ANTÓNIO PORTUGAL DUARTE
SRDJAN REDZEPAGIC
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COORD.

THE EUROPEAN INTEGRATION PROCESS

CRISIS AND RESILIENCE IN THE AFTERMATH OF THE COVID-19 PANDEMIC

The process of European integration is considered the most innovative example of regionalism in the world. The Covid-19 pandemic crisis, which the world experienced since the beginning of 2020, caused a brutal negative shock on the economies. It raised new doubts and challenges about the European integration project, making the prospect of the EU's dissolution something possible, even if undesirable. The book analyses these events, counting with the contribution of 41 authors, from universities and research centers of several European countries, and also from other continents. Its objective is to gather four perspectives to the European integration in a post-pandemic context: i) that of the countries of the Eurozone; ii) that of the Eurozone candidate countries; iii) the East "look" of EU candidate countries, and iv) the view of the rest of the world. The book is divided into four parts, each corresponding to one of these inputs, for a total of 24 chapters.

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PART IV: **THE VIEW OF THE REST OF THE WORLD**

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First, the editors would like to thanks all the authors, for the precious time and expertise they dedicate to contribute to this book[1]. The editors would like also to recognize the valuable contribution of the reviewers for reading and evaluating the chapters and for the suggestions transmitted to the authors. Finally, the editors wish to thank the Faculty of Economics of the University of Coimbra and the CeBER – Centre for Business and Economics Research for supporting the editors in organizing this book and the Coimbra University Press to the openness that expressed since the beginning of this project.

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Foreword

The European Integration Process: Crisis and Resilience in the Aftermath of the Covid-19 Pandemic

This choral book, edited by Prof. Antonio Portugal Duarte, Prof. Srdjan Redžepagić, and Prof. Fátima Sol Murta is about crisis and resilience in the European Union (EU). Two basic concepts when you speak today about Europe. But if you look in the founding Covenant – the so-called Schuman Declaration – of 1950 you will not find any of these words. Looking more deeply, these concepts are implicit all along the document as key ideas able of transforming the History of the Continent.

Words have not a single meaning enshrined in marble. They are flexible and creative, they adapt to circumstances, even in our own mother language. They can even change their meaning in time. What is important is what they mean in a precise moment in an historical context.

Having been working almost a quarter of a century in the Babel Tower of the European Parliament, I have often reflected on the fact that there is much more in common in the basic capital of every single European language than different. These two words are a case in point to show how words can revive and acquire new nuances or meaning in new historical circumstances.

What a paradox when we live in a world full of technological advance! When we must speak with terms that have a durable and deep

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meaning we must draw on classical Greek or Latin concepts. Often, they are coming back through cultivated Anglicisms.

Crisis is an omnipresent word, mostly with a negative meaning. It is useful to remind is original meaning in classical Greek Krisis, in its Latinized form is a "turning point in a disease, that change which indicates recovery or death" (used as such by Hippocrates and Galen), literally "judgment, result of a trial, selection" from krinein "to separate, decide, judge". Useful meaning for the Covid-19 pandemic. It is the same meaning used by Jean Monnet when he said: "Europe will be forged in crisis and will be the sum of the solutions adopted for those crises."

The word *resilience* that has become widespread derives from the present participle of the Latin verb *resilire*, meaning "to jump back" or "to recoil". Now has come back as an Anglicism with a meaning of "the capacity to recover quickly from difficulties; toughness".

With these two concepts as tools it is interesting to read this book about the European integration process, an open-ended constitutional process launched with the Schuman Declaration among neighbouring peoples, foe for centuries. "*Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity"*.

I defined the EU as a "weaver of peace" in my speech at the University for Peace[1] because the change was possible thanks to a patient and lasting work of political weaving of the peace banner. Weaving and cultivating were two founding activities that triggered the creation of settled human societies. Both of them require skills, perseverance…and resilience to convert a thread in a cover or a tapestry. When we analyse the EU we speak of a work in progress of weaving, unravelling and reweaving like Penelope in Ithaca. The result is resilient, and can even be harmonic and beautiful.

The approach of the book is timely, focusing on the study of crisis and resilience in the aftermath of the Covid-19 Pandemic. It faces rightly

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[1] "The European Union, weaver of peace" http://www.brandeu.eu/2013/10/the-european-union-weaver-of-peace/

the pandemic as a global challenge seen not just from the Brussels base power but associating Academia of the partners countries, classified from a political and economic viewpoint: euro area countries, euro candidate countries, east countries candidates to the EU and same cases of the rest of the world, with room for deepening in the study and research.

The main conclusions of this book in my view show that the EU, after an initial reaction of retreating and closing has reacted jumping ahead with the original Schuman line –"un saut dans l'inconnu" and has defined a line of avant-garde with the power of the internal market and the single currency based on the following guidelines: 1st, to consider health as a public good, enshrining the Union of Health and developing policies that represent an answer to it; 2nd, the challenge is global, there are no walls that can isolate countries or continents, what increases the role of multilateral institutions like WHO, WTO and the whole system of the UN. This uphill battle demands resolve, resilience and perseverance in order to triumph.

This is a helpful book because it deals directly with society, people and the ways to overcome the worst pandemics, nationalism, hate and war.

Enrique Barón Crespo

European Parliament President (1989-92)

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Introduction

The process of European integration is considered the most innovative example of regionalism in the world. On May 9th 1950, the French Foreign Minister Robert Schuman, inspired by the ideas of Jean Monnet, delivered a speech proposing that France and the Federal Republic of Germany should jointly use their coal and steel resources in an organization open to other European countries. Since then, the experience of European integration functioned as an important paradigm for other regions that wish to be part of a dominant currency area, or seek to deepen cooperation.

Over time, the European integration process has not been linear. It experienced moments of strong growth and consolidation, namely, following the various enlargements of the European Union (EU), and during the first years after the introduction of the European single currency. It also experienced moments of crisis and elements of disintegration, as it was the case of the crisis of the European Monetary System, in August 1993, and, more recently, the financial crisis of 2008, the sovereign debt crisis of 2011-12, the BREXIT, and the Covid-19 pandemic crisis.

Only the Spanish flu in 1918 may be compared to the Covid-19 pandemic crisis, which the world experienced since the beginning of 2020, causing a brutal negative shock on the demand and supply of the economies, destabilizing economic activity in almost all productive sectors, compromising economic growth and employment. It raised new doubts and challenges about the European integration project, making the prospect of the EU's dissolution something possible, even if undesirable.

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To overcome the economic crisis caused by the coronavirus and give new impetus to the European project of regional integration, the member countries of the EU, in a spirit of solidarity, jointly committed themselves to set about a “new Marshall Plan”, the so-called European Recovery and Resilience Plan (RRP). This financial recovery package of approximately €2 billion has a very significant part to be allocated in the form of grants. Facing these new challenges, the RRP aims to play a decisive role in stabilizing the situation, as well as in achieving the objective of sustained economic growth. The adoption of this European “financial bazooka”, as it has often been called, becomes even more significant considering that this strategy of economic recovery has no similarities in the history of European integration. The large financial resources involved, but also (and mainly) the fact that an agreement has been reached between the 27 Member States, providing for the issuance of common debt and grants, was almost unthinkable due the initial opposition of the so-called frugal Member States (Netherlands, Austria, Sweden and Denmark) and the prospect of a veto from Hungary and Poland.

This strategy to address the pandemic is expected to bring a boost to the European integration project in the upcoming years. However, the question of how collectively Europe, and the world, will continue to resist (and definitively overcome) this new crisis, as well as, how to deal with the financial burdens assumed in the meantime, remains open. Furthermore, Europe has recently experienced a new refugee crisis, following the Russian military invasion of Ukraine, with political, social and economic consequences that are still difficult to predict. The specter of inflation, phenomenon that was thought to be no longer possible within the framework of a monetary union revives, in addition to the emergence of an unprecedented food and energy crisis that go far beyond the European space...

An academic book which has the contribution of 41 authors, from universities and research centers of several European countries and regions, and also from other continents, whose economies are characterized by great economic, financial and social differences and, therefore, with different views on Europe – some more Eurosceptic, others more Europeanist – may, in our opinion, become a relevant working tool and a reference element for a better understanding of the future challenges and opportunities facing by the European integration process.

Therefore, one of the main objectives of this book is to gather in the same work four perspectives to the European integration process in a post-pandemic context, namely: i) that of the countries of the European single currency; ii) that of the Eurozone candidate countries; iii) the East "look" of EU candidate countries, and iv) the view of the rest of the world. In this context, the book is divided into four parts, each corresponding to one of these inputs, for a total of 24 chapters.

Each author was asked to contribute with a small text of theoretical or applied nature, where they analyzed, discussed or reflected on how they see the European integration process in the aftermath of the Covid-19 pandemic. The work should preferably be focused on the perspective of the country where the author usually carries out his academic activity. Nevertheless, the authors could also develop a broader view, namely in comparison with other countries belonging to the same economic integration area or to another region of the world. The works may take the form of an historical retrospective or, preferably, have a more prospective character.

The book seeks to reflect, debate and analyze from various perspectives – economic, historical, institutional and political – the complexity of the European integration process in the context of the Covid-19 pandemic. It tries to find answers to the enormous challenges that Europe faces and, unequivocally, will continue to face in the coming years.

Among the various issues that have threatened the European integration, we find, e.g., the problem of sovereign debt of countries on the European periphery, the controversies with the North Atlantic Treaty Organization, the legitimacy crisis, BREXIT, the financial recession, the refugee crisis, terrorist attacks, the emergence of nationalisms and, at present, the economic crisis caused by the Covid-19 pandemic. Under the great hat of European integration process, these and other themes are analyzed in the context of this book.

To all those who contributed to make this book a reality, we would like to express our appreciation. To those who daily fight in a noble way against the pandemic and to those who, unfortunately, ended up losing their lives, we would like to express our sincere thanks and tribute.

The Editors
António Portugal Duarte
Srdjan Redžepagić
Fátima Sol Murta

PART I

THE PERSPECTIVE OF THE COUNTRIES OF THE EUROPEAN SINGLE CURRENCY

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COVID-19 Crisis and EU Response. Can the NextGeneration Fund be the Key to a More Integrated Eurozone?

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ABSTRACT: Unlike the financial and debt crisis that shattered the Eurozone at the beginning of the last decade, the social and economic meltdown generated by the pandemic outbreak of COVID-19 in early 2020 has been confronted by a united front of the European Institutions with aligned health, social, and economic policies.

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The NextGeneration Fund with the Recovery and Resilience Facility as its centrepiece, and an allocation of €723.8 billion to face the consequences of the crisis, represents not only a common instrument to repair the economic devastation of the pandemic, but can also pave the way to a better integrated Eurozone. Since the funds were raised by the Commission instead of the individual Member States, the continued demand for a mutualized debt instrument has been finally met.

Under the European Commission, these funds can help to bypass the fragility of an incomplete Monetary Union beyond the "Maastricht Criteria", align national fiscal policies and become a powerful tool of a new chapter in the convergence process of the Eurozone economies.

Keywords: NextGeneration Fund, Debt Mutualization, Eurozone, Economics of Monetary Union.

1. Introduction

The COVID-19 crisis in 2020 and the response measures taken were a challenge, not only to the economies of the Eurozone and its principles, e.g. free movement of citizens, but also to the Eurozone as an institution. Among all of the major changes the pandemic has forced onto the European society, telework and production digitalisation revolutionised the reality of national states and workforce. These changes create a new framework of analysis of the cooperation mechanisms between the European partners and the necessary coordination between national economic policies.

This paper examines the impact of the COVID-19 crisis and European reforms as a path towards deeper integration in the Eurozone economic and institutional framework: from an economic outlook of the Monetary Union to the study of the Next Generation Recovery Fund as a step towards debt mutualisation and a more comprehensive common fiscal policy in the future.

2. The Eurozone as an incomplete Monetary Union

The problems stemming from an incomplete Monetary Union present in times of economic turmoil. Over the 23 years of its existence, the Eurozone has faced many challenges, ranging from new membership[1] and the financial global crisis of 2008, to the debt crisis in 2012 and, more recently, the COVID-19 outbreak in 2020.

From an institutional perspective, to complete the Eurozone as an optimum Monetary Union (De Grauwe, 2020 pp. 132-146) the following is necessary:

I. A Central Bank as lender of last resort,
II. Consolidated budget and debts, and
III. Coordinated fiscal and economic policies.

According to the Treaties, these three pillar requirements for an optimal Monetary Union are out of the question. The coordination of the fiscal and economic policies has been addressed by the Stability and Growth Pact and the Maastricht criteria with a controversial success. Meanwhile, the role of the European Central Bank and the possibility to consolidate national budgets and debts have been under discussion for years. *De jure*, the latter require renegotiation of the Treaties, but *de facto* some steps in this direction have been taken in the last decade.

2.1. The limitations of the Monetary Union

The 2008 financial crisis and the sovereign debt crisis in 2012 showed the fragility of the Eurozone as a suboptimal Monetary Union especially due the risks of asymmetric shocks. The imperfect integration of the common labour market and the discoordination of the national fiscal and economic policies represent a permanent risk to the integration process in Europe.

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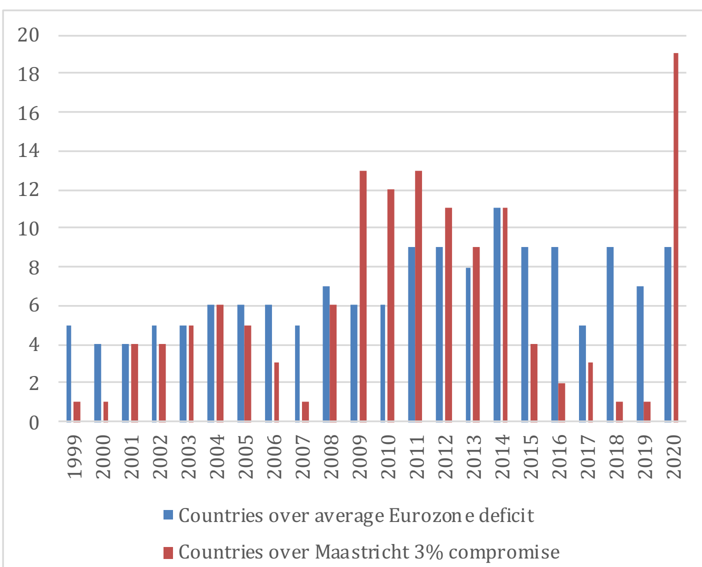
[1] From its initial 12 members to the current 19.

Labour market segmentation has exposed over the years different behaviour of the national labour markets, where at least 4 countries have always endured significantly higher unemployment rates than the Eurozone average since 2009. The compromise over budget stability requires coordination of fiscal policies under the Monetary Union and, since it was conceived, at least 4 countries have not exceeded the average deficit of the Eurozone. Figure 1 highlights the changes in the deficit over the period from 1999 to 2020.

As shown in Figure 1, despite the agreements reached over the possibility of a more "flexible" 3% rule during the financial and debt crisis, coordinating the fiscal policies has been a challenge throughout the lifetime of the Eurozone. There are different reasons for the different behaviour of the fiscal policies across countries[2]. It is a clear indicator of the existence of asymmetric shocks due to the difference in the national economic structures.

FIGURE 1. **Public deficits in the Eurozone (1999-2020)**



Source: Prepared by the authors with data from Eurostat.

[2] Buti and Vanden Noord (2003) analyses the impact of the political cycle on the fiscal policy.

2.2. Crisis as a lever for greater integration

The aftermath of the financial disruptions in the past decade brought 3 key changes to the architecture of the Eurozone, improving its resilience to future financial distress: the design of the European Stability Mechanism, a step further towards the Banking Union and the change in the European Central Bank policy.

The European Stability Mechanism (ESM). The amendment to Article 136 of the Treaty on the Functioning of the European Union adopted on 25th March 2011 created the opportunity to replace the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) with the ESM[3] as the financial support institution for the eurozone countries under financial distress[4]. Since its inception, the ESM has distributed 295 billion euros in lending programmes.

Modification of the European Central Bank (ECB) policy. Since the Monetary Union became a reality, ECB policy and its focus on the mandate over price stability have been under intense discussion. The tensions in the financial markets from 2008 to 2012 even started to raise doubts about the continuity of the Euro as a currency. The debate was "settled" under the presidency of Mario Draghi, resulting in an intensive communication campaign and a definitive increase[5] in the ECB's involvement in the performance of the Eurozone's economy[6].

The Banking Union[7]. Banking integration followed an endogenous process during the 2000-2008 period, due to stable growth experienced since the introduction of the euro. By 2011, after 3 years of financial

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[3] Official Journal of the European Union. Volume 54 6 April 2011. 2011/199/EU: European Council Decision of 25 March 2011

[4] The Treaty Establishing the European Stability Mechanism was finally signed on February the 2nd 2012.

[5] Between 2011 and 2015 the ECB's balance sheet grew 150%.

[6] Dg Internal Policies of The Union Dialogue–23 September 2019

[7] See European Commission (2014).

turmoil, such advances were a memory [8]. The battery of new financial regulation can be summarised as follows[9]: (1) Stronger prudential requirements for banks have been proposed; (2) National Deposit Guarantee Schemes (DGS) raised coverage to a harmonised level of 100,000 euros per depositor, per institution, (3) The Commission's proposal on recovery and resolution tools for banks in crisis.

3. The impact of the Covid-19 crisis and institutional response

The spread of the COVID-19 virus all over Europe in March 2020 brought to the table strong measures intended to slow down the increase in number of cases and allow the national healthcare systems to prepare a response to the pandemic. The most severe measures proposed were the lockdowns, an extreme policy that would affect all "non-essential" activities, the costs of which are still being estimated. By all accounts this crisis was different and resulted in higher costs than previous crises. Under these premises it was necessary to develop new instruments of financial support in addition to the ESM (Bauer & Herz, 2020).

3.1. The economic cost of the COVID-19 crisis

The estimated macroeconomic impact to date[10] of the pandemic presents a challenge due the differential impact suffered by the national economies in the Eurozone. Nevertheless, it is possible to characterise the effects according to the economic structure of the Member States. Therefore, one must assume that countries whose economies rely heavily on SMEs, retail services and tourism have suffered more distress than those economies

[8] Abascal et al. (2015.)

[9] European Commission (2012). A Roadmap towards a Banking Union.

[10] February 2022.

with a stronger digitalisation component. Table 1 summarises the impact of the COVID-19 crisis in terms of public financing needs, GDP per capita growth and unemployment rate.

TABLE 1. **The Economic Impact of the COVID-19 Crises in the Eurozone**

2019-Q4 2021-Q3	Eurozone (19)	Best Performers		Worst Performers	
Unemployment rate	7.5%	3.0 %	(Germany)	17.0%	(Greece)
	7.6%	3.,3 %	(Germany)	14.8%	(Spain)
GDP per capita[11]	0.8%	4.6%	(Lithuania)	0.0%	(Austria; Italy)
	4.0%	12.2%	(Greece)	1.5%	(Slovakia)
Budget surplus (+) / deficit (-)	-1.0%	1.3%	(Netherlands)	-4.0%	(France)
	-4.0%	-0.9%	(Lithuania)	-8.1%	(Malta)

Source: Prepared by the authors from Eurostat.

3.2 Debt mutualisation through NextGeneration EU

Debt mutualisation has been a recurrent topic since the creation of the Monetary Union, especially since the sovereign debt crisis. The most common proposal, branded as “Eurobonds”, rested upon a rather pragmatic premise: the creation of a supranational debt instrument would lower the borrowing costs for most of the members within the Eurozone. While Member States have always taken a positive stance towards sharing the costs of a common debt, they have had serious doubts about the potential moral hazard risks due to the lack of a discipline mechanism for the fiscal policy. In this scenario, “less fiscally conservative” countries would be able to transfer the cost of their budget deficits to the rest of the EMU. Balancing solidarity and responsibility have been in the core of the debate for years (Eisl and Tomay, 2020).

The structure of the Resilience and Recovery Facility within the NextGeneration EU is a step forward to limit the moral hazard problem. Of the

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[11] Chain linked volumes, percentage change compared to same period of the previous year, per capita.

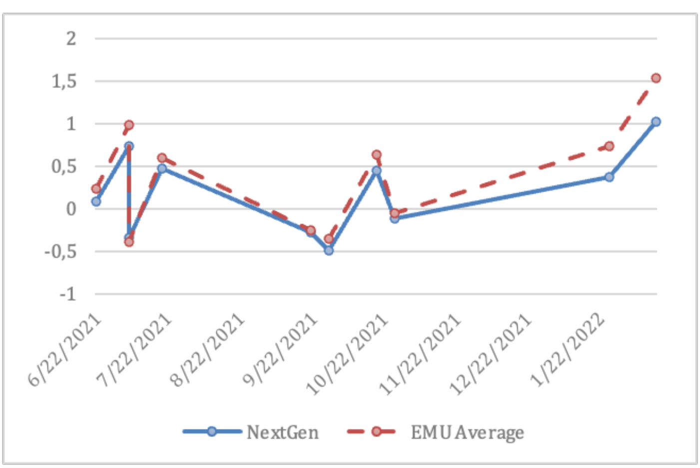
programme's 672.5 billion euros, 360 billion euros (53, 53%) consist of loans, thus creating a market-like mechanism for Member States to discipline their fiscal policies in the medium term to receive the funds and pay back the loans.

Since the fund-raising programme is schedule for several years, it is not possible to estimate the current differential in the interest rates paid by the Eurozone countries, but a first approximation can be made. Figure 2 presents the differential in interest rates between NextGeneration bonds issued until January 2022 and the average interest rates on EMU bond emissions in the same date.

As presented in figure 2, average interest of the EMU-member bonds with the same maturity as those issued under the NextGeneration programme exceeded their average yield on different occasions. A similar trend can be observed under the financing in the monetary market with 3-month bills and 6-month bills issuances in Figures 3 and 4.

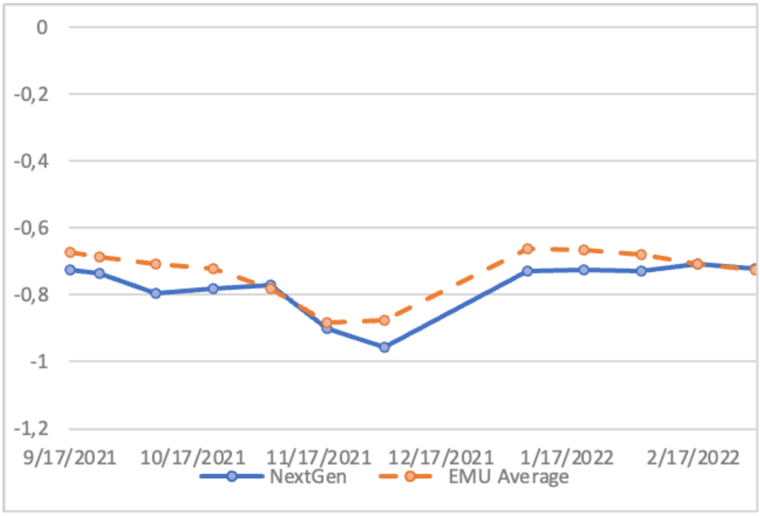
While the bulk of financing for the NextGeneration fund and for the regular Member State operations is obtained by issuing bonds with maturities longer than 10 years on average, the impact of borrowing in the short-term money markets also shows the potential savings on issuing bonds and bills through the NextGeneration program.

FIGURE 2. **Comparison between average EMU bond interest rates and NextGen bond interest rates**



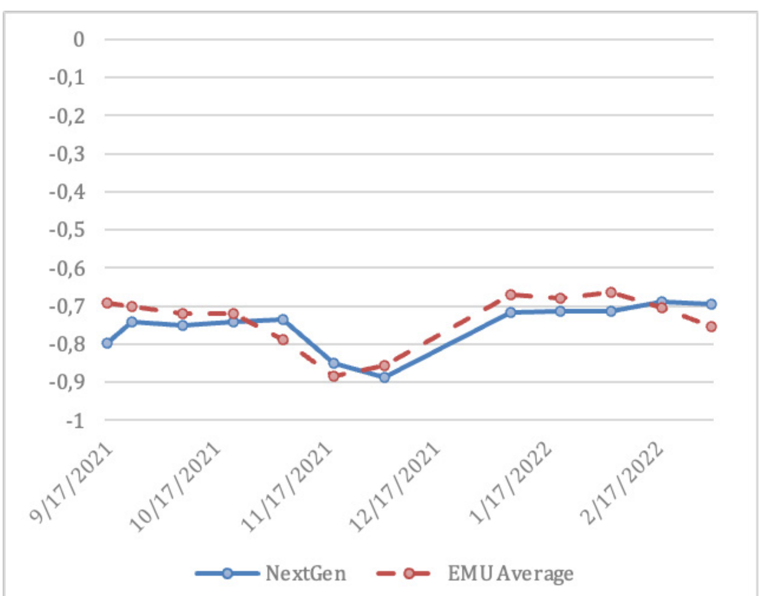
Source: Prepared by the authors with data from Eurostat and the European Commission.

FIGURE 3. **Comparison between average interest rates of EMU 3-month bills and interest rates of NextGen 3-month bills**



Source: Prepared by the authors with data from Eurostat and the European Commission.

FIGURE 4. **Comparison between average interest rates of EMU 6-month bills and interest rates of NextGen 6-month bills**



Source: Prepared by the authors with data from Eurostat and the European Commission.

4. Conclusions

The catastrophic impact of the COVID-19 pandemic outbreak on the Eurozone will take years to be fully understood and its costs in terms of lives lost and economic underperformance will take even longer to be accurately estimated. Even so, there is no doubt that the Eurozone and the European Union have changed forever. Unlike in previous crises, this time around the European institutions formed a common front from the very beginning and took the necessary measures to adapt and reform, when required, the institutional architecture of the Union to face this new challenge.

The creation of the NextGeneration EU fund is a milestone in the Eurozone integration process and raises the question of whether a real economic union may replace the current Monetary Union in the future. The mechanisms embedded in the Resilience and Recovery Facility open up the way for more cohesive fiscal and economic policies in the coming years under the supervision of the European Commission, which can lead to a shared growth path and a new framework for the Eurozone partners.

A better integrated Monetary Union is a necessary step towards a better integrated European Union and since the intention is clearly embodied in the new institutional architecture that emerged during the crisis, the time has come to stay on the path towards that goal.

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The EU and the Pandemic Crisis: From 'Road to Nowhere' to 'I Still Haven't Found What I'm Looking For'[1]

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ABSTRACT: The chapter assesses the role of the European Union (EU) in the context of the COVID-19 crisis management. It starts by addressing the pandemic crisis from a comparative perspective, notably to what extent the crisis was so different from previous crises that affected the EU (the Eurozone crisis, the refugee crisis, the Ukrainian crisis, and the diplomatic crisis that followed the rift triggered by the Trump administration). To that purpose, a three-dimensional analysis is required, looking at the nature of the crises (endogeneity

[1] For in depth analysis of the pandemic crisis management by the European Union see, for example, Vila Maior, P. and Camisão, I. (2022). *The Pandemic Crisis and the European Union: COVID-19 and Crisis Management*. Routledge.

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vs. exogeneity), at the effects (symmetry vs. asymmetry) and at the players involved in controlling the negative impacts of the crisis (externalisation vs. internalisation). The focus is on an analysis across time, starting in the early pandemic days, where national governments' activism ruled out EU activity. We point out how incoherent this solution was, considering that the problem crossed national borders and, therefore, cooperation, if not a supranational approach, was the most reasonable response. Possible explanations are put forward, directed towards national authorities in particular. After the early stage of the pandemic, theoretical normality was restored as national governments were gradually replaced by EU institutions. The EU took its place as crisis manager. The analysis focuses on the areas where EU institutions played an important role. The chapter concludes by looking into the rear-view mirror and trying to assess the role of EU institutions and to what extent the pandemic crisis had an impact on the EU as a policy.

Keywords: EU institutions; Actorness; Crisis Management; Pandemic Crisis.

1. Context: the pandemic crisis as a crisis on its own

When COVID-19 struck European Union (EU) member states (MS), another crisis added to the multi-layered crisis that is a perennial characteristic of European integration (Nanopoulos and Vergis 2019). Yet, this time, the crisis was of a different nature. While previous crises were political and/or economic (e.g., Eurozone crisis, refugee crisis, invasion of Crimea, Brexit, deterioration of bilateral relations with the United States under Trump's presidency), the pandemic crisis unfolded into a unique scenario.

The primary cause of the pandemic was the health emergency triggered by the potential of contagion of COVID-19 and the lethal threat related to the virus. The ramifications of the pandemic crisis are manifold – political, institutional, economic, philosophical, psychological, sociological, and even anthropological. Health risk triggered all other dimensions of the crisis. To this extent, the crisis was exogenous on two accounts (Lipscy, 2020): the geographical source of the crisis was outside Europe; and the overarching crisis was motivated by reasons outside the remit of politics and/or economics.

The most relevant aspect is not so much the geographical fabric of the crisis, but instead the awareness that the crisis began as a sanitary problem and then spread to other dimensions.

Secondly, the pandemic crisis must be judged for its implications. All MS were severely affected. The effects were symmetric, although countries were affected to varying degrees (Moreira and Hick, 2021). Maybe the reader would challenge our understanding and claim that, since a range of macroeconomic consequences were found in different countries, the symmetric label would not fit. We do not measure to what extent each national economy suffered from the pandemic crisis. Our emphasis is that all MS were hit by lower production and consumption, sizeable negative economic growth, higher unemployment, and the deterioration of the fiscal deficit and public debt. The Eurozone crisis, in contrast, was an asymmetric shock.

Thirdly, the crisis analysis also incorporates an institutional dimension: how was the crisis addressed? Who were the relevant actors? Looking through the glass of the institutional dimension, two alternatives are at stake: the effects of the crisis were either internalised or externalised. Since the analysis addresses the EU as the unit under observation, when EU institutions lead the way, the crisis is internalised. The crisis is externalised when national authorities' action downplays the EU.

When sensitive national interests are at stake, or when a critical juncture brings political players near to 'known unknows', MS step in and lock in EU institutions into inaction. Cases of mayhem are paradigms of national action instead of supranational action. As section 2 details, at the outset of the pandemic crisis national governments came into the stage and ignored cooperation. In the early days of COVID-19 the crisis was externalised, although the characteristics of the crisis (a pandemic) would call for joint action, with coordinated efforts between EU institutions and national governments. The choice of national governments was the opposite, denying EU institutions a role.

Only later (see section 3) did the awareness of how superior supranational action shift the paradigm. Gradually, the potential of joint action was recognised. National authorities started to coordinate efforts within the institutional system of the EU. EU institutions were given a role and their actorness was determined (see section 4). The underpinnings of the institutional accommodation to the pandemic crisis showed a drift towards internalisation. Since the effects of the pandemic cut across borders and impacted heavily all MS, joint action was the optimal solution. Instead of uncoordinated, ad-hoc reaction to the crisis (externalisation), the crisis was internalised.

2. The early days of COVID-19: national governments take the stage

The first actors to take central stage in the management of COVID-19 pandemic were MS. After the first case was reported in France, on the 24 January 2020, several cases were communicated by other MS, Italy being at the top of the list. Since knowledge about the new disease was scarce and medical countermeasures were virtually inexistent, MSs entered self-preservation mode by closing their borders. This is a normal reaction when states are faced with a severe threat perceived as an external security issue (Dean and Kruijver, 2020).

Although the new coronavirus was not initially seen as an acceptable reason for suspending the Schengen Agreement, on 13 March 2020 three Schengen area MS (Malta, Slovakia and the Czech Republic) unilaterally announced the closing of borders to Italian citizens and to citizens from some other MS in an attempt to stop the spreading of the disease. In a week several other MS (Schengen and non-Schengen Member States) had reintroduced border controls to reduce the spread of the coronavirus. By late March 2020 all MS (except Ireland) had some level of border bans on public health grounds (Sabbati and Dumbrava, 2020). The reinstatement of border controls was paired with confinement measures that included the prohibition of public gatherings, the closing of schools and shops, cancelation of public events, the shutdown of non-essential activities (such as leisure, hotels, and restaurants), and eventually partial or full lockdown. Restraining measures significantly varied from state to state, as regards their type, severity and length, as well as the nationalities of the citizens temporarily "banned".

