or grants from the central government to lower levels in order to cope with either vertical or horizontal imbalances; iii) The borrowing capacity[5] of the different layers and the respective legal conditions and budget constraints.

The imposition of budget constraints to lower-level governments has in principle to calibrate autonomy and responsibility, in also reflecting the way fiscal and budgetary powers are distributed between different layers of government as well as reflecting the degree of financial decentralization (weak or strong) constitutionally accepted in a certain country. The definition of budget constraints (and the way powers are distributed within this matter) in turn involves either ex ante or ex post mechanisms. Ex ante mechanisms are related to the definition of fiscal rules, which may rely on different budgetary aggregates, e.g. budget balance, debt, expenditure, revenue. It should be noted that these fiscal rules can be self-imposed by lower-level governments on the grounds of full financial autonomy (decentralization of fiscal rules) or be hetero-imposed by the central government, thereby tightening lower-level government hands even further (centralization of fiscal rules). Ex post mechanisms are in turn related to the admission or prohibition of a bailout, that is, to know whether the central government can or cannot act as the 'guarantor of last resource' for lower-level governments. Considering different solutions across the world, one can draw up the following matrix, combining the abovementioned ex ante and ex post mechanisms (Figure 1).

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4 See Shah (1991) for a snapshot of Fiscal Federalism theory. See Cabral (2021a) for details on the transposition of fiscal federalism normative prescriptions to the EU, identifying general and specific limitations for such a transposition.

5 I use the expression 'borrowing capacity' in a *lato sensu* to include not only the strict capacity to contract loans, but also for other forms of public debt issuance, including the issuance of bonds.

Figure 1 – Budget constraints and the distribution of powers: a matrix of ex ante and ex post mechanisms

	Bailout	Bail-in
Centralization of fiscal rules	Germany (the ruling on the 'Bremen and Saarland case')	E(M)U
Decentralization of fiscal rules	U.S. ('too-big-to-fail') e.g. city of New York, State of N.Y., 1975.	U.S. e.g. city of Detroit, State of Michigan, 2013

Source: Created by the author

The most balanced solutions – attempting to combine the right dose of autonomy with that of responsibility – can be found in the second (centralization of fiscal rules; bailout) and forth (decentralization of fiscal rules; bail-in) quadrants of the matrix. Central governments can (re)harden budget constraints of lower-level governments by setting – e.g., at a federal constitutional level – fiscal rules to be imposed on those same governments. To temper such a result, bailout provisions from the central government to lower-level governments can be admitted, therefore (re)softening budget constraints of the latter. Germany's fiscal federalism model tends to fit this profile. As noted by Bury and Feld (2020, p. 20), "the lack of tax autonomy of the Laender, combined with rigid spending obligations, led the Laender to increasingly rely on transfers and borrowing to meet their spending needs and to finance the state governments' individual political purposes. The consequence is high indebtedness in some Laender. This development culminated in a ruling of the Constitutional Court in 1992, according to which the federal level and the other Laender had to bail out the most highly indebted Laender Bremen and Saarland".

In the 4th quadrant of the matrix is the situation where a high level of decentralization of fiscal rules is balanced by a no-bailout commitment (expressed or implicit) by the federal government vis-à-vis the states and/or respective local governments – that is, low level government autonomy and flexibility in managing

their fiscal and budgetary policies are balanced with their own full responsibility when dealing with the effects of that same flexibility (bail-in). This is typically the US case, where "virtually all states operate under some form of balanced budget rule enacted in state laws or enshrined in the states' constitutions" (Laubach, 2005, p. 12). However, on a few occasions, such a commitment may not hold. The most notable case happened in 1975 when, faced with New York City's imminent bankruptcy, President Ford opted for a federal bailout, despite his initial and publicly announced refusal to do so. New York is New York, and so the 'too-big-to-fail' phenomenon eventually prevailed. Budget constraints were doubly softened through the abnormal and one-off combination of bailout with (the maintenance of) decentralized fiscal rules. However, this was an exceptional case in the U.S. fiscal federal experiment.[6]

Also 'abnormal', in this case, because this implies an overblown hardening of budget constraints, is the E(M)U case, where the centralization of fiscal rules (curtailing member states' flexibility)[7] is underscored by the legal prohibition on any bailout from the centre (cf. Article 125/1 of the Treaty on the Functioning of the EU – TFEU).

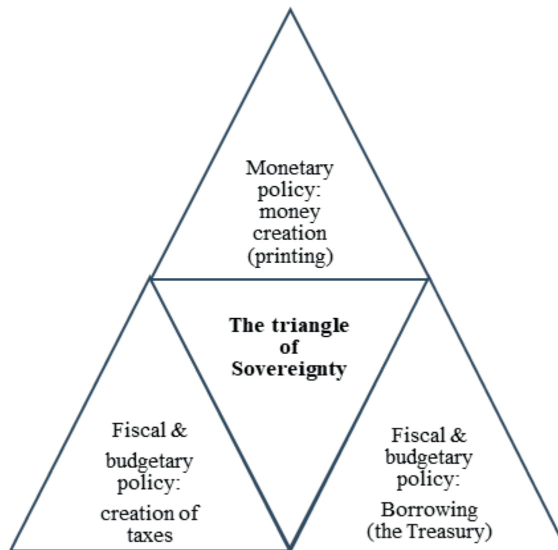
6 Recall the different solution adopted in the case of the more recent Detroit bankruptcy (2013), where a bail-in prevailed. More dramatic was the case of Puerto Rico (a U.S. territory with a specific status), whose bankruptcy was declared in 2017 after years of economic crisis aggravated by natural disasters (e.g. hurricane 'Maria'). As a territory, Puerto Rico's options were limited from the beginning. It could not receive assistance from the International Monetary Fund, like insolvent countries such as Greece have, and it was constitutionally ineligible for bankruptcy protections against creditor claims during the debt restructuring process. Only in 2022, a federal judge approved a final restructuring plan, paving the way for the island to escape bankruptcy and resume making payments to creditors. See information here: https://www.cfr.org/backgrounder/puerto-rico-us-territory-crisis.

7 The legal basis for centralized fiscal rules is, together with the TFEU (Articles 121 and 136), the Stability and Growth Pact, SGP, adopted in 1997, both in its preventive and correctives arms (respectively, Council Regulations (EC) 1466/97, of 7 of July 1997 and 1467/97, same date). The current set of fiscal rules (including the European Semester) comes from the SGP's revision in 2005 and reinforced with the 2011 (the so-called legislative 'Six Pack') and 2013 ('Two Pack') reforms, and also with the adoption of the Treaty on Stability, Coordination and Governance of the EMU in 2012. The rules are: the nominal balance budget rule (with the deficit limit of 3 per cent of GDP); the debt rule (with a limit of 60 per cent of GDP); the structural balance rule to be reached through the 'Medium-Term Objective' (set for each member state); and the expenditure benchmark. Fiscal rules were suspended in 2020 (activation of the SGP's general escape clause) to allow governments to better address the effects of the pandemic. The suspension was maintained in the aftermath of invasion of Ukraine, during 2022 and 2023, to be lifted in 2024. Meanwhile, the political negotiation around the new E(M)U economic and fiscal framework (including the revision of these fiscal rules) is about to start after Commission's legislative package proposal, to be mentioned further on.

c) The personification of sovereignty: the unifying role of the central government

Indeed, there are three main financial powers (or privileges) that embody the very notion of sovereignty (the sovereign – the central government – as the representative of the people): on the monetary policy side, the power to create money (e.g. the printing of money); on the fiscal and/or budgetary side, the capacity both to create taxes and to borrow (*lato sensu*) – indeed, the central government is the main legal centre of debt issuance in a country, both through bonds and loans; finally, the 'treasury' is the central debt agency of the sovereign (Figure 2).

Figure 2 – The triangle of sovereignty



Source: Created by the author

As a result of the allocation of such sovereign powers to a single, same entity – the central government – the interactions between monetary and fiscal/budgetary policies can be seen as 'natural'. Even when the principle of the independence of the central bank holds, consubstantiated in the refusal of fiscal dominance, at least two connected vessels can be identified between the central government and 'its' central bank. Interestingly, the massive engagement in quantitative easing (QE),

after the Global Financial Crisis (GFC), by various central banks across the world has made these vessels even more noteworthy. Firstly, it should be recalled that the central bank is usually the bank of the sovereign and it is the source of a seminal revenue for the sovereign – the seigniorage revenue – which is linked to the sovereign power to print money. QE has created a new source of seigniorage[8] and of central banks' dividends (related to the proceeds of sovereign bonds held by the latter) to be returned to the government as interest revenue (De Grauwe, 2021). Secondly, bearing in mind the consolidation of all entities across the public sector, including the central bank, the situation where the latter acts as creditor for the government has to be computed (Arslanalp *et al.* 2020, p. 63), which is precisely what happens in the case of QE. The impact for the balance-sheet of the entire public sector has to be considered, also acknowledging the management of the debt held by the central bank either when it holds sovereign bonds to maturity (reinvesting this or not) or when it decides to sell this back beforehand (notably in the context of a normalization of monetary policy, the so-called quantitative tightening). In either case, QE can be considered from the outset a form of debt-cancellation (debt monetization?), at least from an economic point of view (De Grauwe, 2021).

3. The state-mimicking method: key features and its implication for E(M)U budgetary union

As with (standard) states, the E(M)U is divided into three layers of political decision-making: the central government or upper level (corresponding to the E(M)U), the intermediate level (member states) and the lower level (regions). However, unlike those states, the E(M)U is marked by disjointed sovereignties, in the sense that the location of the abovementioned sovereign powers is not a single and unique entity (that in a standard manner would be the E(M)U as the top level), but rather they are sliced and distributed into two different layers: whereas monetary policy (and the power to print money) was assigned to EMU (personifying the sovereign here), fiscal and budgetary powers, including tax creation and the treasury function, are assigned to member states, which here actually maintain full sovereignty. Interestingly, as a response to such incomplete sovereignty, the E(M)

8 QE implies the expansion of the asset side of the central banks' balance sheet, but it also implies money creation, now through the creation of banks' reserves in the central bank (the liability side of the latter's balance sheet).

U has developed a heterodox and pragmatic policy-oriented approach or method that can be described as a 'state-mimicking' method (Cabral, 2022).

On the internal front,[9] this approach is marked by the attempt to mimic budgetary instruments of the sovereign state, also affecting the distribution of powers/competences within the fiscal/budgetary field (between the E(M)U and member states) and affecting the very nature of sovereignty allocated to the central government (EMU) in the monetary field and in its link with the fiscal/budgetary domain. Therefore, the 'state-mimicking' method introduces important adaptations within the three previously described predicates of a budgetary union:

a) In budgetary instruments and institutions

The state-mimicking method is indeed implemented through a heterodox legal and institutional setup and through innovative budgetary prototypes that intend, in turn, to imitate conventional budgetary aggregates (e.g. revenues) and/or the budget as a whole. It should be noted that such an approach has been implicitly forged on the basis of the creation of the European Economic Community budget (which preceded the EU budget) and which was developed over the years. It definitely gained a new momentum after the GFC with the E(M)U reforming proposals in this regard (Table 2, to be compared with Table 1).

9 The state-mimicking method also operates on the external front with the attempt to bypass remaining (i) national balance of payments and (ii) fragmented financial markets, using 'proxies' of a non-differentiated territory – respectively through (i) the Macroeconomic Imbalances Procedure and (ii) the building-up of a Capital Market Union, both facing logical caveats (see also, for details, Cabral, 2022).

Table 2 – The state-mimicking method internally

	Before GFC until the present (current framework)	**After GFC (reforming proposals)**
Innovative budgetary prototypes	Instead of 'true' tax revenues, the EU budget is financed by 'own resources', which are actually transfers from Members States (MS) to that budget according to a 'call rate'.[10] Instead of direct expenses paid to European citizens including current expenditures (e.g. unemployment benefits and other social benefits), the EU budget relies on transfers to other subsectors (MS and its regions) mostly as capital expenditures (with small exceptions, e.g. EU personnel expenses). The EU budget, besides its modest size, is not a 'citizens' budget', but rather a 'public sector-oriented transfer budget'.[11]	Instead of a central budget fulfilling a stabilizing role, the proposal to create a 'fiscal capacity', a sort of 'micro-budget', would work as an insurance device or a risk-sharing mechanism aiming to respond to asymmetric shocks (Cabral 2021a). Instead of a Treasury, where debt issuance is made 'in the name and on behalf' of the sovereign central state, proposals create debt pooling instruments (while of a different sort) – e.g. Eurobonds, debt securitization instruments, Coronabonds – whereby debt remains MS debt and not EU debt.
Heterodox legal and institutional setup	The atypical EU budget approval, with a 'two-headed' competence not in a standard bicameral fashion (with the second chamber representing states), instead reflecting the compromise between supranational (the competence of the Parliament) and intergovernmental (the competence of the Council) tensions.	

