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DIALOGUE AND DEBATE: SYMPOSIUM

Europe and the race to structural transformation: a narrow path ahead

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Abstract
Since the Global Financial Crisis, the European Union (EU) has gone from crisis to crisis. The chronic growth and productivity problems have been compounded by the poor management of the Eurozone crisis, by the no-longer postponable green and digital transitions, and by the changing geopolitical environment, with the end of the old multilateral order. The European institutions still embed the principles of an old consensus based on market efficiency, and do not allow for macroeconomic and industrial policies for the structural transformation. We discuss possible reforms to realign the EU institutions with the needs and the challenges the bloc faces.

Keywords: fiscal policy; macroeconomic governance; industrial policy; fiscal rules; debt management

1. Introduction

After the three decades of the supposed 'Great Moderation', that in fact hid increasing macroeconomic imbalances, mounting inequality and an overall weakening of the social contract, the world economy has entered, since 2008, in a new phase, marked by an endless sequence of crises. The EU's very existence has been challenged several times by this sort of 'permapolycrisis',[1] and the response of European policymakers has not always been up to the challenges. The latest episode of the permapolycrisis is the deep deterioration of the geopolitical context that started with the Russian invasion of Ukraine, with the tensions brought about by the reorganisation of value chains (that necessarily involve redistribution of economic power) and with the destabilisation of the multilateral governance architecture, accelerated by the election of Donald Trump and by his erratic trade wars.[2] These shocks occur against the backdrop of long-term structural changes such as climate change, global health matters, digital information flows, the ageing of the European population and the shifting of the world's economic centre of gravity towards China and India.

[1]The term 'polycrisis', originally coined by Edgard Morin, was recently revived by Adam Tooze, to denote a crisis with multiple causes. We prefer to variate it into 'permapolycrisis' to highlight how this situation has been virtually continuous since the Global Financial Crisis.

[2]We explicitly use the term 'accelerated' because the progressive disengagement of the US from the global order that was mostly built by them in the second half of the 20th century has started with the George W. Bush administration and continued through Democratic and Republican administrations alike.

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2. Europe at a crossroads. Again . . .

Today, more than fifteen years after the beginning of the Global Financial Crisis, Europe is, once again, at a crossroads. Not so much because it needs to face another major shock, but rather because it is unclear if, and how, it will be able to implement the structural transformation required by the digital and green transitions; a structural transformation that requires a complete paradigm shift 'from business as usual' and is made even harder by the increasingly unstable geopolitical and economic context. The tensions of this crucial moment are very well exemplified by the cacophony that we saw in the Fall of 2024: with inflation back at the 2 per cent objective, and amid sluggish growth, the ECB started an interest rates reduction sequence (as we write, in February 2026, the interest rate is at 2 per cent), while at the same time most EU governments were forced by the newly reformed Stability and Growth Pact to implement more or less draconian fiscal consolidation plans. In other words, fiscal and monetary policy are currently pushing the Eurozone economy in different directions. At the same time, the publication of the Draghi Report,[3] in September 2024, put forward a set of priorities incompatible with fiscal consolidation, suggesting that Europe needs to abandon its focus on market efficiency to acknowledge the need to equip itself with the instruments to compete in a hostile geopolitical environment.[4] The Report highlights the chronic growth gap between the EU and not only the US, but also China; a gap correctly attributed to a chronic stagnation in productivity growth. The report is not exempt from criticism[5]: for example, its limited focus on social cohesion and on research and development spending and the excessive emphasis on defence expenditures while other items such as the ecological transition do not have the space that they deserve; or, its blind faith in financial markets development, that fails to recognise the complexity of the issue of financing investment through markets or through the banking system. More in general, the Report seems to take the United States as a benchmark for its growth and productivity performance, failing to see how this is not disconnected from a social model and from a distribution of income that are not compatible with the preferences of European citizens. However, the Report has two fundamental merits:

- The first is its emphasis on the urgency of the situation. It is hard to disagree with the former ECB president when he states that this is the last call for the EU. Without a radical change in priorities and on public policies, it will not only fail to be a main player in the ecological and digital transitions; it will eventually be doomed to irrelevance and stagnation.
- The second merit, that is central to the theme of this paper, is highlighting what many economists have long recognised: the team working on the report in fact has emphasised that closing the growth and productivity gap requires a wide spectrum of policies.

Not surprisingly, the Report highlights the need for reforms enabling a better functioning of markets and the full exploitation of the large scale of the European economy. These reforms go from the deepening of the single market – on which the Letta Report also insists[6] – to a better organisation of financial markets (completing the capital markets union), to the streamlining and

[3]See M Draghi, 'The future of European competitiveness', *Report Prepared for the European Commission*, September 2024. <https://commission.europa.eu/topics/strengthening-european-competitiveness/eu-competitiveness-looking-ahead_en>.

