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Taxing Multinationals: A Fundamental Shift Is Under Way

For too long, international institutions have failed to deal with one of the most toxic aspects of globalisation: tax avoidance by multinational corporations. This has reduced governments’ abilities to address international challenges such as the global pandemic, climate change, forced migration and rising inequality. It has also taken away a tool to achieve equality and distributive justice and thereby diminished citizens’ trust in the social contract.

Shifting profits to tax havens, large companies deprive governments of at least $240 billion per year in fiscal revenues. The Global South is disproportionately affected because their revenue sources are more limited, so reliance on corporate tax receipts to fund public services is greater.

In a globalised and digital economy, multinationals operate through centrally managed business models, and their global profits are largely the result of their global operations. Yet current international tax rules, developed nearly a century ago, treat subsidiaries of multinationals as legally independent firms which trade between each other using “arm’s length” or normal commercial prices to transfer goods and services.

But such prices are not always easy to find. Many markets are thin and dominated by the same multinationals, who then exploit this system to minimise their tax liability by shifting profits to jurisdictions with low or zero tax rates. This undermines the tax base of countries where real activities occur and, therefore, where the profits have been generated. These rules are also skewed in favour of rich countries because they help multinationals’ home countries get the biggest share of tax from global profits. This “transfer pricing” is exacerbated by tax competition to the point that the global average statutory corporate tax rate has fallen by more than half in three decades.

Following widespread public anger at tax avoidance scandals in 2012, the G20 mandated the OECD to establish the G20/OECD Base Erosion and Profit Shifting Project in 2013, aimed at tackling the issue. So far, reform proposals have fallen short of expectations. Comprehensive reforms have been hindered by dominant OECD member governments, which come to negotiations with the misplaced perception that national interest is served by protecting multinationals headquartered in their own countries. This has prevailed over genuine, global public interest.

The negotiating process has nonetheless reached agreement that multinationals should be considered unitary businesses. This means that their worldwide profits should be taxed in line with their real activities in each country and allocated to different jurisdictions, based on a formula according to the key factors that generate profit: employment, sales and assets. Many states in the United States use a similar “formulary apportionment” system to determine their taxable shares of US corporate profits. In 2016, the EU Commission put forward a similar proposal for an EU Common Consolidated Corporate Tax Base, but it has not yet been approved by the European Council.

Formulary apportionment would remove the current artificial incentive for multinationals to shift reported income to low-tax locations. Tax liabilities, instead, would be allocated by measures of their real economic activity in each location. But the proposal currently being negotiated involves applying this to only a small share of a firm’s global profits (so-called “residual” rather than “routine” profits) and is mainly directed at mostly US-based highly digitalised multinationals. This is not sufficient to address the problem.

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Instead, we need a more ambitious and comprehensive reform that replicates the US system at the international level, without distinction between digital and non-digital businesses. This would help to establish a more level playing field, reduce distortions, limit opportunities for tax avoidance, and provide certainty to multinationals and investors. To put an end to harmful tax competition between countries, this system should be supported by a global minimum tax on multinationals so as to reduce the incentive for multinationals to shift profits to tax havens.

Until recently, negotiations on a global minimum tax were benchmarked by the existing US minimum tax on US corporations' foreign earnings (known as “GILTI”), which has a rate of 10.5%. As a result, public discourse centred around a possible minimum tax rate of around 12.5% (incidentally, the corporate tax rate in Ireland, one of the EU's own tax havens). Such a low minimum tax rate could in fact over time become the global ceiling, in which case the laudable initiative to oblige multinationals to bear their fair share of taxes would end up doing the opposite.

Negotiations do not happen in a vacuum. The global pandemic has forced a fundamental rethink in many countries of the benefits of a race to the bottom in corporate tax rates. The new US administration campaigned on a manifesto to increase corporation tax from 21% to 28% and to double the current rate of minimum tax to 21%. The UK government has just announced a plan to raise its main rate of corporation tax from 19% to 25% in 2023.

This shift reflects a new understanding of the lack of positive association between corporation tax and investment decisions. The earlier belief that corporation tax cuts could help spur business investment has been contradicted by the reality that corporation tax decreases have failed to provide a step change in the level of capital investment.

This is true in the UK, where the corporation tax rate was cut from 30% before the global financial crisis to the current rate of 19%; in India, where the base rate was reduced to 22% from 30% in 2019; and the US, where the Trump Administration reduced the corporation tax rate from 35% to 21% in 2017. In the case of the US, instead of spurring investment, the rate cut mainly ended up funding dividend payments and stock buybacks.

This lack of effect on investment should not come as a surprise, as corporate taxation is a tax on pure profits – also known as economic rents – and therefore, lowering or raising the rate has little effect on economic activity. Rents have been on the rise over the last decades, notably in the US, but also globally as a result of increased market concentration and monopoly/monopsony power. These have in turn been triggered by gaps in access to technology (fuelled by intellectual property rights) and a series of benefits and privileges not available to smaller firms. The increase of rents suggests that governments should consider progressive corporate taxes, with higher rates on larger firms (especially monopolies/oligopolies) and lower rates on smaller firms in highly competitive sectors.

As companies return to profitability post-crisis, this will allow governments to generate revenue without distorting investment. A more progressive corporate tax structure would also address excess profits enabled by crisis conditions, by raising tax revenues from companies that are thriving during the pandemic (such as some pharmaceutical and highly digitalised businesses).

This shift in thinking may make a strong global agreement on an effective minimum tax a possibility and encourage countries to start a virtuous race to the top. If G20 countries were to agree to impose a 25% minimum corporate tax on the global income of their multinational firms, more than 90% of worldwide profits would automatically be taxed at 25% or more.

There is broad evidence of the need for fundamental reform in the international tax system, but it requires political will to move forward. Any outcome in the 2021 international negotiations must be seen as the first step towards creating a genuinely fair international fiscal architecture.
European Integration and National Elections After COVID-19

The United Kingdom’s departure from the European Union and the COVID-19 crisis are offering a window of opportunity for a deeper fiscal union and further European integration in various policy areas including foreign affairs and defence, tax harmonisation and climate change. While this debate goes far beyond national boundaries, the voters who cast their ballots are still as national as ever. When the EU emerges from the pandemic, the political landscape in different member states will likely become even more crucial for European integration. In this context, the recent elections in the Netherlands, the latest government crisis in Italy and the upcoming national elections in Germany, France and Hungary might show whether that window of opportunity remains. This Forum provides insight into how the domestic politics of EU member states pose a challenge to, and an opportunity for, the future of the European integration project.

Europe After COVID-19: A New Role for German Leadership?
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The EU Elephant: Europe in the 2021 Dutch General Elections
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Presidential Election 2022: A Euroclash Between a “Liberal” and a “Neo-Nationalist” France Is Coming
Thierry Chopin, Université Catholique de Lille, ESPOL, France.

Italy’s Political Turmoil and Mario Draghi’s European Challenges
Mario Pianta, Scuola Normale Superiore, Florence, Italy.

Europhile Public vs Eurosceptic Governing Elite in Hungary?
Borbála Göncz, Corvinus University of Budapest, Hungary.
György Lengyel, Corvinus University of Budapest, Hungary.
Europe After COVID-19: A New Role for German Leadership?

A famous quote by Jean Monnet (1978) states that Europe will be “built through crises” and will be “the sum of their solutions” (417). Nevertheless, many agree that in recent years, the sovereign debt crisis has been “wasted” by European policymakers who have remained largely impervious to the discussion on the respective role of state and market in ensuring economic growth and convergence. Instead of learning from the “rethinking macroeconomics” debate triggered by the global financial crisis to build a less dysfunctional and more cohesive Europe, they locked the single currency in a vicious circle of deflationary policies and sluggish growth. Then came the reaction to the coronavirus pandemic, which was surprising both in size and in timeliness. It is as if the mistakes of previous years, somewhat metabolised, had prompted governments and European institutions to move without hesitation. This article traces the policy response to the COVID-19 crisis, highlighting the role of Germany in this change of perspective. It then investigates the reasons behind the end of the German “virtue” and analyses the implications for the current debate on eurozone reform.

Building a dam against the COVID-19 tsunami

In March 2020, EU governments were the first line in the fight against the pandemic. This was inevitable: the EU is a union of sovereign states and neither public health nor fiscal policies are among its competencies. For the latter, consistent with the no taxation without representation motto, spending and tax decisions can only be made at the national level, where accountability with the voters lies. Measures to support households and businesses fell into three broad categories: firstly, support for health systems under stress (among other things, because of the systematic underfunding of the past decades); secondly, measures to preserve employment and support workers’ incomes; and finally, measures to support the liquidity of companies, with tax deferrals and credit guarantees. Nearly everywhere, the measures were extended well into 2021 as the economic effects of the pandemic unfolded. The impact on public finances was immediate: In 2020, eurozone government deficit and debt increased to 8.4% and 98.1% of GDP respectively (IMF, 2021). The measures were fruitful, as everywhere income and employment have fallen significantly less than GDP. Germany was particularly proactive, with two large stimulus packages (in March and in June) that expanded the duration and scope of both short-time work schemes (kurzarbeit) and unemployment benefits, and provided loans and guarantees for liquidity strapped firms. The June package was aimed at boosting domestic demand through a temporary VAT decrease and incentives for investment in green technologies and digitalisation.

While member states were in the front line, European authorities promptly moved to protect them from market pressure. The Commission activated the Stability and Growth Pact (SGP) suspension clause and softened state aid rules, thus allowing states to pump money into the economy and to support the sectors hit by the pandemic. Meanwhile, the ECB launched an extensive pandemic emergency purchase programme (PEPP), later extended in size and in duration (until spring 2022). Together with the mass of savings available worldwide, this has kept interest rates low, contributing to debt sustainability. Finally, European institutions made loans available to member states for their urgent expenditures. Whether through an existing mechanism (the European Stability Mechanism (ESM) for health-related expenditure), or a newly created mechanism (the temporary Support to mitigate Unemployment Risks in an Emergency (SURE) for labour markets), the principle was the same: Europe borrows at favourable rates and transfers the loans to countries that can thus save on interest expenditure. SURE was extremely successful and in autumn 2020 started lending €90 billion to 18 countries. On the contrary, no country applied for ESM lending: Despite a relaxation of access conditions (the “pandemic line”), it remains an instrument aimed at ensuring the stability of the euro area in the event of financial crises; as such, it allows the European institutions to interfere in member states’ budget processes. No country judged the limited gain in interest that the pandemic line would warrant to be worth this risk of interference.
The medium-term challenges: A proactive EU, but not (yet) a Hamiltonian moment

As we slowly emerge from the crisis, the EU is going from a mere supporting role to being a key player. The transition towards a sustainable growth path, the revamping of public investment, the rethinking of our welfare systems – these are challenges that not even the largest European countries can hope to meet efficiently on their own. Economies of scale and externalities militate in favour of policies implemented, or at least financed and coordinated, at the EU level.

The need to provide these European public goods is what inspired the Next Generation EU programme, which combines the Recovery and Resilience Facility (RRF) and other mechanisms with the European multiannual budget, endowing member states with a total of €1.850 billion over seven years. The innovative aspects of the instrument have been thoroughly discussed. First, the issuance of common debt for significant amounts (€750 billion) to finance an extensive investment programme aimed at channelling the recovery within the EU’s long-term objectives (green growth, digitalisation, social cohesion); then, the allocation of resources to member states based on the needs that have emerged from the pandemic rather than from the usual allocation keys (which is why Italy, usually a net contributor to the EU budget, will be a net beneficiary of the RRF). The debt will be repaid from 2028 to 2058, hopefully thanks to an increase of own resources (the web tax, the carbon border tax, the plastic tax). If progress is not made on these, countries’ contributions to the Union budget will have to be increased.

There is little doubt that Next Generation EU is a turning point: for the first time, the Union is making a joint effort to revive growth based on the idea of temporary mutualisation of debt. What makes the agreement even more significant is Germany’s position, which, from the outset, put all its weight behind the Commission’s initiative. Nevertheless, it is certainly not a Hamiltonian moment, a founding act for a federal Europe. First, the RRF is temporary and does not take on existing debts; moreover, the “own resources” are currently only a wish list: Except for the plastic tax, there is a lack of agreement among member states on the taxation of multinationals, the Tobin tax and the carbon border tax. In addition, investment programmes will remain national; it would have been desirable for this joint indebtedness effort to be put at the service of a vast European investment programme (Creel et al., 2020), but to date the EU does not have a spending capacity comparable to that of a federal state. In this sense, it is welcome news that the Commission has set strict guidelines for financing national plans, aimed at ensuring the overall coherence of national strategies and greater effectiveness in the supply of global public goods. Finally, the price to pay to get “frugal” countries on board has been a drastic reduction in the funding for European public goods such as education, the Invest Europe programme and health. For example, the proposal for a Health Union (the EU4Health programme) had been virtually defunded by the Council; only the commendable work by the European Parliament restored funding to €5 billion, about half of the (already modest) original proposal by the Commission. In a sort of institutional blur, while the RRF is geared towards adapting the European Union to the challenges of the post-pandemic world, the opportunity to direct the EU’s ordinary instruments towards the same objective has been missed.

Nevertheless, if it is true that the RRF is a long way from being a federalist leap (for which, moreover, the political conditions are not met today), it is a game changer, and its impact on the EU landscape in the coming year might go well beyond the significant resources allotted to financing the recovery. What might remain, in fact, is the radical change of heart of the German government that follows the unprecedented fiscal effort of the spring 2020.

The end of German virtue?

Following the global financial crisis, the cursor between the state and the market has moved towards the centre, and many economists today have no problem recognising a role for monetary and fiscal policies in smoothing the cycle and supporting growth. Moreover, the debate on multipliers and public investment has cleared the way for the idea that the sustainability of fiscal policy depends on its effect on growth as much as on public finances – a concept so trivial as to be oft forgotten during the eurozone crisis.

The first 20 years of the single currency and the sovereign debt crisis have shown that markets cannot do everything on their own. Yet, macroeconomic policies in the Economic and Monetary Union (EMU) have been inspired by the principle of risk reduction for a decade: The best way to avoid further crises and economic divergence would be to implement fiscal discipline and reforms in each country, following the idea that a chain is only as strong as its weakest link: The joint management of macroeconomic shocks would be unneces-

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1 Remember that Alexander Hamilton in 1790 transferred the existing debt contracted by the states during the war of independence to the federal budget, financing its service with customs tariffs and an excise duty on whisky and other spirits, the first US federal tax.
sary if each country became resilient on its own. This is why, while fiscal consolidation in peripheral countries squeezed domestic demand and thus trade deficits, the core surpluses persisted and sometimes increased. The eurozone, entangled in a long deflationary spell, was gradually “Germanised”: the current account surplus, close to zero until 2007, increased to a maximum of 3.6% of GDP in 2016.

The COVID-19 pandemic reshuffled the cards. International organisations are now warning against premature consolidations. OECD chief economist Laurence Boone recently noted that the mistake during the global financial crisis was not the lack of stimulus in 2009, but the rapid return to austerity from 2010 onwards. The IMF fiscal affairs department director Vitor Gaspar did not go as far as Boone and call the austerity of the 2010s a mistake. Nevertheless, presenting the IMF (2021) Fiscal Monitor last January, Gaspar insisted that today’s low interest rates change the picture: while public debt in advanced economies doubled from 60% to 120% of GDP over the last 30 years, interest payments have halved from 4% of GDP to 2%, with obvious consequences for sustainability. Similarly, the European Commission noted that in the coming years, despite persistent sluggish growth, even more modest interest rate levels would lead to a downward trend in the ratio of public debt to GDP (Giles, 2021; IMF, 2021; European Commission, 2021).

The new intellectual environment is not the only reason to hope that the 2010 austerity drive will not return. The German change of attitude concerning fiscal policy and the mutualisation of efforts to fight the pandemic is driven by self-interest, and as such might be structural. Firstly, the international framework is different. During the Greek crisis, core EMU countries had looked with detachment at the convulsions of peripheral EMU countries. The collapse in their demand had been easily compensated by redirecting exports towards East Asia and the US. Thus, as long as financial stability was preserved, the health of the European market was of little interest to exporters in the core. Today things are different; there is no reason to think that the new US administration will act less aggressively than the previous one on trade, and world markets will not continue to absorb the surpluses of eurozone exporting countries. In the future, therefore, the European market, its prosperity, and its stable and balanced growth, will be in the best interest of Germany.

Besides the changed international environment, at home Germany is starting to feel the many years of “frugality”. Between 2000 and 2019, both corporate and public investment in Germany were well below the eurozone average (OECD, 2020). The resulting lack of capital creates bottlenecks and in the coming years will inevitably limit Germany’s growth. In particular, firms’ low knowledge-based investment and sluggish adoption of advanced ICTs hold back innovation and productivity growth. Population aging will do the rest, reducing the labour force and leading to a further squeeze on investment and labour productivity, eventually reducing potential growth. Last, but not least, the increase in inequality in recent years has disarticulated the social market economy model and helped to squeeze consumption and domestic demand.

To sum up, today many contradictions of the “frugal” model come to the fore and the reforms of recent years have distorted the ordoliberal model, leaving behind a trail of precariousness and inequality. Themes such as trade surpluses, fiscal policy and wage policies, absent only a few years ago, are gaining momentum in the German policy discussions, which benefit from the emergence of a new generation of economists open to the international debate. The German daily Süddeutsche Zeitung’s 2015 survey of more than a thousand German economists showed that the intellectual landscape was changing rapidly (Fricke, 2015). In the five years since the previous survey, for example, the proportion of economists who believed that fiscal policy plays a role in smoothing the cycle had risen from 18% to 36%. In addition, about two-thirds of respondents favoured the central bank role as a lender of last resort in the event of a financial crisis; this was right in 2015, as conflicts between Bundesbank President Jens Weidmann and ECB President Mario Draghi became public over the newly launched quantitative easing programme. The consensus is likely to have further evolved since then, with the COVID-19 crisis accelerating the movement. We saw that Germany was the European country that most decisively engaged in fiscal support of the economy, abandoning the balanced budget dogma (Hall, 2021). What is more, it was the German Ministry of Finance, a former temple of fiscal orthodoxy, which conceived the Merkel-Macron document in May 2020 recommending joint debt issuance, eventually leading to the Next Generation EU proposal.

The coming months will be key to understanding Germany’s position in the European debate. Angela Merkel will not run in the 26 September general election. Many commentators believe that the most likely outcome is a...
coalition between the CDU and the Green Party, which is likely to enjoy electoral success (Besch and Odendahl, 2021). In that case, investment and income distribution will be high on the agenda, even if the new CDU leader Armin Laschet will have to handle the rigorist wing of the party, which in the past has often resisted Merkel’s choices (from the minimum wage to the green light to Next Generation EU).

Towards a new role for Germany in eurozone reform?

The eurozone institutions have to be adapted to the newly found centrality of macroeconomic policy in ensuring macroeconomic stability and convergence. The coronavirus crisis proves that only real mutual insurance mechanisms, the features of a federal state, could guarantee stability and growth by operating together with (and sometimes compensating for) market adjustments. While it is obvious that today there is no leeway for a federal project, the existence of an ideal solution, however utopian, may be a useful benchmark. A German change of stance could allow progress in several reform areas that would have been unthinkable just one year ago.

From mistrust to solidarity: Financial assistance and automatic stabilisation in the EMU

Over time, the EU has introduced several instruments for financial assistance to member states. A Jacques Delors Centre brief (Guttenberg, 2020) has recently stirred widespread discussion starting from the observation that the success of the SURE mechanism and (hopefully) of the Next Generation EU indicate a change of perspective: While financial assistance so far was based on mistrust among EU countries, the COVID-19 crisis has created political demand for solidarity and stabilisation mechanisms. The brief proposes to repatriate the ESM (now a sovereign bank governed by an intergovernmental treaty between eurozone countries) within the EU perimeter, as proposed by the Commission in 2017, and consolidate it with the plethora of other existing assistance instruments: SURE, the RRF loans scheme, the banks’ Single Resolution Fund and the balance of payments assistance facility. The idea is to have a unique facility capable of offering credit lines differentiated by purpose and conditions of access. The ESM itself (that is today politically toxic) could then evolve into a debt agency (Amato et al., 2020) to coordinate and – in the case of joint projects such as Next Generation EU – mutualise national debts. Furthermore, it could issue that safe asset that would allow better management of European debt.

The reorganisation of the financial assistance facilities should go hand in hand with the creation of a tool for the reabsorption of asymmetric shocks. One such automatic stabiliser could be a European unemployment benefit scheme, proposed by several authors and endorsed by the European Commission (Andor, 2016; Arnold, 2018; Beblavý and Lenaerts, 2017). This should be a contingent scheme that would intervene in the event of significant deviations in the unemployment rate from a country-specific reference value, in addition to national programmes. This is obviously of paramount importance, because it would leave the choice of the extent and duration of protection against unemployment to individual countries’ social contracts. Attempts to simulate the stabilisation capacity of the different proposals show that it could be generally designed in such a way that it does not lead to permanent transfers and that, in case of large shocks, its stabilisation capacity would be significant. Being specifically designed to absorb asymmetric shocks, on the other hand, it would not help in case of global shocks; to support all countries at once, the mechanism should be endowed with the capacity to borrow. In the past, the German Finance Minister Olaf Scholz has backed the idea of a European unemployment mechanism. Nevertheless, what he had in mind was a lending facility (along the lines of the recent SURE mechanism), rather than a proper insurance mechanism (Reuters, 2018).

Together with the introduction of a central stabilisation mechanism, future reform should strengthen the ability of markets to stabilise asymmetric shocks by deepening the capital markets union and the banking union. The divide among member states on this topic is not as deep as on rules or on central fiscal capacity. The only controversial point is the common deposit insurance, necessary to complete the banking union and to break the doom loop between sovereigns and financial institutions. This would introduce a limited amount of risk sharing and as such it has been met with hostility in Germany. However, before the pandemic, Germany had cautiously opened a window of opportunity that may have expanded further today (Scholz, 2019).

A new fiscal rule

Absent a (politically unrealistic) federal budget, common stabilisation tools will unlikely provide enough shock absorption capacity to the EMU. National fiscal policy will remain central. This is why the most important debate of the next few months will be the one on the reform of the SGP. It would be simplistic to say that European fiscal rules forced pro-cyclical fiscal consolidation in the post-2010 period. Austerity is rather the political result of a narrative that traced the debt crisis back to the fiscal profligacy of the EMU peripheral countries. However, the institutions for macroeconomic governance were con-
sistent with the shift towards austerity and, as the Greek crisis shows, provided the appropriate means of exerting pressure to impose it on recalcitrant governments.

Interestingly, the suspension of the SGP in March 2020 came a few weeks after the opening by the Commission of a consultation process on fiscal rules, which in turn was based on a surprisingly severe assessment of the existing framework (European Commission, 2020). The Commission addressed criticisms put forward by independent economists since the SGP inception: The current framework (a) is excessively complex, arbitrary and difficult to enforce; (b) allows for the curbing of deficits but not debt, which is the real measure of public finances’ sustainability; (c) penalises public investment, which is generally easier to reduce than current expenditure; (d) and finally, the European Commission (2020) recognised for the first time that the current framework forced procyclical deflationary policies (particularly between 2010 and 2013). In short, the Commission acknowledged, albeit implicitly, that European rules have made fiscal policy a source of instability and not of stabilisation.

