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Resetting the EU's business model after the watershed

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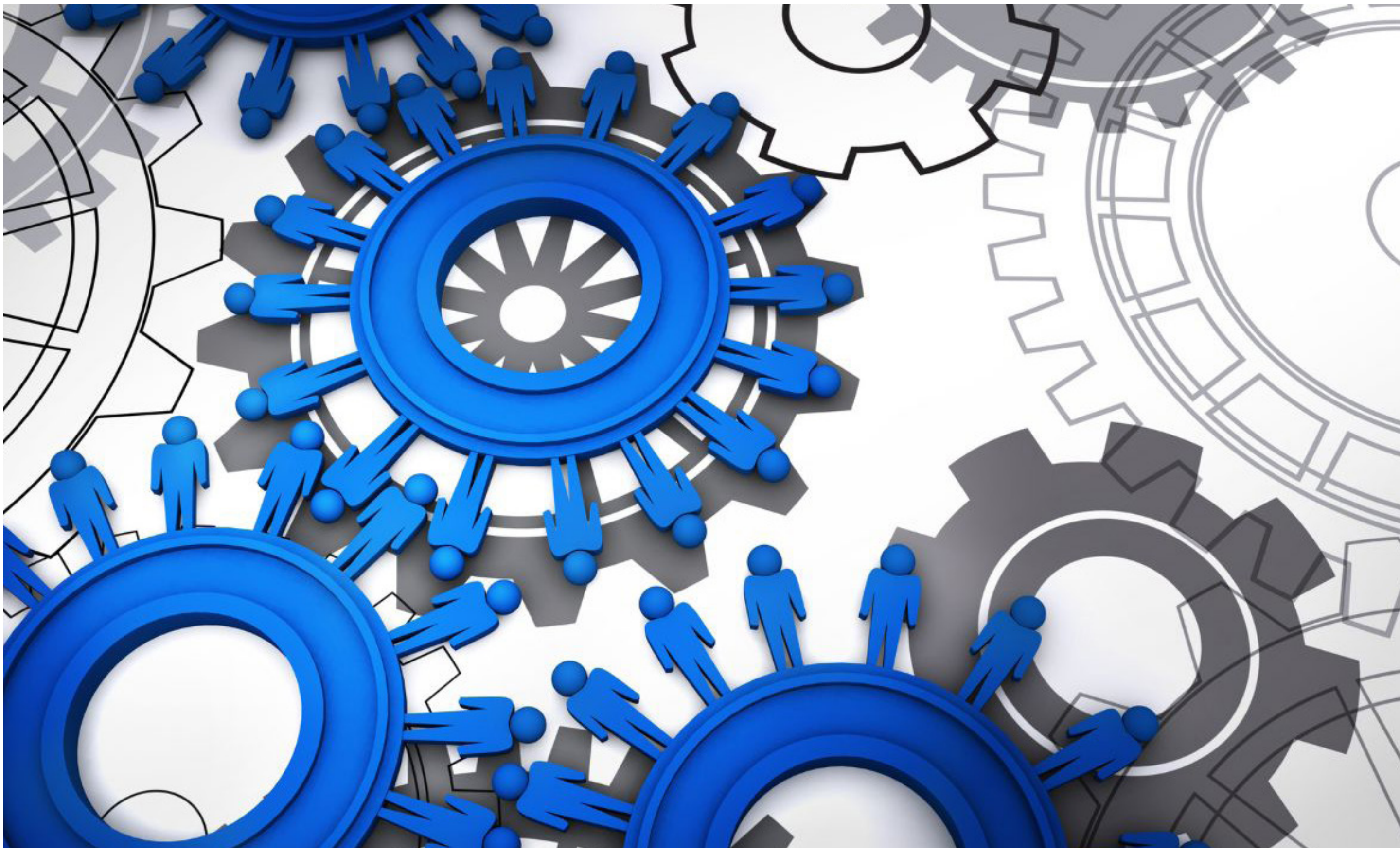

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Executive summary

The European Union's response to the COVID-19 pandemic had raised hopes of an acceleration towards deeper economic and political integration. Most optimists saw Next Generation EU as a paradigm shift that would result in the establishment of a permanent central fiscal capacity. Such hopes were reinforced by the Russian aggression against Ukraine; if not now, when? While the EU displayed remarkable unity in sanctioning Russia, the hopes for another leap forward in integration have not yet materialised.

This paper argues that the present crisis is more existential than the pandemic, as it questions Europe's business model: an energy-intensive, mercantilist production setup is not sustainable going forward, for domestic as well as global reasons. While the current energy crisis has not yet resulted in a centralised intervention, as it did in the case of the pandemic, the response to the US Inflation Reduction Act may be a break: preserving the single market prevents a go-it-alone policy comprised of purely national responses.