[4]See M Moschella and L Quaglia, 'Much More Than a Report: The Search for Europe's New Political Identity and the Politics of Competitiveness' 63 (S1) (2025) Journal of Common Market Studies 416, who further argue that this change of perspective entails the need for institutional reform capable of managing asymmetries and divergences among Member States.

[5]See, eg, Forum Disuguaglianza e Diversità (2024) *The 'Draghi Plan' – We're not there. An X Ray of its diagnosis, objective and remedies*, October, available at https://www.forumdisuguaglianzediversita.org/wp-content/uploads/2024/10/DRAGHI-PLAN-UNDER-X-RAY_DEF.x82434.pdf; and O Blanchard and A Ubide, 'Essential issues raised, but not fully answered by the Draghi Report', *PIIE Realtime Economics*, 8 October 2024.

[6]See E Letta, 'Much More than a Market', *Report Prepared for the European Council* April 2024, available at https://www.consilium.europa.eu/media/ny3j24sm/much-more-than-a-market-report-by-enrico-letta.pdf.

reorganisation of the different layers of regulation that have piled up in a somewhat disorderly manner over the past and that, today, are dragging down growth. But, coming from the former ECB president, this call for market-enabling measures would after all be business as usual. The novelty is that the Draghi Report does not stop there and is unambiguous about the fact that reforms are far from being sufficient. It is in fact impossible to imagine that the digital and green transition and the catching up in terms of productivity and growth can be implemented without massive investment. The team working on the Draghi Report quantified these resources in at around 800 billion euros per year (around 5 per cent of EU GDP), of which a substantial part would have to come from public investment. While it may seem obvious among academics and the EU scholars who have been working on the green transition,[7] this clear call for the mobilisation of new resources as a complement to other instruments is an important step forward for EU policy-makers. The Report even goes as far as invoking, albeit timidly, common instruments for financing this investment.

It is useful here to recall that for all major OECD economies, the weight of public investment in public spending has declined significantly and steadily since the peaks of the 1970s. The two European manufacturing giants, Germany and Italy, have been at the bottom of the list for years, as far as public investment is concerned.[8] This trend accelerated further in the wake of the 2008 financial crisis: in search of ways to reduce the deficit and public debt, many governments chose to cut public investment more severely, as acting on other expenditure items (social security, wages, subsidies to households and businesses) turned out to be much more costly in terms of political consensus.[9] As could be easily foreseen, the decline in public investment ended up deteriorating the stock of public capital, with the consequent effects on productivity and long-term economic growth.

3. Fiscal policy is back in the policymaker's toolbox

In short, the Draghi Report places the need to rethink fiscal policy and public investment at the centre of the European public debate. This rethinking is necessary after the series of crises that have shaken the global and European economies since 2008, debunking the belief in the market's ability to converge toward a natural equilibrium, which characterised the macroeconomic consensus before the global financial crisis.

Post-WWII economic policy was based on a massive use of public expenditure (including for welfare) and on an active role of the state in the economy, certainly one of the factors behind the high growth rates experienced by industrialised countries during the *Trente Glorieuses*. This paradigm vanished following the double crisis caused by the end of the Bretton Woods system in 1971 and the rise in the price of hydrocarbons in 1973. Following this crisis, which is also a crisis of Keynesian theory, a different paradigm emerged, based on confidence in the market's ability to absorb macroeconomic shocks, which symbolically became dominant with the elections of Margaret Thatcher in the United Kingdom and Ronald Reagan in the United States. This New Consensus posits that economic policy must follow clear and predictable rules so as not to interfere with the proper functioning of the markets, whose efficiency is postulated: fiscal policy has a marginal role in managing the business cycle, while greater importance is accorded to monetary policy, which is more effective and less subject to the risk of 'capture' by interest groups.

[7]See, for example, C Baccianti, 'The Public Spending Needs of Reaching the EU's Climate Targets' in F Cerniglia and F Saraceno (eds), *Greening Europe: 2022 European Public Investment Outlook* (Open Book Publishers 2022) 107. The need for a sharp increase in investment emerges from all the chapters of this collective work.

[8]Between 2015 and 2019, capital expenditure in both Germany and Italy was just under 5 per cent of total public expenditure; in the US and Japan it was almost 10 per cent. See F Cerniglia and F Saraceno, 'Il Ritorno Della Politica Di Bilancio e Il Rilancio Degli Investimenti Pubblici' 2 (2022) Rivista Di Politica Economica 31.

[9]see RL Bubbico, PB Brutscher and D Revoltella, 'Europe Needs More Public Investment' in F Cerniglia and F Saraceno (eds), *A European Public Investment Outlook* (Open Book Publishers 2020).