Source: Created by the author

10 Therefore, EU own resources are not true tax revenues – and they are not even described as such – levied directly on individual taxpayers (either persons or corporations), apart from the so-called 'traditional own resources' levied on an identifiable taxable operation. As noted in this regard by Cipriani (2014, p. 7), the concept of 'own resources' should have meant a shift of sovereignty from member states to the EU institutions, allowing the EU to exert direct taxation power over EU citizens. Ultimately, a tax directly borne by EU citizens should not even be registered in national MS budgets. However, this was not the case: most member states still describe their own contribution as a transfer to the EU budget.

11 As explained by Begg (2012), the central government performs the macro-stabilizing role, partly through the action of automatic stabilizers which arise through the interaction of public expenditure and taxation – tending to offset any fall in demand – and partly through discretionary changes in public expenditures or tax rates. The simple existence of a central budget allows for stabilization mechanisms to operate whenever adverse shocks occur. In the case of the EU budget, on the contrary, the type of tax-based resources and expenditures are not designed to pursuit interindividual redistributive functions and through that to pursue any kind of stabilizer goal.

b) Distribution of powers/competences within the budgetary field: the case of budget constraints

In EMU, as seen before, we find an overblown, dual-centralization of ex ante and ex post mechanisms used to harden member state budget constraints (fiscal rules set by the central level combined with the legal prohibition of a bailout).[12] The conventional rationale for this dual-centred solution relies on the need to prevent negative externalities driven from a member state's lax fiscal policy and borne by the other members of the currency area (Eichengreen, 1997). However, one can also attribute such a solution precisely to the incomplete nature of European monetary union (De Grauwe, 2020), thereby preventing possible damages arising from such a lopsided sovereignty.

c) In the exercise (personification) of sovereignty: decentralized monetary sovereignty and its implication for the nexus with fiscal/budgetary policies

Interestingly, the opposite occurs in the monetary policy domain, in its essence a centralized policy at the EMU level. In this case, important ingredients of the decentralization of monetary policy in favour of national central banks (NCBs) remain (Gros, 2017), once again as a means to bypass the disjointedness between monetary and budgetary/fiscal sovereignties. Consequently, QE has definitely expanded the balance sheet of NCBs even more than it has expanded the ECB's and dividends related to the purchase of sovereign debt are mostly assigned to NCBs and eventually distributed to the respective governments as public revenues.

QE has shown new forms of interaction between monetary and fiscal policies, given the mutually positive externalities verified – expansionary monetary policy created space for fiscal policy by reducing borrowing costs and fiscal policy created space for monetary policy, providing a fiscal backstop and therefore internalizing the risks and costs of an ultra-low interest rate environment (Bartsch *et al.* 2020, p. 56). Fiscal policy has thus protected the central bank from having to run with negative capital in the event it incurred large portfolio losses from its monetary operations (e.g. in the case of the normalization of monetary policy), hence preserving its independence and credibility (Bartsch *et al.* 2020, p. 55). However, if this was (is) true, it should also be highlighted that such risk-sharing tended (tends) to be constrained since such a fiscal backstop provided to NCBs has mostly been

12 This is interesting, because although fiscal policy remains a national haven in the EMU scenario, it is conditioned by these two centralized mechanisms of hard budget constraints.

provided by the national fiscal authorities of each of the MS and not by a single Treasury of the Union, as one would expect to find in a centralized monetary policy (Cabral, 2021b). It should be noted, in turn, that debt purchased by the Eurosystem is still debt belonging to MS (still the sovereigns in the borrowing domain) and not central government debt, which is the E(M)U itself. Therefore, unlike what is found in currency unions with complete fiscal sovereignty (both in tax and borrowing areas), the mutually positive externalities in the interaction between monetary and fiscal policies are not fully-fledged and the risk-sharing effect is necessarily more limited. Indeed, as noted by Kyriakopolou and Ortlieb (2021), while QE has created some risk-sharing as reflected in the ECB's holdings and NCB supranational debt holdings, the same QE has created a potential sovereign-NCB nexus, a national bias that can become more dangerous the riskier the (sovereign) assets involved are.

4. Conclusion

The EU is the product of a singular combination of intergovernmental, domestic, (neo)functionalist and 'expertocratic' approaches (see Heipertz and Verdun, 2010). It has been marked over the years by peculiar and pragmatic-driven institutional and legal features, seeking to balance the right doses of centralizing and decentralizing. The state-mimicking method is indeed an expression of such a pragmatic approach.

In the current juncture – post-pandemic and during an energy/inflationary crisis – the management of those opposite forces can already be anticipated, in particular in the fiscal/budgetary field. On the one hand, the COVID-19 crisis management has opened the 'Pandora's box' of the centralization of competences in the borrowing field, as a way to finance the new Recovery and Resilience Facility (RRF) with the European Union being assigned (on behalf of the EU) the power to issue debt (bonds and short-term securities). The repayment of such debt is to be ensured through new EU own resources, which can ultimately be seen as a path for future EU tax sovereignty.[13] In turn, the possible new European Com-

13 As noted by Schelkle (2021), the RRF gave the Commission the power to tax for the first time. See also Cabral (2021b) for an analysis of the transition from a purely national borrowing model to the antechamber of a fiscal federal solution. Moreover, the design of the new generation of own resources, related to climate goals and the digital transition – e.g. the non-recycled plastic waste based contribution, the EU Emission trade-based own resources, the Carbon Border Adjustment Mechanism, and the Digital Levy – points to a greater proximity to true tax revenues, since levied on identifiable taxable operations and individual taxpayers (to further details, see Bongardt and Torres, 2022b).

mission competences to address the effects of the war in Ukraine – e.g. energy, defence – will most likely justify the issuance of new European bonds. These two recent developments seem to have transformed the E(M)U into a new centre of sovereignty on the fiscal/budgetary front, with respect to borrowing and tax competences. Consequently, a more complete match between monetary and fiscal European sovereignties can be anticipated and therefore a new type of interaction between these two policies. Eventually, the debt purchased by the ECB under a future form of QE could now be 'true' European denominated debt, allowing for the full mutual backstop between these two policies, as usually seen in a state with complete sovereignty.

On the other hand, the proposals made by the Commission regarding "new economic governance rules"[14] (implying a structural revision of the SGP) tend to point to a more convincing national appropriation of fiscal rules, which means a possible decentralization of ex ante mechanisms for hard budget constraints (including fiscal rules and medium-term fiscal consolidation plans). Once again, the policy challenge depends on balancing centralization and decentralization tendencies in the right doses and in a pragmatic fashion even from a political point of view.

All in all, the E(M)U, within its hybrid identity – an entity in-between a state and an intergovernmental organization – has learnt early on to function well, using a certain level of creativity and innovation in the various spheres of its action and competences. As an example, the 'Alternative Budgetary Union' built over the years and laid down in innovative budgetary prototypes and peculiar institutional features, while imperfect, has so far been suitable in sustaining the E(M)U. Why not continue to do so in the future?

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CHAPTER 24

The role of European public goods in a central fiscal capacity

Marco Buti and Marcello Messori

1. Introduction: From NextGenerationEU to a permanent Central Fiscal Capacity

When the pandemic hit the world in spring 2020, the European Union (EU) took unprecedented measures which crossed 'deep red' lines. NextGenerationEU (NGEU) and its main programme, the Recovery and Resilience Facility (RRF), were hailed by some as representing a "Hamiltonian moment" for the EU (Olaf Scholz). The policy discussion has since mainly focused on the challenges in delivering the reform and investment commitments under the RRF, the implications for the monetary-fiscal policy mix, and the possible 'vertical coordination' of a temporary centralised fiscal capacity and national fiscal policies in an economic environment where the risk of stagflation have come prominently to the fore.

In the last years several academic papers have called for the setting up of a permanent Central Fiscal Capacity (CFC) at the EU or Euro Area (EA) level, as a successor of NGEU that will expire in 2026 (see, e.g. Beetsma et al., 2021; Maduro et

al., 2021; Romanelli et al., 2022). During the public consultation on the review of the EU economic governance by the Commission, the European Central Bank (ECB), IMF and OECD have made similar proposals.

In a previous paper (Buti and Messori, 2021), we outlined that – in principle – a CFC could focus on three functions: cyclical stabilisation, support for the implementation of national structural reforms and investment, and the supply of European Public Goods (EPGs). Table 1 sketches out the main goals, the operational targets, and the key features of these three options.

Table 1 – Central fiscal capacity: three options

Central fiscal capacity **Policy Goal**	**Stabilisation function**	**Reform and investment support**	**Supply of EPGs**
Main goals	Ensure a balanced policy mix in case of large shocks	Enhancea resilience and sustainability	Promote the double transition and security
Operational targets	Support of domestic demand	Boost reforms and investment for growth and adjustment	Increase centrally financed long-term investment
Key features	*EA dimension of stabilisation*	*Trust building as condition for vertical coordination*	*Foster open strategic autonomy*

Source: authors' elaborations

Creating a central stabilisation capacity would be the most rational choice for the completion of the EA's economic governance framework. It would complement the response of the ECB and of national fiscal policies to symmetric and country-specific demand shocks. The most cumbersome political issue is the so-called 'moral hazard': if the national governments anticipated the support by a central fiscal instrument in case of negative shocks, they would have a lower incentive to create national fiscal room for manoeuvre in periods of strong growth. This would lead to a ratcheting up of public debt and would increase the risk of that form of fiscal dominance that characterised the EA in the period 2014-2018.

The observed lack of fiscal adjustments during 'good times' strengthened this argument (see e.g., European Commission, 2019). Hence, the political feasibility of the first option will remain untested unless there is a significant improvement in cooperation (and trust) between the EU's member states.

The second option, that is, setting up conditional transfers to the EU member states to support national reforms and investment, would build on NGEU arrangements and be akin to *de facto* reviving the proposal of 'Contractual Arrangements' made by Herman van Rompuy in mid-2013 when he was at the helm of the European Council. The proposal was rejected by the majority of the EU's member states at the end of that same year: the Northern countries refused permanent transfers whilst the Southern countries resented an intrusive role of the European authorities in their domestic policy choices. Under the pressure of the pandemic shock, NGEU overcame those objections by its temporary nature.

A third option is to use the CFC to step up the supply of EPGs. Whilst NGEU represented a breakthrough and a fundamental institutional innovation, its 'European added value' in its final design was lower than in the initial proposal by the Commission. As we pointed out in an earlier paper (Buti and Messori, 2020; see also: Pisani Ferry, 2020), in the agreement on NGEU reached at the European Council in July 2020, the part of the RRF that was devoted to European programmes was substantially reduced in favour of transfers to member states. Conversely, the supply of EPGs (as dubbed by Buti and Papaconstantinou, 2022) such as a European security system, the joint public procurement of vaccines, investment in hydrogen energy, the construction of a European telecommunication network, the joint production of semiconductors cannot be satisfied by the simple aggregation of national public goods.

2. A Central Fiscal Capacity in the response to shocks

The three options for a CFC have different implications in the response to shocks. In a recent paper (see Buti and Messori, 2022), we analyse how a CFC could help achieve policy efficiency, that is, selecting the policy mix with the lowest costs in terms of changes in monetary policy and national fiscal policies. We build a stylised aggregate demand-aggregate supply model where the size of a CFC depends on the intensity of shocks and the degree of compliance with common fiscal rules. We show that a CFC helps rebalancing the combination of the common monetary

policy and national fiscal policies in absence of shocks. Instead, in response to shocks, the CFC's benefits depend on the typology of shocks as well as on the specific option chosen among the three illustrated in Table 1.

Under negative demand shocks, a central fiscal stabilisation capacity improves policy efficiency by reducing the pressure on national fiscal policies – hence favouring compliance with the common fiscal rules – and helping monetary policy to escape the Zero Lower Bound (ZLB) / Effective Lower Bound (ELB). Under negative supply shocks, policy efficiency is instead improved by a CFC focusing on supporting reform and investment or delivering 'pure' public goods. By boosting potential output, these two options of CFC help stem the need for monetary restrictions and hence lessen the trade-off between growth and inflation. We argue in the paper that, between the option of supporting national reforms and supplying 'pure' public goods, the latter is likely to be more effective due to its direct impact on potential output.

Our analysis helps assess the efficiency of the EU's response to the pandemic. The introduction of NGEU as a temporary fiscal tool contributed to achieving a more effective response to the COVID crisis compared to the response to the global financial crisis and the EA crisis. To help monetary policy escape the ELB, fiscal policy had to become expansionary. However, if only national fiscal policy had been available, the appropriate national fiscal stance would have required a stronger boost and hence an even larger violation of the rules of the Stability and Growth Pact. This national fiscal stance would have also increased the pressure on the ECB, thereby accentuating the risk of fiscal dominance in the EU.

