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The Covid-19 crisis, Italy and Ms. Merkel's turnaround: Will the EU ever be the same again?

Luigi Bonatti* and Andrea Fracasso**

ABSTRACT

The European debt crisis has brought about permanent changes in the Eurozone (EZ). The no-bailout rule was—*de facto*—removed, new institutions such as the ESM and the banking union were designed and partially implemented, new monitoring and surveillance schemes, such as the macroeconomic imbalance procedure, were introduced. In this way, the functioning of the EZ has been irreversibly transformed. Now, as a consequence of the Covid-19 pandemic, a new—even more devastating—crisis has hit the EU. In response to this crisis, it is taking place a substantive—if not also formal—infringement of well-established principles such as those preventing the ECB from monetizing government deficits and the EU from acting as a transfer union with a common debt. The latter development was made possible by German Chancellor Angela Merkel's abandonment of her reiterated opposition to substantial intercountry transfers and any form of debt mutualization. This turnaround was motivated by the exceptional circumstances due to the pandemic and was presented by the German Chancellor as a one-off policy change. The risk that Italy's fragile financial, economic and political situation, exacerbated by the current crisis, could destabilize the entire EZ in the absence of sizeable external assistance was probably one of the main determinants of the German government's policy shift. We argue that, although this shift is sufficient to prevent Italy from plunging into a major financial and political crisis in the short term, thus buying time, it is far from sure that it will be sufficient to drive Italy into a sustainable and satisfactory growth path, so as to avoid that in the longer term it will be in need of further financial support from EU institutions and member states. Hence, the latter may again face the dilemma of whether to provide financial assistance to the EZ most vulnerable countries, thus making permanent what was supposed to be temporary, or exposing the EZ to a possible implosion.

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1. INTRODUCTION

Ms. Christine Lagarde's "*whatever it takes"* moment came on March 18, 2020, when the President of the ECB commented the announcement of the ECB's 'Pandemic Emergency Purchase Programme' (PEPP) by saying that "*there are no limits to our commitment to the euro"*. Actually, the PEPP consisted not only in an additional €750bn asset buying plan (subsequently increased to €1.35tn and extended to mid-2021), but also in the loosening of the issuer limit and capital key constraints that previous ECB's bond purchase programmes had to satisfy.[1] This announcement calmed the market jitters that were fueled by Ms. Lagarde, when on March 12, 2020, she answered *"we are not here to close spreads, this is not the function or the mission of the ECB"* to a journalist who asked whether the ECB could support Italy any further. As a matter of fact, the yield differentials between Italian and German bonds had risen sharply in the previous days (see fig. 1), as it had become apparent how widespread was the Coronavirus in Italy, the first Western country where the government had to put the entire country in lockdown.

On May 18, 2020, Mr. Macron and Ms. Merkel unveiled the proposal of a joint recovery fund that—via EU-level borrowing—was meant to distribute €500bn in the form of grants to the EU countries worst affected by the pandemic. Proposing such a fund, Ms. Merkel went back on the words to which she had stuck for years, namely that Europe would not have mutualized debt "*as long as I live*". Several observers have argued that one of the main reasons for this turnaround was the ruling whereby the German Constitutional Court (Bundesverfassungsgericht or 'BVerfasG') declared, on May 5, 2020, that the ECB acted outside the scope of its powers in relation to the 'Public Sector Purchase Programme' (PSPP) launched by the ECB in 2015, notwithstanding the European Court of Justice had expressed itself on the contrary. Indeed, this ruling was widely perceived as an objective obstacle to the possibility for the ECB to provide unlimited and

[1] "*For the purchases of public sector securities, the benchmark allocation across jurisdictions will continue to be the capital key of the national central banks. At the same time, purchases under the new PEPP will be conducted in a flexible manner. This allows for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions…The Governing Council will do everything necessary within its mandate. The Governing Council is fully prepared to increase the size of its asset purchase programmes and adjust their composition, by as much as necessary and for as long as needed. It will explore all options and all contingencies to support the economy through this shock. To the extent that some self-imposed limits might hamper action that the ECB is required to take in order to fulfil its mandate, the Governing Council will consider revising them to the extent necessary to make its action proportionate to the risks that we face."* (European Central Bank, 2020. 18 March Press release).

prolonged support to heavily indebted countries like Italy in the aftermath of the Covid-19 pandemic,[2] thus exposing the Eurozone to the risk of a new debt crisis in the absence of substantial intercountry transfers and some form of debt mutualization. Hence, the announcement of the Franco-German proposal helped to partially close the spreads that the BVerfasG's decision had contributed to reopen (see figures 1 and 2). Moreover, the Macron and Merkel's initiative paved the way for the €750bn 'Next Generation EU' (NGEU hereafter) plan disclosed by the President of the EU Commission, Ms. Ursula von der Leyen, on May 27, 2020, and finally approved (distributing €390bn as grants and €360bn as loans) after a 4-day negotiation by the European Council on July 21, 2020. Together with the other programmes envisaged in the proposal for the new multiannual financial framework 2021-2027 (i.e. the EU budget), the NGEU brings the total amount of resources mobilized by the EU for the period 2021-27 up to €1.824tn.[3]

Ms. Merkel motivated her turnaround by invoking the exceptional circumstances due to the pandemic and presented it as a one-off policy reaction.[4] She is not alone: also the so-called "Frugal Four" countries (Austria, Denmark, Netherlands and Sweden) insisted on the unique and not repeatable character of the set of policies implemented by the EU to face the Covid-19 pandemic. In contrast, genuine European federalists—together with those who less idealistically are simply eager to obtain more subsidies from richer EU countries and through the EU's own debt—hail the EU policy shift as the beginning of a long-awaited new era, where a fiscal union pillar finally matches the existing monetary union.

While this is clear, in this paper we shall try to indicate what scenario will possibly materialize after the pandemic. We shall also address a few relevant questions: is the substantive infringement of long lasting principles, such as those preventing the ECB from monetizing public deficits and the EU from acting as a transfer union (and issuing common debt), bound to be purely temporary, or will this infringement be long lasting or, even, permanent? In particular, will the functioning of the EZ be irreversibly transformed by the

[2] As IFO Director Clemens Fuest promptly noticed, the Court's ruling *de facto* limits the scope for the ECB to buy Italian government bonds, thus putting «*pressure on euro-area governments to provide assistance to individual member states in the form of fiscal policy*». (Ifo Press release - 05.05.2020)

[3] It is worth mentioning, in passing, that the NGEU is in fact calculated in 2018 prices, and it is actually larger in current prices.

[4] As Angela Merkel (2020) stated in an interview, "*For me, the Fund is a special answer to a special situation*" ("*Für mich ist der Fonds eine besondere Antwort auf eine besondere Situation*").

current crisis? What are the conditions that, once the pandemic will be over, might put the current equilibrium at risk, thereby forcing the EU countries to make a decision on what structural and permanent changes the EU and the EZ need to undertake?

We claim that what will go on in Italy in the next few years will be of primary importance for the future of the EZ. As known, Italy is among the main beneficiaries of the NGEU (it will receive €82bn as grants and €127bn as loans),[5] and—not by chance—the prospect of its adoption brought the spread between Italian and German bonds back to its pre-Covid level (see fig. 1). Furthermore, the sequence of events outlined above (see table 1 for a synthesis) reinforces the perception that one of the main motivations inducing France and Germany to launch the recovery fund was their concern that the ECB interventions alone would have not been sufficient to rescue Italy, which is too big to fail without undermining the euro, "*sparing it the politically destabilizing humiliation of the Troika*" (see, e.g., Fubini, 2020). Although the combination of policies undertaken by the EU institutions is sufficient to prevent Italy from plunging into a major financial and political crisis in 2020-21, one may wonder whether in the longer term they will be sufficient to drive it into a sustainable and satisfactory growth path, so as to avoid that it will be in need of further financial support from EU institutions and member States. Indeed, if the Italian economy will not succeed to get out of its long-run stagnation, the large public debt that Italy is now adding to its already high stock of outstanding obligations is likely to force the EU institutions and even its reluctant EU partners to face again the dilemma of whether to provide more financial assistance to Italy, thus making permanent what was supposed to be temporary, or exposing the EZ to a possible implosion.

The paper is organized as follows: section 2 explains why Italy is (and will remain) at risk; section 3 discusses the motivations underlying Ms. Merkel's turnaround and how the EU institutions responded to the Covid-19 crisis; section 4 is devoted to outline the possible future developments; section 5 concludes.

[5] However, if we consider the additional contribution to the future EU budget that each country will be liable to pay because of the Next Ge Eu grants, it is Spain—and not Italy—the country that will end up getting the most out of these grants (see Merler 2020).