Although MS' first attempt to deal with COVID-19 was not irregular, several problems resulted from the "everyman for himself" type of strategy. First, it conveyed an image of deep lack of coordination and cooperation amongst MS. They also failed to consider the (negative) impact that unilateral decisions would have on each of them and, consequently, on the EU as a whole. As the President of the Commission, Ursula von der Leyen, said time and time again, coordination at the EU level, and therefore cooperation, was key to guarantee an effective management of the COVID-19 crisis in its multiple fronts. Instead, early MS "cacophony" appeared to put the EU on the "road to nowhere".

Second, although justified for public health reasons, border closures (or restrictions) and other containment measures hindered a building block of the EU's "way of life", which is freedom of movement. While at first the majority of European citizens seemed to understand and even support restrictions (Zerka, 2020; Silver et al., 2020), the length and recurrence of restraining measures (that were reinstated as new waves of the COVID-19 pandemic appeared) raised questions about their legality, as not all of them appeared to pass the necessity and proportionality tests required by international and European law to legitimately put on hold (temporarily) some citizens' rights (Vila Maior and Camisão 2020).

Third, the inward-looking response challenged the EU construction, and, above all, European solidarity. This negative image was further confirmed by glimpses of fierce competitiveness (for example, concerning the purchase of personal protection equipment, test kits, medicines and vaccines) (Kovács cited in Gray, 2020) and by some controversial public statements, such as by the Czech Prime Minister, Andrej Babis, who claimed that Italy should ban travel of all its citizens to the rest of Europe (Reuters, 2020). The narrative of European disunion made the headlines of several media outlets worldwide and the end of the EU was once again bluntly announced. The "disunion narrative" captures the feelings that many European citizens experienced back then, particularly when the EU failed to respond in a timely manner to Italy's request for activation of the EU Civil Protection Mechanism (Deen and Kruijver, 2020) to get additional protection equipment, particularly masks. Accepting that the

EU should have done more in the early stages of the pandemic, the President of the Commission presented an “heartfelt apology” to Italy in a speech delivered before the European Parliament (EP) in April 2020 (von der Leyen, 2020a).

3. After havoc: EU institutions step in

The EU has mostly supporting competences in public health issues, even though the Treaties and other specific legislation give room to coordination at the EU level. The first EU responses to COVID-19 involved the activation of early warning systems and regular risk assessment by technical bodies such as the European Commission’s Directorate General for Healthy and Food Safety (DG SANTE), the Health Security Committee (HSC) and the European Centre for Disease Prevention and Control (ECDC). On 9 January 2020, DG SANTE issued an alert notification on the Early Warning and Response System which allowed MS to share information on possible cases in their territory and their response.

Later that month (on 28 January 2020), the Croatian Presidency activated the integrated political crisis response arrangements (IPCR) in information sharing mode[2]. Also on 9 January, the ECDC started to publish a Threat Assessment Brief on the new coronavirus to assess the risks for travellers and the likelihood of the virus spreading to Europe. One week later, the HSC initiated a series of meetings on the new disease. While risk assessments initially pointed out that the new virus was unlikely to reach Europe there was a rapid change in the perception of threat, and the ECDC and the HSC converged on the idea of ‘high potential impact’ of COVID-19 outbreaks and ‘likely’ global spread (Health Security Committee, 2020, p. 1). Change in risk perception occurred not only in Europe, but globally.

At the political level, despite the contribution for crisis management of the Council of the European Union (Council) and the EP (namely by adopting

[2] In early March 2020 the Croatian Presidency escalated the IPCR to full activation mode.

legislation at an unusually rapid pace, but also by holding hearings and by making ample use of parliamentary questions to monitor the EU response, in the case of the EP), two EU institutions stood out in the response to the crisis: the Commission, as a result of policy entrepreneurship, and the European Council, the natural forum for political leadership in crisis situations. The role of the European Central Bank (ECB) was also key in the economic dimension of the crisis.

The first EU institution to take central stage was the Commission. Faced with MS misalignment, the Commission was forced to step in to control the policy narrative and to avoid national egoism from hampering the effectiveness of crisis response. Several factors converged towards the Commission's activism. First, the assertiveness of President von der Leyen, who, despite some less successful episodes during crisis management, showed leadership and skilfully neutralised the narrative of disunion. Building on the argument that uncoordinated action equals ineffectiveness, the Commission claimed the role of coordinator (von der Leyen, 2020a). Second, the pandemic crisis unfolded into multiple dimensions that encroached several EU policy domains besides public health, with the single market at the top of the list. This enabled the Commission's intervention, justified both to keep the market functioning and to protect citizens against the new disease (von der Leyen, 2020b). Exploring the multidimensionality of the crisis, von der Leyen established a new Corona Response Team (CRT) in charge of coordinating the EU response to the pandemic by bringing together the different strands of action needed (medical sector, mobility and transport, and economy). Third, not only did the other EU institutions and MS endorse the idea that the Commission should coordinate crisis management, but they urged the Commission to do so: "[MS] stressed the need for a joint European approach and close coordination with the European Commission." (European Council, 2020).

As a result, after a low-profile start, the Commission steadily became proactively involved in all fronts of crisis management. Two proposals are specially telling of the importance of the Commission's activism. First, the EU vaccine strategy that included joint procurement of COVID-19 vaccines and the coordination of national vaccination campaigns. Although this endeavour was not without hurdles, it promoted a balanced vaccination campaign in MS and, importantly, prevented the escalation of “vaccine nationalism”, which could have jeopardized one of the most effective medical countermeasures to deal with the pandemic. The Commission was also involved in international efforts to guarantee fair and equitable access to COVID-19 treatments and vaccines worldwide (namely through COVAX).

Another milestone in crisis management is the Commission´s proposal for a recovery plan, dubbed Next Generation EU. Urged by the European Council to present a recovery plan to mitigate the economic effects of the pandemic, the Commission put forward an ambitious proposal (€bn750 in grants and loans) paired with a revamped proposal of the Multiannual Financial Framework. Although the level of ambition of the original Commission’s proposal was curtailed to accommodate divergent preferences of MS it was a clear sign that the EU was committed not to repeat the errors of the Eurozone crisis response. When fiscal policy indiscipline aired, the Commission swiftly decided to suspend the Eurozone’s fiscal rules. Finally, the Commission was mandated to issue public debt on behalf of the EU to fund Next Generation EU loans.

Actually, the idea of avoiding the mistakes of the Eurozone crisis was confirmed by the proactive attitude of the ECB. ECB’s President, Christine Lagarde, followed Draghi’s “whatever it takes” stance by announcing a bold Pandemic Emergency Purchase Programme (PEPP) that contributed to ease the reactions of the financial markets and to provide a buffer to economic policy accommodation of the crisis. The ECB was proactive since the learning effects of the Eurozone crisis were not disregarded. The ECB granted national governments the leeway to boost the fiscal deficit (as anticipated because of the substantial and sudden drop in GDP) and calmed down financial markets, signalling the political willingness to support MS as they would not bear rising interest rates on the public debt (Ladi and Tsarouhas 2020). The programme was reinforced twice (up to €bn1.850) with rising uncertainty as new strains of COVID-19 delayed economic recovery.

As normally happens in crisis situations, the European Council was the central and strategic political leader, particularly when more controversial, high-stakes, proposals were on the table. However, unlike other crises (such as the Eurozone or the migration crises), in which the effect of "summitization" (Dinan, 2018) (i.e., the proliferation of European Council summits and the massive media attention they attract) clearly outshined the performance of other EU institutions, this time the European Council took a back seat. This, however, does not change the fact that EU's response to crises is still in part shaped by intergovernmental bargaining. Hopefully, the proposals put forward to strengthen the EU crisis management capacity (resulting from the first balance of COVID-19 crisis management) might help Europe find what it is looking for. In the Commission's words:

> "[i]n light of the COVID-19 crisis and of the transition-led political agenda, it is clear that Europe needs to further strengthen its resilience and bounce forward, i.e., not only recover but emerge stronger by intensifying these transitions. The EU needs to draw lessons from the pandemic, anticipate future developments, and strike the right balance between the wellbeing of current and future generation." (European Commission, 2020, p. 6)

4. The actorness of the EU as crisis manager

As national authorities handed over the centripetal role of crisis management to EU institutions, two questions surface: (i) was there institutional re-calibration (sub-section 4.1), and (ii) to what extent did the reaction to the pandemic crisis impact the evolution of the EU (sub-section 4.2)?

4.1. Is there a new institutional balance?

The shift from the national level to the EU unfolds implications for each institution's position. This, in turn, might represent a new institutional balance.

The ECB's role in crisis management shows how proactive the institution was. The Commission played an important role in crisis management. The role of policy entrepreneur was maximised at unprecedented levels, restoring to this institution a political profile that was hardly recognised before. The Commission's proactive stance may be due to the fact that the institution had learnt the lessons of the Eurozone crisis. Both the Commission and the ECB quickly understood the challenges of the pandemic crisis and they resorted to the recent experience of the Eurozone crisis, where inertia extended the dramatic effects of the crisis.

To assess the actorness of the Commission, it is important to recall that public debt was issued at the EU level for the first time. The taboo over "Eurobonds" seems to have vanished amidst the COVID-19 crisis. Although the label does not appear in the official rhetoric, loans issued by the Commission inaugurated the federalisation of public debt in the EU (Costa Cabral 2021).

The European Council and the Council were the late comers. As before, their reaction was hampered by internal divergence, since not all MS accepted risk-sharing as part of the adjustment to the crisis. While internal discord delayed these institutions' decisions, the EU postponed important ingredients of the reform package designed to overcome the pandemic crisis. Stalemate was broken after a political initiative of the German chancellor and the French president, who announced discussions about an ambitious plan aiming at promoting economic recovery in the EU. As several times before, the key to melt cacophonous, self-centred discussions required a German-French initiative.

In the chessboard of the EU's institutional system, the ECB and the Commission represent supranational interests, while the European Council and the Council represent national interests. The most significant input for the accommodation to the pandemic crisis came from institutions representing supranational interests. The actorness of the ECB helped to strengthen its position within the institutional system of the EU, as happened with the Commission. Without putting into question the centrality of the European Council for the development of the EU, this institution lagged behind the ECB and the Commission. This seems to illustrate another step towards a discrete recalibration of the institutional system of the EU, where the institutions that represent supranational interests moved upwards at the expense of institutions that represent national interests (Schmidt, 2020).

The position of the EP does not affect our assessment. Notwithstanding, the parliament did speed up the approval of legislation that was crucial for managing the crisis that falls within the remit of the institution. Political monitoring through hearings also bears a neutral impact, although the EP showed how it paid close attention to possible distortions of citizens' fundamental rights.

4.2. The impact on the evolution of European integration

Did the move towards an EU-wide response to the pandemic crisis bear consequences for European integration? First, the recognition of the EU as the main actor in the mitigation of COVID-19 is significant as it shows how the EU came to play a prominent role. Second, the institutional re-calibration examined in sub-section 4.1 might also entail implications for European integration.

At one level, when MS finally realised that supranational crisis management was more reasonable than an inward, national response, they allowed room for a proper role for EU institutions. This is, to a certain extent, the recognition of how relevant the EU was. The preliminary assessment is the strengthening of the EU. Yet, the assessment deserves some qualifications.

On the one hand, European integration is not the outcome of a zero-sum game. European integration is about the interaction and close partnership between EU institutions and national authorities. If the latter decided to give way to the intervention of EU institutions, this can hardly be seen as a symptom of "more Europe" (and accordingly "less national level"). Crucially, bottom-up is the method that allows EU institutions to act on behalf of MS. The decision is the outcome of national authorities' perception that the supranational level is better equipped to provide efficient solutions.

On the other hand, the analysis casts doubt on whether the actorness of the EU means, per se, "more Europe" and "less national level". Indeed, context matters. The pandemic crisis was an unprecedented crisis for the exogeneous nature, symmetric effects, and multi-dimensional impacts (a sanitary crisis with many ramifications). After the early period of national reassurance, coherence spoke louder. The awareness of a different type of crisis, together with the growing potential of contagion and the death toll unwrapped a problem that moved beyond national borders and became a source of common concern. The theoretical underpinnings of joint action were triggered. It therefore seems exaggerated to postulate that "more Europe" is the consequence of the EU embracing the role of crisis manager. An alternative, somehow ambiguous reading, is to consider that Europe has been "failing forward" (Jones, Daniel Kelemen and Meunier, 2021).

Institutional re-calibration moves the chessboard to another level. Since institutions representing supranational interests became salient and institutions representing national interests lagged behind, the outcome apparently shows how EU interests played high. Perhaps this change of relative forces brings a different picture to European integration, where institutions acting on behalf of the EU became prominent while institutions speaking on behalf of national interests were struck by inertia. If the interpretation holds, institutional re-calibration depicts an EU with a stronger input from institutions that represent supranational interests, which in turn moves the pendulum of the EU towards the supranational pole.

This, however, is a partial picture. First, it replicates events that encapsulate a single episode. If the larger picture of European integration is envisaged, conclusions are somewhat different. At best, the relevance of institutions representing supranational interests reproduces a modest enhancement of the supranational nature of the EU. Institutional dynamics outside the context of the pandemic crisis leaves things as they were before. Notwithstanding, one might ask whether the innovations brought by crisis management at the EU level signal a precedent for future developments that reinforce the supranational nature of the EU. Such a speculative exercise is beyond the reach of this chapter.

Second, the assessment of institutional re-calibration must be settled within the impact of the pandemic crisis on the EU as an actor on its own. As mentioned before, the centripetal role of EU institutions does not bear the immediate recognition of "more Europe". Both dimensions interact, as the impact of the pandemic crisis on the EU and the institutional re-calibration are aligned. While institutional re-calibration might be seen as a symptom of "more Europe" (with the qualifications of the previous paragraphs), when it is combined with the impact of the crisis on the role of the EU the conclusions are not as clear. Even though a moderate increase in the role of the EU and of institutions that represent supranational interests gives the impression of a strengthening of European integration, the bigger picture – a comprehensive analysis of European integration on an inter-temporal dimension – casts shadows on that conclusion.

A cynical conclusion would forge the following question: what if the resort to EU institutions, and the actorness of the EU as a proper crisis manager, was an opportunistic move of national authorities? The question opens up to a range of alternative research avenues (outside the reach of this chapter). Nonetheless, the hypothesis unveils the "business as usual" scenario: the EU is instrumental to national interests, as MS resort to EU institutions' action when they reckon that joint action outweighs the costs and benefits of unilateral, nation-based action (Bressanelli, Koop and Reh, 2020). Such is perhaps the rationale of European integration. Maybe, it fails to consider the spill over effect of institutionalisation.

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"FlexEurope": Ten Years of Change in the Economic Policy of the European Union

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Abstract: The building of the European Union must be understood as a dynamic process in which a single objective – to unify European countries through the economy – has been developing in highly changing economic environments for over six decades. During that time the European Union has been shaken by far-reaching economic changes,

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such as the one suffered by the international monetary system; global economic crises, such as oil shocks or the global financial crisis. It has also overcome economic paradigms; first Keynesianism and then neoliberalism. Despite all of these events, the project has remained afloat and the European Union has managed to adapt and transform itself, not without making crucial mistakes. Over the past ten years, a new European Union is taking shape in terms of economic policy, replacing rigidity with flexibility. This is the new Europe: “FlexEurope”.

Keywords: European Union, FlexEurope, Fiscal Policy, Monetary Policy

1. From the Treaty of Rome to the Economic and Monetary Union

Any law that seeks to regulate the economy and economic policy is always a child of its time. When the Treaty of Rome was signed on 25 March 1957, launching the most important process of peaceful unification in the history of Europe, Article 2 of the treaty highlighted the economic concerns of the time; namely, to achieve rapid, harmonious and stable economic growth, and thereby improve the quality of life of its citizens. For this purpose, in Article 3 the signatory countries focused their efforts on avoiding or mitigating any national policies – mostly fiscal and regulatory – which might limit free trade, mobility and competition, and they set out to define a common agricultural policy, a European Social Fund and a European Investment Bank as instruments to offset the possible harmful effects of these measures.

From today’s perspective, it is almost incredible that a treaty whose ultimate objective was to promote international trade failed to provide clear guidelines on foreign exchange and monetary issues. However, the treaty was consistent with an international economic environment in which the exchange rate stability set by the Bretton Woods system prevailed, based on currency parity with the convertible dollar and strict control of capital flows. Bretton Woods made it unnecessary to set targets in these areas.

The Nixon administration ended dollar convertibility in 1971, leaving the global monetary system without the indirect gold standard created in Bretton Woods and triggering exchange rate instability that would eventually become the main obstacle to the development of the European Common Market. The first efforts to take control of the situation sought to create a European club of currency stability – the "snake in the tunnel" system created in 1972 – a "dirty" floating system between the currencies themselves and against the dollar, allowing for a narrow margin of fluctuation (Wittich & Shiratori,1973). Some currencies left the system as a result of the instability caused by the oil shocks of 1973, and the attempt failed.

Faced with the inability of the European partners to maintain stable exchange rates against the dollar, in 1978 the EEC modified its objective, abandoning the idea of exchange rate stability against the dollar and targeting only internal exchange rate stability, i.e. between European currencies only. This is how the European Monetary System was born, with a unit of account, the European Currency Unit, whose value was given by the weighted average of the value of the currencies that formed part of the EMS, and including a mechanism that anchored currency values to that of the ECU within a narrow band of fluctuation, the so-called European Exchange Rate Mechanism (ERM). The creation of the EMS meant that the Dollar was no longer the monetary reference and transferred this reference to the German mark, so that it was the Bundesbank that would largely govern monetary matters in Europe until 2012 (Riemer, 1993; Alessi, 2013).

Internal exchange rate instability did not end after the EMS was founded. The limits of the band of fluctuation were modified depending on the circumstances, until they became unrecognizable (± 15%)[1]. The Delors Committee was then appointed in 1988 to lay down the steps required to achieve the European Monetary Union. The committee issued its report in 1989 (the European Commission, 1989) and the Treaty of Maastricht was signed on 7 February 1992, in which European structures were adapted

[1] It is important to highlight the problems that may come out of setting a band of fluctuation of ±15% for international trade. It means that export prices may fluctuate up to 30% due to fluctuations in the currency's exchange rate.

to the monetary union. The weakness of the EMS became clear when, on 6 September 1992, known as "Black Wednesday" (Roberts et al., 2017), a downward speculative attack against the pound took the British currency out of the EMS. Currency instability was the new reality and only a single currency could put an end to it and guarantee that the single market would function. This is how Europe moved from the Treaty of Rome – where monetary issues were absent – to the Treaty of Maastricht, whose fundamental element was monetary affairs.

The basic architecture of the system designed in Maastricht mirrored the prevailing ideas of the time (Hierro et al., 2021) and the new Europe featured the following: first, a financial system based on absolute freedom of capital movements (art. 63 TFEU); second, a single currency with an independent monetary authority (art. 130 TFEU), the European System of Central Banks whose fundamental institution is the European Central Bank (art. 128 TFEU), and which would maintain a single monetary objective – control over inflation (art. 127.1 TFEU); and third, as a consequence of the above, a total ban on financing member states by the ECB (art. 123 TFEU) and by the common budget (art. 125 TFEU), as well as strict control over member state budget stability (art. 126 TFEU). One further aspect should be added, which was apparently technical, but was of fundamental importance for the crises that would later come: the absence of a specific mandate of banking supervision for the ECB (art. 127.5 TFEU) and, consequently, each member state's responsibility for solving its banking crises. In 1999, the euro was launched and began to circulate physically at the beginning of 2001.

From 1999 to 2008, economic growth allowed the system to function as designed to do. Member States evidenced no major divergences in macroeconomic terms and no fiscal problems. For its part, the ECB behaved as designed to do, controlling the liquidity of the system by setting the interest rate, applying contractionary policies when faced with any problem that might jeopardise the inflation target.

The first problem emerged with the 2008 global financial crisis. The initial reaction was a countercyclical fiscal policy, reflected in the 2009 and 2010 budgets, which agreed at the international level during the G-20 Summit in Washington in December 2008, and set out in point 7 of the Agreement (G20, 2008). However, the EU soon signalled that it would be taking the opposite direction and, in May 2009, it approved a strict rule for calculating the deficit and debt to apply the excessive deficit procedure (art. 126 TFEU and Protocol no. 12). In 2010, the countries that had championed fiscal austerity demanded compliance with the treaty vis-à-vis budget stability, and while the Federal Reserve (FED) began quantitative easing, the ECB maintained monetary policy strictly separated from fiscal policy (Borrallo & Hierro, 2019; Hierro et al., 2019). From that point on, the flaw in the EU's design would be confirmed.

2. 2010-2013. The consequences of "StrictEurope"

The events from 2010 onwards brought down the pillars on which the euro had been built. One of the design flaws in the monetary union was to separate the responsibility of supervising banks from the capacity to create money, such that supervision and resolution of financial entities remained in the hands of member states. These states lacked the capacity to cover bank losses with money creation and had to bail out banks and guarantee deposits with tax revenues or debt issuance. The most striking case was Ireland, which was forced to set up a general bank guarantee of €440 billion (Eichengreen, 2015). The result was that any banking crisis was transmitted directly to the public budget and became a sovereign debt crisis if the country was subject to liquidity restrictions in the bond market. Furthermore, a second design flaw was that the treaty prevented the ECB from financing member states, such that sovereign debt was left at the mercy of financial speculation, leading to sovereign debt crises. This is how the euro crisis, which began in 2010 and did not end until August 2012, was triggered. This crisis jeopardised the euro's very survival (Hierro et al., 2021).

The initial official narrative of the euro crisis, based on the prevailing orthodoxy and the literal interpretation of the treaties, blamed the debt crisis on the lack of compliance with the Stability and Growth Pact (SGP) rules

(Comman, 2017). Central European countries, led by the German finance minister Wolfgang Schäuble, were reluctant to provide financial assistance, alleging moral hazard and the very configuration of the Treaty of the Union itself. In early 2010, downward speculation in other countries' sovereign debt markets intensified, creating a dichotomous vision of the EU that materialised into widespread use of the term PIGS, which blamed the weaknesses of the euro on peripheral countries, which suffered major budgetary and economic imbalances (Schäuble, 2011, Brazys & Hardiman, 2015).

The risk of Greece immediately defaulting, coupled with pressures on the Irish, Portuguese and Spanish debt markets, led to the creation of the European Financial Stability Facility (EFSF) and the European Semester in May 2010, with the ECB timidly joining the solution with the Securities Market Programme (SMP), through which it would purchase public debt securities in unspecified amounts in the secondary market (Hierro et al, 2019). It was of course made clear that intervention in the debt market was aimed at safeguarding financial stability.

The EU stuck to its narrative that attributed the sovereign debt crisis to the economic imbalances which the countries affected were dragging, and it created the Macroeconomic Imbalance Procedure (MIP), an instrument in theory designed to prevent and correct macroeconomic imbalances and which included an early warning mechanism and a procedure for dealing with excessive imbalances. However, the MIP has always been criticised for its inability to provide effective early warning (Moschella, 2014) or for the variables included therein (Koll & Watt, 2022) and it has never had the intended relevance, although it did offer the basis for the discourse at the time.

In autumn 2011 the crisis changed yet again, with the sovereign debt crisis taking the form of a potential new banking crisis. The reason lay in the decision to impose heavy loss on private creditors in Greece's second bailout. This situation worsened expectations about the solvency of creditor banks, thus establishing a vicious circle between sovereign and banking crises (Micossi, 2015). The ECB's Longer Term Refinancing Operations (LTRO) also contributed to this, as banks embarked on carry trade operations using this new liquidity to buy sovereign bonds, thus reinforcing the sovereign-bank nexus (Mody & Nedeljkovic, 2019).

Diving deeper into its perspective of the December 2011 crisis, the EU embarked on a set of economic governance measures (Six-Pack) to guarantee supervision of member states' budgetary policies and to correct the so-called "excessive deficit". Faced with the prospect of a likely collapse of the euro area, in February 2012 the EFSF gave way to a permanent institution – the European Stability Mechanism (ESM) – and in March 2012 the Stability, Coordination and Governance Treaty (SCGT) was signed in the Economic and Monetary Union, forcing countries to include a balanced budget rule in their legal system.

The action taken during this first period of the crisis not only failed to bring it to an end, but actually made it worse. The EFSF imposed a procyclical economic policy on countries that had been bailed out (Greece, Ireland, Portugal, Cyprus and, partially, Spain), consisting of fiscal adjustment programmes and labour market liberalisation. The result was a contraction in aggregate demand that, as expected (Palley, 2010), intensified deflationary pressures and deepened the recession (De Grauwe, 2014), while financial markets questioned whether economic growth compatible with debt repayment would be generated in the countries affected (Bowley, 2010), and with the asymmetric distribution of the costs of macroeconomic adjustment worsening (Vermeiren & Steinberg, 2016).

The ineffectiveness of the economic policy that had been applied for two years and the pressure on Spanish and Italian debt led Mario Draghi to finally announce, in August 2012, ECB intervention in an effort to put an end to downward speculation and the sovereign debt crisis. In early September 2012, the Outright Monetary Transactions (OMT) programme was approved. Through this programme the ECB would purchase unlimited sovereign bonds from countries affected by a bailout programme. The OMT was never applied and managed to solve the sovereign debt crisis by merely being announced. This was because the OMT meant that the ECB formally assumed something which, in a strict interpretation, was prohibited by the treaty: the role of lender of last resort for countries in crisis. Through its success, the OMT certified that the problem of the sovereign debt crisis had been the result of a faulty design of the ECB's role stemming from the Treaty of Maastricht, and which prevented it from acting as lender of last resort, thereby leaving states vulnerable in debt markets (Hierro et al., 2019). The EU had taken the first step to remove the mistakes inherent to the design of the ECB's roles. Even so, the error persisted, and in 2013 the so-called Two Pack was approved, reinforcing budgetary control measures. Three years of self-inflicted economic crisis had not been enough for the EU, although it was for its partner, the IMF who, in 2013 through its chief economist, Oliver Blanchard, recognised the failure of its economic approaches by acknowledging that it has made a mistake estimating the fiscal multipliers for Greece's rescue programme (Blanchard & Leigh, 2013). The EU made no such acknowledgement until 2019 when, in a solemn session in the European Parliament on the occasion of the 20th anniversary of the euro (01/15/2019), European Commission President Jean-Claude Juncker apologised to Greece for having imposed the austerity programme.

3. 2015-2022. The new conception of the ECB's role and new fiscal policy

Although the OMT solved the sovereign debt crisis, it was never applied, and article 123 of the TFEU was not touched. However, that very summer, the EU began working on European banking supervision, to reinforce the ECB's responsibilities in the Single Supervisory Mechanism in 2013 and create the Single Resolution Mechanism and a Single Resolution Fund in 2014. The EU assumed that member states could not solve banking crises through their budgets and that certain financial institutions were large enough to contaminate not only their domestic economies but also the rest of the EU. Solving banking crises became the responsibility of the ECB, which assumed the mandate to supervise through an interposed body.

The definitive change in terms of monetary policy came in 2015 when the ECB embarked on a quantitative easing programme, five years after the US FED. Deflationary pressures, weak growth, increasing asymmetries and the risk of a relapse meant that mistrust in the euro as a common currency, and in the EU as a viable project, persisted. Euroscepticism grew in member states. The EU had to make a move, and it did so through a radical change in its monetary policy by implementing a quantitative easing programme, the Expanded Asset Purchase Programme (PAPP). The launch of the Public Sector Purchase Programme (PSPP) within the quantitative easing programme was the first real step towards making the EU's economic project for monetary policy more flexible. The ECB was finally able to circumvent the limitations of article 123 of the TFEU regarding the ban on financing member states and took on the role of lender of last resort through the secondary market. The more orthodox wing of European economic policy fought against the PSPP. The German Federal Constitutional Court even ruled against the programme because of its failure to satisfy the principle of proportionality when implementing monetary policy and because it exceeded the ECB mandate (BVerfG, 2020). However, the ECB, as a European institution, was not deemed to be subject to the resolutions of any member state court (CJEU, 2020) and the ECB's public debt purchase programme went ahead and was finally supported by the Court of Justice of the European Union (CJEU, 2018).

Finally, another change concerned how the ECB's objective of price stability was designed. Initially, the objective set by the Governing Council of the ECB was to maintain a year-on-year increase in the HICP below 2% in the medium term (ECB, 1998) and, although in 2003 the Governing Council updated the objective and set it below but close to 2% (ECB, 2003), in 2020 the ECB carried out a strategic review that considers deviations above or below the 2% target equally undesirable. It will, nevertheless, allow a transitory period of inflation above the target to avoid deflationary pressures during periods in which the economy lies within the "effective lower bound" (ECB, 2021).

Economic recovery between 2015-2019 led to relaxation in the economic but not in the political situation, the severity of which increased due to the EU's deteriorating image. The damage to the EU caused by many years of mistakes had already been done (Hierro et al., 2021) and was manifested in a singular but traumatic event: following a referendum, the United Kingdom voted to leave the EU. For the first time, a country was to leave this select economic club and lead the way for those who felt oppressed by the EU. What had once been averted in Greece could not be averted in the United Kingdom.

When the COVID-19 pandemic began in 2020, the ECB, albeit not without hesitation (Hierro et al., 2021), quickly deployed its full arsenal, activating a new extraordinary public debt purchase programme (Pandemic Emergency Purchase Programme). The programme provided for greater flexibility in the composition of the debt acquired in order to avoid asymmetries in the risk premia, allowing deviations from the limit set by the capital subscription of national central banks. Art. 123 of the TFEU had finally been laid to rest.

However, the main shift in European economic policy during this crisis had been on the fiscal front. In March 2020, the European Commission suspended the fiscal rules of the Stability and Growth Pact, activating the general escape clause included in articles 5(1), 6(3), 9(1) and 10(3) of Regulation (EC) No 1466/97 and articles 3(5) and 5(2) of Regulation (EC) No 1467/97. In this regard, it must be remembered that in the previous crisis, rather than activating the escape clause, steps were taken in the opposite direction to reinforce compliance with the excessive deficit procedure. Second, the Support to mitigate Unemployment Risks in an Emergency (SURE) programme was launched. It was aimed at providing loans to member states to finance expenditure related to unemployment benefits and short-time work schemes. It was financed by debt issued by the European Commission. Once again, art 125 of the TFEU had been laid to rest.

Despite all these measures, the main innovation in the fiscal field has been the creation of the Resilience and Recovery Facility (RRF), a fiscal instrument at the European level designed to fund member state spending and investment programmes, especially in sustainability as well as green and digital transition. This programme, endowed with €723,800 million, is financed by debt issued by the European Commission and is made up of grants (€338,000 million) and loans (€385,800 million) to member states. Allocation of the funds has a redistributive component between member states, favouring lower income countries and those most hard hit by the pandemic. This instrument is the latest example of the new conception of economic policy, since the EU contravenes article 125 of the TFEU – the non-bailout clause – which prevents member countries from assuming debt from other member countries, and it finally crosses the last Rubicon that protected StrictEurope.

The economic crises of demand have proved the impracticality of the fiscal rules stemming from the Treaty of Maastricht and its subsequent restrictive developments. On the one hand, high levels of debt in many countries make it impossible to apply the fiscal adjustments required by the rules without causing economic crises such as those triggered by the Euro crisis (Hierro et al., 2021). On the other hand, the design of these rules, using unobservable variables such as structural deficit (see Barnes & Oliinyk, 2021), has resulted in misguided calculations and forecasts. In addition, changes in monetary policy and the milieu of low interest rates it creates make higher levels of debt sustainable. Together with other reasons, these led the European Commission to launch a process to change EU budget rules in February 2020, just before the start of the pandemic. This process is still under discussion and will determine how much of the original fiscal design of the Treaty of Maastricht will remain alive.

4. The conclusion: "FlexEurope" is born

On 7 February 1992, the Treaty of Maastricht was signed. Thirty years later, after two global economic crises and a European crisis, the economic environment has changed completely and the economic foundations on which monetary union was built are no longer valid. Many of these foundations were included literally in the treaties and are almost impossible to reform, since it would require unanimous agreement. This situation, which lead Europe to a dead end, has had the EU follow in a new path aimed at adapting itself to these changes without having to modify the treaties: forcing them to be interpreted in order to adjust praxis to reality, regardless of how literal the rules might be. The European project has risen above its own rules, and "FlexEurope" is born.