The consultation process resumed in early 2021; as the SGP will remain suspended at least until 2022, it is safe to bet that the existing rules will be replaced before they come back into force. It is important that the new fiscal framework reconciles the objective of public finances’ sustainability with the newfound centrality of budgetary policies in the policymaker’s toolbox. The old idea of a golden rule of public finance, excluding investment from the deficit calculation, is once again making its way into the debate. The Commission recently announced that it is working on a proposal linking the rule to green investment (Euractiv, 2021). However, the pandemic showed once more the inadequacy of a purely accounting approach, identifying public investment with physical capital; following this approach, a large part of health expenditure, for example, would be considered current expenditure. The challenge would be to define investments in functional terms, to include all expenditure that increases not only physical capital, but also social and intangible capital, which are equally essential for growth. A political process involving the Commission, the Council and the Parliament would be central to the functioning of this “augmented golden rule” (Saraceno, 2017). Germany so far has been hostile to the idea of a golden rule; nevertheless, the already mentioned infrastructure gap and the colossal investment needs of the ecological transition might push towards a change of position, especially if the Green Party is part of the ruling coalition.

Conclusion

The COVID-19 crisis has revived the economic policy debate in Europe, wiping out timidity and hesitation. In just a few months, tools for a common management of the crisis have been created that could eventually evolve into a completely different organisation of European macroeconomic policies. Interdependence and the need for risk-sharing instruments are now highlighted in areas such as health, public investment, ecological transition and the management of asymmetric shocks. While it is too early to say where this will lead, recent German actions are a reason to hope that in the next few years, the country will be an engine for reform rather than a stubborn defender of the status quo.

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The EU Elephant: Europe in the 2021 Dutch General Elections

The Netherlands held general elections in March 2021, the first in a series of national elections in the Netherlands, Germany, France and Hungary that could determine the course of the European Union in the coming years. As had often been the case in the past, televised debates were the most important arena where the Dutch election campaign was fought. EU integration did not play a major role in the campaign and was only mentioned in a single debate on the day before the elections. The absence of a serious debate about the European Union led a group of academics and political observers to introduce the “EU Elephant” in the public debate (Boekestijn, 2021; Boekestijn et al., 2021; Groen, 2021). In their view, the EU was the elephant in the room that parties did not address in the campaign. Even when parties address the issue in public, the Dutch debate often flattens into a pro-/anti-EU debate. This does not reflect that the Netherlands – the largest of the small member states – may likely shape what the EU will look like.

While the EU was absent from the debate in the run-up to the elections, it still appears to have played some role in the outcome, showing a country that is deeply conflicted about the future of the Union. Moreover, the results of the elections and – perhaps more important in the Dutch case – the ensuing cabinet formation, will determine the shape of the future cabinet’s EU policy. In the last 11 years, the Netherlands, under the leadership of Liberal Prime Minister Mark Rutte, has certainly been a brake on any step that would transform the EU into a transfer union between economically stronger Northern European countries and economically weaker Southern countries.

This article discusses the election campaign, the result of the elections, the balance between pro-European and Eurosceptic parties and which policies the current Dutch government is likely to pursue.

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instead that she had acted in the country’s interest by advocating for peace and stability in the region. The perspective of ‘new leadership’ under Kaag became a real possibility in the waning days of the campaign.

Victors and losers

The new old and new composition of the Dutch Tweede Kamer, as well as all 17 parties currently in parliament, are listed in Table 1. D66 won five seats more than in 2017. Kaag ended up winning 24 out of 150 seats (as much as the party’s legendary leader Hans van Mierlo did in 1994). This was an exceptional feat as governing had always cost D66 dearly in the elections. The party drew support from the pro-European progressive parties: The progres-
sive left-wing GreenLeft lost six out 14 seats, while the social democratic Labour Party kept nine seats but lost all the gains it had made in the polls after its disastrous 2017 loss. At the pro-European side of the spectrum, a new party also entered parliament: Volt. This party has a social liberal manifesto and is committed to European federalism. The party presents itself as the Dutch branch of a pan-European party that also has a single (German) representative in the European Parliament.

The VVD ended up winning just one more seat than its 2017 total. Still, the liberals were the largest party in parliament. The CDA lost five seats (falling from 19 to 14) and the fourth government party, the Christian social CU, kept its five seats. All in all, the government parties expanded their seat total compared to 2017. It is the first time since 1998 that the parties supporting the government actually expanded their support. It is the first time since 1998 that the parties supporting the government actually expanded their seats, and the first time since 2003 that the government parties won a majority.

We also saw notable shifts in seats for the Eurosceptic parties. The Dutch Tweede Kamer currently has three radical right-wing populist parties, which all combine some degree of nativism, authoritarianism, populism and Euroscepticism. The largest, the Freedom Party of Geert Wilders, lost three of its 20 seats. It advocates a Next and focuses its nativism on Islam. The Forum for Democracy of Thierry Baudet expanded its support from two to eight. Half a year before the elections, the party had become embroiled in a scandal about anti-Semitic memes shared by members of its youth organisation. The moderate wing left the party to form a new party, Yes21. Baudet retained the leadership of his party and refocused its course on COVID-19. The party focused its entire campaign on ending the lockdown measures. They argued that the coronavirus crisis was overstated, and that the lockdown measures could be lifted as long as the vulnerable were isolated. It no longer focused on its Eurosceptic and anti-immigration manifesto. Yes21 is more moderate also in its Euroscepticism, not advocating a Dutch exit from the EU but merely proposing to bring the EU back to a free trade association. This party won three seats. Together the radical right-wing populists won 28 seats, as much as the right-wing populist parties had done in 2002 under Pim Fortuyn. Among the soft Eurosceptic parties on the left, the radical left-wing Socialist Party lost five seats and the deep green Party for the Animals won one seat.

On the European dimension

We could classify the Dutch parties along the EU dimension with five positions (Table 2; see also Vollaard and Voerman, 2015). These categories also line up with how parties are placed on the EU dimension by the experts in the Chapel Hill Expert Survey (Bakker et al., 2020). At the most pro-European side, there are two parties that advocate the EU becoming a fully fledged federation: D66 and Volt. This implies a fundamental shift in the structure and the competences of the EU. Volt is more radical in this than D66, arguing that the EU should determine policies concerning social security and economic inequality that traditionally belong to member states. D66 favoured a eurozone budget and Eurobonds long before the current crisis (Vollaard and Voerman, 2015, 166). D66 is a member of ALDE, and Volt Netherlands is the Dutch branch of the pan-European party Volt (which sits with the Greens in the European Parliament). The parties expanded their seat total from 19 to 27.

Then there are the pro-European parties: the Labour Party and GreenLeft as well as the new anti-racist, anti-capitalist, feminist party As1. These parties advocate strengthening solidarity in the European Union, for instance, by adopting common rules to fight tax avoidance and increasing spending at the European level. They also want to strengthen democracy in the EU and are critical of the role of big business interests. The Labour Party’s EU policy has been less consistent veering between a pro-European and a more Euro-pragmatist course (Vollaard and Voerman, 2015, 137-138). With Frans Timmermans as its lead candidate for the European elections (and the subsequent reward for that choice in the elections), the PvdA has steered a more pro-European course. The GreenLeft has become more pro-European in recent decades, realising that for the eurozone to work, further economic and budgetary integration is necessary. The PvdA is a member of the Party of European Socialists, and the GreenLeft is a member of the European Greens. As a bloc, these parties lost five out of 23 seats.

Next, the Euro-pragmatist parties or self-styled “Euro-realists” (Harryvan and Van der Harst, 2013, 275) have

<table>
<thead>
<tr>
<th>Position</th>
<th>Parties (with CHES positions)</th>
<th>2017</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro-federalist</td>
<td>D66 (6.9), Volt (No value yet)</td>
<td>19</td>
<td>27</td>
</tr>
<tr>
<td>Pro-European</td>
<td>PvdA (5.9), GL (6.5), As1 (No value yet)</td>
<td>23</td>
<td>18</td>
</tr>
<tr>
<td>Euro-pragmatist</td>
<td>VVD (5.1), CDA (5.3), 50PLUS (3.9), CU (4.0), DENK (4.7)</td>
<td>64</td>
<td>58</td>
</tr>
<tr>
<td>Soft Eurosceptic</td>
<td>SGP (2.9), SP (2.8), PvdD (2.6), BBB (No value yet), Yes21 (No value yet)</td>
<td>22</td>
<td>22</td>
</tr>
<tr>
<td>Hard Eurosceptic</td>
<td>FVD (1.1), PVV (1.3)</td>
<td>22</td>
<td>25</td>
</tr>
</tbody>
</table>

Source: Bakker et al. (2020); and author’s compilation.
accepted the EU as it is, but do not favour further EU integration (Kopecký and Mudde, 2002). In their view, the EU is primarily a free trade area. The common currency is there to promote free trade. These parties are reluctant to hand over more competences to the EU, for instance on taxation, and are opposed to making the eurozone a transfer union. These parties are the VVD, CDA, the pensioners’ party 50PLUS, CU and the party of, for and by people with a migration background, DENK. The VVD is a member of ALDE but is more Eurosceptic than the mainstream in this group: the national (economic) interest determines their EU policy (Vollaard and Voerman 2015, 161). The CDA, 50PLUS and CU all sit (or sat) in the group of the European People’s Party. Of these, the CU is least committed to the euro and has hinted that it would not lament if weaker economies left the eurozone, betraying the party’s Eurosceptic past (Vollaard and Voerman, 2015, 127). These parties together lost six out of 64 seats.

Additionally, there are the soft Eurosceptic parties. These parties are opposed to the current policies of the European Union and propose reducing the EU to an intergovernmental body, stripping it of its supranational features. These are the SGP, SP, the deep green PvdD, the farmers’ interest party Farmer-Citizen Movement and the moderate right-wing populist party Yes21. SP and PvdD sit (or sat) in the United European Left-Nordic Green Left and favour EU regulation to protect workers and animals. The SGP and the Yes21 MEPs (that all left FVD) currently sit in the European Conservatives and Reformers. They, like the Euro-pragmatist parties, see the EU primarily as a free trade zone. These parties kept 22 seats combined.

Finally, there are the hard-Eurosceptic parties (FVD and PVV). These parties advocate for the Netherlands leaving the EU. For these parties, the EU has become a monstrosity that cannot be reformed. They look at the arrangements that Switzerland, Norway and now even the UK have as alternatives to EU membership (Vollaard and Voerman, 2015, 171). The PVV sits in the Identity and Democracy group, and the FVD lost its MEPs to Yes21. These parties expanded their seats from 22 to 25.

We can clearly see that the victors of the elections were at the extremes of the EU dimension. Both the most pro-European parties (D66 and Volt) and the most Eurosceptic party won (FVD) seats. The EU might not have been a major issue in the public debate surrounding the election, but the polarisation on the EU dimension is clearly visible. There are specific choices in the campaign that led to this outcome (e.g. the selection of Kaag as D66 leader and the choice of FVD to campaign on COVID-19). But from a more distant perspective, it may be that in the absence of a substantial debate between the economic left and economic right, voters may have expressed a deeper underlying cultural division between cosmopolitans and patriots in their vote. The importance of this division has grown in the past few years (De Vries, 2018; De Vries et al., 2013). Thus, the Elephant of EU politics was not absent in the minds of citizens.

The EU policy of a new government

What does this mean for the EU policy of the Netherlands in the coming parliamentary term? For the Netherlands, the single most important EU issue is the future of the eurozone. The Netherlands has always seen EU integration primarily as an economic enterprise (Harryvan and Van der Harst, 2015). In the past eleven years, the Netherlands has argued for restrictive fiscal policies and has been a brake on transferring money to economically weaker states without restrictions. During the coronavirus pandemic, the Dutch cobbled together an informal alliance of the ‘frugal four’ (Sweden, Denmark, Austria and the Netherlands) to, albeit unsuccessfully, prevent debt mutualisation. The key issue in the coming term will be whether the crisis measures taken in the COVID-19 pandemic will have a lasting character. That is, whether the recovery fund with its sovereign bonds will be a permanent feature of the EU cooperation on the one hand; and whether criteria of the Stability and Growth Pact that have been waived in the crisis will return after the coronavirus crisis has faded on the other. These issues will certainly need to be addressed by the new government. The parties may have been able to ignore the EU Elephant during the three month campaign, but they can no longer ignore it over the next four years.

The elections are only one step into the Dutch political process. The votes of Dutch voters disappear in what some have called the Bermuda Triangle of Dutch politics: the process of coalition formation (Van Keken and Kuipers, 2021). Here, the preferences of the different parties are transformed into a coalition agreement that binds the parties together. The previous coalition agreement committed the parties to a stringent eurozone course opposing future bailouts, Eurobonds, permanent economic stabilisation mechanisms and a strict application of the Stability and Growth Pact – despite the presence of the Euro-federalist D66 at the negotiating table. Its three Euro-pragmatist negotiating partners were able to determine the agenda.

Which parties will join the new government is still unclear days after the election. The formation of a new government will take some time: 94 days on average in the post-war period (Ecker and Meyer, 2015). Currently, it looks as though the Liberal Party and D66 will form the core of this
new government. EU policy will mostly be determined by the interplay between VVD and D66 and their prospective government partners.

The Euro-pragmatist and fiscally conservative VVD will continue to act as a brake on anything resembling a transfer union. The liberals only accepted deviating from the rules of the Stability and Growth Pact because of the exceptional circumstances. The growth of the radical right may put electoral pressure on the VVD not to deviate from their current course. If it is up to the VVD, Rutte’s reputation as “Mr. No” will continue (Van Wiel, 2020).

D66, however, will want to chart a much different course, both in tone and in policy. Certainly, D66 will want the government to take a less adversarial path regarding other EU member states. They are more open to the possibility that the crisis measures (the steps towards debt mutualisation, European taxation and a eurozone budget) will be made permanent. The entry of Volt into the parliamentary arena may also pressure them to bring their pro-European promises to fruition.

The minister of finance, together with the prime minister, are the faces of Dutch EU and euro policy: since 1989, the second largest party in the government has supplied this position. This means that a more pro-European party D66 is likely to get this position and with it greater influence on EU policy.

Much will depend on which government will be formed in the extremely fractionalised landscape. Many configurations are possible, but they will need to bridge major divides regularly. The policies that the parties agree on in the coalition agreement are those that most parties desire (Willumsen and Otjes, 2019). If the current government continues, D66 will be outgunned by Euro-pragmatist parties. The same is true if VVD and D66 are joined by other less conventional partners like the soft-Eurosceptic parties. The same is true if VVD and D66 are joined by other less conventional partners like the soft-Eurosceptic parties.

Much now depends on how they play the game and, in particular, which other parties will be invited to the table. In this respect, the VVD appears to have a stronger hand because the centre-right, Euro-pragmatist parties have performed better than the left-wing pro-European parties.

**Conclusion**

The Dutch elections are, as Dutch elections often are, important but not decisive in determining the country’s policies. They distribute the cards for the upcoming formation. Two parties have been dealt a good hand: the Euro-pragmatist, conservative liberal VVD and Euro-federalist, social-liberal D66. Hovering over the table, will be the EU Elephant, the inevitable question of whether the current European economic measures are merely temporary stop-gap procedures to deal with an unprecedented crisis or the start of a European transfer union. Both D66 and VVD are under electoral pressure to stay the course. Much now depends on how they play the game and, in particular, which other parties will be invited to the table. In this respect, the VVD appears to have a stronger hand because the centre-right, Euro-pragmatist parties have performed better than the left-wing pro-European parties.

**Literature**


De Vries, C., A. Hakkerverdian and B. Lancee (2013), The dynamics of voters’ left/right identification: The role of economic and cultural attitudes, Political Science Research and Methods, 1(2), 223-238.


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Given the high level of uncertainty at this political moment (as it is difficult to know to what extent we will still be in crisis or post-crisis at the beginning of the election campaign in less than a year) as well as the electoral volatility and the “crisis of democracy” at the national level, we have to be cautious in the following analysis. Drawing on recent research conducted in European studies, this article develops a typology of the five models of French political actors’ positions vis-à-vis the EU: the “left-wing sovereignist”, the “social-economic integration”, the “liberal integration”, the “right-wing sovereignist” and the “neo-nationalist” models. This typology is constructed by cross-referencing the ideological preferences of political leaders and their choices regarding European governance. By taking into account both structural trends and the political situation informed by polls, we develop two scenarios corresponding to the re-election of Emmanuel Macron and the election of Marine Le Pen. The first scenario embodies the liberal model, while the second defends the neo-nationalist model, but both are distinguished by their preferences for the integration and differentiation of EU governance, the level of politicisation of European bargaining and priorities of the political agenda. These differences outline two dynamics of Europe in the first part of the 21st century.

The making of French politics through ideological preferences and European governance

French politics are in a process of strong evolution, determined by the “new public management”, which stems from technocracy and expertise, and aims at the imperative of “efficiency” (Schmidt and Thatcher, 2013). The authority of the head of state and the permanent link be-

**Thierry Chopin and Samuel B. H. Faure**

**Presidential Election 2022: A Euroclash Between a “Liberal” and a “Neo-Nationalist” France Is Coming**

How could the 2022 French presidential election impact the dynamics of European integration? Generally speaking, there is an increasingly strong link between national elections and domestic politics on the one hand and European issues on the other (Bulmer and Lequesne, 2020). From the point of view of the national context in France, the presidential political system gives major importance to this election because the most strategic decisions with European partners are still made by the president – all the more so in a context of crises that reinforce the role of the European Council (Wessels, 2015). The EU has been marked since the beginning of the 21st century by a “polycrisis” (Juncker, 2016) that has strengthened the institutional position of the European Council (Bickerton et al., 2015). Moreover, the current COVID-19 crisis poses a number of challenges to the citizens of EU member states that have a clear European dimension, such as economic recovery, energy transition, defence policy, etc.

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tween the head of state and the people are reinforced by the presidentialist institutions of the Fifth Republic: It is the “return of the Prince” (Martigny, 2019). The omnipresence of social media shakes up public debate by reinforcing the salience of certain public problems such as laïcité, or secularism. France is thus defined by a new logic of democracy in Europe described as “techno-populism” (Bickerton and Invernizzi Accetti, 2021). Marine Le Pen (Rassemblement National, RN) and Emmanuel Macron (La République en Marche, LREM), who reached the second round of the presidential election in 2017 and have dominated the polls ever since, present themselves as anti-establishment and defend a policy of radical reforms.² Le Pen and Macron see themselves as outsiders in French politics embodying a new era (nouveau monde).

However, Le Pen has been a major player since the turn of the century (MEP and regional councillor since 2004), and Macron was adviser (2012-14) and then Minister of the Economy (2014-16) under the mandate of his predecessor, President François Hollande. But above all, this political opposition between “techno-populists” has not replaced the traditional ideological divide between the left and the right, which is proving resilient,³ even within LREM. The left-right rivalry is characterised, on the one hand, by the nature and degree of political regulation chosen by the actors and, on the other hand, by their framing of the political agenda (Table 1). This positioning can be analysed using the relations with liberalism: In France, the left is liberal politically and culturally but to a large extent opposed to economic liberalism; the right is liberal economically but not culturally, prioritising security and traditional values over individual liberties; and the extremes are illiberal politically and economically.

French left-wing actors defend a strong market interventionism with “dirigiste” capitalism, while being more liberal in their vision of society regarding, among other things, minority rights and youth. On the other hand, right-wing actors value a weaker regulation of the market by a state with reduced prerogatives and (neo-)liberal economic logic, while supporting conservative positions on societal issues.⁴ Moreover, left-wing programmes are oriented around climate change, the ideal of social justice and equality for all citizens, as well as institutional transformations in favour of a more participatory and therefore bottom-up democracy. Conversely, French right-wing actors put the competitiveness of businesses and the value of freedom, the issue of national identity linked to security, and the status quo of a centralised and top-down organisation of the political regime on the political agenda.

This left-right paradigm is useful but insufficient to capture the preferences of French actors linked to European politics, often summarised in public debate by a rivalry between the “sovereignist” camp, which defends the nation, and the “globalist” camp, which values the EU (Grunberg, 2021).⁵ Research conducted on EU member states demonstrates that it is more heuristic to make a distinction in terms of governance (Bulmer and Lequesne, 2020). Some French actors favour a strictly intergovernmental functioning of the EU. They prefer the European Council and the Council of Ministers, arenas where decisions are taken by unanimity (Novak, 2017). They are inclined to politicise negotiations, use their veto to defend national interests and block positions preferred by other member states. Within and beyond EU institutions, the effort to create more political opposition to the EU is labelled “Euroclash” (Flißstein, 2008) and can lead to institutional crises such as the “empty chair” crisis in the 1960s, which concerned the common agricultural policy (Moravcsik, 1998).

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1 They share the “dégagisme” idea that French political problems would come from a unified political class around outdated political parties, in particular, the Parti Socialiste on the left and Les Républicains on the right.
3 It may be recalled that Le Pen and Macron represent less than one out of two voters. Moreover, a significant proportion of citizens, sometimes a majority of them as in the European elections of 2019 and the municipal elections of 2020, do not vote, confirming the argument of a “democracy of abstention” (Braconnier and Dormagen, 2007).
4 This assertion should not obscure the fact that there is a tradition of a Colbertist right in France, which defends state interventionism vis-à-vis the market.
5 We find this cross-party polarisation in other international issues such as France’s position vis-à-vis Russia (Schmitt, 2017) or the United States (Charillon, 2021).

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### Table 1

The left-right divide in French politics

<table>
<thead>
<tr>
<th></th>
<th>Left</th>
<th>Right</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>State regulation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market regulation</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Role of public authorities</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Regulation of civil society</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td><strong>Policy framing</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Economic and social issues</td>
<td>Equality and solidarity</td>
<td>Business competitiveness and freedom</td>
</tr>
<tr>
<td>Societal issues</td>
<td>Climate change and justice</td>
<td>National identity and security</td>
</tr>
<tr>
<td>Institutional issues</td>
<td>Change</td>
<td>Status quo</td>
</tr>
</tbody>
</table>

Source: Authors’ own elaboration.
Other French leaders do not limit themselves to intergovernmental work in order to govern the EU, but also involve supranational institutions such as the Commission, the European Parliament, the Court of Justice and the European Central Bank (ECB). Supranational institutions are not abandoned or criticised – their political competences being delegitimised in the name of national sovereignty – but are conversely used as another political instrument to promote a “French Europe” (Rozenberg, 2020). In the context of a differentiated European integration (Chopin, 2017a; Faure and Lebrou, 2020; Schimmelfennig and Winzen, 2020), the articulation by a state of several formats (bi-, mini- and multilateral), arenas (within and outside the EU) and instruments (intergovernmental and supranational) of European cooperation can be called “flexilateralism” (Faure, 2019a).

To summarise and reformulate it in a more conceptual way (Bickerton, 2012), while Macron favours France’s link to the EU and a consensual practice of power (i.e. the “member state model”), Le Pen could choose “the people against Europe” by reinforcing the politisation of the way France’s European policy is conducted (i.e. the “nation state model”).

### Mapping French political actors’ positions on EU politics

The intersection of these two ideological and political continua reveals the distribution of French actors between five models of political position vis-à-vis the future of European integration (Figure 1). Like any typology, this one does not exhaust the complexity of reality. However, this typology shows the main political trends that order the national political field vis-à-vis the EU and can thus improve our understanding of how European issues will be addressed in the 2022 presidential election.

The first group brings together actors who defend a left-wing political agenda and values by supporting strong state interventionism and intergovernmental European governance: This is the “left-wing sovereignist” model regrouping as the “Chevènementists”. Jean-Luc Mélenchon (La France Insoumise), as well as certain former members of the Parti Socialiste, such as Ségolène Royal and Arnaud Montebourg, are the heirs of this model. Indeed, Royal had oriented her 2007 presidential campaign (which she lost in the second round to Nicolas Sarkozy) around the ideas of nation, sovereignty and borders. Arnaud Montebourg (MP, 1997-2012; Minister of the Economy, 2012-14) has positioned himself since the beginning of 2010 as the main promoter of “Made in France” and thus of an assumed economic protectionism.