We believe that developing an effective centralised strategy should be based on three overarching considerations: (i) the EU needs to implement a new industrial policy aimed at strengthening value chains, addressing technological gaps with the US and China, and promoting a structural change in the competitive advantages of the EU's economic model; (ii) the implementation of this policy requires the EU's member states to be less risk averse and more open to common solutions; and (iii) a necessary, though not sufficient condition for a cooperative game is an effective implementation of the national Recovery and Resilience Plans that give access to the Recovery and Resilience Facility's funds.

Targeted European public goods are the way to mitigate the impact of the war in Ukraine on the European economy and address the economic model's obsolescence.

Achieving those goals is key to rebuilding political trust and reviving the 'Next Generation EU spirit.' The pandemic and energy crises have shown that the winners of yesterday aren't necessarily the winners of today or tomorrow. The path of the EU economy has also shown that none of its existential crises has been solved by country-specific measures alone. Under systemic uncertainty, the payoff of a common strategy is potentially large. Today, targeted European public goods are the way to mitigate the impact of the war in Ukraine on the European economy and address the economic model's obsolescence.

1. From the pandemic to the war: Different economic responses to two existential shocks

Next Generation EU (NGEU) raised hopes for a paradigm shift in the EU's integration process, in the form of a cohesive and supportive response to the pandemic shock, unlike the one seen following the global financial and sovereign debt crises. As Germany's then finance minister Olaf Scholz called it, NGEU was a potential 'Hamiltonian' moment for the EU. This view raised hopes of a permanent change in European economic governance.

NGEU was seen by the pro-European camp as an opportunity to rebuild trust among countries as a precondition for overcoming the constraints posed by the approach of "risk reduction first, before talking about risk sharing," which had led to a decision-making paralysis in the euro area (EA) and the EU in the aftermath of the global financial crisis. Provided that the major beneficiaries manage to respect their commitments, NGEU would create the prerequisites for greater solidarity among member states. NGEU could thus represent the first step in the creation of a permanent central fiscal capacity (CFC) that would better articulate the coordination between national and centralised fiscal policies.

Furthermore, NGEU could reconcile the EU's domestic agenda with the EU's international strategy. Achieving a more balanced policy mix between fiscal (domestic and centralised) and monetary policies would create an opportunity to reduce the dependence of the EU and, in particular, the EA on demand from third countries. In this respect, the partial centralisation of fiscal policy could (i) lead to the issuance of a European safe asset, apt to strengthen the international role of the euro and develop the area's financial markets; (ii) channel substantial resources (public and private) to the green and digital transition, while still aiming for better social inclusion; and (iii) enhance European strengths (regulation, welfare), thereby increasing the EU's influence in global economic governance.

In this optimistic view of the EU's evolution, the ball would be in the court of the most vulnerable countries, also because the latter benefit from a larger share of EU funding in the form of both loans and transfers. The effective use of these common resources would show Germany and the 'frugal' countries that the approval of NGEU has been "a good economic (and political) investment." A successful implementation of the national Recovery and Resilience Plans (RRPs), which is the condition to access funds under NGEU's most important programme, the Recovery and Resilience Facility (RRF), would become a prerequisite for converting NGEU's 'big one-off' into a paradigm shift.

The faster-than-expected economic rebound achieved by many EU countries in 2021 and the resilience of the European economy for much of 2022 seemed to support this view. Moreover, the existential shock due to Russia's war on the EU's Eastern border could have provided a further push for a quantum leap in European integration through the creation of a security and defence community and a common energy policy. Unfortunately, this prospect ran into significant obstacles due to new macroeconomic constraints and divergent policy responses.

2. New economic obstacles

The unexpected persistence of the pandemic-induced disruptions in global supply chains and the systemic shock of the war led to radical changes in the international landscape and in the EU's internal dynamics. In this new environment, additional pressure points have emerged, requiring *ad hoc* responses. From a macro and microeconomic perspective, there have been outbursts of inflation, a growing risk of weak growth, and the need to rethink the EU production model. These economic challenges have been compounded by geostrategic and politico-institutional problems.

The economic reasons for external and internal changes in the EU can be summarised in three points;

First, like the pandemic, the energy shock has been exogenous and common in origin, but it has produced asymmetric impacts across EU member states because of the different degrees of energy dependence and, more importantly, because of the varying national dependence on energy imports from Russia. Unlike the pandemic shock, these different energy mixes and the EU's greater energy vulnerability (compared to other international areas, like the US), have resulted in highly differentiated national initiatives. The recent agreement on a flexible price cap on gas and on REPowerEU has partly mended this state of affairs. The two initiatives are important because they have shown the political cohesion of the EU and have contributed to the decline in the price of gas.