FIGURE 1 Spread Germany 10 years / Italy 10 years bond, 1/1/2020 - 7/22/2020

Source: World government bonds

FIGURE 2 Italy 5 Years Sovereign CDS, May 2020

Source: World government bonds

TABLE 1 Italy, EU and the Covid-19 crisis: Summary of the key events

End of February 2020/ beginning of March 2020	Italian government recognition of the Covid-19 outbreak → beginning of national lockdown (March 8)
March 12, 2020	ECB President, Ms. Lagarde 'not here to close spreads' comment
March 18, 2020	ECB announces €750bn 'Pandemic Emergency Purchase Programme' (PEPP)
May 5, 2020	German Constitutional Court ("BVerfasG") ruling on the legality of the ECB's 'Public Sector Purchase Programme' (PSPP)
May 18, 2020	Mr. Macron and Ms. Merkel unveiled a Recovery Fund that—via EU-level borrowing—is supposed to distribute €500bn in the form of grants
May 27, 2020	EU Commission President Ms. von der Leyen discloses €750bn Next Generation EU (NGEU) plan (€500bn of grants and €250bn of loans)
June 4, 2020	ECB increases PEPP to €1.35tn, extending it until June 2021 at the earliest, with a pledge to reinvest proceeds until at least the end of 2022
July 21, 2020	After a 4-day negotiation, the EU Council approves the €750bn NGEU plan (€390bn of grants and €360bn of loans)

2. WHY ITALY IS (AND WILL REMAIN) AT RISK

Developments regarding Italy have systemic implications for the entire EU and for the EZ in particular, both because of the country's size and for its tight interconnection with the other economies in Europe. It is for this reason that Italy's long-lasting weaknesses and its Covid19-contingent problems have been carefully scrutinized by its foreign partners, as well as by international investors. It is not an exaggeration to argue that Italy's financial, economic and political weaknesses, shortly outlined below, have been under the microscope of the international community.

2.1 High public debt

The stock of the Italian government debt is large (≈€ 2,413bn in 2019, that is ≈135% of Italy GDP and ≈20.2% of EZ GDP) and approximately 1/3 of it is held in the portfolios of non-residents. Moreover, one may notice that Italy is the only EZ peripheral country unable to reduce its public debt-to-GDP ratio in the years preceding the pandemic (see fig. 3), in spite of the falling burden of the interest payments due to the ECB's quantitative easing (see fig. 4). Indeed, over the years Italy has become increasingly dependent on the ECB's asset purchase programme to sustain its public debt: purchases of government bonds by the Eurosystem allowed it to keep the ratio between government debt held by the public and GDP in 2019 at the same level it was in 2009 (≈112%, see fig. 5) even though the ratio between total public debt and GDP grew in the same decade from 116.6% to 134.8%. Therefore, it is not surprising that concerns about the sustainability of Italy's public debt grew immediately when the Italian government—first among the Western countries—had to impose severe lockdown measures and forecasters predicted that in 2020 Italy would have experienced a GDP drop of not less than 10%, with its public debt jumping to 160% of GDP. It was also apparent that, if only because of its size, an Italian sovereign debt crisis would have had serious spill-over effects over the European financial markets, with foreign holders of Italian debt and Italian banks—holding, respectively, 25.6% and 16.8% of Italy's government bonds at the end of 2019 (see Banca d'Italia 2020)—as the main vehicles of contagion.[6]

[6] Italian banks' vulnerability to their government is amplified by their loans to public sector's entities such as local authorities, regional governments and similar, amounting in 2019 to about 290bn of euro.

2.2 No growth

As the Covid-19 pandemic struck, Italy's real GDP per capita was lower than 20 years before, a unique case amongst the advanced economies (see figures 6 and 7), while its real GDP was only a meagre 3.8% larger in volume than in 2000 as a result of population increase due to net immigration. Underlying this very disappointing performance, there is the stagnancy of labor productivity and the decline of total factor productivity (see figures 8 and 9). The quasi-stagnancy of the GDP is the reason why Italy has not succeeded in reducing its public debt-to-GDP ratio in the years that followed the European debt crisis, although its governments have maintained primary surpluses (in between 1% and 2% of GDP) over this period (see fig. 10). Given the long-standing structural inability to grow at decent rates of the Italian economy, the issue of public debt sustainability has become more and more problematic, and made the country more vulnerable to possible large adverse shocks.

2.3 Populism

Differently than other advanced economies, Italy has not seen a significant increase in income inequality in the last two decades: even during the 2009-14 crisis and its aftermath, the Gini index has raised very modestly, remaining below the level reached at the end of the 1990s (see fig. 11). Accordingly, the discontent and widespread frustration recorded in recent years among vast groups of the Italian population cannot to be attributed to increasing inequality, as happened in other countries, but it is rather the result of more than two decades of very anemic growth (as discussed in section 2.2). Indeed, when the economy stagnates, a larger number of individuals find themselves worse off or exposed to the risk of falling into poverty than when the economy grows at decent rates. Italy's long economic stagnation can thus be linked to the ascent of political parties that self-define—or are widely recognized—as populists. Actually, the three parties that can be considered as populist tend to enjoy a majoritarian support (with a share of votes above 50% in local elections and in opinion polls, although with a continuous reshuffling among them, since the general elections in March 2018), and their attitudes towards the EU range from the openly anti-euro

fundamentalism of a fringe of Salvini's League, and the aggressive statements of the post-fascist Brothers of Italy against the EU institutions and the alleged Franco-German hegemony over them, to the ambiguous stance of most 5Star Movement's representatives. Although the new coalition in power since the autumn 2019 is certainly more pro-European than the previous government based on the coalition between League and 5Star, euro-skepticism in Italy has grown strong in the electorate since the burst of the European debt crisis (Nicoli 2017). Political preferences in Italy have been considerably affected by the widespread concerns over immigration flows (Caselli et al. 2020a, b), but also these, due to a skillful political campaign by the populist parties, have *de facto* been associated with a growing mistrust in the European Union.

2.4 Austerity and Italian-style Keynesianism

There is a widespread consensus among political parties in Italy that fiscal austerity is (at least co-) responsible for the low growth trajectory of the country and for the deterioration of public services. As a matter of fact, instead, austerity was in Italy a one-year episode (mostly concentrated in 2012) that coincided with the technocratic government headed by Mr. Monti, even if part of the most restrictive measures were taken by the previous government headed by Mr. Berlusconi (Valdes, 2018). If one adopts a longer time perspective, Italian fiscal policy has not been particularly tight after the introduction of the euro. As noticed by the IMF (2018), "*During 2000–05, Italy eased fiscal policy—in structural primary terms—by 5½ percent of GDP versus 1 percent in the rest of the euro area. When the global financial crisis struck, it eased fiscal policy further by nearly 2 percent of GDP, before sharply tightening the stance in 2012–13. During 2014–17, it again eased fiscal policy by over 2 percent of GDP and spent entirely its considerable interest savings that emanated from accommodative monetary policy*". Also in the most recent period before the pandemic, the fiscal stance was slightly expansionary, with results in terms of GDP growth that—as said—have remained meagre.

Political economy considerations explain why Italian politicians are particularly eager to bash the European fiscal rules and to push for more deficit spending. Not surprisingly, this has been a persistent source of tensions between the Italian and the EU authorities and countries, reluctant in the pre-Covid-19 years to relax such rules and grant all the fiscal "flexibility" that Italian governments were calling for. More surprising

is that a remarkable number of Italian professional economists supported such political claims, interpreting the country's decades-long stagnation only through the lens of insufficient demand. These economists, deeply embedded in the tradition of Italian-style Keynesianism, point to the current account (CA) surplus and the associated trade account surplus that Italy has exhibited in the aftermath of the Euro debt crisis (see fig. 12) as evidence that the country has not suffered from a lack of external competitiveness, but rather from a shortage of domestic demand that should be cured by fiscal expansion at home and, possibly, in the partners' countries.[7] According to some of them, fiscal multipliers could be so large to ensure that the additional growth activated via increased public demand could generate enough additional revenues to leave unchanged the public debt-to-GDP ratio. For them, moreover, this bonanza would be obtained without implementing any structural reforms. Be it as it may, it remains not at all clear what would happen to the country's growth once the temporary benefits of an extraordinary fiscal stimulus would dissipate. Implicitly, those embracing this reasoning appear to suggest that successive rounds of fiscal stimuli would be needed to keep the country going, thus further accumulating public debt. A perspective that is clearly at odds with the European stability rules and with the economic paradigms informing the majority of political forces and institutions in Europe.

2.5 Depressed investment and structural reforms

Actually, the switch from the CA deficit of the period preceding the 2008-2012 double-dip recession (1.4% of GDP in 2007) to the CA surplus of the post-crisis period (2.5% and 3% of GDP, respectively, in 2018 and 2019) was largely due—as in other peripheral countries—to the fall in GDP per capita (6.9% in Italy between 2007 and 2018): keeping constant the propensity to import, a back-of-the-envelope calculation shows that—other things remaining equal—Italy would have had a CA deficit in 2018 if its GDP per capita were in that year at the same level as it was in 2007 (see Caiumi and Cottarelli, 2019).[8] The excess of saving over investment that has emerged in Italy since 2012 is the effect of the fall of investment that occurred

[7] The then Minister of European Affairs in the League-5Star government, Paolo Savona, was particularly vocal in arguing that, since Italy was running a €50bn CA surplus, it had to increase its public deficit by €50bn.

[8] Furthermore, rigid product and labor markets makes unlikely that a boost to domestic demand would not cause a rise of prices and wages, with a rapid erosion of external competitiveness.

during the double-dip recession, from which investment has only partially recovered (see figures 13a and 13b). Although the entire EZ has not been particularly successful in stimulating private investment, given its declining working-age population and relatively high capital-output ratio (considerably higher than in the US) depressing profitability, the reduced capacity of Italian firms to invest has been exacerbated by the increase in labor costs, which—in the lack of progress in labor productivity—has eroded corporate profits and capital returns, in particular in the less advanced sectors (see figures 14a and 14b; IMF, 2020; Garcia-Macia, 2020).