It is not difficult to recognise how the Stability and Growth Pact (adopted in 1997), binding European countries to the goal of a balanced budget over the business cycle, is based on this theoretical framework, dominant at the time of its adoption.[10]

The long period of the so-called Great Moderation, with stable growth and inflation, led some to imprudently speak of the end of history even in economics.[11] In fact, macroeconomic stability came at a high price, as the Great Moderation actually fuelled increasing inequality and financial fragility. In particular, the global financial crisis of 2008 showed the fallacy of the New Consensus: markets, progressively deregulated during the previous decades, generated speculative bubbles, excessive inequality, debt and balance of payments imbalances and proved incapable of stabilising the economy. Monetary policy also proved powerless to revive growth, caught in the liquidity trap and the effective lower bound on interest rates.[12] In the aftermath of the crisis, the search was therefore on for a framework to inspire new economic policies; a framework that recognises the role of the public hand.

The process of 'rethinking macroeconomics'[13] triggered by the permapolycrisis, the reassessment of the respective role of the state and the market to ensure growth and convergence, is not yet complete, and it is unclear whether (and which) new doctrine will emerge. However, the repeated and evident inability of markets to coordinate on stable and satisfactory equilibria suggests that future theoretical models will foresee a role for economic policy in pursuing socially desirable outcomes; depending on the circumstances, this may involve accompanying and enabling, steering, and sometimes opposing the markets.

Fiscal policies are a centrepiece of this rethinking process;[14] after three decades in a closet, since 2008 they have returned to the toolbox of policymakers. Initially, during the global financial crisis, they supported aggregate demand through 'classic' Keynesian policies. Then, they were invoked to address chronic demand deficiencies (the 'secular stagnation' hypothesis).[15] Later, the focus shifted on the provision of global public goods (healthcare, education, social policies) to prevent economic and social collapse during the pandemic. Last, but certainly not least, the debate on fiscal policy has been centred lately on industrial policy and public investment: in the short term, to tackle the disruption of the global economy caused by the pandemic, by inflation, by the reorganisation of global value chains and by repeated geopolitical shocks; in the long-run, to facilitate and guide the long-term ecological and digital transitions.[16]

The return of fiscal policy has in turn revived the Keynesian research stream on fiscal multipliers, that had disappeared from the intellectual landscape during the Great Moderation. Recent empirical studies, particularly relevant for the scope of this essay, robustly indicate that public investment stimulates private capital accumulation, because it increases the expected profitability of private investments and fosters a stable macroeconomic environment, reducing

[10]See F Saraceno, *La scienza inutile. Tutto quello che non abbiamo voluto imparare dall'economia* (Luiss University Press 2018); F Saraceno, *Oltre le banche centrali. Inflazione, distribuzione e politiche economiche* (Luiss University Press 2023).

[11]See RE Lucas, 'Macroeconomic Priorities' 93 (1) (2003) American Economic Review 1.

[12]See Saraceno, *Oltre le banche centrali* (n 9).

[13]This was coined by OJ Blanchard, 'Rethinking Macro Policy: Progress or Confusion?' in OJ Blanchard, RG Rajan, KS Rogoff and LH Summers (eds), *Progress and Confusion: The State of Macroeconomic Policy* (MIT Press 2016) 287–90.

[14]See F Saraceno (2017) 'Rethinking fiscal policy: Lessons from the European Economic and Monetary Union', *ILO Employment Working Paper*, number 219, August, available at https://researchrepository.ilo.org/esploro/outputs/encyclopediaEntry/Rethinking-fiscal-policy-lessons-from-the/995219081502676.

[15]See IMF, 'The Natural Rate of Interest: Drivers and Implications for Policy', in *World Economic Outlook. A Rocky Recovery* (International Monetary Fund 2023) 45.

[16]See F Bontadini, V Meliciani, M Savona and A Wirkierman, 'Nearshoring and Farsharing in Europe within the Global Economy', *Luiss LEAP Working Paper* 16/2024, August, available at https://leap.luiss.it/wp-content/uploads/2024/09/WP16.24-Nearshoring-and-Farsharing-in-Europe-within-the-Global-Economy.pdf; Cerniglia and Saraceno, Greening, above, n. 7; F Saraceno, 'Taming Inflation Through Global Policy Mix Strategies', *ISPI Commentary*, August 1st, 2023, available at https://www.ispionline.it/en/publication/taming-inflation-through-global-policy-mix-strategies-137166.

uncertainty. For this reason, as pointed out by recent work on fiscal multipliers,[17] the positive effect on the economy is even greater when uncertainty is high, such as during periods of structural transformation like the one the global economy will face in the coming years.

4. The 'new' industrial policy

The ever-going debate on markets vs the State has shaped the discussions on industrial policy as well, with those arguing the need for the public hand to steer the economy towards socially desirable long-term goals opposed by those who argue that the State is particularly inefficient in 'picking the winners', a task that should be left to markets. An increasing number of economists argues today that industrial policy is particularly relevant in periods of structural transformation, as it shapes the economy in the long term, well beyond enabling markets. Mariana Mazzucato's 'Entrepreneurial state'[18] has in fact some characteristics that private entrepreneurs lack. Firstly, it does not aim to maximise profit, but social welfare; it also has an indefinite time horizon (the state does not 'die') and can patiently wait for long periods to reap the benefits of investments;[19] last, it generally has deep pockets, and superior borrowing capacities to those of private operators. These characteristics allow the entrepreneurial state to go beyond markets not only in dealing with standard market failures, but also, and equally important, in exploring productive possibilities that are not accessible to private actors and in implementing public policies that lay the groundwork for (private and public) long-term investment, both tangible and intangible.