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Second, the European Central Bank (ECB) and the central banks of non-euro EU countries are adopting an increasingly restrictive monetary policy to counter the inflationary dynamics triggered by the supply-side bottlenecks. This process is creating tighter constraints on the management of national fiscal policies and is negatively affecting aggregate demand. However, by itself, it cannot overcome the supply constraints. In this situation, the option of increasing spending at the community level (in the wake of NGEU) is hard to justify from a macroeconomic perspective: to the extent that such an increase in spending would stand as a stimulus to aggregate demand, it would exacerbate the problems caused by a contraction in aggregate supply. This explains why, in recent months, the ECB has sharply dialled back its previous message to create a central stabilisation tool and is now calling for prudence in the management of national budgetary policies and for gradual adjustments to fiscal rules.

Third, it is widely recognised that the pandemic has produced both demand and supply shocks. However, to handle the emergency, national policymakers essentially acted as if the pandemic impact were a demand shock. The bulk of domestic resources was used for liquidity transfers to businesses and households without countering the supply shock that would have been reinforced by the effects of the Russian invasion of Ukraine. The policy mix put in place by the EU during the pandemic has been overall very positive and considerably more appropriate than that during the global financial crisis. Nonetheless, the above demand bias has contributed to the unexpected persistence of disruptions in global supply chains, which have only recently started to abate.

The first outcome of these economic factors is clear. The Russian invasion of Ukraine not only marked the end of expansionary policies in the EU but also prevented the maintenance of the 'method' at the heart of the new policy mix adopted in response to the pandemic: the search for a balanced horizontal and vertical coordination between the single monetary, national and EU fiscal policies. However, there is also a deeper and, perhaps, less obvious economic outcome. At least *prima facie*, the pandemic did not challenge the European production model. The prevailing reaction conceived the supply constraints as a temporary phenomenon and the required reorganisations of production activities and logistics as merely the acceleration of a pre-existing trend due to digital innovations. The war in Ukraine and the related energy crisis have overturned this reading.

Combined with the shortening of global supply chains and with the escalating geopolitical conflicts (see below), the Russian aggression and the European political reaction made the EU's energy-intensive and export-driven economic model unsustainable. Economic reasons, therefore dictate a rethinking of the EU business model prevailing in the main member states. This discontinuity requires a different combination between the workings of the markets and the state's economic role and calls for an innovative industrial policy to be implemented at the EU level.

3. Why did the war not lead to a leap forward in integration?

The response to the pandemic had the ambition of reconciling the EU's domestic and external agendas. The EU goal was a return to those 'positive-sum games' in international relations that had traditionally been characterised by both pre-Trumpian multilateralism and pre-pandemic globalisation. Such European strategies seemed to offer a credible framework for stable global governance even at the end of the pandemic's most acute phase. Given the degree of interdependence of the world economy, the scenario of a disintegration of the multilateral equilibrium was seen as an extreme event (akin to a global Brexit) despite the breaks in the global supply chains and the growing technological conflict between the US and China. Today, one may ask whether the Russian invasion of Ukraine has, conversely, made this vision of a world confrontation unrealistic.

In the context of irreconcilable conflicts between the US and China, extending from technology to geopolitics, the attractiveness of the EU's integration model appears greatly diminished. The EU can incentivise and improve multilateral cooperation by sharing rules, social norms, and a framework of environmental protection. In short, EU leadership is based on 'soft power'. Instead, the emerging international landscape is characterised by the logic of 'hard power', which brings out 'zero-sum games' or 'negative-sum games', marked by a perverse spiral in which the overall end result is negative. If none of the major players prevails in the short period, the medium-term outcome can be an 'ultra-negative-sum game', in which it becomes ultimately impossible to make a net gain even at the individual level.

The EU is able to incentivise and improve multilateral cooperation by sharing rules, social norms, and a framework of environmental protection; in short, EU leadership is based on 'soft power'.

The previous observations show that the push toward a change in the EU's economic model is corroborated by geopolitical variables. The EU's internal political-institutional dynamics reinforce this conclusion, at least for three reasons.

First, the 'Franco-German motor' that had worked well in the launch of NGEU has lately been less effective. It has been difficult to take bold decisions (that are positive in the long run, but not always in the short run). It is necessary to recreate those conditions today. This requires European political leadership.

Second, during the negotiations on NGEU, the main emphasis was on transfers to member states via the RRF. Several of the common EU-level initiatives proposed by the Commission were not part of the final agreement.