Depressed private investment has been paralleled in Italy also by a decline of public investment (see fig. 15). More than by fiscal consolidation, public investment has been hampered by weak governance and low capacity to implement investment projects, even when co-financed by the EU. As of June 2020, only 83% and 40% of the 72 billion euro worth programmes that Italy planned to develop to access the 44 billion euro provided by the ESIF 2014-2020, have been, respectively, decided and spent. Moreover, available evidence indicates that Italy is one of the countries less capable to transform public investment into actual improvements in the quantity and quality of public assets because of a series of wastes and inefficiencies (see IMF,2014).[9] Clearly, against this scenario, it is natural to wonder whether the Italian public administration will manage to plan and implement projects for more 200 billion euro, that is the sum either granted or loaned to Italy via the NGEU. Besides feasibility concerns, another more general worry is that these project may not be worth their costs. Especially in a country characterized by a high public debt-to-GDP ratio, fiscal sustainability concerns should dictate that a public investment project implying an increase in public debt is planned and implemented only if its long-term impact on potential output exceeds the increase in public debt that it brings about.[10] It is doubtful, we argue, that public investment packages may

[9] Over the years, this state of affairs has not prevented a number of Italian politicians and pundits from asking the introduction in the Growth and Stability Pact of a "golden rule" exempting public investment from deficit and debt calculations.

[10] "*Any increase in public investment financed by higher public debt must be weighed up against possible fiscal sustainability concerns. Last, the longer-term positive effects on the economy's potential output and the impact on public finances crucially depend on the effectiveness of investment and the productivity of public capital. If these are low, an increase in public investment is associated with a greater deterioration of the debt outlook and less persistent output gains. In conclusion, to produce positive effects, any recommendation for a public investment push in the EU must go along with a rigorous selection of projects, to ensure that the investment is efficient and productive*" (de Jong et al., 2017, p. 36).

have such positive effects on Italy's long-term growth if they are not accompanied by a revision of the administrative procedures and, more importantly, by those structural reforms that have been repeatedly suggested by the European and other supranational institutions over the years.[11] For instance, it will be difficult to strengthen the growth potential of a country with sharp territorial divides without also reforming those wage-setting institutions that impose to pay the same nominal wage or salary to workers located in areas with relatively high overall productivity levels and living costs and to workers located in depressed areas characterized by much lower productivity levels and living costs, and much higher unemployment rates. As only a substantial increase in the productivity of public administrations, firms and workers located in the laggard regions would be compatible with greater territorial cohesion and with more homogeneous labor markets, it is even more fundamental that such new investment programmes and the associated reforms eventually succeed in promoting a substantial growth in the long term productivity.

Unfortunately, with the electoral victory of populist parties in 2018, several structural reforms have come to a complete halt; some counter-reforms were even implemented, as for instance by reintroducing the possibility of early retirement at favorable conditions for the retirees. While the incumbent government and coalition claim to be aware and firmly convinced of the need to tackle the structural bottlenecks highlighted in the Commission's country recommendations, it would be naïve to underestimate the important role that societal forces opposing such reforms may eventually play, again. Hence, Italy's past performance in terms of investment and reforms remains a reason of concern for many domestic and international observers.

2.6 Is Italy trapped into a populist doom loop?

The demand for populist politics swells as a growing number of people experience a deterioration of their living conditions and ask for assistance and protection. Populist politicians typically respond by promising more protection and less competition (especially from abroad, but not only), more public spending (especially for subsidies and grants), and lower taxes in favor of specific groups. Once in power, they do everything possible for circumventing budget constraints and fiscal rules that prevent them from keeping

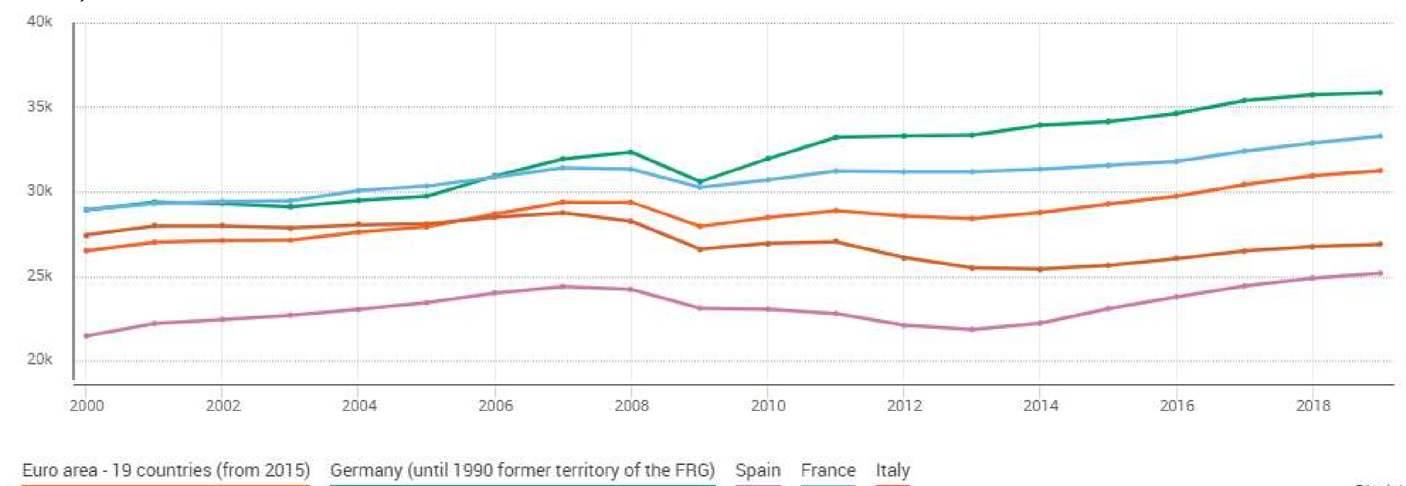
[11] See, e.g., European Commission, 2019; IMF, 2019, 2020. See Bonatti and Fracasso (2019) for a formal setup modeling situations where a government may be induced to not undertake structural reforms even when the society at large would benefit from their introduction.

their promises. Moreover, if they can, they exert pressure on the central bank so as to push it to conduct ultra-expansive monetary policies. Structural reforms that may enhance the economy's growth potential are rejected since unpopular among politically powerful groups. This perverse mechanism has materialized in Italy and other countries.

This political strategy is clearly bound to fail as a way to bring about a lasting and sustainable improvement in the country's growth performance and standards of living. This notwithstanding, the substantial failure of populist policies does not necessarily discredit populist attitudes to policy making. On the contrary, the resulting disillusion may feed even more aggressive forms of populism, thus giving rise to a sort of populist doom loop. Populist hegemony in public discourse plays a crucial role in reinforcing this process, with the dominance of narratives that hinge on scapegoating and on depicting the people as exploited by some evil elite.[12]

There are some hints that Italy has entered in a populist doom loop, at least since—more than two decades ago—Mr. Berlusconi entered the political arena by making amazing promises (first of all, huge tax cuts) that never materialize. Differently from his party, Forza Italia, in the last years more radical populist parties have added to the rhetoric a clear anti-European spin, arguing that EU institutions are the main culprits of the country's economic decline due to the austerity they have imposed on the country.

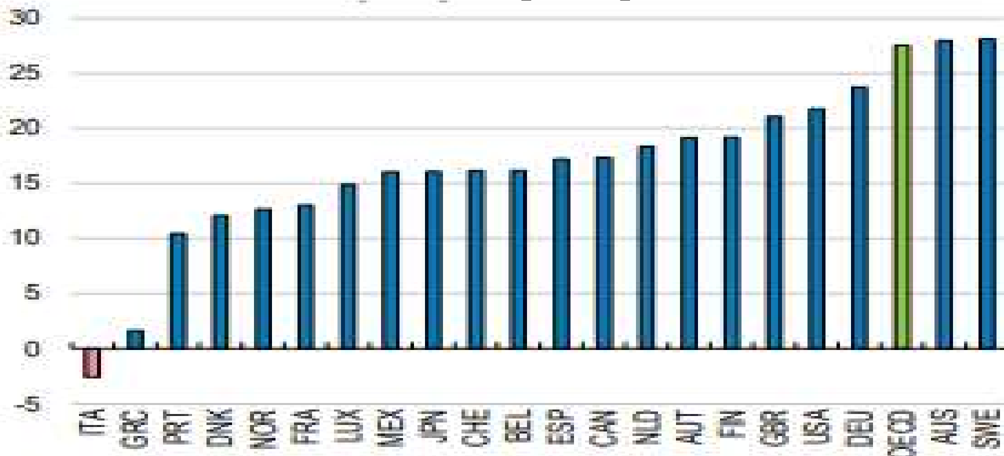
FIGURE 6 Main Euro area countries: real GDP per capita, 2000-2019 (thousands of euro)