Adopting the view of Gelfand et al. (2011) on the distinction between rigid and flexible cultures, what has happened in the 30 years since Maastricht is that European economic governance has gone from being guided by a culturally rigid vision (many strict norms and low tolerance of deviant behaviour) to a culturally flexible vision (weak social norms and a high tolerance of deviant behaviour), resulting in a new malleable and adaptable Europe, which allows the project to sail on despite the disruptions over the past 15 years.

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Paradigm and Crisis of the European Union. Waiting for Godot or the Revolution to Come.

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Abstract: Crises are linked to the impossibility of an everlasting paradigm – its bildung sustained over its past achievements. However, the shift to a new paradigm that is not preceded by a revolutionary period in the Kuhnian sense does not resolve a crisis. The history of the EU is made of cyclical crises intertwined with the reshuffling of its economic paradigm (avoiding the revolution). This increases the enchainment of anomalies that have to be mopped up. What does this mean considering the critical limits and the vulnerability of the EU in political integration? The answer to this interrogation must overcome the economic dogma to lay down a European cosmopolitical community.

Keywords: cosmopolitics, crisis, paradigm, anomaly, sovereignty

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1. Paradigm and crisis cycles

From the treaty of Paris that established the European Coal and Steel Community (ECSC) in 1951, bringing together West Germany, France, Italy and the Benelux countries, to the dawn of the twenty-first century, the successive waves that set up and consolidate the European Union are frequently considered as the unfolding of a utopian project made possible by the alliance of some visionary men. Yet, the principle of action of the founding fathers of the European Union was above all realistic. Their goal was to heal the wounds of terrible devastation and to supersede a crippled economy and its industries through concrete achievements, a wish that all sides who fought on the European soil shared[1].

The founding fathers were convinced that a step-by-step program was the only possibility to deter future wars and to trigger a 'chain reaction' [2] towards a wider economic and – to some extent – social integration. They knew that the institutional corollary of the project could not be the construction of a European identity or the political unification dreamed by the federalists, such as the visionary Alfiero Spinelli[3]. The default option was to build partial integration, based on *de facto* solidarity between the six states to reinforce democracy. A more complete union was not in the immediate interest of all nations, particularly France. The European Defence Community was a move that implied a broader integration and was going to falter in the French

[1] This does not mean that there was not a strong underlying ethical *nous* in the founding fathers' action. They did apply to the realm of values and sometimes with fervent optimism as seen in Robert Schuman's declaration (May 9, 1950) that war (between France and Germany) would not become 'merely unthinkable, but materially impossible'. They had to conform to the political limitations of their time.

[2] The incomplete nature of the integration and the supranational function, limited to some economic, bureaucratic and technical areas, was thought by Monnet as a paradoxical way to lead the countries to gradual enlargement of the scope of the European project (Spolaore, 2015).

[3] Spinelli spent years in Mussolini's jails and was a fierce supporter of the ESC, better known by the French abbreviation CED (*Communauté européenne de défense*).

Assemblée Nationale[4] in 1954, exposing dissent over the future of Europe. This failure opened the door to the expansion and dominance of NATO under the leadership of the United States.

The ECSC is thus not the first step towards a supranational state in the Kantian sense (let us also not forget that it had an expiration date), although the European Union did embrace a monetary union and several traits common to federal systems, such as the European Parliament, the Court of Justice of the European Union, and symbols of statehood have always been present in the history of its evolution. Since the EU is by no means a State and does not have real geopolitical weight, it is exposed and is vulnerable to multiple crises linked to the global 'relational space'. The network of self-interested sovereignties that constitute the EU lacks resilience as reflected by the sub-prime hecatomb. In 2008, with Northern Europeans refusing to allow their economies to be touched for rescuing Southern countries, it was evident that *de facto* solidarity between its members was not an *acquis*, but only one of several symbolic or abstract praised principles.

1.1. The ideas of anomaly, crisis and revolution

Crises are not negative *per se*. To better understand their role, let us apply analogically T. S. Kuhn's epistemology[5]. According to the author of *The Structure of Scientific Revolutions,* all scientific disciplines imply the establishment of a paradigm whose acceptance represents the emergence of a new tradition aggregating scientists to form a community[6].The notion of paradigm can be summed up as a set or constellation of main and auxiliary theories, concepts, exemplary experiments, past achievements, values and beliefs that lay the grounds for further practice by a scientific community. It is a sort of disciplinary matrix and that includes "law, theory, application, and

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[4] The lower house of the parliament under the French Fourth Republic (dissolved in 1958).

[5] For the sake of clarification, here is not the place to discuss Kuhn's theory. We only intend to explain the importance of these concepts in their original meaning for our work. For several critical perspectives see Lakatos and Musgrave (1970).

[6] Which means 'an enduring group of adherents'(Kuhn, 1970, p. 10).

instrumentation together" (Kuhn, 1970, p. 10). All the cumulative scientific problem-solving activities, firmly based on the models of the accepted paradigm, are called by Kuhn 'normal science', the *longue durée* period.

The purpose of the scientist is not to test the paradigm (refutation or confirmation), because its preservation allows for more sustained knowledge (in this sense there is development or continuity). Consequently, 'normal science' tends to represent a conservative shift. The scientific community is only committed to solving *puzzles* (Kuhn's terminology for problems) that remain open under the prevailing paradigm[7].

There is a kind of *imitatio* in the scientific production that is strongly based on a previous articulated body of solutions and on the community authority, both explained in scientific textbooks[8]. However, with the progress of research within 'normal science' there will always be *puzzles* that resist being solved, the *juxtaposition* paradigm/nature being impossible. At first, this will be considered an anomaly rather than a weakening of the paradigm. So, scientist's work consists also of what Kuhn calls mopping up operations ('cleaning up' anomalies). Although very persistent ones, touching vital parts of the paradigm, or an accumulation of them will inexorably open a period of crisis. The idea of crisis is therefore linked to the concept of anomaly[9]. A crisis is a failure in the continuity of mopping up activities, because our expectations concerning how the world displays itself and the effectiveness of our theories and technology will inevitably change. If we cannot reshuffle the paradigm, we no longer believe in the future under the same guidance. The crisis is thus the *intensification* and severity

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[7] Only the problems recognized as part of the tradition and scientifically admitted by the community which encourages scientists to undertake them are considered to be puzzles. This means they're expected to be solved and there are steps and rules that must be met in all scientific fields.

[8] These textbooks represent a kind of booklet for scientist education, the pedagogical path contributing to the homogenization of scientists.

[9] An anomaly can be displayed in multiple ways: either as persistent unsolved problems, new problems as a consequence of new empirical evidence at the disposal of the community, problems that may need urgent solutions due to external reasons to science or achievements in certain fields that can destabilize other scientific fields.

of anomalies that affect and *awaken* the entire community to the fragility of the paradigm[10]. This triggers a debate about the fundamentals and the crisis plays hence a key role in the end of the 'normal science' period.

In Kuhn's explanatory model, scientific revolutions (in analogy with political revolutions that overturn older institutions) come after a crisis that the paradigm could not surpass. These revolutions are periods of discontinuity (it does not work by accumulation of new theories over older ones, but by replacement), of a certain creative chaos, a lack of consensus due to the downfall of the paradigm and consequently overlapping and competing new theories. Inevitably, this will open the way to a new paradigm[11]. This is not a logical shift based on strictly objective reasons – a wide persuasion underlines the establishment of a new paradigm concomitant to the demise of the older one.

According to Kuhn, there is incommensurability between paradigms, compatibility between them is impossible and the process of substitution is irreversible. The change implies a different worldview (scientists have to deal with a *gestalt switch* [12]) and a redefinition in science itself (data, meanings, etc.). In the historical development of science, we can thus register successive cycles of continuity and discontinuity, namely of 'normal science' (the establishment of a paradigm in a community), crises (but not necessarily), scientific revolutions, again 'normal science' (with a paradigm shift), and so on.

1.2. Paradigms and milestones of the European Union

How is this useful for understanding the milestones and the future of the European Union? I see the European Union history under this analogy

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[10] While the anomalies continue to be mopped up, only some scientists may be affected by them, not the entire community.

[11] Which does not, necessarily, mean a conflict. The discovery of new phenomena (a new aspect of nature which was previously unpredictable) that the old paradigm cannot handle demands new concepts, which can be enough to trigger a revolution.

[12] What were ducks under the old paradigm will be rabbits in the new one (Kuhn, 1970, p. 114).

as divided into three periods of *normal Bildung* [13]. The first phase goes from the foundation of the ECSC to the 1980s, the second from the single market to monetary integration and the third amounts to the 21st century.

In a way, the founding fathers of the ECSC designed a progressive integration, step by step. It represents the first period of the EU with the constitution of a small community of states, linking winners and losers of the war (the UK refused to join), working under the same paradigm, dedicated to solving *puzzles* of policies and institutions in economic and technical areas related to coal, steel and trade. The disciplinary matrix here is denoted by the principles of supranationalism, limited by intergovernmentalism, and of solidarity against breakdowns or external destabilization, thereby strengthening democracy through sustained economic growth[14]. However, it was clear from the beginning that the final stage of the process represented an anomaly, because it was uncertain and divisive for the *intelligentsia* in European countries what would be its nature. The United Nations of Europe? What dialectical bridges between national sovereignty and political integration had to be built? At the level of the nation states, there are still no signs of more cultural, social or political convergence, but the six members are relatively homogenous. This anomaly in terms of finality has been mopped up for the time being and the early federalists were superseded by the straightforward technical puzzle-solving activity[15]. Many puzzles required solutions in order to create a mature Union (community in this case)[16].

The outlook *Towards a Federal Government of Europe* [17] was not a threat to the ECSC paradigm nor a chimera, considering all the work that still had

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[13] In the sense of the activity to build together spirit and form. It corresponds to the 'normal science' described above.

[14] The principle of supranationalism was not submitted to a European referendum, only national parliaments were involved.

[15] The final stage was avoided, but it could still be frozen as a promise for future *puzzle*-solving. The idea of 'chain reaction' was in a way a form of mopping up this anomaly with an optimistic confidence in its future solution.

[16] It should not be forgotten that the Americans had a word to say in this foundational period and were concerned by the anti-trust measures targeting the Ruhr industries.

[17] See the Bulletin from the European Community for coal and steel (October, 1954).

to be done. Consequently, the kernel of this Europe was fundamentally trade. The first stage of *normal* activity was included in the supranational community, but its members act more as a club without great divergent interests – their economic systems are more or less similar and the economic reconstruction of Europe allows for flexibility in competition. The creation of the common coal and steel market was the solution to the rational distribution of production and to putting an end to trusts in these industries.

The Treaty of Rome in 1957 and the Merger Treaty in 1967 were further steps towards the improvement of the same paradigm still relying on the economic strengths of the members of the club for steady economic growth. Social policy was limited to a broader sense of development of the employment, the creation of a structural fund and of welfare directed to the lowest paying workers of the mine industry.

The European Economic Community (EEC) faced protectionism and could not further implement the free movement of goods. The supranational ideal and, later, the Common Agricultural policy were a source of discord – for instance, France wanted to reduce the power of the High Authority. De Gaulle, a main adversary of a broader European sovereignty, imposes in 1966 a veto when national interest is at stake. And until the end of his presidency, the European parliament will not have an electoral system in place. The 1960s is also when other countries were applying to be part of the adventure. Several periods of expansion will occur after 1973, triggering the 'chain reaction' ideal. The European project, despite its crises, seems destined to succeed and the EEC becomes a larger international actor than the ECSC (Mourlon-Druol, 2012, p. 2).

Realignment of the paradigm appears in the middle of the 1980s, without any transitory revolution. It corresponded mainly to a breaking wave of change at nation-state level in terms of economic orientation[18]. It was the decade of a policy shift to the free market, global competition, internationalisation of capital, private property, and massive global deregulation extended to commodities, which were traditionally protected.

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[18] Mitterrand's France will not be an exception.

Those were the years of the 'implacable' tandem Reagan-Thatcher. The Common Market became the Single Market under the Single European Act (1986). This represents a reconfiguration of the market economy of the ECSC [19], based on free trade and stabilisation of prices, into a fully capitalistic market with its dogmas[20]. The nature of the political approach to the European community changes deeply, favouring the north of Europe to the detriment of the south (all recent members except Italy) – the promise of 'All Market'.

Central and Eastern European borders open up to the West (East Germany ceases to exist, reunified with West Germany) at the close of the decade and this wave will also conquer these countries, with new markets open to Western multinationals. There is collusion between the European project, the global neoliberalism and the institutions (WTO [21], IMF) that veil to its dominance and are at the service of the richest and so-called most developed countries. The end of the Cold War is thus perceived as the victory of globalised capitalism.

The European Community results from this externally sourced anomaly which is determinant for the new focus of the paradigm[22]. But Europe is then already more heterogeneous, suffering a financial crisis and a war in the dismembered Yugoslavia. Notwithstanding, the economic paradigm is again reshuffled and the Maastricht (1992) and Amsterdam (1997) treaties bring with them the European citizenship, the application of Schengen and a convergence in foreign and security affairs, but also the creation of the Economic Monetary Union and the autonomous European Central Bank – independent of political scrutiny (Lipietz, 1993). Had it not failed, the Multilateral Agreement on Investment would have been a step further in trade

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[19] This was still the leitmotif of the Barre governments at the end of the 1970s (12th, 13th and 14th governments of the Fifth French Republic).

[20] See Schäuble's intervention to the *Annual German Symposium* at the London School of Economics (2016).

[21] The WTO dismantled mechanisms of regulation in 1994, which represent a step benefiting multinationals.

[22] At the same time, it is also an internal anomaly because the EEC is still an association of sovereign states. The states bring their own ideologies from scratch.

liberalisation and its legal framework at the OECD level[23]. All of this will depict a paradigm shift. The new disciplinary matrix will focus strongly on free competition as imposed by the elites governing the European institutions.

The third period represents, therefore, a more significant paradigm shift in the history of the European Union, though without any sign of revolution and with an extreme mopping up activity. Besides the fact that Denmark refused the Maastricht Treaty by referendum held, the Treaty was still implemented to pave the way for the Monetary Union, as well as to allow the enactment of the Euro. It marked the turn of the financial Europe with the rules soon dictated by the Troïka (European Commission, ECB, IMF (an external institution)).

The principle of solidarity is now mediated by financial markets that control sovereign debt. The disciplinary matrix will take the form of a European Stability Mechanism, which is the establishment of a fake financial federalism with the marginalisation of politics. This is paradoxical since the Euro is also a half-hearted political project. It has political implications due to the fact that it does reflect a neoliberal restructuration of the labour market (with collateral social dumping), and does not entail a real European budget capable of reinforcing the principle of solidarity; instead, it forces free competition between states with huge differences in productivity, wages, taxation levels, and entails salary depreciation to address internal and external competition[24].

2. The paradigm shift of the EU and its anomalies

After the Soviet Union collapsed, peace faded as a major principle. The enlargement of the European Union in 2004 contributed to a further

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[23] The GATS and the TTIP are other instruments of such liberalization. Renato Ruggiero, General-Director of the WTO, described the MAI agreement as follows: “We are writing the Constitution of a unified world economy.” (Wallach, 1998, p. 22).

[24] As stated by Beckfield, the paradigm implied changes in several countries’ welfare state. In concomitance with more integration, it increased inequality (Beckfield, 2006).

step in the heterogeneity of the EU and granted the success of the German *hinterland.* It also represents a shift towards the 'new' German ordoliberalism: the market stretched as much as possible and state intervention is negative, limited to the strictly essential, i.e. within the rules granting full autonomy to the market. As such the consequences of the international financial crisis (also a crisis of the Euro) caused social and economic disaster in several Eurozone countries[25]. The EU's reaction to the subprime crisis appears as obstinacy to save the ordoliberal economic paradigm[26] – the dogma of market effectiveness means that the theoretical potentials of the free market are not yet fully explored as if its rationality were unlimited, which is not reasonable[27].

The possibility of a new crisis breaking out is thus present, with evident systemic risks, because no revolution took place in between the paradigm shift. Each new crisis was mostly faced by commensurability with previous solutions, propelling governments to dig further to disguise anomalies[28]. The Lisbon Treaty provides the legal framework of the present Union which is dominated by its most competitive sovereign member, Germany, and the imposition of the 'governance by the rules' (the Stability and Growth Pact and the Fiscal Stability Treaty).

2.1. Four anomalies

The European Union and its pillars are not a science and as such are not exactly determined by Kuhn's cycles. If in his perspective scientists cannot contain the anomalies forever, nor can they work under the same paradigm after it has failed, and are thus brought to a period of non-paradigmatic revolution, the crisis that affects and affected the European Union could only

[25] See the 2011 projections of the French Observatory of Economic Conjunctures.

[26] The performative contradiction played by Syriza in confrontation with that obstinacy is an astonishing example.

[27] The distinction between rational/reasonable is proliferous. See Rawls (1999).

[28] The paradigm incommensurability is the critical and most contested point of Kuhn's theory.

deflect the paradigm. The community (the European political and economic elites with their interests) sustained the same sacred 'textbooks' during the crisis[29]. Still, the following anomalies that I will detail hereafter are too persistent to not imply a revolution[30].

A) Nation states are still part of the problem. It is even more complex if we consider the multipolar nature of the world today. Multiple networks of interest intercept at the international level, new identities conflict and balances of power are redefined. Is there an emerging European identity? Until the third period, this question had no substantial urgency. However, the contentiousness involving Hungary and Poland, with serious dissent in the union, and the way Brexit took place, demonstrate that ignoring the *puzzle* of identity will trigger shocks[31].

The issue is increasingly relevant considering the democratic dimension (at least its need) of the European construction and a shared meaning of the European ideal (not) conceived by its paradigm – not only in economic terms, but also in social, ethical, cultural, scientific and geographical terms. Europe faces a crisis interrelated to all these terms. It is certain that this identity cannot be based on historical links between Union members, history being strongly divisive and the cause of wars between them. Conflicts also involve religious (plural) and secular values and the emergence of new minorities.

A widening gap between cosmopolitan and multiconnected citizens, who feel increasingly European, and populations left behind and exploited in the globalised world also has to be taken into account, as it has serious repercussions on the principle of solidarity. The question of what to do with the migration flow into Europe is again an open problem that intertwines with that radical difference between the two aforementioned groups of

[29] As frequently mocked, TINA (there is no alternative) is the *leitmotif* of this paradigm.

[30] Living in France, but with ties to Portugal and the Czech Republic, the way I formulate them is necessarily biased.

[31] Not that the EU did anything to achieve a European identity. The Erasmus program and multiple other cultural and scientific programs, and indirectly the free movement of people in the Schengen area. There are not many accounts of its effects, but in general the adherence to the European ideal did not grow (Fuchs & Klingemann, 2011).

Europeans, refugees (who aspire to integrate Europe), but are regarded as a threat to the national identity of those who earn lower wages. This implies a struggle related to the issue of cultural heterogeneity in the national field with repercussions for the adoption of the shared model of the European Union[32]. Xenophobia and nationalism are emergent.

B) Quis custodiet custodes? The treaties are voluntary and democratically agreed, but seem to progressively underpin technocracy, which shadows democracy and ties its senior officials to lobbying activities, not seldom against the mutual benefits of EU members. The Treaty of Lisbon, refused by the Irish without consequences, increased the complexity of its legal expression, which was one way of avoiding scrutiny by citizens. This translates into routine and subverts the principle of cooperation amidst its members with public support, as well as the accountability of *normal Bildung* period[33]. For citizens, this also represents a crisis of leadership and legitimacy at the national and international levels. And, thereby, the loss of confidence in the authority of the European institutions. In particular, economic governance is perceived as a diktat at the service of financial forces and easily becomes the scarecrow of national politicians in the national domain.

Citizens are lost in translation due to the complexity and the distance of the system. As a consequence, elections have weak turnovers and are considered subsidiary to the national political arena: they symbolize a golden retirement for disgraced politicians, at least in the French case. This is particularly paradoxical since, in terms of justice, the *Acquis Communautaire* represents for the citizens a set of rights of enormous political significance. But this is the essence of what Beck (1992) calls risk: we do not only trade goods, but also evils (Latour, 2001, p. 8).

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[32] For a perspective on identity in the development of states into a network state see Castells (2010).

[33] The scandal of the luxury life of some high officials of the European Court of Auditors, in itself an institution of accountability, is just an example of the iceberg (Quatremer, 2021).

C) With the Euro as with Schengen, the EU embraced strong symbols without the implementation of its preconditions. Schengen has multiple flaws, a border and migration policy which are not commonly accepted (demonstrated by the refugee crisis of 2015). The euro is condemned to drift or be guided by the weight of the German economy that fills the gap as a sort of statehood incapable of imposing checks and balances. The Eurozone is a market without statehood – for Germany, the Euro is undervalued, for the majority of the other countries it is overvalued. It is a rush forward; it was an irreversible step.

The political consequences of the implementation of the European Union were mopped up. Born as an elite-driven project, the EU seems powerless to reverse this image and thus involve the mistrust of citizens, especially when the 'government by the rules' is not respected by those who make them, as was the case with the German-French tandem, which exempted itself from the Stability and Growth Pact. It is not anodyne that the 2008 crisis caught the European Union without any capacity to face it at a stage of co-sovereignty. Germany and the ECB took the reins and were able to impose tough austerity measures at quick pace, regardless of the social cost and the consequences for the image of the European institutions.

D) Another major problem is depoliticization. The integration process assumes a growing shift of sovereignty with democratic flaws – and gaps between the institutions and the citizen. Representative democracy is shadowed by the bureaucratic distance. The failure of the legitimacy process culminating with the significant rejection of the treaty establishing a Constitution for Europe was also mopped up. Brexit blows up centrifugally in this failure. All this increased distrust for citizens of the European bureaucrats, who wanted to accelerate the process, but had to shift legitimization into the hands of the same old parties and long-term national political class.

In the interest of efficiency, the institutions that guide economic policies (politics) are depoliticized – presented as a route to appease the divergent political interests inside the union. However, this is an illusion, because Europe is then condemned to constant adjustments to catch up with globalisation under the ordoliberal paradigm, without leverage in confrontation with the larger political blocs of the world. This was particularly exposed in the way Recep Erdoğan *played* with the presidents of the European Commission and the European Council, who have no political weight. France and Germany (and the UK outside the EU) do not want to leave the role of the political helmsman.

E) Major problems that nation states face today are *cosmo-political.* The states do not have sufficient leeway to deal with these problems, especially at the level of small European nations facing Russia, China, and even the USA. As Danilo Zolo (2009) says, the West view tends to be duplicated and spread around the globe on the back of "modernisation" involving the market economy, the ambition to dominate nature, faith in technological progress, the optimisation of production, the obsession with acquisition and consumerism, and the cult of speed (p. 80) all the while, ignoring *cosmo-puzzles*. Also, sometimes associated with the use of force by the superpower nations and hijacking of narratives to suit their needs.

These enormous puzzles require cosmopolitical solutions while worldwide interactions are extremely slowed down by the fragmentation of the world, correlated with the centralisation of power and the unidirectional flow of the ownership of production from the poorer to the richer citizen countries, always fostered by more competition and greed for growth. Today we are confronting two major and immediate cosmopolitical problems with the coronavirus pandemic and an ecological crisis that can represent the collapse of ecosystems, which includes extinctions, narrowing of liveable space, huge human displacements and even a major threat to life[34]. In the first case, besides the efforts (mostly scientific) we saw cooperation break down and countries move away from a cosmopolitical solution to adopt scattered solutions. In the second, the mopping up activity still continues, exposing societies strapped into the dogma of growth.

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[34] See the sixth assessment report of the IPCC.

3. Concluding remarks

These anomalies are sufficient to raise the argument about the need for a cycle of revolution, however many others could have been described here. It is evident that the EU is more floating than sailing with the ordoliberal paradigm and dissension continues to increase. The revolution (in Kuhn's sense) is inevitable. The *core* of the paradigm is nevertheless sustained, but the new generations are closer to the leaking zone of dissent (as the new generations of scientists in Kuhn's perspective) and see with greater acuity that *penumbra* is being mopped up (Hart, 1958).

If we still want to be ready to save the EU project, there is no other way than to assume the revolutionary period and put the project at risk of abandonment at the same time. In this phase, the confrontation of several solutions can emerge. Any further expansion of the EU must thus wait for another normal period (with the hope that only states converted to the new paradigm can be integrated). Can the articulation of the European project and the neoliberal globalisation survive this period? Or will the project be blown away and evolve into the reconstruction of sovereign protectionism? Either way, the issue is the nature of the state's relations: to readapt the EU economically and reinvent another type of market? To domesticate the economy politically at the supranational level with solidary protectionism or to abandon it and restore national sovereignty? Both questions still rely on the economic core (though articulated with politics).

The EU project does not seem to me completely irreversible, but considering that positive political answers are presented by different schools, I see two options that are more capable of competing for greater prominence: the federalist and the cosmopolitical solutions. The first solution implies the creation of a supranational European state (the core is the political nature of the Union), the United States of Europe – the European State is the federalist answer, broadly speaking. The second solution, which I uphold, has nothing to do with the cosmopolite Europe, which is still connected to the liberal core. Political here does not imply a transfer of political authority that unveils the logic of universality and its overhanging 'violence' (Balibar, 2002)[35], nor does it feature a vertical Europe as a confederal democracy.

This solution implies the issue of the European identity and, as such, must articulate the concepts of citizenship and nationality, and people, nation and state. It will transfer the sovereignty conception horizontally. (I prefer to understand it as lateral universality inspired by Merleau-Ponty (2008).) It must lay down a cosmopolitical law architecture (in the Kantian sense) – in other words, the union should be cosmopolitical, involving performative relations between citizens and the states (and equal freedom between them). This solution articulates the cosmopolitical order (whose authority must be defined) and the sovereignty of the states (which will not be lost as in the federalist answer). Consequently, it must connect the parliament (the cosmopolitical parliament, where citizens must be represented independently of the states) to the national and regional parliaments. Finally, it must contain the financial and banking powers under an ethical code (the anomaly D must be superseded to avoid financial shocks). The development of this cosmopolitical paradigm constitutes my work on the progress programme.

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[35] In other words, universalisation. The politics of the universal also risks the syndrome of the Kantian supranational State. The logic of universality is a vast subject that I cannot discuss here. For more on this subject see Walzer (1989), Balibar (2002) and Merleau-Ponty (2008).

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How Covid-19 Opened Pandora's Box in Europe

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ABSTRACT: It has been almost two years since Covid-19 grasped Europe causing unimaginable suffering to people and disruption in socio--economic and political life worlds. It has opened a Pandora's box from which sorrow, pain and disease have poured out and spread all over. It has also spurred new nationalism and anti-democratic strategies. The discussion below probes into new nationalism and examines how the European Commission has correctly highlighted the threats to European democracy and embarked on the strengthening of fundamental rights. Hope – the remaining gift in Pandora's box, pithos, – aligned with the values and constitutional fundamentals of European democratic systems are the means of our resistance to regression and to democratisation reversals.

Keywords: Rights, Nationalism, European Democracy, Covid-19, Citizenship

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1. Introduction

It has been almost two years since Covid-19 grasped Europe causing unimaginable suffering to people and disruption in socio-economic and political life worlds. Lockdowns, restrictions, travel bans, a short breathing space for resumed ordinary activities were quickly followed by new lockdowns, restrictions and border closures as Covid-19 mutated to Delta and then to Omicron. Every time hope for an end to the pandemic resurfaced, a new variant of Covid-19 made hope dissipate. The end to the pandemic became distant, once again, and the time of 'connecting Nothing with nothing', to use Eliot's poetic expression, continued.[1]

It is as if Covid-19 opened Pandora's box from which sorrow, pain and disease have poured out and spread all over. In ancient Greek mythology, Pandora had been sent by Zeus as a bride to Prometheus' brother, Titan Epimetheus, with a view to condemning mankind to prolonged suffering. She had brought with her a *pithos*, a jar, in which pain and disease were stored. When Pandora opened the lid of the *pitho*s, uncontrollable negative forces escaped to torment mankind – only hope remained in it. Hope was an important force, though; it would give mankind the courage to persevere and to navigate obstacles, misfortune and disaster.

Hope helped mankind to cope with the onslaught of Covid-19, while a number of certainties about the future were gradually stripped away as a result of the pandemic. Faced with death, hospitalisation, the symptoms of 'long-Covid', business closures, joblessness and workers' resignations, citizens and residents of Europe embraced fluctuating and unpredictable dynamics as the new normal (Kostakopoulou, 2021). They also sought meaning in other daily activities and some rediscovered what was of true value to their lives. While the invention of vaccines against Covid-19 in November 2020 gave hope that the world would soon return to its pre-pandemic normality, the continued grip of the virus on humanity made everything harder to know and to predict. The behaviour of large sections

[1] T. S. Eliot, 'III. The Fire Sermon' in The Waste Land (1922) in the *Complete Poems and Plays: T. S. Eliot* (London: Faber and Faber Ltd, 1969, p. 70).

of society became less comprehensible and feelings of anxiety, fear and tiredness dominated people's private life-worlds.

Mental illness and anxiety gripped the population; children, persons with disabilities, homeless persons and the elderly were amongst the most affected groups. Online contact was a poor substitute for 'real', that is, face to face, connectivity and the warmth of physical gestures of love, friendship, empathy and care. Children's education suffered throughout Europe. Domestic child abuse increased behind 'closed doors'. Women, on the other hand, experienced unprecedented violence in both domestic and public settings in several EU countries. Ethnic, racial, religious and national minorities became also vulnerable. Rising homophobia, too, made the lives of lesbian, gay, bisexual and transgender persons unnecessarily taxing and stressful. In other words, the explicit awareness of the common human vulnerability and the daily sacrifices of public, spirited health care practitioners and frontline workers were accompanied by muddled, angry, judgmental and confused voices and actions by individuals and groups. This contradictory dynamics of kindness, compassion and care, on the one hand, and violence, prejudice and incivility online and offline became quite apparent during the second year of the pandemic.

Contradictory reactions and policies were also observed in the public realms of European societies. On the one hand, state actors allowed neo-liberal templates to disintegrate and stepped in generously and pro-actively to protect their populations though mass vaccination and economic protection initiatives while, on the other hand, they eagerly limited civil rights, such as rights to freedom and security, the freedom of expression, the freedom of assembly and the freedom of association, and adopted travel restrictions, entry bans (Thym and Bornemann, 2020) and even emergency laws[2] with little discussion in parliamentary fora. In the European Union, restrictions under Schengen Border Code were enacted without much discussion about their compliance with the principles of non-discrimination and proportionality.

[2] For an excellent discussion, see FRA's Bulletin 3 on 'Coronavirus Pandemic in the EU – Fundamental Rights Implications: With a Focus on Older People' (Luxembourg: Publications Office of the European Union, 2020), pp. 15 et seq.

Public health considerations and the permitted derogation from free movement under the so-called Citizenship Directive (Dir. 2004/38)[3] were deemed to be an objective justification for 'gated states'.

Accordingly, the public, civic space became constricted and challenging in tandem with policies intended to make territorial space controlled and 'safe'. Democratic accountability, human rights and citizenship rights became secondary considerations. Initially muted, civil society became more vocal and militant as the pandemic progressed. It was important for democratic voices to highlight the risks to safeguarding human rights and democratic accountability, facts-based public discourse and values-based policy-making that treats all groups with consideration and respect. They also did not hesitate to demonstrate that the creation of national safe spaces led to a weakening of the internal civic space, albeit mobilisations to reclaim it by feminist and anti-racist movements. Citizen-led initiatives also ensured that medicines and food reached the vulnerable groups, frontline services were delivered and that support was offered though helplines to the victims of domestic violence and abuse. Solidarity and humanness increased civil resilience and helped to create a supportive environment during the challenging months of the pandemic, at least for some persons and groups.

However, like the contradictory forces in Pandora's box, the same environing conditions that spurred solidarity also laid down a fertile ground for right-wing discourses and extremism. Covid-led hardship and discontent, high unemployment, rising national debts, sectors of the economy under severe stress and stagnated investment, fears of recession, misinformation and post-truth politics, all have been capitalised by demagogues willing to traffic in people's fears and grievances in order to attack democracy and freedoms. Adorno's lecture at the University of Vienna in 1967 (Adorno, 2020) sheds much light onto what he calls

[3] European Parliament and European Council Directive of 29 April 2004 on the right of citizens of the Union and their Family Members to move and reside freely within the territory of the Member States (2004/ 38/EC) repealed the above mentioned Directives; OJ 2004 L 158/77 (30 April 2004), Chapter VI, Articles 27, 29 and 30.