A second cluster of political actors is identified on the left and differs from the first one by defending a more integrated EU governance: This is the “social-economic integration” model associated with the “Mitterrandians”. This political line is embodied by the ecologist party (Europe Écologie-Les Verts) and its main representatives, such as MEP Yannick Jadot and the Grenoble mayor Éric Piolle. The Socialists’ contingent who voted in favour of the Treaty establishing a Constitution for Europe (TCE) in 2005 share this political orientation towards a deeper European integration. This is the case of the former President, François Hollande, as well as his Minister of Justice, Christiane Taubira, and the current mayor of Paris, Anne Hidalgo. Without clearly establishing the links between the political and intellectual fields, this position corresponds to the proposals formulated by Thomas Piketty among others (Hennette et al., 2019) in favour of a treaty for the democratisation of Europe. According to them, the main institutional challenge is not so much safeguarding national sovereignty, but rather crafting a transnational democracy.7

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6 The federalist movement that would lead political parties to defend an exclusively supranational governance of the EU is absent from the French political landscape, being reduced to a few isolated figures such as Daniel Cohn-Bendit, who no longer play an active role.

7 This also recalls the legal and economic contribution of Aglietta and Leron (2017), as well as the recent tribune of Vallée (2020), who also insists on the democratic stake.

---

#### Figure 1

**Five positions of French political actors vis-à-vis the EU**

<table>
<thead>
<tr>
<th>Intergovernmentalism and supranationalism (Member state)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Social-economic integration</strong></td>
</tr>
<tr>
<td>The Mitterrandians</td>
</tr>
<tr>
<td>Anne Hidalgo</td>
</tr>
<tr>
<td>Emmanuel Macron</td>
</tr>
<tr>
<td>Valérie Pécresse</td>
</tr>
<tr>
<td><strong>Liberal integration</strong></td>
</tr>
<tr>
<td>The Giscardians</td>
</tr>
<tr>
<td>Xavier Bertrand</td>
</tr>
<tr>
<td>Bruno Retailleau</td>
</tr>
<tr>
<td>Laurent Wauquiez</td>
</tr>
<tr>
<td><strong>Left-wing sovereignty</strong></td>
</tr>
<tr>
<td>The Chevènementists</td>
</tr>
<tr>
<td>Jean-Luc Mélenchon</td>
</tr>
<tr>
<td>Arnaud Montebourg</td>
</tr>
<tr>
<td>Ségolène Royal</td>
</tr>
<tr>
<td><strong>Right-wing sovereignty</strong></td>
</tr>
<tr>
<td>The Gaullists</td>
</tr>
<tr>
<td>Nicolas Dupont-Aignan</td>
</tr>
<tr>
<td>Marine Le Pen</td>
</tr>
<tr>
<td>Florian Philippot</td>
</tr>
<tr>
<td><strong>Neo-nationalism</strong> (including Frexitiens)</td>
</tr>
</tbody>
</table>

Source: Authors’ own elaboration.
The third guild of French leaders shares support for a flexilateral EU (intergovernmental and supranational governance) with the previous group while distinguishing itself with a preference for centre-right political ideas and values: This is the “liberal integration” model that unites the “Giscardians”. The European policy conducted by President Macron since 2017 and by the former Prime Minister Édouard Philippe (2017-2020) corresponds to this model, which does not seem incompatible with the moderate part of the conservative party (Les Républicains) embodied by Valérie Pécresse, president of the Île-de-France region.

The fourth model of political actors, like the previous group, favours a preference for right-wing political values, but moves away from it with a strictly intergovernmental governance of the EU: This is the “right-wing sovereignist” model that binds the “Gaulists”. It associates part of Les Républicains, such as Bruno Retailleau, Senator since 2004 and President of the Les Républicains group in the Senate since 2014, and also Laurent Wauquiez and Xavier Bertrand, presidents of the Auvergne-Rhône-Alpes and Hauts-de-France regions, respectively. Their political positions on security and immigration converge, as does a defence of the rural society and traditions (Rozenberg, 2020, 82).

Finally, a fifth model involves the “neo-nationalists” (Badie et al., 2017). Unlike the two classic types of nationalism (“liberal” nationalism linked to the principle of self-determination of peoples and “authoritarian and expansionist” nationalism which marked the history of the first half of the twentieth century), the return of nationalism nowadays (neo-nationalism) is more specifically a nationalism of withdrawal and protection which is characterised by a defensive political discourse. Neo-nationalist movements take advantage of the context of the current sovereignist moment (Lamassoure et al., 2019).

This neo-nationalist model includes political leaders who defend France’s exit from the EU (Frexit). This position has been residual in the political arena since Le Pen changed her narrative and strategy when she lost the presidential election in 2017, stating that France would remain within the EU and the eurozone if she were elected President of the French Republic. Frexit is supported by far-right micro political parties, such as Les Patriotes led by Florian Philip-

8 The difference between social-economic integration and liberal integration models corresponds, conceptually (Scharpf, 1999), to the distinction between “positive integration” (market correcting) and “negative integration” (market making).

9 Although Laurent Wauquiez and Xavier Bertrand voted in favour of the TCE in 2005, Wauquiez considered a posteriori that he had changed his mind by taking a sovereignist turn developed in his 2014 book and Bertrand spoke out against the Maastricht Treaty in the referendum organised in 1992.

While no extreme left-wing political movement has openly pronounced itself in favour of Frexit, an ideological and semantic shift is observed among some leaders of La France Insoumise. For example, Jean-Luc Mélenchon stated on Twitter on 30 January 2020, the day Brexit was activated: “The United Kingdom, freed from the tutelage of Brussels, is renationalising the railroad that the liberals had put into chaos. Independence is paying off”. In the context of social inequalities increased by the COVID-19 pandemic, it would not be surprising if an activist from the yellow vests social movement were to present him- or herself in 2022 on a similar political line.

Given the current polls (Gallard et al., 2021), more than a year before the presidential election, the following two sections focus on two of these five models forming a Euroclash: the liberal model represented by Macron’s re-election and the neo-nationalist model embodied by the election of Le Pen. For each scenario, we analyse the political and institutional preferences for governance, as well as the political agendas related to the main economic and social issues (Table 2).

Table 2
A comparison between Macron and Le Pen programmes vis-à-vis the EU

<table>
<thead>
<tr>
<th></th>
<th>Macron</th>
<th>Le Pen</th>
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</thead>
<tbody>
<tr>
<td>Political position vis-à-vis the EU</td>
<td>Liberal model</td>
<td>Neo-nationalist model</td>
</tr>
<tr>
<td>Type of state</td>
<td>Member state</td>
<td>Nation state</td>
</tr>
<tr>
<td>Level of governance</td>
<td>European</td>
<td>National</td>
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<tr>
<td>Level of integration</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Level of differentiation</td>
<td>High</td>
<td>High</td>
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<tr>
<td>Level of politicisation</td>
<td>Low</td>
<td>High</td>
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Source: Authors’ own elaboration.

The main question surrounding the re-election of Macron is the uncertain balance of France’s flexilateral policy vis-à-vis the EU in a post-Brexit and COVID-19 context: Strengthening European integration by changing France’s practice towards the EU or taking an inter-
governmentalist turn by using – in a very classical way – Europe as an “Archimedes’ lever” to defend national interests. In the hypothetical case of Macron’s re-election, it seems clear that the President of the French Republic will seek to pursue the implementation of his agenda aimed at developing the constitution of European sovereignty (Macron, 2017; Beaune, 2020). This project is not perceived as the will to build a federal state at the European scale, but to consider that the EU constitutes a relevant scale of public action complementary to the national level of the member states in order to provide responses to challenges that both go beyond nations and concern the heart of state sovereignty (Chopin, 2017b).

Nonetheless, this notion of European sovereignty presents a certain ambivalence (Bertoncini and Chopin, 2020a, 2020b; Fondation Jean Jaurès and Fondation Friederich-Ebert, 2021). It leads to the defence of the Mitterrandian-Delorist position reflecting a preference for a deeper socio-economic integration, and at the same time, working in favour of a Gaullist and/or a Chevènementist position that supports national sovereignty (Faure, 2020a). In the COVID-19 context, we observe a semantic shift from the theme of sovereignty to that of independence, “Made in France” and national sovereignty over European sovereignty, and strategic autonomy (Faure, 2020b; Tertrais, 2021). The discourse carried by Macron is increasingly similar to the traditional French narrative that France should use the EU as a power multiplier, the famous Archimedes’ lever referred to by General Charles de Gaulle himself. In other words, Macron shares with his predecessors a “French Europe”, i.e. a “certain idea of Europe” (Parsons, 2006). This could be summed up by considering that Macron’s European policy is featured both by a certain idea of France (Jackson, 2018) and by an uncertain idea of Europe (Faure, 2020c).

This political ambiguity is reflected in institutional issues. Is it a question of strengthening the role of the European Commission and Parliament in the political governance of the EU? Or rather promoting European governance foremost through the European Council and the role played by the heads of state and government, a role that has been strongly reinforced by the ten years of “polycrisis” that have affected Europeans? The French President seems to favour voluntarism and the search for leadership rather than the patient search for a compromise negotiated with his European partners, which corresponds to French institutional and political practice and habits (Chopin, 2017b). This shows a preference for the European Council as the real executive power of the EU and an intergovernmental conception of European policy. Nevertheless, this political style seems to be combined at the same time with a focus on supranational institutions (and France’s influence within them), especially the Commission, the Parliament and the ECB (Bertoncini and Chopin, 2019).

Concerning the programme and the political preferences likely to be carried in the next presidential election, they should be as high on the candidate’s strategy and agenda as in 2017, for at least three reasons. First, Europe is at the heart of the political DNA of Macron’s voters. Second, the left and the right are divided on the European issue. Third, in the perspective of a “return match” against Le Pen, Europe will be a very divisive issue politically, notably in the context of the French Presidency of the EU Council. With regard to this last point, however, it should be noted that the terms of the debate will not be the same in 2022 as they were in 2017. On the one hand, Macron will have to defend the European assessment of his five-year term; on the other hand, Le Pen has abandoned the Europhobic “exit” strategy and has refocused her speech on the classic themes of the extreme right, such as immigration and security. Moreover, the question arises as to whether the French President will seek to pursue the promised “European Renaissance” or whether he will decide to promote a less ambitious programme with the choice of a few (more) modest reforms. Finally, the themes and main features of the 2022-27 programme could be defined on the basis of the priorities that have been announced for the forthcoming French Presidency of the EU Council in the form of the triptych: relance (recovery), puissance (power) and appartenance (belonging). This discursive register and political agenda seems to confirm and extend the liberal model mentioned above.

**Le Pen’s election: A demanding remainder in favour of the nation state**

If we know that Le Pen has renounced her “exit” strategy and the will to leave the EU, her position once she comes to power will be neo-nationalist, corresponding to the slogans “Make France Great Again” and “France First”. In such a perspective, Le Pen would support national sovereignty rather than European sovereignty and the preference (when possible) for ad hoc bilateral or multilateral collaborations rather than the use of the multilateral framework within the EU. The question arises as to what would happen in a situation of cohabitation if the RN does not manage to obtain an absolute majority in the legislative elections following the presidential election: Would this lead to a paralysis of Europe by a regime crisis? Alternatively, what would happen without cohabitation? Would it lead to a Frexit by referendum, even if opinion polls clearly indicate the absence of a majority Europhobia, or hard Euroscepticism, in France (see Chopin and Lequesne, 2020; Chopin et al., 2020b)?
In such a scenario, the election of Le Pen would first of all have a number of obvious implications in terms of European governance. France would undoubtedly favour a strict intergovernmental functioning in accordance with a conception of the EU as an alliance of sovereign national states seeking above all else to defend their national interests, i.e. the Gaulist model. It should be stressed that such a practice of power at the European level could risk blockages, or even paralysis, in the event of too strong co-habitation and confrontation between the president and the prime minister or certain powerful sectoral ministers from another political party. Alternatively, one could imagine a duplicitous game between the “moderates” and the “radicals” – as among the Tories between David Cameron and Boris Johnson (Evans and Menon, 2017) – with a sectoral minister who would push the president further to the right, and further away from the EU, to the point of asking for a referendum. Furthermore, it is likely that the presidency of Le Pen will seek to cooperate in Europe as much as possible outside the EU through ad hoc cooperation, and moreover bilaterally, where Macron would continue to play first and foremost the EU game (Table 2). This would lead to the strengthening of the logic of differentiation of Europe not so much as a path to integration which has been a structuring logic in the history of European construction (Chopin and Jamet, 2008; Faure, 2019b), but rather leading the EU towards the risk of fragmentation and even of disintegration (Jones, 2018; Webber, 2018).

The election of Le Pen could change the practice of governance in the EU and France’s influence accordingly. On the political level, it is possible to anticipate a reinforcement of the intergovernmental politicisation of the negotiations in the European Council, following Viktor Orban’s practices to push the comparative advantage to the breaking point. Moreover, the political credibility of France, a “large” founding country participating in all EU policies (the euro, Schengen, etc.), could be strongly affected. It is difficult to imagine that Le Pen, elected to the Presidency of the Republic, would be able to exercise political leadership at the European level with France’s partners in a context where the health crisis will also have reduced its budgetary room for manoeuvre, thus reducing the country’s economic credibility. On the institutional front, it is likely that Le Pen’s strategy for France will lead to criticism of the supranational institutions (against the Commission of which the liberal Thierry Breton will still be a member until 2024, but also against the Court of Justice). In other words, while remaining within the EU, as already mentioned, we would observe the transition of France from a member state to a nation state (Bickerton, 2012).

In terms of a political agenda, Le Pen’s strategy is to reassure and win over a “popular” right-wing electorate, particularly pensioners, whose voter turnout is traditionally high. On the economic front, the objective will be to propose a more reassuring economic programme. This would involve abandoning the most radical positions concerning Europe, which would bring uncertainty, particularly with regard to the exit from the euro, an abandonment that had already been noted at the time of the last European elections. The “moderation” of the economic discourse also involves a change in the thinking on debt with the abandonment of the idea of having the ECB cancel public debt. On the contrary, Le Pen has recently declared herself in favour of debt repayment while insisting on points already mobilised by the current government such as investments in the future, support for companies, etc. This economic narrative is keen to reassure right-wing voters who are attached to the conservation of their heritage. On the question of borders, it is likely that Le Pen develops a defensive and closed vision of European national societies in line with a neo-nationalist conception and advocates the closure of borders to immigration as well as the limitation of the free movement of people within the EU, including free movement within the Schengen area.

Conclusions

Given the complexity of these issues and the contingency of the political situation, it would not be surprising if our probabilities do not hold. Perhaps Macron will not run again for the presidency, maybe Le Pen will not win. Moreover, this analytical grid is a draft, by definition imperfect and non-exhaustive. However, there is little doubt that the 2022 presidential election will be animated by a Euroclash, and we have explained the reasons that lead us to believe that this Euroclash will see the opposition of a liberal project to a neo-nationalist project, both situated on the right wing. Finally, we hope to have proposed an effective compass that will allow us to grasp the main political and institutional trends shaping French EU policy and which will undoubtedly impact the future of European integration.

References

In 2021, the pace of Italy’s political change has again accelerated. During the previous year, Italy was the first European country to be hit by the COVID-19 pandemic, an emergency that was faced by the second government of Giuseppe Conte, supported by the Five Star Movement (M5S), the Democratic Party (PD), a small left party, and Matteo Renzi’s moderate group Italia Viva. Renzi distanced himself from the government in December 2020, leading to its fall on 13 February 2021. Mario Draghi, the widely respected former governor of the European Central Bank (ECB), was quickly called in to establish a ‘national unity’ government, which is now supported by all major parties with seats in key ministries – with the exception of the ‘post-fascist’ Fratelli d’Italia and of the small left party Sinistra Italiana. The Draghi government was expected to be more in line with the new Biden administration in the US and with the economic and financial mainstream. Greater unity and stability was anticipated in general, but in fact, Italy’s fragile political system experienced the opposite.

All parties have undergone major turbulence. Matteo Salvini’s Lega carried out a drastic U-turn from its extreme-right, anti-European populism and lent its support to Draghi, ending its political isolation and returning to power just in time to influence the distribution of Next Generation EU investment towards Northern Italy’s business base of Lega.

Berlusconi’s Forza Italia is increasingly divided between the moderate pro-Draghi wing and those emphasising the centre-right coalition with Lega and Fratelli d’Italia. Such a coalition – in spite of differences over Draghi – remains the favoured political alignment of the three parties.

The Five Star Movement was deeply divided in the vote for the Draghi government, with the leadership pressing for support, against the opposition of grassroots groups; members of parliament who did not vote for Draghi were expelled. After much confusion, Giuseppe Conte agreed to become the new leader of the Five Star Movement, bringing his large popularity to the rescue of an ailing party, which is now shedding its populism to embrace a government role and a ‘centre-left’ political agenda.

A similar political void at the top emerged in the Democratic Party. Its leader Nicola Zingaretti resigned over the internal squabble between the neoliberal wing – associates of Matteo Renzi who did not follow him in the split of Italia Viva – and the other party factions. The appointment as party leader of Enrico Letta – the former Prime Minister who was ousted by Matteo Renzi in 2014 – has given new energy to a party that has lost much of its working class base and has been unable to recover, gaining only 18% of the vote in the 2018 political elections under Renzi’s leadership (in 2019 he split to form Italia Viva).

Italy’s turbulence

The very large parliamentary support for the Draghi government conceals a fractured political landscape; Italy’s turmoil is likely to continue as a result of three main factors. First, the political crisis is here to stay. The ‘bipolar’ system that was forced on Italian politics in the ‘Second Republic’ after 1994 collapsed in the 2013 and 2018 elections with the populist success of the Five Star Movement and Lega. While the centre-right and the PD-M5S coalitions still provide the background of Italy’s political stage, efforts to create a centrist neoliberal force with a clear connection to Draghi are in full swing with competing projects – including the one by Renzi – aiming to occupy such a political space. So far, Draghi is keeping parties at a distance and has barely made a public speech after the parliamentary votes. His government – with technocrats in key economic ministries – provides a temporary reprieve, but no stabilisation of the political system. The paradox is that Draghi’s arrival – expected to bring competence and political strength – has in fact increased the instability of political alignments. Moreover, Draghi’s eyes are on Italy’s presidential election scheduled for January 2022, where he is expected to draw large cross-party support. A major realignment could emerge prior to the 2023 elections.

Second, the demise of populism is evident. M5S and Lega have shifted to ‘responsible’ political choices, although...
Salvini’s rhetoric continues. Their coalition in Conte’s first government in 2018 failed to reshape the political system, barely lasted a year, achieved little and deeply divided the country. As the largest forces in parliament, M5S and Lega progressively abandoned their anti-politics platform and turned into institutional players. The extreme-right, anti-European banner is now raised by Fratelli d’Italia. The centrist shift of the M5S has widened the political void on left and green issues, where no significant political force is emerging.

Third, the economic crisis is dramatic. In 2020 Italy’s GDP fell by 8.9% (Istat, 2021); in the twelve months of the coronavirus pandemic 600,000 jobs were lost – mainly among fixed-term workers and the self-employed. The ban on layoffs of permanent workers has been extended to June 2021, when job losses could skyrocket. The previous government had confronted the crisis with €110 billion of deficit spending, of which €60 billion went to across-the-board subsidies to firms and the rest was mainly for household income support.1 Draghi has announced plans to reorganise such measures, but will likely be forced to continue with similar emergency policies. Likewise, in the public health measures for confronting the pandemic, a continuity can be found with the measures of the Conte government, with the vaccination plan now in the hands of an army General.

These three factors are deeply rooted in Italian problems, but have a close connection to the European dimension, where key political decisions are made.

**Draghi’s Europe?**

At home, the success of Mario Draghi’s government will be measured by his ability to control the pandemic, address the economic crisis and obtain the €209 billion of Next Generation EU funds allocated to Italy. But much of the solution to these challenges lies in Brussels. In fact, Draghi’s success will mainly depend on his ability to change Brussels’ political agenda and revise the economic rules of the Union, providing Italy with the policy space that is needed to confront its complex crises. Draghi is facing three challenges in Europe that are likely to be much more difficult than forming his government in Rome.

**European fiscal policy**

With the COVID-19 emergency, Europe activated the “general escape clause” of the Stability and Growth Pact, suspending the obligation of governments to move towards balanced budgets. In the early months of 2020, Italy played a major role – with Prime Minister Giuseppe Conte, Economy Minister Roberto Gualtieri and EU Commissioner Paolo Gentiloni – in this decision, as well as in the launching of Next Generation EU as the first instrument of a common fiscal policy in Europe.

On 3 March 2021, the European Commission decided to extend the suspension of the Stability and Growth Pact until the end of 2022, allowing the government deficit spending needed to confront a continuing crisis. Italy’s economy is not expected to return to pre-pandemic levels before the first half of 2023, and an early return to budgetary constraints would be disastrous.

The thornier question is the rewriting of the EU’s fiscal rules. Although this debate is slowly getting under way,2 it will not take off before the 2021 elections in Germany. With Angela Merkel leaving office this autumn, Draghi has a real opportunity to step in, frame the debate in novel terms and redress some of the worst mistakes of Europe’s economic Union, starting with the Maastricht rules on public budgets and debt. In his inaugural speech, Draghi discussed the “irreversibility” of the euro and emphasised “the prospect of an increasingly integrated European Union that will lead to a common public budget capable of sustaining countries in periods of recession” (Presidenza del Consiglio dei Ministri, 2021). Draghi’s plans for the new fiscal capacity of the EU should be presented as soon as possible and should offer a clean break with the austerity policies of the past.

At the very least, there is a need to make Next Generation EU a permanent tool of EU policies, financed with Eurobonds and supporting appropriate public spending where the Union needs it most. On the revenue side, there is a major need for fiscal harmonisation in order to avoid tax competition within the EU and for new EU-wide taxes on digital platforms, multinational corporations, financial transactions, carbon emissions and imports, etc.

**Public debt**

In his *Financial Times* article, Draghi (2020) wrote that, in the face of the pandemic, “it is already clear that the answer must involve a significant increase in public debt”. In 2020, its increase has been generalised in Europe and a significant part – about a quarter for some countries – of the public debt is now held by the European Central Bank. While current ECB monetary policies – near-zero interest rates and quantitative easing – have made debt

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1 See Pianta et al. (2020) for an assessment of Italy’s economic policy in the COVID-19 crisis.

2 See the proposals of German Finance Minister Olaf Scholz on the ‘debt brake’ (Hall, 2021); and Blanchard et al. (2021).
financing manageable for governments, a structural solution has to be devised, the sooner the better. A key proposal is to “freeze” the debt in the hands of the ECB, transforming it into perpetual zero-interest bonds. In an interview on 14 November 2020 with the Italian daily La Repubblica, the President of the European Parliament David Sassoli declared that debt cancellation is “an interesting working hypothesis, to be reconciled with the fundamental principle of debt sustainability” (D’Argenio, 2020). An appeal from over 100 European economists, including Thomas Piketty, has recently called for the cancellation of public debt in the hands of the ECB, asking governments to allocate the same amount of resources to new social and environmental investments (Le Monde, 2021).

**Industrial policy**

Due to the pandemic, Brussels suspended the ban on state aid to businesses; all governments – Germany more than any other country – offered subsidies, tax breaks and public capital to the companies most affected by the crisis. This state aid suspension is temporary: If it were reintroduced, millions of European companies would go bankrupt. Even the so-called frugal countries are worried: the Danish Minister of Industry – together with Austrian and Czech ministers – has asked Brussels to raise the limit of subsidies to companies (€800,000) and of the compensation allowed so far (currently €3 million; Joergensen, 2021).