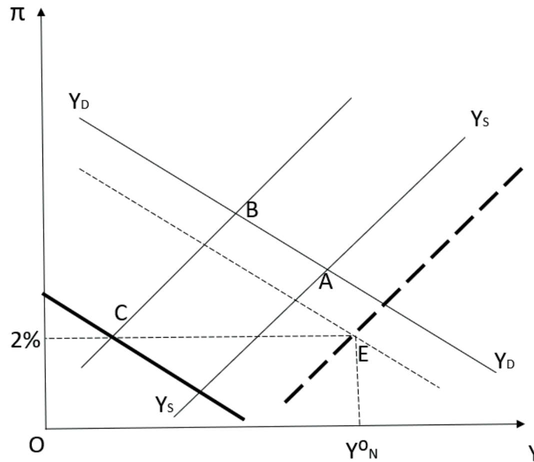
3. Addressing the risk of stagflation

The EU policy response to the stagflationary shock brought about by the legacy of the pandemic and Russia's invasion of Ukraine is still in the making. The rise in the inflation rate has pushed the ECB to discontinue its unconventional net purchases of financial assets, to reduce its amount of refinancing, and to move out of the negative policy interest rates territory. Moreover, the ECB has announced that the sequence of rises in its rates on the main refinancing operations (currently at 4 per cent) has not been concluded by the decisions taken in mid-June 2023. On the fiscal side, it will become necessary to bring the bourgeoning national public debts under control, particularly in the most fragile EA member states deprived of the ECB's safety net. This necessary retrenchment will lead to a gradual reduction in the national structural deficits. The resulting policy mix is needed to put the

inflation rate under control; however, it also increases the risk of recession in the EA. This trade off would be lessened if the EU were to agree on a recurring extension and a strengthening of the CFC. Given the goal of taming inflation, the centralised fiscal intervention should be designed so as to boost the supply side of the economy in order to counter the negative supply shock that was the trigger of excessive inflation rates from mid-2021 to the first half of 2022. This is equivalent to stating that the focus should be on the second and third form of CFC, as stressed in Table 1, and specifically on the CFC as production of a specific form of EPGs.

The negative evolution of the inflationary process in the EA until the last months of 2022 has led to a gradual strengthening of the monetary policy restrictions. The ECB complemented the end of its net asset purchase programmes (March – June 2022) by worsening the re-financing conditions towards the banking sector and by increasing the policy interest rates by 400 basis points in the meetings from July 2022 to June 2023. These measures are justified by the ECB's mandate which is centred on price stability. However, the trigger of the EA's high price dynamics should be found in the supply-side bottlenecks caused by the unexpected persistence of the pandemic breaks in the global value chains and by the dramatic impact of Russia's war in Ukraine on the price of energy, other raw materials, and food. The increases in aggregate demand, triggered by government support for firms and households during the pandemic and recorded from spring 2021 to mid-2022 in most member states, have only strengthened the inflationary pressure caused by the fall in aggregate supply. Currently, even if the excessive price dynamics are widespread, the main root of the EA's inflation will remain supply shocks. Hence, the ECB faces a dilemma. Being unable to directly handle the supply-side problems, the ECB's monetary tools can only adapt aggregate demand to the constrained aggregate supply, so that its control of inflation inevitably increases the risk of a slowdown in the EA's economy. Figure 1 offers a stylised representation of this dilemma.

Figure 1 – Addressing stagflation



In the EA, the average market inflation rate overcame the target of 2 per cent in July 2021. Hence, mid-2021 the EA's equilibrium can be represented by point A in the figure: the current inflation rate is just above 2 per cent. However, in the last months of 2021 and in the first half of 2022, the combination of the old and persistent supply bottlenecks and the unexpected shock from the war shifted the aggregate supply curve leftward and led to point B, characterised by price increases that are incompatible with the ECB's target. Hence, the equalisation of demand and supply based on an upward shift along the aggregate demand curve requires further adjustments in the short term too. Thus, the reproduction of the ECB's restrictive monetary policy and its binding impact on national fiscal policies could lead to the shifted demand curve and to a new equalisation of aggregate demand and supply in point C.

Point C would satisfy an inflation target of 2 per cent (see again Figure 1) but at the cost of a large negative decrease in the activity level. However, the ECB's current monetary policy is not so drastically restrictive. Hence, it is likely that the EA's macroeconomic equilibrium in mid-2023 will be set at some of the intermediate points belonging to the segment *BC*. In these points the EA's economy would be characterised by a stagflation. Our figure shows that a different equilibrium is possible: point E would be the result of a rightward shift in the aggregate supply curve. This counter-shift and the consequent equilibrium can be obtained, in the short-medium term, through the strengthening of the supply of EPGs fo-

cussing on increasing aggregate supply without immediately stimulating aggregate demand.

Examples of such EPGs are a common investment in the field of energy, the creation of a European hydrogen bank, EU rules on critical raw materials, and a European sovereign fund to support trans-European projects pursuing strategic innovation. These proposals would facilitate the emergence of tangible and intangible networks for EU's most innovative services, which today are often constrained within national borders, thereby not exploiting economies of scale and leading to duplication of costs. Such EPGs could be produced by beefing up existing programmes, such as the "Important Projects of Common European Interest" (IPCEI), the "Joint Undertaking Key Digital Technologies" (KDT), and the "European Digital Infrastructure Consortium" (EDIC). If well designed, such projects could also help the EU to regain greater strategic autonomy in international markets.

4. Conclusion

Two overarching policy implications emerge from our analysis. First, given the current stagflationary risks, priority should be given to a central fiscal action that has positive supply side effects. Second, the appropriate size and the effective form of the CFC need to be calibrated according to the different circumstances of the EU economy (typology of the exogenous shocks, cyclical phase, etc.). This can only be achieved by a system of economic governance with a strong central power, namely a European Minister of the Economy in charge of 'vertical coordination' of national budgets and the CFC in its various forms. The establishment of a European Minister for the Economy was put forward by the Commission in December 2017 as part of a proposed reform of the EA's institutional setting (see European Commission, 2017). However, this attempt was unsuccessful.

The above would imply a radical overhaul of the European system of economic governance. We realise that this is clearly a tall order and may be out of reach in the present circumstances. However, as the establishment of NGEU shows, whilst the EU continues to operate in a second-best environment, its 'political capital' is elastic, especially in periods of deep uncertainty such as the present one. In such circumstances, setting the political and institutional ambitions high is the prudent strategy to pursue.

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PART VI

THE EXTERNAL AND SECURITY DIMENSIONS

CHAPTER 25

Russia's war and EU peace: The role of the Russian 'other' in European integration

Hubert Zimmermann

1. Introduction

Vladimir Putin's war against Ukraine has been credited for attaining many goals that are the opposite of what the Russian president actually wanted to achieve with his murderous invasion. Among them are the creation of a stable Ukrainian identity which for decades, maybe centuries, will be firmly based on memories of suffering and resistance against Russia; the strengthening of NATO by instilling it with a new sense of purpose and setting in motion a new round of enlargement; the (though probably temporary) re-orientation of the United States towards Europe; the planned massive strengthening of European military capabilities because territorial defence became once again a core task of European states after decades of cashing in on the peace dividend; the abandonment of Germany's 'change through trade' policy which gave Moscow both huge economic benefits and valuable leverage over German foreign policy. The list could go on. One

further unintended consequence of the war against Ukraine might be its effect on European integration. Already three days after the invasion, German chancellor Olaf Scholz, in his famous 'Zeitenwende' speech paraphrased John F. Kennedy when he said that now was the time to stop asking what the EU could do for one's country but rather to act according to what was in the best interest of the Union and to strengthen European sovereignty (Bundesregierung, 2022: 17). He elaborated on this argument in a programmatic speech five months later at Karls-University Prague. There he painted a clear dichotomy between neo-imperial autocracy of Putin's Russia and the EU as a pluralist peace project representing freedom, democracy and human dignity. Faced with such a serious threat, he called on the EU to develop its sovereignty, to enlarge its membership and to deepen its cooperation across areas such as defence, energy policy and migration. Citing Russia's attempt to impose autocracy in its sphere of influence, he called for action "if not now, then when?" (Bundesregierung, 2022: 49). This passionate call for a deepening and widening of European integration was echoed by numerous other European politicians. In his address to the nation of 2 March 2022, French president Emmanuel Macron, repeating his earlier calls for a sovereign Europe, said that Europe now "must become a power that is both more independent and more sovereign" (Macron, 2022). East European politicians in particular have called on Europe to leverage its economic power and vastly increase its military capabilities faced as they are by an evil empire in the form of Russia. In their Versailles declaration of 11 March 2022, EU leaders pledged, inter alia, to invest in joint defence projects and technologies, create a European defence industrial base and seek synergies in procurement and development (EU Council, 2022). After a decade of crises that created a deep sense of malaise in the EU, the Russian war against Ukraine seems to have galvanized member states to new activity and opened the possibility of another pivotal moment in European integration. Both scholars and the press have speculated on such a possibility (Wunderlich, 2022; Bergmann et.al., 2022; de Gruyter, 2023).

This renewed emphasis on the EU poses the question whether such a ubiquitous invocation of an external threat requiring common action will manage to create a lasting sense of purpose overcoming deep-seated divergences. Possibly, this would be not the first time that European integration received a push because of the existence of a fundamental menace from the outside. Paul-Henri Spaak, the famous Belgian post-war statesman and secretary general of NATO allegedly quipped that the real father of Europe was Joseph Stalin. Already in 1946, Konrad Adenauer, later first German chancellor from 1949 to 1963 wrote to an American friend that in his opinion "Asia stood at the river Elbe". Only a united

Europe under French and British leadership might be able to stop "the further spiritual and territorial advance of Asia" (Adenauer, 1946). Such warnings also referred to other external influences. Hannah Arendt in her 1958 essay about Europa and America claimed that "each nationalism…begins with a real or fabricated common enemy…the current image of America in Europe may well become the beginning of a new pan-European nationalism" (Arendt, 1958). This idea has been pronounced also by conservative writers and politicians (such as General de Gaulle), echoing pre-World War II fears about cultural decadence resulting from the consumer culture sloshing across the ocean.

What these arguments have in common is the invocation of an external threatening 'Other' that requires a closing of the ranks, and thus enables the overcoming of constraints to collective action that would not be possible in 'normal' times. Such arguments are the subject of a by now substantial literature in the social sciences which deals with processes of identity-building in international politics and tries to explain extra-ordinary policies with discursive 'Othering'. A focus on such a constructivist explanation of European integration can supplement traditional neo-functionalist arguments that see integration as a response to collective action problems which were exposed by crisis and disfunction. This contribution refers to these literatures and discusses whether the attack on Ukraine has set into motion a period of renewed dynamism in European integration.

2. State-building, external threats and the role of Russia in European integration

So-called bellicist theories of state-building stressed the role of war in the creation of states since a long time (Tilly, 1992). They argue that wars create a functional need for resource extraction and effective governance that builds up state capacity. Some argue that not only war, but also intense rivalry has the potential to act as a federating force (Diehl and Goertz, 2001). Riker (1996) even maintained that federal state-building can only happen when the constituent units are faced with an external enemy. In an article published three months after the Russian attack on Ukraine, EU scholars Daniel Kelemen and Kate McNamara suggested that this might be just such a pivotal moment for European unity (Kelemen and McNamara 2022). They argue that the absence of military exigencies and the focus on market integration account for the uneven political development of the Union. As the quotes reported above indicate, external threats might have played a larger role than acknowledged in political science theories of integration process-

es, giving the current onslaught of Russia against Europe's military and economic security and against its core values added significance.

In fact, scholars such as Iver B. Neumann have pointed out that Russia since a long time has defined itself against Europe and vice-versa. In 19th century Europe, the image of a barbaric Russia sitting at the outskirts of Europe and constituting a looming threat was widespread (Neumann, 1998: 41-42). It played a similar though more ambiguous role than the Ottoman empire which since centuries had created appeals for a Christian unity of European peoples resisting the invading Muslim forces. Various European nations experienced episodes of Russophobia in which the threat of Russia to European civilization was invoked to justify extra-ordinary policies. Scholars also have argued that the idea of the West as a civilizational community emerged from debates about whether Russia could be seen as a European power (Heller, 2010).

Such dichotomies between civilized and barbarian societies, Europe and Asia, democratic and totalitarian systems formed habitual elements in the public discourse of the Cold War years, at least in most of the ruling elites which excludes the leftist opposition parties which rather saw the Americans as the barbarians at the gate. The identification of Communist parties as Soviet fifth column bolstered this image of Russia as a pervasive threat existing not only externally, but also internally. After the fall of the Berlin Wall, the Soviet (or Russian) menace disappeared quickly and thus also its role as an external uniting force. Instead, Russia was now seen as being on its way towards Europe, and therefore as a potential part of Europe as soon as it had implemented and internalised the core norms of democratic governance (Neumann, 1998). The reporting about the Orange Revolution, the Chechen War and the protests on the Maidan square, however, once again contrasted the Europeanness of the democratic intentions of Ukraine with the despotism of Russia. Thus, already before the annexation of Crimea in 2014 and the full-scale war in 2022 Russia had contributed to the emergence of the EU as coherent actor by figuring both as territorial and temporary 'Other' (Prozorov, 2009: 156).