‘pathic nationalism’ (Adorno, 2020, p. 5) and the conditions that lead to ‘far-right turns’.[4] The new far right-turn is different though.

2. Inside the new nationalism

‘Old’ (or older) nationalism tended to be anti-authoritarian and anti-statist. It prioritised the uncontrolled operation of market forces, extolled private entrepreneurship and complemented the empowered, liberal, secular and pluralist societies. It was *laissez-faire* nationalism. In contrast, the new right is both pro-authoritarianism and pro-statism. It broadcasts a nostalgia for ordered, walled spaces in which small town folk can feel secure and looked after. This entails the weakening of the free-market dogma (i.e., the free market as the magic cure of all ills) and the strengthening of a pro-active, disciplined and more ideological right-wing politics.

New nationalism needs followers and champions of an anti-liberal agenda that, apparently, is no longer constrained by rules, transparency requirements and oversight. It needs to deliver to its ‘people’ and, for this reason, in pursuing its political programme, it does not rule out angry reactions, a backlash against the trend of liberalised and liberalising societies, surveillance and control policies, more aggressive border management, opposition to the perceived ‘cultural’ threat of ‘Muslim’ migration and the alleged ‘burden’ of refugees and the restoration of the centrality of identity and patriotic pride. Patriotism requires uniformity of opinion; the role of the public sphere is not to encourage different opinions and dialogic

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[4] Adorno (2020) observes: ‘Now, ladies and gentlemen, I repeat that I am aware that right-wing extremism is not a psychological and ideological problem but a very real and political one. Yet the factually wrong, untrue nature of its own substance forces it to operate with ideological means, which in this case take the form of propagandist means. And that is why, aside from the political struggle by purely political means, one must confront it on its very own turf. But we must not fight lies with lies, we must not try to be just as clever as it is, but we must counteract it with the full force of reason, with the genuinely unideological truth.’; pp. 39-40.

exchanges, but to promote public order and the government's definition of the public interest. Subjecthood and the state's licensing of public opinion are thus the new values that align with contemporary historical options. Liberal nationalism and civic nationalism of the 1990s (Dunn, 1995; Touraine, 1994; Kostakopoulou, 2008, 2018) have been superseded by an anti-liberal, muscular ethno-nationalism, brandishing national identity on the national flag in the 21st century. But such ideas are both old-fashioned and out of sync with a culture that by law has to recognise and to affirm in practice diversity, hybridity and respect for 'any' Other.

The new right is thus characterised by a hard survivalist orientation and a projected potency to bring about social and political change without any of the constraints imposed by either constitutional or international law or EU law. 'Taking back control' is thus a synonym of doing 'what one wishes in an unconstrained manner', including the freedom of elites to be above the law or to step outside law, if they find it necessary. Its followers breathe an air of entitlement and power: 'I can do what I wish and can get away with it'. It is not that they do not believe that there are no rules or appropriate actions or truths; it is more about a generalised understanding that strict compliance with them is not necessary, thereby indirectly encouraging corruption and directly undermining the rule of law and the acceptable standards of good governance. Evidently, it is debatable whether such approaches can survive in the long run. Even if institutions are captured by self-serving and authoritarian elites for a certain period of time, any form of governance cannot be sustained for long on the basis of either a half-hearted commitment to observing rules and laws or contempt for them. Rule breaking is anomie and a disdain for facts, evidence and the truth is a characteristic of corrupt or failed governance.

Turning from politics to economics, the New Right's survivalism is predicated on a form of capitalism that guards against extreme strain, mobility, competition, social alienation while simultaneously being reliant on open international trade and on elitist dominocracy. Capitalism thus plays an important role in the programme of reconfiguring the state that has been criticised heavily for having abandoned the 'nation' (or its poorer members) and in the simultaneous reconfiguration of nationhood by insisting on 'thicker' features and manifestations of it. The latter leads to the exclusion of those who do not share them, the Others, be they migrants, refugees, religious and racial minorities.

The new right has little interest in gender and race equality, human rights treaties and disregards Europe's colonial, imperial and antisemitic past. The neo-nationalist elites are more interested in self-promotion, the propagation of (national) authoritarian dynamics and ideology. They do not hesitate to use populist rhetoric and existential narratives of protection and social security to grasp the imagination of people fearing uncertain futures and who have been affected by the economic downturn of the last 12 years and the current pandemic.

In the same way they used the economic crisis and migration crisis of 2015 to disseminate an anti-liberal or illiberal alternative to liberal democracy, they use the pandemic to promote their authoritarian agenda. Political conflict for them is articulated on the basis of anti- or pro-freedom, rights, democracy, the rule of law and binding rules and state power. This is authoritarian nationalism that is ready to turn its back to democratic values and individual empowerment and intends to transform societies into societies of control and surveillance by restricting the freedom of the population, with help from the digital technological giants and private security and internet companies.

Whether the new right will succeed is debatable. Unlike the old nationalism, it is not a comprehensive belief system and depends on electoral exigencies which are unfathomable as well as unpredictable. It is also vulnerable to both critique and societal mobilisation against it. We do not have reasons to believe that people's time horizons have shifted in a fundamental sense and will overwhelmingly support it. And although it is true that the pre-pandemic order is not a reliable guide on what may happen in the near future, because many shifts have taken place during the pandemic, thereby creating a new abnormal 'normality' or 'routine', neither democratic processes, nor freedoms, nor the globalised world are easily reversible. It is equally true that much is still unfolding and requires new angles that can map out the current juncture and can provide guidance on what has to be done.

In Pandora's box, hope remained intact. Hope is important. It provides consolation and keeps us moving. But we need more than just hope. We have to engage with the world in the right way. We need a normative framing, because the societal 'mood' or the 'feel bad factor' can be easily manipulated by populist and authoritarian nationalists. This factor accounts for differences in voting behaviour and will play an important role in the post-Covid 19 era.

We need to re-affirm, defend and strengthen the values of democracy, human rights, rule of law and equality in Covid's aftermath, since these are the guideposts for dignified living and good socio-political governance in the future. They provide a clear direction and help frame a democratic humanist project for the globe. If we fail to champion those values,[5] we will be sleepwalking into an uncertain future which right-wing extremism and elite authoritarianism might seek to mould in accordance with their own objectives and ideas and to structure it in their favour. Interestingly, although right-wing extremism pontificates its appeal to people(s), in reality the executioners of its ideas tend to regard and treat human beings as objects or means or as statistical items apt to categorisation and manipulation.

3. Values and constitutional essentials: fundamental rights and European democracy

Nearing the end of the first year of Covid-19's grip, the European Commission sought to reinforce the EU's commitment to fundamental norms and constitutional essentials. It published in December 2020 two important documents confirming that the European Union is essentially a community based on laws[6] and principles which form the common thread uniting all its constituent units and that its constitutional charter in the 21st

[5] *Protecting Civic Space in the EU*, European Union Agency for Fundamental Rights, Luxembourg: Publications Office of the European Union, 2021.

[6] As the Court of Justice had stated, the Community 'is based on the rule of law, in as much as neither its Member States nor its institutions can avoid a review of the question whether the measures adopted by them are in conformity with the basic constitutional charter, the Treaty' (Case 294/83 *Parti Ecologiste 'Les Verts' v European Parliament* [1986] ECR 1339 [23]).

century includes the rights and principles enshrined in the EU Charter of Fundamental Rights. The EU Charter on Fundamental Rights was signed on 7 December 2000,[7] was amended on 12 December 2007 and became legally binding following the entry into force of the Treaty of Lisbon, and thus has the status of primary EU law. The two documents were the Strategy for Strengthening the application of the Charter on Fundamental Rights[8] and an action plan on the European Democracy.[9] These were published on 2 and 3 December 2020, respectively, thereby reinforcing the idea that democracy and human rights are both complementary and mutually reinforcing, and that the values of the EU (Article 2 TEU) matter a lot.

The Commission's strategy to strengthen the implementation of the Charter of Fundamental Rights acknowledged the increasing importance of the Charter to the protection of people's fundamental rights and the need for 'a renewed institutional commitment' to the effective application of Charter rights and principles.[10] The previous strategy was ten years old[11] and needed a revision in the light of new challenges, such as digitalisation, and developments, including recent state responses to the pandemic. The Commission built the strategy on four strands: namely, i) ensuring the effective implementation of the Charter; ii) empowering civil society organisations, rights defenders and justice practitioners; iii) fostering the use of the Charter as a compass for EU institutions and iv) strengthening people's awareness of their Charter rights. Concrete actions and 'invitations' to the Member States to act in specific ways accompany each strand. A more

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[7] Treaty of Nice, signed on 26 February 2001, O.J. C080, 10 March 2001, in force on 1 February 2001.

[8] European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *Strategy to strengthen the application of the Charter of Fundamental Rights in the EU*, COM(2020) 711 Final, Brussels 2.12.2020.

[9] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on *the European Democracy action plan*, COM(2020) 790 Final, Brussels, 3.12.2020.

[10] Ibid, pp. 2-3.

[11] See European Commission, *Strategy for the effective implementation of the Charter of Fundamental Rights by the European Union*, COM(2010) 573 Final, Brussels, 19.10.2010.

structured and targeted approach stems from such initiatives. For example, under the first strand, the Commission refers to the strengthening of the partnership with the Member States and local authorities, its annual report on the implementation of the Charter, EU budgetary conditionalities and its intention to initiate infringement proceedings for breaches of EU law. The important role of civil society organisations and national human rights institutions will be further enhanced through EU programmes, capacity building and the training of judges and other justice practitioners through the use of EU funds and the tools developed by the Fundamental Rights Agency, such as Charterpedia and the Handbook on the implementation of the Charter for practitioners.[12] Guidance, e-learning tools and training will also be promoted at EU institutional level and the mainstreaming of the Charter throughout the EU legislative process will be enhanced. The final strand of the strategy focuses on initiatives to promote people's awareness of their Charter rights and citizen empowerment.

The Action Plan on European democracy, on the other hand, addressed key challenges to democracy and citizen participation arising from restrictions to freedom of expression and media pluralism, digitalisation, rising extremism, authoritarianism, election interference and the spread of manipulative information. It announced a series of concrete measures (these will be reviewed in 2023) in order to: a) protect free and fair elections and democratic participation, b) strengthen media freedom and pluralism and c) counter disinformation, irrespective of the geographical location of its source. More specifically, in order to protect the resilience of EU democracies, the Commission will propose legislation in the area of sponsored content in a political context ('political advertising') thereby addressing online campaigning and micro-targeting and behavioural profiling techniques and will propose a revision of the Regulation on the funding of European political parties and European political foundations.[13] The

[12] These are available on FRA's website: https://fra.europa.eu.

[13] Regulation 2018/673 of 3 May 2018 amending Regulation No 1141/2014 on the statute and funding of European political parties and European political foundations (OJ L 114I, 4.5.2018, p. 1); Regulation 2019/493 of 25 March 2019 amending Regulation 1141/2014 as

Commission will also set up a new joint operational mechanism through the European Cooperation Network on Elections to support the deployment of joint expert teams and to work closely with the NIS (security of information systems) Cooperation Group to counter threats to electoral processes. It will continue to promote EU citizenship rights and inclusive, deliberative and participatory democracy, to mainstream equality and to combat hate crime and hate speech. An effective tool for the promotion of media pluralism will be the establishment of a new Media Ownership Monitor – a database on media ownership which shall be applicable to all 27 Member States. In countering disinformation and election interference, the action plan states that the Commission will enhance the EU's existing toolbox for countering foreign interference in our information space by including new instruments that envisage the imposition of sanctions on perpetrators. And although the action plan does not provide a blueprint for European democracy, it helps our minds to focus on what needs to be done in order to combat the undermining of democratic institutions and practices and to upgrade them in the light of new challenges and digital realities.

4. Hope and resistance

The question of our times thus has essentially become a question of our lives, both private and collective. It is distilled into questions such as how we live together in peaceful democratic environments in the EU, and beyond, and how we should live together. The Covid-19 pandemic has made the rethinking of our times a personal responsibility and one can only hope that the experiences of suffering and loss unleashed to the world can 'become renewed, transfigured, in another pattern', to use Eliot's poetic expression[14] once more. It has been both strange and worrying

regards a verification procedure related to infringements of rules on the protection of personal data in the context of elections to the European Parliament (OJ L 85I, 27.3.2019, p. 7).

[14] The Little Gidding (III) in the *Complete Poems and Plays: T. S. Eliot* (London: Faber and Faber Ltd, 1969).

that for the last twenty-two years so many events have intruded into our lives uninvited, disturbing our peace and well-being, leading to the loss of millions of people, and undermining the constitutional fundamentals of liberal democratic systems. The expectations we had about a better, more ethical future which is respectful of human dignity at the dawn of the new millennium have been shattered and wherever we look, beyond the confines of our neighbourhoods, localities, regions, countries and continents, we clearly observe similar experiences and cries of anxiety and unease. Following terrorist atrocities, wars in the Middle East, economic crises and austerity policies, two years of Covid-19 and now the invasion of Ukraine, humanity really struggles in the waves of very rough seas.

But hope, – the remaining force in Pandora's *pithos* – can turn limitations into the powers to be. And the values of freedom, democracy, respect for human dignity, human rights and the rule of law, equality and non-discrimination, honesty, integrity and accountability that are the foundations of our socio-political systems are the means of our resistance and the aids for standing firm and strong for what is right and true. This is the time to resist all democratisation reversals, to insist on agreed rules which hold the powerful to account, to respect the sanctity of human personality and to strengthen the enforcement of law and bills of rights, including the EU Charter of Fundamental Rights. For only open, democratic and socially resourceful systems can enhance the life prospects of individuals and communities and create enlarged public spaces which combine cosmopolitan openness with personal and collective identity and freedom. The secret in Pandora's box is the tie of hope with value-compliant processes, policies and strategies, and humanism.

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Can Structural Interconnectedness be Harmful when a Pandemic Strikes?

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ABSTRACT: The aim of the paper is to simulate the impact of pandemic measures adopted in the EU on CEE countries. The underlying rationale is that strict measures significantly decrease the production of certain countries, which translates into a fall in the production of other economies through a value chain channel mediated by foreign trade of goods and services. We utilize a Stringency index provided by The Oxford Covid-19 Government Response Tracker as a proxy for a drop in the production brought on by pandemic measures in individual countries. Subsequently, we calculate the spill-over effects of these measures on production. This way we measure potential disruptions for the domestic economy induced by these measures, and their disruptions facilitated by global value chains. The structural interconnectedness of economies and value-chain linkages are identified by a Multi-Region Input-Output model. Using this methodology, we are able to estimate indirect economic effects of the pandemic and identify the consequences of anti-covid measures beyond direct domestic and country-specific effects.

Keywords: Covid-19, Global Value Chains, Input-Output Analysis, CEE Countries

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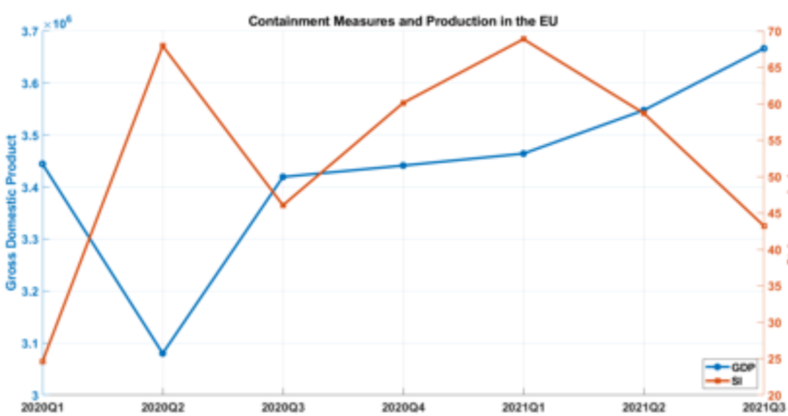
1. Overview

The pandemic broke out in Europe in February 2020. One of the very first European countries to record a massive outbreak of the virus was Italy. Gradually, the virus had spread to every single EU country by the end of March (Jones, 2020). The European economy was severely hit by this pandemic and associated containment measures. The pandemic combined both supply and demand shocks to the European economy (for a short discussion see Baldwin (2021; 2020)). According to Brinca, et al. (2020), the decomposition of hours worked in the US economy indicates that the labour market was severely hit by the supply shock due to mitigation measures, which consequently caused a drop in the consumption rate due to loss of jobs. In Europe, the total hours worked declined at the sharpest rate ever recorded. The labour force declined by 5 million in the first half of 2020. The decomposition of worked hours and labour force decline in the European labour market highlights the same similarities and differences from the financial crisis as in the US context. During the financial crisis, the demand shock accounted for two supply shocks in the labour force decline. The current pandemic crisis indicates the opposite correlation (Anderton et al., 2021). To minimize the short-term and long-term disruptions in the labour market and negative feedback loops to aggregate demand, the massive intervention of fiscal policies, and hard monetary stimulus was also needed. The first move of the ECB was the call to clarifying responsibilities in the action against the spread of the virus and minimization of its economic consequences. Soon after, the ECB announced the massive asset-purchase program which helped ease the burden that European fiscal authorities had been carrying on their shoulders (Jones, 2020). The pandemic, however, created a potential for a long-term, more productive re-allocation of labour due to strong pressure of digitalization and automation. However, these trends may have an adverse effect on the deepening of the skill mismatch, which could possibly lead to higher structural unemployment and further economic difference between labour markets in Europe.

FIGURE 1. **Average Stringency Index and Gross Domestic Product for EU27**



Source: Authors´ calculations based on Eurostat data and The Oxford COVID-19 Government Response Tracker.

The current pandemic differs from any other post-war pandemic we have experienced. It hit the economically dominant nations and spread across the globe. At the same time, the world economy differs in multiple dimensions from that of the mid-2000s. Production activities are organized globally, and the production process is fragmented across nations. Goods cross the borders several times before they reach end consumers (Koopman et al., 2014). Thus, economic harm caused by COVID-19 in one country spread to other countries via the global value chains. Global value chains create feedback loops that can significantly postpone the economic recovery if policymakers do not adapt and coordinate their policies and measures.

In contrast to the usual business cycle contraction, the current economic slowdown is caused simultaneously by demand and supply shocks. Countries that face high rates of contagion are affected by direct supply disruptions as the governments adopt anti-covid measures that restrict the production and labour supply. Movement constraints, social distancing and the spread of the number of infected people forced companies to close and stopped production lines. Cross-border restrictions and supply chains amplified direct supply shocks. Countries that were less affected by the virus faced the problems of "imported" production disruptions. Companies and manufacturers find it harder and more expensive to acquire the intermediate goods they need for production. Local and nationwide lockdowns have an international impact. And finally, as consumers delay their purchases and companies delay investments, economies experience demand disruptions with their own negative feedback loops (Baldwin et al., 2020). At the beginning of 2020, there was hope for a short, albeit sharp crisis. We are now in 2022 and it is still not over. There is hope that we can get back to our normal lives as soon as vaccination and a more infectious but less harmful variant of the virus spread across the nations, but the future is still uncertain.

Governments need to think about production networks more than ever. The combination of containment policies that restrict production and stimulus packages that support demand creates supply-side problems and results in cost-push inflation (Baldwin, 2020).

In this chapter, we analyse the potential supply-side effects of the coronavirus pandemic that spread across the nations through global value chains. We illustrate the impact of lock-down and anti-covid policies of one country on other countries. First, data and methodology are presented. Then, we provide the empirical results and conclude.

2. Data and methodology

Input-output tables provide a detailed description of the use of inputs for production by industries to produce intermediate goods and services, and final demand goods in the domestic economy. International trade statistics record the flow of goods and services across the borders and provide detailed data on imports and exports. Multi-regional input-output tables combine these two data sources and describe the complex linkages between industries both within and across economies.

Several multi-regional input-output tables of the world economy are available: the world input-output database constructed by the group of researchers led by the Groningen Growth and Development Centre, the OECD inter-country input-output database, the EORA database, and recently released FIGARO tables by Eurostat. Each one of them has pros and cons linked to country and time coverage, the level of detail by industries, and assumptions made during their construction process. In this chapter, we use WIOD Database for global network analysis and data from newly released multi-regional input-output tables by Eurostat for direct and indirect effects of containment policies in the EU. FIGARO tables provide data on production, international trade, and final use of goods and services in the world economy with detailed coverage of European countries that are at the centre of our interest.

The FIGARO database (**F**ull **I**nternational and **G**lobal **A**ccounts for **R**esearch in input-**O**utput Analysis) is a new statistical tool of integrated global accounts for economic modelling. They cover 46 countries and 64 industries for the period of 2010 – 2017. From 2018 to 2019, they provide data for 17 countries and 30 industries. We use tables for the year 2017 in our simulations as they provide the most recent data with detailed linkages across industries and a broad range of countries available.

Our results are calculated using Input-Output analysis (for more detail, see Miller & Blair, (2009)). The backbone of this approach is the so-called Leontief matrix, for which the following relation between total production vector $\boldsymbol{x}$ and final demand vector $\boldsymbol{y}$ holds.

$$\boldsymbol{x} = \boldsymbol{L}\boldsymbol{y} \tag{1}$$

As can be seen from this equation, an element $l_{i,j}$ denotes the overall production in the industry represented by i induced by the final demand in the industry represented by j. Mathematically speaking, in terms of differences, this is summarised as follows:

$$l_{i,j} = \frac{\Delta x_i}{\Delta y_i}. \tag{2}$$

In our contribution, we focus on changes in the production of one industry induced by changes in production in other industries. Dividing the elements in a Leontief inverse matrix $\boldsymbol{L}$ by its diagonal allows us to calculate these relations.

$$\boldsymbol{L}^* = \boldsymbol{L}(\hat{\boldsymbol{L}})^{-1}. \tag{3}$$

Here, $(\hat{\boldsymbol{L}})$ denotes a diagonal matrix whose diagonal coincides with $\boldsymbol{L}$. For an element $l^*_{i,j}$ we get

$$l^*_{i,j} = \frac{l_{i,j}}{l_{i,j}} = \frac{\Delta x_i}{\Delta x_j}. \tag{4}$$

Therefore, we can calculate the change in production in the economy given a vector of direct changes in the production in each industry denoted by $\bar{\boldsymbol{x}}$ as follows:

$$\boldsymbol{x}^* = \boldsymbol{L}^* \bar{\boldsymbol{x}}. \tag{4}$$

In our study, the direct decrease of production is linked to the reaction of each industry to containment measures. We differentiate the sensitivity of each industry to containment measures according to the results published by Battistini and Stoevsky (2020). We only keep the proportions among the industries, but the direct decrease is four times smaller than the decrease presented by Battistini and Stoevsky (2020). It is owing to the fact that Battistini and Stoevsky (2020) provide overall (direct and indirect) decreases. Further analysis would be needed to estimate the direct effect of containment measures. However, it is not our objective to simulate the real COVID-19 pandemic as it happened. Rather, we aim to simulate a hypothetical situation similar to the pandemic. We also assume that these differences between individual industries are the same in every country. In each country, we multiply the percentage of decrease by a number[15] which represents the level of strictness of observed containment measures. The direct decreases in each country can be seen in the right panel of Figure 4.

The structure of global value chain (henceforth GVC) activities is based on the Koopman et al. (2014) and Wang et al. (2013) decomposition of gross exports. GVC activities can be divided into the simple GVC activities in which domestic value added (henceforth DVA) crosses borders only once, and complex GVC activities in which DVA crosses borders at least twice. In our study we consider as complex GVC activities the sum of DVA in intermediate and final goods exports that are reexported to third countries to be absorbed there and returned DVA in reimported intermediate and final imports to the domestic country. Respective double-counted term in trade of domestic value added is excluded.

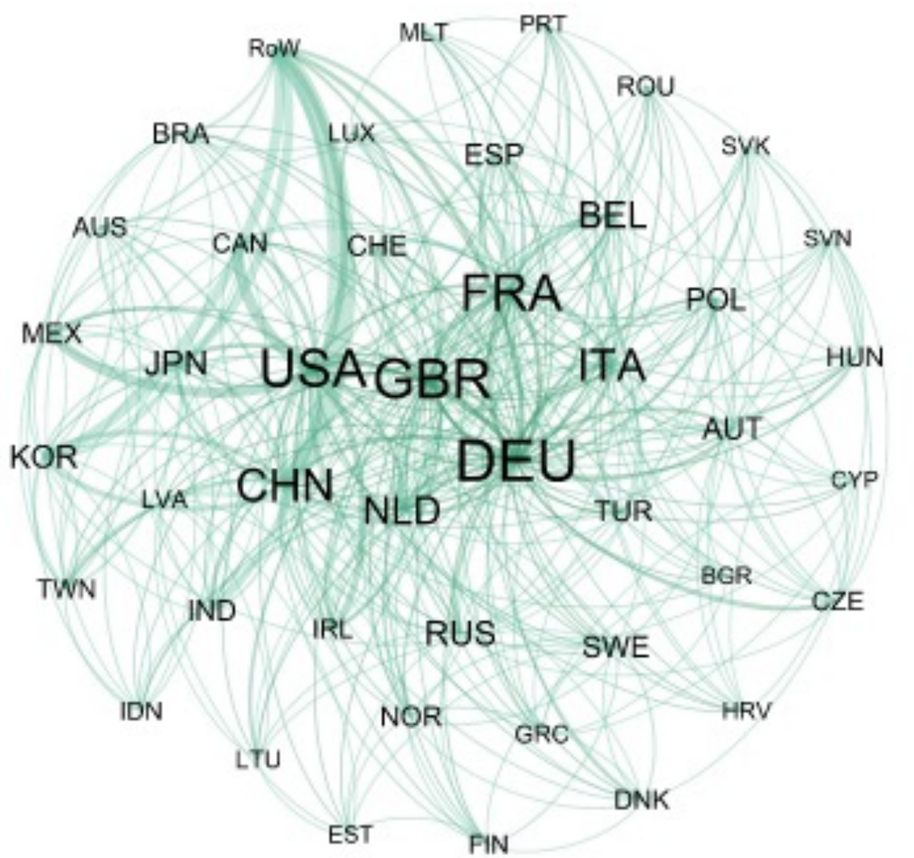
3. Results

Let us start by demonstrating the importance of various countries in the fragmented value chains. Figure 2 depicts the trade of domestic

[15] The number is an arithmetic mean of the Oxford Government Response Index provided by Hale et al.(2021) (henceforth Stringency Index SI) from March 12, 2020 to May 31, 2020.

value added induced by intermediate and final demand. Respective sizes and positions of the countries in the graph are not entirely random, but depend on their centrality in the Global Value Chain (henceforth GVC). The edges are scaled with respect to the relative size of domestic value added in global export and only the 10 most important edges are shown for each country. Six large world economies, all of them hardly hit by the pandemic, are in the centre of the global value chains: Germany, Great Britain, France, the USA, China and Italy.

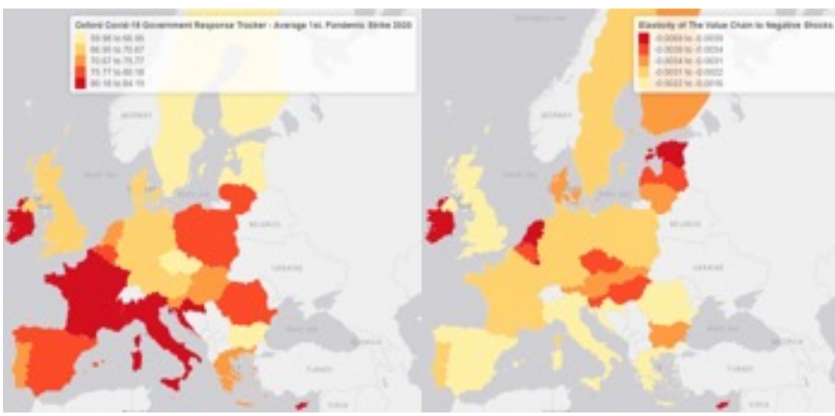
FIGURE 2. **Complex Global Value Chain Activities**



Source: Authors´ calculations based on WIOD Database.

As shown in the left panel of Figure 3, some of the central countries from the GVC network had some of the tightest anti-covid measures during the first wave of the pandemic (namely, France and Italy). In the right panel of Figure 3, we can see the sensitivity of domestic production in each economy to a 1% decrease in the production of all other economies. Small open economies were apparently the most negatively affected. This result does not come as a surprise, since these economies are more closely linked to the other economies, the production of which hinges on the final domestic demand more tightly.

FIGURE 3. **Government response to the pandemic and the elasticity of GVC**



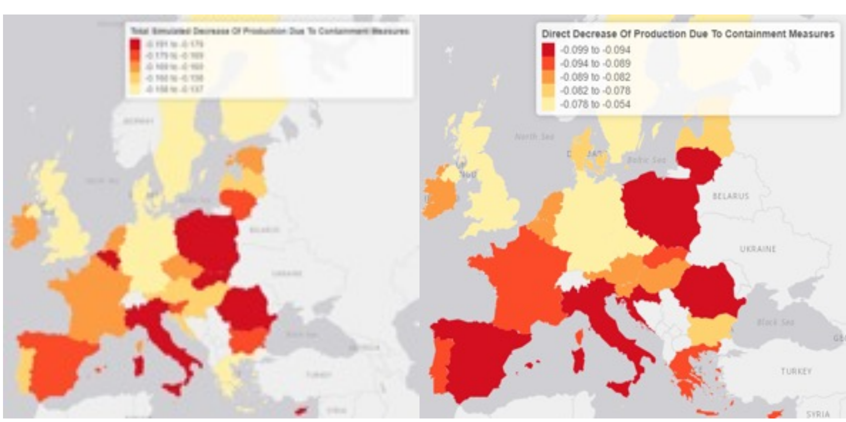
Source: Authors´ calculations based on The Oxford COVID-19 Government Response Tracker and FIGARO Database.

The overall, and direct, decreases in production in each economy can be seen in Figure 4. First, it may be quite intriguing to compare the severity of government response (measured by the SI) with the direct decrease in production (since it is calculated using the SI). If the direct decrease in production is relatively more severe than the depicted anti-covid measures (meaning that the country's color is 'hotter' in the direct decrease map than in the government response map), one could conclude that the most negatively affected industries are of less relative significance to the economy concerned compared to the other economies.

One may expect that the higher the elasticity of GVC the more severe the total effect will be in comparison with the direct effect on the respective production. In general, our results support this expectation, with the exception of some countries such as Hungary and the Netherlands. There is at least one possible explanation. If the total decrease in a given economy is more severe than it should be based on the elasticities and direct decrease, it could be because the economy is highly connected in production with economies where the direct decrease is relatively more severe.

In Figure 5, we simulate the effect of 1% decrease in Germany and Slovakia's production on the total production of other economies. A similar exercise could be performed for every single economy and the degree of interdependence could be easily seen. Generally speaking, the closer the countries to the country where the shock originates the greater the impact. Currently, there are multiple hypotheses to examine, which could explain this phenomenon. The countries could be similar in their industry structure due to path dependence. Another hypothesis could be based on their geographical closeness and low transportation costs that foster the fragmentation of value chains among them. Most likely it cannot be explained by a single phenomenon, but rather it is a combination of multiple factors.

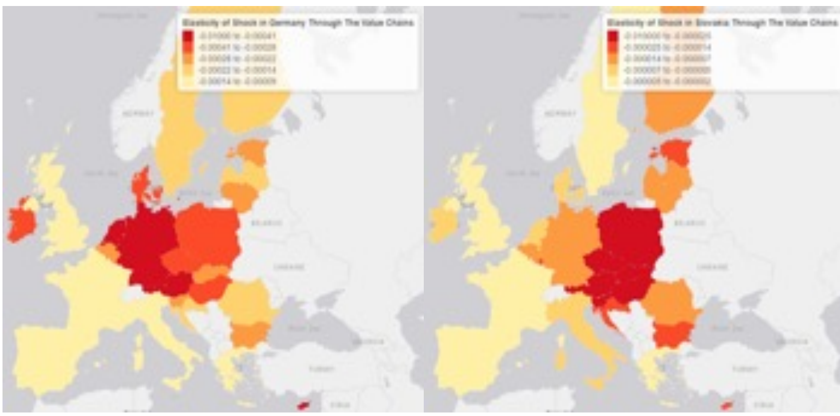
FIGURE 4. **Total and direct decrease in production due to containment measures**



Source: Authors´ calculations based on The Oxford COVID-19 Government Response Tracker and FIGARO Database.