The European meetings of economic ministers on 15-16 February 2021 confirmed the need to support firms that will be viable in the post-pandemic economy. This is in line with the report of the Group of 30 (2020), an international body of financiers and academics chaired by the former governor of the Indian Central Bank Raghuram Rajan and by Draghi himself, which has provided indications to governments on how to move from general support to business towards more targeted measures, ensuring the prudent use of limited public resources and allowing market forces to manage “the pace of the needed creative destruction”.

What will be Draghi’s agenda on policies for a post-pandemic production system? Here again, a radical rewriting of European rules is needed. Public intervention orienting and supporting business choices should no longer be seen as a “distortion” of the market, allowed as an exception only. Europe needs to institutionalise an industrial policy charting a new growth trajectory based on environmentally sustainable economic activities with a high content of knowledge, technology and quality of work, a policy that should strive, at the same time, to reduce social and territorial disparities among European regions.

Industrial policy has indeed made a comeback in Europe’s agenda. Germany and France are pushing their plans in key fields – from high technology to electric cars – with the aim of strengthening industrial sovereignty and autonomy in strategic areas (Planta et al., 2020; Federal Ministry for Economic Affairs and Energy and Ministry for the Economy and Finance, 2019, 2021). Vaccines are a key case, and former president of the EU Commission Romano Prodi (2021) has argued that governments should organise and finance the production of COVID-19 vaccines in “the largest possible number of firms” in all countries.

The opportunity to move in this direction is there and includes investments funded by Next Generation EU that could be a first step in a new trajectory of digital-age, environmentally sustainable growth. The key question is whether Draghi will pick up this challenge for rebuilding the economy of a post-pandemic Europe.

**Long-term reconstruction**

In his inaugural speech, Draghi stated that the government will have to protect workers, all workers, but it would be a mistake to protect indifferently all economic activities. Some will have to change, even radically. And the choice of which activities should be protected, and which ones should be gradual change is the difficult task that economic policy will have to face in the coming months. (Presidenza del Consiglio dei Ministri, 2021)

However, he gave no indication of the objectives of his government’s choices, nor of the policy tools that could stimulate research, investments, productions and employment. He did not outline the role that the country should have in key industries. In his speech, Draghi never mentioned the term “industrial policy”. This is worrying in the context of Italy’s deepening crisis. These problems did not start with the coronavirus pandemic; the country is facing the legacy of a decade-long recession. The crisis of 2011-2014 wiped out 200,000 firms and 800,000 jobs; compared to 2007, in 2019 the economy still had 5% fewer hours worked and the industrial production index had lost almost 20% (Cresti et al., 2020). The need for reconstruction would have existed even without the pandemic. Moreover, the pandemic has highlighted other weaknesses in the Italian economy: the extent of precarious work, the incomplete protection of incomes and the distortions of the welfare system.
For Italy, the opportunity provided by the resources of Next Generation EU is indeed crucial to rebuilding production capacities and starting a new growth trajectory. But a broader industrial policy framework would be required, with clear objectives and novel policy tools. The latter could include a public investment agency, a holding company concentrating public shareholdings and a public investment bank capable of taking over and assisting declining companies and launching new ventures in priority fields.3

There are major obstacles – economic, political and institutional – to overcome on Italy’s road to recovery. The first one is the unending political instability described above. A successful industrial policy for rebuilding the economy should be a clear government priority based on a long-term vision with a strong political commitment.

Secondly, the industrial policy strategy should be shared by companies, the trade unions, workers, civil society and public opinion, turning it into a theme above the fray of short-term conflicts. A broad consensus should emerge on a new balance between market activities and public intervention, between capital and labour, and among environmental, social and economic priorities, with a wide distribution of expected benefits, focusing on employment creation, reduction of job insecurity, fewer territorial, social, gender and health inequalities4.

Finally, the implementation of industrial policy requires a renewed public administration, with greater capabilities, higher efficiency, ensuring transparency and democratic participation.

It is not easy for these three conditions to be fulfilled. However, after the COVID-19 pandemic, the alternative to a reconstruction of this type would simply be a worsening of the decline that has marked Italy in recent decades. And a failure of Italy in this effort would also be a failure of Europe.

The challenges that Draghi is facing in Brussels are parallel to the ones he is confronting in Rome. They amount to an opportunity for change that has appeared all but impossible for decades – that is, the political space for rewriting the rules of the European Union. As head of the ECB, Draghi was bound to respect the Treaties and government policies; yet he managed to overturn the conservative monetary policy he inherited in 2011 from Jean-Claude Trichet. Now, as leader of the Italian government, Draghi has the opportunity to give Europe the coherence between fiscal and monetary policy that it has been lacking so far. But the political opportunity before us is grander than that – the troubled neoliberal past of austerity could be replaced by a healthier, smarter, more sustainable and more equal Europe.

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3 See Cresti et al. (2020) for our proposal for an industrial policy.

4 Such an agenda was proposed by the Sbilanciamoci! (2020) campaign.
Borbála Göncz and György Lengyel*

Europhilic Public vs Eurosceptic Governing Elite in Hungary?

Hungary was perceived to be the “good student” among EU candidate countries in the 1990s and early 2000s. However, over the past decade, the relationship between the EU and Hungary has deteriorated. Hungary and specifically its Prime Minister since 2010, Viktor Orbán, are continually criticised for violating EU values and breaking rules of EU membership. On multiple occasions, Orbán and the Fidesz regime have implemented measures that question democracy, the rule of law, freedom of the press, academic freedom and minority rights among other things. The confrontational politics were accompanied by a very symbolic domestic communication about the EU based on populist anti-EU rhetoric; most recently, this dynamic led to Fidesz quitting the European People’s Party in March 2021.

Confrontations and negative domestic campaigns accompanied all stages of the EU’s multidimensional crisis starting in 2008 with the global financial meltdown that lead to the eurozone crisis, followed by the 2015 migrant crisis, the subsequent challenges of illiberalism in Hungary and Poland and the most recent adversities around the COVID-19 pandemic. Different facets of the crises brought about different obstacles to European integration: supranational vs national solutions, the politicisation of the question and whether identity politics were activated (Börzel and Risse, 2018) – all of which were well reflected in the Hungarian government’s anti-EU campaigns.

At the time of Hungary’s accession to the EU in 2004, there was a wide societal consensus about the benefits of EU membership for the country, while the general public discourse remained technical and pragmatic. Nevertheless, the economic crisis, paired with eroding support for the government, started in 2006 in Hungary. The situation further deteriorated following the global financial and economic crisis, which led to the change in government in 2010 when Fidesz won a two-thirds majority, became a party of constitutionalising capability and managed to keep its position through the 2014 and 2018 elections. Now, on the verge of the 2022 elections, one might wonder what lies ahead.

Although a crucial and oft-cited element of the Fidesz government is that it represents and defends the interests of Hungarian people, it appears that the Hungarian people are not that hostile toward the EU as their repeatedly re-elected government. It seems that, in line with the phenomenon of rising public Euroscepticism all over Europe, Hungarian public support tended to decrease until 2012 but has been on the rise since then despite the negative impact that one might expect due to the anti-EU government rhetoric. The fact that general public opinion does not reflect the changed elite discourse may be due to pragmatic attitudes towards the EU valuing the economic benefits that it represents (Lengyel and Göncz, 2010). An alternative explanation is that there is an increasing satisfaction with Hungary’s economic and political performance, which is reflected in the attitudes of Hungarians towards the European integration project. Yet another possible explanation for the prevailing diffuse support for the EU in Hungary is based on emotional attachment or past identification; however, despite being rather strong in Hungary, this element did not have a significant impact on support for the EU (Lengyel and Göncz, 2010). In the following, attitudes of the general public as well as those of Hungarian political elites are considered.

Support for the European integration project in Hungary

The legitimacy and the stability of a political system partly comes from the general support for it. System theorists distinguish between specific support based on the perception of the performance of a system and diffuse support representing a reservoir of positive attitudes towards a system that make people accept non-favourable outputs (Easton, 1965; Harteveld et al., 2013; Ringerova, 2015). Scholarly work supporting the European integration project mirrors this distinction as the main explanatory models elaborated so far revolve around utilitarian logic and explanations based on identification that could...
be considered manifestations of specific and diffuse support respectively. In utilitarian logic, attitudes are defined by a rational evaluation of the EU’s advantages and disadvantages at the individual or at the country level (e.g. Gabel, 1998; Brinegar and Jolly, 2005; McLaren, 2006), or explanations focused on the perception of the functioning of the EU, i.e. how efficient one finds European institutions (e.g. Opp, 2005). Starting from the 2000s, identity-based explanations appear to challenge the utilitarian ones, with a focus on the impact of affective or emotional attachment to Europe based on perceptions of the European integration process (e.g. Duchesne and Frognier, 1995; Hooghe and Marks, 2005; Opp, 2005; Bruter, 2005; Risse, 2010). According to studies focusing on concepts such as identity, belonging to a group or loyalty, identity-based explanations have an increased relevance among the general public due to a lower level of cognitive capacities, knowledge of or interest in the issue (Hooghe and Marks, 2009). Nevertheless, the concept of European identity is very much contested in the academic community in terms of its content, plausibility or possible measurement (Favell, 2005).

Similarly, those arguing that the European integration process is too complicated or remote for ordinary people to understand or be interested in should remember that people might rely on familiar proxies in order to form an opinion. The domestic political arena and the perception of national political and economic performance is thus important as they create the parties’ stance and messaging (e.g. Gabel, 1998; Anderson, 1998; Carrubba, 2001; Steenbergen et al., 2007; Hooghe and Marks, 2009).

Attitudes of the general public

During the 1990s and early 2000s, there was a wide societal consensus in Hungary about its accession to the EU. This period was characterised by a broad public discourse about the “return” of the country to Europe. However, general positive attitudes were paired with widespread ignorance. About one-third of the population had a positive perception of the EU’s objectives and activities, another one-third held a neutral opinion, and the remaining third was divided between those without an opinion (21%-34%) and those opposed to the EU (6%-11%). Support for the country’s EU membership reached its peak in 2002 and began a steady decline thereafter (Lengyel and Gőncz, 2010). Nevertheless, after a successful referendum on the accession in 2003 with 84% in favour (albeit with a turnout of 46%), general support was still above the EU average at the time of the accession in 2004.

Data show that this decreasing tendency prevailed up until 2012, but since then the share of positive perceptions follows an increasing tendency besides a steady share of neutral opinions (38%-45%). Figure 1 shows that 46% of Hungarians had a positive image of the EU in 2004 as opposed to 24% in 2012; most recently, positive perceptions climbed up to 49% in 2020. Similarly, 14% had a negative perception of the EU in 2004. This sentiment peaked in 2012 when it went up to around one-third of the population and then decreased by 2020 to 12%. As we can see, while Hungary was among the most Eurosceptic countries in 2012, it was one of the most supportive ones by 2020.

Previous studies seem to confirm that the elections might have a positive impact on the perceptions of the EU, opinions generally being more positive in the year of elections – and this was the case in 2002 and 2006 (Lengyel and Gőncz, 2010). However, with the change in government in 2010, this relation appears to be more blurred, perhaps due to the intense negative campaign against the EU after Fidesz took power in 2010. Despite the constant presence of negative discourses and campaigns from the governing elite since 2010, positive public perceptions of the EU increased. This raises several questions about the mechanisms behind public opinions. While it has been suggested that utilitarianism had a more individual character in Central and Eastern European countries (McLaren, 2006), utilitarian evaluations might have become even stronger after the financial and subsequent economic crises (Hobolt and Wratil, 2015), which may be the reason why the Hungarian
Perception of the political elite

After the post-socialist transformation of Hungary, there was an elite consensus about the Euro-Atlantic orientation. A large consensus accompanied the whole negotiation process and accession of the country to the EU – only Fidesz, then the opposition party, expressed reservations. Nevertheless, the Hungarian Parliament voted unanimously for accession. The 2010 elections, however, mirrored citizens’ dissatisfaction with the political elite and led to significant changes in party structures and the national parliament. Fidesz won the elections while a right-wing extremist party Jobbik got into the parliament, and parties of the transition like the liberal SZDSZ and the conservative MDF disappeared. The change of the political and economic context resulted in a significant shift in public discourse about the EU as well as the EU increasingly appearing in a negative light based on symbolic messages.

Previous studies point to the fact that either due to their higher exposure to EU matters or their status, European political elites hold more positive opinions about the EU than the general public. Hungary was not an exception to these trends up until the change in governance in 2010. However, by 2014 the views of Hungarian parliamentarians changed to resemble those of the general public. In a political and economic context characterised by rising public Euroscepticism and an increasing gap between the public and their elites after the financial and economic crisis, Hungary showed very different tendencies, as seen in Figure 3a. The gap first increased and then strongly decreased by 2014 (Vogel and Göncz, 2018).

Although previous studies suggest that the polarisation of political elites in political issues should be higher than the polarisation of the general public (McAllister, 1991), in terms of variation of opinions about European integration matters, elites are generally less polarised than the general public, but Hungary was an exception in 2014 (Vogel and Göncz, 2018). Besides these general tendencies, preferences for supranational institutional design prevailed in 2007 and 2009, while Hungarian parliamentarians became rather state-centred by 2014 adopting a more intergovernmental idea of the European construct. Representatives of the dominant governing party, Fidesz, believed that European integration had gone too far, that the EU endangered Hungarian culture and generally trusted EU institutions less than the small oppositional groups of socialists and greens. In this respect, the dominant governing party differed sharply even from its almost invisible pro-EU Christian Democrat satellite. Nevertheless, even after the change in government, in 2014 the majority of parliamentar-
It seems that the Hungarian general public is engaged with the European project even if the government – supported by the same public – is very critical about it. Taking into account the important embeddedness of the subject in the domestic political arena, this might seem a contradiction.

Looking at trust in institutions, a possible measure of perception of the performance of a system and a measure of its legitimacy, one can see that trust in the EU is somewhat higher than trust in the national government in general; however, this is even more pronounced in Hungary, at least in the period leading to the change in government in 2010 (see Figure 4). This gap closed, however, in the period 2017-2018, when trust in the two institutions was even. Trust in government has rather stagnated around 47% since then, while trust in the EU increased somewhat. Looking at the period before 2010, it seems that trust in the government and trust in the EU follow similar tendencies, with trust a little higher around the elections what higher than trust in the national government in general.

Source: Eurobarometer.

Notes: (a) The wording of the questions measuring the perceptions of the European integration project is: INTUNE/ENEC: “Some say European unification should be strengthened. Others say it already has gone too far. What is your opinion? Please indicate your views using a 10-point scale. On this scale, “0” means unification ‘has already gone too far’ and “10” means ‘it should be strengthened’”. EES: “Some say European unification should be pushed further. Others say it already has gone too far. What is your opinion? Please indicate your views using a scale from 0 to 10, where “0” means ‘unification has already gone too far’ and “10” means ‘it should be pushed further’”. (b) The wording of the questions measuring attachment is: INTUNE/ENEC: “People feel different degrees of attachment to their region, to their country and to Europe. What about you? Are you very attached, somewhat attached, not very attached or not at all attached?”. EES: “For each of the following statements, please tell me to what extent it corresponds or not to your attitude or opinion. You feel attached to Europe”. Answers: Yes, totally/ Yes, somewhat/ No, not really/ No, not at all. Values have been recoded so as to have the averages on a 0-3 scale, where 3 stands for “very attached”/ “Yes, totally” and 0 stands for “not attached at all”/ “No, not at all”.


What might the future hold?

The fact that the negative symbolic governmental messages and campaigns in Hungary did not have a deteriorating effect on the general support for the European integration process since 2012 may eventually be due to utilitarian logic, which might have prevented a significant impact of symbolic messages and could represent the relevant frame of reference when evaluating the European integration process (McLaren, 2006; Lengyel and Göncz, 2010).

Attitudes towards the EU in Hungary among the general public and the political elites

Perception of the European integration project and attachment to Europe in Hungary among the general public and the political elites

<table>
<thead>
<tr>
<th>Year</th>
<th>Population</th>
<th>Elites</th>
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<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
<td></td>
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</table>

Notes: (a) The wording of the questions measuring the perceptions of the European integration project is: INTUNE/ENEC: “Some say European unification should be strengthened. Others say it already has gone too far. What is your opinion? Please indicate your views using a 10-point scale. On this scale, “0” means unification ‘has already gone too far’ and “10” means ‘it should be strengthened’”. EES: “Some say European unification should be pushed further. Others say it already has gone too far. What is your opinion? Please indicate your views using a scale from 0 to 10, where “0” means ‘unification has already gone too far’ and “10” means ‘it should be pushed further’”. (b) The wording of the questions measuring attachment is: INTUNE/ENEC: “People feel different degrees of attachment to their region, to their country and to Europe. What about you? Are you very attached, somewhat attached, not very attached or not at all attached?”. EES: “For each of the following statements, please tell me to what extent it corresponds or not to your attitude or opinion. You feel attached to Europe”. Answers: Yes, totally/ Yes, somewhat/ No, not really/ No, not at all. Values have been recoded so as to have the averages on a 0-3 scale, where 3 stands for “very attached”/ “Yes, totally” and 0 stands for “not attached at all”/ “No, not at all”.

This raises a question about the outcome of the upcoming Hungarian elections in 2022 as during all elections since 2010: Can the Fidesz government be voted out of office? Despite high hopes from the united opposition, the level of public trust in the actual government suggests caution.

It seems that the change in the political elites’ structure and rhetoric has not affected public attitudes towards the EU significantly. Although previous research confirmed the effect of media news on attitudes in questions related to the European integration project (Bruter, 2003), these do not seem to be reflected in the Hungarian case. While anti-EU rhetoric started around 2010, Euroscepticism started to increase earlier and seems to be decreasing from 2012, although there were no changes in communication or political preferences of the government. Several possible explanations arise. The most probable one is the suggestion that public opinion about the EU is very much utilitarian and pragmatic in Hungary and, despite government communications, EU membership still holds advantages for the country or at the individual level. Another possible explanation is that Hungarians are strongly attached to European values, which indicates diffuse support and means that their attitudes towards the EU are less prone to change. This explanation is somewhat disproved by previous findings that identification is not a key driver of general support in Hungary (Lengyel and Gönzc, 2010). A third possible explanation is that Hungarians are satisfied with the economic and political performance of the country under the Fidesz regime, proved by their increasing trust in their government, and, as a “cue”, they extrapolate their satisfaction to the supranational level. In any case, trust in the Hungarian government seems to have stagnated since 2017, while trust in the EU is more volatile; still, according to the most recent data, it exceeds the trust in the Hungarian government.

All in all, the question of what drives public attitudes in this case needs further research. A very practical implication of what has been described is the future of Hungary in the European Union: How much can the perception of a government be separated from the actual people (from the point of view of the EU)? How long will this gap between the governing elite’s discourse and public opinion be maintained? What will be the implications of the outcome of the next elections of this question? And could the question of EU membership lead to an eventual change in governance?

It depends on how successfully Fidesz pursues blamgame tactics concerning the EU, diverting attention from government failures and strengthening the clientele, and how functional the opposition coalition will be. The threat of an epidemic narrows the scope for political competition. As Fidesz’s position within the EU has weakened significantly with the withdrawal from the European People’s Party, and the COVID-19 crisis is generating serious social tensions, the questions seem to be more open in the spring of 2022 than during the previous three elections.

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Favell, A. (2005), Europe’s Identity Problem, West European Politics, 28(5), 1109-1116.


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The Regional Comprehensive Economic Partnership Agreement and Its Expected Effects on World Trade

The Regional Comprehensive Economic Partnership agreement creates the world’s largest free trade zone. The agreement has the potential to increase trade relations among its members and further promote the development of regional value chains in “Factory Asia”. This article presents the topics included in the recently concluded agreement, details the existing economic linkages between its members and discusses the expected consequences for its member states and third countries.

On 15 November 2020, 15 Southeast Asian and Pacific countries signed the Regional Comprehensive Economic Partnership (RCEP) agreement creating the world’s largest free trade zone. The members of the Association of Southeast Asian Nations (ASEAN), including Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam, initiated the talks for the trade deal. After more than eight years of negotiations, the ASEAN members reached an agreement with China, Japan, South Korea as well as Australia and New Zealand. As of today, the trade bloc covers 28% of global GDP, 28% of global trade and 29% of the global population (see Figure 1) – the sheer size is impressive and unprecedented.

What topics are included in the recently concluded agreement? What are the expected consequences for intra-RCEP trade? To what extent are third countries affected? This article aims to shed light on these questions. In a first step, it describes the economic linkages between RCEP states, which were already strong before the mega deal was concluded. The rise of China and the formation of the “Factory Asia” can in part explain the observed patterns. “Factory Asia” refers to a highly interconnected production process across national borders within RCEP countries that has gained importance with emerging global value chains.

Secondly, this article investigates the content of the RCEP agreement and likely changes in trade policy. Unlike most trade agreements, tariffs as well as non-tariff barriers have already been largely eliminated between RCEP states: Except for the country pairs Japan-China and Japan-South Korea, trade agreements for all bilateral links between RCEP countries already exist. Only a few additional tariff cuts are expected, but the largest reduction of trade barriers will be due to the harmonisation of the rules of origin. Under the current network of bilateral treaties and given the tight linkages in the region through complex value chains, rules of origin constitute a high bureaucratic burden for firms in the region.

On the one hand, the RCEP agreement is expected to boost intra-RCEP trade, which might decrease demand from third countries due to trade diversion. Countries that are strongly connected to RCEP states but are not part...
International Trade

Figure 1
The 15 members of the RCEP agreement

ASEAN
Brunei
Cambodia
Indonesia
Laos
Malaysia
Myanmar
Philippines
Singapore
Thailand
Vietnam

ASEAN + 3
China
Japan
South Korea

ASEAN + 5
Australia
New Zealand

Sources: World Bank; UN Comtrade, Gaulier and Zignago (2010); authors’ illustration.

of the trade agreement are affected particularly negatively. On the other hand, more resilient supply chains and cheaper production in the RCEP region provide an opportunity for firms doing business there and final consumers.

Background and trade patterns of RCEP members

ASEAN was established in 1967 and covers not only topics in trade policy, but also other economic issues such as investment promotion, intellectual property rights, compliance with labour standards as well as environmental and security issues. Already in 1990, the idea of a trade agreement between the ASEAN members, China, Japan and South Korea, i.e. an ASEAN +3 agreement (see Figure 1), floated around. However, it took 22 years for plans to solidify: in 2012 the negotiation talks on RCEP started, in which India, Australia and New Zealand also participated. Eight years later, on 15 November 2020, the agreement was finally signed, albeit without India, who decided shortly before the finalisation of the RCEP agreement against a membership citing domestic policy reasons.

Why did the countries make the effort to reach an agreement despite these difficulties? First, the RCEP agreement is the Chinese response to the failed Trans-Pacific Partnership (TPP) Agreement, which was signed in 2016, but was revoked only a few days after the inauguration of former US President Trump. China took the opportunity to fill the power vacuum and wrapped up a trade deal without US participation. Second, the economic linkages between RCEP countries are profound and have increased in the last years. Figure 2 shows the most important trading partners of RCEP countries since 1990. A distinction is made between intra-RCEP trade, trade with “Western countries”, defined as the EU28 and North American Free Trade Agreement (NAFTA), and trade with the rest of the world.

Trade between RCEP countries increased sharply since 1990

The relative importance of EU28 and NAFTA countries as trading partners for RCEP members has sharply declined. The import share decreased by 17 percentage points to 22% and exports decreased by 14 percentage points to 33% between 1990 and 2018. At the same time, the share of imports within RCEP has increased by ten percentage points and accounted for 50% of total imports in 2018. Interestingly, much of this development took place before China’s accession to the WTO in 2001, the starting point for the rapid rise of the emerging economy. Similar patterns can be observed on the export side, although RCEP countries play a somewhat smaller role as a sales market in comparison to imports (39% of total exports in 2018).

