General Introduction*

This book collects 16 of the Policy Briefs that I wrote during my directorship of the Luiss School of European Political Economy (SEP). SEP, which was established at the end of 2013 thanks to the initiative of the then-Rector of Luiss, Massimo Egidi, and a few other economists (Marcello De Cecco, Jean-Paul Fitoussi, Stefano Micossi, Gianni Toniolo, and myself),[1] has been a non-traditional place where top European scholars and policy-makers could analyze the economic and institutional problems of the European Union (EU) and the Euro Area (EA). SEP's friendly atmosphere has fostered in-depth debate seminars and open-minded and penetrating discussions that get to the core of the various theoretical and policy issues. The number of SEP papers that I have co-authored (see www.sep.luiss/publications) demonstrates how deeply indebted my analyses are to the most active group of SEP fellows and to the SEP seminars' contributors. The choice of including in this collection more than 40% of SEP's co-authored Policy Briefs is also meant to testify to the importance of the collective work performed at SEP.

In the same period (2012–2021), I was fortunate to take part in another stimulating experience in the field of European economics: the co-coordination of two Working Groups at the Astrid Foundation.[2] The first group, centered on the Banking Union process (see Part II), produced a collective book on this topic (see Barucci and Messori, 2014). The second group, which guaranteed and continues to guarantee stimulating interactions with some of the top Italian members of the European Commission and the European Parliament, is offering profound discussions on the main European economic problems in the 2016–2021 period. Last but not least, my view of European issues has been strongly enriched by the involvement in an informal group of Italian friends, self-labeled "Europeos" and coordinated by Stefano Micossi. These friends work in different disciplinary fields that, nevertheless, are all focused on analyzing Europe's institutional and economic problems.

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[1] Stefano Micossi and Jean-Paul Fitoussi are – respectively – the President of the Scientific Council and the President of the International Advisory Board of the Luiss School of European Political Economy. I am one of the Senior Fellows at the school.

[2] The Astrid Foundation is a think-tank located in Rome and headed by Franco Bassanini.

This General Introduction is devoted neither to summing up the content of the book's five parts nor to examining the phases in the evolution of the economic and policy framework of the EU and EA, which are specifically covered in different chapters of each part (three in Parts I – IV, and four in part V). These aspects are examined in the introductions to the book's five parts. Here, the aim instead is to offer a unitary interpretation of the main changes in European economic governance and in the utilization of the monetary and fiscal policy tools that have characterized the EU and EA since the international financial crisis (2007–2009). Until the beginning of 2015 these changes, which have deeply influenced the content of the European directives and rules, had tried to find compromises between the main features of the "market social economy" approach (see Section 1) and the governance adaptations to the new economic problems in the EU and EA threatening the equilibria and – in a few cases – the survival of the monetary Union. From 2016 to the first pandemic shock (February 2020), this search for a compromise was abandoned and European economic governance regressed. Consequently, the monetary policy of the European Central Bank (ECB) became the "only game in town." Conversely, since the pandemic shock, Europe's response to the COVID-19 outbreak has opened a new scenario characterized by potentially groundbreaking innovations in the institutional and economic framework of the EU and EA. The challenge is the effective exploitation by the most fragile EA countries of the opportunities opened up by this new framework.

Section 1 of this General Introduction examines the economic governance characterizing the EU and EA at the end of the international financial crisis (2009). According to the strategic view of the European institutions in the previous period, the efficient functioning of the EU and EA economy was guaranteed by only a few elements: in the long term, by the progress in the single market and in its institutional framework; in the medium term, by national fiscal policies subject to binding centralized constraints, and by national regulations and welfare systems; and in the short term, by a centralized monetary policy and "market discipline." The international financial crisis and the consequent "real" crises emphasized the crucial role played by market and regulatory failures affecting the EU and EA member states in asymmetric ways. In particular, the EA sovereign debt crisis (end of 2009–spring 2011) and the "doom loop" between this crisis and that of the European banking sector (mid-2011–mid-2012) revealed the need for a more centralized regulatory and policy setting, based on the principle that asymmetric shocks require national adjustments but – in the meantime – European interventions. However, this new governance was characterized by structural weaknesses and its implementation was undermined by various policy shortcomings that fed an institutional uncertainty (see Section 2).