Source: Eurostat

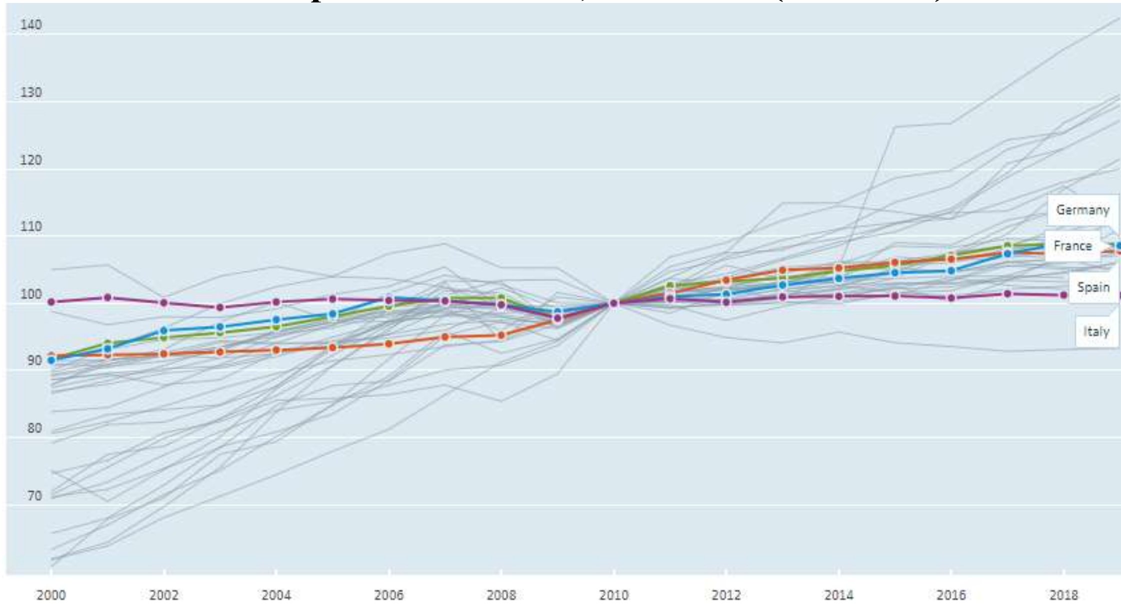
[12] According to Wirth et al. (2016), anti-elitism, people-centrism, and demands for restoring national sovereignty are the three core dimensions of populism.

FIGURE 7 Difference in real GDP per capita between 2000 and 2018 (%)



Source: OECD

FIGURE 8 GDP per hour worked, 2000-2019 (2010=100)

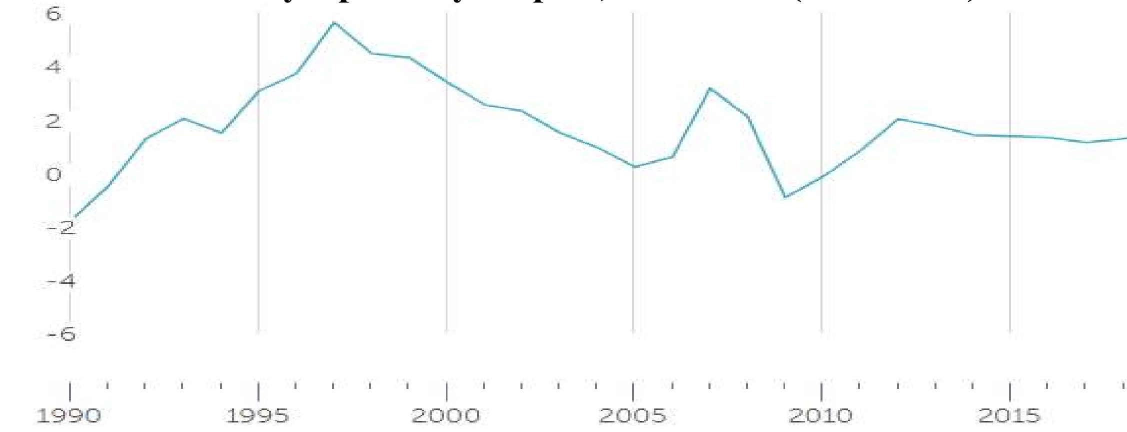


Source: OECD

FIGURE 9 Total factor productivity, 2000-2018 (2000=100)

Source: IMF

FIGURE 10 Italy's primary surplus, 1990-2019 (% of GDP)

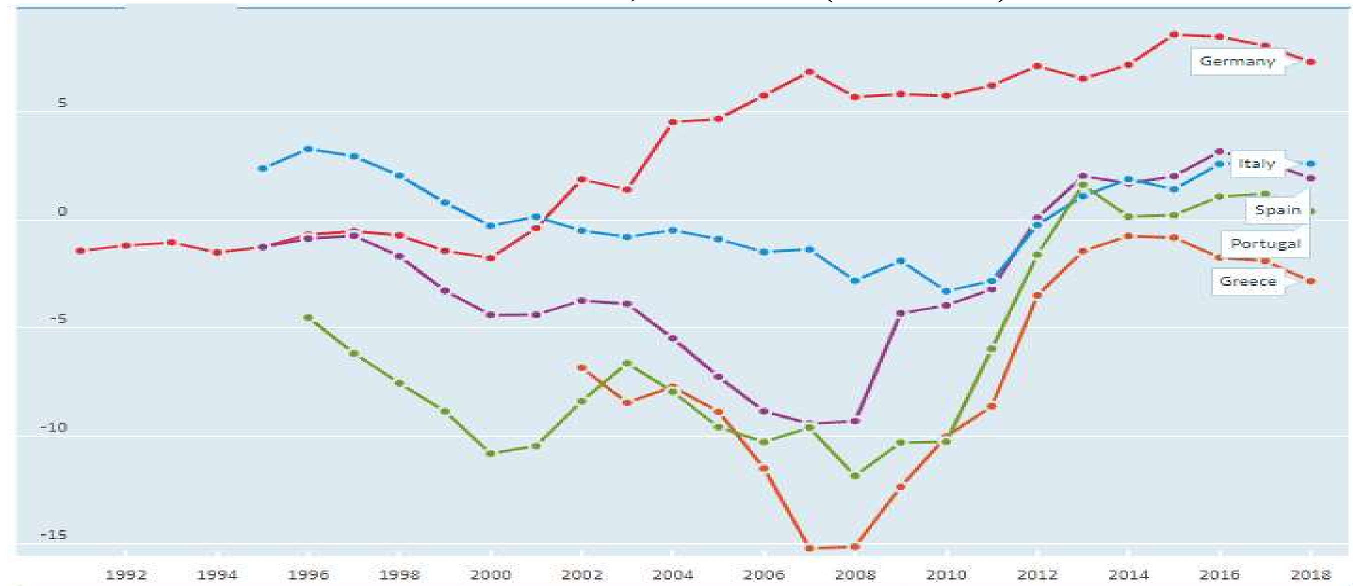


Source: IMF

FIGURE 11 Italy: Gini index, 1998-2018

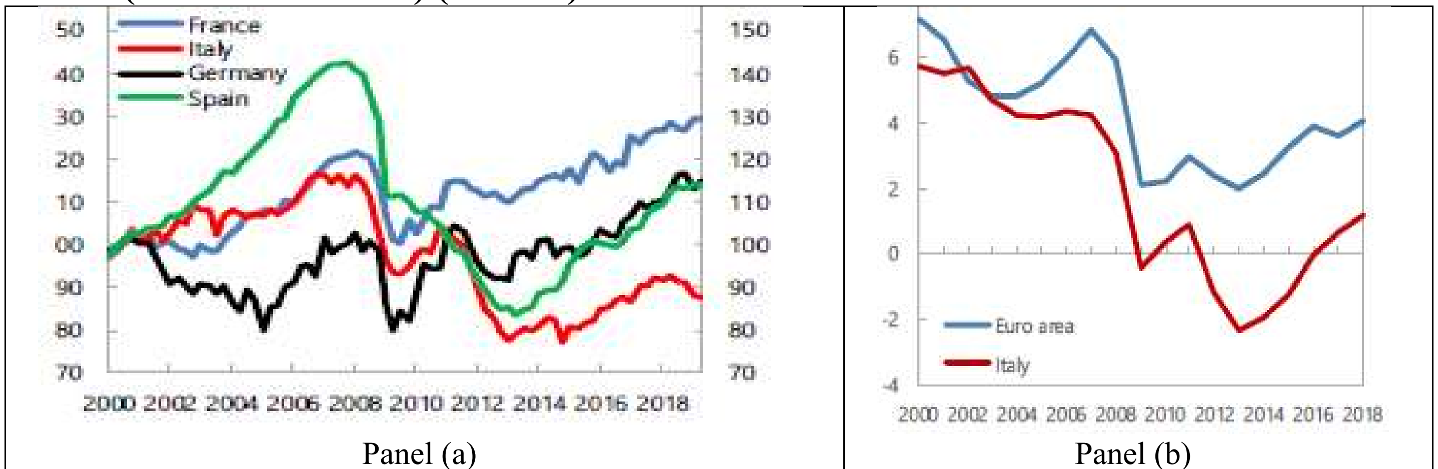
Source: Worldbank

FIGURE 12 Current account evolution, 1990-2018 (% of GDP)