In fact, there is a substantial literature on the role of such exclusive identity constructions in enabling exceptional policies. In a widely cited study of American foreign policy, David Campbell, in one of the foundational texts of so-called post-structuralist international relations (IR) theory, has analysed how the construction of an antagonistic Soviet Union as implacable enemy with foreign and threatening characteristics bolstered the 'national security state' in the United States (Campbell, 1992). Building on a well-known psychological literature which shows

how threat perceptions increase group cohesion, such studies argue that the perception of having to face a serious enemy results not only in a rational attempt at power-maximisation through the closing of ranks but also shapes inter-subjective feelings of belonging and identity. IR scholars have used the concept of ontological security to describe the constant search of states for stable identities, predictability, continuity and order (Mitzen, 2016; Steele, 2008). Such a search for a stable self always is relational and therefore it needs a significant 'Other' which represents the threat. Identity-based constructions, these authors argue, lay at the roots of many antagonistic policies. It is clearly visible, for example, in the Russian official and public discourse that clearly is mired in a never-ending identity crisis (Hansen Flemming, 2016).

For the EU, too, research has indicated that such antagonistic identity policies can be a factor in creating community, for instance with the reference to the threat by migrants or terrorism (Mitzen, 2018). Other scholars have pointed out that the way in which Europe constructed its own identity worked primarily with reference to its own troubled past (Waever, 1998). The invocation of the endless European wars, the attendant atrocities, the histories of dictatorial rule in the East and West and the suffering imposed on European and other peoples as well served as a constant reminder of the importance of the European Union. The growing politicization of European integration, however, has shown that such arguments progressively lost their persuasiveness. This is where the new Russian threat comes into play.

3. The War against Ukraine and the future European integration

Very soon after the invasion, the worst fears and suspicions regarding the conduct of Soviet forces were confirmed. The massacres discovered in Bucha and other liberated towns were followed by an unending stream of reports about Russian war crimes, from the indiscriminate shelling of Ukrainian towns and villages to the widespread ecological destruction caused by the blowing up of the Kakhovka dam. Internet sources now frequently call all Russians simply 'orks'. In addition, the continuous threats by Russian politicians, including Putin, and by commentators on Russian state media of attacking the countries supporting Ukraine by military means, up to nuclear annihilation, served as a clear reminder that the times are over when Europe had to worry mainly about domestic threats such as terrorism while it was secure from any conceivable armed attack from foreign countries. In

addition, the function of the United States as provider of security that had spared the Europeans during the Cold War the extent of military spending commensurate with their antagonistic relationship to the Communist bloc has been placed in fundamental doubt by the presidency of Donald Trump. All future European defence planning now routinely figures in the uncertainty of the future trajectory of US national security policy and, usually, in the same breath stresses the importance of European cooperation.

How has this impacted support for European integration and the pursuit of common European projects? Based on a study of Eurobarometer data, Gehring (2021) found that already the 2014 annexation of Crimea by Russia led to an increase in European identity in EU member states, to more trust in EU institutions and to increasing support for common policies. Recent polls also showed that support for an integrated European army grew in all EU member states after the February 2022 invasion of Ukraine, and even in Britain (Smith, 2022). In a study based on surveys of students, which was recently published in the Journal of Common Market Studies, Steiner et al. (2023) found that the Russian invasion had produced a rally-around-the-flag effect among the respondents which significantly bolstered their pro-EU stance. Mader et al. (2023), however, caution against to straightforward conclusions from this data. They argue that external threats can either lead to a stronger emphasis on national cohesion, given that Europeans still identify mainly with their nation, or to more support for stronger European defence. In their survey of 25 European countries, though, they found increasing support for European cooperation both among Europhiles and Eurosceptics after the war. According to them (Mader et al., 2023: 17) that is driven less by emotions and identity but rather by the realisation that a clear common interest in deterring Russia suggests more cooperation. Such a functional support might therefore just be a temporary effect. In fact, responding to these arguments, Genschel et al. (2023: 352) recently wrote that any effect of the Russian invasion rather led to a strengthening of national capabilities because of the relative comparative advantage of the national level in responding to the challenges posed by Russian policies. Similarly, Truchlewski et.al (2023) showed that the increasing salience of common policies responding to the situation also breeds increasing polarisation which, over time, undermines support for more common policies. Thus, the war, instead of promoting increasing centralization, rather pushed EU member states towards intergovernmental alliance-building by strengthening defence, energy and fiscal policies. This scepticism is backed up by other analyses, for example Anghel and Jones 2023. Their arguments, however, remain clearly focused on functional gains, as long as clear shifts in identity cannot yet be observed with more accuracy.

4. A Critical juncture for European integration

How does the situation present itself now that the war has been going on for more than a year? Recent polls indicate that sympathy for Ukraine and the perception of Russia as threat has strengthened over the course of the war (Krastev and Leonard, 2023). However, support for EU institutions and a common defence policy in general, while remaining at a high level, has not risen significantly (Eurobarometer 2023). The invasion of February 2022 has stabilised a general pro-European trend, but it has not superseded national allegiances to a substantial extent. As poll after poll shows, significant minorities in all European countries are still opposed to any long-term burden that would result from the elevating of Russia to a threat that requires the mobilisation of combined European forces (see the EP's collection of polls: European Parliament 2023).

In addition, actual policy breakthroughs towards an integrated European security and defence policy have but slightly accelerated. They do not constitute a sea change to the incremental pace that was characterizing this area for more than 60 years. As recent Franco-German disagreements on European defence demonstrated, for example on the German proposal for a European Sky Shield, a real coordinated push towards common European defence is still not visible (Besch, 2023). The EU has not become the focal point to turn to when common defence is considered: it competes with the national level and with NATO, and more often than not is relegated to a second or third rank option. Differences about which option to privilege to what extent have not diminished in the past two years (Wang and Moise 2023). While Putin's War has strengthened European 'we' feelings noticeably which will translate in increased cooperation further down the line, it has not yet (and will hopefully never) achieved the status of existential threat that creates a true European state.

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CHAPTER 26

European digital sovereignty

Daniel Innerarity

1. Introduction: Digital deterritorialization and renationalisation

The emergence and development of the internet has been linked to expectations of deterritorialization, generating in some cases euphoria and in others unease, under the impetus of a cyberlibertarian culture or sparking debate about the most appropriate sphere for its proper regulation. As a global architecture, the internet has challenged political regulation and left little room for state intervention. The text that best expresses the deterritorialization of digital space was John Perry Barlow's (1996) "Declaration of the Independence of Cyberspace", which proclaims the arrival of a world that is everywhere and nowhere, and addresses a very strong message to those who aspire to any form of control: "You have not sovereignty where we gather".

This supposed irrelevance of states and the corresponding fluidification of the principle of territoriality were strongly influenced by the early developments of the internet, when state hierarchy and the principle of territoriality were presented as the opposite of the flexible, diffuse and adaptive constellation of the global digital network. The governance of the internet, in principle, according to its

technological infrastructures, seems to be a typical example of global governance beyond the nation state. Nation states were faced with great technical difficulties when they wanted to intervene with their regulation, which became evident very early on with data protection. The belief in the capacity of decentralised, collective and consensual regulation explained the rejection of the legitimacy of state regulation and foreshadowed the configuration of a new public space that would no longer necessarily correspond to the sphere in which the state monopoly of violence is exercised.

The debate between network and sovereignty, between the logic of connectivity and the logic of hierarchy has been ongoing, not least because the digital world has not taken one direction versus the other, but has resulted from a combination of principles that were assumed to be incompatible, giving rise to a peculiar hybridisation. The historical development of the internet also shows that state frameworks and stimuli have been a very significant factor, which has not taken place outside the legal spaces of states, their regulatory regimes and infrastructures. Classic examples of this are its birth in the American military sector or the public leadership in some innovations from which we users and companies now benefit (Mazzucato, 2013). And the European Union has developed an entire regulation of the digital space, exercising an authority that complements that of its member states and presents itself as a global reference.

Although everything related to the internet seems to challenge the categories of statehood, national boundaries and the logic of territoriality, there are phenomena that speak of a fragmentation and renationalisation, such as the issues of security, data protection and patents or the domain system, while simultaneously another territorial dimension has grown in its increasing *geo*-strategic significance. Furthermore, authoritarian states have deployed the state apparatus to control communication on the internet, providing new instruments for surveillance of the population, while liberal democracies are establishing a so-called "surveillance capitalism" (Zuboff, 2018) with equally disturbing results, even if it is not the state but the market and companies that are doing the surveillance.

Thus, we could conclude the description of this new landscape by stating that, with different procedures and strategies, states have made every effort to strengthen their legislations and increase their intervention in the digital sphere (Goldsmith and Wu, 2006). The aim was to ensure the sovereignty of states and the security of their critical infrastructures, even if this might interfere with the open and universally accessible nature of the internet, thus provoking a fragmentation that spoils the opportunities linked to this openness and has very negative economic and political impacts on those who are digitally isolated.

2. The concept of European digital sovereignty

It is in this context of deterritorialisation, renationalisation and geostrategic competition that the idea of a European digital sovereignty is born, at different times and with different formulations. There has been talk of "technological sovereignty" (Leonard and Shapiro, 2019), "strategic autonomy" (European Commission, 2018) and "digital autonomy" (Voss, 2020). In July 2020 the German government, in its official programme for the presidency of the European Council, announced its intention "to establish digital sovereignty as a leitmotiv of European digital policy" (The German Presidency of the EU Council, 2020). It was one of many recent moments when the term digital sovereignty was used by governments to refer to the idea that Europe should assert its authority over the digital space and protect its citizens and businesses from the various challenges facing its autonomy.

What is to be understood by such a strange term as "digital sovereignty" when both the very nature of Europe and of the digital world seem to respond to a post-territorial logic? It is an expression that combines two in principle incompatible realities: power over a territory in a deterritorialised matter, hegemony over others in a field where logics other than imposition or exclusion seem to govern. The sovereignty aspired to has very little to do with its classical meaning, linked to modern statehood and formulated as an exclusivist pretension of the European Union, which is neither a state nor a mere aggregation of states (Innerarity, 2018). In my interpretation, this version of the concept of sovereignty cannot be understood as a monopolistic and interference-free power when it comes to the global governance of digital infrastructures and technologies. My proposed interpretation is to consider sovereignty as the ability to maintain one's own model in competition with others, to achieve both competitiveness and normative principles.

3. The geostrategic dimension of European digital sovereignty

The relevance of the idea of European digital sovereignty is due to the fact that it could extend beyond the borders of the Union and affect both foreign companies operating within the EU and somehow also any citizen of the world. This is a way of exercising sovereignty in an interdependent world that needs to be explained.

The digital world is a world that is inexplicable and ungovernable with the territorial delimitation of states. On the one hand, the mobility of people and goods is leading to talk of "iborders" (Pötzsch, 2015) and "biometric borders" (Amoore, 2006), through eGates and scanners, which would make it possible to identify the movement of people "remotely", before they reach the territory of another state. This is relevant, for example, when it comes to security or health issues, for migration, climate risks or epidemics. The ideas of one's own territory and outer space are controversial and even completely useless for many issues. The suggestion that Europe is in a process of "rebordering" (Schimmelfennig, 2021) makes perfect sense here, not only in relation to traditional forms of state borders but also to new borders across the different domains that characterise the 21st century, many of which have to do with digital space.

Governments today seek to operate in spaces outside their own territory and to redefine boundaries for which their sovereignty seemed inapplicable. Obviously, as in the old colonial logic (with respect to which it has similarities and differences), all this raises numerous problems, mainly of legitimisation. In the international order, we are witnessing a resurrection of the concept of sovereignty as a geopolitical aspiration that has set in motion a race to establish and extend one's own sphere of influence.

Europe's digital sovereignty is linked to a global battle over the model of digitalisation. China, the United States, Russia and the European Union now find themselves in a competition of different digitalisation models, a battle in which the shape of global markets and regulations is contested. At stake are conceptions of privacy, human rights, the platform economy and, ultimately, how markets, states and societies should relate to each other. The current trade conflicts between Europe, China and the United States go beyond purely economic issues. Digital technologies are the infrastructures of advanced societies. With digitalisation, a new kind of conflict begins in global politics over acceptable and universalisable standards. Behind the flags that are raised in geostrategic battles there is a competition of models. The USA, China and the EU represent, respectively, digitalisation as a business, as an instrument of power or as an area in which a balance of social and democratic values has to be achieved. There are big differences between Europe and China regarding human rights and political freedoms, but also between Europe and the US when it comes to privacy protection in relation to security issues.

In Europe, the term digital sovereignty is used to refer to an ordered, value-driven, regulated and secure digital sphere that meets the demands of individ-

ual rights and freedoms, equality and fair economic competition (Bendiek and Neyer, 2020). The European Commission and the Council of Europe have advocated a democratic, social and rights-based approach to digitalisation. In their various documents, technology is conceived as an opportunity for the improvement of society, which should not only be efficient but also respectful of human rights and democracy. What is thus advocated is a market that does not drive out humans, decision-making procedures that do not abandon us completely to automaticity, algorithms that do not discriminate, data understood as a common good, governance that prevents the absolute power of digital giants.