This can be done directly, through public investment banks, or indirectly, for example, by incentivising businesses to pursue long-term investments with significant social returns, by designing appropriate regulatory and trade policies, and more. In fact, a new doctrine of industrial policy is emerging[20] that emphasises precisely that industrial policy cannot be reduced simply to enabling markets to function, for example by 'levelling the playing field' and reducing or eliminating rents and market power (the doctrine that has prevailed within the European Commission in the past and occasionally surfaces in the Draghi Report); nor can it aim solely to foster the creation of large oligopolistic conglomerates to compete on international markets, or operate exclusively through regulation. Instead, industrial policy must be a *multidimensional strategy* that fosters structural transformation, reduces bottlenecks in strategic sectors, and facilitates the process of creative destruction, reallocating resources from low-productivity activities to sectors that are strategic either for economic reasons, such as the ecological and digital transitions, or for geopolitical reasons.[21] The multidimensional character of industrial policy also questions the idea that there is an optimal institutional architecture for capitalist economies. The remarkable performance of China in the race for global hegemony is the latest

[17]See, for example, L Durand, R Espinoza, W Gbohoui and M Sy, 'Crowding In-Out of Public Investment' in F Cerniglia and F Saraceno (eds), *The Great Reset: 2021 European Public Investment Outlook* (Open Book Publishers 2021) 107.

[18]M Mazzucato, *The Entrepreneurial State* (Anthem Press 2013).

[19]The perennial nature of the State is an important feature that should be considered in the debate on public debt as well; see F Capie, C Goodhart, S Fischer, CW Munn and N Schnadt (eds), *The Future of Central Banking: The Tercentenary Symposium of the Bank of England* (Cambridge University Press 1994) and M Amato, E Belloni, P Falbo and L Gobbi, 'Europe, Public Debts, and Safe Assets: The Scope for a European Debt Agency' 38 (3) (2021) Economia Politica 823.

[20]See K Aiginger and D Rodrik, 'Rebirth of Industrial Policy and an Agenda for the Twenty-First Century' 20 (2) (2020) Journal of Industry, Competition and Trade 189; R Cherif, F Hasanov and X Li, 'A "True" Industrial Policy for Europe is a Technology and Innovation Policy' in F Cerniglia and F Saraceno (eds), *Investing in the Structural Transformation. 2024 European Public Investment Outlook* (Open Book Publishers 2024) 99; R Juhász, N Lane and D Rodrik, 'The New Economics of Industrial Policy' 16 (1) (2024) Annual Review of Economics 213.

[21]A good recent example of multidimensional industrial policy is the US Inflation Reduction Act of 2022, that contained several provisions aimed at reindustrializing the US and fostering the transition. These went from demand pull measures to subsidies, through targeted protectionism, public investment and even changes to the tax code.

of many examples of the capacity of capitalism to adapt and to prosper under different institutional settings.[22]

5. The investor state is not enough

However, the state cannot limit itself to investing. The 'multi-instrument' industrial policies should be designed having in mind the risk that the benefits of public action (eg, significant public funding for research and development) are privatised, creating opportunities only for a few firms already in oligopolistic positions, who appropriate the incentives and incremental knowledge often generated by public intervention,[23] thereby exacerbating inequalities. The race of US Tech giants in creating situations of market dominance in the AI market is a good case in point. Nobel Prize winner Acemoglu's recent research[24] focuses on the need for policies that guide technological innovation. The *regulatory state* plays a key role in ensuring that markets do not thrive at the expense of society's welfare goals.

Innovation and investment, Acemoglu argues, do not follow predetermined paths. Rather, they are influenced by the choices made by policymakers and regulators. The regulatory state, then, must steer the innovation process to ensure that technological advances, such as AI, create new tasks and improve workers' conditions, rather than simply replacing them. History shows that shared prosperity stemming from the balance between innovation and regulation, in which technical progress generates employment and wage increases, is possible. However, since the 1990s, the mechanism jammed, and innovation has in the recent past led to greater inequality and concentration of both economic and political power (the recent case of Elon Musk's influence in the United States is paradigmatic in this sense). For Acemoglu, then, the policy prescription is straightforward: to guide artificial intelligence and other technologies towards shared prosperity, the State must act on several levers: from using taxation to favour human capital, to better regulation (for example on the use of data by tech giants), as well as recovering the centrality of trade unions and collective bargaining and, again, investment in skills on new technologies (eg, AI) within the public administration and the regulatory bodies.