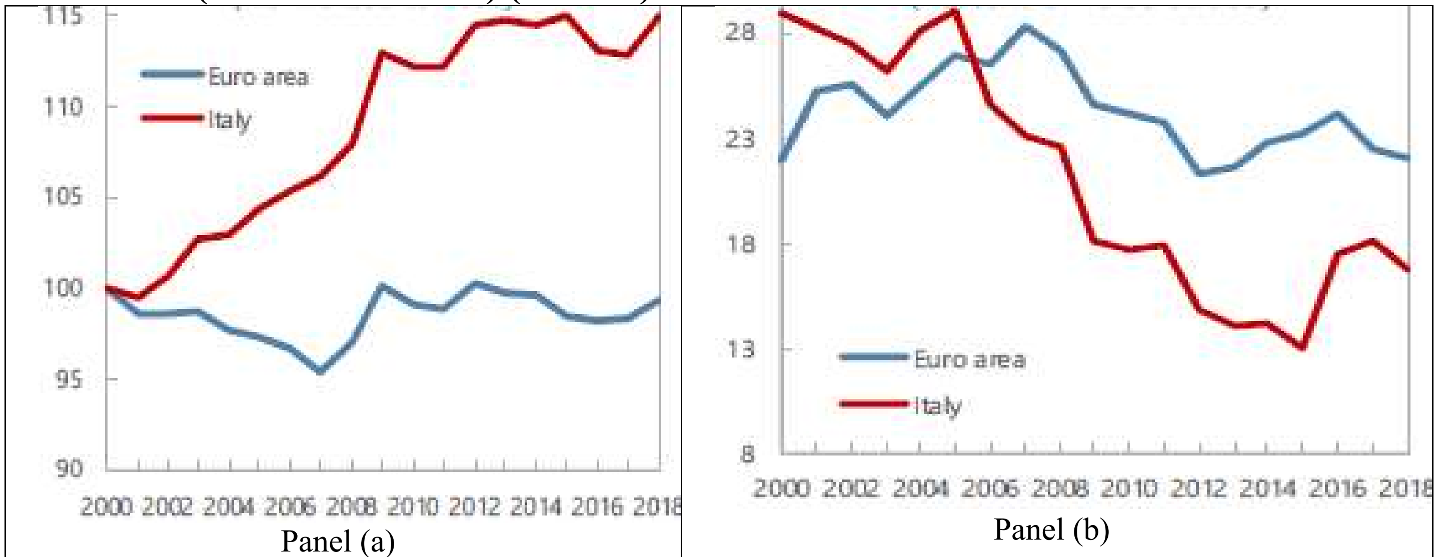
Source: OECD

FIGURE 13 Real investment, 1990-2019 (2000=100) (Panel a) and Net investment, 2000-2018 (% of value added) (Panel b)



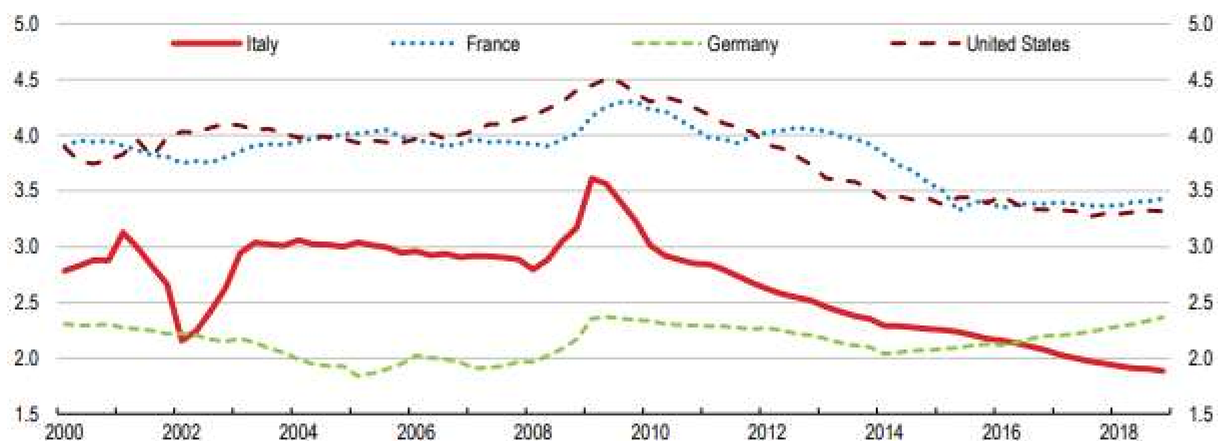
Source: IMF

FIGURE 14. Unit Labor Cost, 2000-2018 (2000=100) (Panel a) and Returns on capital, 2000-2018 (% of value added) (Panel b)



Source: IMF

FIGURE 15 Government fixed capital formation (% of GDP)



Source: OECD

3. AN “EXCEPTIONAL RESPONSE” TO “TEMPORARY BUT EXTREME CIRCUMSTANCES”

3.1 Explaining Ms. Merkel’s turnaround

As stressed above, it is hard to think that the BVerfasG’s ruling on the legitimacy of the ECB’s APP programme has not played an important role in convincing Ms. Merkel to abandon her long-lasting opposition to debt mutualization and inter-country transfers within the EU and to announce, together with Mr. Macron, the proposal of establishing a joint €500 billion Recovery Fund, partially founded on the markets and guaranteed by the EU own resources. This, as all know, has then become the core of the €750 billion NGEU. Commentators have emphasized other contingent factors that facilitated the Chancellor’s turnaround, such as the high personal approval rate that she enjoyed because of her efficient handling of the Covid-19 crisis, or the fact that—having decided to not run for re-election—she could downplay the internal opposition (even inside her own party) to her policy shift.[13] However, we would like to stress more general considerations that we believe probably motivated her path-breaking decision.

First, in a world where the current pandemic will accelerate the so-called de-globalization process (i.e. higher protectionist barriers, disruption of value-added chains, reshoring of production, regional retrenchment and prevalence of trade blocs over multilateralism, massive public support of national champions, etc.), it becomes more and more valuable for Germany to preserve the EZ as its reference economic bloc (both as destination market for its products and as provider of intermediate products for its industry),[14] even at the cost of investing large resources for avoiding the implosion of its weak EZ partners. As Angela Merkel (2020) stated in a recent interview, "*It is in Germany's interest to have a strong internal*

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[13] According to Frank Baasner and Stefan Seidendorf of the Fondation Robert Schuman (2020), “*The decision to propose a European reconstruction fund ... is thus in line with the other radical turnabouts that Merkel has managed to impose on her party (CDU) and the Germans. From the phasing out of nuclear power in 2011 to the introduction of a minimum wage in 2014, the decision to take in hundreds of thousands of refugees in 2015 and the decision to rapidly create the legal basis for "marriage for all", these decisions have a few points in common. While Angela Merkel seemed each time to be driven by the firm conviction that the change in question was necessary by the very nature of the problem posed, she had also and each time understood more quickly and before most of the other players that such a change had become possible, that political circumstances allowed it, between the evolution of German public opinion, the constellation of political forces in place (fundamental in a parliamentary system), the situation in her own party and the balance of power between the federal and regional levels.*”

[14] Estimates of the total benefits accruing to Germany from its participation to the EU and the EZ are contained in Gasparotti and Kullas (2019), and Mion and Ponattu (2019).

market and to have the European Union grow closer together, not fall apart. What's good for Europe, it was and it is good for us".[15]

Second, there is no doubt that geopolitical risks are on the rise and that destabilizing crises in some EZ countries may increase them, particularly in the "backyard" of Germany. EU solidarity would be useful to weaken souverainists' claims in those countries that may be the Trojan Horse of hostile external powers. This applies also to Italy that, under the previous government, cultivated and exploited its preferential relationships with Russia and China to reduce the costs from ItalExit and, ineffectively, increase its negotiating power within the EU.

Obviously, beside the direct costs of financing the loans and grants to the vulnerable EU countries,[16] this policy shift involves also political costs and risks for Germany. First, the country had to split with its traditional allies (such as the so-called «Frugal Four»), since the latter—being small countries—could not lead the venture and do have incentives to free ride on the German efforts to rescue the weakest EZ members. Second, the decision increases the exposure to the risk that some vulnerable EZ countries may default or leave the eurozone. In the case of Italy, for instance, in addition to the rapidly growing holdings of its debt by the Eurosystem and the rising liabilities in the Target2 system (see fig. 16),[17] the country's exposure towards the EU institutions will be further increased by the resources that it will receive through the various emergency funds. In particular, Germany will provide a guarantee on about 27% (roughly equal to the percentage of its contribution to the European budget) of the funds that the European Commission is about to raise by issuing bonds to finance the NGEU and the SURE (87 billion euro). There is a political risk in this, as the government of a country in trouble may utilize the German exposure as a lever in future negotiations over additional grants, loans and bailouts. Although the European Council established *ad hoc* rules to prevent the allocation of NGEU resources to countries that stray from the Commission's

[15] "*Es liegt im deutschen Interesse, dass wir einen starken Binnenmarkt haben, dass die Europäische Union zusammenwächst und nicht auseinanderfällt. Was gut für Europa ist, war und ist gut für uns*" (Merkel, 2020).