The risk was a stalemate in EU and EA economic governance. European institutions reacted to this risk by launching promising programs (in particular, the Banking Union process) framed in ambitious institutional designs (see "Towards a genuine economic and monetary union", usually known as the Four Presidents' Report). However, due to the divergences within the EA, the implementation of these programs created an opposition between "risk sharing" and "risk reduction" that, in turn, led to a lack of trust among various member states, and between European institutions and the most fragile countries. In this respect, the Greek case played a crucial role; however, Italy's problems also had significant weight (see Section 3). The result was that the innovations in governance were not completed and the institutional uncertainty increased, so that it became difficult to progress in the construction of an effective European economic union.

Despite a few inconclusive attempts to relaunch strategic designs (see, for instance, "Completing Europe's Economic and Monetary Union", usually known as the Five Presidents' Report), the 2015–2018 period was characterized by the recourse to an unconventional monetary policy, as a short- to medium-term absorbent of European disequilibria, and by a new emphasis on market discipline as a long-term adjustment mechanism at the national level. This framework put the principles of the market social economy under pressure. In any case, it could not represent an effective and efficient solution for an economic and institutional union among different member states. In particular, the recourse to market discipline as the long-term solution to European disequilibria determined a stalemate in European economic governance and an increase in political-institutional uncertainty, maximizing the long-term constraints and distorting the short-term benefits for the most fragile countries (see Section 4).

The symmetric shocks of the COVID-19 pandemic, which have asymmetrically affected the various EU and EA countries and productive sectors, have at least offered the opportunity to overcome this stalemate. Since spring 2020, the EU and EA have been characterized by innovative coordination between a strengthened unconventional monetary policy, and centralized and national expansionary fiscal policies; and in July 2020, the EU launched a groundbreaking initiative called Next Generation-EU (NG-EU) (see Section 5). This initiative is opening new perspectives for the evolution of the EU and EA. If the EU member states were able to exploit this opportunity, it would become possible to open a phase dominated by a centralized fiscal policy leading to a gradual process of institutional and political unification in the EU. Conversely, if some important EU countries were unable to successfully implement the main programs of NG-EU, it would become very difficult to design effective European economic governance (see Section 6). In a few concluding remarks, I will stress that the EU and EA are at a crossroads; and, in this case, it would be mistaken to maintain that the "known devils are better than the unknown devils" for Europeans.

1 The Fragile European Construction

In this General Introduction it is impossible to examine the complex analytical structure of so-called ordo-liberalism (see Eucken, 1950; Peacock and Wilgerodt, 1989; and Bilger, 1964). It suffices to recall three aspects. First, one of the main features of ordo-liberalism is that the efficient functioning of competitive markets cannot be reduced to the economic choices and constrained actions of individual agents; the surveillance and the possible intervention of the state are required to ensure the institutional framework and the economic conditions for a non-distortionary regulation through prices. Second, this economic order is often defined as "market social economy" to emphasize that the market and the state should interact in a rich institutional setting combining the price-based allocation, the related market rules, state regulation and social protection toward the disequilibria induced by market functioning. Third, the principles of market social economy imply that governments as fiscal policy-makers do not aim at supporting aggregate demand but take full responsibility for the failures of the economic system in which they operate. Moreover, these principles suit the more recent approach according to which, having the monopoly of the seigniorage power, monetary authorities should act independently of governments' preferences and of fiscal policies, and pursue pre-determined stability rules (see, for instance, Cukierman, 1992; Alesina and Summers, 1993).

The economic governance and the institutional framework of the EU and EA at the beginning of the international financial crisis (2007) were largely compliant with the market social economy approach.[3] Germany supported the monetary union under the non-negotiable condition that the ECB would enjoy full independence from national governments and would not be involved in fiscal issues (so-called monetary dominance). The construction of the single market, centered on the four freedoms (free circulation of goods, services and capital, and free mobility of persons/workers), was mainly based on prices' allocative functions. Nevertheless, the European Commission held strong powers in competitive market regulation through the broad tasks assigned to the Directorate-General (DG) Competition. By monitoring and managing market "failures," this regulation justified the crucial role attributed to market discipline: any (direct or indirect) form of "bailout" toward government debts was prohibited, to such an extent that the ECB cannot even influence the relative levels of interest rates on public bonds issued by different EA member states (the so-called spreads). Moreover, fiscal policy remained the responsibility of national governments, which were subject only to the constraints fixed by European institutions. However, these constraints should be rigorously met to dis-incentivize opportunistic actions which could generate instability and threaten the ECB's independence in a decentralized fiscal setting. If binding, these constraints could require national recourse to various forms of "fiscal repression."[4]

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[3] This statement does not imply that the market social economy is the sole doctrine inspiring the EU and EA architecture. This architecture has its roots in the European history and in the European philosophical, legal and social culture. More specifically, the principle of a European supranational government, at the core of the European federalist movement (see Spinelli 1989), and the principle of subsidiarity as the catalyst of European common interests, framed by Monnet (1976), have played crucial roles in laying the foundations of the recent EU political and social institutions. However, despite the critical attempt to read the evolution of European economic governance through the Monnet's lenses (see Guiso et al., 2016), I maintain that the German legacy has prevailed in framing the EU and EA economic institutions.