Having stated the above, it is important to keep in mind that the results may not (and probably do not) reflect the real situation during the first wave of the COVID-19 pandemic. They merely serve as a hypothetical simulation of production shocks caused by a pandemic-like event.

FIGURE 5. **Elasticity of value chain to shock in Germany and Slovakia**



Source: Authors´ calculations based on FIGARO Database

4. Conclusions

Herein, we have simulated a hypothetical scenario similar to the first wave of the COVID-19 pandemic. Our results indicate that the elasticities to disruptions in the production of other economies are higher in small and open economies of the European Union. This finding is in accordance with the observed interdependency between central and peripheral economies (as shown in Figure 2). These results are supported by the simulation of total effects, where the small and open economies appear to be relatively worse off compared to the direct decrease. The linkages in value chain activities tend to be spatially linked as well. Elasticity to shocks of particular economies support Baldwin's idea that

"…, the world is not flat and distance has not died – especially when it comes to international production networks" (Baldwin & Lopez-Gonzalez, 2015).

In our scenario, small and open economies seem more vulnerable to shocks in other economies than bigger economies. However, our analysis disregards the differences and peculiarities between individual nations which, apart from other things, result in different behavioural response to the pandemic. These differences in behaviour can have a huge impact on the economy as well. Further research could provide more nuanced evidence on differences in the anti-covid measures and their consequences.

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Malta and the Pandemic: From a Small State Angle

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ABSTRACT: The COVID-19 pandemic was an exogenous shock which hit the EU and its member states with economic, health, political, psychological and social repercussions. This chapter focuses on the crisis and its impact on European integration from a small state perspective, using Malta as a case study. Crises have often led to turning points in European integration and COVID-19 was no exception. It encouraged the EU member states to increase their cooperation in health which is primarily a national competence, not only to cope with current pressures, but also prepare for future pandemics. The EU is now pursuing a "health union" which has still to be defined. For small states the EU's main attraction is the "shelter" which it provides them with and which became amply visible during the pandemic. However, small states need to proactively use the opportunities provided by membership to strengthen their resilience and learn how to help themselves rather than rely on the arrival of EU aid when crises strike. Malta started promoting joint-procurement of medicines before the start of the pandemic, particularly during its 2017 presidency of the Council of the EU. Later, joint procurement and joint action became the touchstone of the way in

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which the EU handled the pandemic. Resilience is an important objective for small states and this requires them to learn from their experiences during crises to strengthen their domestic decision-making institutions and infrastructure. Resilience, comprising the ability to bounce back, should not be restricted to its economic dimension.

Keywords: Integration, Malta, small states, resilience, shelter

1. Introduction

The Covid-19 pandemic led to economic, political, psychological and social ramifications at national and EU level and affected the member states in similar and dissimilar ways. Its impact on European integration is not fully clear.

This chapter focuses on how crises affect European integration from the angle of small states, taking Malta's experience as a 'case-study'. In Malta, the first covid-19 infections were reported on 7 March 2020. Containment measures were announced a few days later and were implemented gradually (Department of Information Malta, 2020a & 2020b). Throughout the pandemic, the public was constantly kept informed on their implementation.

Given Malta's population density at 1,380 persons per km^2 and the island's openness and traffic with the rest of Europe, and the fact that little was known about the virus in the initial stages, the measures did not raise a lot of public resistance or confusion. The testing and vaccination programme progressed well from 2020 onward with Malta eventually registering one of the fastest roll out of the vaccine.[1]

[1] Figures provided by the Ministry of Health which are continuously revised showed that by mid-April 2022, 87.4% of the population had taken one dose of the vaccine 86.2% had taken the primary dose and 67% the third (booster) dose. https://vaccinetracker.ecdc.europa.eu/public/extensions/covid-19/vaccine-tracker.html#national-ref-tab

2. When States Face Threats

When states feel threatened, they try to fend off danger by closing ranks, usually by strengthening existing alliances or by creating or switching to new alignments. External threats are also credited with the formation of federations. In 1964, William H. Riker proposed that states form federations by surrendering some of their sovereign rights to jointly fend off a common threat or grasp an opportunity to expand their territorial control. The emergence of the Swiss confederation and the United States of America have often been cited as examples. This explanation is partially true because there are other explanations for the emergence of federations.

Non-military threats have also been credited with convincing states to integrate further in a confederal or federal structure (McKay, 1996). However, we should not ignore the 'irrational' when in similar circumstances states reject integration and act in different ways. That is what happened in the early stages of the Covid-19 pandemic in the EU.

3. Crises Have Fired European Integration

Crises have generally led to important turning points in EU integration. However, Kühnhardt (2008) observes that not every crisis was productive and not every turning point in European integration resulted from a daunting crisis. Schimmelfennig (2018) claimed that while the Euro and Schengen crises had similar causes and beginnings "In the Euro crisis, governments preserved the key public good of the policy regime, the common currency" and strengthened supranational integration, but in the Schengen crisis, provoked by the arrival of Syrian refugees in 2015, they retook "control of open borders, the key public good provided by the Schengen regime," and "failed to agree on substantial integration progress." (p.970)

Similarly, with just under five million refugees fleeing the war in Ukraine to neighbouring EU countries, no progress in existing EU policies on migration seem apparent, and although fast track membership was offered to the beleaguered country by the Commission's President Ursula von der Leyen, it was later retracted by the EU Council at its meeting in Versailles. In this analysis the relevant point is whether the pandemic's characteristics resembled those of past crises which had led to significant turning points in European integration.

4. Article 168 TFEU – A Springboard

The pandemic has encouraged more European cooperation in the public health sector, and led to calls for a "Health Union". The launching of the European Health Emergency Response Authority (HERA) (European Commission, 2021) represents an encouraging step forward, although it is uncertain whether the enthusiasm for a Health Union will outlast the pandemic. Public health is not a core EU competence, and Article 168 (TFEU) sets the main Union objective as the achievement of a high level of human health protection and to take complementary measures to national actions. Another objective is to encourage cooperation between the Member States to improve the complementarity of their health services in cross-border areas. It assigns responsibility to the Commission to promote coordination in consultation with the member states and the European Parliament. The European Parliament and the Council, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee and the Committee of the Regions, can adopt measures setting high standards of quality and safety of organs and substances of human origin, blood and blood derivatives; measures in the veterinary and phytosanitary fields whose direct objective is the protection of public health; and measures setting high standards of quality and safety for medicinal products and devices for medical use. The European Parliament and the Council, acting by the same procedure, may also adopt incentive measures designed to protect and improve human health and in particular to combat the major cross-border health scourges, measures concerning monitoring, early warning of and combating serious cross-border threats to health (European Union, 2016, p.122).

Integration in Public Health may not arouse public concern about ceding sovereignty as happens in other policy areas such as foreign policy. It might even receive more public support when it is seen as improving health security. In classical neo-functionalist language, health qualifies as 'low politics', the public appreciates the benefit of integration and a permissive consensus may prevail.

5. The 'Size of Nations' Matters

While crises have different impacts on EU integration, not much is known about them from a "size of member state" perspective. The EU member states differ in power, territorial and economic size. Most of them could be classified as small states or medium powers in comparison with rest of the states in the world.[2] Size matters because the larger member states dispose of more resources in crisis situations, while small states tend to bandwagon and focus strongly on survival.

The first substantive conclusions on Covid-19, adopted by the Council on 13 February 2020, emphasised the global nature of the crisis and the need for global measures pursued through multilateral coordination particularly within the World Health Organization (WHO). Concurrently the Council mobilised existing EU instruments in the field of health security (Council of the EU, 2020). In June 2020, following a pan-European survey, the European Council for Foreign Relations (ECFR) reconfirmed an earlier finding that "the crisis had not led to either a populist revival or a re-evaluation of European federalism" (Zerka, 2020, p.2) The ECFR's *solidarity tracker* indicated that "European solidarity was a reality, and often strongly so" (Zerka, 2020, p.2). Solidarity is

[2] UN population data for 2022 shows that one EU member state, Germany, ranks nineteenth among the top 20 in the world rankings. Five-member states rank among the top 40 and the rest rank between 61 and 175. Luxembourg and Malta rank at 169 and 175, respectively.

crucial during crises, but it is not integration. Findings from another public opinion survey, showed that while intra-EU cooperation grew steadily as the pandemic unfolded, its economic consequences differed across Europe, raising similar divides as those observed in previous crises (Krastev and Leonard, 2021). These observations if reconfirmed by further research permit a fuller assessment and a clearer direction for a "health union".

6. Shelter Theory

An understanding of the behaviour of the smaller member states during the pandemic must begin by theorizing what they seek to achieve by EU membership. The EU offers small states several advantages such as increased security, connectivity, a large internal market and a strong alliance to help them navigate the challenges of world politics and augment their negotiating powers in multilateralism. The price which they have to pay for membership is relatively low compared to the advantages. The costs for the Union are almost negligible. Thorhallsson (2019) developed a "Shelter Theory" to show how small states address their inherent, size-related weaknesses. For him, small states seek shelter by aligning with larger states and/or international/regional organizations (including the EU) for domestic and international relations reasons.

Thorhallsson's conception of shelter is not static, metaphorically an umbrella to be opened only on a rainy day. "Shelter" is dynamic allowing small states to augment their power without causing alarm to their shelter provider/s or other states; it helps them overcome their domestic limitations and exposes them to constant interactions with other cultures, ideas and ideologies thus enabling them to overcome excessive isolation and social stagnation. It permits them to overcome lack of knowledge, weak infrastructure and small bureaucracies. However, Thorhallsson cautions that protection can impose enormous costs on small states due to penetration by the larger state or entity providing it. This danger is probably less intense in the EU, where small states participate in the institutions, agenda-setting and coalition-building. In all these, member states align more around other issues than size. Outside the EU, small states in a dyadic relationship with a stronger power run greater risk of penetration which can lead to dependence and hegemony of the stronger partner on the weaker one. Rarely, though not improbably, does a small state manipulate the stronger power in an alliance.

7. Strengthening Resilience by Self-Knowledge

EU shelter for small states works best following a Europeanisation process (which evolves continuously and can progress or regress) and the small state can use all the EU opportunities to strengthen its resilience. Resilience signifies the ability to withstand adverse external or internal shock (or both, simultaneously) and bounce back to recover from the negative effects. Resilience requires states to strengthen their societies' capabilities to resist and recover from the disruptions provoked by crises. In general, a state's resilience depends not only on outside help but also on the quality of its institutions, social stability and cohesion, good governance, the reliability of its infrastructure including its health services and civil protection, economic reserves and forward planning. Due to their lack of resources, small states depend more on effective solidarity. Hence, EU membership shelters a small state to a high degree (note for example Article 42.7 of the TEU and Article 222 of the TFEU), which increases when states have strengthened their internal governance, economy and society.

Using a metaphor employed by Lino Briguglio in 2004 to discuss economic resilience, small states can either be "self-made", i.e. they succeed in buttressing their resilience despite their inherent vulnerabilities, or they behave like the "prodigal son" by squandering their resources thus increasing their vulnerabilities to external and internal shocks. Resilience cannot be restricted to an economic connotation. It has other factors: political, governance, societal, environmental, educational, R&D capacity, dependable and renewable energy supplies, reserves to be used in times of crisis, and a reflexive ability to adapt to the continuously evolving geopolitics. EU membership does not bestow these advantages automatically, however small member states can proactively take advantage of additional resources, such as cohesion funding, to strengthen their economic, environmental and social infrastructure, connectivity, the acquisition of knowledge and best practice to strengthen their resilience to internal and exogenous shocks.

8. Malta and the Health Union

The story of Malta's approach to the EU's Health Union confirms the Shelter Theory discussed in the previous section. It starts during the runup to Malta's first Maltese presidency of the Council of the EU in 2017. Prior to the Presidency, the health authorities led by minister and deputy Prime Minister Chris Fearne, a medical surgeon by profession, began to lay emphasis on voluntary structured cooperation between the member states on EU-wide health problems and cross border issues. Azzopardi-Muscat et al. (2017, p.11) summarized it succinctly: "The Maltese EU Presidency has chosen to focus on the scope of voluntary structured cross-border cooperation between Member States to ensure access to innovative medicines and technologies as well as access to highly specialised health services. The needs of small populations, referring both to populations of smaller countries, as well as patients with Rare Diseases, are highlighted. Structured cooperation between Member States can enhance capacity, increase equity and also improve quality and efficiency of health system interventions." Another important proposal which solidified during the Maltese presidency concerned affordable medicines. Minister Fearne broached the issue at the European Health Forum Gastein in September 2016, when he highlighted the need of more transparency in the pricing of medicines and urged member states to work together more closely on it.

An informal meeting of European Ministers of Health held in Valletta on 20 March 2017 discussed the main themes of the Maltese Presidency, namely Childhood Obesity, HIV and Structured Cooperation between Health Systems (Department of Information Malta, 2017a). Later, on 8 May, six southern EU ministers of Health convened in Valletta and decided to strengthen their collaboration to improve access to “effective and affordable medicinal products in a sustainable manner” (Department of Information Malta, 2017b). They agreed “that it is opportune for Southern European countries to work closer on a regional basis in order to improve better access and affordability of medicines for both the benefit of patients and their respective health systems, which need to be continuously supported and sustained for the future” (Department of Information Malta, 2017b). This became known as the “Valletta Process.”[3] The ministers established a technical committee to explore several areas of cooperation, including joint price negotiations. Joint procurement of medicines was then taken to the 67th WHO Regional Committee Meeting for Europe, which met in Hungary in September 2017.

The issues discussed at the Malta meetings also featured in the European Commission’s 2017 *Reflection Paper on the Social Dimension of Europe* (European Commission, 2017). However, the Valletta proceedings did not gain sufficient attention nationally, mostly because they were overshadowed by a snap election campaign called in the wake of serious allegations of official corruption made by journalist Daphne Caruana Galizia, who was murdered four months after the election on 3 June 2017.

It can be seen from this discussion that before the notion of an EU health union had begun to take shape, Malta was already urging more cooperation and further integration in his sector. When Covid-19 started spreading rapidly in 2020, the member states scrambled to secure themselves by closing borders and preventing exports of essential supplies. However, by June agreement was reached to implement a joint procurement procedure to be administered

[3] The Valletta meeting was attended by the Health Ministers of Cyprus, Greece, Italy, Malta, Portugal and Spain; the following day Ireland and Romania signed the declaration; Slovenia and Croatia joined on 30 January 2018.

by the European Commission to ensure that all member states would have access to vaccines and other equipment such as ventilators. It was recognised that only an effective vaccine could stop the pandemic and that the costs and time needed to develop one were enormous and uncertain. The Advanced Purchasing Agreements (APAs) concluded with a number of pharmaceutical firms which were most likely to develop a successful vaccine increased the probability of a positive outcome and that no member state would be left behind. Malta was a strong supporter of this approach.

Malta's policy stance is consistent with the policies which it pursued before the onslaught of the pandemic particularly during its Presidency of the Council of the EU. Later, when HERA was launched, Minister of Health Fearne, said that this was a good step but not the Health Union, and more needed to be done. During a panel discussion at the 2021 Health Care Forum organized by Politico Europe (2021), Fearne stressed that there is definite scope for a European Health Union. While cautioning that member states still jealously guarded their powers in public health, they would be willing to go "federal" if something can be done better when it is done together. He said that a health union would permit universal health care and make medicines available more widely and at a more reasonable price particularly in the case of orphan drugs. The Minister urged the EU to take advantage of the positive experience of the joint procurement approach during Covid-19 to extend this principle further.

9. The Domestic Impact of Covid-19

It was argued in this article that small states need to strengthen resilience to future shock by buttressing internal resilience. The pandemic triggered several types of analysis in a number of disciplines and on an array of subjects which improved our understanding of what can work or malfunction in the event of an exogenous shock. Bezzina et al. (2021) analysed the effects of working remotely on the Maltese public service and uncovered inherent weaknesses in the service's IT infrastructure.

The legal basis at Maltese law for the implementation of containment measures are summarized by De Gaetano (2020). Laws had to be occasionally finetuned as their gaps were exposed. Harwood (2022) provides a clear assessment of Malta's policy responses and the difficulties which they encountered. The arrival of the pandemic occurred at a rather inauspicious time when important changes were taking place at government level with a new Prime Minister taking office a few weeks before the onslaught of the crisis. Despite the excessive polarization that characterizes Maltese party politics, Covid-19 was never politicised, neither at intra nor partisan party levels, though at some junctures, rumours were rife of differences in approach between the health authorities who favoured tighter measures, and the Prime Minister who leaned towards the removal of the measures to boost economic activity (Harwood, 2022). Harwood places special emphasis on Malta's institutions which are based on the Westminster/Whitehall model, an inheritance from the islands' colonial past, which centralises decision-making in the executive. This permitted timely decisions. Parliamentary scrutiny was negligible but all the meetings of Parliament's Standing Committee on Health in 2020-22 centred on the pandemic. The minister of health made four statements in plenary during the same period.

Setting aside the loss of life[4] economic, social and psychological impacts were also evident. The containment measures led to new modes of schooling, office work, retailing and several other economic activities. Travel restrictions overseas, both outgoing and incoming, dealt a severe blow to the tourist industry one of Malta's leading economic sectors. Not all economic activities were impacted in the same way. Rapa (2021) asserts that the containment measures not only had a very strong impact on economic activity, but also affected the public's risk assessment: when the daily cases of COVID-19 increased, mobility decreased showing that the public's risk assessment played a crucial role in determining economic activity. The Government countered the negative economic effects by a stimulus package consisting of a mix of fiscal measures including tax deferrals, bank guarantees and direct capital injections (Grima et al., 2020) which were renewed whenever containment measures were relaxed only to be reimposed later in the face

[4] 719 deaths due to Covid-19 by 25 May 2022 in a population of 516,000.

of growing infections (Harwood, 2022). These measures took their toll on Malta's fiscal balances with the general government spending going from positive to -9.5% of GDP in 2020 and -8.0% in 2021; debt to GDP rose from 40.7% in 2019 to 57% in 2021 (National Statistics Office Malta, 2022a).

Real GDP declined by 8.2% in 2020, but rebounded by 5.9% in 2021. Supported by the EU's Recovery and Resilience Plan, real growth is expected to grow by 6% in 2022 and by slightly less in 2023. Inflationary pressures increased in 2022 partly because of the war in the Ukraine and because the economy started growing again (European Commission, 2022). The Labour market remains buoyant with negligible unemployment: in February 2022, the monthly unemployment rate was 3.1 per cent, 3.2 per cent for males and 3.0 per cent for females. Youth unemployment stood at 10.5 per cent while the rate for those between 25 and 74 years stood at 2.3 per cent (National Statistics Office Malta, 2022b). According to the Central Bank of Malta (2022), "the general government deficit is expected to narrow substantially… as COVID-19 measures unwind and macroeconomic conditions improve further. By 2024, it is forecast to narrow to 3.3% of GDP (while) the general government debt-to-GDP ratio is projected to stand at 60.9% of GDP in 2024." The Maltese economy shows strong signs of a rapid recovery after the sharp decline of 2020.

10. Conclusion

The discussion of Malta's battle against Covid-19 leads to three conclusions. The first is that a small state in a 'shelter' relationship by virtue of EU membership stands to gain from protection and in bouncing back from the effects of a crises that present a veritable challenge to its limited resources. For a small state being in the EU is better than having to negotiate for aid as an outsider. In addition, membership of a regional organization allows small states to engage in coalition building to reach some common objectives, as illustrated by the 2017 "Valletta Process" and EU solidarity during the pandemic.

Lastly, crises should not just be lived through but also assessed, because the knowledge gained permits small states to address weakness in their national decision-making structures and prepare them for future crises. Resilience should not rely exclusively on the help that a small state receives from an international organization, but also on its own preparedness to confront crises. Malta's sound fiscal position before 2019 allowed it to dig into its pockets when the pandemic struck in 2020 and assure itself of a strong economic rebound in 2022 – assuming no devastating economic counter impacts occur as a result of Russia's war against Ukraine.

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The Next Generation EU: A Political and Normative Outlook of a Debtor Country

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ABSTRACT: Stemming from the principle that the Next Generation EU (NGEU) means an historical step towards European integration, this chapter questions the optimum future viability of the new budgetary and fiscal instruments achieved from the perspective of political science and political economy. The rationale behind such position consists of the theoretical framework of democratic deficit in the EU, and of the idea that it created a political over-hegemony of surplus economies over the deficit ones. Furthermore, the argument is laid down on an historical tracing of decisions in economic governance in the European integration, since the creation of the EMU. It's argued that the NGEU, although highly significant for EU economic governance, should be supported by political integration to allow politicisation of decision-making, to the detriment of nationally biased decision-making, which would shelter democracy in Europe and reinforce it the EU.

Keywords: Recovery and Resilience Plan, Next generation EU, Economic and Monetary Union, Democracy, Pandemic Crisis

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1. Introduction

EU economic response to the pandemic crisis may be considered a milestone in European integration. The innovating character of measures approved open avenues for a significant deepening of supranationality in the realm of economic governance. Besides other emergency response instruments approved[1], it was the historical decision of the European Council on 21st July 2020 which adopted the financial package Next Generation EU (NGEU) of €750 billion that represents a milestone in European integration. The innovating character of this move is that part of the fund is delivered in the form of grants for member states, which will be guaranteed by EU debt issued in credit markets, of which payment is ensured through future European taxes levied. These decisions break the longstanding taboo of Eurobonds and fiscal competences of the EU, paving the way to reinforcing the European budget with new own resources and endowing the EU with a stronger redistribution element.

Moreover, these decisions are very important for net beneficiaries of the EU budget and debtor member states of the Economic and Monetary Union (EMU), e.g. Portugal. Unlike the kind of response to the Eurozone sovereign debt crisis, they provide financial relief to the domestic fiscal policies within the SGP framework, feed an expansionary policy, and strengthen the EU budget with a redistributive element that is more decoupled of national revenues. More importantly though, this move should be accompanied by political integration. Based on a normative approach, this chapter questions the future optimum viability of this solution from the perspective of political science and political economy. The rationale is informed by the democratic deficit theoretical framework, and the subsidiary idea that it allows for a political hegemony of economies in surplus over those in deficit, replacing political representativeness with economic representativeness. It is argued that if NGEU decisions continue

[1] Like the suspension of the convergence criteria under the Stability and Growth Pact, the several loans provided through the European Investment Bank and the European Stability Mechanism, and the Pandemic Emergency Purchase Programme, by the ECB.

to be made under the current decision-making procedure, it is most likely that this will perpetuate suboptimal solutions for the debtor states, and postpone political conflicts for the future, which may enhance parties and citizens' opposition to the integration process, and also endanger European democracy.

To build on this argument, a qualitative analysis of EU primary sources and media articles is made, alongside with an historical process-tracing of decision-making regarding EMU creation and governance. This empirical analysis is read through the lens of political science democratic deficit and political economy literature. The chapter is structured as follows: the first part analyses the measures resulting from the NGEU approval and substantiates its importance for economic governance in the EU, while clarifying the decision-making procedure they will be subject to. Building on that decision-making procedure, the second part tracks the historical trends of political outcomes in the EMU and highlights a disfunction in decision-making procedures, with decisions being determined by the economic powerful/surplus states. The third part provides a diagnosis of the problem, identifying the institutional causes that explain it, and lays out some prescriptive lines.

1.1. The important role of the RRF in economic governance: truly European own resources and de-nationalisation of budgetary bargaining?

The approval of the €750 billion financial package "Next Generation EU" brought prospects of deepening European integration, launching the basis for the creation of new supranational competences in economic and financial governance. The Recovery and Resilience Facility (RRF) is the main financial instrument of the NGEU, accounting for €672.5 billion of the total amount of €750 billion. React EU, the Horizon Europe, InvestEU, Rural Development, Just Transition Fund and RescEU are other instruments that make up for the remaining €77,5 billion. The €672.5 billion of the RRF comprises grants amounting to €312 billion and loans of €360 billion (2018 prices) (European Council, 2020). This is an addition to the €1,074 billion (2018 prices) of the 2021-2027 Multi-financial Framework, allowing for the creation of extraordinary funds combined with the classical budgetary ones.

The exceptional character of this agreement lies in the fact that to make the €750 billion package possible, the European Commission (hereinafter EC or Commission) was empowered "to borrow funds on the capital markets on behalf of the Union" until 2026, thus creating European public debt. Furthermore, to guarantee the payment of the European debt by 2058, the European Council committed to reform the own resources system by introducing new own resources, with priority to tax levy on non-recycled plastic, a carbon border adjustment mechanism, and on digital business, by 1 January 2023 at the latest. There is still the possibility for revising the EU Emissions Trade System, probably extending it to the maritime and aviation sectors, and introducing a financial transaction tax (European Council, 2020). At the end of 2020, a regulation was approved to set the EU recovery instrument [Council Regulation (EU) 2020/2094] and an interinstitutional agreement between the European Parliament (EP), the Council of the EU and the Commission was achieved to frame the new budgetary requirements, namely financial management discipline, and the EU commitment to pay the extra recovery package with the creation of new own resources, setting a roadmap for the implementation of new levies from January 2021 until January 2023 at the latest. Moreover, the agreement still provides for a digital transaction tax by 2026 (EP, Council & Commission, 2020).

Following this, in December 2021, the Commission issued a communication (EC, 2021) for the next generation of own resources for the EU budget, proposing three new own budget resources: 75% of the revenue generated by a carbon border adjustment mechanism[2]; 25% of revenues from the emissions trading system[3], and 15% of the share of the residual profits of the largest and most profitable multinational companies[4]. In conformity, a

[2] Proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, COM (2021) 564 final].

[3] This proposal aims at amending previous legislation on carbon emissions trading, as part of the New Green Deal.

[4] Under this scheme, each member state will contribute to the EU budget based on the national share of the taxable profits of a multinational company that are reallocated to the EU member states under the ongoing global agreement OECD/G20 Base Erosion and Profit Shifting Project. It intends to fight tax erosion and avoidance of companies

proposal for a Council Regulation was presented to amend the existing system of own resources of the EU (EC, 2021a), which is still under preparatory discussions in the Council, and is subject to unanimous voting. Following a global agreement on a framework to fight tax erosion, the digital tax levy that had been envisaged was put on hold. The Commission is expected to start a second package of own resources by the end of 2023, which shall include a financial transaction tax and a levy linked to the corporate sector.

While providing the EU with new competences, these measures, taken to tackle the economic consequences of Covid-19, pave the way to changing the political economy of the EU, putting in place some policies that economists have upheld as structural to lend economic rational coherence to EMU governance. Some of these measures were for long faced as taboos by European policy makers, as is the case of mutual debt and fiscal competences. Predicting the birth of an EU fiscal policy, those decisions allow to address one historical problem: the small size budget compared with the EU goals. Whereas the EU has progressively enlarged, acquired more competences, and set more ambitious political objectives, the budget has stagnated since the Delors II Package (1993-1999), ranging between 1-1.2% of the EU GDP.

What is remarkable is that the EU budget increase is achieved not through direct national transferences, but through truly European own resources, while simultaneously regulating the market, setting forth climate policies and fighting against tax evasion. This is important in two ways: (i) because it creates fiscal revenues while addressing other supranational policy goals dependent on the single market and global dynamics; (ii) and because it allows to de-nationalise budgetary policy-making, which has been historically bound by the divergent interests of net contributors and net beneficiaries. Since the introduction of a percentage of the VAT and of the GNI in the 1970s and 1980s, respectively, as own resources, the intergovernmental bargaining for the multi-financial framework has been a politically complex and controversial process, with bargaining centred on the calculation of the national net financial contribution or benefit.

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exploring gaps between national tax systems and to tackle challenges of digitalization of the economy (OECD, 2021).

With the introduction then of these own resources derived from national contributions and the EU trend for free trade, the traditional own resources, i.e. customs duties and agricultural levies, became minimal as revenues in the whole budget. While in the 1970s they represented almost 0.4% of the EU GDP, in 2018 they dropped to about 0.1%. VAT and GNI-based own resources, according to a calculated rate over national income, became the predominant revenues, amounting to almost 1% of the GDP and to about 80% of the total budget (EC, 2017, pp. 29-31). This created huge national political cleavages between the net contributors and the group of cohesion member states, the net receivers, preventing the budget from evolving. Therefore, for a cohesion country like Portugal, whose GDP is still below 90% of the EU average, the NGEU provides for an increase of financial transfers. Moreover, considering that the new own resources have become permanently[5] part of the EU budget, they have the potential of stepping forward to unlock budget bargaining, as they introduce a trend to de-nationalize revenues[6], strengthening the redistributive character of the budget all the same.

Although these measures are not specific to the EMU, as they cover all member states, they also influence Eurozone economic governance in a positive way for debtor countries, such as Portugal. Not only because of the adoption of the escape clause on the SGP, and the ECB's quick response by launching the PEPP (based on the previous experience initiated in 2012), but mainly because of the short-term impact of the NGEU on the national economic policy.

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[5] Although the recovery facility instrument/ NGEU is mentioned as temporary, the proposal for the Council Regulation to amend the previous decision of own resources does not mention a temporary character for the new own resources, thus implying that they are permanent own resources of the EU budget (EC, 2021a).

[6] This is the case of the carbon adjustment mechanism. Regarding the others, although they are generated by national revenue calculation, the resources do not come from traditional national levies, but are directly linked with EU or global market regulation initiatives. It is the case of the revenue of the emissions trade system, which originates from national revenue that derives originally from an EU directive under the EU climate policy. Concerning the own resource based on taxation of residual profits of large companies, even though it comes from a national contribution based on the share or residual profits of the largest and most profitable companies reallocated to member states, it introduces principles of fiscal justice between member states. It is thus politically harder to deny those as own resources, as it is with GNP or VAT.

It will provide relief in budgetary policy within the framework of the SGP[7], allowing for active expansionary policies to tackle the economic and social effects of the pandemic, in contrast with the deflationary policy adopted to face the Eurozone debt crisis. Although these are junctural responses to pandemic, the new own resources can pave the way for a different paradigm of political economy in the EMU governance. The EU broke the taboo of the "Eurobonds" and fiscal competences, which lay the ground for the accomplishment of fiscal transfers and mutual debt, and thus for a shared responsibility of fiscal balances in the Eurozone, a component that can provide the EMU with the economic rational typical of an Optimum Currency Area (Hix & Hoyland, 2011, pp. 245-249; de Grauwe, 2009, pp. 107-108). This is a favourable approach for debtor countries, by compensating the non-bailout clause of the EMU.

Hence, the structural effects of these measures are dependent on the possibility of them becoming permanent and reinforced. On the other hand, we argue that these new competences need to be accompanied by a political enhancement to enable the weaker and debtor economies, to achieve optimal performance. In other words, the interinstitutional agreement that commits the EU to the fiscal measures "does not alter the respective budgetary and legislative powers of the institutions as laid down in the Treaties" (EP, Council & Commission, 2020). Such competences are defined by the primary law of the EU, which fits taxation and related legislation into a special legislative procedure, providing the Council with the exclusive decision power, subject to unanimity (articles 113, 115, and 352 TFEU). This is precisely the concern raised, and the origin of the argument of this chapter. By leaving these competences under the exclusive decision power of the intergovernmental body, and subject to unanimity, they have the potential of replicating historical and political imbalances in decision-making, in favour of the economically powerful member states, and thus preventing the development of optimum solutions for the future correction of structural economic asymmetries. This concern arises from the historical trend of decision-making outcomes in the EMU.

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[7] Besides the Commission has activated the escape clause, to provide full fiscal flexibility to member states, thus suspending convergence criteria of the SGP, this being a temporary decision.

2. Historical trends in the outcomes of decisions made in the EMU

The EMU is not merely an economic project, but one whose origin is very much related with maintaining geopolitical balances in European integration.