4. Conclusion: the externalisation of Europe

This European model is discredited on two opposing grounds: as being too self-interested and too naïve. According to the first accusation, what Europe wants to do is to internationalise its criteria in order to externalise the costs of its own adaptation and not to harm its competitiveness. However, Europe has every right to demand the universalisation of its criteria if it believes them to be appropriate, even if they are to its advantage. The fact that certain values serve its own interests does not necessarily delegitimise them.

The other accusation, that of naivety, would see this approach by the EU as damaging to its competitiveness. The reality, however, is somewhat different. Consider the issue of data protection. A demanding measure that was originally intended for the European area has been taken as a model in other legislations, adopted by non-European companies and thus ends up protecting the privacy of many citizens outside Europe. The reason for this curious protection is that global companies do not want to leave the European market. Data mobility effectively makes them subject to European regulation, which thus becomes transnational, as it is more efficient and cheaper for many companies to follow European regulations around the world than to operate according to different standards. In this way Europe de facto extends the territorial scope of its data protection legislation. If by sovereignty we mean the ability to assert one's own criteria externally, here we have an illustrative, albeit paradoxical, example, not so much in the logic of classical nation-state power but in line with the reality of digitalisation. This is a curious case of the "externalisation of Europe" (Bendiek and Romer, 2019) or the "Brussels effect" (Bradford, 2012).

Global interdependence requires global standards, which is an incentive for an economy whose deployment depends precisely on this standardisation being as broad as possible. In the digitalised space, the idea of sovereignty as an attribute indicating hegemony and control (absolute and exclusive over one's own territory) makes little sense. European digital sovereignty must instead be thought of as a property that includes reputation, capacity to influence and intelligent regulation. Such sovereignty can no longer be understood from the classical attributes of the nation state that could have been transferred to the pan-European level; rather, it is about complementing the Union's internal power with the battle for global harmonisation by valuing its potentially universal benefits (Floridi, 2020). In this sense, European digital sovereignty depends on making progress in the governance of global interdependence with the criteria that Europe defends and promotes.

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CHAPTER 27

Challenges for EU migration policy

Leila Simona Talani

1. Introduction

Although international migration has existed since the beginning of history, the current dynamics relating to this phenomenon have acquired specific characteristics which produce new challenges and new difficulties also for the European Union. This chapter will contextualise the challenges of migration for the EU within the new political and economic landscape created by globalisation, underlying the main features of the EU response to international migratory flows. To this aim, this chapter will first analyse the impact of globalisation on international migration. It will then reconstruct the steps towards the adoption of a common migratory policy, the question of securitisation and the problems that this poses for both migrants and EU citizens.

2. International migration in the era of globalisation

The first aspect of international migration in the age of globalisation is whether globalisation-induced migratory flows can be governed and by whom.

The focus here is on the macro-analysis of immigration policy, i.e. the study of the conditions of the entry and exit of migrants from national territories and whether these conditions can still be controlled by the nation state.

The question relating to the role of the state in allowing or stopping migration, however, does not have a single answer in the literature on globalisation. In the analysis proposed by realist scholars there is no doubt that national institutions are totally in control of migratory dynamics in the globalisation era and any outcome of migratory policy, including the increase of irregular migration, is an intended consequence of specific policy provisions. On the contrary, for neo-institutionalists, liberal democracies do not have the ability to implement restrictive migratory policy as international migrants are attracted to their territories by legal systems that protect their rights. The enforcement of those liberal legal provisions by national, but also regional or even international courts, makes it impossible for western democracies to limit the rights of migrants with the aim of limiting migration. There is however the scope for international organisations to intervene to regulate and control the phenomenon.

Overall, both mainstream theories remain confident that international migration in the age of globalisation can be governed by either national, for the realists, or supranational institutions, for liberal institutionalists. The two theories still attribute to the political dimension, whether at the national or at the supranational level, the ability to control globalisation.

On the other hand, the globalisation thesis, posits that the phenomena comprising what Mittelman (2000) terms the globalisation syndrome, including international migration, cannot be governed by political entities at any level. The forces unleashed by globalisation escape governance as they are structural necessities.

In particular, starting from a qualitative definition of globalisation, the globalisation thesis argues that the structural transformations of the global political economy lead to the structural need for populations to move both within regions and outside them. This is the consequence of the three paradoxes of globalisation and their impact on the motivations for migration:

- The paradox of 'marginalisation' and its impact in terms of increase of extra-regional permanent migration and brain drain.
- The paradox of 'regionalisation' and its consequences in terms of intra-regional temporary migration.
- The paradox of 'securitisation' and its consequences in terms of irregular migration.

These paradoxes follow from the structural nature of globalisation and the emergence of a new global division of labour and power, and therefore the urge to migrate cannot be stopped by political entities. From this perspective, thus, migration cannot be controlled, regulated or governed neither by the state nor by supranational institutions. By imposing restrictive regulatory regimes to international migration, the only result that political institutions can obtain is to transform regular into irregular migration. Moreover, because of the paradox of regionalisation within globalisation and of the paradox of marginalisation, the population of the non-regionalised, marginal areas of the global political economy experience an increased incentive to migrate, thus adding two further elements to globalisation: the increase of mass migration and brain drain. Below we analyse how the EU reacted to these new characteristics of international migration.

3. Fortress Europe and the refugee crisis

The debate on the implementation of a common migratory policy vis-à-vis third country nationals in the EU is a thriving one and one that does not seem to be easy to resolve. Much of the discussion focuses on the notion of 'Fortress Europe', defined in the literature as an area that enjoys internal mobility while erecting barriers to entry and stay with respect to non-EU citizens (Geddes, 2003). According to scholars, the notion of 'Fortress Europe' comes from the ECC (the Council of the European Communities or the Council) Regulation 1612/68, which for the first time distinguished between the movement rights of citizens of an EU country and the rights of movement of third country nationals (TCNs) (Huysmans, 2000; Ugur, 1995).

This divide was further intensified by the establishment of the freedom of movement for citizens of an EU country effected by the Single European Act in 1986, and even more by the 'EU citizenship' measures introduced by the Maastricht Treaty in 1992. Conversely, the rights of entry and stay for third country nationals were constantly restricted leading to a parallel increase of irregular mi-

gration. Thus, the EU common approach to migration has been progressively securitised and, according to some authors, after the refugee crisis of 2014-2015, it has come closer to the 'militarisation' of borders (Geddes, 2003; Boswell and Geddes, 2011; Guiraudon, 2018).

In fact, the EU's approach to migration faced new challenges with an extraordinary inflow of refugees from Syria in the period 2014-2015, in what came to be known in the literature and mass media as Europe's 'migrant or refugee crisis'. As well as a social crisis, the refugee crisis became an institutional one, with the widespread perception that the EU was unable to manage it either in a consistent or coherent way. Indeed, EU member states failed to find a suitable agreement to reform the Dublin approach to refugee policy. They also failed to properly establish an EU wide resettlement scheme and reverted to the re-adoption of border controls within Europe, notably by suspending Schengen prerogatives (Trauner, 2016).

Much of the confusion about whether the crisis was a 'migrant' or 'refugee' one comes from the fact that asylum seekers, unable to enter the first safe country within the EU by regular means, had to revert to irregular entry into the EU, often using dangerous routes used by irregular migrants. Indeed, whereas the United Nations Convention relating to the Status of Refugees (1951) and the Dublin Convention (later the Dublin Regulations) gave the right for refugees to apply for asylum, both failed to specify "how" precisely a safe country could be reached. As regular entry is usually allowed to those showing regular documents, it becomes very difficult for someone fleeing a situation of civil war or political prosecution in their own country, to obtain a regular visa, leaving no other choice than to revert to irregular entry as irregular migrants.[1] Hence the confusion in the public opinion, press and sometimes even the literature, between migrants and refugees (similarly Guiradon, 2018).

The measures adopted by the EU to resolve the refugee crisis, from the establishment of the hotspots in Italy and Greece, to the institutionalization of military operations in the Mediterranean, account for a *de-facto* militarisation of the border.

Scholarly interventions on refugee policy have traditionally adopted institutionalist approaches by, for example, focusing on the Europeanisation of national asylum systems, on the decision-making procedures and the content of EU asylum

1 The UN convention on refugee actually explicitly recognises the possibility that asylum seekers enter a safe country illegally, see https://www.unhcr.org/3b66c2aa10.

law, on the attempt by the EU to externalise refugee protection and on how burden sharing has played a role in shaping EU asylum policy. In particular, institutionalist accounts have sought to explain the EU approach to the 'refugee crisis' by identifying the actors that compose its 'hierarchical and horizontal' levels (Geddes and Lixi, 2018). Security oriented actions were mainly implemented within the hierarchical level by actors such as the Interior Ministries in EU, member states and the DG HOME in the European Commission. With the 2014/2015 'crisis', the EU had to come to terms with the increased politicisation of migratory issues at the member state level, especially by populist parties. Given the difficulties reported above in identifying common solutions to the crisis, the EU sought to externalise border controls and refugee protection to third countries. This approach is notable in the various deals made with Turkey and even with Libya despite its on-going political turmoil (European Council on Refugees and Exiles, 2017). When externalisation could not be proposed, such as, for example in the case of post-Arab Spring Tunisia, the EU reverted to the 'fight against migrant smuggling' in parallel with a renewed effort to achieve higher rates of return and readmission of irregular migrants (see European Commission, 2015a, 2015b, 2016a, 2016b, 2017; and European Trust Fund for Africa, 2017).

Both approaches reflect the aim of securitising the prevention of irregular migration, in line with the EU's traditional external migration governance regime. This hierarchical approach to the EU's external governance of migration/refugee policy aligns with a more global trend towards the migration of third country nationals (Lixi, 2019: 95). Guiraudon explicitly talks about the militarisation of the EU's approach to migration and refugee policy after the 2014 and 2015 'crisis' (Guiraudon, 2018: 156-157). Overall, the literature suggests that the EU's reaction to the 'crisis' is a continuance of the security oriented framework of previous approaches to refugee and migration policy at the EU level. The EU basically passed only 'emergency measures', such as a new military operation, as well as two Council decisions never being fully implemented to derogate from the Dublin regulation and relocate refugees on the basis of other criteria, and a statement between the EU and Turkey which was outside any international and legal framework. All this suggests that the EU failed to effectively address the problem. This applies in particular to the humanitarian aspect of the 'crisis' (Trauner, 2016: 313; Guiraudon, 2018: 158).

However, these measures had little or no impact on reducing the number of migrants entering its territory irregularly. Therefore, the question remains why did the EU decide to react to the refugee crisis of 2014/2015 by further increasing

the securitisation approach, thus adding to the paradox of securitisation within globalisation? Below the challenges of the securitization approach to international migration will be addressed.

4. The challenges of securitisation

The notion of 'securitisation' entails the conceptualisation and treatment of migration as a 'security issue', and its consequent management by security agencies, like the police or even, in the case of militarisation, the army (Huysmans, 2000; Guiraudon, 2018).

Not only did similar measures not restrain migrants nor refugees from starting the migratory process irregularly, but they also did not have an impact on reducing the number of victims at sea, which is still extremely high, as reported extensively by the media.

Indeed, the securitisation of migration policy overall only results in the opposite effect, which is in the increase of insecurity. It does so through the irregularisation of migrants and refugees which leads to extremely dangerous if not deadly journeys to reach destination countries; to the involvement of organised crime in the smuggling and exploitation of migrants; to the increased precarity of the working conditions of both the local and the migrant working force which can configure instances of modern slavery; to the necessary involvement of irregular migrants in the underground economy and their related marginalisation and criminalisation by host societies; to the ethnification of jailed populations and an increased incentive to misbehave and even commit crimes; to the growing hostility of migrant communities against receiving countries that could lead to social unrest or even terrorism, and vice-versa, i.e. the growing hostility of 'native populations' to migrant communities which leads to Islamophobia and the rise of right wing populism.

All this is a consequence of the paradox of securitisation within globalisation. If international migration is a structural component of globalisation, political institutions cannot stop it. The policy gap is real. The implementation of restrictive policies only produces the irregularisation of international migration. In a nutshell, increasing securitisation increases insecurity.

The "irregularisation" of migration is, then, another negative consequence of globalisation on migration. This entails the creation of new inequalities in labour markets, the rise of the so-called 'modern slavery', as well as the death toll that the process of migrating through irregular means inevitably produces.

There is a widespread consensus in the scholarly community that international migration is generally beneficial for the economic performances of host societies. International migration is considered in the literature a positive sum game for destination countries as it allows them to cover the gaps in the labour market, complementing the skills of the local labour force and overall enhancing the productivity and efficiencies of their economies (Talani, 2022). This happens despite the fact that they are often underemployed, are relatively less employed than the local population and have to accept working conditions below standards, which is often the case for both regular and irregular migrants.

The negative aspects of globalisation-induced migratory flows, in fact, come from their irregularisation which substantially contributes to the antagonisation, even criminalisation, of international migrants by receiving societies.

Due to the paradox of the securitisation of migration within globalisation and the impossibility of stopping international migration by using restrictive migration policies and deterrence, legal migration is very limited while irregular forms of entry and stay thrive.