6. Adapting EU institutions to the newly (re)found role for fiscal policy

Will European institutions enable the development and implementation of industrial and fiscal policies for the structural transformation of the economy, as partially advocated in the Draghi Report? There is little room for optimism. The introduction of *Next Generation EU*, the most innovative instrument introduced by the EU in decades, seemed to finally break through the stubborn refusal of European policymakers to imagine common tools both to address crises and manage structural transformations.[25] The abundant literature on optimal currency areas tells us that while markets play a role in absorbing shocks and allocating resources, mechanisms typical of

[22]See the remarkable analysis by RB Freeman, 'Single Peaked Vs. Diversified Capitalism: The Relation Between Economic Institutions and Outcomes', *National Bureau of Economic Research Working Paper Series* No. 7556 (2000), available at https://www.nber.org/system/files/working_papers/w7556/w7556.pdf.

[23]See M Florio, *La Privatizzazione Della Conoscenza* (Laterza 2021).

[24]See D Acemoglu, 'Escaping the New Gilded Age', *Project Syndicate*, 27 September 2024, available at https://www.project-syndicate.org/onpoint/wealth-inequality-billionaires-undue-influence-bad-for-society-by-daron-acemoglu-2024-09; D Acemoglu & S Johnson, 'Rebalancing AI', 60 (4) (2023) Finance and Development 26.

[25]See F Saraceno, 'Europe After COVID-19: A New Role for German Leadership?', 59 (March/April) (2021) *Intereconomics*, 65, and F Saraceno, 'The return of fiscal policy. The new EU macroeconomic activism and lessons for future', *ILO Working Paper*, 59 (April 2022), available at https://researchrepository.ilo.org/esploro/outputs/encyclopediaEntry/The-return-of-fiscal-policy-the/995219444002676.

a federal budget, particularly transfers among regions/countries, are equally crucial.[26] It becomes increasingly essential to complement the common management of the currency with a Central Fiscal Capacity to stabilise the economy and finance European public goods more effectively and at lower costs than national policies, while also making transnational investment projects easier and more stable to finance.[27] In short, the most efficient way to ensure that the EU is endowed with the capacity to react to shocks and to steer the structural transformation is the creation of a unique fiscal policy to coordinate with the ECB and to carry on EU wide fiscal and industrial policies. Of course, creating a centralised capacity to tax and spend while accountability to the voters remains at the national level, would require a complex system of checks and balances to ensure that no new democratic deficit emerges. The most obvious way to do so, would be to require a EU Parliament approval of this 'Industrial Policy Agency' project proposals, analogous to national parliamentary budget processes.

Unfortunately, however, the momentum from the collective and solidarity-based reaction to the pandemic, that led to Next Generation EU, quickly dissipated. The widespread political fragmentation revealed by recent European elections, the weakening of pro-European parties in many countries, and Germany's return to its obsession with frugality in the negotiation that led to the reformed Stability Pact,[28] leave little room for optimism on the front of common policies. The reactions of many countries (starting with Germany) to the timid proposal for common investment policies in the Draghi Report only confirm this sentiment.

Therefore, although it is not optimal, the capacity to implement industrial policies will have to be created at the level of the Member States. In the current juncture two problems arise. The first is that the Stability Pact prevents, even in its reformed version and even for the most virtuous countries, the implementation of investment plans of the necessary size. The second is that the high public debt inherited from past crises risks exposing countries to market pressure and therefore limits the fiscal space.

The two problems must be tackled simultaneously, aiming for a coherent institutional framework, that should be based on three pillars. The first is that of a new revision of the Stability Pact, such that public investment is protected. In fact, the reform of the Stability Pact that just came into effect improves the old rule only at the very margin. After three years of virtual inaction and a few months of frenetic negotiations, in December 2023 the European Finance Ministers finally reached an agreement to reform the Stability and Growth Pact, which had been suspended in 2020 during the pandemic. The new rules took effect upon ratification by the European Parliament in April 2024, and it was not long before the European Commission recommended (on June 2024) the opening of excessive deficit procedures against seven EU Member States, including Belgium, France and Italy,[29] for government deficits in excess of 3 per cent of GDP.

[26]CD Alcidi, PD 'Imperio and G Thirion, 'Risk-sharing and Consumption-smoothing Patterns in the US and the Euro Area: A comprehensive comparison', *CEPS Working Document* (2017/04), available at https://cdn.ceps.eu/wp-content/uploads/2017/05/No%202017_04%20CAlcidi%20et%20al%20EMU%20vs%20US%20Risk%20Sharing.pdf.

[27]M Buti, A Coloccia and M Messori, 'European Public Goods' in F Cerniglia, F Saraceno and A Watt (eds), *Financing Investment in Times of High Public Debt: 2023 European Public Investment Outlook* (Open Book Publishers 2023) 191.