Third, the reduced focus on joint initiatives was reinforced by the nature of NGEU as a one-off set programme. The emphasis on the temporariness of common debt issuance has weakened the attractiveness of European bonds to financial portfolio managers, with the effect of weakening its liquidity and worsening issuance conditions.

The combination of geopolitical and economic factors points to the need to formulate an ambitious EU-level policy response to the crisis.

The combination of geopolitical and economic factors points to the need to formulate an ambitious EU-level policy response to the crisis. The combined effect of the energy crisis in the EU and the conflicting dualism between the US and China in the international scenario, has highlighted the limits of the European 'Energy-Industrial Complex' with ancillary services. In this new environment, major EU countries cannot continue to base their production organisation and social prosperity on an economic model driven by net exports and centred on solid but mature technologies. Hence, despite the adverse short-term conditions and the lack of opportunities to cooperate, it has become necessary to build a new EU business model. However, the internal European political dynamics do not naturally deliver it. Can the response to the recent US industrial policy initiatives provide the necessary trigger?

4. A policy-induced shock: The US Inflation Reduction Act

The need for rethinking the EU business model has been strengthened by the recent industrial policy decisions taken in the US. The Inflation Reduction Act (IRA), amounting to $369bn, steps up the positive efforts to accelerate the green transition. However, this initiative includes elements that have a protectionist nature. The Act's main goal is to reinforce the US technological supremacy towards China through a set of incentives for sustainable investment implemented by innovative firms and via support on the related demand. In so doing, these policy measures hit trade openness and technological cooperation with Western allies. The IRA creates competition distortions by transferring a large amount of public resources to US firms whilst denying foreign firms operating in the same segments of the US market access to these resources. The open-ended nature of these provisions makes their impact potentially sizeable. The discriminatory and asymmetric transfer is strengthened by means of distortionary incentives to consumers via public support devoted to 'buying American'.

The adoption of the IRA has given rise to a strong policy reaction in the EU.

The adoption of the IRA has given rise to a strong policy reaction in the EU. For the reasons analysed above, the supply-side bottlenecks and the energy crisis were unable to trigger European policy initiatives comparable to those induced by the pandemic shock. EU member states were hit differently by the quantity and price constraints in the energy, raw materials, and food sectors. So far, it has been difficult to find a common ground that would allow a joint policy reaction in the area. On the contrary, the IRA may highlight an EU shared interest: avoiding further increases in technological gaps with the US as a condition for relaunching the rules-based international trade system.

Three possible avenues should be avoided in the EU: (a) a reaction exclusively focused on a further weakening of the European rules on state aid that have already been mitigated during the pandemic through various versions of the *Temporary Framework*; (b) a rear-guard, mercantilist effort just centred on the restoration of the positive net export flows that were the main driver of the EU's economic growth from 2014 to 2019; and (c) a strategic view limited to narrow economic aspects, disregarding wider geopolitical issues. Point (a) rests on the illusion that the EU can protect itself from the US market distortions by using national public resources in compliance with national fiscal capacity, neglecting the consequent divergencies between member states within the area. Point (b) overlooks the need to reduce the EU's technological gaps with the US. Point (c) does not consider the strong links between the EU's internal and external agenda, namely, the European interest in preventing the bilateral conflict between the US and China from impeding any multilateral cooperation in the international market.

If a review of the State aid Temporary Framework adopted during the pandemic cannot be avoided in the short-term, it is necessary to be mindful of the risk of widening the divergences within the area. Countries with a significant national fiscal space would be able to increase public spending, whereas the 'fragile' countries with high public debt-to-GDP ratios would be forced to meet binding constraints. As pointed out by the President of the European Commission, Ursula von der Leyen, the introduction of the Temporary Framework in the spring of 2020 implied that over three-quarters of the overall amount of state aid were granted by Germany and France alone. What is at stake is a 'double fragmentation' in the single market: real and financial.

Accordingly, the ensuing negative-sum game in the international market would risk pushing towards an 'ultra-negative-sum game' within the EU. To avoid this outcome, any revision in the state aid framework should mainly focus on its functioning and effectiveness. It should be also combined with a medium-to-long term strategy, centred on the activation of common funds and aimed at gradually closing the European technological gaps towards the US and China.

A holistic response to the IRA should provide the opportunity for an ambitious strategy of 'vertical coordination' between the EU national budgets to tackle the challenges to the EU's competitiveness.