In turn, there are clear winners and losers in the transformation of regular into irregular migration. On the one hand, irregular migration allows for an uber-flexibilisation of the labour force, both the local and the migrant one. Besides, irregular work reduces the size and function of the welfare state, limiting substantially state contributions. Consequently, both workers and citizens would appear as clear losers from the growing 'irregularisation' of migration.

Moreover, the irregularisation of migration intensifies the negative perception of migrants by host societies which, in turn, leads to more marginalisation and exploitation, including instances of 'modern slavery'. This is due to the fact that irregular migrants can only be employed in the underground economy of receiving countries. As such, they are perceived by host societies as acting at the margins of legality, if not in the illegal economy proper, as they are often smuggled into the country of arrival by organised crime and are therefore indebted with it. Since, as irregular workers, they do not pay taxes, this makes local populations blame them for using public services, such as education or the health system, without contributing to it.

It must be noticed, with Reyneri (1999), that by no means the underground economy is created by irregular migrants nor are irregular jobs their prerogative. To the contrary, it is the underground economy that acts as a pull factor for irregular migration. In reality, the biggest majority of irregular workers are represented

by locals. However, there is a stigmatisation attached to irregular workers from third countries which does not apply to the natives. The former are also usually considered more prone to committing crimes when they are involved in the underground economy.

De facto, it is possible to identify a phenomenon of the ethnification of the jailed population. This has been connected to a process of the self-selection of irregular migrants. If they are willing to undergo the process of migration irregularly and to be involved in the underground economy, then it is also possible that they have a higher propensity to misbehave. They might therefore be more likely to engage in deviant or even criminal behaviour. This could be incentivised by the fact that illegal activities are often more profitable than legal ones. Also, irregular migrants might also be bound to engage in criminal activities by the same criminal organisations that smuggled them in. There is then the possibility that migrants do not realise that rules have to be respected in a country that allows them to enter and stay illegally as well as to work in the submersed economy. Finally, it should be noticed that in many countries, irregular migration is actually a crime, and therefore irregular migrants are criminals by definition, which certainly lowers their reluctance to misbehave.

From a different viewpoint, the securitisation paradox, which is often justified as a way to limit global terrorism, could paradoxically fuel terrorist tendencies, not only in first-generation, but also in second and third-generation migrants. By revealing instances of discrimination and Islamophobia, the paradox of securitisation could act as a catalyst for Islamic communities to grow more hostility towards host societies, that could be reflected in social unrest, radicalisation and even terrorism.

All the considerations above contribute to the antagonisation of irregular international migrants by host societies and to their criminalisation. This, in turn, is what is called a short-circuit of criminalisation, incentivises them to engage in illegal activities.

Clearly the solution to this conundrum would be to legalise international migration, thus eliminating its dark side. However, this does not seem to be the solution chosen by nation states or supranational institutions. Quite to the contrary, the tendency is towards an even greater securitisation of the border. This is the case even in relation to the entry of refugees, who would have a right to ask for asylum as per UN Convention on refugees of 1951, but do not have a right to reach a country regularly. They are therefore likely to undergo irregular migratory

processes until they reach the shores of a country where they can ask for asylum. This increases insecurity for refugees, who may die at sea, may be trafficked by organised crime and may be smuggled into destination countries where they are exploited to repay the debts incurred to pay for the journey. It also makes host societies much less safe as they have to deal with irregular migrants, criminal networks and exploitation of workers, modern slavery and illegal activities on their territories.

But, if this is the case, why is the practice and discourse of securitisation so pervasive around the globe? Who are the winners and the losers of these insecurity enhancing securitisation measures?

If the losers, as seen here, are represented by international migrants and refugees and by local citizens, there are however also winners and these are populists and right wing anti-migrant parties.

5. Conclusion

This chapter analysed the changing nature of international migration in the globalisation era highlighting its structural nature and the related impossibility of stopping international migratory flows nowadays. It also reviewed the developments leading to the creation of 'Fortress Europe' and identified the opposite migratory regimes existing within the EU for intra-regional and extra-regional migration. The chapter concludes by giving some insights on the challenges posed by the securitisation of migratory policy, and by its militarisation and externalisation especially after the refugee crisis. Opening the borders to legal migration would help solve many of the above-mentioned challenges for the EU.

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CHAPTER 28

Asserting trade identity in the EU 'response' to the US Inflation Reduction Act

Maria Helena Guimarães

1. Introduction

The US Inflation Reduction Act (IRA), signed into law in August 2022[1], is the 'signature' project of the Biden Administration to address global climate change. The IRA seeks to catalyse nearly 400 billion US dollars of federal funding to reduce carbon emissions, by boosting clean energy production and promoting innovation in clean technologies. The IRA is a game-changer in US policy on climate. After years of federal inaction, the IRA provisions on the green transition establishes *the* US federal policy to address the climate crisis.

These ambitious climate efforts, however, are creating trade policy and investment-related frictions with the European Union (EU). The IRA includes public financing programmes and subsidies packages in the form of tax credits that are contingent on national content and assembly requirements.[2] These

1 Public Law No. 117-169 (August 16, 2022).

2 Subsidies are conditional on production made in the US and on inputs sourced from North America.

programmes, that are designed to give a competitive edge to the US by fostering American green technologies, have generated concerns about their international trade and investment effects. The IRA is a climate act but also a powerful instrument of trade policy.

From the EU perspective, the IRA has significant protectionist elements as the green subsidies to combat climate change not only breach international trade rules but also provide a magnet for European companies to invest in the US. Although the climate-related objectives of the US Inflation Reduction Act are in line with the EU's climate agenda, the IRA provisions for the green transition are not fundamentally market-driven (Confederation of Swedish Enterprise, 2023), which has triggered the trade- and investment-related tensions in the transatlantic relationship.

This contribution focuses on the trade implications of the IRA and the subsequent EU policy response to the US climate Act. There has been an extensive debate on how the EU should respond to the IRA (Kleimann et al., 2023; Posen, 2023; Elkerbout, 2022). This climate law has brought to the fore the challenges that the EU faces in its 'response' to the new Act. The issue is whether the EU policy reaction to the US climate policy will mimic the US toolbox – which includes demand-side and supply-side discriminatory instruments – or whether it will assert the EU trade values and identity.

The design of the EU response to the US IRA is a case in point to illustrate how identities are intrinsic attributes of, and can be nurtured by, relationships (Berenskoetter, 2017: 3602). Given the EU's significant market clout in global trade and its normative power in the global trading system (Damro, 2012) the EU response to the IRA is an opportunity for Europe to promote its values-based trade model, and to project its global influence (Nicolaïdis and Howse, 2002). Moreover, the EU reply to the American climate Act can also be symbolic of the future path of EU trade policy.

In section 2, this contribution unpacks the EU concerns on the IRA's consequences for the Europe. Section 3 discusses how the EU is seeking to assert its trade identity in its reaction to the IRA climate programmes. Section 4 briefly discusses how the choice of the EU policy response to the IRA may impact the integrity of the single market. The final section reflects on the paths forward to address the climate-trade nexus in the transatlantic relationship.

2. Unpacking the Inflation Reduction Act's consequences for the EU

The impact of the IRA on the EU and on its member states has been on top of political agendas in Europe. The concerns have been frequently voiced by various EU leaders, such European Commission President U. von der Leyen (2022), President M. Macron of France (see Euractive, 2002), and German Chancellor O. Schultz (see Preussen, 2023). The EU recognizes the significance of the US Act to address the global climate crisis and its push to promote the green transition. While the EU is fully supportive of the US climate goals – indeed the EU has for a long time encouraged the US to bolster its climate policy (Vestager, 2022) – it has serious concerns about the IRA's direct effects on EU trade and investment.

As part of its financial incentives, the IRA includes ambitious subsidies packages, that by the amounts involved and their design, are perceived in the EU as non-transparent, market-skewing, discriminatory for EU green industries, and causing inefficiencies and market distortions. Indeed, *prima facie,* the incentives for the US manufacturing of clean technologies will threaten to divert green investment flows away from the EU, and industrial capacity (and jobs) to the US, at Europe's expense. The IRA's discriminatory elements benefit US-based companies, penalizing EU producers and EU exports, and put the EU at a competitive disadvantage. In turn, while the IRA discriminates EU companies in the US market based on local content requirements, the access of US firms to the EU Single Market is not subject to similar constraints. This further tilts the level playing field in favour of US firms. In other words, while US companies compete with European green tech industries in the EU Single Market under the WTO multilateral rules, the EU reckons those rules are not applied to EU firms operating in the US market. From the EU perspective, the IRA potentially violates three key WTO norms – the National Treatment principle enshrined in the Agreement on Tariffs and Trade, the Agreement on Subsidies and Countervailing Measures, and the Agreement on Trade-Related Investment Measures.

With its landmark effort to decarbonize its economy, the US actually seeks to address China's strategic and massive investments in critical sectors (minerals, for example), which created significant vulnerabilities in US supply chains. The IRA is a US geopolitical priority aimed at swiftly becoming a leader in the production of clean technologies, to be at the forefront of the industrial green transition. While the IRA is part of the US policy of "decoupling" in trade with China to reduce its

dependence in strategic clean technologies and to take back supply chains towards the US, the IRA will possibly cause collateral damage to the EU. Although that might not be its intended effect, EU supply chains might be impacted by the strong incentives of the IRA for European companies to move to the US, and potentially European countries may see their supply chain dependence move from China to the US.

3. Trade identity in the EU response

Reconciling the climate ends of the IRA – which Europe backs – with its rather protectionist industrial policy – which the EU decries – has put the EU at a crossroads in considering its response to the IRA. Initially, some member states, such as France and Germany, urged the EU to respond with its own "green protectionism" and suggested the EU should build its own "European preference strategy". The European Commission, on the contrary, has preferred to avoid a tit-for-tat response, which would give a protectionist stance to EU trade policy, contrary to its WTO commitments. For some, such response would be against the "Commission DNA" of trade liberalization (Bourgery-Gonse, 2023). It has become more consensual among member states and the European Commission that the best and most cost-effective solution to support the green transition are market-based measures, as subsidies are not an efficient policy measure to build long-term competitiveness (Crawford, 2023). Replicating the US strategy to boost climate objectives could entice a fierce zero-sum competition between the US and the EU, and a detrimental transatlantic subsidy race.

In the European Commission's narrative Europe's strategic interests and trade values should guide the protection of the European economy from unfair trade practices to ensure a level playing field (European Commission, 2017 and 2021). Within this policy framework, one should expect an EU reaction to the US Climate Act framed by the principles of a market economy and open trade, and by the rules-based international trading system. With the present strained global value chains (due to COVID-19 and the war in Ukraine), the strategic trade and security challenges coming from China, and the impact of the aggressive trade instruments of the US climate policy, keeping up the EU's trade principles is key for the assertion of Europe's normative clout. As identities in international political economy emerge from economic exchange (Duina, 2019), upholding EU key values in this ever more uncertain and unstable international trading environment comes as a challenge, and an opportunity for the EU to (re)affirm Europe's trade identity.

That means signalling the EU commitment to open trade and stressing its willingness to pursue trade values in the context of its own climate policy (see Bongardt, 2023, this volume; Schoenmaker, 2023, this volume). With that purpose, the EU has not prioritised trade-distorting initiatives when pondering how to mitigate the consequences of the US federal climate policy in the European economy. Europe is strategically using its 'free trade paradigm' with this critical partner as the *leitmotiv* for its response (De Ville and Siles-Brügge, 2018), thus trying to reiterate its identity in global trade relations.

The EU rejoinder has been targeted at furthering its own climate policy agenda[3] without resorting to trade discriminatory instruments. The EU's 'first response' – the Green Deal Industrial Plan (or EU Climate Law) followed by the Net-Zero Industry Act (NZIA), illustrates that policy choice. From the EU perspective policy measures that are discriminatory, that distort international trade and investment flows, and that incentivize retaliatory protectionist policies in third countries, are not efficient instruments to attain climate objectives. Put in short, the end does not validate the means. On the contrary, the EU fears that such unilateral policies trigger a zero-sum game that ultimately will impair the attainment of shared global climate objectives. In Posen's (2023) assessment, this is a short-sighted, self-serving approach, as a subsidies contest with the EU is a misguided strategy to move forward a climate agenda.

Despite the fact that the EU purports to promote trade values and identity, EU trade policy is also experiencing a unilateral, geoeconomic turn of which the new Anti-Coercion Instrument to help the bloc fight off attempts of economic interference is a paramount illustration. Additionally, between 2021 and 2023 alone, the EU has proposed or adopted a set of instruments to address strategic sectors and climate objectives, such as the European Chips Act, the Carbon Border Adjustment Mechanism, or the Foreign Subsidies Regulation (FSR). However, the EU's climate initiatives have a long-term competitiveness focus rather than emphasizing reprisal based on trade related countermeasures. In the climate-trade nexus the EU is seeking to affirm its "normative power Europe" identity – pursuing rules-based free trade and managing trade policy under the norms of multilateral institutions – despite the shift towards a more "geopolitical power Europe" (Couvreur at al., 2023; Orbie, 2021; Meunier and Nicolaïdis, 2019). In its reaction to the US IRA, the EU is avoiding retaliation by engaging in a subsidy war, nor is it resorting to the WTO dispute settlement system to counter the US's behind-the-border

3 The EU objective is to achieve carbon neutrality by 2050 and cut its greenhouse gas emissions by more than half before the end of this decade.

measures, which would cause further damage to an already weak multilateral trade regime beset by unilateral and protectionist measures and initiatives.[4]

4. The integrity of the Single Market

Depending on the EU response to the IRA, the level playing field in the Single Market may be stake. The new EU legislation on clean technologies to cope with the new competition challenges coming from the US should ensure equal competitive conditions among member states. A response that resorts to protectionist measures would compromise the integrity of the single market (Demertzis, 2023).