[4] "Fiscal repression" means that fiscal policy-makers should take initiatives to reduce the actual returns on financial wealth relative to possible market returns, driving the pursuit of negative "real" interest rates. These initiatives would obviously impede that process of financial liberalization which has

The EU and EA lacked centralized mechanisms to manage economic crises and centralized financial regulation and supervision, because regulated competition should be sufficient to avoid systemic market failures; and local failures would have to be handled by national regulatory mechanisms and by national fiscal authorities. The same principles explained the lack of monetary policy guidance during emergencies, because the latter should be solved through pre-determined conventional tools, given the main local responsibility of the national fiscal policy-makers.

It is controversial if the combination of these different factors inevitably leads to the "inconsistent quartet" defined by Padoa Schioppa (1982, 2004a). In any case, the international financial crisis was characterized by widespread market and institutional failures, the collapse of the international financial markets, and a high risk of systemic bankruptcy of the most important European banking sectors. Moreover, it caused the "great recession" of the "real" economy in the most advanced areas (the United States and the EU). Europe's response to this situation was, in the first phase, entrusted to the ECB and the national banking supervisors. The ECB eased the access conditions to its conventional open-market operations and decreased its policy interest rates.[5] The national governments, acting in agreement with the banking supervisors, implemented discretionary bailouts of banking groups on the brink of failure in order to contrast possible local contagions (see Messori, 2009, pp. 26–35). Then, after the bankruptcy of one of the most important US investment banks (Lehman Brothers in mid-September 2008) and the rescue of one of the biggest insurance companies (AIG) by the US Treasury Department and Federal Reserve,[6] a number of EU member states (mainly Germany, the UK, the Netherlands, Belgium and France) launched public interventions to socialize the private losses of their banking sectors and to avoid national systemic financial collapse. Moreover, the large majority of EA countries further increased public spending to handle the recessionary phase and, especially, to meet the automatic activation of national social stabilizers (such as unemployment benefits).

These national initiatives were not based on efficient European coordination.[7] The EU's interventions were limited to suspending the rules on state aid relative to the

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been advocated by several economists and strongly criticized by others. This debate finds its root in the history of economic analysis (Wicksell, 1898; Schumpeter, 1912). In the more recent literature, it can be dated back to the contributions of Shaw (1973) and McKinnon (1973).

[5] However, although clear-cut signs of recession indicated that the inflation pressures were temporary, the ECB increased its policy interest rates in July 2008, that is, a few weeks before the peak of the international financial crisis and of the economic recession. This distortionary choice was reproduced twice (April and June 2011) immediately before the peak of the European sovereign-debt crisis (see Section 2).

[6] AIG held a dominant position in the international market for "credit default swaps"; hence, it was at the center of a web of high-risk relations with a large number of US and European financial institutions.

[7] It would be interesting to discuss whether this lack of supranational coordination was the unavoidable result of the structural limits characterizing the euro construction. In this regard, different approaches and different responses can be found in: Angeloni et al. (2003); and De Grauwe (2013). Here, I cannot address an issue so demanding that would require a careful and detailed analysis.

financial sector and to de facto easing the fiscal constraints imposed by the Stability and Growth Pact. However, since April 2009, it became evident that the lack of centralized coordination in the national aid programs in favor of the various European banking sectors contributed to the limited effectiveness of these interventions compared to those implemented in the United States. Moreover, especially since 2011, the economic recession implied a dramatic surge of Non-Performing Loans (NPL) in the national banking sectors less affected by the international financial crisis due to their traditional business models.[8] On the other hand, the combination of the increase in national public spending and the severe fall in national GDPs implied that the large majority of the EA countries became non-compliant with the European fiscal parameters at the basis of the centralized fiscal rules.