[28]K Rietlzer and A Watt, 'Germany: Additional Investment Needs Require Reform of the Debt Brake' in F Cerniglia and F Saraceno (eds), *Investing in the Structural Transformation. 2024 European Public Investment Outlook* (Open Book Publishers 2024) 53. While in the Spring of 2025 Germany has finally embraced an increase of public investment (see below), this has not yet led to a softer stance in Europe regarding fiscal rules.

[29]Romania was in an Excessive Deficit Procedure since 2020, and the Commission has left the procedure open, bringing the total to eight (Hungary, Malta, Poland and Slovakia). EDP for a ninth country, Austria, was launched in July 2025.

7. Protect public investment with a golden rule of public finances

The previous Pact, introduced in 1997, came in for almost universal criticism.[30] Firstly, because it was baroque and based on a plethora of indicators, some of which, like the structural balance, were arbitrary and difficult to calculate.[31] Secondly, because its emphasis on identical annual targets for all countries meant that it was geared towards short-term discipline, with the effect of being pro-cyclical. And thirdly, because it discouraged public investment, a particularly acute problem at a time when European countries were embarking on the ecological and digital transitions. Above all, the old Pact was a product of the dominant worldview of the 1990s,[32] which to free suposedly efficient markets, envisaged reducing the State's role in the economy, *inter alia* by tying the hands of fiscal policies with restrictive rules.

That world has never existed, and after the multiple crises that have plagued the world economy since 2008, even European policy-makers finally seemed to accept that public policies are a necessary ingredient of stable and sustained growth.[33] The Global Financial Crisis, the calamitous management of the euro crisis, the pandemic and, last but not least, inflation, have shown that there can be no macroeconomic stability and growth without stabilisation policies, without adequate levels of global public goods such as health and education, and without industrial policies and public investment to manage the structural transformation of the economy – in short, without an active role for the State.

This newfound role for macroeconomic policies is among the factors explaining the decision to launch the Stability and Growth Pact reform construction site in 2020. The reformed rule, it was widely agreed at the time, was supposed to foster a radical change in approach with a focus on restoring fiscal space for governments to pursue short- and long-term objectives (while, of course, ensuring the sustainability of public finances). This change in philosophy was at least partially reflected in the reform proposal presented by the European Commission in 2022,[34] which, although not devoid of shortcomings,[35] represented a significant step forward. The rule proposed abandoned one-size-fits-all annual targets in favour of medium-term plans designed and owned by countries in agreement with the Commission, within a framework that guaranteed debt sustainability and some (albeit still not enough) protection for public investment.

In short, at the heart of the framework proposed by the Commission was a probabilistic Debt Sustainability Analysis (DSA) that considered country-specific characteristics and radical (and therefore inevitable) uncertainty over the various determinants of debt dynamics. By its very nature, this type of analysis is imperfect and dependent on several assumptions (and therefore, in a way, on the political preferences of those who make them), but it certainly represents a significant step forward compared to the previous idea that the only measure of sustainability was debt reduction. In the Commission's proposal, the DSA would then serve as the basis for a multi-annual adjustment process, prepared in consultation with the Member State, with the deliberately

[30]See, eg, European Fiscal Board 'Assessment of EU fiscal rules', (September 2019). <https://commission.europa.eu/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation_en>.

[31]See Z Darvas, 'Why structural balances should be scrapped from EU fiscal rules', *Bruegel Blog*, 1 October 2019, https://www.bruegel.org/blog-post/why-structural-balances-should-be-scrapped-eu-fiscal-rules.

[32]See Saraceno (n 13).

[33]See Saraceno (n 24), 'Europe After COVID-19'.

[34]European Commission, 'Communication on orientations for a reform of the EU economic governance framework', 9 November 2022, available at https://economy-finance.ec.europa.eu/document/download/43105168-be28-463e-81e7-8242c59f0cd2_en.

[35]The rule proposed by the Commission remained quite complex, it did not completely ditch the problematic concept of structural balances and, last but not least, gave too much power to the Commission. See, eg, O Blanchard, A Sapir and J Zettelmeyer, 'The European Commission's fiscal rules proposal: a bold plan with flaws that can be fixed', Bruegel Blog post, 30 November 2022, available at https://www.bruegel.org/blog-post/european-commissions-fiscal-rules-proposal-bold-plan-flaws-can-be-fixed and C Wyplosz, 'Reform of the Stability and Growth Pact: The Commission's proposal could be a missed opportunity', VoxEU.org, 17 November 2022, available at https://cepr.org/voxeu/columns/reform-stability-and-growth-pact-commissions-proposal-could-be-missed-opportunity.

unquantified objective of placing the country on a reasonable debt reduction trajectory. In the case of major investment and reform plans, countries could also have negotiated an extension of the adjustment period (from four to seven years).