[16] As estimated by Merler (2020), the additional annual burden for Germany due to the grants of NGEU for the years 2021-2027 amounts to 10.8bn of euro, which adds to its net annual contribution to the EU budget of the same period that is estimated to be 13bn of euro. For different estimates, see Bruegel (2020).

[17] As Gros (2019) remarks, the key advantage for Italy of the various QE programmes has been to transform "*debt subject to market forces (BTPs) into opaque obligations towards the rest of the euro area*".

recommendations and from the agreed plan of action, it is through the national assets purchased by the ECB that countries remains inevitably exposed one to each other.[18]

3.2 The ECB in the face of the pandemic

Article A4 of the deal reached at the European Council on July 21, 2020, states that "*Given that NGEU is an exceptional response to those temporary but extreme circumstances, the powers granted to the Commission to borrow are clearly limited in size, duration and scope*" (European Council, 2020). Similarly, with regard to the PEEP, the Governing Council of the ECB established that: i) the asset purchases will be temporary, contingent to the crisis and exceptional; ii) allocations will be guided by the capital key, even though only over the medium term; iii) the programme will ensure only a limited extent of risk sharing, according to the APP rules; iv) the Governing Council has established a clear (though reviewable) net purchase horizon (i.e., June 2021) for the PEPP, whereas the APP will continue to have a contingent horizon (i.e., "*for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates*") (see Bonatti et al., 2020). The decision of Germany's Federal Constitutional Court on the proportionality of the PSPP may, to a certain extent, strengthen the case for not stretching too far the adoption of instruments developed to achieve specific, contingent and temporary objectives.[19]

The insistence whereby the European authorities emphasized the extraordinary and temporary nature of such programmes can be interpreted as a way to minimize their moral hazard implications. It is worth noticing that ECB's officials downplayed the moral hazard problems associated with the temporary monetary accommodation of debt issuances by stressing that the Covid-19 shock is "*exogenous, detached from economic fundamentals and affecting all countries in the euro area*" (Lagarde, 2020). In fact, although the

[18] Notably, by issuing more a trillion euro of EU debt to finance programmes under NEGU, SURE, BEI and MES, the EZ countries are about to create a sort of supranational EZ safe asset that may facilitate the expansion of ECB asset purchase programmes without raising further its exposure to individual member states. But this process will take time to have fully-fledge effects.

[19] The Decision (EU) 2020/440 of the ECB of 24 March 2020, published in the Official Journal of the European Union, states that: "*The PEPP is established in response to a specific, extraordinary and acute economic crisis, which could jeopardise the objective of price stability and the proper functioning of the monetary policy transmission mechanism. Due to these exceptional, fast-evolving and uncertain circumstances, the PEPP requires a high degree of flexibility in its design and implementation compared with the Asset Purchase Programme (APP) and its monetary policy objectives are not identical to that of the APP*".

origin of the current crisis is truly exogenous being due to an event beyond the control of the governments, its effects and implications on different countries and regions depend also on how national and local authorities have reacted to the pandemic. Furthermore, the capacity of the different governments to respond to the crisis is heavily conditioned by the fiscal space they have, which in its turn is negatively correlated with their outstanding public debt-to-GDP ratio, whose level when the Covid-19 pandemic hit the EU was the result of previous national policies.[20] Hence, in the presence of huge differences in terms of fiscal buffers among EZ countries, a programme of massive sovereign bond purchases by the ECB does not have the same relevance and urgency for all countries, even when the adverse shock—as it is currently the case— is common to the entire currency union and when the purchases are allocated in accordance to the capital key criterion. It is key to realize that such quantitative easing programs are indeed essential for the proper functioning of the monetary policy stimuli, but they ultimately provide more valuable relief to the more vulnerable members of the Union; this is so evident that financial markets promptly registered this asymmetry by reducing the interest differentials among EZ government bonds after the PEPP announcement and its expansion. Thus, it is undeniable that this asset purchases programme, inevitable as it is, does also raise a problem of moral hazard, that is obviously accentuated by the concomitant implementation of a programme of fiscal transfers in favor of the more vulnerable countries through the EU budget and the NGEU initiative. Although the European institutions have righty judged that in the present circumstances the concern for the moral hazard brought about by these programmes is strictly dominated by the risk that, without a strong policy response at the European level, the Covid-19 pandemic could even lead to an implosion of the EZ, the issue is still present and will lean on every further political negotiation.

One can also argue that—together with moral hazard concerns—the ECB has temporary removed the role that market discipline is supposed to play for inducing governments to conduct prudent fiscal policies. Indeed, the Governing Council emphasized the existence of a non-fundamental and volatile component of

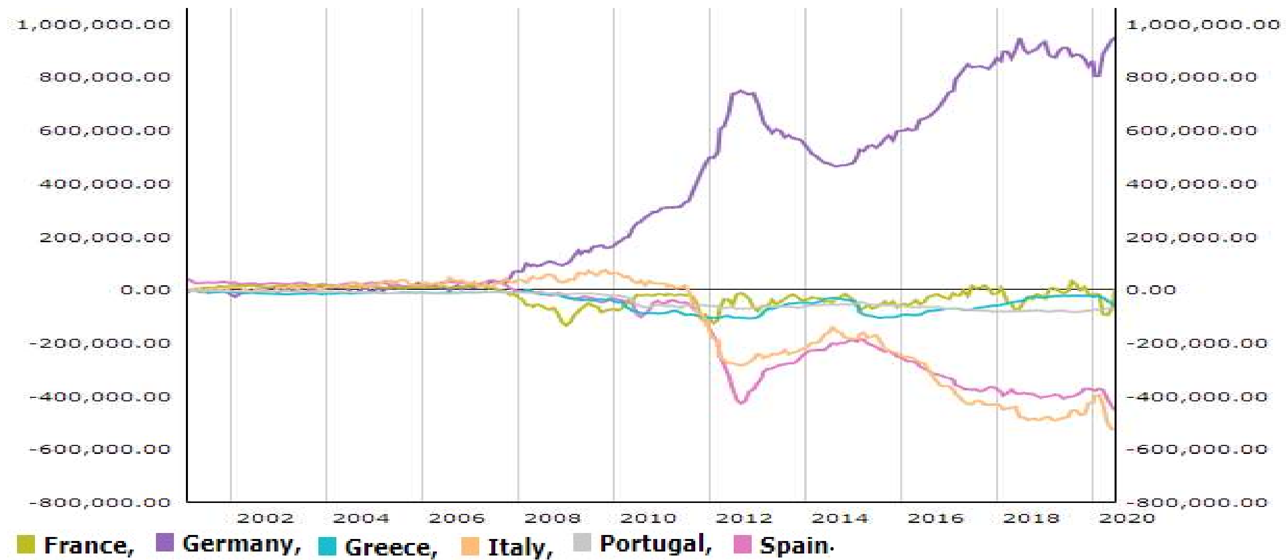
[20] In a sense, this has vindicated the concerns voiced for years by the frugal countries as the current crisis has confirmed that keeping high public debt levels is a source of vulnerability, because when events with low probability but high impact do strike, the tension between the necessity of a large fiscal stimulus and debt sustainability is exacerbated. As Borio (2020) remarks, "*this episode has reminded us once more that precautionary buffers, far from being a luxury, are absolutely essential, regardless of how unlikely adverse outcomes may seem.*"

sovereign bond yields, possibly associated with self-fulfilling vicious dynamics, that impairs the smooth transmission of monetary policy, and that needs to be tackled by the authorities. As explained by Lane (2020), "*liquidity provision and asset purchases by central banks can limit self-fulfilling overshooting dynamics and the associated risks to financial stability… In the absence of active market stabilisation by the central bank, the intrinsic self-validating nature of flight-to-safety dynamics creates the risk of asset price movements and cross-border financial flows that, in terms of their magnitude, are unwarranted by fundamentals, but that also reflect a switch across multiple self-fulfilling beliefs-driven equilibria*". This explanation provides the rationale for the market stabilization role that the ECB is consistently playing after Ms. Lagarde's improvident statement of March 12, 2020.

Clearly, fundamentals-driven crisis and expectations-driven turmoil are difficult to distinguish, both *ex ante* and *ex post*. Divergent assessments of the extent to which asset prices or interest-rate spreads reflect fundamentals are normal and legitimate. Many analysts, for instance, are convinced since long ago that the ECB's bond buying programmes and 'buyer of last resort' status keep Italian bond spreads tighter than they should be based on debt and growth fundamentals. In the special circumstances created by the pandemic, however, it is hard to deny that the ECB could not but act as a market stabiliser, also in the attempt to crowd-in private investors and limit the escalation of vicious self-feeding circles. Similarly, no investor has now the convenience to defy the ECB and to risk destabilizing the Eurosystem. Yet the issue will emerge again once the quantitative easing programme will come to an end and the associated problems are bound to re-emerge in the future. The Dutch central bank Governor Mr. Klaas Knot has repeatedly warned against the creation of a "central bank put" for the potential distorting effects it may have in financial markets. If, normally, the concern for a "central bank put" refers to the perception that policy will ease in busts but remain inactive in booms, thereby creating incentives for investors to speculate and take risks (see Filardo et al 2019), in this scenario the "central bank put" may indeed concern sovereigns. As explained in previous sections, this scenario is particularly important for two reasons. First, it may have implications at the macroeconomic level on the incentives to be fiscally prudent (e.g. debt sustainability and moral hazard); second, it may impact on

the microeconomic level to the extent that the resources are used by the authorities to intervene massively in the private sector.