The persistent fragility of the European banking sector and the disequilibria in government balance sheets have been important determinants of the doom loop between the EA sovereign debt crisis and the European banking crisis that resulted in a new and long EA recession from the last quarter of 2011 to mid–2013. However, at the core of this new crisis – and specifically of the near-bankruptcies of Greece, Ireland and Portugal (2009–2011) – has been the "sudden stop" in the growth path followed by the most fragile EA countries (the so-called peripheral countries) during the period preceding the international financial crisis.[9]

In the years 1999–2006, the "peripheral" EA countries recorded GDP growth rates that were higher than those of the "core" EA countries thanks to an amount of national aggregate investment greater than that of national aggregate savings. This imbalance was, obviously, mirrored in a corresponding amount of negative net exports. The consequent negative imbalances in the current accounts of the large majority of peripheral EA countries were compensated by the financial and capital inflows coming from the banking sectors and other investors of the core EA countries that were looking for profitable allocations of their excess national savings. According to the prevailing view (see Blanchard and Giavazzi, 2002), the negative imbalances in the current accounts and the compensating financial inflows signaled the successful and sustainable "catching up" process performed by peripheral EA member states. Moreover, at first sight, this process offered empirical evidence that Euro-

[8] A typical case is represented by the Italian banking sector. Until 2010, it was a common opinion that Italian banks had been among the most resilient to the international financial crisis (see for instance, De Bonis et al., 2012). This had justified a minimal state aid program in favor of this sector in 2009–2010. However, in 2014 it became clear that Italian banks had accumulated a large amount of NPLs, and that the most fragile of these banks were undercapitalized (see Part II, Chapters 2 and 3 of this book).

[9] In that period, the subset of peripheral countries consisted of Greece, Ireland, Italy, Portugal and Spain, as well as of newcomers such as Cyprus, Malta, Slovakia and Slovenia. Let me underline that the interactions among the adjustments in current accounts imbalances, the European banking crisis and the crisis of the EA sovereign debt are so thick that it would be inapposite to impute causal links. Nevertheless, the EU and EA economic governance and institutional framework, as well as the fiscal policy national reactions, focused on the government balance sheets disequilibria.

pean governance, based on market social economy, decentralized fiscal policies, and non-binding market discipline was working efficiently.

Unfortunately, the financial crisis of 2007–2009 revealed the inconsistencies of this view (see Micossi, 2016). The increase in "risk aversion" of the core countries' investors led to a quick reallocation of their financial funds to safer havens (the so-called fly to quality). These investors were, then, imitated by a significant part of the wealth owners of the peripheral EA countries. As a consequence, these latter countries recorded financial outflows and were thus unable to reproduce the previous negative imbalances in their current accounts. Their difficulties were worsened by the discovery that a significant part of the previous financial inflows had been allocated in speculative investments or short-term spending without improving the competitiveness of their production systems (see Canofari et al., 2015). The consequent "sudden stop" required drastic short-term adjustments centered on restrictive fiscal policies that led to severe economic recessions and social disruptions.

As already stated, the unsustainability of the public debt in Greece, Ireland and Portugal, and the subsequent Spanish and Cypriot crises can be ascribed to various combinations of disequilibria in government balance sheets, overly rapid and severe recessionary adjustments of the imbalances in current accounts, and the difficulties of the banking sector. Italy, which has been burdened by excessive public debt since the 1980s and has been in economic stagnation or recession since the beginning of the twenty-first century, was not deeply involved in the sudden stop and the consequent dramatic adjustments of the other peripheral EA countries because the negative imbalances in its current accounts (2005–2011) were not so significant. Nevertheless, Italy has been one of the EA countries that recorded the worst recession in 2011–2013 and the weakest recoveries in 2014–2019; Italy also suffered the deepest difficulties in the banking sector (2015–2017).

2 First Steps Toward More Centralized Governance

The Greek sovereign debt crisis at the end of 2009 and the growing difficulties faced by the Irish and Portuguese governments in allocating their new bonds in the financial markets during 2010 convinced the European institutions that the EA needed a centralized mechanism to manage the sovereign debt crises of its member states. However, in compliance with the market social economy approach, European governance had not provided for such a mechanism because the task of solving national fiscal crises and other national economic disequilibria was entrusted to decentralized fiscal policy-makers and possibly to national fiscal repression. Accordingly, European Treaties forbid any type of bailout of government debt, except if the country's difficulty was due to "exceptional reasons beyond its control." Even in such cases, ECB involvement and "direct" purchases of the concerned country's government bonds by other EA institutions or member states were not permitted.

It is obvious that these legal constraints hindered the initiatives to be taken for the implementation of centralized management of sovereign debt crises in the EA. This