The negotiation process that followed the proposal yielded a very different outcome. The rule that was eventually agreed upon and is now in force maintains the Commission proposal's framework, but de facto transforms it into an empty shell. On paper, the multi-annual plans and the protection of public investment still exist. But a group of countries led by Germany succeeded in imposing a plethora of complex safeguard clauses that will be triggered in the event of a deviation from the adjustment path (ie, almost always and for almost everyone) and which, whatever the plans agreed with the Commission, amount to imposing the same annual numerical constraints for everyone in a situation of stress in its public finances. For example, a country whose debt exceeds 90 per cent of GDP must reduce the ratio by at least one point per year on average, regardless of any other consideration; short-term one-size-fits-all objectives, therefore, are present in the reformed Pact as much as they were in the old one. Furthermore, the new Stability Pact is also baroque and extremely complex, even more so than the old rule. Last, but not least, like the old one, it features problematic indicators, such as the structural balance, which is difficult to calculate and has in the past been the subject of exhausting negotiations between the Commission and Member States. It is not easy to understand, even for insiders, how this web of constraints will end up being applied. What is clear is that, in practice, it makes the multi-annual and country-specific plans mostly redundant. As in the old Pact, in short, the Member States subject to an excessive deficit procedure have to reduce their structural deficit by 0.5 per cent of GDP per year until their total deficit falls below 3 per cent of GDP.[36] Above all, the change in philosophy (the creation of fiscal space in a framework ensuring debt sustainability) that was the greatest merit of the Commission's proposal has been completely nullified: debt reduction remains the principle inspiring the framework that governs European countries' fiscal policies, and it is no coincidence that all the so-called 'frugal' governments are delighted that the new rules will be more effective than the old ones in ensuring fiscal discipline, at the risk of inducing fairly widespread fiscal consolidation and insufficient resources devoted to public investment and industrial policies. It is not surprising that in the first year of application of the new rule the fiscal stance has been restrictive in most EU countries (especially the large ones).

The conclusion is necessarily very pessimistic, as we can see only a narrow path ahead. The 'new' fiscal framework does not allow Member States to implement policies for the ecological transition and to provide for global public goods such as education and health. At the same time, the political space for the creation of common fiscal tools is virtually non-existent. Yet, as the Draghi Report so convincingly points out, Europe faces its last call and will need all the fiscal tools it can possibly mobilise. It therefore seems inevitable to reopen the discussion on reforming the fiscal rule. It is not possible to behave as if public finances were at the levels of the end of 2019, and to still pretend to target the levels of deficit and public debt imagined in 1991.[37] True, it is at first glance unrealistic to imagine that a construction site that has just been closed, especially regarding a controversial issue such as fiscal policy, can be reopened soon (the old Pact remained in force from 1997 to 2024, with only two reforms, in 2005 and in 2011). But in the coming months the flaws of the new rule will unfortunately become increasingly evident, even for countries like Germany that wanted and imposed it. That might happen even earlier than anticipated: some argue[38] that the recent reform of the German constitutional brake, and the creation of the

[36]See, eg, Z Darvas, L Welslau and J Zettelmeyer, 'The implications of the European Union's new fiscal rules', *Bruegel Policy Brief*, 10/24, 20 June 2024, available at https://www.bruegel.org/policy-brief/implications-european-unions-new-fiscal-rules.

[37]It is useful to remind that these numbers, the foundations of the EU 'numerology', were arbitrary; see LL Pasinetti, 'The Myth (or folly) of the 3% deficit/GDP Maastricht "Parameter"' 22 (1) (1998) Cambridge Journal of Economics 103.

[38]A Steinbach and J Zettelmeyer, 'Germany's Fiscal Rules Dilemma', *Bruegel Analysis*, 24 April 2025, available at https://www.bruegel.org/analysis/germanys-fiscal-rules-dilemma. The authors also plead, as we do in the following, for the introduction of a Golden Rule.

€500 billion extrabudgetary fund for additional infrastructure investment will lead to a clash with the European rules.

Discussions on the architecture of fiscal rules in Europe should therefore resume to allow for meaningful protection of public investment. We have long called for a 'Golden Rule' that excludes investment (in a broad sense) from the 3 per cent deficit limit. An 'augmented' form of the Golden Rule would allow the Council and the Parliament to periodically agree on the policy priorities to increase the stock of (tangible and intangible) capital and allow countries to raise debt to finance these priorities.[39] The recent activation of national exemption clauses for defence expenditure, already used by 15 countries, follows the same logic. It is important to emphasise, nevertheless, that a fully-fledged Golden Rule would require, on one side, a more democratic process to determine what items to exempt; and, on the other side, not to rely on safeguard clauses that by their very nature are temporary.

8. A diaphragm between member countries and markets

It goes without saying that allowing borrowing to finance investment expenses would lead to an increase in debt. In this regard, it is worth remembering that, despite high levels of debt, global debt sustainability is not an issue today, because there are still hundreds of trillions of savings in circulation and looking for a placement. This will likely exert a downward pressure on interest rates and make global debt more sustainable. Specific to Europe, furthermore, Trump's policies risk causing a loss of attractiveness of the dollar and of American debt, making it even more likely that even a significant increase in European debt will plausibly be absorbed by markets without problems.