The IRA creates incentives to use domestic responses (tax-cut polices or subsidies) that can lead to the fragmentation of the Single Market. Pressed by some member states, namely France, the European Commission has relaxed some European subsidy rules, but by also adopting a subsidy route, in particular if accepting to match US aid with subventions to European companies, the EU model of openness and the EU Single Market could be in jeopardy (Dombrovskis et al., 2023). National policies would primarily benefit the largest EU economies, therefore damaging competitive markets within the EU, and distorting intra-EU trade flows in the industries of the future. Additionally, the IRA may also prompt subnational action. There is the potential that regional entities in Europe try to use their own policy tools, notably in federal member states, which could lead to a race of substate financial incentives to protect their local industries and to attract foreign investment. This substate aid can further distort competition in the Single Market and become another ripple effect of the IRA across the EU. The reaction of regional and local governments to the IRA is probable, as subnational entities increasingly demand a say in trade-related issues that affect their economic and material interests, namely employment opportunities (Egan and Guimarães, 2022). With that in mind, EU-level policies may be more effective if they avoid both the segmentation of the Single Market and the unpredictability derived from different and divergent national (and subnational) financial schemes. However, the downside for EU-level action is the resistance of the 'frugal' EU member states, namely Germany and the Netherlands.

4 While the appeals mechanism of the WTO dispute settlement is not functioning because the United States is blocking appointments to the Appellate Body, WTO members can still make complaints against other countries' trade measures that they deem in violation of the multilateral rules.

The IRA has further ramifications in the EU Single Market. To balance Europe's competitiveness challenges with fair competition in its internal market, the European Commission is considering the possibility that US companies benefiting from IRA subsidies could be subject to the new EU Foreign Subsidies Regulation, aimed at tackling market distortions caused by foreign subsidies for firms active in the EU. Although the Regulation primarily targets China, US companies may also be required to notify their subsidies to the European Commission, should they present threats to competition in the European Single Market (Stolton, 2023).

5. Paths forward

The IRA is a *fait accompli*. The publication of the Act[5] has left the EU with no option other than to accept it (Fleming et al., 2023; Vinocur, 2022). In this *ex post* context, the EU is in search of a balanced response, avoiding hasty steps. While a 'European IRA' cannot be expected (for example, tax credits are a national competence), the EU is working on a comprehensive set of policies, not only to address the IRA programmes, but also to anticipate other foreign countries' initiatives of the same sort.

With respect to the US – a large economy with close and strong economic and political ties with the EU – one way forward is engaging in collaborative strategies, away from trade clashes, where dialogue is central to mitigate the potential harmful effects of the IRA in the EU economy. The EU-US Task Force on the IRA is expected to reach negotiated and cooperative solutions to address EU concerns and defuse trade tensions. In turn, the US-EU Trade and Technology Council (TTC) launched in 2021, although not including negotiations on new market access commitments, does require that the transatlantic relationship promote market-oriented values and competitiveness. The expectation is that the fourth TTC meeting will avert the escalation of the trade rifts related to the passing of the first US federal climate policy package.

The US climate policy is also having ripple effects in the global trading system, as other countries, such as Canada, are also considering creating their own versions of the IRA. The US IRA may be inducing a 'domino effect' of national climate policies that resort to industrial subsidies, local content requirements and other discriminatory provisions. In the EU perspective, coordination with economic

5 Public Law No. 117-169 (August 16, 2022).

partners – be it the US, Japan, Canada or South Korea – is better than competition in matters of public investment in green tech industries, as this avoids trade conflicts, and simultaneously reduces barriers to the spread and progress of critical green technologies (Posen, 2023).

To advance its strategic interests and preserve its values, the EU will likely resort to trade agreements with foreign countries – a key feature of its foreign economic policy – to incorporate climate issues in the design of trade rules, and to promote open trade in its partners' green transition policies. In the US, however, even though under the Biden Administration climate is part of the federal trade agenda, full-fledged trade agreements with a broad and deep liberalisation agenda continue to be viewed with distrust. The challenge for the future is to reconcile these two views. The way forward, still 'in the making', seems to be the forging of bilateral and plurilateral issue-based joint agreements, namely on sectoral and specific products (such as critical minerals) among the United States, the European Union, and other economies. These are the so-called minilaterals – agreements that are limited in scope, can be informal, and bring together a limited number of like-minded countries sharing specific interests. Such "trade collaboratives" are regarded as market-efficient instruments that in principle comply with WTO rules and are in line with the EU's backing of multilateralism. These may be effective avenues to reinforce transatlantic relations (Beyrer, 2022), and to build trust between the US and the EU after years of limited communication – both on trade and on climate transition.

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Postface

Ready for adult life?

Loukas Tsoukalis

1. Integration in response to the unexpected

European integration has had many ups and downs, many successes and failures. It has also had more than its fair share of crises, especially in recent years when crisis has become almost the norm. Yet, if we look at its long-term development what clearly stands out is a remarkable and continuous expansion in terms of both members and functions. It is an unmistakable upward trend that requires some explanation.

Good old functionalists will point with glee to the inherent expansive logic of economic integration and the reduced capacity of member states to handle problems on their own. Others with a legal bent may stress the implicit imperialism of European law and the way it has been repeatedly interpreted by the ECJ. As for diehard nationalists, they will denounce, as they always do, the role of the *illuminati* and the Brussels cabal in an everlasting plot against proud European nation states fighting to protect their sovereignty.

There is surely some truth in all these explanations. But a more careful look at the history of integration free from ideological and other blinkers would rather suggest that more than anything else it has been the collective European response to the unexpected that has largely shaped the common project over the years.

‘Events, dear boy, events’ was the answer given by Harold Macmillan, former UK prime minister, when he was asked what he considered to be the main challenge to a statesman. Before him, Jean Monnet had argued that ‘Europe will be forged in crisis and will be the sum of solutions adopted during those crises’. He was right after all.

Think about it. We would most probably not have euros in our pockets today, as most of us do, had it not been for the disintegration of the Soviet empire and the fall of the Berlin Wall, which in turn led to German unification. How many Sovietologists and other international relations experts had expected this to happen? Neither economic arguments for monetary union, which admittedly never reached broad consensus among the *cognoscenti*, nor calls for a common currency as an instrument for political union had proved strong enough in the past to help regional monetary integration survive the test of successive exchange crises. In the end, it was high politics that played the decisive role.

We would not have had a European monetary fund (in the form of the ESM) or a banking union, still incomplete, had it not been for the big financial crisis that shook the euro construction at its foundations some years later. Until then, the apostles of economic orthodoxy preached the efficiency of financial markets, that is until the meltdown happened. We would not have had large borrowing in the name of the Union either, albeit still not Europe’s Hamiltonian moment, had it not been for the recent pandemic that took so many lives. The last time this had happened in Europe was about a century ago.

Sure, European leaders do not always resort to common action and more integration each time the unexpected happens that shakes them off their comfort zone. Otherwise, we would probably have the United States of Europe by now. No automaticity or inevitability in the European integration process in other words. But it still moves on.

Today’s debate is dominated and rightly so by Russia’s invasion of Ukraine that has brought a full-scale war back on the European continent. Most Europeans had liked to believe such wars were only happening to unfortunate others in faraway lands. Alas, not; it was a rude awakening. And then, Europeans were for another shock: much of the rest of the world does not share the view that a European problem is necessarily a global problem. Europe has long ceased to be the centre of the world: we should have learned this lesson several decades ago.

The war has put an end to the post-Cold War order in Europe as shaped by those who won it in the first place, namely the West led by the United States. It

has also put an end to economic interdependence between Russia and the rest of the continent mostly based on energy, which was mutually beneficial as long as it lasted. Of course, the main victims of this terrible war are those doing the fighting and the people of Ukraine in general who have suffered enormously. But Europe as a whole has also paid a big price in economic terms and not only. It feels weaker and more vulnerable. Will Putin end up being Europe's great unifier? The stakes are even higher than before and so is the challenge.

2. The next phase of integration will be more difficult

This volume contains a rich and highly diverse collection of essays written by renowned experts in their respective areas of specialization. It is largely about how recurring crises during the last fifteen years or so have shaped European integration in different policy areas, with a heavy emphasis on EMU. The EU in a permanent crisis mode is how the two editors put it in their Introduction. Annette Bongardt and Francisco Torres should be congratulated on an excellent job done.

Several authors revisit old (perennial?) questions and offer new insights and policy recommendations. The wide gap between common tasks and capabilities: Sergio Fabbrini refers to the executive deficit of European institutions; Kalypso Nicolaïdis calls for a more extensive use of citizens' assemblies in European *demoicracy*. The (impossible?) combination of a common currency and the lack of state: can European re-insurance schemes act as a good enough substitute for the lack of fiscal federation as suggested by Waltraud Schelkle, or is EMU destined to remain for (too?) long a fragile construction according to Paul de Grauwe? European integration has always required a delicate balancing act between national sovereignty and the common interest as Charles Wyplosz reminds us.

Dirk Schoenmaker refers to the Green Deal as a transformative policy. Indeed, it has to be if we are to achieve the goals set and formally enshrined. It would not be the first time after all that (European) policymakers fail to match long-term ambitions with concrete measures. Even more so today, in the context of fragmented societies and weak governments when the ephemeral often rules. Such problems are only multiplied at the European level.

The last part of this volume deals with the external and security dimension. If I were to make a constructive criticism of this collective work, it would be that the external dimension deserves more attention. In today's rapidly changing world,

characterized by growing strategic rivalry, rising nationalism and the weakening of the old multilateral order, European integration is and will continue to be decisively influenced by the world outside. In a world in which security considerations take precedence over economic efficiency, Europe is being faced with the big challenge of making the transition from a peace to power project. We need both. A geopolitical EU? Easier said than done.

Europe is shrinking in terms of population, economic weight and influence. Individual European countries, even the old Great Powers, no longer count for very much on the global stage. The war in Ukraine and its aftershocks have sent one (more) clear and loud message for anybody ready to listen. Closer European unity in a world in transition will be a necessary pre-condition for Europeans to be able to define autonomously and defend effectively collective interests and values. They need to combine soft with more hard power. Is Europe ready for adult life? I discuss elsewhere in more detail what the question may imply in economic and political terms and what a still partial answer to this question may entail (Tsoukalis 2022).

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Notes on contributors

Annette Bongardt is a member of CICP-University Évora and Visiting Professor of European Political Economy at FCH/UCP and Católica Lisbon. She has extensively lectured and published on political economy and European integration. She was Visiting Senior Fellow at the LSE and at the RSCAS-EUI and Academic Visitor at Oxford. Other research/teaching positions included CEPS, ICER, Rotterdam School of Management, U. Victoria, King's College London and U. Pisa. She obtained her PhD in Economics from the European University Institute. ORCID: https://orcid.org/0000-0003-3264-5519

Marco Buti is Tommaso Padoa-Schioppa Chair of Economic and Monetary Integration at the Robert Schuman Centre for Advanced Studies of the European University Institute, Florence. Beforehand, he was Head of Cabinet of the Commissioner for Economy (2019-23) and, between 2008 and 2019, Director-General for Economic and Financial Affairs at the European Commission. A graduate of the universities of Florence and Oxford, he has published extensively on EMU architecture, macroeconomic policies, fiscal rules, EU budget, welfare state.

Nazaré da Costa Cabral is Chair of the Portuguese Public Finance Council since March 2019 and Associate Professor with Aggregation at the School of Law, University of Lisbon. She has published mainly (and worked as a legal advisor and consultant) on public finance, public budgeting and social security coordination. She graduated in Law and also in Economics (Nova SBE). She holds a master's degree and a PhD in Law by the School of Law, University of Lisbon. ORCID: https://orcid.org/0000-0002-7070-4236

Michele Chang is Director of the Transatlantic Affairs programme, Professor in the Department of European Political and Governance Studies, College of Europe, Bruges. Her current research interests include euro area governance, financial crises and Brexit. Her most recent books are The Political Economy of Adjustment Throughout and Beyond the Eurozone Crisis (co-edited with Federico

Steinberg and Francisco Torres, Routledge 2019) and Economic and Monetary Union (Palgrave 2016). She obtained her PhD from the University of California San Diego. ORCID: https://orcid.org/0000-0002-8275-8119

Stefan Collignon is Research Professor of Economics at Chulalongkorn University in Bangkok and Visiting Professor at the LSE. He was Centennial Professor of European Political Economy at LSE and Professor at Sant'Anna School of Advanced Studies, Pisa, Visiting Professor at Harvard University and taught at the University of Hamburg, the Institut d'Études Politiques in Paris and Lille, the College of Europe in Bruges and the Free University of Berlin, from which he had received his PhD and Habilitation. ORCID: https://orcid.org/0000-0002-2285-0183

Paul De Grauwe is Professor at LSE. He was a member of the Belgian parliament (1991-2003). He is honorary doctor of the Universities of Sankt Gallen, Turku, Genoa, Valencia, Maastricht and Murcia. His recent book publications include: "The Limits of the Market", OUP, 2017, "The Economics of Monetary Union", OUP, 13th Edition, 2020, "Lectures on Behavioral Macroeconomics", Princeton, 2012, and Behavioural Macroeconomics. Theory and Policy, 2019, (co-authored with Yuemei Ji), OUP. He obtained his PhD from the Johns Hopkins University.