To sum up, a holistic response to the IRA should provide the opportunity for an ambitious strategy of 'vertical coordination' between the EU's national budgets to tackle the challenges to the EU's competitiveness. Ultimately, the EU cannot forsake its *raison d'être*: to contribute to the rebuilding of positive-sum games centred on rule-based integration, more robust value chains, and the provision of 'global commons' are producing effective externalities. In short, the aim should be "made with Europe", rather than "made in Europe".

5. Designing effective policy responses

Faced with problems of this magnitude, a policy of preserving the *status quo* or muddling through is not viable. It would only bring out latent conflicts between EU member states and condemn the area to irrelevance in the new geopolitical landscape dominated by bilateral technological and geopolitical conflicts between the US and China. This, however, is not a foregone conclusion. The EU does have options for moving forward. To seize its economic opportunities, the EU should acknowledge that the current supply bottlenecks are also the result of the responses provided by the policy mix implemented during the pandemic crisis, which was ground-breaking in various respects but too focused on supporting the demand side. More importantly, the 2022-2023 scenario is significantly different from the one at the peak of the pandemic. To overcome the structural supply constraints and to achieve price stability and technological improvements, the EU economy needs a new business model.

Today, it is a matter of acknowledging the differences relative to 2020-2021 and assessing what policy tools can be deployed. The priority goals of economic and social policy remain those at the centre of the European Commission's initial agenda: digital transition, green transition, and social inclusion. However, these goals cannot be achieved through measures that mainly support aggregate demand. In the short-to-medium term, the twin transitions and the social cohesion should aim at overcoming the supply-side bottlenecks that triggered the EU's excessive inflation by limiting the access to energy and to an increasing number of raw materials critical for innovative productions. Such a supply-side strategy would make it possible to gradually reach price stability without a recessionary compression in demand that could lower investments and compromise future economic growth and social inclusion. The consequent scenario would be conducive, in the medium-to-long term, to a qualitative restructuring of the EU's production specialisation and a new organisation of the labour market and welfare systems.

These policy challenges cannot be met without a new interaction between national and EU policies. Pursuing a change in the EU business model requires that NGEU and RRF be supplemented by the centralised production of European Public Goods (EPGs) whose aggregate supply effects must be stronger than their demand effects.

The selection of this kind of EPGs should lead to at least three additional results. First, these EPGs should exert downward pressure on prices already in the short-to-medium term. Second, these same EPGs should hinder the depreciation of the euro, which characterised the initial phase of the current economic cycle and may become an additional vehicle for inflation or, at best, an illusory return to the EU's export-led economic model. Finally, they should become a key building block for a European industrial policy able to overcome the weaknesses of the current energy and production setups that are typical of the EU's main member states. The CFC, centred on these EPGs, would also free up space for European initiatives outside the strictly economic realm, such as in the areas of common security and defence.

6. Some conclusions: Solidarity as insurance

We have argued that the EU needs to change its business model. Our analysis can be read as an attempt to specify some of the conditions required to start this new approach. It can be summarised in three overarching points:

1. The production of EPGs that can sustain output supply and foster a structural rethinking of the competitive advantages of the EU's economic model in the long-term, is based on the design of a new EU industrial policy.

2. The implementation of this policy requires that the EU's member states become less risk averse and more inclined to trust and cooperation.

3. Although not sufficient, effective implementation of the RRPs remains a *sine qua non* to rebuild such trust and make space for the production of EPGs with the characteristics outlined above.

How to rebuild such political trust and recover the 'NGEU spirit'? As the energy crisis made clear, yesterday's winners are not today's or tomorrow's winners. So, cooperation does not require one-way solidarity from strong to fragile member states. Therefore, in full agreement with what Juergen Habermas already stated ten years ago, solidarity should be understood in terms of insurance.

As the energy crisis made clear, yesterday's winners are not today's or tomorrow's winners.

Mutual trust and insurance are peculiar and complex ingredients of the EU new business model. One of their main features lies in their contribution to the rediscovery of common EU roots. Being orphan of ordo-liberalism and lacking a new analytical framework fit for our time, the EU can enhance these common roots and rebuild its own identity also through improved trust and economic cooperation. We are not starting from scratch: solidarity *à la* Habermas characterised two successful responses to recent EU existential crises. In 2012, Draghi's "whatever it takes" and the ECB's Outright Monetary Transactions (OMT) rescued the EA economy from the "doom loop" between the sovereign debt crisis and the banking sector crisis; in 2020, the launch of NGEU saved the EU economy from the effects of the pandemic and remains crucial in the post-pandemic phase. It would have been impossible to implement OMT and NGEU by means of country-specific measures alone.

Today, the same conclusion applies to the production of targeted EPGs that are the necessary tools to save off the impact of the war in Ukraine on the EU economy and tackle the obsolescence of the European economic model.

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