Moreover, the region gained in importance with the rise of global value chains, which has been one of the most important developments for foreign trade of the 21st century (Baldwin, 2012). The next section discusses the role of global production networks to illustrate the extent of interdependencies between countries.

---

1 For the agreement between the EU-Canada Comprehensive Economic and Trade Agreement, for example, it took over ten years to complete negotiations.
The rise of global value chains (GVCs) offers a good indicator of interdependencies between RCEP states. GVCs are a special form of production that relies heavily on international trade, as the production of a final good may require that intermediate inputs or intermediate goods cross a national border several times. The OECD’s annual Inter-Country Input-Output tables covering the period 2005 to 2015 are used to compute linkages of different stages of production across countries. The previous section provided an analysis using ordinary trade statistics. However, standard trade data do not account for input-output linkages of different stages of production across countries. Hence, standard data overestimate the value added generated by foreign trade. Moreover, the analysis using input-output tables allows us to better understand global linkages and thus interdependencies between countries. Several empirical facts are presented in the following.

Complex GVCs are more prominent than simple GVCs in RCEP countries

The analysis follows Meng et al. (2019) and Wang et al. (2017) and characterises production activities into four broad types: (i) pure domestic, when value added of a good is produced and consumed in the same country, (ii) traditional trade, when only domestic value added is used to produce a final good that is exported and consumed in a foreign country, (iii) simple GVCs, when stages of production are divided across countries and factor content crosses a national border once for production abroad, and (iv) complex GVCs, when stages of production are divided across countries and factor content crosses a national border at least twice.

The first type of production activity, domestic production, represents the largest share of value added created in all countries under investigation. On average, 80.5% of the value added created in RCEP countries is produced and consumed domestically. This number is larger than the average for EU member countries (71.8%) or the average for the rest of the world (78.1%), which indicates the importance of the domestic market. The second type refers to “traditional trade” and accounts for on average 7% of the value added created in RCEP countries. In this case, value added is created in the home country and the final good is consumed in a foreign country.

Figure 3 focuses the value added created over simple or complex GVCs. It shows that GVC activities are relevant for value added creation. In RCEP countries, complex value chains are relatively more important than simple value chains. Over 50% of the value added created through GVCs is created through complex chains; in China this share is 58%, which is high in comparison to other countries. For instance, in the EU only 41%, in the US only 42% and in the rest of the world only 38% of the GVC value added is created through complex value chains. The high
share of goods that cross borders multiple times through GVCs in RCEP states indicates the importance of creating harmonised rules of origin for RCEP countries, as discussed below.

Regional supply chains: “Factory RCEP” is China’s most important partner region

When analysing GVCs, it is possible to take the view of the upstream or downstream sectors/countries. We speak of forward linkages when the value added of a sector/country reaches the consumer. The question here is how much dependence there is on downstream production in another country. Backward linkages, on the other hand, evaluate supply chains to produce final goods, i.e. the direct and indirect supply structure with value added from upstream sectors/countries. The question here is how dependent a country is on value added from abroad to produce its own goods. We investigate interdependencies among the three largest production networks – “Factory RCEP”, “Factory Europe” and “Factory North America” – and their three nodes, China, Germany and the US.

We uncover several empirical facts on supply linkages between countries (see Figure 4). First, the linkages between factories are not one-sided but reciprocal, as value added is created by all factories both in backward as well as in forward linkages. Second, regional value chains play an important role. In China, for instance, in the year 2015, 49% of the value added created through backward linkages and 35% of the value added created through forward linkages is created within RCEP countries. Third, different from Germany and the US, in China the share of value added created over GVCs decreased over time, both for backward and forward linkages. Fourth, the relative importance of “Factory RCEP” in the other factories increased over time, as shown for the factory nodes Germany and the US.

A quarter of imports of RCEP countries come from China

Table 1 shows for each of the 15 members the three most important trading partners and their shares of the total volume of trade in 2018. The table illustrates the strong linkages within the entire RCEP area, and in particular with China. RCEP states receive an average of 25% of their imported goods from China. China, as purchaser, belongs to one of the three most important markets in all member states besides Brunei and Cambodia. Furthermore, the table stresses the importance of the intra-RCEP trade. In almost all cases, the three most important importers and exporters of RCEP members are in fact other RCEP states. Only three non-members, the US, Germany and Hong Kong, are important trade partners, too.

The impact of RCEP on trade policy in the Asian region

For GVCs, low trade barriers between participating countries are particularly important because products cross country borders multiple times – with high barriers, high costs accumulate, and this type of production becomes unprofitable. Therefore, with the emergence of GVCs in Asia, RCEP members have had great incentives to liberalise trade policy, at least in sectors that are relevant for “Factory Asia”, i.e. intermediate goods for complex industrial goods.

Most RCEP countries already have bilateral trade agreements

The tariffs and non-tariff barriers between RCEP countries have already been largely eliminated: except for Japan-China and Japan-South Korea, trade agreements exist between all remaining RCEP members. Table 2 gives an overview of the existing agreements. Dark green colouring means that an agreement has been reached. The average tariff within the RCEP area in 2017 was only 1.6%. Hence, at first sight the RCEP agreement does not lead to great changes and trade liberalisations for the member states.
Table 1
The three most important importers and exporters of RCEP members, 2018

<table>
<thead>
<tr>
<th>Importer</th>
<th>CHN (34%)</th>
<th>SGP (16%)</th>
<th>MYS (12%)</th>
<th>JPN (33%)</th>
<th>THA (12%)</th>
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<td>AUS (15%)</td>
<td>USA (10%)</td>
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</tbody>
</table>

Notes: Shares in parenthesis; light green boxes refer to RCEP countries; AUS Australia, CHN China, DEU Germany, HKG Hong Kong, JPN Japan, KOR South Korea, MYS Malaysia, SGP Singapore, THA Thailand, USA United States of America, VNM Vietnam.

Sources: UN Comtrade; Gaulier and Zignago (2010); authors’ illustration.

Table 2
Average bilateral tariff rates and existing trade agreements between RCEP members, 2017

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Notes: The table shows the bilateral (unweighted) average tariffs of RCEP members. The tariff data describe the year 2017; for the trade agreements, all those notified to the WTO are included (cut-off date 25 January 2021). Dark green = deep agreement; light green = shallow agreement; dark grey = no agreement.

Sources: Teti (2020); WTO; authors’ illustration.

Table 2 shows the average tariffs that apply for the 210 bilateral trade relationships in 2017. Import countries are shown in the rows, and the columns show the exporters, i.e. the table is to be read as follows: the average export tariff from Brunei to South Korea amounts to 5%. The tariff data is only available for 2017, thus tariff reductions coming from the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, which has been in effect since 2018, are not included. This refers especially to the trade relation between Japan and New Zealand, for which tariffs are overstated.

Within ASEAN states tariffs are particularly low, but tariffs are also low for bilateral links between ASEAN and other RCEP members. The upper right part of the table shows high barriers between Cambodia, Laos and Myanmar against Japan, Australia and New Zealand, which stem from development policy objectives: highly developed trade partners grant those three countries a slow and gradual reduction of tariffs to reduce competition from Japan, Australia and New Zealand.

Largest tariff cuts expected for China, Japan and South Korea

The largest tariff cuts can be expected for the three largest economies: China, Japan and South Korea. Hence, trade between these three country pairs is expected to increase the most thanks to RCEP. Although there exists a trade agreement between China and South Korea, it has not yet led to tariff reductions on a large scale. Instead, tariffs still amount to 8%-9%, and non-tariff barriers still
RCEP is less ambitious than most other modern agreements. While the Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada, which is considered one of the most comprehensive in the world, eliminated 99% of all tariffs, RCEP is only expected to reduce up to 90% of tariffs. Exceptions, especially in the agricultural sector, are expected, as it is barely touched upon in the agreement. In other areas, for instance vehicles, full tariff elimination will take up to 20 years.

As in most modern trade agreements, RCEP also goes beyond the elimination of tariffs and regulates a wide range of other issues. The negotiating parties could agree on mutual recognition of professional qualifications. However, no agreement could be reached on environmental standards or on uniform labour standards. RCEP members also missed the opportunity to regulate future issues such as e-commerce. However, it is expected that RCEP will bring these topics back on the agenda, as regular meetings discussing the extension of the negotiated agreement are planned.

Harmonisation of rules of origin: An important achievement of RCEP

The harmonisation of the rules of origin is probably the most important achievement of RCEP. Although barriers for bilateral trade, for instance between ASEAN and Australia, are low, the structure of bilateral treaties that were so far regulating trade policy in the Asian region are a challenge for exporters: Every trade agreement has its own set of rules, the so-called rules of origin, that must be complied with in order to receive the preferential market entry.

To qualify for preferential market access, exporters need to provide proof of origin, which establishes “domestic production”, i.e. all exported goods need to be produced mostly within the respective free trade area. For instance, Chinese automobile exporters need to prove that at least 40% of their production took place either in China or in another ASEAN country to receive duty-free access to Laos. If this proof is not provided, a tariff of 20% applies. Similar rules apply to automobile exporters who supply to other countries with whom China has signed an agreement. However, in this case only the intermediate inputs from the respective partner count when determining the share of domestic production. With respect to Chinese exports to Australia, only intermediate inputs from China or Australia can be considered to reach 40% of domestic production.

This is costly and inefficient, especially for exporters with complex global value chains, which span several Asian countries: Instead of using the most efficient intermediate producer, countries might end up using a more expensive one just to comply with the rules of origin. Alternatively, exporters can decide not to comply and instead pay the most-favoured-nation tariff. Either way, unnecessary costs arise. Complex GVCs make it harder to accumulate enough regional value content to comply with the rules of origin as the production is fragmented and scattered across different countries.

RCEP consolidates and harmonises the rules of origin of existing contracts: Intermediate inputs from the 15 member states also count in domestic production. This will promote even stronger economic linkages and the expansion of existing supply chains despite low tariff reductions. This is particularly important for complex GVCs, which are affected much more adversely by strict rules of origin. The multiple crossing of borders amplifies the costs that arise due to the non-eligibility of preferential treatment.

Impact of RCEP on world trade

The RCEP agreement leads to lower trade costs between member states and harmonises the rules of origin, which is relevant given large interdependencies between RCEP members. Since RCEP countries account for about 30% of world trade, the agreement brings challenges and opportunities for third countries, too. Intensified trade within RCEP will divert trade from third countries.

Figure 5 shows the dependencies of selected third countries from RCEP. For this purpose, we calculate the trade share with RCEP members, i.e. exports to RCEP as a share of total exports of a country (left panel) and imports from RCEP as a share of total imports of a country (right panel). We analyse the trade exposure of the EU28 members, India, Russia, the US, the Mercosur members (Argentina, Brazil, Paraguay and Uruguay) and consider the rest of the world in the aggregate.

Some aspects stand out: First, RCEP is a minor trade partner for the EU28 members. Only 9% of the total exports of the EU28 go to RCEP countries, and 13% of total imports are coming from RCEP countries. In contrast,
these shares are much higher in other countries: 25% of US products are exported to the RCEP region, the share for the Mercosur countries amounts to 31%. Interestingly, except for Mercosur, the share of imports is always higher than the share of exports. India imports 36% of all imports from the RCEP area, the US 37% and the Mercosur states 28%.

Higher intra-RCEP trade leads to lower demand for goods from third countries, for which RCEP may therefore have negative effects. Particularly affected are countries that are strongly intertwined with RCEP countries, but are not part of the deal, such as India, the US and the Mercosur members. At the same time, more resilient supply chains and cheaper production in the RCEP region provide opportunities for firms doing business in Asia. Moreover, harmonised standards across all 15 RCEP members can be expected, which helps firms from third countries that export to Asia.

Conclusion

The RCEP agreement creates the world’s largest trade zone. This article shows that (i) trade relations and interdependencies between RCEP countries are more prominent in comparison to third countries, (ii) the relative importance of intra-RCEP trade has increased over the years, (iii) complex value chains play an important role in the region, and (iv) for the giant China, “Factory RCEP” is the most important partner network. The RCEP agreement has the potential to increase trade relations among its members and further promote the development of regional value chains in “Factory Asia”.

Although only small tariff reductions are expected, given that most country pairs within RCEP already have bilateral trade agreements, one can expect trade creating effects from RCEP. The most important contribution of RCEP is the harmonisation of the rules of origin, which has important positive implications for global value chains in the region. On the one hand, India and the US are expected to be affected most by trade diversion effects, whereas RCEP only plays a minor role for the EU28 members. On the other hand, more resilient supply chains, harmonised trade standards and lower production costs in the “Factory Asia” also provide opportunities for exporters from third countries.

Even if the RCEP agreement is not deep in comparison to prior agreements such as CETA, its ratification puts the US and the EU under pressure. The EU and the US are currently not making progress with their trade policies: The EU struggled with Brexit and is not in a position to ratify further trade agreements such as CETA or Mercosur. China and Asian countries, on the other hand, demonstrate that they can negotiate through the largest trade zone of the world.

Since the negotiations have already been concluded, it would be easy for President Biden to revive the TPP. The EU should intensify trade talks with Asian partners, too. While trade agreements with Japan, South Korea and Singapore already exist, negotiations with Australia, New Zealand and the ASEAN members progress only slowly. Chances of a trade deal with China are slim: although the EU made significant progress towards signing a bilateral investment agreement with China by the end of 2020, a comprehensive trade agreement is not yet in sight.

References
The European Green Deal (EGD) has been proposed as a mission for Europe to become the world’s first carbon-neutral continent by 2050, and to strengthen European cohesion through this mission (von der Leyen, 2019). Both goals present massive challenges; we argue that they can be turned into not only an environmental, but also a social and economic opportunity.

Over the last two decades, processes of divergence and polarisation have been unfolding in the EU and the eurozone (Gräbner et al., 2020; Algan et al., 2017). With the coronavirus pandemic and the measures taken to control its spreading, these processes have intensified. Expected growth rates for Spain, Italy and Portugal in 2020 are -11%, -8.8% and -7.6% respectively; the expected losses for Germany and Denmark are less severe, at -5% and -3.5% respectively (European Commission, 2020e). At the same time, the fiscal impulse in response to the crisis amounts to 8.3% of GDP in Germany and 5.5% in Denmark, whereas in Spain, Italy and Portugal it amounts to 4.3%, 3.4% and 2.4% respectively (Anderson et al., 2020). The EU recovery plan promises to mitigate these processes – as should the EGD.

The target to cut greenhouse gas (GHG) emissions by at least 55% by 2030 (compared to 1990), proposed by the European Commission, has gained geopolitical weight with Chinese plans to peak carbon emissions in 2030 and reach carbon neutrality no later than 2060 (UN, 2020). A whole range of nations and regions has declared similar goals.

A European climate strategy aiming at carbon neutrality by 2050 can only be successful if it shifts the economy to a new development path that generates broad social and political support early on. This means it needs to come with tangible improvements of living conditions for European citizens at large, across all regions and social groups. Grounded in a line of research about how climate
policy can trigger a transition to a new growth path (Jaeger et al., 2011, 2015; Jaeger, 2012; Schütze et al., 2017), this article presents a feasibility check of such a shift.

A historical transition like the EGD cannot and should not be planned in detail all the way to 2050, nor is it sufficient to declare an ambitious 2050 goal. First steps need to be specified. In this sense, we sketch a proof-of-concept EGD investment profile for 2021-2030 and explore its potential consequences in terms of emissions, unemployment, growth and inflation. Analysing what it takes to achieve the strictest GHG emission reduction target of 60% (as proposed by the European Parliament) technically, economically and socially, the main findings would remain in place also for the 55% target.

The quantitative scenario outlined is meant as a contribution to further discussions on designing and implementing the EGD in its first decade. By 2030, key developments will need to be carefully documented and evaluated in order to apply what is learned in the following decades.

Relevant emissions dynamics and the path towards a carbon-neutral Europe

Among the multitude of dynamics relevant for the EGD, the EU’s GHG emissions can be rather reliably specified; as illustrated in Figure 1, the pattern shows variation around a linear trend. In the baseline year of current climate policy, 1990, GHG emissions of today’s EU27 countries stood at 4,857 Mt CO₂ equivalent (CO₂e). This includes CO₂ emissions and other gases like methane, calculated by CO₂e. By 2018, they had fallen to 3,764 Mt (with 3,055 Mt CO₂ emissions), i.e. the decline was about 39 Mt per year on average (Eurostat, 2020b). A 60% reduction by 2030 implies a target of 1,943 Mt. This requires an annual decline in the order of 162 Mt, a massive break with the trend of past decades. After 2030, two decades remain for reducing the remaining 1,943 Mt to zero, implying an average annual decline of 97 Mt. It is reasonable to expect that if the challenging 2030 target is reached, the EU will then be able to move towards climate neutrality in 2050.

With the pattern thus illustrated, emission dynamics fluctuate around three different speeds of linear decline: a phase of sluggish reduction for the past three decades, a breakthrough decade starting at the time of writing, and two decades for bringing the effort to completion. Once available, the EU27 figures for 2020 may seem on track with emission reductions required for the coming decade, but the economic recovery expected for 2021 is likely to increase emissions again, leaving little time for achieving the 2030 goal.

This is relevant for the role of carbon prices as they can quickly influence the way existing capital stocks and other durable goods are used. But they fail to incentivise the quick replacement of existing stocks necessary for carbon neutrality (Patt and Lilliestam, 2018). Therefore, direct regulation is as important as carbon prices, as shown by the rapid impact of recent EU emission rules for cars (Financial Times, 2020).

Neither carbon prices nor direct regulations, however, will automatically trigger the investments needed for building the infrastructure to support a carbon-neutral Europe. Public investment is therefore indispensable. At the same time, public investment is needed to overcome the widely underestimated slack in the EU economy (Brooks and Fortun, 2020). Because of this slack, well-targeted public investment can reduce GHG emissions without increasing costs for industries, but rather by creating additional output, employment and welfare – i.e. a new development path (Jaeger et al., 2011). The basic idea underlying this article hence is that the key to earning the buy-in of European citizens for the EGD lies in unleashing the full potential of the European economy by combining carbon

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1. We use emissions data excluding international aviation.
2. At the time of writing, the most recent data available are those for 2018. The 2019 value is estimated by subtracting the average annual decline of 39 Mt from the 2018 figure, and the required reductions for 2020-2030 are computed from this.
3. The 55% target implies an annual decline of 140 Mt – hardly reducing the break with the past.
4. In the winter 2021 forecast, the EU Commission expected a GDP decline of 6.3% for the year 2020 as a whole and a rebound of 3.7% for 2021 (European Commission, 2020e).
taxes and direct regulation with EGD-oriented public investment.

Further criteria for a new development path

Change required for carbon neutrality can be perceived as change for the better if the European Green Deal generates tangible and widely shared economic and social benefits. Along with the breakthrough in emission reductions discussed above, we consider the following additional criteria important:

Unemployment rates below 7% and rates of youth unemployment below 15% across EU member states by 2030. Overall unemployment in the EU (6.3% in the last quarter of 2019) is not a sufficient criterion since unemployment figures for individual countries differ widely. Pre-COVID-19 levels ranged from 2% in the Czech Republic, 3.1% in Germany and 3.3% in Poland to 10% in Italy, 14.1% in Spain and 17.3% in Greece (Eurostat, 2020f).

Similarly, youth unemployment rates were 29.2% in Italy, 32.5% in Spain and 35.2% in Greece before the current crisis (Eurostat, 2020g) and are expected to rise significantly (Bacher and Tamesberger, 2020). The EGD can be experienced as an attractive perspective if it improves the current situation quickly, reaching and stabilising the stated goals by 2030.

Strengthening convergence and cohesion. A related issue is reducing inequality of wealth and income, both between and within European countries. The latter, in particular, has been increasing recently (Blanchet et al., 2019). Agreeing with European Parliament President David Sassoli that the “Green Deal must be an opportunity to fight inequality” (European Parliament, 2020), we leave the specification of measurable goals on this issue to further, urgent and promising research.  

Average annual growth rates of EU GDP clearly above 2% until 2030. The EGD should support a fast and strong recovery from the current crisis and help avoid another period of sluggish growth at a lower level than before the pandemic, as happened after the financial crisis. Between crises, growth rates hovered around 2% (European Commission, 2012; Trading Economics, 2019) and pre-COVID-19 growth estimates relevant for the decade 2020-2030 pointed to a range between 1.5% and 2% (Gros and Alcidi, 2013; European Commission, 2012; PwC, 2017; Knoema, 2019; Trading Economics, 2019). For the coming decade, a tangible improvement of the new development path over the previous one is needed. To the extent that improvements in other indicators of well-being – e.g. of public health, harmony with nature, fairness, fulfilling jobs – should materialise, such indicators may later become more salient than GDP growth (Stiglitz et al., 2018; Jakob et al., 2020).

Inflation rates in line with price stability as defined by the ECB, i.e. currently “below, but close to, 2% over the medium term” (European Central Bank, 2019). Runaway inflation experiences are well documented at levels higher than 10%, but there is no evidence suggesting that a monetary policy focusing on a stabilisation goal of, say, 4% would be problematic, quite the opposite (Ball, 2014). However, an EGD driving inflation higher than the defined upper bound would be obstructed by the ECB raising interest rates. Most observers consider inflation rates since the financial crisis in the EU27 – averaging 1.55% between 2008 and 2019 (Eurostat, 2020c) – too low. Forecasts for the COVID-19 crisis are lower still: 0.7% for 2020 and 1.5% for 2021 (European Commission, 2020e). Inflation rates substantially below 2% are an indicator of slack and signal economic depression. The EGD should help to overcome this condition in the short run and avoid it in the long run.

A proof-of-concept investment profile up to 2030

In view of the above criteria, for the first decade of the EGD, we consider the following annual expenditure profile, summarised in Table 1, building on two previous proposals (Wolf et al., 2020; Creel et al., 2020). The first items are geared directly towards emission reductions.

A European electricity grid for 100% renewables

The electricity industry accounts for around 1,015 Mt CO₂e, or 27% of EU emissions (European Environment Agency, 2020b). Creel et al. (2020) describe the necessity and feasibility of frontloading investments into the European electricity grid for 100% renewables by 2050 (no fossil or nuclear fuels) described by the European Network of Transmission System Operators for Electricity (ENTSO-E, 2015). Their proposal amounts to an average of about €25 billion annually until 2030.

Transforming the car-based mobility system

There were around 233 million passenger cars in the EU27 in 2018 (computed from the European Automobile Manu-
Manufacturers Association, 2019), responsible for about 15% of the EU27 CO₂ emissions (European Environment Agency, 2020b), i.e. 469 Mt CO₂, or about 2 t per car. Currently, passenger transport uses almost 83% passenger cars, 9% motor coaches and under 8% rail (Eurostat, 2020e). Emissions can be reduced via more efficient cars and via shifting the modal split, e.g. increasing the share of public transportation, which is four times more efficient in terms of CO₂ than cars (UITP, 2014). The latter option can provide additional benefits in terms of noise, air quality, road safety and health. For cities, large variations in modal split – e.g. in London the share of cars is 10%, in Bilbao that of walking is 65% (EPOMM, 2020) – suggest possibilities for a sustainable mobility system.

For a breakthrough towards sustainable mobility (not only for cities), we consider an annual public investment of €20 billion reasonable, rounding up the infrastructure investments proposed by Wolf et al. (2020) for electric charging stations (€5 billion), cycling (€5 billion) and local public transport (€10 billion).