Sebastian Diessner is Assistant Professor at the Institute of Public Administration at Leiden University. Prior to this, he was a Max Weber Fellow at the European University Institute. His research interests include comparative political economy, the politics of macroeconomic policy, and technological and institutional change in the advanced capitalist democracies. His doctoral dissertation examined the political economy of central banking and central bank independence in Europe and Japan. He obtained his PhD from the London School of Economics. ORCID: https://orcid.org/0000-0002-9458-980X

Sergio Fabbrini is Professor of Politics and International Relations and Head of the Political Science Department at LUISS. He has been Pierre Keller Professor, Harvard Kennedy School of Government, and Recurrent Professor of Comparative Politics, University of California at Berkeley. His latest English-language book is *Europe's Future: Decoupling and Reforming,* Cambridge University Press, 2019. He is political affairs' editorialist for *Il Sole 24 Ore.* He specialized in Political Economy in Trento and Cambridge. ORCID: https://orcid.org/0000-0001-6174-6656

Maria Helena Guimarães is Associate Professor at University of Minho and holds a Jean Monnet Chair in European economic integration. She was a Fulbright Visiting Scholar at American University (Washington DC) and Visiting Scholar at the University of Washington (Seattle). Her main areas of research and teaching are political economy of European integration, the Single Market and political economy of international trade. She holds a PhD in the field of International Political Economy from the University of Cincinnati. ORCID: https://orcid.org/0000-0003-1432-4113

Anna-Lena Högenauer is Associate Professor at the University of Luxembourg and Deputy Head of the Institute of Political Science. Her research includes questions of multi-level governance and regional interest representation, environmental policy-making, Europeanization, parliamentary scrutiny of European affairs and legitimacy in EU policy-making. She studied European Studies at King's College London (BA), European Political and Administrative Studies at the College of Europe in Bruges (MA) and holds a PhD in Politics from the University of Edinburgh. ORCID: https://orcid.org/0000-0002-1602-7238

David Howarth is Professor at the University of Luxembourg. He lectured at Aston University and the University of London (QMC) prior to moving to the University of Edinburgh in 2003 where he was Jean Monnet Chair and ran the University's Jean Monnet Centre of Excellence. He is director of the University of Luxembourg's Robert Schuman Initiative. He won a Rhodes Scholarship to attend the University of Oxford, where he obtained an MPhil and a DPhil in Politics. ORCID: https://orcid.org/0000-0003-2697-165X

Daniel Innerarity is Chair in AI & Democracy, School of Transnational Governance, EUI, Ikerbasque Research Professor and Professor of Political Philosophy, University of the Basque Country. He has held visiting positions at the EUI, LSE and Max Planck Institut and the Universities of Munich, Paris and Georgetown. He was awarded, among others, the National Research Prize. He is a Doctor of Philosophy. ORCID: https://orcid.org/0000-0003-4307-8468

Erik Jones is Director and Professor at the Robert Schuman Centre for Advanced Studies of the European University Institute. Until 2023, he was also Professor of European Studies and International Political Economy at Johns Hopkins University, School of Advanced International Studies. He is the author and (co-)editor of books and special issues of journals on international and European political economy, including the Oxford Handbook of the EU (2012). He obtained his MA and PhD at Johns Hopkins SAIS. ORCID: https://orcid.org/0000-0002-6473-7680

Marcello Messori is Professor of European Economy and European Economic Governance at the Department of Economics and Finance, LUISS University, Senior Fellow at its School of European Political Economy and adviser to the European Parliament. He has been Visiting Professor in various universities and Visiting Scholar at the Massachusetts Institute of Technology and Stanford University, among others. He published more than two hundred works. He holds degrees in Sociology and Administration from the universities of Trento and Torino. ORCID: https://orcid.org/0000-0003-2422-4466

Francesco Paolo Mongelli is Senior Adviser in the Directorate General Monetary Policy at the European Central Bank and honorary Professor at the Goethe University Frankfurt. Among other positions in the ECB, he was also at the Directorate General Research and Editor of the ECB Occasional Paper Series. Prior to that, he spent several years at the International Monetary Fund in Washington. He holds a Master's degree and a Ph.D. in economics from the Johns Hopkins University in Baltimore. ORCID: https://orcid.org/0000-0002-9543-2855

Pedro Duarte Neves is Advisor of the Board at Bank of Portugal and Visiting Professor at Católica Lisbon. He was Vice-Governor of the Bank (2006-2017), Alternate Chairperson of the European Banking Authority (2013-2018), Chairman of the Portuguese Deposit Guarantee Fund (2006-2016), and Chairman of the Board of Directors of ANACOM (2004-2006). He has published in The Journal of Econometrics, Economics Letters and Economic Modelling. He holds a PhD in Economics from Université Catholique de Louvain.

Kalypso Nicolaïdis is Chair in Global Affairs at the School of Transnational Governance, European University Institute, on leave from the University of Oxford. She was professor at Harvard University's Kennedy School of Government and at Ecole Nationale d'Admistration, Paris. In 2021, she co-authored with Adis Merdzanovic *A Citizen's Guide to the Rule of Law*. More information on her website: http://kalypsonicolaidis.com/. She is a graduate of Sciences-Po and received her PhD from Harvard University in Political Economy and Government. ORCID: https://orcid.org/0000-0002-4596-3148

George Pagoulatos is Professor of European Politics and Economy at Athens University of Economics and Business, Visiting Professor at the College of Europe in Bruges, and was Director General of the Hellenic Foundation for European & Foreign Policy (ELIAMEP). He is Greece's Ambassador to the OECD and served as European Affairs advisor to the President and senior advisor/director of strategy with two Prime Ministers of Greece. He holds a D.Phil. in Politics from the University of Oxford. ORCID: https://orcid.org/0009-0009-9052-8573

Alexandre Palma is Associate Professor of Theology at the Catholic University, Lisbon. He is also a priest. He is a member of the European Society for Catholic Theology, of the journal Communio's editorial board and of the «Seminar of young scientists» of the Lisbon Academy of Sciences. Having begun his studies in engineering, he graduated in and acquired his master's degree in theology. He received a doctorate in theology from the Pontifical Gregorian University in Rome. ORCID: https://orcid.org/0000-0003-2641-1724

Lucia Quaglia is Professor at the University of Bologna. She taught at the Universities of Limerick, Bristol, Sussex and York (full professor, 2012-17). She held visiting positions at the Robert Schuman Centre for Advanced Studies and the Department of Social and Political Studies at the European University Institute, the Max Planck Institute for the Study of Societies (Cologne), Hanse-Wissenschaftskolleg (Delmenhorst), University of Bremen, and University of Luxembourg. She holds an MA and DPhil from the University of Sussex. ORCID: https://orcid.org/0000-0001-8816-0583

Waltraud Schelkle is Joint Chair for European Public Policy at the Department for Political and Social Sciences and the Robert Schuman Centre for Advanced Studies at the EUI. Before joining the EUI, she was Professor in Political Economy at the LSE. She authored *The political economy of monetary solidarity: understanding the experiment of the euro* (Oxford University Press, 2017). She holds a PhD and a Habilitation from the Free University of Berlin. ORCID: https://orcid.org/0000-0003-4127-107X

Vivien A. Schmidt is Jean Monnet Professor of European Integration and Professor of International Relations, Pardee School of Global Studies, and of Political Science, Boston University. Her latest book is *Europe's Crisis of Legitimacy: Governing by Rules and Ruling by Numbers in the Eurozone (2020).* She holds an honorary doctorate from the Free University of Brussels and was recently named a Chevalier in the French Legion of Honour. She received her PhD from the University of Chicago. ORCID: https://orcid.org/0000-0001-7764-0610

Dirk Schoenmaker is Professor of Banking and Finance at Rotterdam School of Management, Erasmus University, and a Research Fellow at CEPR. He is co-author of two textbooks: Principles of Sustainable Finance (OUP) and European Financial Markets and Institutions (CUP); and the author of 'Governance of International Banking: The Financial Trilemma' (OUP). He is consultant for the IMF, the OECD and the European Commission. He earned his PhD in economics at the London School of Economics. ORCID: https://orcid.org/0000-0003-3571-6976

Leila Simona Talani is Professor of International Political Economy and Jean Monnet Chair of European Political Economy in the Department of European and International Studies at King's College London. She is editor of the Palgrave Migration Series. In 2017 she was a Visiting Professor at the Kennedy School of Government, University of Harvard. She is the author of numerous books on international political economy. She was awarded a PhD with distinction at the European University Institute. ORCID: https://orcid.org/0000-0002-0054-7001

Roberto Tamborini is Professor of Economics, University of Trento. He is also fellow of the School of European Political Economy, LUISS, Rome, member of the Board of Experts of the Monetary Dialogues of the European Parliament and member of the editorial boards of Economic Policy and European Union Studies. Previously, he was Associate Professor at the University of Padua. He obtained an MPhil in Economics at the University of Cambridge and a PhD at the European University Institute. ORCID: https://orcid.org/0000-0003-0416-1437

José Tavares is Full Professor of Economics at the Nova School of Business and Economics and Research Fellow at the Centre for Economic Policy Research in London, specializing in macroeconomics wand Political Economy. José has published in the *Journal of Monetary Economics,* the *Journal of Public Economics,* and the *European Economic Review,* among others. José holds a Ph.D. in Economics from Harvard University. ORCID: https://orcid.org/0000-0002-8159-9646

Francisco Torres is Visiting Professor of European Political Economy at FCH/UCP and Católica Lisbon School of Business and Economics. He has held positions at the London School of Economics, Oxford University, the RSCAS/European University Institute and CEPS. He has also taught at U. Victoria, U. Rome II and King's College London, published numerous journal articles and (co-)authored and (co-)edited 15 books. He holds an MA from Johns Hopkins, an MRes from Nova and a PhD from Católica, Lisbon. ORCID: https://orcid.org/0000-0001-6396-7081

Loukas Tsoukalis is affiliate Professor at the Paris School of International Affairs (Sciences Po), Emeritus Professor of the University of Athens and President of the Board of the Hellenic Foundation for European and Foreign Policy (ELIAMEP). He has also been Professor at the LSE and the College of Europe. He authored many books translated into several languages and he advised Commission and European Council presidents. He obtained his doctoral degree from the University Oxford, where he taught for many years.

Amy Verdun is Professor of Political Science and founding Director of the European Studies Program at the University of Victoria (BC Canada) where she served as Department Chair (2010-2013) and in 2017 was awarded the first Distinguished Lansdowne Fellow. Earlier appointments include the Universities of Leiden (1991-92; 2018-2020) and Essex (1995-96). She was co-editor of the *Journal of Common Market Studies*. She holds a PhD in Political and Social Sciences from the European University Institute. ORCID: https://orcid.org/0000-0002-4876-753X

Tomasz Woźniakowski is Assistant Professor (adiunkt) at the Institute of Political Science, University of Wrocław, and Bekker Visiting Fellow at LUISS Rome. He was an ERC-funded Post-Doctoral Researcher at the Hertie School, Berlin, and a visiting fellow at the University of California, Berkeley. His monograph 'Fiscal Unions' was published by Oxford University Press. He holds a PhD in Political and Social Sciences from the European University Institute and received the Supranational Political Economy Prize for his dissertation. ORCID: https://orcid.org/0000-0001-9475-7845

Charles Wyplosz is Emeritus Professor of International Economics at the Graduate Institute, Geneva, where he was Director of ICMB. Previously, he has served as Associate Dean for Research and Development at INSEAD and Director of the PhD programme in Economics at the Ecole des Hautes Études en Sciences Sociales in Paris. He is a CEPR Research Fellow and has served as its Policy Director and Director of the International Macroeconomics Programme. He received his PhD in Economics from Harvard University.

Hubert Zimmermann is professor for International Relations at Philipps University Marburg, Germany. He has held positions at Düsseldorf University (Germany) and Cornell University (USA). His current research interests focus on international security, global financial and monetary policy, the European Union and transatlantic relations. Among his publications are *Money and Security* (Cambridge UP 2002), *Drachenzähmung* (Nomos editors 2007), and numerous edited volumes and articles. He received his PhD from the European University Institute in Florence. ORCID: https://orcid.org/0000-0003-1687-3984

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