Despite economic reasons for creating a single currency (Chang, 2009, pp. 15-44), it was above all the French political will to keep Germany committed with the West that unlocked the ultimate negotiations for the creation of the Euro. With the implosion of Soviet Union, and the resurgence of new states in the East, the threat of a reunified Germany turning to the East and neglecting European integration was awakening French historical ghosts of an uncontrolled and hegemonic Germany in Europe. François Mitterrand's persistent call for the creation of the single currency aimed, on one side, to guarantee the future political commitment of Berlin with European integration, and on the other side, accepting reunification but diluting the power of the German mark in the single market (Dinan, 2014, pp. 227-231; Hix & Hoyland, 2011, pp. 254-258). On its turn, Germany relinquished monetary sovereignty under the condition that an ECB would be developed in the image of the Bundesbank, with the political economy of EMU reflecting the ordoliberal model. Yet, the construction of the EMU also reflects the general consensus in Europe around neoliberalism, and more precisely monetarism, at the end of the 1980s (Dinan, 2014, pp. 232-235; Hix & Hoyland, 2011, pp. 258, 259; Lang, 2004, pp. 136-138).

The history of activation of excessive deficit procedures in the framework of SGP has also witnessed an influence of hegemonic economies. The first SGP breaches were registered in 2002 and 2003 by Germany, Portugal and France. In 2002, the Ecofin ignored Commission recommendations to warn Germany, and by 2003 the Council had decided to suspend excessive deficit procedures and not to follow the Commission's recommendation to begin proceedings against Germany and France, according to the SGP norms. This motivated a complaint by the Commission to the Court of Justice of the EU, which decided in favour of the Council (Chang, 2009, p. 127). After this event more flexibility was allowed in the convergence criteria until the outbreak of the 2008 financial crisis.

The responses to the Eurozone debt crisis are very much indicative of the hegemonic influence of advanced economies. This conclusion is based on a review of events and on a critical reading of the diverse literature that tries to understand the drivers of institutional and political responses of EMU to the crisis.

Neofunctionalist literature considers that it was the EMU functional economic and financial national interdependencies that formed governmental preferences and forced decision for more integration following the crisis (Niemann and Ionnaou, 2015). The problems of an incomplete EMU were triggered by the international financial crisis, unveiling functional interdependencies between the member states, pressing corporate and political actors for more integration.

Although this theoretical reasoning may explain why the crisis resulted in more integration, it does not justify the kind of solutions agreed. Why were measures, such as an integrated fiscal scheme or debt mutualisation, not taken, but instead the monetarist feature of EMU was strengthened?

While the international interdependency of the Eurozone led to a consensus between all Euro members on the priority of keeping the single currency stable, two opposed governmental positions emerged about which measures to take to guarantee stability. On the one hand, the surplus and export-led economies, such as Germany and other northern countries, preferred national financial adjustment in the form of prices and wage depreciation, adequate expenditure containment and widespread austerity to address their credits. On the other hand, debtor and demand-led economies, those of the "south", called for the sharing of the burden of adjustment, through debt mutualisation, fiscal equalization schemes and a specific budget for the Eurozone to operationalize fiscal transfers (Schimmelfenning, 2015). The two polarized positions were a result of the asymmetrical model of growth that the EMU created, thus expressing the rational economic interest (together with re-election intents) in the intergovernmental bargaining, of which collective decision derived from the minimum common denominator (Armingeon & Cranmer, 2017).

But why was it the monetarist-kind solution, when it was evident that the structural inefficiencies of the original EMU architecture enhanced the consequences of the global financial crisis in the Eurozone (Ahumada, 2015; Stockhammer, 2016, Stiglitz, 2016, pp. 179-187)? Why was the crisis not an opportunity to change the economic policy paradigm, fostering the creation of some policy instruments that were noted long ago by economists to provide economic coherence to the EMU (Krugman, 2012; Grahl, 2011, de Grauwe, 2009, pp. 11-142; Stiglitz, 2016, pp. 131-178)?

Studying four decision-making procedures during the crisis management, Csehi and Puetter (2020) concluded that governmental elites, such as the ministers of finance and the heads of government, were the most influential, followed by the EU bodies involving collective intergovernmental decision, such as the Eurogroup, and others such as the ECB and the Commission. On the extreme side of influence are the non-executive domestic actors, such as parliaments, businesses and labour interest groups, public opinion, and the European Parliament (Csehi & Puetter, 2020, pp. 9-17). Interviewees in the research stressed that some decisions were already "pre-cooked" in the Eurogroup Working Group and the Eurogroup, and that parliaments were mere spectators (Csehi & Puetter, 2020, pp. 13-14). Other authors (Ezrow and Hellwig 2014) claim that international economic interdependency is stronger than national interests in the outcomes of the crisis, and national constituencies were deprived of collective decision-making.

Both conclusions are complementary and evidence that economic power corresponded to political power. The highly internationalised EMU economy, with transnational economic actors pressing for urgent response, forced Euro member states to make joint decisions, ignoring domestic players' preferences, while privileging the influence of some national executives, exerted in the intergovernmental EU level bodies of decision. This resulted in an economic policy solution relying in the continuation of the ordoliberal strategy (Ryner, 2015). It was the case of the approval of the TSCG and the six-pack regulations to tighten macroeconomic surveillance in the EMU, recovering premises of the 1996 SGP, already informed by ordoliberalism. Liberal intergovernmentalism theorists corroborate that response to the crisis reflected Germany and its allies' preferences (Schimmelfening, 2015). If institutionally the debtor countries could refuse that, the reality was that, considering the economic constraints of the crisis and the structural economic interdependency of the Eurozone, any solution for them was preferable to no solution at all (Sebastião, 2021, p. 258). We should thus underline that by assuming this, it's supposed that the debtor states were mere victims of the Eurozone crisis. Bailed out countries suffered from a mix of long-term domestic economic mismanagement and of the faults of EMU institutional norms (Parker and Tsarouhas, 2018; Buendía, 2018; Dooley, 2018; Gkasis, 2018).

Constructivist studies contradict the supremacy of governmental preferences, reasoning that national interests are permanently shaped and reconstructed in collective decision-making bodies, making domestic interests and EU collective spheres permeable and mutually influential (Crespy and Schmidt (2014). This may precisely explain why debtor countries, while having an opposing national economic interest to ordoliberal solutions, gave in to creditor countries' preferences. But the authors stress the fact that even Germany has re-shaped its position and withdrew its initial rejection of financing a rescue plan for the indebted countries. But when attaining to the economic impact of the decision taken, we conclude that Germany had just to choose between the less harmful option: between bailing or not bailing out Greece. While the former would bring temporary financial costs to Berlin by supporting loans to Athens[8], the latter would trigger uncontrolled financial and economic systemic risks to the national economy, with the exposure of German banks to Greek debt. Guaranteeing liquidity to debtor countries would guarantee liquidity to the creditors' banking system (Copelovitch *et al.*, 2016, p. 828). Furthermore, while this was a short-term response to the crisis, structural responses were needed for the institutional disfunctions of the EMU. And when it came to this, Germany did not shift its ordoliberal preference.

Hence, economic representation seems to overlap political representation in intergovernmental bargaining. Even if the pandemic response suggests

[8] Note that the credit supported by each member state was on the basis of a repayment agreement with the beneficiary country.

that a learning process occurred, leading to substantial policy change (Lady & Tsarahouas, 2020, pp. 144-151), it does not mean there was a change in the decision-making paradigm of power. On the contrary, the economically hegemonic states kept playing a crucial role in decision-making (Sebastião, 2021). The decision to issue supranational debt and grant the EU fiscal competences was made due to the different nature of this crisis. First, it affected all member states alike (Khan & Arnold, 2020), and most severely the exporting-led economies, given the disruption of the world market (EC, 2020a, 2020b). Secondly, the possibility of repeating Eurozone austerity led some states to ponder the possibility of abandoning the Euro, as the cost of exiting could be lower than a new austerity (Eurointelligence, 2020, 2020a). The single market seemed to be facing a serious existential threat, which impelled politicians to engage in different solutions (Ladi & Tsarouhas, 2020, pp. 1046, 1047). As an economy whose growth model is very dependent on the EMU path, Germany supported the Commission's joint debt issuance proposal and pressed the initial opposing "frugal four" member states.

The institutional and economic interdependency compelled states to a common solution in both crises. In the former, joint debt was also put forward as a medium/long term solution, but it was not followed through. The element of change in the pandemic crisis was the German political support, dragging the "frugal four", which is a clear sign of the weight of this state to guide decision (Sebastião, 2021, p. 258). But as the decision procedure is bound by the unanimity rule, the four reluctant – and competitive – economies of the EU (Netherlands, Austria, Denmark and Sweden) could highly influence the extent of the financial package approved all the same, requiring the substantial reduction of the grant amount of €500 billion initially proposed to €350 billion. While one can say that intergovernmental decision-making could approve a more equitable solution, this time much more favourable for debtor countries, it was only possible because one member state changed its historical stance on economic issues. Even so, a minority of economically powerful states could be highly influential in the outcomes.

Based on this, we argue that if future economic decisions, namely on fiscal matters, continue to follow this decision-making procedure, asymmetric interests will continue to polarise bargaining between competitive and less competitive economies, with political overlapping of the most competitive economies.

3. Problem diagnosis and prescriptive outlook

The root causes of the constraints described above are mainly embedded in the democratic deficit of the EU political system. Literature on the democratic deficit is controverse, but the advocates of this critical approach argue that the EU "constitution" still lacks principles of representative democracy for the exercise of power. Hence, democratic deficit deals with the need for democracy to procedurally legitimize the EU's authority (de Jongh & Theuns, 2017) and make its outputs more effective (Hix & Hoyland, 2011, pp. 131-136). A permanent dialectics exists between democratic legitimacy and effective policies. In other words, when the political system's outputs do not live up to the demands of the electorate and they seek an alternative, political competition and an executive power based on a majority rule becomes crucial for citizens.

In the EU, however, citizens can hardly influence the alternative, as the main political office (the President of the Commission) is not elected. Despite the progressive role of the EP as co-legislator, its political weakness is evident in some areas (as in EMU economic governance), as it has not been empowered proportionally to the loss of power of the national parliaments (Hix & Hoyland, 2011). Intergovernmentalism is still too heavy in the EU balance of powers (Schmidt, 2007, p. 521), and executive bodies, such as the national government leaders, make most decisions, the EU resulting in an imperfect bicameral system (Moreira, 2017, p. 55). This constitutional design deprives the Commission of a citizen's mandate, without which it is weakened to mediate intergovernmental bargaining. In alternative, it will do its best not to obtain the most suitable solution for its "constituencies", but to reach a consensus in the Council, which contributes to the depoliticization of EU outcomes (Sebastião, 2021).

Furthermore, institutional norms also concur for the hegemony of the economic interests in decision-making. Unanimity rule in the Council makes the decision dependent of one or a minority of member states, even if they represent a very small minority of the population. This was evident during the pandemic, where the frugal four managed to influence the outreach of the NGEU (Zalan, 2020), as demonstrated above. In parliamentary based systems, majority is also subject to negotiation, but the problem in the EU is that unanimity boosts the power of a few political actors, which may correspond to a minority of the citizens represented therein. This dynamic was key in changing the NGEU Commission's proposal for a suboptimal solution in a way that would be more difficult under a majority rule voting context (Sebastião, 2021).

The secrecy of intergovernmental bargaining in the European Council and informality of some bodies, as the Eurogroup, only makes matters worse, by limiting the ideological debate and the public outreach thereof, privileging nationalistic arguments (Sebastião, 2021). The Council is undeniably the legitimate guardian of national interests, and therefore a forum to negotiate them. However, if one governmental leader wants to use ideological arguments and mediatise the debate to clarify public opinion and counterbalance peers' messages of purely domestic electoral interests (Darroch, 2020), their capacity to do so is very limited. This is also not to deny the role of the EP as the ideological debate arena of the EU *par excellence*, but in EMU governance and fiscal issues the EP has no formal power.

The fact is that economy is a matter of politics in the tradition of European democracies. Nonetheless, EMU institutional architecture paved the way for a depoliticization of economic governance. The SGP provides a kind of constitutional status (Dieter Grimm, cited in Habermas, 2015, p. 547) for the political economy in the Eurozone, limiting supranational and national policy options. In fact, ordoliberalism, which informed the creation of the EMU, can still be conceived as a theory of how market society can be depoliticized through the state and politics (Bonefeld, 2012). Additionally, the deep historical interdependency of national economies within the EMU framework reinforces the trend of depoliticising the economy in the Eurozone.

According to Ezrow and Hellwig (2014), national economic interdependencies push political elites away from the electoral interests, making them more responsive to market actors. Despite parties compete in the left-right dynamics and commit with voters in elections, they only succeed if the national economy is sheltered from the world economy (Ezrow and Hellwig, 2014). This perverse relation is even stronger in the EMU, where a hugely deep economic interdependency exists. Here, powerful economic agents are not only market actors, but also states, and the political representativeness becomes derisory vis-à-vis the economic hegemony, with capital accumulation as the driver of political power in intergovernmental bargaining. The fragile structural position of debtor states becomes even more fragile when they are exposed to international economic crises, and no decision is worse than a bad decision (Sebastião, 2021).

Riekmann and Wydra (2013) concluded that during the Eurozone debt crisis in the context of approval of rescue mechanisms, executive actors managed to circumvent national parliaments and societies' interests. Although parliaments became strongly aware of the Euro crisis management regarding financial and fiscal issues, national majorities voted in favour of government legislative proposals, meaning that national parliaments' role of controlling its executives did not have the power to counterbalance the European Council.

Moreover, the new EMU regulatory regime stemming from the Eurozone debt crisis further constrained national governments and fiscal policies, conditioning even more party competition and performance in opposition. The fact that mainstream parties face limitations in their political choices fuels nationalist and Eurosceptic challenger parties, impacting seriously the electoral systems (Laffan, 2014). Mudde (2019) sees here a breeding ground for populism, with unelected bodies, such as the ECB or the IMF, having a huge influence over important policy areas, thus severely limiting the manoeuvre of elected politicians. Confronted with the no alternative solution, political leaders avoid politicization of the debate, and often present liberal policies as necessary and inevitable in the context of globalisation or foreign organisations (Mudde, 2019, p. 117).

Consequently, Riekmann and Wydra (2013, p. 579) defend that "without restoring the EP as arena for democratic representation of the whole and for appropriate control if its European counterpart, the democratic deficit of the Union will continue." Yet, one can argue that, just as the national left-right competition is mitigated by the European economic interdependency, the political competition at the supranational level is also exposed to the same constraint, with the EU itself being dependent on the global market. If this much is true, the weight of the EU economy in the global market makes it more resistant to transnational economic and financial actor pressures than each of the national economies by themselves, on the one hand. On the other, the supranationalisation of political competition in economic governance would be a more effective way of the national constituencies expressing their demands in political competition, as ideological cleavages would not be nationally fragmented, but aggregated at the European level. This would require the EP to have formal decision power in economic governance, at first instance, and ideally the EU would have a majority based executive power, which would result in enhanced left-right competition and ideologization of EMU issues.

In effect, taxation, a derived competence of the NGEU, is a core element of political competition in the tradition of European democracies. Furthermore, taxation in the EU tends to trigger serious national conflicts, as this new competence stems from very different structural situations of the member states, some of which base their economic growth strategies on competitive tax systems. This is a very sensitive context for at least one of the proposed new own resources, based on taxation of residual profits of large multinational companies. Maintaining the decision-making procedure under unanimous intergovernmental power creates a great potential of perpetuating the cleavage between economies in surplus and in deficit and thus mitigates the effects of taxation on redistribution and correction of asymmetric growth in the EU.

Moreover, taxation and debt issuance as part of economic policy requires ideological reasoning to address social cleavages. Although nationality is also a legitimate social cleavage in a polity based on shared sovereignty like the EU, the fact is that economy cannot be reduced to that. Economic policies derive by nature from a vision for organising wealth production and redistribution, which goes much beyond national specificities. Ideology must be restored as a structuring element of the political debate and policy options, for the sake of the EU and liberal democracy in general. Not doing so is feeding arguments of challenger populist parties, which try to moralise the debate and re-politicise matters and groups that are mostly disregarded. And this legitimizes the uncomfortable questions they pose about alleged undemocratic aspects of liberal institutions (Mudde, 2019, p. 118). Not doing so is exposing the EU and European democracy to the paradox of the "invisible hand" of the market, which is strengthened by supranational European norms.

4. Conclusion

Highlighting the potential of EU economic response to change the political economy of the EU, this chapter raised awareness of the constraints that the institutional decision-making procedures pose to the outreach of the new measures. The arguments were built on EU decisions tracing and on literature analysis, under a normative orientation for democracy. Moving to a more democratic decision-making procedure would allow for a more balanced weighting of dichotomic economic interests in policy outputs and for the rescue of economy from a *technocratisation* circle, bringing it back to politics, to ideological competition, where it belongs. This rationale is not based on partisanship, but envisages the preservation of democracy in the national political systems, and the strengthening of the EU. The criticism set forth above aims at contributing to the improvement of decision-making processes and, ultimately, at shaping the EU political system into a more representative based one. This assumes that the EU is a more effective institutional and political system to affirm national interests in the international economy, by contrast with each state by itself. But if the EU continues to make decisions the way it has until now, while accumulating new competences, it will possibly continue approving suboptimal outcomes, running the risk of maintaining, or even aggravating, structural economic inequalities. Consequently, it will not be using its political potential to shelter each national economy from the disproportional economic forces of the global market, but politically and institutionally reproducing those same constraints.

Fiscal policy, as a competence resulting from the adoption of the NGEU, is at the heart of the construction of national welfare states and parties' competition, translating into a crucial element of public discontent. The preservation of current institutional procedures will continue to result in decisions that are made on territorial preferences and are highly influenced by technocratic supranational bodies, while they should be made on political grounds.

Changes to the *status quo* would require small incremental moves. Endowing the EP with decision power in fiscal issues would be an early step forward towards the politicisation of economic decisions[9]. However, as long as a true dialectics of political competition based on power-opposition is not built in the EP, the ideal politicisation of economy in the EU is not plenty reached.

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[9] Even though not always, the EP political groups are cohesive in voting. National divergences do occur within the groups, but historical analysis shows a trend for cohesion in political groups (Hix *et al.*, 2005, 2006).

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The Monetary Policy of the European Central Bank – an Obstacle to the Enlargement of the Eurozone

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Abstract: The European Central Bank (ECB) was established following to a large extent the statutes of the German Bundesbank, seeing its primary goal in pursuing price stability with respect to the current economic situation. In the aftermath of the Global Financial Crisis (GFC) of 2008 and the following sovereign debt crisis of the eurozone, the ECB changed its policy and focused on the goal of financial stability by using the instrument of quantitative easing. Thus, the monetary markets were flooded with liquidity.

Initiated by the former president of the Bank of England, Mark Carney, the role of the central banks in fighting climate change started in 2015. The ECB focused intensively since 2019 on this aspect and it has become part of the strategy of monetary policy of the ECB in 2021.

Thus, the article analyses the development of the change of monetary goals and policies, looking at the impact on fighting inflation and economic performance of the Eurozone as well as on the conflicts arising from the new focus on financial stabilization and the integration of climate change into its policies. Consequently, the potential impacts for the future enlargement of the European monetary integration are analysed by especially

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looking at the monetary policy of the central banks of the Czech Republic, Hungary, and Poland and the potential economic performance of these countries.

Keywords: monetary policy, European integration, European Central Bank, Eurozone

1. Introduction

The European Central Bank (ECB) was established in 1998 and started to work in 1999. According to the treaty on the functioning of the European Union (TFEU) the ECB was designed as a technocratic institution (Tokarski, 2016). However, the sovereign crisis of Greece in 2010 has shown that the ECB has taken over also a political role by formulating the framework of the rescue package for Greece in 2010 and the restructuring of Greek debt in 2011 and 2012.

Originally the ECB took over the mandate of responsibility for the monetary policy in the euro area. Thus, two major goals had to be pursued. Primarily, the ECB had to guarantee price stability and to do this by paying attention to the general economic policy of the EU. This perception was valid for the first decade of the existence of the euro. The Global Financial Crisis (GFC) of 2007/2008 has led to the pursuit of another goal: the financial stability of the euro area. This new goal, although not explicitly formulated, has led to the dominance of the goal of financial stability in the second decade of the euro system (Fratzscher, 2014). This decade was characterized by introducing five new instruments for the implementation of financial stability (Le Héron, 2016).

By the end of the second decade of the euro the issue of climate change and its impact on financial stability came to the forefront. There is a broad consensus among economists that climate change threatens financial stability (Tokarski, 2021). Thus, substantial interventions of financial institutions, including central banks, would become necessary. The executive board of the ECB has started some efforts to make monetary policy "greener" (Fuest *et al.*, 2021).

The article lines out the impact of the design of the changes of monetary policy goals and monetary strategies on the performance of the euro area. Has the pursuit of these goals been successful so far? Are there conflicts arising from these goals and their implementation? Finally, we must ask whether the development of the monetary policy of the ECB constitutes an obstacle for the enlargement of the euro area. The EU members having entered the EU from 2004 onwards, have signed that they will enter the euro area one day. In the first decade of the euro this seemed to be only a question of fulfilling the Maastricht criteria and could be achieved in a relatively short period of time. Today we must ask whether the new member countries are well advised to do this as quick as possible, because the euro system sets up more requirements and limits the opportunities of these countries to catch up and thus reduces the convergence process. In this article reference is made to three new member states which have gone quickly and relatively successfully through the period of transition, i.e., the Czech Republic, Hungary, and Poland.

Consequently, we will have a look and we have analysed the three major changes of the monetary goals and monetary strategy of the ECB and discuss the problems arising from these changes in the Euro area and will then turn to the present monetary policies of the three new member countries and their impact on economic performance before we assess the issue of convergence or division towards the euro area. Finally, the article concludes with some statements about the future institutional development of the euro area to deepen integration of the economic and monetary European Union.

2. The shrinking dominance and redefinition of the goal of price stability

From the start of the ECB in 1998, the ECB council pursued a stability oriented monetary policy which was confirmed after the first years of operation in 2003 (Deutsche Bundesbank, 2004). The strategy of the ECB is based predominantly on achieving the goal of price stability, which is understood as the stability of the price level. In operative terms this goal consists of an announcement of a quantitative definition of the price stability. Up to 2021 this was defined as an increase of the harmonized consumer price index (HCPI) for the euro area of less, but close to 2% compared to the previous year. For the period of 1999-2018 the average rate was about 1.75%, hitting the goal perfectly (Trichet 2019). Assisting the general economic policy was a goal subordinated to price stability and should only pursued when price stability was not endangered. The importance of the goal of price stability assumes that the costs of inflation are extremely high and that there are negative social consequences regarding the distribution of wealth (Adam & Mayer, 2020, p. 283).

The monetary strategy of implementing price stability was based on two pillars: the monetary analysis and the economic analysis. The first pillar focuses on the development of monetary aggregates such as the growth of the quantity of money, measured by M3 and the development of credits and interest rates. The second pillar focuses on data of the business cycle, prices, and costs. Thus, we have a combination of quantity of money steering and inflation targeting (Adam & Mayer, 2020).

The toolbox for achieving price stability was to a large extent the traditional one used for decades for implementing monetary policy in Germany and the other member states. Table 1 lists the instruments available. A look at this table reveals one remarkable point. Outright transactions were already included in this toolbox regarding fine-tuning operations and structural operations. This was mainly due to the influence of the Bank of England during the preparatory period (Bank of England, 2015). The Bank of England had a long experience using outright transactions as a standard tool of monetary policy and refinancing (Mooslechner, 2019). Apart from that which seemed to be a takeover of the tool kit of the Deutsche Bundesbank there were also discussions on the use of minimum reserves as well as the criteria for eligible collateral and the concrete auction model to be used in tender operations (Mooslechner, 2019). Thus, the first toolkit paved the way for the implementation of new instruments in the second decade of the existence of the euro area. A second remark alludes to the interest rate setting policy.

This was no longer an autonomous decision after the outbreak of the GFC because financial stability could not be achieved by this instrument.

The focus of monetary policy and its use of instruments was laid on open market operations.

Until the outbreak of the corona pandemics the goal of price stability was achieved even after the impacts of the GFC in 2008/2009 and the sovereign crisis in 2012. There seemed to be the danger of deflation from 2015 onwards as Figure 1 demonstrates which was caused by the policy of financial stabilization during the second decade of the existence of the euro. It must be said that the inflation rate is just the average for all 19 member states. For the period 1999 to 2011 which marked the climax of the financial crisis the price level in Germany had increased by 20% whereas in Greece the respective value amounted to 48% and for Spain amounted to 41% (Adam & Mayer, 2020). Due to these differences macroeconomic imbalances could not be avoided.

TABLE 1. **ESCB monetary operations toolkit: EMI blueprint of 1998**

Monetary policy operations	Types of transactions		Maturity	Frequency	Procedure
	Provision of liquidity	Absorption of liquidity			
Open market operations					
Main refinancing operations	• Reverse transactions	–	• Two weeks	• Weekly	• Standard tenders
Longer-term refinancing operations	• Reverse transactions	–	• Three months	• Monthly	• Standard tenders
Fine-tuning operations	• Reverse transactions • Foreign exchange swaps	• Foreign exchange swaps • Collection of fixed-term deposits • Reverse transactions	• Non-standardised	• Non-regular	• Quick tenders • Bilateral procedures
	• Outright purchases	• Outright sales	–	• Non-regular	• Bilateral procedures
Structural operations	• Reverse transactions	• Issuance of debt certificates	• Standardised/ non-standardised	• Regular and non-regular	• Standard tenders
	• Outright purchases	• Outright sales	–	• Non-regular	• Bilateral procedures
Standing facilities					
The marginal lending facility	• Reverse transactions	–	• Overnight	• Access at the discretion of counterparties	
The deposit facility	–	• Deposits	• Overnight	• Access at the discretion of counterparties	

Source: ECB (1998).

Source: Mooslechner (2019).

It was only in 2021, when a stronger increase of the inflation rate was forecasted, that the ECB revised the quantitative target of price stability. According to the Governing Council of the ECB price stability is best maintained by aiming for a 2% inflation target over the medium term. This target is symmetric, meaning negative and positive deviations of inflation from the target are equally undesirable (Amaro, 2021). This change to average inflation targeting has been sharply criticized by numerous economists saying that this meant an increase of the inflation target. Moreover, the former president of the German Bundesbank, Jens Weidmann, concluded that theoretically a symmetrical average inflation targeting could function as an automatic stabilizer during business cycles, which means when the inflation rate drops below the target, the central bank attempts to achieve a higher inflation rate in the future. However, empirical research demonstrates that the central banks were never successful in finetuning the expectations of the private sector (Candia *et al.*, 2020 and Coibion *et al.*, 2018). A solution of this problem could have been an asymmetric average inflation targeting, which would mean that the central bank would only react in case of inflation rates below the target and not in case of exceeding the target and going for a sharp reduction of inflation rates below the target. Such an approach, however, could lift the accepted average inflation rate (Weidmann, 2022).

FIGURE 1. **Development of the inflation rate (HCPI) from 1999 to 2022**

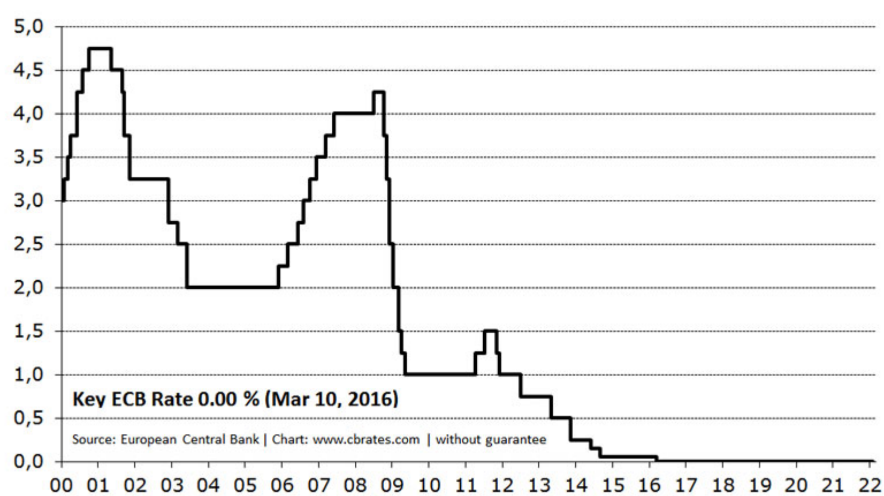
Source: ECB.

The steep increase of the price level from mid-2021 resulted from an excess liquidity in the euro area, from the impact of the corona pandemics, the new trend towards deglobalisation due to the partial breakdown of the supply chains, from the outbreak of the Russian-Ukrainian conflict in 2022 leading to a sharp increase in energy prices as well as of food prices, and speculation and market power. However, the average inflation rate of 8.1% for the euro area in May 2022 does not represent the deviations in the various countries of the eurozone as well as in the EU. Thus, in April 2022, Estonia faced 19.1%, Lithuania 16.6%, Latvia 13.1% as members of the euro area whereas the Czech Republic faced 13.2 %, Poland 11.4%, and Hungary 9.6% compared to the EU-27 average of 8.1%. One must conclude that there are still tremendous differences between the members of the euro area as well as among the other EU members outside the eurozone. One of the reasons for this development as mentioned before is the increase in liquidity due to the growing focus on financial stability since 2008.

3. The focus on financial stability after the outbreak of the GFC in 2008

Up to 2008 it was conventional wisdom that achieving price stability also ensures financial stability (Iwanicz-Drozdowska & Kurowski, 2021). The GFC has changed this perception and led to the conclusion that price stability is necessary but not sufficient for maintaining financial stability. Monetary policy may strengthen financial imbalances as can be seen in several cases in the eurozone. In 2008 a breakdown of the credit transmission channel between private banks arose due to the collapse of the US bank Lehman Brothers. The ECB had to provide liquidity to the banks. Interest rates were lowered having a mid and long-term effect: low interest rates gave incentives to finance unprofitable investment projects. In the long-term banks created risks of the proliferation of so-called zombie companies, which were unable to service debt from profits and thus created problems for the banks. Thus, the risky behaviour of banks turned into a systemic risk. In the situation of the GFC and the sovereign crisis several reasons led to the fundamental imbalances in the financial sector such as the underestimation of the riskiness of securities created with financial engineering, rating agency failures, excessive funding of long-term assets with short-term assets, flawed assumptions regarding house prices, elevated household debt, the belief by bankers that their institutions were too big to fail, misaligned incentives, global imbalances, excessively loose monetary policy, inadequate or flawed micro and macro-prudential regulation, and deep flaws in supervision. All these reasons explain the existence of the subprime crisis and the development after the outbreak of the GFC (Sibley, 2019). Moreover, countries such as Greece had not complied with financial and monetary rules and standards in the EU, nor with the Maastricht rules and other countries had not used EU money from cohesion and other funds to restructure their economies, and especially the financial sector. The monetary policy had assisted in strengthening financial imbalances. Consequently, one may conclude that monetary policy could not effectively function without stable financial markets (Tokarski, 2016). Thus, macroprudential policy is a must.

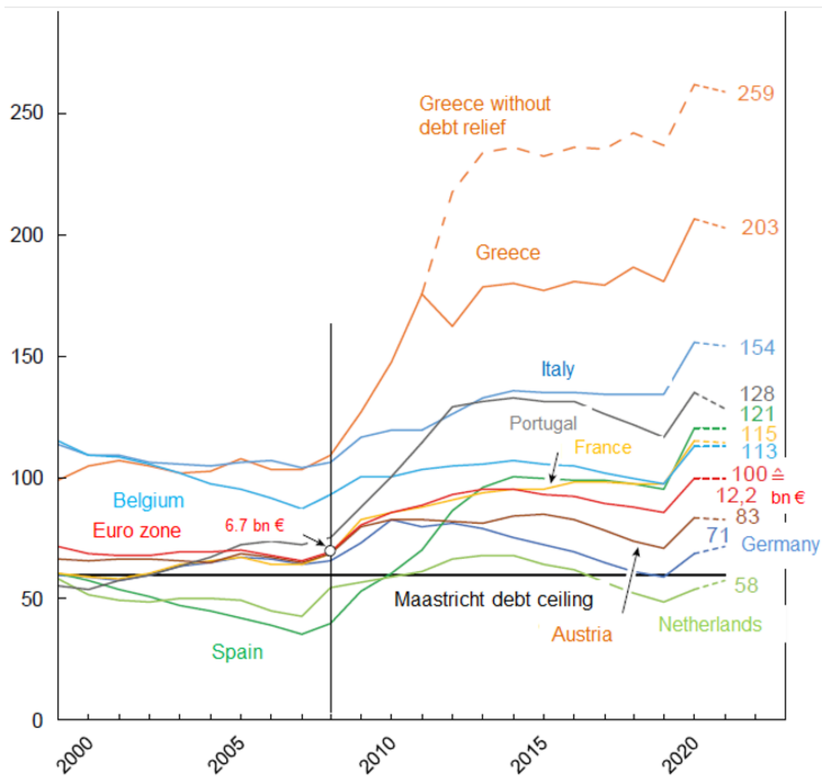
FIGURE 2. **Refinancing Rate of the ECB**



Source: ECB.