Of course, a savings glut and low interest rates at the aggregate level do not exclude that, in the current context of fragmentation, a single country will not find itself having financing difficulties or even facing a financial crisis. But if the debt is sustainable at the European level, addressing the public finances problems of a single country becomes a purely technical problem. And that is what the second and third pillars are for.

The problem to be solved is how to protect individual countries from unwarranted market pressures, while at the same time ensuring that they have access to funding and do not have the incentive to act irresponsibly. A solution exists, a European Debt Agency (EDA), that would act as intermediary between markets and governments.[40] The mechanism behind the working of the EDA is quite straightforward: the Agency would issue Eurobonds and use the resources raised to substitute maturing Eurozone countries' debt with perpetual loans,[41] freeing them from the necessity to refinance themselves on markets. The instalments (interest payments) would be variable and linked to compliance with the Stability Pact (in its Golden Rule version), thus avoiding both debt mutualisation and the incentive for member countries to behave irresponsibly. Gradually, therefore, all the debt of European countries would be transformed into loans from the EDA, and eventually only Eurobonds would remain in the markets. Speculative attacks on a country would then become impossible. The interest of such a mechanism is that, while it would (obviously) benefit the countries more prone to speculative attacks, it would not harm the more stable countries. Simulating different scenarios, Amato and coauthors[42] show that the increased

[39]See F Saraceno, 'When Keynes Goes to Brussels: A New Fiscal Rule for the EMU?' 51 (2) (2017) Annnals Fondazione Luigi Einaudi 131; F Cerniglia and F Saraceno, 'Introduction' in F Cerniglia and F Saraceno (eds), *A European Public Investment Outlook* (Open Book Publishers 2020) 1.

[40]See eg, Amato, Belloni, Falbo and Gobbi (n 18).

[41]It is useful to remind that the State is perpetual, therefore in principle it needs not to reimburse the principal on its loans, but only service it. This is the principle behind the sustainability condition $r\text{-}g < 0$.

[42]M Amato, E Belloni, CA Favero, L Gobbi and L Priviero, 'European Sovereign Debt Risk Management: The Role of a European Debt Agency' 15 (2024) Journal of Government and Economics, available at https://doi.org/10.1016/j.jge.2024.100118.

stability and reduced fragmentation would benefit some, while not harming the others, thus leading to a Pareto improvement. This, together with the absence of debt mutualisation, would help gain the support of frugal countries, especially in the current situation of high and heterogeneous levels of public debt (and market pressure).

Two important additional benefits of the creation of an EDA are, first, that its existence would free the ECB from the task of contrasting market fragmentation (a problem that other central banks do not have), and allow it to focus on its monetary policy tasks; second, that it would finally allow the creation of a European safe asset, end the fragmentation of European financial markets and offer an alternative to investors in case they were fleeing the dollar.

9. A fund for the European strategic autonomy

Setting up a European Debt Agency would take some time. Furthermore, the absorption by the EDA of European countries' sovereign debt would be gradual, paced by the maturity of the existing stock of securities. A temporary fix, to ensure that in the short-term European countries can continue to borrow at sustainable rates, might then be necessary. EU countries could create a Fund using the blueprint of SURE (the Fund created in 2020 to finance job retention schemes and other labour market-related expenditures in the fight against the pandemic).[43] A joint guarantee by Member States would allow this Fund to borrow at advantageous rates and embed these low rates in loans to governments; these would then be allowed, especially the more fragile ones, to finance themselves at better conditions than they would obtain on the markets. As with the Recovery and Resilience Facility, a smart use of conditionalities could ensure the coordination of national policies towards common objectives: for example, countries could resort to loans from the Fund only for expenses that they jointly decided to exclude from the deficit limit in the framework of the 'Augmented Golden Rule'.

In short, the challenge for Europe is to mobilise a massive amount of resources in a framework that remains fundamentally non federalist. The solution proposed in this paper is to build an institutional system that allows member countries to implement structural transformation policies by coordinating them towards common objectives and avoiding that the fragmentation of European financial markets expose them to undue pressures and limits their fiscal space. The revision of the Stability Pact towards an Augmented Golden Rule, together with the creation of a European Debt Agency, complemented in the short term by a new SURE, would make it possible to achieve both objectives and would help set the old continent back on track.

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[43]While the working of SURE (joint borrowing transferred to Member Countries) could be a blueprint, its legal basis should not be borrowed. It is well known that SURE was based on Art 122 of TFEU, ruling emergency situations. One might of course argue that catching up with our competitors and the transitions are urgent matters. But it would be more appropriate to find an alternative legal basis for the work of this transitory instrument.

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