A European Silk Road

Heavy duty trucks and buses were responsible for about 5.5%, or 208 Mt, of EU GHG emissions in 2018 (European Environment Agency, 2020b). As Creel et al. (2020) argue, it is time to balance the Chinese Belt and Road initiative with a European Silk Road initiative (see also Holzner et al., 2018; Mangalagiu et al., 2016). In terms of emissions, this offers a unique opportunity for a shift from yesterday’s heavy vehicles to tomorrow’s trains.

If the financing is organised through a special purpose vehicle (SPV) established by EU countries so as to be able to issue long-term bonds at near zero (positive or negative) real interest rates, public investment can be rather small compared to the overall volume. To set up the SPV and to ensure positive spillovers to the European transport network, an annual flow of €20 billion will suffice. The experience with the European Fund for Strategic Investments (EFSI), supporting investments of around €500 billion, using €33.5 billion of public investment and guarantees in five years, can serve as an example (European Investment Bank 2020).9

Accelerating the energy renovation of the building stock

Buildings are accountable for 36% of the CO₂ emissions in the EU (European Commission, 2016a), presently about 1,100 Mt. The largest part of these emissions, about 750 Mt, is due to residential buildings.10 With about 16 billion m² of residential floor space,11 the average is about 47 kg/m².12 Until now, only about 0.4% to 1.2% (European Commission, 2016b) of the building stock has been renovated each year, i.e. at most about 150 million m². At this pace, renovating the inefficient European building stock – esti-

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8 European Commission (2020d) states 12%, but an average of about 160 g CO₂/km tailpipe emissions (ICCT, 2018) and an average of 12,000 km/year for the EU as a whole (Odyssee-Mure, 2020) is consistent with the former source.

9 For an analysis of EFSI-funded projects, see Schütze et al. (2020); unlike for EFSI, here the allocation of funds needs to be shifted away from funding airports and highways, e.g. to railways.

10 The calculation is based on relative energy intensity of residential and non-residential buildings as stated by Buildings Performance Institute Europe (2011).

11 Calculated by subtracting UK’s 4 billion m² from a total EU28 floor space of 25 billion m² and taking into account that about 25% of the total floor space is non-residential (European Parliament, 2016a).

12 This is a very crude estimate obtained by dividing total emissions by total square metres. However, as Coma et al. (2019) find, data on the European building stock are scarce and spread over a factor of ten for their analysis of six European countries.
mated at about 75% of the total (European Commission, 2016a) – would take more than 60 years.

To accelerate energy renovation of residential buildings, we consider an annual investment in the order of €70 billion. Present estimates of energy renovation costs range from €200 to €450 per square metre, depending on the depth of renovation (European Parliament, 2016b). Providing €100 in grants per square metre out of €70 billion, on the condition that house owners invest at least €200 per square metre, would allow for the energy renovation of about 700 million m² per year. \(^ {13}\)

Research and development in digitalisation for energy saving

While the information and communication technology (ICT) industry produces GHG emissions through its own energy use, digitalisation can lead to much larger emission reductions through energy savings – in buildings, transport, industry, households, agriculture and more. With the exception of some specialised niches, the EU ICT sector lags behind its main global competitors. In the EU, research and development (R&D) investment by ICT businesses was about 0.2% of GDP, and the amount publicly funded was less than 0.05% of GDP in recent years (European Commission, 2019). We suggest an additional public investment stream of €30 billion, i.e. another 0.2% of GDP, to change this situation in the direction of the EGD. These should be disbursed in such a way that they increase incentives for ICT companies to invest in applications promising large-scale energy savings and carry out the respective R&D in cooperation with building companies as well as regulating authorities.

While the following investments cannot be as directly associated with emission reductions, they are nevertheless essential for such reductions to happen under the given circumstances, e.g. to bring down emissions from industry.

Advanced green vocational education

The EGD will disrupt occupational biographies in a number of sectors and requires innovative forms of advanced vocational training nurturing new skills on a broad scale (Jaeger, 2014). An annual investment stream of €30 billion can provide education opportunities, including a year of training for about 10% of the workforce in the construction sector (Wolf et al., 2020).

A European breakthrough innovation system

Since World War II, Europe has excelled in continuously improving existing technologies and practices, but not in generating breakthrough innovations. Catching up on such innovations developed elsewhere has worked occasionally, as in the case of planes and high-speed trains. However, for carbon neutrality, breakthrough innovations will be crucial to bring down the costs of transforming existing urban structures and in fields like green hydrogen, agriculture and ICT. In the view of the EGD, industry needs a combination of challenges from regulation and an overhaul of the European innovation system (see, e.g. Mazzucato 2016, 2018).

The US innovation system, which clearly has breakthrough capacity, differs in institutional arrangements and in funding magnitude: \(^ {14}\) US public R&D expenditures at the federal level alone (i.e. without states like Massachusetts or California) are in the order of 0.8% of GDP (Hourihan and Parkes, 2019). R&D expenditures of the EU are less than one-tenth of that – in 2019, e.g. the EU umbrella programme for R&D, Horizon 2020, amounted to around €12 billion, i.e. 0.075% of (then EU28) GDP. We hence suggest an additional investment stream of at least €30 billion, or about 0.2% of (now EU27) GDP, as a step in the direction of an innovation system capable of breakthroughs centred on the EGD.

Subcontracting management tasks

Realising the EGD will require greatly amplifying the managerial capabilities of the EU and its member states. As in many other domains, public-private partnerships are important here. Carefully organised, an annual investment of €10 billion in human capital can become a unique experience of mutual learning by public administration and private enterprise for management at the local, national and European levels.

A European planetary health policy

Finally, it was the COVID-19 crisis that triggered fundamental change in financial resources becoming available to tackle common challenges in the EU. To consolidate this process, it is vital to embed the goal of climate neutrality in the broader ambition of tackling the risks and seizing the opportunities of the Anthropocene. As a response to the coronavirus pandemic, the EU should develop a European planetary health policy (Whitmee and Haines, 2015). Initial tasks include building the capability

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\(^ {13}\) Grants should be disbursed on a first come, first served basis, with suitable regulations giving a strong signal to home owners that sooner or later their buildings will have to satisfy stringent energy standards.

\(^ {14}\) A discussion of an equivalent of the US Defense Advanced Research Projects Agency, with the EGD acting as its backbone rather than the military is beyond the scope of the present paper (but see Marin, 2020).
and infrastructure for real-time monitoring of European health dynamics, initiating rapid large-scale contact tracking and testing, the cross-border transfer of medical equipment, vaccines and pharmaceuticals, step-wise development of health-conscious socio-ecological systems and expanding the global professional information exchange beyond intergovernmental channels.

Estimates for appropriate annual investments vary between €20 and €70 billion (European Commission, 2020c). As the long-term establishment of a European planetary health policy will be a stepwise process, we consider an initial budget of €20 billion per year, to be complemented by investments of member states.

The proposed investment profile amounts to an annual public investment of €255 billion, which is about 1.8% of the EU27’s 2019 GDP and is in the range of volumes previously discussed in view of the EGD (European Commission, 2020b).

Feasibility check

To show that the investment profile outlined can shift the EU economy to a new development path compatible with the proposed criteria, we roughly estimate plausible effects of the investments, based on literature and basic calculations. The obvious first step concerns emission reductions.

The emission reduction trend before the EGD. As the investments proposed here are in addition to existing measures, the average annual reductions of the past three decades (about 40 Mt of CO₂e per year) form the basis on which to build. GHG emissions per capita differ widely among European countries, as does, e.g. carbon intensity in electricity generation – from Sweden’s 13g CO₂/kWh to 773g CO₂/kWh in Poland (European Environment Agency, 2018). This leaves room for a continuation of the previous trend if countries can catch up to the least carbon-intensive ones.

Frontloading of a 100% renewables European electric grid.

Currently, renewables in the EU make up 15% of total energy use, and the state of the grid is a key hindrance to rapidly expanding that share. Frontloading the 100% scenario proposed by the European Network of Transmission Operators for Electricity can deliver 30 Mt of annual emission reductions. As this corresponds to less than 3% of current emissions from electricity production, it is a conservative estimate.

Transforming the car-based mobility system. With tailpipe emissions of an average car of about 160g CO₂/km (IC-CT, 2018) and around 122g CO₂/km for a new car in 2019 (European Environment Agency, 2020a), replacing an old car provides an efficiency gain of about 24%. Investments in charging infrastructure will be critical to achieving the 2020/2021 average fleet emission target of 95g CO₂/km (European Commission, 2020d), corresponding to about 40% gained. About 9 million old cars were replaced in 2018; similar numbers lead to emission reductions of about 7 Mt if the greater efficiency gain is implemented. Further, we estimate that the investments outlined lead to a modal shift of 20% switching from passenger cars to an improved public transport system and 5% switching to biking and walking by 2030. Roughly, that corresponds to an annual modal shift of 2% and 0.5% respectively. Since each percent of the modal shift using cars corresponds to 5.65 Mt of emissions, this would save another 11.3 Mt, resulting in reductions of 18 Mt annually.

The European Silk Road. Today’s railways are up to nine times less CO₂ intensive than the road (Finger et al., 2019), and a European Silk Road would constitute a “big push” for a European train-centred freight system of the future (Creel et al., 2020). According to CER (2015), a doubling of rail freight transport, with the freight shifted from roads, could result in a reduction of GHG emissions of around 45-55 Mt CO₂e per year. As such an initiative takes time to realise its full potential, we estimate emission reductions in the order of 20 Mt CO₂e per year.

Accelerating the energy renovation of the building stock.

Turning an average inefficient building into an efficient building means reducing its emissions by around 75%, or by an average of about 35kg CO₂ per square metre. Renovation of about 0.7 billion m² per year, as sketched above, then decreases emissions by about 24.5 Mt.

R&D in digitalisation for energy saving. Estimates for CO₂ emission reduction potential through ICT range from 0.1%-1.0% per year for households alone (Bastida et al., 2019) or to up to 3.7% across the whole society (British Telecommunications, 2019). The Global Enabling Sustainability Initiative (GeSI, 2015) estimates net GHG emission reductions in the order of 1.3% per year, corresponding to just under 50 Mt CO₂e in the EU27’s early 2020s. To exclude energy savings already accounted for above, we conservatively estimate 30 Mt CO₂e per year.

15 In the EU27, 14.1 million cars were new (Eurostat, 2020d) in 2018, but the total number of cars increased by five million compared to 2017.
16 This is computed from the fact that 469 Mt correspond to 83% of the modal split.
17 Energy Class A compared to E, or D compared to A+ (Enev Oline, 2014).
Thus, the total annual emission reductions achievable with the proposed investment profile fit the requirements for the breakthrough decade 2020-2030, keeping in mind that investment streams into education, a breakthrough innovation system and a planetary health policy generally support these emission reductions.

Concerning the criterion of growth, €255 billion, slightly more than 1% of GDP, will lead to additional growth of at least 1.5% of GDP, due to a fiscal multiplier of at least 1.5 (Boitani and Perdichizzi, 2018). Together with the pre-crisis trend of around 1.5%, the annual growth rate will total at least 3%. According to the International Monetary Fund (2020), in conditions of high uncertainty, like those created by the COVID-19 crisis, the fiscal multiplier might even be larger than two, as the €255 billion would trigger further private investments. This does not consider important indirect effects, such as the role of technical change, nor the fact that training accelerates the rate of productivity growth (Sala and Silva, 2011), so that growth effects can be expected to be larger in the longer run.

The criterion of unemployment was defined at country level in view of the danger of divergence and the possibility of convergence in the EU. We consider the case of Greece, the EU country worst hit by unemployment, especially for youth. It has 2% of the EU population, about 800,000 unemployed in 2019 (Eurostat, 2020a) and a GDP of about €200 billion. Therefore, directing 5% of the €255 billion, i.e. about €13 billion, towards public investments in Greece would be a shock of about 6% of Greek GDP.

Under present conditions, employment would increase by about 1.2% over two years in response to a positive shock of 1% of GDP due to public investment (International Monetary Fund, 2020). Considering the resident working age population of about 3.8 million (Eurostat, 2020a), with the employment multiplier of 1.2, this shock translates to about 270,000 additional jobs over two years, constituting concrete steps towards the proposed targets, especially if hiring young people is incentivised.

Significant amounts of EGD public investments will need to be directed towards countries with excessive unemployment rates, but of course in such a way that countries near to or at full employment still experience a substantial stimulus. If the EU as a whole can accelerate growth to 3%, employment in Greece can further increase to meet the goals. By similar considerations, this also holds for other countries with unemployment rates currently above the stated goals.

At present, the main challenge for the ECB is to bring average inflation close to 2%. The investment push consid-ered here would make this goal easier to reach, especially if wages catch up with productivity where they are lagging. The required increase of inflation would then facilitate an innovative dynamic of the overall economy, keep the danger of deflation at bay and create leeway for policy responses in future crises.

Conversely, to avoid a rise of inflation above the target set by the ECB, the quality of the European innovation system and the development of new forms of vocational education become crucial. Improvements in these areas create the capacity and flexibility needed to overcome bottlenecks that might lead to problematically high rates of inflation.

A broader perspective

The present analysis is meant as an initial step in a broader research programme for understanding how Europe, and ultimately also other parts of the world, can shift to a new development path characterised by reducing emissions and increasing well-being.

Once such a new development path is reached, the level of public investment required to maintain it is likely to be lower than the level needed to trigger the transition. Given a decade of large-scale directed technical change, shifting back to a “brown” trajectory once a “green” one has been implemented is unlikely (Acemoğlu et al., 2012); the change in behaviour and social norms that leads to improved living conditions, such as cities with less pollution and noise (Gehl and Rogers, 2013) is also likely to remain.

It is setting in motion the virtuous circle of investment, well-being and innovation towards such a new development path that requires further research on potential options and development of the relevant technologies. Dialogue processes with decision-makers and citizens for deliberating what is desirable in a given context and negotiating contributions to the necessary changes are just as important (Mielke et al., 2017). Against this background, a co-evolutionary development of policies, technologies, cultural values and economic institutions seems to offer the best chance of successfully designing and implementing the European Green Deal.

The structure of a Green Deal outlined here is intended as a proof of concept. It aims to encourage discussion of elements of the EGD and related orders of magnitude that can lead to a shift to the new development path indicated. It also points to questions that will need answering, such as how to create a European innovation system capable of the breakthrough innovations needed to decarbonise not only Europe but the world economy as a whole.
A related and even more daunting challenge lies in establishing a common will to realise the European Green Deal across EU member states. The nationally fragmented initial response to COVID-19 has confirmed the need for reversing the trend of decreasing European cohesion, observable in rising support for anti-European parties in many countries, with Brexit as its most obvious example. It remains to be seen whether and how the ambitious mission of becoming the first climate-neutral continent may be turned into an opportunity for uniting the European people.

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Robust Policy in Times of Pandemic

The pandemic exposes policymakers to fundamental uncertainties about future economic scenarios. While policymakers have to act forcefully to mitigate the impact on the economy, these conditions call for policy strategies that are also robust to uncertainty. This article compares two concepts of robust strategies: robust control and robust satisficing. It argues that a robust satisficing strategy is preferred and shows that the crisis responses of governments and central banks in Europe share features of robust satisficing in several dimensions.

The pandemic creates fundamental uncertainty

The pandemic is an unprecedented shock with a sizeable downward skew. The event is not reflected in past data, so its social and economic impact cannot be quantified based on known probability distributions. This makes any forecasts fundamentally uncertain, as explained long ago by Knight (1921).

The economic impact of the pandemic is fundamentally uncertain for several reasons. We do not know how many waves of COVID-19 will affect our societies or for what duration immunity is obtained after vaccination. The impact of the virus on social and economic developments has the potential to change the economy’s productive capacity either permanently or for a sustained period. Such shocks to the economy are associated with radical, or Knightian, uncertainty (Issing, 2002). In these circumstances economic policymakers need strategies that are robust to fundamental uncertainty.

Robust strategies

Two distinct concepts of robust strategies have emerged: robust control and robust satisficing. A robust control approach (Hansen and Sargent, 2008) assumes that an aggressive strategy in times of fundamental uncertainty helps minimise the likelihood and impact of potential worst-case outcomes. For policy responses to the coronavirus crisis, this could imply a massive monetary and fiscal response to prevent a particular worst-case economic scenario from happening.

Robust control strategies in economics are derived from control theory in engineering and the min-max concept (Wald, 1945): minimising the impact of a maximally adverse situation. Although the goal of avoiding the worst outcome seems attractive, in economics it is difficult to realistically identify meaningful worst cases. While engineers can sometimes usefully identify worst cases, economic scenarios are far more complex and multi-faceted, making worst cases hard to formulate reliably.

The difficulty of identifying realistic worst cases in times of fundamental uncertainty and the need to achieve specific policy objectives motivate the robust satisficing strategy. The central concept is satisficing, which means achieving acceptable outcomes or, equivalently, meeting critical goals. As pointed out by Simon (1956, 1983), this is distinct from outcome-optimising that aims to achieve the best possible outcome. It is also different from min-max that seeks to ameliorate the worst-case outcome. The satisficing approach recognises that fundamental uncertainty precludes both outcome-optimisation and worst-case minimisation. It identifies critical goals that must be achieved and tries to achieve them as reliably as possible. The resulting policy response can either be moderate or aggressive, depending on the critical goals.
Policy trade-offs

Economic policymakers nowadays face a range of challenges: output losses, increasing unemployment, looming bankruptcies, rising budget deficits and debts, and so on. These challenges are preferably addressed together and this may involve trade-offs between them. For instance, supporting economic recovery may exacerbate budget deficits, and support to firms may weaken long-term productivity. But the overarching trade-off is between the economic goals and the management of the deep underlying uncertainty.

As the goals become more demanding, like aiming at a V-shaped recovery from a lockdown, the vulnerability to adverse surprise increases as well. This is because greater aspirations can fail in more ways than modest aspirations. The proactive policymaker must identify the essential goals and achieve them as reliably as possible, despite the potential for severe adverse surprise. This may call for a precautionary approach, though not aimed at minimising the likelihood of a particular worst-case scenario.

Critical goals can usually be satisfactorily achieved in diverse ways precisely because one is not aiming at a unique optimal outcome. Various alternative policies would satisfy (but not necessarily optimise) the outcome. This plurality of satisficing policies creates an additional degree of freedom in policy formulation: something other than the outcome can be optimised, while the outcome itself is satisfied. Specifically, the policymaker can optimise the robustness to uncertainty and surprise, while satisfying the quality of the outcome. The robust satisficing approach balances the ambitiousness of the goals and the robustness to surprise.

A common misconception is that robust satisficing is inherently cautious or slow to act. This results from misinterpreting the concept of satisficing, which means “meeting critical goals”, as if it meant “meeting minimal goals”. The critical goals may be very ambitious, and probably should be very ambitious in extreme circumstances. This implies that robust satisficing could also advise vigorous policies to support the economy in the current crisis.

Consider the depression of the 1930s: economists agree that US fiscal and monetary policymakers did too little, too late (Fishback, 2010). Policymakers at the time could have adopted the ambitious satisficing goal of reducing unemployment from 25% to 15%, and then to 5%, over two or three years, for instance. Satisficing goals like these are not optimisations, such as “minimise unemployment” or “minimise the duration of excess unemployment”. But they would have been highly ambitious. Once satisficing goals are defined, the policymaker adopts the most robust policy for achieving them.

Proxies for robustness

Both robust control and robust satisficing strategies can be evaluated in terms of their strength in several proxies for robustness. The robustness of a policy strategy is the ability to achieve specified goals, despite the occurrence of unanticipated adverse events, like another surge of COVID-19 infections. Robustness is a multifaceted attribute of a policy (Ben-Haim, 2010, 2018; Ben-Haim and Demertzis, 2016). We identify six conceptual proxies for robustness to uncertainty. They overlap to varying degrees, but each reflects a different aspect of robustness.

Resilience: rapid recovery of critical functions. Some adverse events interrupt critical economic functions. A policy that enables rapid restoration of such functions has resilience to uncertainty.

Redundancy: multiple alternative solutions. A policy has redundancy if alternative tools can be brought to bear in responding to surprise.

Flexibility: rapid modification of tools and methods. A policy is flexible if it can be altered and new effects achieved at short notice.

Adaptiveness: modification of tools and methods over a longer time. Flexibility is a short-term attribute, while adaptiveness of a policy refers to its long-term ability to adjust to changing circumstances.

Margin of safety: excess of benefits. A policy has a margin of safety if it provides policy space to act in unanticipated stressful circumstances.

Comprehensiveness: interdisciplinary system-wide coherence. A policy is comprehensive to the extent that it addresses diverse facets of the challenge. A comprehensive policy assesses the impact in different sectors, over different horizons, while also taking into account the actions of other players.

Assessment of policy strategies

The proxies for robustness can be used to evaluate both robust control and robust satisficing. A strategy is preferred if it is strong in most or all of the proxies and hence robust for achieving specified critical goals. While a robust control strategy likely scores high on at least some of
Robust Policy Strategies

the six criteria, this strategy also has downsides in a state of fundamental uncertainty.

First, it can give a false sense of being in control, while the future dynamics of the economy are unknown. It does not seem sensible to design policies for selected worst cases about which one knows very little (Sims, 2001). This may reflect policymakers’ overconfidence in achieving the objective.

Second, pre-committing to particular future actions will reduce adaptiveness and the margin of safety. It can also constrain the possibility of other interventions. This may undermine the policymaker’s credibility.

Third, suggesting that policies are in place to minimise the impact of a worst-case outcome may reduce resilience. It can incentivise market participants to change their behaviour, causing the economy to deviate from desired outcomes.

To some extent these pitfalls may also accompany robust satisficing strategies. A robust satisficing strategy may create a false sense of control if it entails a long-term commitment, although this would be in the context of flexibility and adaptiveness. A robust satisficing policy is preferable to min-max robust control in several aspects.

- It is flexible and has redundancy in terms of alternative measures by aiming at the objective in diverse ways, precisely because there is not just one optimal outcome.
- It scores high on adaptiveness, since it works under flexible assumptions by acknowledging the prominence of uncertainties of scenarios and outcomes.
- It scores high on resilience because it tries to achieve the objective as reliably as possible, thereby implicitly nurturing critical functions of the economy.
- By not pre-committing specific resources to cope with specific worst-case scenarios, it preserves a margin of safety (also in terms of reputation and credibility) to respond to future surprises.
- It scores high on comprehensiveness because a satisficing strategy has a modest view on what the policymaker can achieve and acknowledges that actions by other economic agents are also needed.

Robust control and robust satisficing can also be compared on a more conceptual level with the four aspects of decision making shown in Figure 1. The figure displays the methodological preference for robust satisficing.

**Figure 1**

Conceptual comparison

Source: Authors’ own elaboration.

Modulation: variation in the policy response. Robust control is inherently aggressive because it is designed to respond to postulated worst cases. Robust satisficing on the other hand allows the policymaker to explore the full range of uncertainty by examining the trade-off between robustness to uncertainty and quality of outcome. This implies that robust control has medium modulation, while robust satisficing has large modulation.

Uncertainty modelling: dexterity in modelling and managing uncertainty. Robust control is a relatively blunt strategy: the wide and rich range of contingencies and scenarios is embedded in postulated worst cases. Robust satisficing directly addresses uncertainty in its myriad dimensions. Hence, robust control is medium and robust satisficing is high in uncertainty modelling.

Input feasibility: ease of providing required input data. Robust control requires estimated worst cases, about which one knows little and which are extremely hard to calibrate. Robust satisficing requires that the policymaker specifies essential or critical outcomes. The reliability and feasibility of the robust control inputs are low, while those of robust satisficing are medium, limited primarily by the knowledge of the policymaker’s priorities.