Due to all the shortcomings, the ECB has clearly been more actively involved in safeguarding financial stability. Thus, the goal of financial stability started to dominate the goal of price stability. The ECB started to lower the refinancing interest rates. With the emergence of the sovereign crisis in Greece in 2009/2010 the key rate went further down as can be seen in Figure 2. As a member of the Troika (EU, IMF and ECB) the ECB left in 2010 its political neutrality and insisted on conditional assistance for the credits and acquisitions of bonds of Greece, Portugal, and Ireland (Tokarski. 2016, p. 22). During the period from December 2011 to February 2012 banks could get credits for a period of three years, instead of three months as before. Thus, the European banks got credits worth of 1 trillion euro (Fratzscher, 2014, p. 187). In addition, in 2011 the first purchase programme started, the so-called Securities Market Programme (SMP), which enabled the ECB to buy state bonds of Greece, Italy, Portugal, and Spain. Until the end of the SMP, in 2012, the ECB had spent on purchases of state bonds of shaken states by the crisis a value of 220 billion euro (Fratzscher 2014, p. 187). However, this was only implemented after the ECB got the confirmation that the countries started reforms, especially striving for a balanced budget. The ECB became more and more a creditor of these countries and a partner of the structural reforms All these activities were backed by the introduction of the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF) which envisaged a credit volume of up to 700 billion Euro. The announcement of Mario Draghi as the governor of the ECB in 2012, to back the euro, “whatever it takes” put the ECB under heavy pressure. The official programme of Outright Monetary Transactions (OMT) started. Ireland followed the rules of the ECB as well as Portugal. Both countries left the rescue umbrella of the European Union in 2013 (Ireland) and 2014 (Portugal), whereas the others could not follow due to the tremendously increasing debt to GDP ratio which is displayed in Figure 3 and shows that most of the Eurozone countries have exceeded the Maastricht criteria. Moreover, it turned out that without a supervision mechanism over the national banks you cannot be sure that the liquidity granted to the needy countries is used in an efficient way. Thus, in November 2014 the Single Supervisory Mechanism (SSM) was established.

FIGURE 3. **Development of debt-GDP ratio in the Euro zone**



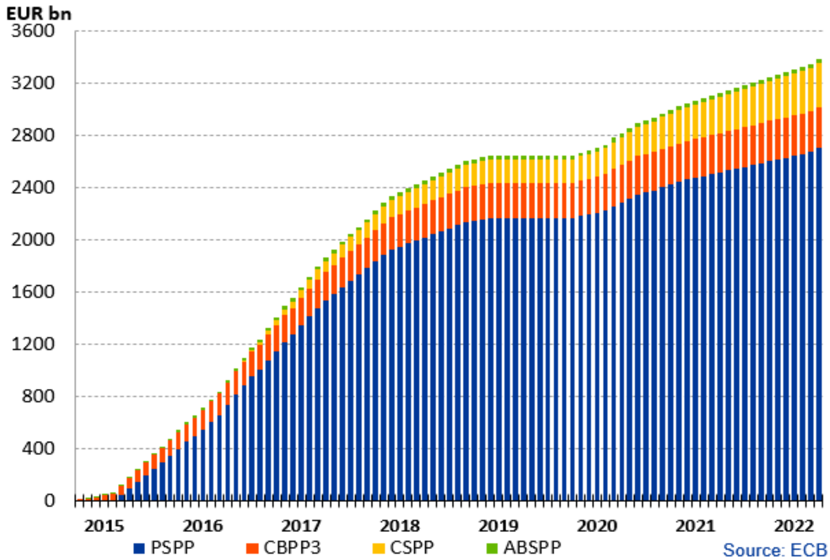
Source: Sinn (2021), p. 141.

Already in 2011, due to the GFC, the European Systemic Risk Board (ESRB) had been created. However, this institution, which should ensure effective policy coordination in Europe by discussing risks, vulnerabilities, and policy options, and consequently lead the way into macroprudential policy formulation, had no political and decision-making power. Macroprudential policy is regarded to prevent financial stability risks coming up and "...is based on – and complementary to

– micro prudential policy, which ensures the safety and soundness of individual financial institutions." (Buch, 2021). A perfectly working macroprudential policy will protect fiscal and monetary policy from financial dominance. An effective macroprudential policy may be regarded as the financial sector counterpart to the Stability and Growth Pact. Although this approach can be regarded as helpful and necessary, the use of this policy is implemented by instruments such as countercyclical capital buffers and capital requirement regulations etc.. However, there is still a high degree of heterogeneity in Europe. The implementation of macro and micro prudential policy has been intensified during the period of 2011 and 2012. Yet, there are a few things on the "to do list", such as more intensified research on the issue, why cyclical and structural risks differ in the various countries. In addition, the complexity of the current regularity framework must be analysed in detail to introduce robustness into financial regulation while avoiding deregulation or excessive regulation (Buch, 2021). In addition, the impact of digitalization of financial services did up to now not receive too much attention.

In 2015/2016 when the fear came up that Greece despite all the assistance in the past would have to leave the euro area, the policy of quantitative and qualitative easing was lifted to a much higher level than before. Mario Draghi can be quoted by saying: "The ECB is not the institution that decides whether a member should stay in the euro or not. The ECB works, acts and decides on the assumption that all members of the Union will continue to be so. It is other institutions that have the responsibility." (EP, Committee of Economic and Monetary Affairs, 2015, p. 15). The easy monetary policy was intensified by bringing down in 2016 the key interest rate to zero and the deposit rate to minus 0.5% which lasted until July 2022. Numerous asset purchase programmes were started. The largest one was, as can be seen in Figure 4, the Public Sector Purchase Programme. In addition to this programme, three other programmes came into existence: the Third Covered Bonds Purchase Programme (CBPP3), the Corporate Sector Purchase Programme (CSPP) and the Asset-Backed Securities Purchase Programme (ABSPP). The stock of APP bonds stood at 3388 billion euro at the end of April 2022. The base money of the ECB rose from 876 billion euro in mid-2008 to 5.99 trillion in September 2021, more than sevenfold (Sinn, 2021) enabling the current strong increase of inflation rates.

FIGURE 4. **Cumulative APP net purchases, by programme**



Source: ECB (2021).

The ECB recognized, when financial markets became rather volatile, that it had to communicate its intentions about monetary policy based on the assessment of price stability to the public in more detail than before. Since 2013, the communication policy, labelled as "forward guidance", was introduced to provide information on the long-term intentions of the monetary policy. This forward guidance was adopted to the past circumstances by not only providing information on the development of interest rates but also on the purchase programmes. Thus, the market participants were for some time appeased and oriented towards a mid- and long-term horizon. However, as has been criticised, the anticipation of future shocks is not possible, and consequently a loss in confidence may emerge (Adam & Mayer, 2020, p. 303). The recent events have proven this criticism.

The virtually non-existent key interest rate as well as the increase in the quantity of money, documented before, have led to the relatively high inflation rate at present. Up to spring 2022 this seemed to be no problem, because a large amount of money fuelled the construction sector as well as the real estate sector where a speculative bubble came into existence especially in urban areas. The Corona pandemics as well as the coming up of the Russian-Ukrainian conflict were exogenous shocks which have led to an open inflation in the Euro area of 8.4% in May 2022. Consequently, the ECB seemed to give up its resistance against a rise of interest rates. However, this could create some problems to those euro area members, which are heavily indebted, such as Greece and Italy.

The dominance of the goal of financial stability has led to a conflict with the goal of price stability. Recent empirical studies (Iwanicz-Drozdowska & Kurowski, 2021) confirm that an expansionary monetary policy for a longer period, as in the case of the ECB, seem to strengthen financial imbalances. In addition, the before mentioned study has found that business cycles and credit cycles are not fully synchronized. Consequently, the only use of interest rates makes it impossible to achieve price and financial stability goals simultaneously. The use of forward guidance and macro and micro-prudential policy may help only to a certain extent. An even more active macroprudential policy is needed eliminating the negative impact of monetary decisions on the stability of the financial system. The conflict of the two goals has become even more visible in the recent past. Yet, there is still a new determinant threatening the effectiveness of ECB monetary policy: the impact of climate change.

4. The impact of climate change on monetary policy

The discussion on the impact of climate change was started by the former governor of the Bank of England, Mark Carney, in 2015. He pointed out the specific risks of climate change for the monetary policy and demanded that central banks should commit themselves to fight the risks connected with climate change (BoE, 2015). The basis for this statement can be seen in climate-related risks which can easily switch over from the real sector into the financial sector. This applies to physical climate risks, such as damages caused by hurricanes and flooding, and to transitional risks such as political activities to reduce CO2 emissions which impose financial damages to enterprises due to higher production costs or losses of production. Enterprises may face a shrinking of the value of their assets, financial losses or even must abandon their business (Balz, 2022). This in turn may influence the stability of financial institutes. Central banks must control that climate-related risks of the companies are correctly considered by the risk management of financial institutes.

Moreover, since 2019 the ECB has started to work on its future role to pay attention to climate change when pursuing its mandate. Several researchers point out that the ECB faces a legal basis for including environmental protection into its design and implementation of monetary policy (Sjafjell & Wiesbrock, 2017). The interpretation of article 11° of the treaty of functioning of the European Union (TFEU) demands that the design and implementation of monetary policy also has to include environmental protection. Mario Draghi admitted in 2018 that the ECB had not analysed the consequences of the purchase of securities of the enterprise sector with respect to climate change (De Santis *et al.*, 2018). Christine Lagarde, when getting into office, put the focus on questions of climate change for a new monetary policy strategy (Lagarde, 2021) on the agenda. In July 2021 the ECB presented a first plan of actions on climate protection within the frame of a monetary strategy (ECB, 2021).

Instruments envisaged to contribute to "green goals" are asset purchases and collateral policy which could contribute to a larger decarbonization of the ECB balance sheet. In addition, the ECB could inform about the risks of climate change for the financial sector and introduce new macroeconomic models for the risk analysis, enlarge the databanks and conduct stress tests (Tokarski, 2021, p. 21). The first stress test of the balance sheet of the euro system concerning climate risks is foreseen in 2022. Within this model the impact of climate change on 4 million enterprises and 2000 banks during a period of thirty years will be simulated (Balz, 2022). The purchase of green bonds functions within the framework of the CSPP as well as within the PSPP. However, the share of green bonds within the CSPP amounted only 6% in the beginning of 2020. One of the reasons for that relatively meagre result can be seen in the principle of market neutrality. The ECB is not allowed to discriminate a group of issuers. Thus, the current practice does not seem to be very effective. Concerning the collateral policy, a major part of accepted collateral stems from carbon-intensive sectors. Investment in climate-neutral technologies have quite often a higher risk and demand a higher capital buffer. The lack of coherent taxonomy for green investment and the current relatively low capital costs raise doubts about the efficiency of this instrument (Tokarski, 2021, p. 23).

There are still a few more critical remarks to be mentioned concerning the issue of ECB engagement in climate policy. When the ECB purchases green bonds and must stop the programme due to concerns about inflation, this would prevent a consequent pursuit of a green monetary policy. In addition, the intervention in favour of climate policy could reduce the independence and autonomy of the ECB which would put the focus on the correction of market failure. The main goal of the ECB is maintenance of price stability. If certain prices, such as food prices, arise due to environmental disasters and lead to inflation this would mean that the ECB must prevent climate change (Fuest *et al.,* 2021, p. 2). Up to now there does not exist any meaningful investigation about the direction and magnitude of the impact of climate change on individual prices and on the price level. Monetary policy is conceived for short-term changes. Moreover, climate change is a global phenomenon and thus cannot be controlled by European monetary policy. Definitively, the ECB would overstep its mandate (Fuest *et al.,* 2021, p. 3). There would be a conflict between the goal of price stability and climate neutrality. Monetary policy cannot substitute a global CO2 price or the global issuance of emissions licences.

All these arguments lead to the conclusion that monetary policy would definitively prevent a more efficient allocation of CO2 savings among sectors. Monetary policy cannot be mixed up with environmental policy. With respect to market neutrality and appropriate evaluation of risk management the ECB can invest part of its purchases in green bonds. However, as the idiomatic phrase used in German says: a cobbler should stick to his last and that means monetary policy should pursue price stability by observing the development of financial stability which is important but should not dominate the goal of price stability.

Having displayed the current discussion on the achievement of different goals by the ECB, we have to raise the question, if it is possible and worthwhile for non-euro members of the EU to enter the eurozone as quickly as possible and if the current development in the euro area is dividing the European integration process.

5. The monetary policy of the Central Bank of the Czech Republic, Hungary, and Poland

The monetary policy is very similar in all these three countries. Price stability is the primary goal.

Looking at the Czech Republic (see Figures 5-8), the Czech National Bank (CNB) uses inflation targeting, which is based on an inflation target of 2% and a forward guidance policy. The decision on the interest rates is the main monetary policy instrument of the CNB. The board of the CNB assumes that the decisions made will affect the development of inflation during the next 12 to 18 months. The decisions taken are based on macroeconomic forecasts by the economic department of the CNB.

Thus, when we look at the empirical data, we can observe, that from 2007 onwards the money supply increased steadily and rose during this period by roughly four times. The CNB pursued a loose monetary policy in line with that of the ECB, lowering the key interest rate to zero percent between 2013 and 2018. It was only from mid-2021 that the CNB increased the interest rate to May 2022 stepwise to 5.75%. Thus, the CNB implemented a restrictive monetary policy aiming at fighting the inflation coming up much earlier than the ECB.

FIGURE 5. **Money Supply (M 2) in the Czech Republic from 2000 to 2022**

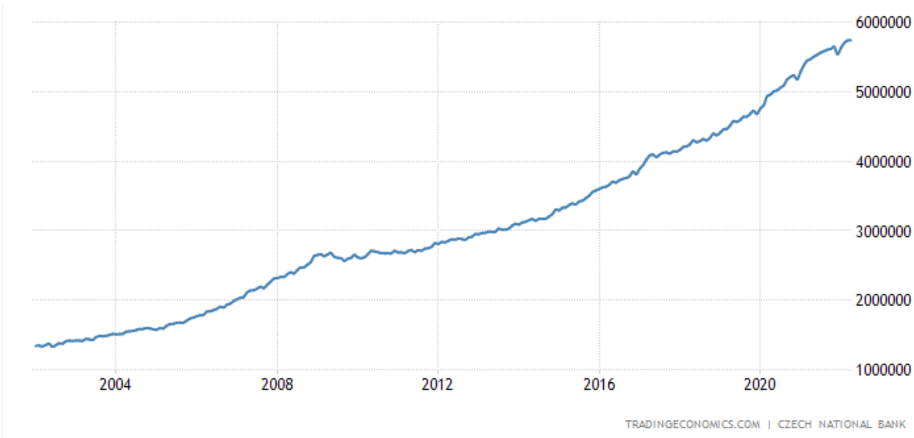


FIGURE 6. **The development of the key interest rate during the last 25 years in the Czech Republic**

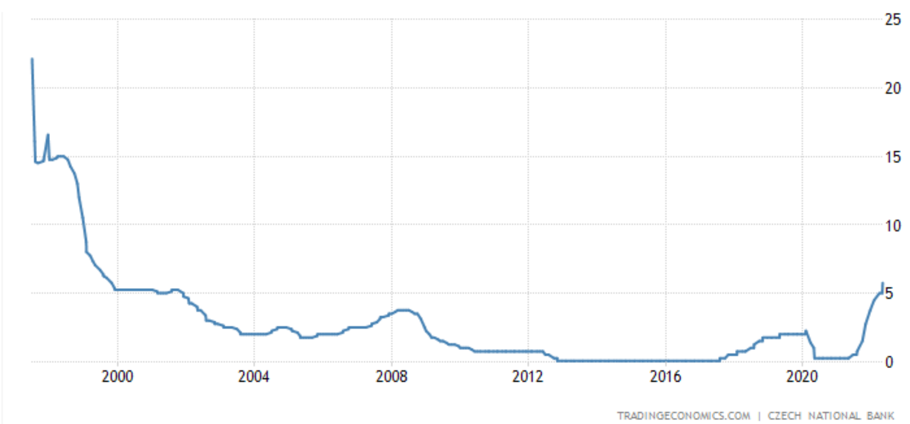


FIGURE 7. **Czech inflation rate 1989 – 2027 (compared to the previous year)**

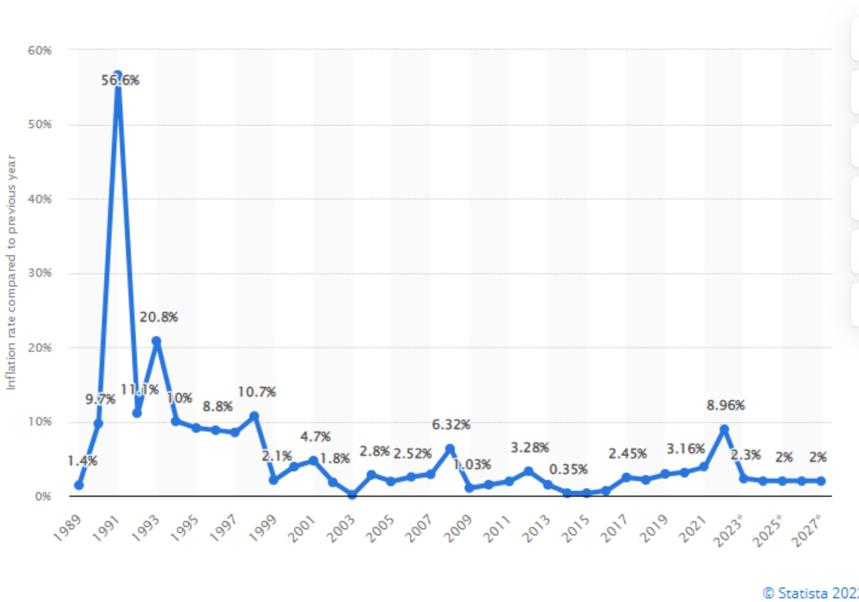


FIGURE 8. **The development of the exchange rate of the Czech Crown towards the Euro**

Source: https://www.ecb.europa.eu/stats/policy_and_exchange_rates/euro_reference_exchange_rates/html/eurofxref-graph-czk.de.html

This development was made possible by the partial floating of the Czech Koruna. Especially in the aftermath of the GFC, as well in 2021, a devaluation took place in order to guarantee the international competitiveness of the Czech economy. Overall, the monetary policy of the CNB was successful in pursuing price stability and will go for the 2% target of the euro area. During 2017 to 2019 the growth of GDP was between 3 and 5.2 % and the external debt to GDP ratio went up to 76.1% in 2020.

In Hungary (see Figures 9-12) the Magyar National Bank (MNB) followed a similar course. The primary objective of the MNB is to achieve and maintain price stability. In addition, the MNB supports the economic policy of the government by using the traditional monetary policy instruments at its disposal. Hungary was supposed to join the eurozone already in 2010, which would have meant losing control of monetary policy by the MNB. Central bankers criticized the plan expecting fiscal austerity requirement leading to slow growth. In addition, there were rumours about the loss of independence of the MNB leading to downgrading by rating agencies. An upgrade started only in 2016 due to the positive macroeconomic performance. The following figures display the policy pursued by the MNB. The base money went up by three times since 2007, as can be seen in Figure 9.

FIGURE 9. **The development of base money in Hungary 1997 – 2022**

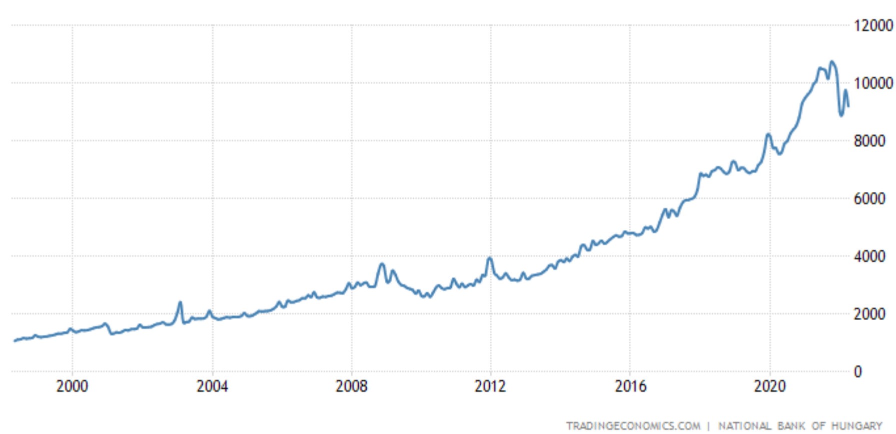


FIGURE 10. **The development of the key interest rate in Hungary 1996 – 2022**

FIGURE 11. **The development of the inflation rate in Hungary 1987 – 2027**

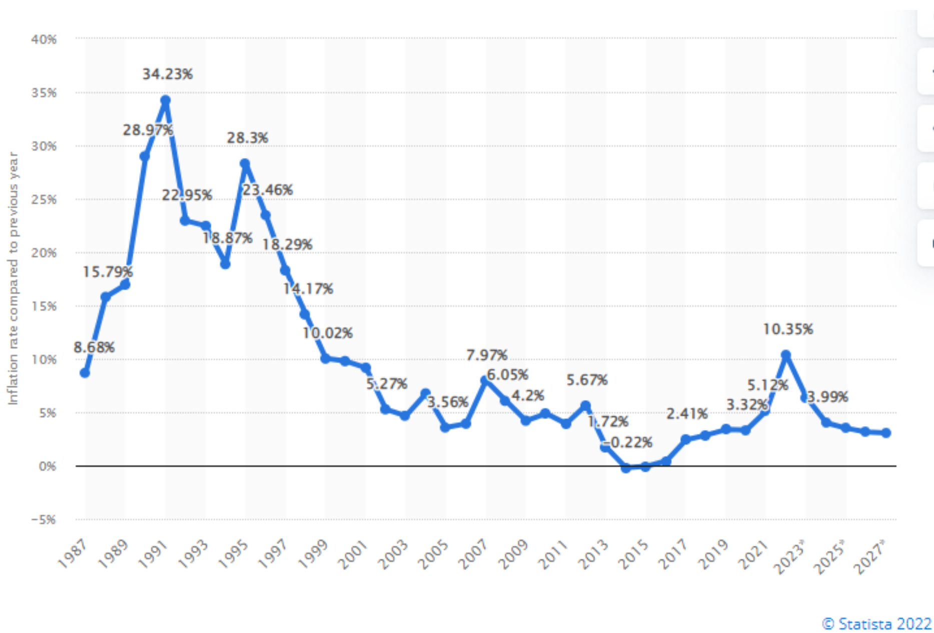


FIGURE 12. **The development of the exchange rate of the Hungarian forint towards the Euro**

Similarly, to the Czech Republic Hungary used the exchange rate as an instrument to improve its international competitiveness by continuously devaluating its currency towards the euro. From 2017 to 2019 the GDP growth amounted 4.3% and 5.5%. The inflation rate came down to an average between 2.4% and 3.4% and the external debt decreased to 73.6%. Thus, the MNB as well as Hungarian economic policy functioned quite well.

The Polish Central Bank (NBP), see Figures 13-16, started after the hyperinflation of the end of the 1980s a second phase of monetary policy in 1997 (Barczyk & Brezinski, 2020, p. 164). Price stability was also the primary goal. Since 1999, NBP pursued direct inflation targeting. From 2004 onwards, the continuous inflation target was at 2.5% with a permissible fluctuation band of +/- 1 %. The NBP influences the level of inflation mainly by determining the official interest rates. The main instrument to influence short-term interest rates was open-market and credit-deposit operations. In addition to the traditional monetary instruments a floating exchange rate has been used since April 2000. The NBP intervenes when it seems to be necessary to achieve the inflation rate and contribute to GDP growth. In Poland a Financial Stability Committee was established as a competent authority responsible for the macroprudential supervision of the Polish financial sector. The objective was to constrain systemic risk and to strengthen the resilience of the financial system and thus contribute to price stability as well to economic growth in the long-term.

The empirical data display a similar development as in the other two countries. Base money increased steadily by four times from 2007 onwards. The key interest rate came down steadily to even zero in 2020 but then increased to 5.25% in May 2022. Thus, the monetary policy turned out to be more rigid than in the eurozone and reacted much faster to the emerging higher inflation.

FIGURE 13. **The development of base money in Poland 1997 – 2022**

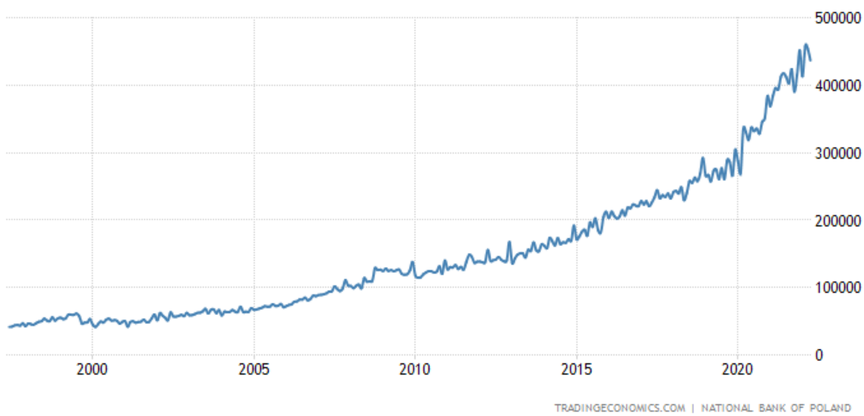


FIGURE 14. **evelopment of the key interest rate in Poland 1998 – 2022**

FIGURE 15. **The Development of the inflation rate in Poland 1987 – 2027**

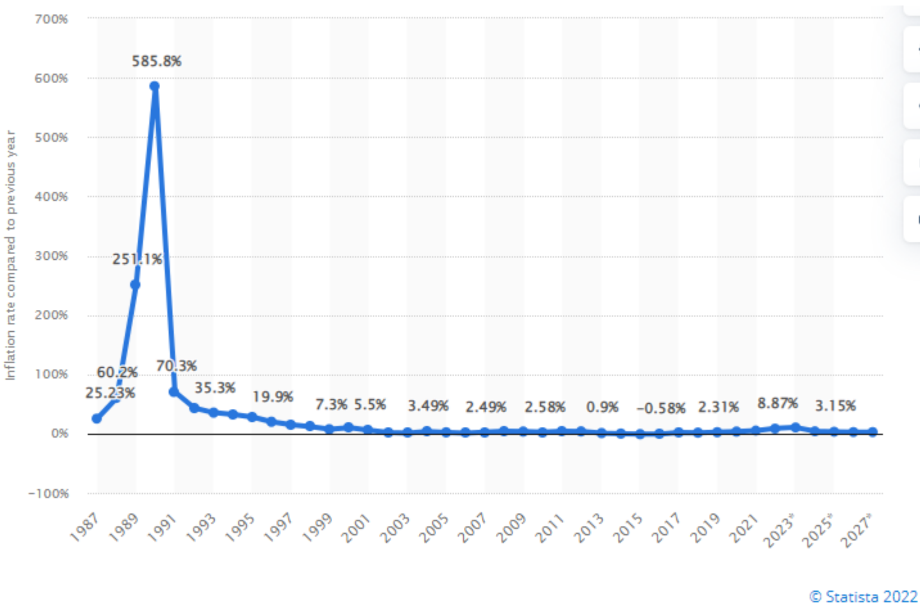
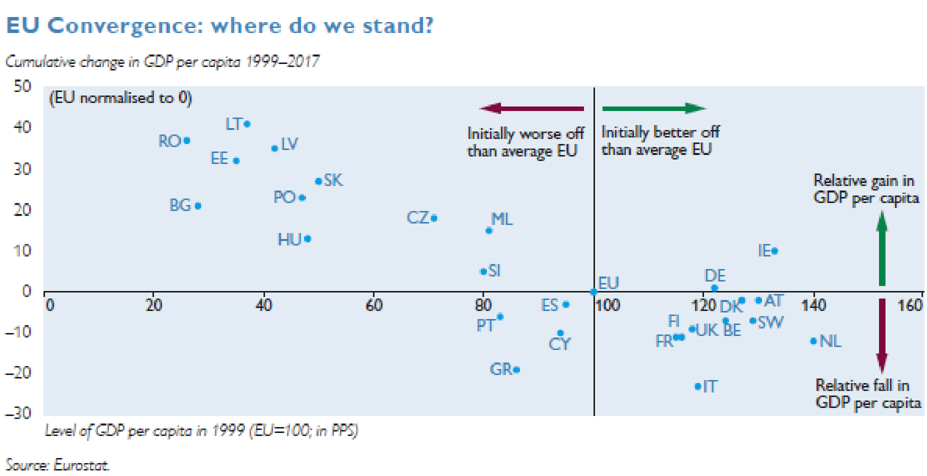


FIGURE 16. **The development of the exchange rate of the Zloty towards the Euro**

As can be seen from Figure 16 the exchange rate floating in Poland was much stronger than in the case of the Czech Republic and Hungary. In 2008 when the GFC was felt, a strong devaluation towards the euro was observed, enabling Poland to have positive growth rates of GDP, the only country in the EU. Poland faced growth rates in GDP during 2017 and 2019 amounting to 4.7 to 5.4% during this period. The inflation rate came down to less than 2% and the debt to GDP ratio went down to 58.8% in 2019. Thus, everything seemed to be perfect. However, all three countries were hit by the exogenous shocks from 2020 onwards.

Yet, as can be seen in Figure 17, they did better than the countries in the Eurozone.

FIGURE 17. **EU Convergence: where do we stand?**



The cumulative GDP growth of the three states was higher than that of the eurozone countries apart from the Baltic area which started from a lower level. In addition, it must be admitted, that the institutional divergence with regard to the monetary constitution and the institutional framework has created a greater divide between the three non-eurozone members and the members of the euro area. The ECB seems to have lost its independence and suffers from multi-tasking concerning the goals of price stability, financial stability and at least the support fighting climate change. The memorandum of former members of the ECB as well as former governors of central banks from 2019 stated precisely: "… the suspicion that behind this measure lies an intent to protect heavily indebted governments from a rise in interest rates is becoming increasingly well founded. From an economic point of view, the ECB has already entered the territory of monetary financing of government spending, which is strictly prohibited by the Treaty." (Sinn, 2021, p. 272). The loss of independence may be at least also observed in the Polish case (Barzyk & Brezinski, 2020 p. 171). Anyhow, there exists still a national monetary autonomy and the instrument of a floating exchange rate regime can be used. Given the present circumstances with a relatively low debt to GDP ratio, a relatively high growth rate of the GDP, and an inflation rate in line with the inflation rate development of the eurozone, there seems to be no need to quickly enter the euro area. The expectation to take over the joint liabilities for the debts of other states does not seem to be a real incentive.

6. Conclusion

The eurozone has not yet implemented the missing instruments for a well operating currency area, such as a fully-fledged banking union and an EU fiscal policy. The eurozone monetary policy has evolved into a direction where the economically weak members have taken over command and implemented conflicting goals. This has led to an institutional divide between members and future members. Taking over financial obligations for economically weak members which face a relatively large debt burden does not increase the attractiveness of the eurozone for non-eurozone members (Brezinski, 2019). The incentives of having one currency and thus avoiding transaction costs or to benefit from the better rating of the eurozone leading to better economic performance for new members does not seem to be a realistic promise. The policy of quantitative easing has destroyed the functioning of traditional monetary policy against inflationary developments. The case of Croatia, which will enter the eurozone after being 10 years a member of the EU, will show whether the advantages of being in the euro area are greater than the disadvantages connected with the loss of monetary autonomy. The Czech Republic, Hungary, and Poland still are not convinced that it pays for them to be a member of the Eurozone.