FIGURE 16 Eurozone: target balances, 2001-2020



Source: ECB

4. WHAT FUTURE?

4.1 Deflation, inflation or stagflation?

It is legitimate to be skeptic about the temporary dismantling of the principles of EU borrowing and no-bail-out that was established with the NGEU, once the pandemic emergency will be over, and to wonder whether a policy shift that has been portrayed as purely temporary may become permanent, thus bringing the EU closer to a true transfer union. Similar skepticism may apply also to the possibility that ECB's policies will return to some "normality", thereby both stopping the accumulation of assets and starting a tapering strategy. Obviously, the direction toward which the EU and its institutions will evolve depends on future economic and political developments that are now shrouded in uncertainty. More than one scenario looks plausible.

One may think that the pandemic will have persistent depressive effects on the propensity of households and enterprises to consume and invest, especially because many people will be inclined to overestimate the likelihood of a repetition of similar disruptive events. In this case, zeroing of interest rates,

tax cuts and subsidies will not be enough to boost private sector's demand. And it will be unlikely that public spending may continue for too long at such high rates in the attempt to offset the fall in private consumption and investment. Debt overhang, one of the legacies of the response to the pandemic, may add to the forces that hinder, rather than boost, the recovery of private spending (Becker et al., 2020). Under counterparty or market pressures, debtors' priority will be save and service (even repay) the debt, thereby feeding a "deleveraging" process (Koo 2011).

In addition, there are supply-side forces that may obstacle a quick and sustained recovery. In particular, the economy after the "reopening" will not be the same before the lockdown. Not only the composition of final demand will be changed, thus leading to the shrinking of some sectors and the expansion of others, but a number of firm-level and policy-driven decisions will have affected the development path of sectors, regions and countries. Relocation will take place on a large scale, in a vast and uncertain process of re-organisation of personal, economic, and financial networks (Barrero et al., 2020). The national banking systems will be highly exposed to the successes and problems faced by the various companies involved in this massive re-allocation process, especially because of the generous liquidity stimulus that banks were called upon to transfer to the real economy under the insistence of both fiscal and monetary authorities.

In this scenario characterized by anemic growth and deflationary pressures, central banks cannot but go on with some form of aggressive quantitative easing, and in particular with the monetary financing of government spending that is currently taking place, without fear of rekindling inflation. Keep the economy going, notably, will also serve to support the banking system and the stability of EZ payments.

Alternatively, it is possible that, when the pandemic will be over, the large amount of liquidity available will feed inflation as a result of supply-side forces. First, the acceleration of the reversal of globalization due to the Covid-19 and the creation of more regional value chains may provide a one-off inflationary stimuli because, as Eichengreen (2020) pointed out, supply chains will have to be restructured in ways that make production costlier. Although the inflationary impact of this price increase will ultimately depend on second round effects, one cannot exclude that a price-wage spiral may be ignited in such scenario of high liquidity and generous fiscal policy. Moreover, the government increasing protection of incumbent firms and workers,

together with the restrictions to competition in the market for corporate control that have been decided during the pandemic, may contribute to create room for price increases and for the preservation of high markups by the protected companies. The diminished competition of emerging economies' producers because of de-globalization may contribute as well.

Depressed aggregate demand and increased upward pressure on prices can thus give rise to some form of stagflation, which would present central banks with the difficult choice of whether to accommodate the increase in prices or stick to their inflation targets. A number of commentators have argued that in this scenario some moderate inflation (something above the 2% threshold) should be tolerated for a while. The rationale for this is that it would erode the real value of the huge private and public debts accumulated in these years, thereby helping firms and governments to serve their debt and, ultimately, support the underlying value of the asset portfolios held by the central banks. To safeguard their credibility, central banks will simply have to commit to avoid—once the Covid-19 emergency will be over—any form of fiscal dominance. In this regard, Borio (2020) rightly stresses how essential is to preserve this credibility, since "*it is precisely what has allowed central banks to take such extraordinary actions during this crisis*." The equilibrium between being, at the same time, fairly accommodative now and restrictive in the medium term, is however hard to find and with limited supporting evidence in the past.

It has been noticed that governments may be tempted to prolong indefinitely the availability of easy credit at very low costs and generous public subsidies in favor of firms and households. This strategy would avoid the social and political costs associated with bankruptcies, job losses, massive reallocation of resources across sectors, and a reduction in the standards of living. Although reasonable under several viewpoints, this highly accommodative approach may lead to neglect the longer-term and largely invisible costs due to inefficiencies and misallocation of resources. For instance, the very favorable financing conditions enjoyed by governments are accentuating the tendency to make the State inject fresh capital into companies in distress

and join the shareholders: while a necessary measure to tame the crisis, if prolonged this approach may allow zombie firms to stay afloat for too long.[21]

In sum, the abundance of cheap credit and the consequent temporary softening of governments' budget constraint in the long term may prove to be a double-edged sword in terms of its implications on long-run growth and debt sustainability. While, on the one hand, governments may undertake more growth-enhancing investments (such as those in critical material and immaterial infrastructures or basic research), on the other hand, a less prudent fiscal stance may be directed towards vested groups or to flattering voters, to appease economic and political discontent. In this latter case, one would have an increase in public debt that is not accompanied by the strengthening of the growth potential of the economy. Countries indeed may show less ambition to undertake the unpopular reforms that are necessary to boost long-run growth and support debt sustainability if market pressure recedes. Which of the two tendencies will prevail in any specific country depends on its political system and the extent to which its public opinion is sensitive to populist arguments. The tight relationship that exists between the successful ignition of a post-Covid19 growth process, on the one hand, and the political feasibility of a transition to a new socioeconomic model, on the other, is indeed the reason why, in the first part of the paper, we have discussed the economic, technical and political factors suggesting that Italy is and remains a country at risk.

4.2 PEPP and NGEU: game changers for Italy?

For a country like Italy, with its very high government debt, both the ECB's bond purchases and the NGEU funds represent a vital relief, since they do not add to the debt that the country must sell on the market and roll over. While the *purchase* programmes are temporary, as explained above, it is reasonable to presume that the sovereign assets purchased during the pandemic by the Eurosystem through the quantitative easing programme (APP) and the *ad-hoc* programme (PEPP) will be rolled over indefinitely, if necessary (Claeys, 2020). In the end, neither the Federal Reserve nor the Bank of Japan have ever managed to start tapering, and any preliminary attempt to do so (such as in December 2018-January 2019 in the US) has been followed

[21] On the ever growing phenomenon of zombie firms, we refer to Banerjee and Hofmann (2018,2020).

by large fluctuations in financial markets that discouraged the authorities from proceeding forcefully. Moreover, the ESM, SURE, EIB and NGEU loans can help Italy to get the highly needed front-loaded money at a cost lower than the market rate it would pay on its own government bonds (more than 1% at current annual rates) and with a much longer maturity (about double the average maturity of Italian debt that is currently equal to 7 years). Although loans from EU institutions are preferred debt that will subordinate bonds issued by national governments, the availability of these loans not only reduces the dependence on ECB's purchases and market pressure, but it also allows countries in trouble to be indebted to EU institutions rather than to private investors. This, as mentioned, can potentially give them political leverage in further negotiations, in particular to obtain better terms in matter of debt restructuring (e.g., lengthening of maturities, lower interest rates and even debt relief).

In this favorable context, it is remarkable that the access to the ESM special credit line for health expenses connected to the pandemic (Pandemic Crisis Support) remains a hotly debated issue in Italy. This is due to the fact that the ESM is taboo for Italian populists, due to the idea that any memorandum of understanding represents a breach of Italian sovereignty, a key claim in the current populist rhetoric. This very reason has also prevented the country from benefiting from potentially unlimited OMT interventions by the ECB in case of crisis, which are allowed only if the interested country has agreed upon a memorandum of understanding with the ESM. As the NGEU fund will not be distributed before the spring 2021 (even bravely assuming a quick and successful negotiation between the European Parliament and the Council on the EU multiannual financial framework 2021-2027), Italy's possible access to such credit line would be particularly significant, since it would signal to the investors a reduction of Italy's political risk. The political outcomes from recent regional elections and a referendum (in mid-September 2020) may suggest that this scenario is more likely than it was only a few months ago. Yet, it is still unclear how this might accord with the attempt to approve the reform of the ESM: such reform was blocked in 2019 by the Italian government, and then postponed due to the pandemic, because of some technical problems in the proposed sovereign debt restructuring mechanisms and, more importantly, because of the widespread opposition in the Italian Parliament to the ESM, as mentioned above.

Finally, even if NGEU grants have to be partially repaid in the form of increased contribution to the EU budget,[22] this repayment is supposed to begin in 2028, thus contributing to buy time for a much needed structural adjustment.