Decision support: providing conceptual tools to support deliberation and selection of policy. Robust control tends to be a one-way street, portraying the ability of policy alternatives to manage the postulated worse cases. Robust satisficing encourages the policymaker to have alternative policy options available. Hence, robust satisficing is strong in decision support, while robust control is moderate.
Evaluation of the European policy response

Economic policy measures taken to address the economic fallout of the COVID-19 crisis can be assessed by their robustness to uncertainty. Governments in Europe have provided unprecedented financial support to households and firms to compensate for their reduced income and turnover in the lockdowns. The measures range from direct income support to guarantees on bank loans that indirectly support the liquidity position of firms (see IMF, 2020, for an overview). Extended liquidity supply and asset purchases by the European Central Bank (ECB) have supported banks and financial markets in providing the necessary financial services to the economy.

In terms of the robust satisficing concept, governments and central banks have aimed at critical goals that must be achieved in a fundamentally uncertain market environment. Governments aim at keeping businesses afloat that are viable in the long run. This also supports jobs and prevents long-term economic damage due to insolvencies and hysteresis effects. Such effects can be related to long-term unemployment and loss of company-specific knowledge. The goal has been to keep these losses at tolerable – though not explicitly minimal – levels. Central banks and supervisors have supported the critical functions of the financial system, while being vigilant for financial amplification effects that may occur through adverse spillovers from the corporate sector to financial institutions.

The policy measures meet several proxies for robustness and aspects of decision making discussed above. The measures contribute to resilience by preserving critical functions of the economic and financial system to prevent long-term economic damage. They also meet the redundancy criterion, since government and central banks have used alternative tools to support the economy. From the onset of the pandemic, it was unclear which measures were most effective. This motivated authorities to roll out support packages that contained a host of measures and support schemes. Such packages provided the necessary flexibility to modify the responses and tools to changing circumstances. This is in line with the modulation principle in decision making, which advocates variation in the policy responses.

In most countries the government support measures are also adaptive over time, which is the case if their use and conditions move in sync with the economic situation. It is important that the process of winding down the support measures in a later stage remains cognisant of the persisting uncertainties in the economic and medical spheres. Adaptability is also part of those government support schemes that provide incentives to adjust to the new business realities. Keeping in place the support measures too long may be costly if the economic structure changes due to the COVID-19 crisis. It is not cost-efficient if firms and sectors that will have a smaller market share in the future continue to be supported. The private sector itself also shows adaptability owing to learning effects from the first lockdowns in the spring of 2020. Firms have learned how to adjust in a lockdown, which has limited the economic damage in subsequent lockdowns (DNB, 2020).

The measures by governments and central banks have been unprecedented in terms of size and scope. This has provided a margin of safety. The increase of fiscal deficits and public debts are a reflection of the policy space that has been created to act in these unanticipated stressful circumstances. In the euro area countries, fiscal spending in the form of transfers and subsidies to firms and households amounts to about 4.5% of GDP (ECB, 2020). As a consequence, the average euro area debt ratio is projected to peak in 2021 at almost 100% of GDP. It reflects the role of the public sector as insurer against extreme tail risks such as the pandemic. It underlines the importance of sufficient policy space, created by building up financial buffers in normal circumstances. The three safety nets endorsed by the European Council for workers, businesses and sovereigns also provide important funding support. The fiscal response is supported by the accommodative monetary policy of the ECB. Since March 2020, the ECB has purchased government bonds and corporate bonds through the Pandemic Emergency Purchase Programme to preserve favourable financing conditions until it is judged that the coronavirus crisis phase is over. The current fiscal and monetary policy mix displays interdisciplinary system-wide coherence, as the fiscal and monetary measures work in the same direction. This meets the comprehensiveness criterion of robustness.

The ECB’s monetary policy measures are based on two alternative scenarios for the economy, in addition to the baseline scenario (ECB, 2020). The scenarios vary according to different assumptions about the pandemic and about the economic response. In that sense, the scenarios are a tool for uncertainty modelling and are supportive to managing uncertainty. The scenarios are adjusted in the course of time to include new incoming information. This is in line with the input feasibility aspect of a decision making process that is robust to fundamental uncertainty. The scenarios provide conceptual tools to support the deliberation and selection of monetary policy. As a decision support instrument they stimulate the policymaker to consider alternative policy options available. If the rollout of vaccinations leads to sufficient herd immunity by the end of 2021, the economy will start to function under more normal circumstances (Lagarde, 2020). That could
mark the end of the emergency phase and of the large uncertainties under which policymakers have to make their decisions.

Conclusion

The pandemic has created fundamental uncertainties about the economic outlook. It has challenged policymakers to define a strategy that is robust to future unexpected dynamics in social, medical and economic spheres. We conclude that a robust satisficing strategy that maximises robustness to uncertainty and satisfies policy goals is preferred over a robust control strategy that minimises the impact of postulated worst cases. This conclusion is motivated by the huge uncertainties related to the COVID-19 crisis that makes the identification of realistic worst cases highly unreliable.

The policy strategies of governments and central banks in Europe share the distinguishing features of robust satisficing in several dimensions. The unprecedented policy responses have created a margin of safety and display an interdisciplinary and system-wide coherence that is needed to effectively address the economic challenges of the coronavirus crisis. It supports the achievement of critical goals, such as preserving jobs and activities in viable businesses in circumstances characterised by fundamental uncertainty.

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China’s Investments in Germany and the Impact of the COVID-19 Pandemic

This paper analyses how China’s investments in Germany have developed over time and the potential impact of the COVID-19 pandemic in this regard, based on four different datasets, including our own survey in mid-2020. Our analysis shows that Germany is currently one of the most attractive investment destinations for Chinese investors. Chinese state-owned enterprises have played an important role as investors in Germany – particularly in large-scale projects. The COVID-19 pandemic has had some negative but rather temporary effects on Chinese investments in Germany. Germany is expected to stay attractive to Chinese investors who seek to gain access to advanced technologies and know-how in the future.

In early 2020, COVID-19 first caused a drastic lockdown of the Chinese economy. Subsequently, lockdown measures and further containment policies like business closures and mobility restrictions have been implemented worldwide to stop the spread of the coronavirus. The pandemic has led to a massive shock to the world economy (Ozili and Arun, 2020). Against this background, the United Nations Conference on Trade and Development (UNCTAD) expects that foreign direct investment (FDI) flows in 2020-2021 will drop by about 30% to 40% (UNCTAD, 2020a).

Decreasing FDI flows may make it more difficult for firms to acquire resources for their business and best satisfy the market needs. Such FDI decreases may further weaken the investment-based development impetus in many countries, impede the processes of idea exploration and research and development (R&D) and thus pose a threat to global prosperity.

This paper provides empirical evidence of how China’s investments in Germany have developed over time and of the investment impact of the COVID-19 pandemic. It also shows the relevance of China’s policies in this regard. The analysis is based on four different data sources, including our small-scale survey in mid-2020 on the COVID-19 impact on FDI.

Policy background: Outward FDI for China’s development

Many Chinese firms investing abroad were motivated by their business interests (e.g. Cheung et al., 2012; Li et al., 2017; Wu, 2007). But their investment decisions and engagement have also been strongly guided and regulated by the Chinese government. China’s economic development foci and strategies to overcome its economic challenges have been reflected in related Chinese policies that build the rules and regulations guiding Chinese investors’ behaviour abroad (e.g. Child and Rodrigues, 2005; Morck et al., 2008).

China’s ‘Go Global’ policy was announced in 1999 and marked a turning point in the Chinese government’s attitude towards actively encouraging and supporting Chinese investments abroad (Rosen and Hanemann, 2009). Increasing investments abroad will help China to better deal with the appreciation pressure on the renminbi and more efficiently allocate the accumulated foreign exchange reserves.

With its accession to the World Trade Organization in 2001, China faced increasingly severe market competition. China thus increased its emphasis on the key role of science and technology and later also indigenous inno-
viation and upgrading for enhancing Chinese firms’ competitiveness and for sustaining China’s economic growth in the long term. The Go Global policy was then formally integrated into China’s national development strategy as reflected in the 10th Five-Year Plan (2001-2005) and reasserted in the 11th Five-Year Plan (2006-2010). Increasing Chinese investments abroad is intended to help Chinese firms gain better access to more advanced know-how and technologies, develop innovation capabilities and move up the global value chains.

With its strong economic development over decades, China became the second largest economic power worldwide in 2008 and the world export champion in 2010. China’s economic growth has been, however, much weaker since then (Liu and Langhammer, 2016). New initiatives such as the Belt and Road Initiative (Felbermayr et al., 2019), Made in China 2025 (e.g., Garcia-Hererro et al., 2020; Zenglein and Holzmann, 2019) and the National Innovation-driven Development Strategy (Central Committee of China’s Communist Party and State Council of China, 2016) were carried out to explore new development stimuli to deal with the emerging growth challenges.

In the new wave of innovation promotion as a national strategy, private firms have received more attention than ever before. These initiatives co-shaped China’s policies for guiding and encouraging outward FDI, which gained a much clearer regional and industrial/technological focus of FDI destinations or targets than before to help achieve the national long-term development goals. A key FDI guiding and regulating document announced by the National Development and Reform Commission (NDRC et al., 2017) clearly shows that Chinese outward investments that are more advantageous for supporting China’s developing strategies such as its Belt and Road Initiative as well as structural change towards high-tech and advanced manufacturing are encouraged, while the investments in, e.g. real estate, sports and entertainment sectors are rather restricted.1

Considering the developing trends in China’s Go Global Policy, Europe and, particularly Germany, now clearly belong to the attractive destinations for Chinese outward investments. On the one hand, the abovementioned Belt and Road Initiative aims to improve China’s connectivity with Europe. On the other hand, the advanced countries in Europe such as Germany are potential sources of valuable know-how and technologies that are crucial for China to move up the global value chains and to achieve innovation-driven growth and technological leadership in the long term. On 30 December 2020, after years of negotiation, the EU and China finally concluded in principle the EU-China Comprehensive Agreement on Investment. Such an agreement will further enhance the attractiveness of Europe (and Germany) for Chinese investments in the future, although it is still highly uncertain whether the agreement can be adopted and ratified and how long it will take until it can really be enforced.

Research data

To learn more about how China’s investments in Germany have developed over time and how they have been affected by the coronavirus pandemic, four different datasets with their unique strengths are analysed in this paper. First, the data from the Annual Statistical Bulletin of China’s Outward Foreign Direct Investment (MOFCOM et al., 2007-2019) helps to provide an overview of the development of Chinese investments abroad in general and those in Germany in particular. Second, the data from the Investment Project Database provided by MOFCOM gives information about the distribution of all approved Chinese investment projects in Germany by ownership and by sector. Third, the China Global Investment Tracker (CGIT) provided by the American Enterprise Institute and the Heritage Foundation (2020) is used to deepen and update the investment distribution analysis by focusing on Chinese large-scale investment transactions in Germany. Last but not least, our own survey “Potential Impacts of the COVID-19 Pandemic on the Chinese Investment in Germany” also provides insight on the topic.

Different from many previous studies (e.g. Knoerich, 2010) for which investor data were analysed, our survey addressed consulting firms and organisations in Germany that have been intensively engaged in providing FDI consulting services to Chinese investors in mid-2020.2 Since

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1 In 2014/2015, several bureaus in charge of regulating Chinese investments abroad such as MOFCOM (2014) and SAFE (2015) simplified the regulation measures and approval procedures for Chinese investment projects. The Chinese government considered, however, a part of the strongly expanding Chinese outward FDI as inefficient and thus turned to strengthen its guiding and regulating role in 2017 (Huang and Tang, 2017). NDRC et al. (2017) clearly indicate the directions of Chinese investments abroad that are encouraged, restricted or prohibited. Chinese investments abroad in support of the Belt and Road Initiative and upgrading Chinese exports, in high-tech areas and advanced manufacturing, in energy and resources areas, in agricultural cooperation and in the finance sector are explicitly encouraged. In addition, state-owned enterprises (SOEs) are also required to better manage and supervise their enterprises abroad to enhance their investment quality and efficiency (MOF, 2017).

2 The list of invited firms and organisations is based on sector-related information collected from the Chinese Chamber of Commerce in Germany, the German-Chinese Business Association, the Investment Platform China/Germany and the German-Chinese High-Tech Alliance. We also consulted an expert in the consulting sector in Germany to further extend our list to include smaller key players less visible on the public platforms.
they consult not only investors who are already active in Germany, but also potential investors and those who left or are leaving the German market, our survey can help to provide a broader overview of whether and how Chinese investors may change their engagement in Germany in response to the COVID-19 pandemic. In total, 71 consulting firms and organisations in Germany were invited to join our survey, and 18 questionnaires (25%) were completed and returned. The small-scale survey might not be representative, but it can still provide some up-to-date information for business and policy orientation. The majority of these 18 firms and organisations are small in size in terms of the number of employees who were involved in providing consulting services related to Chinese investments in Germany at the end of 2019 (56%: 1-9 persons; 39%: 10-25 persons).

Chinese investments in Germany: Key developments

Since the beginning of the new century, even against the backdrop of the global financial crisis and a significant slowdown in long-term global economic growth, Chinese investors continuously increased their FDI. The outward FDI flow substantially increased from about $0.9 billion in 2000 to $117 billion in 2019. In 2015, China’s outward FDI flow even exceeded its inward FDI for the first time. With its outward FDI stock of $2,100 billion in 2019 (about 75 times its outward FDI stock in 2000, $28 billion), China is the third largest FDI source country in the world (UNCTAD, 2020b).

Germany is one of the most attractive FDI destination countries for Chinese investments

China’s outward FDI stock in Germany reached more than $14 billion at the end of 2019. Although this was only about 0.7% of China’s total FDI stock in the world, Germany was ranked tenth among all destination countries of the Chinese investments (in stock) in 2019 (MOFCOM et al., 2019).³ Chinese investors substantially increased their FDI flow to Germany after the global financial crisis (Figure 1). From 2009 to 2017, the Chinese outward FDI flow to Germany increased continuously at a much stronger rate than Chinese outward FDI in general, with the year 2015 being an exception. As a result, the share of Chinese investments in Germany in its world total clearly increased from 0.32% in 2009 to 1.72% in 2017. As mentioned above, the Chinese government strengthened its guiding role and regulatory power for Chinese overseas investment projects in 2017. This led to a substantial reduction in the Chinese investment flow to Germany in 2018 that remained stable in 2019 against the backdrop of further decreasing Chinese investments abroad in general.⁴

Chinese SOEs played an important role as investors in Germany – particularly in large-scale projects

Figure 2 shows that there were 89 approved Chinese investment projects in Germany in 2014, compared to 11 projects ten years earlier.⁵ A continuous increase in FDI projects can be observed after the global financial crisis.

³ The top three destination countries/regions are well-known stop-over destinations and/or offshore financial centres: Hong Kong (58%), the Cayman Islands (12.6%) and the British Virgin Islands (8.5%).

⁴ The relatively strong decrease in China’s investments in Germany compared to the world that led to a reduction in the corresponding share in 2018 can also be attributed to the increasingly strict supervision over non-EU FDI in Germany. In 2018, the German government for the first time prohibited an acquisition of a German firm by a Chinese company on national security grounds and prevented another acquisition attempt by a Chinese electricity giant.

⁵ The time period is determined by China’s Investment Project Database provided by MOFCOM. The database is not further updated in a comparable way after 2014.
SOEs play a much more important role as investors of large-scale (at least $100 million) investment transactions in Germany (Figure 3). From 2011 to 2014, they accounted for a significantly higher share of large-scale investment transactions in Germany than in case of the approved FDI projects in Germany in general (Figure 2). In the recent past, when the Chinese government again strengthened its guiding and regulating role in Chinese investments abroad, the number of Chinese SOEs’ large-scale projects in Germany strongly decreased from 2016 to 2017 but stayed constant after that. The number of large-scale projects of non-SOEs decreased more strongly in the same period. The average size of the SOEs’ large-scale investment transactions was larger than that of their non-SOE counterparts in all years since 2011, except for 2018.7

Large-scale Chinese investments in Germany increasingly focused on transport and high-tech sectors

6 SOEs refer to enterprises with capital injection from the central and/or local governments (National Bureau of Statistics of China, 2003).

7 CGIT is able to identify the final recipients of Chinese investments, even if they have been made via third countries (Scissors, 2019). Comparing Figure 3 with the first two figures suggests that a great amount of Chinese FDI in Germany have been carried out indirectly, i.e. via third countries and this is particularly the case for Chinese SOEs as investors.

From 2005 to 2014, the large-scale investment transactions by Chinese investors in Germany were mainly targeted in the real estate sector (seven of the 20 projects in total), followed by the transport sector (five projects).8 While the transport sector clearly gained in importance as a target industry after 2014, the attractiveness of the real estate sector substantially decreased. From 2005 to 2019, 20 of 25 large-scale transport investment projects (80%) in Germany were carried out in the last five years, compared to 30% in the real estate sector (three out of ten projects) in the same period. The investment projects in the transport sector in the last five years accounted for more than 92% of the total investment value in this sector from 2005 to 2019.9

The technology sector was ranked third in terms of project number and value for the large-scale investment transactions for the whole period considered. Similar to the transport sector, this was a result of a strong increase in attractiveness of the technology sector among large-scale investment projects by Chinese investors in Germany after 2014. Five of the six (83%) investment projects and 89% of the $5.9 billion investment amount in this sector from 2005 to 2019 were realised in the last five years.

The increasing importance of the transport sector and the technology sector as target industries of Chinese large-scale investments in the recent past is not surprising. As described above, in this period the Chinese government particularly encouraged outward FDI projects in support of China’s new initiatives such as its Belt and Road Initiative and its need for structural change towards high-tech and advanced manufacturing.

Both SOEs and non-SOEs had large-scale transport investment projects in Germany and non-SOEs played a more dominant role in this regard (Figure 4). Non-SOEs were responsible for 13 of the 20 (65%) large-scale transport investment projects from 2015 to 2019 (75% measured in value), when the transport sector gained attractiveness as a target industry. Although the transport sector was also an important target industry for SOEs’ investment in Germany (50% of their large-scale investment projects in number from 2015 to 2019), the average size of the SOEs’ transport investment projects was smaller than...
that of their non-SOE counterparts, accounting for only about 40% of SOEs’ total large-scale investment value in this period.

The role of non-SOEs was even more prominent in large-scale investment projects in the technology sector in Germany. They were responsible for all six such projects for the whole period from 2005 to 2019, including five that were carried out from 2015 to 2019. In contrast, SOEs were clearly dominant in Chinese large-scale real estate investments in Germany. They carried out eight of ten such projects for the whole period and accounted for more than 90% of the corresponding investment value, completely dominating in this area from 2015 to 2019 (three of three projects). SOEs’ dominance in real estate investment projects in Germany and the stricter restrictions upon such projects imposed by the Chinese government provide some additional explanation to the strong decrease in SOEs’ large-scale investment projects in Germany from 2016 to 2017.

The COVID-19 pandemic has a negative but temporary impact on Chinese investments in Germany

Eighteen of 71 invited interviewees joined our small-scale survey. Twelve of them indicated that they received fewer general enquiries from Chinese investors regarding investment in Germany for the first half year of 2020 compared to the same period in 2019. They indicated that the COVID-19 pandemic had some but not a strong impact on such decline in general investment enquiries.

Such decline seems to be mainly driven by a decreasing number of Chinese investors’ enquiries about new investment projects in Germany. As shown in Figure 5, the majority of the 18 interviewed firms and organisations observed a decline in enquiries about new investment projects in Germany by Chinese investors in the first half of 2020 compared to the same period in 2019. On the contrary, for the other investment/divestment purposes, a high share of firms and organisations interviewed did not observe significant change over the same research period. Despite this, still more than one-third of the firms and organisations indicated that the enquiries by Chinese investors for expanding their business operations in Germany – in scale (36%) or in scope (44%) – decreased in the same period. However, only a (much) smaller share received more enquiries by Chinese investors about scale reduction (13%), scope reduction (23%) and market exit (31%). The findings suggest that at the time of the COVID-19 pandemic, Chinese investors turned out to be more cautious particularly regarding new investment projects in Germany. They may also hold off their investment expansion projects. But many of them may not immediately choose divestment.

10 The increase in enquiries for market exit as observed by about 31% of consulting firms and organisations interviewed is likely to be related to the fact that the Chinese investment projects in Germany (in terms of project number) have been traditionally concentrated in wholesale and retailing as well as leasing and commercial services. These sectors have been facing immediate market demand challenges due to strict containment measures amid the pandemic.
Foreign Direct Investment

In line with the findings of a reduction in enquiries about new investments as observed by many consulting firms and organisations, the business registration services were less in demand in the first half of 2020. Almost half of the consulting firms and organisations that provided such services observed such a decline in development (Figure 6). Many of them (40%) also received fewer enquiries from Chinese investors for searching investment locations.

Consistent with the finding that Chinese investors may not immediately decide for divestment, but for problem-solving, many consulting firms and organisations observed increasing enquiries from the Chinese investors for consulting services for employment and labour issues (67%), financing and liquidity problems (50%) as well as supply chain disruption between the EU and China (60%). For the other consulting services, a clearly dominant share of the firms and organisations surveyed did not perceive significant change in enquiries from Chinese investors over the research period.

Firms and organisations interviewed tend to be optimistic as to their future business perspective (Figure 7). Focusing on consulting firms and organisations that also answered the survey question as to the current change in investment enquiries (Figure 5), almost half of them expect an increasing number of enquiries about new investments in Germany in the near future. Almost 40% (34%) of firms and organisations expect more enquiries from Chinese investors to expand their investment projects in scale (scope) in Germany. The shares of firms and organisations expecting more enquiries for divestment in the future are smaller and they are hardly different from those in the early crisis period.

Conclusions

The analysis presented in this paper shows that Chinese investments in Germany increased strongly after the global financial crisis, when China’s policies shifted towards intensively encouraging quality- and innovation-based economic growth with outward FDI as an important instrument for Chinese firms to better access know-how and advanced technologies from abroad. Chinese SOEs were found to play a more important role in large-scale projects than in small-sized projects in Germany. The transport sector and the technology sector have become particularly more attractive to Chinese investors in large-scale projects since 2015 – the year of the release of China’s strategy Made in China 2025. Our survey results suggest that the COVID-19 pandemic had some but not a strong negative impact on Germany’s attractiveness for
Chinese investments and that such a negative impact is expected to be short-lived. Our findings are in line with the expectation that Germany, with its clear strength in high-tech, smart manufacturing and innovation activities, has become an attractive target for Chinese investments with their developments being strongly guided and regulated by Chinese policies.

The closing communiqué of the Central Committee of the Chinese Communist Party suggests that promoting innovation will continue to be one of China's top policy priorities. China will, inter alia, continue to work on modernising its industries and supply chains as well as on strengthening its manufacturing capability to pursue quality-based and innovation-driven growth in the future (Central Committee of China’s Communist Party, 2020). Against this background, it is to be expected that Chinese policies will further encourage Chinese investments abroad that can help China to achieve its future innovation-driven development goals. Thus, Germany will probably continue to be attractive to Chinese investments in the future. This can be advantageous for sustaining Germany’s future economic growth. A key question is, however, whether and how Germany should deal with Chinese investment attempts where the Chinese government plays a strongly guiding role. On the one hand, it is essential for Germany to develop adequate FDI policies to ensure its openness towards (Chinese) FDI so that Germany and its industries can further benefit from the foreign capital inflows and probably enjoy a fairer Chinese market access in return. The EU-China investment agreement may help here. On the other hand, while staying open to Chinese investments, addressing national security concerns without curbing Chinese investments in an unnecessary way is a critical challenge to Germany’s FDI policies. Germany will also need to ensure fair competition, especially in mergers and acquisitions. Last but not least, how German firms and industries facing intensified competition from China can increase their competitiveness and whether and how the German government should support them in doing so will remain an important question for Germany’s industrial policy.

References
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Over the last two decades, income disparities between EU member states tended to decline, particularly before the financial crisis. While Central and Eastern Europe caught up with the EU average, Southern Europe fell behind after 2009. Catch-up growth in both peripheries relied on nominal convergence (real appreciation) and foreign capital. Further growth can and should be fostered by an economic policy that does not neglect domestic demand, stabilises capital markets and invests in research, education, health and intangibles.

The European Union has long shown large income disparities between its member states (measured by average per capita income). This was mainly due to the entry of new member states with significantly lower income levels to the EU between 1973 and 2013. Reducing these disparities and achieving cohesion requires catch-up growth.

The convergence of income levels in Europe has been the subject of various studies and is anchored in the treaties as a goal of the EU. The most important instrument to achieve it has been EU funds, but they are relatively small and amount to less than 0.5% of the EU’s GDP. However, the track record of EU cohesion policy (documented in regular reports by the Commission) has been modest. That leaves the question open as to whether the income disparities would be even greater without the EU’s support. In this article, the development of income disparities are described, their causes examined and possible policies for reducing them are discussed.

The size and development of income inequality between member states also depends on the choice of indicators. This applies to income itself (market income, disposable income, GDP) and its conversion into euros. Converted at exchange rates, the income disparities are significantly greater than those at purchasing power parity (PPP), as purchasing power is higher in poorer countries where the price level is lower (see Table 2). But the choice of indicators of inequality also influences the result. Some indicators measure relative inequality (such as quintile ratios or the coefficient of variation), some measure absolute disparities (e.g. standard deviation, Gini). A declining standard deviation indicates sigma convergence (see Figure 1) while beta convergence, i.e. stronger growth in poorer countries, improves indicators of relative inequality. Paradoxically, in the short and medium run, beta convergence does not necessarily imply sigma convergence and indicators of relative and absolute inequality may show opposite trends (Barro and Sala-i-Martin, 1991; Islam, 2003; Dauderstädt, 2020).

In certain periods of time and for certain groups of member states, beta convergence could be observed (see Table 2). At the same time there is a lack of sigma convergence, i.e. the dispersion of incomes does not decrease – except during the crisis. Figure 1 shows the development of the standard deviation between the per capita incomes of the member states and the regions at NUTS 1 and NUTS 2 levels. Income disparities have increased

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1 Barro and Sala-i-Martin (1991); for an overview of the literature, see Dauderstädt (2014), Table 12.

2 The latest report has been the Seventh report on economic, social and territorial cohesion, European Commission (2017).

3 Nomenclature des unités territoriales statistiques (NUTS) indicates the set of regions of the EU. NUTS 1 comprises 98 regions; NUTS 2 is more disaggregated and comprises 277 regions.
almost continuously, except in the 2007-2009 period when, during the financial crisis, the incomes of the poorer countries of Central Eastern Europe (CEE) fell less sharply than those of the relatively richer member states. As mentioned above, the standard deviation for incomes measured in purchasing power standards (PPS) is lower than that for incomes calculated in euros using exchange rates. Inequality has increased most at the NUTS 2 level, which indicates growing regional disparities.

If, on the other hand, one chooses indicators of relative inequality such as the coefficient of variation (standard deviation/mean) or the ratio of the highest to the lowest income, a different picture emerges, as Figure 2 shows. An almost steady decline in the coefficient of variation can be observed for the member states and NUTS 1; but here too, the greater income disparity is evident at the NUTS 2 level. Inequality fell more sharply until 2008, after which the convergence process weakened. The value levels for income in PPS and in euros show the expected difference (lower in PPS).

If the ratio of the highest to the lowest income is selected as the indicator, a similar picture of steady decline emerges, albeit at very different levels. Looking at the NUTS 2 level, the richest sub-region in the EU was Inner London West with a per capita income of €142,100 in 2000 and the poorest was Nord-Est in Romania with €1,600. In 2018, Inner London West had increased its average per capita income by 50% to €213,400, but for the poorest region (then Severozapaden in Bulgaria), it had jumped by 225% to €5,200. This paradoxically means that the absolute gap has increased further (from €141,500 in 2000 to €208,200 in 2018), while the relative ratio declined from 109 to 41.

Another frequently used indicator of relative inequality is the quintile ratio (S80/S20 ratio), which gives the relation between the income of the richest one-fifth (quintile) of the population and that of the poorest. In Table 1, the EU population quintiles (approximately 102 million people each) were constructed using different methods. If one adds up the member states (or parts of them) to get the

### Table 1: Quintile ratios of income in the EU

<table>
<thead>
<tr>
<th>Compared entity</th>
<th>Neglected disparities</th>
<th>2000</th>
<th>2010</th>
<th>2018/19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Member states PPS</td>
<td>Income disparities</td>
<td>3.10</td>
<td>2.02</td>
<td>1.80</td>
</tr>
<tr>
<td></td>
<td>within member states</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Member states</td>
<td></td>
<td>5.48</td>
<td>3.81</td>
<td>3.15</td>
</tr>
<tr>
<td>NUTS 1 PPS</td>
<td>Income disparities</td>
<td>4.00</td>
<td>2.80</td>
<td>2.77</td>
</tr>
<tr>
<td></td>
<td>within NUTS 1 regions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NUTS 1</td>
<td></td>
<td>4.02</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NUTS 2 PPS</td>
<td>Income disparities</td>
<td>4.00</td>
<td>2.80</td>
<td>2.77</td>
</tr>
<tr>
<td></td>
<td>within NUTS 2 regions</td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Households PPS</td>
<td>Income disparities</td>
<td>6.99</td>
<td>5.87/5.56</td>
<td></td>
</tr>
<tr>
<td></td>
<td>within national quintiles</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Households</td>
<td></td>
<td>9.48</td>
<td>8.45/7.90</td>
<td></td>
</tr>
<tr>
<td>To compare: USA states</td>
<td>Income disparities within federal states</td>
<td>1.69</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Analysis of the author at a time when these data for 2000 and 2010 were still available from Eurostat.

Source: Eurostat, author’s calculations.
20% of the EU population, one neglects the differences within the member states. Similarly, when constructing the quintiles from NUTS 1 or NUTS 2 regions, the disparities within the regions are neglected. The household level takes account of income differences both within and between member states, since it uses the national quintiles (but also ignores the differences within the quintiles). All ratios were calculated measuring the respective incomes at exchange rates and PPP. Table 1 shows that the inequality increases with the granularity (choice of smaller regions). However, at all levels, the inequality decreases over time, which is in line with the data presented above.

The impact of the COVID-19 pandemic on cohesion

The coronavirus pandemic has affected the EU member states to different extents. Countries that depend on tourism suffered more than those who rely on manufacturing. Less indebted member states such as Germany could afford stronger fiscal support programmes than already highly indebted countries. These qualities, however, are not closely correlated with levels of per capita income. In a similar way, it is not clear if poorer countries will experience a stronger decline of GDP than richer member states. As Figure 3 shows, the richest countries tended to have somewhat weaker recessions in 2020, but the dispersion within both groups, poorer (left of vertical line) and richer (right of vertical line) member states, is very high.

Given this picture, it appears likely that the pandemic and the ensuing crisis did not substantially affect overall inequality between countries. But it has hit the Southern periphery much harder than the Eastern periphery and reinforced the already persistent trend visible in Table 2.

Catch-up growth in Europe

Catch-up growth, i.e. higher growth rates in the poorer countries relative to the richer ones (beta convergence) does not reduce the absolute income gap immediately, but is a necessary condition for long-term (sigma) convergence (Islam, 2003). We consider three specific groups of (originally) poorer member states corresponding to the three waves of enlargement – Ireland, GPS (Greece, Portugal and Spain) and CEE – with different growth performances in the past and compare them with the group of high-income member states (the north-west of the EU).

As Table 2 shows, the poorer member states of CEE showed significantly higher income growth between 2000 and 2019 (99.6% and 167.9% at PPS) than the richer core of the EU (18.6% and 49% at PPS respectively), whereby the absolute income gap, measured at exchange rates,
the EU15 average to around 120% in 10 years and, despite already being a high-income country, continued to grow significantly faster than the other richer member states after 2000.

Figure 4 shows the continuous catching-up process of the new member states of CEE, albeit faster before the financial crisis of 2009 than afterwards, while Greece, Portugal and Spain fell relatively behind after 2009. One also can observe the familiar pattern of relatively higher income levels when measured at PPS.

Different patterns of catch-up growth

As Table 2 shows, different parts of the lower-income EU periphery performed differently due to different initial conditions and policies. This is demonstrated by the following brief histories.

Ireland, the most successful poorer entrant, has used tax dumping and the resulting transfer pricing to attract massive foreign direct investments, which added fictitious value to its GDP. One medium-term consequence was that, although GDP rose sharply, gross national income lagged behind and the wage share plummeted (Dauderstädt, 2001). In the longer term, however, there were further demand impulses and rising price levels (from 92% of the EU average in 1995 to 119.5% in 2008), which were corrected briefly in the financial crisis, but ultimately undermined the catching-up success.

Greece, Spain and Portugal had lower growth rates. Greece in particular started to fall behind relative to the core member states already in 1981 (after joining the European Community), while Spain and Portugal slowly caught up from 1986 onwards (also thanks to more favourable world market conditions). After 2000, all three countries benefitted from the euro (e.g. lower real interest rates). Since their growth was higher than in the EU core, they attracted capital inflows from there, which helped finance the credit expansion in the South (see Figure 5). Current account deficits accumulated (see Figure 6), and prices and wages rose faster than in the core. The financial crisis brought the catch-up process financed in this way to a sudden stop. Counterproductive policies of the EU in the face of the sovereign debt panic in 2010 and the austerity programmes that were subsequently imposed produced deep recessions without solving the debt problems (Dauderstädt, 2016).

CEE performed much better than the South. It partially followed the Irish path by attracting parts of international value chains (especially from German industry), but never achieved the attractiveness of Ireland nor the volume of investment per capita. The strong migration from Eastern Europe to the Western EU created income (remittances) and increased per capita income, but also deprived the economies of manpower. But for Eastern Europe, too, as in the South, higher inflation and foreign debt were part of the catching-up process: the unweighted average price level rose from 48.6% of the EU average in 2000 to 67% in 2019. The current account deficits increased between 2000 and 2008 and the net foreign position deteriorated by 40 percentage points of GDP (see Figures 6 and 7). However, CEE benefitted from huge transfers from EU funds (1%-2% of GDP per year). The financial crisis slowed down the catching-up process in CEE, too (see Table 2).
Nominal and real convergence

Catch-up growth has two components: nominal and real convergence. Nominal convergence reflects the rise of prices and incomes in nominal terms. A country with, say, half the EU’s average income per capita could virtually achieve parity by doubling all prices and incomes, albeit with problematic consequences such as a surge of imports, decline of exports, bankruptcies of exposed firms and rising unemployment. A real case of rapid nominal growth has been East Germany when it adopted the Deutschmark at an overvalued exchange rate. It could only survive the consequences thanks to massive transfers from West Germany.

True real convergence must be based on a rise of production and value added that depends on increasing productivity and hours worked. Poorer member countries are poorer because their labour productivity is lower while their workers often work more hours (sometimes more than 2,000 per year) than those in richer member states (often with less than 1,500). However, less employment (lower participation rates, higher unemployment) can and often does reduce the impact of more hours worked per employee. Structural change (like shifting labour from the agriculture to the manufacturing industry and trade-induced specialisation), investment in physical, human and intangible capital, and the adoption of better technologies and management techniques increase the average productivity of a country’s economy.

Growing levels of employment and productivity depend not only on supply-side factors but on increasing demand, too. Real productivity (measuring real output) increases when capacities are fully utilised and economies of scale occur. Higher demand also tends to raise output prices, which increases nominal or monetary productivity and, in the end, GDP. That demand does not have to be foreign demand for exports. Economies can grow by expanding their domestic market and the production of non-tradable goods and services. Indeed, this is the only way the world economy is growing.

However, successful real convergence implies nominal convergence, too. While in catching-up economies, some industries approach the productivity frontier defined by the most developed economies, real productivity in other sectors such as services (e.g. education, health care, public administration, music industry) will remain the same. Incomes in these industries must rise by increasing (relative) prices, which, in turn, increases the nominal productivity (monetary value added per worker or hour) in these industries. In economic theory, this process is known as the Balassa–Samuelson effect. It implies a real appreciation of the catching-up country’s currency via higher inflation and/or nominal revaluation of the exchange rate. Actually, prices in the periphery did approach average EU levels, as seen in Figure 7. The rise was faster before the financial crisis and slowed down afterwards including a temporary reversal that was stronger in Greece, Portugal and Spain due to the austerity enforced there.

While exchange rates were fixed for euro area members Greece, Portugal and Spain, most CEE countries could have used currency appreciation and devaluation to manage nominal convergence. They used this option modestly, probably because they were constrained by the wish to join the euro area and/or they did not want...
The EU has achieved higher convergence rates than many other integration areas or nation states (Dauderstädt, 2014). But neither market integration nor regional policy are ways to guarantee catching-up success, as Southern Italy, Eastern Germany and parts of the EU show. The different growth paths and results (see above) indicate that success depends not only on the European framework and policies, but also on national measures. Thus, we consider both the European and the national level whereby it should be borne in mind that EU membership (and even more so that of the euro area) restricts the choice of national policies.

The European internal market guarantees access for catching-up countries to the affluent markets of the richer countries, which has favoured the relocation of production to the poorer countries. But it also exposes the producers of the less developed countries to the competitive pressure of the more developed member states. The EU forbids subsidies and industrial policies like those used by the successful East Asian “tiger economies”, although it tolerates subsidy-like cost reductions for companies through low wages and taxes or even demands it within the framework of austerity programmes.

Where it intervenes directly, the EU should avoid harming growth. The conditions of the Troika for the South were characterised among other things by incompatible goals (budget consolidation, current account improvement/internal devaluation, growth). Internal deflation and wage cuts lowered tax revenues and made budget consolidation more difficult. The latter, in turn, dampened growth and the austerity policy weakened spending on research, education and infrastructure, which are important for structural competitiveness. As a result, the debt ratio rose and there was hardly any improvement in competitiveness. Current accounts improved primarily because imports declined in the wake of the recession.

In general, the EU’s economic policy is supply- and stability-oriented while the demand side often remains neglected. This is evident in its monetary policy and fiscal policy, and in its recommendations for national economic policy in the context of the macroeconomic imbalance procedure. Uniform targets like the 3% deficit and the 60% debt level limits for all countries make no sense because, according to the Domar growth model, these values are only compatible with a nominal growth rate of 5%. The EU should actually aim at such a nominal growth rate and tolerate moderate inflation rates of 2%-6%, in particular in poorer member states. In such a macroeconomic context, debts, which are important drivers of growth,
are sustainable. With regard to member states (and candidate countries) that have not yet joined the euro area, the EU should not insist on stable exchange rates and low inflation as conditions for entry as this impedes real appreciation and catch-up growth.

The European Central Bank (ECB) and the EU should guarantee the sovereign debts of all member states of the eurozone, as the ECB has been implicitly doing, albeit belatedly since 2012, in order to relieve the pressure of the capital markets and prevent doom loops of sovereign debt panic and banking crises. As mentioned above, the successful catch-up growth before 2008 was driven by capital inflows, which need to be stabilised and immu-
nised against sudden changes of market sentiment.

The EU funds have obviously not promoted convergence very effectively in the past, as seen in the cases of Mezzo-
giorno, Greece or Ireland up to 1990. East Germany also shows that such massive transfers lead to only limited suc-
cess in catching up. On the other hand, it is striking that the successful CEE countries received high inflows of funds from the EU budget – between 1% and 4% of their GDP. But these funds could and should be used in a more targeted manner.

Beyond a more expansive macro policy, the EU could and should pursue a proactive industrial policy that supports the upgrading of the production and export structure of the catching-up countries through investments in education and research as well as public procurement programmes. But import substitution can also help. The EU could pro-
mote the development of alternative energy production – especially in the South – in order to both reduce energy imports and support climate protection. The coronavirus crisis has shown that the structure of international supply chains should not only be left to market forces and geopo-
tical capers. Relocating systemically relevant productions (e.g. medicines) from third countries to the EU would be an opportunity to support previously disadvantaged locations.

The success of growth also depends on how the coun-
tries use the international environment and European aid. Ireland did it very skillfully (albeit at the expense of others); Greece obviously less so. The prevailing opinion, which shaped European economic policy, saw supply-oriented “reforms” as the way to more growth. These consisted primarily of the liberalisation of markets, especially the labour market, of privatisation and deregulation. These measures should stimulate investment (including foreign investment) and exports. The less influential counter-
position focused on strengthening domestic demand through a productivity-oriented wage policy, a strong wel-
fare state (less inequality, at least in terms of disposable income) and an expansion of the non-tradable sector.

Governments should act on both, the supply and the de-
mand side. The supply side is about improving the sup-
ply of factors (capital stock, infrastructure, education and upbringing) and increasing productivity. This increasingly includes investments in intangibles (brands, patents, market information, etc.), which up until now have mainly been concentrated in the highly developed countries. The demand side can be secured by appropriate fiscal poli-
cies, a well supervised credit expansion and the growth of the non-tradable sector, including housing.

It should be noted that the modern economy is no longer dominated by industrial mass production alone, but increasingly by value creation that results from the appreci-
ation by client groups who are interested in social distinc-
tion and unique consumer opportunities (Reckwitz, 2019; Boltanski and Esquerre, 2019). In Southern Europe in particular, tourism in its various forms (mass and package tourism, individual and quality tourism, long-term stays in holiday homes) plays an important role. Here, the climate, landscape and cultural heritage can be marketed, whose value (and thus price and sales) can be improved through targeted strategies (marketing, events, the location of attrac-
tions such as museums, provision of roads and hiking trails). New approaches will be needed to counteract the dire effects of the COVID-19 crisis on the EU’s Southern periphery in particular.

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Making the Most of Their Shot: The American Rescue Plan Package

The Biden Administration and the very narrow Democratic party majorities in Congress see the country as facing three existential threats simultaneously: the COVID-19 pandemic, climate change, and the attack on American elections and the constitution from parts of the Republican party. As a result, they believe that they have a narrow window ahead of the November 2022 midterm elections to make major policy moves that deliver on electoral promises. They hope to demonstrate that democratic and Democratic government are desirable for a clear majority of voters in the US – a large majority is needed for Democrats to secure a working majority in government due to the configuration of the US electoral system and voter suppression efforts by Republicans.

Therefore, it should not come as a surprise that the American Recovery Plan (ARP) legislation passed along a strict party line vote and, more importantly, included the full $1.9 trillion of additional spending initially proposed. This package comes on top of the $900 billion pandemic relief bill Congress passed in September that included stimulus payments of as much as $600 for many individuals, enhanced unemployment benefits and provided more support for small businesses. The element of the ARP that attracts the most attention is the top up of the stimulus payments to individuals earning less than $75,000 to $2,000 each. On paper, this is deficit spending of roughly 14% of GDP to be paid out in 2021.

Broadly speaking, that is an exaggeration of the cumulative fiscal spending, but not one that changes the implications very much. Both packages combine spending directly dedicated to working the problem of the pandemic in the limited US welfare state and unemployment system, with actual stimulus payments. Roughly $1.1 trillion of the ARP package fits in that first category, meaning direct funding for vaccine distribution, public health measures, state and local government capacities, and an extension of unemployment benefits. These are essentially self-liquidating measures, meaning that when vaccines are distributed, state governments balance their budgets, or workers return to employment, the spending will automatically stop. So, the actual expenditure is likely to be at least $200 billion less. The state and local governments in particular are in better financial shape on average than expected, and they will bank much of the transfer from the federal government. Another $350 to $400 billion of projected spending will be disbursed over more than just the next nine months.

But this point is in some sense a moot point as it still leaves 10% of GDP in deficit-financed stimulus for the US economy in the remainder of calendar year 2021, perhaps even 2% more than that depending upon how you allocate the December money. This is why Olivier Blanchard and Lawrence Summers have both expressed their concerns about overheating as a result of the ARP. Official estimates of the pre-ARP output gap for the US economy (for example, of 4% of GDP by the Congressional Budget Office) are biased downwards. That bias, however, is not enough to offset the mismatch between a realistic output gap (of say 6% of GDP) and the stimulus of 10% to 12%.

Does the significance of this mismatch depend upon the multiplier of the various fiscal components? Some economists, including those in the Biden Administration advocating for the plan, contend that the multiplier will be quite low. If that is the case, however, it is reasonable to question how much of this spending beyond targeting the pandemic problem, particularly the stimu-
lus checks, is urgently needed. But even allowing for low multipliers on all the directly pandemic-related spending and state and local government transfers does not remove the issue. Much of the recession in the US economy is due to the coronavirus and fears of it (not the lockdown), so when, hopefully, the vaccines are widely accepted and work, there will be a growth rebound even without stimulus.

The available evidence suggests that a considerable amount of pent-up demand is poised to provide a strong boost to spending once restrictions are lifted and people view it as safe to interact with others again. Personal saving in 2020 was about $1.5 trillion above what one might have expected based on pre-pandemic behavior – the equivalent of 7% of GDP. We should expect “excess saving” to rise even further before it peaks, boosted in part by income associated with the additional fiscal measures described.

As my colleague Karen Dynan has pointed out, even at the bottom end of the income distribution, where unemployment is now concentrated, there is little evidence that the loss of earnings has translated into widespread financial distress that will constrain spending. For example, data from the Opportunity Insights Economic Tracker suggest that consumer spending in low-income zip codes has remained close to pre-pandemic levels. The vast majority of tenants are still current on their rents, and bankruptcy filings have remained low. This outcome does not mean that lower-income households have been insulated from the economic fallout associated with the pandemic. Rather, it should be interpreted as a near-term victory for the aggressive fiscal and monetary support put in place last spring.

I would go even further with regards to savings behavior. After the Great Depression, we saw the US personal savings rate rise on a lasting basis for young people, after some transitional dynamics. We saw a similar lasting rise in the household savings rate for the US after the 2008-10 financial crisis. The rate was 3.5% prior to 2008; it shot up during the crisis of course, and then stabilized around 7.5% after 2012. We should expect something similar in coming years for young people who have now seen their second exogenous mass unemployment shock in just over a decade, meaning the savings rate would stabilize at 9% to 10% – but only after a few years of transition dynamics.

There is some push back on the pent-up savings leading to the spending forecast. Durable goods and residential construction spending were already strong over recent months, as well as auto sales. Meanwhile, some observers point out that consumers cannot have too much pent-up demand for many services, whether haircuts or restaurant meals, which cannot be accumulated. This overlooks an important sector, health care, which makes up at least 18% of total US GDP. There is ample evidence that due to fear over the COVID-19 virus and shifts in medical availability, many ‘elective’ health procedures were foregone by consumers in 2020. These elective exams, operations and treatments run the gamut from cosmetic surgery to cancer follow-ups. As a result, these have likely truly pent-up demand that will be expressed in coming months. A similar argument on a much smaller share of GDP can be made for higher education.

So, there will almost certainly be overheating and a historic boom in US GDP growth. Forecasts of 8% real year-over-year GDP growth are plausible and common, and US real GDP is projected to surpass its pre-pandemic high in the middle of this year. But what does that overheating actually mean? Even those concerned about excess spending are rightly reluctant to forecast runaway inflation. As Joseph Gagnon argues, the proper historical parallel for this period is probably the 1950s following the visibly finite temporary spending on the Korean War, starting from a small but extant output gap and unemployment. This is not the inflationary 1970s, where demand above potential was sustained long after unemployment fell, and government programs showed no reason to be deemed temporary. While the Federal Reserve could turn temporary inflation into a persistent problem, this is far from likely in a world where we have had trouble achieving even 2% target inflation for years.