In the case of Italy, the relief provided by the EU programmes has to be assessed in the light of the serious deterioration of its public finances because of the Covid-19. According to recent unofficial (but authoritative) forecasts (Osservatorio CPI, 2020), in 2021 Italy's government debt-to-GDP ratio will be 154.9% (20 percentage points above its level in March 2020), with 48% of its gross financing need that will satisfied by the European institutions, as a result of which 27% of its public debt will be in their hands. Given this situation, an important question is if the monitoring of the European Commission and the Council will be sufficient to insure that the use of such funds will boost its growth potential and make its public debt more sustainable.

As previously argued, the use of European funds in Italy in the past is no reason for optimism. But will it be different this time? Although at this stage it is too early for an informed and comprehensive judgement, since the Italian government has not yet presented its plan for the use of NGEU funds to the European Commission, there are reasons to be cautious, or even skeptic.[23]

To start, investments such as those that accelerate the diffusion of digital technologies are certainly growth enhancing, in particular in a country like Italy which is well behind the other advanced economies. However, the structure of incentives to which political and social actors respond to such investment plan has not changed. Political short-termism and intense competition for votes will still be overwhelmingly dominant, especially because recent Italian experience has shown that fiscal responsibility and painful structural reforms are not rewarded by voters (paraphrasing Gresham law, the advent of populist politics has driven out good policies and narratives less inclined to engage in scapegoating and to distort evidence).

[22] It has been argued that, as the NGEU will have to be partly repaid through higher national contributions to the EU in the future, countries may eventually have to finance such payments by resorting again to the financial markets. While true, this will occur only gradually and it will start 7 years from now. Hence, even though the net present value of the EU transfers to Italy may amount only at 17 billion euro in the end, the overall relief that these resources give for the refinancing needs of the country in the medium terms is much higher. As estimated by Merler (2020), the net annual benefit for Italy due to the grants of NGEU for the years 2021-2027 amounts to 4.6bn of euro.

[23] At the moment, this skepticism is quite diffuse among independent commentators. See, e.g., Boeri and Perotti (2020).

Vested interests and pervasive economic rents created by regulations and (central or local) government practices appear as strong as ever. Moreover, part of the public administration does not seem to be prepared to deal with such large number and size of investment programmes. On September 26, during a public debate at the Festival of Economics in Trento, the Italian Prime Minister, Mr. Giuseppe Conte, announced that the government will define *ad hoc* procedural and administrative measures to ensure that it will be possible to handle the planning and implementation of such large resources. On the same day in another debate of the Festival, the Italian Ministry for European Affairs, Mr. Vincenzo Amendola, claimed that part of the funds will be allocated to support private sectors' investments in green and digital projects, thereby reducing the sums that will be handled by the public sector. Both such sensible reassurances may reduce the problems associated with dealing with very large and expensive investment programmes, but cannot solve the abovementioned risks concerning the incentives of political and social actors. On the one hand, the abundance of funds for the next few years is seen by lobbies and special interests as an unrepeatable window of opportunity. On the other hand, one can see the symptoms of a resurgence of hard statalism, which—under the label of "industrial policy" definition - combines the bail out of zombie firms with state dirigisme. Another observation to make is that, in Italy, there seems to be a widespread perception that, after years of relative fiscal restraint (made inevitable by the prolonged GDP stagnation), it has finally come the time to start with satisfying those needs that have long be compressed. Many people expect that thanks to European funds there will be more spending on public services and social provision, which might be welfare improving in the short run, but not necessarily enhancing growth and improving debt sustainability in the long run.

In sum, the NGEU and the PEPP do have the potential to be a game changer for Italy and for the better. Yet, high is the risk that they will hit the entrenched social and political bottlenecks and may even feed them. To close the circle, hence, we now discuss what the developments in Italy might imply for EU institutions and its European partners.

4.3 The EU's dilemmas

The ECB will face very demanding challenges in the tapering of quantitative easing compared to other central banks. This is due to the fact that its jurisdiction is characterized by deep structural disparities, and above all (and this is unique to the ECB), because it is the monetary authority of 19 sovereign States, which makes its decisions inevitably politically sensitive and potentially divisive along the national borders. If now, with the pandemic not over yet, and with the PEPP and NGEU programs implemented, these differences and tensions have quieted down, it is to be expected that they will re-emerge when we shall return to some normality. Italy's performances in the use of NGEU funds and the prospective sustainability of its debt will be important factors in determining the extent and the intensity of such tensions.

In particular, if, after the end of the pandemic (presumably late in 2021/beginning of 2022), there will be signs of an asymmetrical recovery in the EZ, with the most vulnerable countries lagging behind the EZ core ones, the ECB will be faced with serious problems. One the one hand, it may have to start reducing new purchases or even tapering the programme, on the other hand, by doing so, it could foster those forces leading to EZ segmentation. A confidence crisis concerning the public debt sustainability of one or more peripheral countries may become possible again, with the consequent flight-to-safety episodes and with serious risks of contagion; this will be evident if the countries will be in trouble because of the lack of political consensus on a process of fiscal consolidation and implementation of effective growth-enhancing reforms.

In these circumstances, the ECB would therefore be faced with the difficult choice of whether to support the debt of the countries in trouble, through purchases of their government bonds well beyond what the capital key prescribes (possibly even in the absence of a clear political commitment by their governments to undertake a drastic adjustment programme as prescribed by the OMT), or to expose the EZ to a crisis that might lead to its implosion. Nobody can rule out the possibility that, by that time, in the weakest and most exposed countries, aggressive governments might negotiate some form of bailout and/or ask for additional grants, for instance by blackmailing EU partners and institutions with the threat of defaulting on their obligations towards the rest of the EU. Although one may legitimately question the credibility of such threat (that in the case of Greece in 2015 turned out to be non-credible), it is appropriate that the European policy

makers are well aware that such "worst-case" scenario is—if not probable—at least fully possible. Both Brexit and the evolution of the EU-UK post-Brexit deal should remind everyone of the impact that strong societal and political forces, notwithstanding their negative impact on the majority of the population, may ultimately have on fundamental twists in the political and economic scenarios.

In this case, it is likely that the German government will have to face the same dilemma that it faced after the outbreak of the Covid-19 emergency, that is, either accept some form of debt mutualization and intercountry transfers, or let the EZ implode. One could argue that NGEU is the last proof of the pudding of the imperfect EZ integration process, and that the EZ implosion might be the only solution politically acceptable in the majority of the core countries. Yet, it can also be argued that the same reasons that led the German government to support NGEU, and the "Frugal Four" to accept it, are likely to prevail again in the future, and that any of the current commitments on the "temporary" and "exceptional" nature of PEPP and NGEU programmes is bound to be time inconsistent. However, political circumstances, public opinions, psychological climate (the pandemic will be over and the solidarity towards the population of the countries in trouble will be fading away…) and personalities (Ms. Merkel will step down in 2021…) will not be the same. Moreover, the situations will be shaped by many other factors, such as the future political scenario in France, the evolution of the East-West divide in the EU, and the difficult negotiations on the management of EU migration inflows. Thus, if such "worst-case" scenario will materialize, the way out of the consequent crisis is everything but certain.

5. CLOSING REMARKS

We have seen how the Covid-19 pandemic induced the ECB to adopt a set of emergency measures. In parallel, the Stability and Growth Pact was suspended, and the EU approved a number of programmes that for the first time have determined substantial fiscal transfers among countries belonging to the Union. As a result, the EZ countries—even the most vulnerable among them—managed to enlarge their government deficits practically without limits with a view to facing the emergency, without losing market confidence on the sustainability of their public debt.

The monetary authorities and the EU core countries have been careful in making clear that all such measures are temporary and closely linked to the Covid-19 emergency. This should be interpreted as meaning that—once the pandemic will be definitely over—the amount of government debts purchased by the Eurosystem (exceptionally large in the midst of the pandemic) will be drastically reduced, these purchases will be again strictly subject to capital keys and tightly constrained by issuer limits, any interventions on the market to support the bonds' prices of countries in trouble will be conditional on formal commitments (i.e. memorandum of understanding) to undertake fiscal consolidations and structural reforms, and the ECB will be fully free to raise—if needed—short-term interest rates without being restrained by the fiscal problems of some member states.

Similarly, not only the "Frugal four" want that the NGEU to be temporary and one-off with a clearly stated sunset clause, but also the German government has stressed the importance that these measures are exceptional, either strictly associated with the Covid-19 emergency or directed to push long-term growth, making individual countries and the EU as a whole more resilient and competitive. But is this credible?

In contrast to this view that mixes the EU common actions with the preservation of a fairly intergovernmental approach, several European federalists think (and hope) that the NGEU and the PEPP will be only the first step towards a genuine and permanent transfer union, entailing a much larger EU budget, European taxes, and some debt mutualization, thus completing the monetary union with a full-fledged fiscal union. Is it just wishful thinking?

We have argued that, once the Covid-19 pandemic will be over, it is fully possible that one or more of the most vulnerable EZ countries, and in particular Italy, will be again in a situation of quasi stagnation, with serious problems of debt sustainability and governments reluctant to undertake any fiscal consolidation or effective structural reforms, but aggressively demanding for financial assistance by the EU institutions and partner countries. As in any genuine crisis, the way out is shrouded in uncertainty, depending predominantly on economic, political and public opinion developments in various countries. The future of the EU, and especially the evolution of the EZ towards a greater integration or alternatively towards a possible implosion, is very much linked to these developments.

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