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Weidmann, J. (2020). Kampf gegen den Klimawandel – was Zentralbanken tun können und was nicht, Rede beim European Banking Congress am 20. November. https://www.bundesbank.de/de/presse/reden/kampf-gegen-den-klimawandel-was-zentralbanken-tun-koennen-und-was-nicht-851614

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PART II:

THE PERSPECTIVE OF THE EUROZONE CANDIDATE COUNTRIES

(Página deixada propositadamente em branco)

The Attractiveness of the Eurozone for the New Member States. A Comparative Approach

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Abstract: This chapter focuses on the six non-euro area countries, namely Bulgaria, Czech Republic, Croatia, Hungary, Poland and Romania, as new member states which joined European Union after 2004 (in 2004, 2007 and 2013) and are legally committed to adopting the euro as the national currency. Our main interest is both the investigation of nominal convergence criteria fulfilment, while focusing on some real convergence criteria, and with an eye on the perception of the population and the support for euro area adoption among those states.

Keywords: eurozone, new member states, euro convergence criteria, perception.

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Introduction

"The EMU has very deep roots in the history of European integration. It started with the Werner Plan in 1970 and since then, a long series of efforts towards economic and monetary integration has been made, of which the establishment of a single currency had the biggest echo; it was one of the bravest projects drawn for the new integrated Europe. Moreover, although the way to economic and monetary union was strewn with many successes and vexing challenges, it was never abandoned, not even during the most severe crisis of its history"[1].

Nowadays, there are 19 European Union (EU) member states in the euro area and eight EU countries outside eurozone. Among those states outside the euro area, Denmark has an opt-out arrangement signed together with the Maastricht Treaty. Bulgaria and Croatia recently joined the "the waiting room", the Exchange Rate Mechanism II (ERM II), thus becoming pre-in members.

The global financial crisis, the euro area crisis and recently the COVID-19 pandemic crisis affected the fulfilment of nominal convergence criteria, but also changed the perception of the attractiveness of the euro for the society, business community and governments[2],[3],[4], [5]. Also, beginning with 2014,

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[1] Dornean Adina, Diaconasu Delia-Elena, Fundamentals of Monetary and Financial Integration in "European Financial&Monetary Integration. Challenges of the Single Currency" (editors Angela Roman, Irina Bilan), p. 7-33, Universitatea „Alexandru Ioan Cuza" Iaşi Publishing House, 2015, ISBN 978-606-714-198-6, 324 p.

[2] Bod, P. Á., Pócsik, O., & Neszmélyi, G. I. (2021). Political and policy dilemmas of euro adoption in CEE countries: What next when crisis hits?. European Policy Analysis, 7(2), 470-485.

[3] Deskar-Škrbić, M., & Kunovac, D. (2020). Twentieth anniversary of the euro: why are some countries still not willing to join? Economists' view. Comparative Economic Studies, 62(2), 242-262.

[4] Dandashly, A., & Verdun, A. (2020). Euro adoption policies in the second decade–the remarkable cases of the Baltic States. Journal of European Integration, 42(3), 381-397.

[5] Backé, P., & Beckmann, E. (2022). Euro adoption in CESEE: How do financial literacy and trust in institutions affect people's attitudes?. Focus on European Economic Integration, (Q1/22), 7-28.

the entry criteria have been substantially broadened, being conditioned by the fulfilment of many other requirements, including the joining of the Banking Union.

Our chapter focuses only on six non-euro area countries, namely Bulgaria, Czech Republic, Croatia, Hungary, Poland and Romania, as new member states that joined the European Union in 2004, 2007 and 2013 and are legally committed to adopting the euro as their national currency. The selection of these countries is based also on their joining process and geographical location. These member states benefit from a derogation from obligations concerning the achievement of the economic and monetary union.

As stipulated by the Treaty on the Functioning of the European Union (TFUE, Article 140(1)), the six countries are committed to adopting the euro, which implies that they must strive to fulfil all of the "Maastricht" convergence criteria.

The first criterion refers to "the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability" (TFUE, Article 1 of Protocol (No 13)). This condition supposes an inflation rate not exceeding by more than 1,5 % the average of the rates of the three Member States with the lowest inflation rates.

The second criterion stipulates "the sustainability of the government financial position, without an excessive deficit as determined in accordance with Article 126(6)", which implies a government budget deficit that does not exceed by more than 3 percent each country's GDP, and also a gross debt to GDP ratio that does not exceed 60 percent.

The third criterion requires "the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro". Thus, in this context the country must have participated in the mechanism for at least two years without severe tensions before joining the euro area.

The fourth criterion for assessing the achievement of a high degree of sustainable convergence stipulated "the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism being reflected in the long-term interest rate levels". In this context, nominal long-term interest rates must not exceed by more than 2 percentage points that of the three countries with the lowest inflation rates.

The first, third and fourth criteria are designed to ensure monetary stability by supporting a fixed exchange rate regime among member countries, stability that is strengthened by the second criterion (fiscal stability), which protect the euro area from threats of inflation which may arise from government budget deficits and from high public debt levels.

This chapter is structured as follows: Section 2 briefly reviews the costs and benefits of the eurozone; Section 3 provides an overview of the convergence indicators for the considered countries, analyses and argues the extent to which they accomplish the nominal convergence criteria, considering also the perceptions of the euro across the countries analysed; Finally, Section 4 concludes.

2. Costs and benefits of the euro

The Treaty of Accession signed by every country who become an EU member did not specify the date of the introduction of the euro.

The euro was introduced in 19 countries only, while the other countries postponed euro adoption by formally opting out of the agreements and by making different policy choices or by implementing reform packages for improving the governance of the eurozone[6]. As we can see in Table 1, Czech Republic, Hungary and Poland have not set a target date for the adoption of the euro.

In earlier studies[7], both the costs and benefits of the EMU were difficult to accurately estimate, but it was assumed that they are rather small.

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[6] Palankai, T. (2015). The introduction of the euro and Central Europe. Economics & Sociology, 8(2), 51-69.

[7] Afxentiou, P. C. (2000). Convergence, the Maastricht criteria, and their benefits. Brown J. World Aff., 7, 245.

On the other hand, in 2002 (the introduction year of the euro) Backé and Wójcik[8] stated that "there are good reasons to believe that the cost-benefit balance of full monetary integration will turn positive for some accession countries within a few years if sound macroeconomic policies are retained and structural reforms are carried on further".

For the Central and Eastern European (CEE) countries, eurozone the following were mentioned as specific advantages[9] of the eurozone membership: the elimination of the foreign exchange risk for the intra-European commercial and financial relations; the increase of foreign direct investments and higher economic growth; an efficient and independent monetary policy; fiscal-budgetary discipline as imposed by the Stability and Growth Pact and a reduction of the interest rate margin.

TABLE 1. **The European Commission's view of new member states' euro policy**

Country	Current status	Euro adoption policy	Foreign exchange rate
Bulgaria	EU member since 2007. The lev (BGN) is part of the ERM II since 10 July 2020.	It must participate in the ERM II without severe tensions and without devaluing its central rate against the euro for at least two years.	The lev observes a central rate of 1.95583 to the euro. Committed unilaterally to continue its currency board arrangement within the ERM II.

[8] Backé, P., & Wójcik, C. (2002). Unilateral Euroisation: A Suitable Road Towards Joining the Euro Area for Central and Eastern European EU Accession Countries. Alternative Monetary Regimes in Entry to EMU. Tallinn: Eesti Pank.

[9] Stoica, O. (2004). Toward Successful Euro Adoption in Romania. Available at SSRN: http://dx.doi.org/10.2139/ssrn.952412.

Country	Current status	Euro adoption policy	Foreign exchange rate
Croatia	EU member since 2013. The kuna (HRK) is part of the ERM II since 10 July 2020.	It must participate in the ERM II without severe tensions and without devaluing its central rate against the euro for at least two years.	The kuna observes a central rate of 7.53450 to the euro with a standard fluctuation band of ±15%.
Czech Republic	EU member since 2004 and is currently preparing to adopt the euro. The Czech koruna (CZK) has not yet joined the ERMII.	Does not have a target date to adopt the euro.	Floating
Hungary	EU member since 2004 and is currently preparing to adopt the euro. The forint (HUF) is not yet within ERM II.	Does not set a target date for adopting the euro.	Floating
Poland	EU member since 2004 and is currently preparing to adopt the euro. The zloty (PLN) has not joined the ERM II.	Has not set a date for adopting the euro, aims to do so as soon as possible. Adopting the euro is one of the priorities of the Polish government.	Floating
Romania	EU member since 2007 and has committed to adopt the euro once it meets the necessary conditions. The leu (RON) has not yet joined the ERM II.	In 2018, Romania has set 2024 as its target for adopting the euro. Later, it was (again) postponed for 2027 or 2028; an official date had not been announced to date.	Floating

Source: European Commission (2020). EU countries and the euro. Available at: https://ec.europa.eu/info/euro-0/eu-countries-and-euro_en.

Thirteen years after the introduction of the euro, although member states mostly agree that the advantages (benefits) of the euro are higher than the disadvantages (costs), generally speaking, Palankai[10] stated that these advantages and costs are differently distributed among the countries, social groups, sectors or regions. In his study focusing on three EU Central countries, namely Czech Republic, Hungary and Poland, Palankai[11] explained the mentioned countries' refusal to readily join the eurozone based on arguments in favour of preserving monetary policy autonomy, particularly possible currency depreciation, because the loss of national exchange rate mechanisms was considered one of the major costs of monetary integration.

Furthermore, Jóźwiak[12] highlighted the fact that the Hungarian National Bank opposes the quick introduction of the single currency, mentioning 2030 as a possible adoption date and until that date less-developed EU countries (including Hungary) should pursue their own monetary policy, especially to maintain the possibility to devaluate the national currency in order to improve the economy's competitiveness.

Until now, EU integration and membership have largely contributed to the convergence of the CEE countries, but still more effort is needed to integrate the eurozone, as we will highlight next.

3. The comparative analysis regarding the fulfilment of the Maastricht convergence criteria

Some countries, such as the Czech Republic, Hungary and Poland seem to rather postpone the introduction of euro, the same but less strongly occurs in Romania, while Bulgaria and Croatia have already

[10] Palankai, T. (2015). The introduction of the euro and Central Europe. Economics & Sociology, 8(2), 51-69.

[11] Palankai, T. (2015). The introduction of the euro and Central Europe. Economics & Sociology, 8(2), 51-69.

[12] Jóźwiak, V. (2017). Prospects of Euro Adoption in Hungary. Bulletin. The Polish Institute of International Affairs, 97 (1037).

joined the ERM II and the Banking Union. Thus, by 2020, there were two subgroups[13],[14]: one with target date or strong official commitment to enter the eurozone (Bulgaria, Croatia and Romania), the other without official target date (Czech Republic, Hungary and Poland).

In this context, Table 2 summarizes the perception of the population regarding the introduction of the common currency in their countries.

TABLE 2. **The perception of the population from non-euro countries regarding the idea of introducing the euro (%)**

Country	Year	For	Against	Do not know
Bulgaria	2021	54	44	2
	2021-2020	+6	-6	=
Croatia	2021	61	37	2
	2021-2020	+6	-5	=
Czech Republic	2021	33	67	0
	2021-2020	-1	+4	-2
Hungary	2021	69	26	5
	2021-2020	+3	-5	+1
Poland	2021	56	41	3
	2021-2020	+8	-8	=
Romania	2021	**75**	**23**	**3**
	2021-2020	**+11**	**-7**	**-4**
Total	2021	**57**	**40**	**3**
	2021-2020	**+7**	**-6**	**-1**

Source: European Commission, Flash Eurobarometer 492 – Introduction of the euro in the Member States that have not yet adopted the common currency. July 2021, https://europa.eu/eurobarometer/surveys/detail/2284..

[13] Bod, P. Á., Pócsik, O., & Neszmélyi, G. I. (2021). Political and policy dilemmas of euro adoption in CEE countries: What next when crisis hits?.hits? European Policy Analysis, 7(2), 470-485.

[14] Zimková, E., Farkašovský, V. & Szostak J. (2018). Perception of the Euro in the European Countries – A Cluster Analysis. The 12th International Days of Statistics and Economics, Prague, September 6-8, 2018.

As we can see from Table 2, overall, 57% of respondents are in favour of introducing the euro in their country (the survey included Sweden), but there are significant differences between member states, from the most positive opinion regarding euro introduction in Romania (75% in favour) and Hungary (69%), to the most negative, in Czech Republic (67% against) and Sweden (56% against). The current Czech government did not put the adoption of the euro on the policy agenda, which is not surprising, given the low public support for euro adoption (only 33%). In the case of the Czech Republic, the main reasons for the refusal are the unstable economic situation in the eurozone and the negative attitude of citizens. Apart from this, their studies (Flek, 2013; Gapon, 2019) highlighted that the Czech National Bank was the key responsible for the country's negative attitude towards the adoption of the euro.

This attitude towards the euro is correlated with the perception of population regarding the consequences of the euro for their country, according to the same survey[15]. Thus, positive consequences are prevalent in Romania (63%) and in Hungary (60%), and the negative consequences are dominating the perception of citizens in Bulgaria (49% negative consequences) and Czech Republic (63% consider that the euro will have more negative than positive effects). Overall, 2021 is the first year since 2015 where the proportion of positive views outnumber negative views,[16] with 52% suggesting "positive consequences" versus 43% answering the "negative consequences" (in 2015 53% of the respondents believed there had been "negative consequences" versus 41% for "positive consequences".

In spite of the perception of the population that the adoption of the euro was good, it is important to analyse the extent to which the euro area candidate countries fulfil the convergence criteria.

[15] European Commission, Flash Eurobarometer 492 – Introduction of the euro in the Member States that have not yet adopted the common currency. July 2021, p.23.

[16] European Commission, Flash Eurobarometer 492 – Introduction of the euro in the Member States that have not yet adopted the common currency. July 2021, p. 22.

According to the last Convergence Report of the European Commission[17] of 2020, Croatia meets the price stability criterion; Bulgaria, Czech Republic, Croatia, Hungary and Poland meet the criterion on public finances; Bulgaria, Czech Republic, Croatia, Hungary and Poland meet the long-term interest rate criterion; none of the six countries considered fulfil the exchange rate criterion, as none participate in the ERM II. However, after the publication of the mentioned Report, in July 2020, Bulgaria and Croatia joined the ERM II.

For our purpose, we analysed the three last reports of the European Central Bank (2016, 2018 and 2020) considering the fact that in 2015 Lithuania was the last country who introduced the euro and the euro area has not been enlarged since.

Table 3 provides an overview of the performance of non-euro area CEE EU member states regarding the convergence criteria during the period 2016-2020.

TABLE 3. **The evolution of convergence criteria in new EU member states (candidate countries)**

		Price stability	Government budgetary developments and projections			Exchange rate		Long-term interest rate
		HICP inflation	Country in excessive deficit	General government surplus (+)/ deficit (-)	General government debt	Currency participating in ERM II	Exchange rate vis-a-vis the euro	
Bulgaria	2016	-1.0	No	-2.0	28.1	No	0.0	2.5
	2018	1.4	No	0.6	23.3	No	0.0	1.4
	2020	2.6	No	-2.8	25.5	No	0.0	0.3
Czech Republic	2016	0.4	No	-0.7	41.3	No	0.9	0.6
	2018	2.2	No	1.4	32.7	No	3.5	1.3
	2020	2.9	No	-6.7	38.7	No	0.2	1.5
Croatia	2016	-0.4	Yes	-2.7	87.6	No	0.5	3.7

[17] European Commission (2020). Convergence Report. European Economy Institutional Papers. Luxembourg: Publications Office of the European Union, 2020. ISBN 978-92-76-16318-3. ISSN 2443-8014. doi:10.2765/508213.

	2018	1.3	No	0.7	73.7	No	0.4	2.6
	2020	0.9	No	-7.1	88.6	No	-1.0	0.9
Hungary	2016	0.4	No	-2.0	74.3	No	-0.7	3.4
	2018	2.2	No	-2.4	73.3	No	-0.7	2.7
	2020	3.7	No	-5.2	75.0	No	-4.3	2.3
Poland	2016	-0.5	No	-2.6	52.0	No	-4.2	2.9
	2018	1.4	No	-1.4	49.6	No	1.7	3.3
	2020	2.8	No	-9.5	58.5	No	-0.6	2.2
Romania	2016	-1.3	No	-2.8	38.7	No	-1.0	3.6
	2018	1.9	No	-3.4	35.3	No	-1.9	4.1
	2020	3.7	Yes	-9.2	46.2	No	-1.1	4.4
Reference value 2016		0.7		-3.0	60.0			4.0
Reference value 2018		1.9		-3.0	60.0			3.2
Reference value 2020		1.8		-3.0	60.0			2.9

Source: European Central Bank, Convergence Report 2016, 2018 and 2020.

Bulgaria meets four nominal convergence criteria regarding inflation, long-term interest rate, budget deficit and public debt and from July 2020 joined also the ERM II. Even so, studies concerning Bulgaria[18] showed that “the low level of socio-economic convergence of Bulgaria and macroeconomic imbalances may delay its membership in the monetary union. Therefore, while respecting the country’s aspirations to join the euro area, one cannot ignore the risk of another destabilization of the euro area”, as in the 2008 crisis and recently under the coronavirus crisis.

Croatia was the last country to initiate the Eurozone accession process. It has met the price stability criterion, the long-term interest rate criterion and the criterion on participation in the exchange rate mechanism, and

[18] Możdzierz, A. (2019). Macroeconomic stability as the condition for Bulgaria to join the euro area. Equilibrium. Quarterly Journal of Economics and Economic Policy, 14(2), 295-315.

it joined the ERM II in July 2020; in the context of the pandemic crisis, Croatia did not meet the criterion on public finance concerning budget deficit and public debt.

In 2020, *the Czech Republic* did not meet the criterion on price stability due to persisting domestic inflation pressures[19]. The Czech Republic was compliant with the criterion on the government financial position in both the budget balance and debt components until 2019. Due to the COVID-19 pandemic, the economic activity registered a decline in 2020, which required fiscal support measures that pushed up the deficit to 6.7% of GDP and raised general government debt, albeit below the reference value. The Czech Republic has been compliant with the criterion on convergence of interest rates during the period 2016-2020. Regarding the criterion on participation in the exchange rate mechanism (ERM II), the Czech Republic is formally non-compliant, since it has not joined the mechanism.

According to Table 3, in 2020 *Hungary* complied with only one convergence criteria, that which concerns the long-term interest ratio. Concerning the other criteria, inflation (3.7%) is greater than the reference value (1.8%), the budget deficit increased from 2.4% of GDP in 2018 to 5.2% of GDP (above the reference value of 3% of GDP), the government debt ratio is still significantly above the 60% reference value (75% of GDP), and Hungary does not participate in the ERM II, nor does it meet this formal condition.

Poland is one of the largest countries in the region of Central and Eastern Europe (CEE). The 2016 and 2018 ECB Convergence Report showed that Poland fulfilled the convergence criteria, with one exception, that concerning the criterion on exchange rate. In 2020, in the context of the COVID-19 crisis, the Polish economy was affected and, consequently, the price stability criterion and fiscal criterion were hit the hardest.

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[19] Ministry of Finance of the Czech Republic and National Bank (2020). Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area. ISSN 2336-5110.

As far as *Romania* is concerned, exploring the data in Table 3, we see that in 2020 none of the criteria had been met, although in 2015[20] all of the nominal convergence criteria were met, excepting the participation in the ERM II. This negative evolution is explained by the political instability and the COVID-19 pandemic.

Even so, there were years where Romania met some of the convergence criteria (such as fiscal deficit or/and public debt), but this has not been the case for price stability. There has not been a year in which Romania fulfilled the criterion of price stability. The index of consumer prices (CPI) is used to estimate the evolution of prices for goods and services purchased by the population. In 2020, the rate of CPI inflation was 2.6%[21] and the rate of HICP inflation was 3.7% (Table 3). The differences can be explained by the weight of food products in the family budget. Thus, in 2020 households in Romania occupied the first position and spent around a fourth of their total income on food and non-alcoholic beverages (26.4%)[22], while the EU average was 14.8%. An important aspect to highlight is that in 2010-2020 the prices of “Food and non-alcoholic beverages” increased 16.8%, which can explain the difference between the CPI inflation rate and the HIPC inflation rate.

One positive aspect in the euro adoption process, which can be considered an opportunity for the Romanian economy, is the euroization[23] and the increase in euroization. The euroization process began in the mid-nineties as a dollarization process, because of the high inflation. Later, with the ascension of the euro, the US dollar was replaced by the euro as

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[20] Schipor, G. L. (2020). Euro Adoption in Romania: An Exploration of Convergence Criteria. Ovidius University Annals, Economic Sciences Series, 20(2), 190-199.

[21] National Institute of Statistics (2022). CPI – annual data series. Available at: https://insse.ro/cms/en/content/cpi-annual-data-series.

[22] Eurostat (2022). Household consumption by purpose. Available at: https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Household_consumption_by_purpose#Composition_of_EU_household_expenditure_in_2020.

[23] Dinu, M. & Marinas, M. & Socol A. G. (2012). Analysis for the Degree of Euroization in Romania. Annals of Faculty of Economics, University of Oradea, Faculty of Economics, 1(1), 290-297.

a refuge, as a reference point, better serving as a standard of value in an economy where inflation was among the highest in the European Union on the long run. Euroization may be considered also a vulnerability for the economy where the adoption of the single currency is delayed, or in the case of external shocks which can determine a depreciation of the national currency, as was the case in 2008.

The eurozone crisis, triggered ultimately by the global crisis, which broke out in May 2010 closed the window of opportunity for CEE EU countries to join the eurozone due to the excessive public sector deficits, total indebtedness, contractions in the banking sector, economic recession, increasing unemployment and related social tensions[24]. Before 2020, CEE candidate countries to the euro would have been able to join the eurozone from a macroeconomic perspective, but in the case of the Czech Republic, Hungary and Poland there is mainly a lack of willingness to meet such criteria in order to join the monetary union[25],[26],[27].

The 2020 coronavirus crisis affected once again the economic stability of the EU and the eurozone. Severely affected in 2020 by the negative effects of the COVID-19 crisis, the EU economy regained the pre-pandemic output level in the summer of 2021 and started 2022 with the objective to remain robust over the forecast horizon. In this context, the European Commission forecasts EU economic growth of 4.0% in 2022, the same as in the euro area, and 2.8% in 2023 (2.7% in the euro area)[28].

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24 Flek, V. (2013). The Blundered Strategy of Euro Adoption in the Czech Republic: A" Pre-crisis "Retrospective. Review of Economic Perspectives, 13(3), 132-145.

25 Rózsahegyi, Z. R. (2021). The power of discourse behind economic policies Why the common currency has not been introduced in Hungary? (Doctoral dissertation, Central European University).

26 Visvizi, A., & Tokarski, P. (2014). Poland and the Euro: between lock-in and unfinished transition. Society and Economy, 36(4), 445-468.

27 Deskar-Škrbić, M., & Kunovac, D. (2020). Twentieth anniversary of the euro: why are some countries still not willing to join? Economists' view. Comparative Economic Studies, 62(2), 242-262.

28 European Commission (2022). Winter 2022 Economic Forecast: Growth expected to regain traction after winter slowdown. https://ec.europa.eu/info/business-economy-euro/

However, no crisis-free periods longer than 10–15 years can be expected[29]. All of these crises give rise to two questions: 1. Will the candidate countries be ready to adopt the euro until the next crisis?; and 2. Do candidate countries think they can implement the necessary changes better and faster alone, rather than as part of a system with numerous participants such as the eurozone?

"In order to be effective rules for monetary and fiscal stability, the Maastricht criteria must operate within an environment characterized by economic homogeneity, not by internal or external economic disparities and disequilibria. Such an environment satisfies the main conditions for an optimum currency area."[30]

In this context, meeting the Maastricht criteria is a necessary condition, but it is not sufficient[31]. Reaching a high level of real convergence has become essential in the current economic situation[32], because joining the euro currency is deemed harder until growth becomes balanced and sustainable.

4. Conclusions

The current chapter has sought to highlight the new member states' ability to meet the eurozone convergence criteria in relationship with the perceptions of the euro across these countries.

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[29] Gottfried, P. (2021). Thoughts on the Dilemma of When to Introduce the Euro in Hungary. Financial and Economic Review, 20(3), 110-126.

[30] Afxentiou, P. C. (2000). Convergence, the Maastricht criteria, and their benefits. Brown J. World Aff., 7, 245.

[31] Dulgheriu, R. G. (2014). Romania: The Way to Euro. The USV Annals of Economics and Public Administration, 14(1 (19)), 79-84.

[32] The real convergence indicator is higher within the 'old' member states than within the new EU member states (Stoica, O., Roman, A., & Diaconașu, D.-E. (2019). Real Convergence and European Integration with Focus on the New Member States. Scientific Annals of Economics and Business, 66(SI), 215–228, p. 225).

The research showed that on the one hand, there are some new member states whose strong economic standing is coupled with positive attitudes toward euro adoption, while there are other new member states that have so far refrained from joining the eurozone even though their thriving economies already make them eligible or could easily make them so. Thus, there are three groups of countries across the new member states: the first group includes Bulgaria and Croatia, who have already joined the ERM II; the second group refers to countries that fulfil the euro convergence criteria, but do not want to join the eurozone (Czech Republic, Hungary and Poland); and the third group includes only Romania that wants to join the euro area, but does not fulfil the nominal convergence criteria.

We consider that the new EU member states should follow their own path towards the adoption of the euro, while continuing to implement their planned euro adoption policies, as did the Baltic states[33] which decided to join the euro in the midst of the financial and the sovereign debt crises. Despite international organizations' recommendations to change their policies of currency boards and exchange rate pegs or to devaluate the currencies which could have caused severe delays in euro adoption timetables, Estonia, Latvia and Lithuania regarded eurozone entry as a strategic act.

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Covid-19 as a Challenge to the Eurozone and the EU

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Abstract: The paper describes an attempt to correct the Economic and Monetary Union, i.e. to introduce centralised fiscal policy, safeguarding the financial system against bankruptcy or debt burden. The analysis aims to show the difficulties in introducing reforms on the one hand and, on the other hand, in demonstrating ways of making changes that involve: (1) the participation of all EU Member States in the EMU rescue instruments; (2) expansion of fiscal centralisation in the EU; (3) the accumulation of capital by the strongest countries in the internal market, including sometimes at the expense of Central European countries.

Keywords: Covid-19, the Economic and Monetary Union, fiscal centralisation, the Banking Union, the Capital Markets Union

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1. Introduction

The Covid-19 crisis had considerable negative consequences on the southern countries of the euro area and highlighted the systemic problems of the Eurozone. What turned out to be the main problem of the monetary union was the inappropriate design of the system, in particular leaving the fiscal policy decentralised, i.e. at the discretion of Member States. Centralising this policy and increasing the fiscal potential of the Economic and Monetary Union (EMU) without democratisation of the European project is a difficult task. Another problem is that the most affluent states are politically reluctant to engage in fiscal redistribution to the benefit of the economically weaker EMU countries.

In fact, this resulted in political tension between the two largest EU-member countries, namely France and Germany. The tension reflected broader disagreements between the northern and southern parts of the monetary union. While Paris believed that the best way to mitigate crises in the EMU was to increase fiscal redistribution from the affluent North to the indebted South of the monetary union, Berlin tried to counteract such anti-crisis policy, e.g. by rejecting the ideas of developing an EMU budget or appointing a finance minister for the euro area (Degner & Leuffen, 2021; Wasserfallen et al., 2019). This resulted in another trend among the most prosperous and, at the same time, most influential EU countries, namely in the highly competitive EMU countries which attempted to maintain their economic advantages and even extend them to new areas whenever possible, also beyond the functioning of the EMU. In particular, this involved the search for ways to increase internal market advantages against the countries of Central Europe, in such areas as services (especially financial services) and energy and climate transformation, etc. Another phenomenon was the desire to increase EU financial transfers to the south of the EMU at the expense of transfers to the less developed and less prosperous areas in the eastern part of the EU.

In this paper, I will be examining the attempt to correct the EMU, i.e. the centralisation of fiscal policy and increasing the scale of redistribution from richer to more indebted and less economically competitive countries.

Afterwards, I introduce the measures to safeguard the financial system against bankruptcy or excessive debt. The analysis aims to draw attention to the difficulties involved in introducing reforms on the one hand and, on the other hand, to highlight ways of making changes that involve: (1) the participation of all EU Member States in the EMU rescue instruments; (2) extension of the scale of fiscal centralisation in the EU; (3) accumulation of capital by the strongest countries in the internal market, including sometimes at the expense of Central European countries.

2. Fiscal centralisation

The monetary union in Europe was planned in an atmosphere of outspoken conflicting economic ideas and economic interests among the largest founding countries. On the one hand, German economists favoured the ordoliberal view and advocated fiscal discipline at the national level. They also believed that a centralised monetary or fiscal policy should be implemented only after sufficient macroeconomic harmonisation is achieved between individual Member States. On the other hand, French economists and politicians endorsed more protectionist ideas, which implied the need to centralise monetary and fiscal policy governance in the monetary union. However, having faced resistance from Berlin, they observed realistically that this type of "revolution" would encounter insurmountable political obstacles. Therefore, they assumed that the process of monetary integration would force, like a catalyst, appropriate adjustment changes on the part of economic and political instruments (Pisani-Ferry, 2006).

This approach can be seen as pragmatic enforcement of the adjustments, resulting from the preconceived assumption that the integration would progress through crises that force the opponents into further concessions. A theory has even emerged from European studies that describes this manner of integration, which is referred to as "failing forward" (Jones et al., 2016). It means that crises enforce the changes that are insufficient to counteract the problems effectively, and therefore they trigger another crisis in the future. Nevertheless, institutionalisation and subsequent adjustments in the integration process continue to progress in this sub-optimal manner. Such philosophy has been burdened by a significant risk from the very beginning, as it entailed enormous social and political costs of inevitable and chronic crises. Therefore, it has exposed the EMU to the dissatisfaction of voters and political conflicts, which could eventually destroy the monetary union itself and affect the EU negatively. Concerns about the stability of the monetary union will certainly impact the future of the entire community, and problems related to the methodology of insufficient reforms in the EMU will probably infect the integration processes across the EU.

Therefore, experts have, unsurprisingly, considered the EMU as institutionally incomplete and asymmetrical from the very beginning. Above all, this is linked to the imbalance between the centralised monetary policy and the decentralised fiscal policy, which is left to the discretion of the Member States (Dyson, 2000; Verdun, 1996). National fiscal policy is coordinated only marginally, mainly in terms of containing fiscal expenditure and directing the budget policy towards the reforms that are considered vital for the competitiveness of local economies. This degree of coordination is deemed insufficient and, in the pandemic crisis after 2020, the most critical component of fiscal coordination so far – namely the criteria of the Stability and Growth Pact, intended to contain budget expenditure and prevent the accumulation of public debt – has been put on hold.

Another element of institutional incompleteness and imbalance between the centralised monetary policy and the decentralised and relaxed fiscal policy of countries in the pandemic crisis is the lack of a political union in the euro area. Such a union seems necessary to increase the fiscal potential of the EMU, especially the introduction of a budget for the Eurozone and real European taxes (the EU's own revenues as we have known them so far, even if they have a tax formula, are actually collected by Member States and partly transferred to the EU). The fiscal potential that is necessary to stabilise the Eurozone should amount to around 10% of the GDP in the euro area (Howarth & Schild, 2021, p. 214), and it should be continuously transferred to the least competitive parts of the monetary union, the most indebted ones or those in crisis. The instruments for redistribution could be both automatic economic stabilisers (e.g. social spending for the unemployed) and investment programmes that would reduce macroeconomic imbalances in the EMU and thus accelerate convergence.

Primarily, the effect of the EMU's institutional imbalance is that the main burden of stabilising the euro area during successive crises is borne by the European Central Bank (ECB) and, subsequently, the centralised monetary policy. While ECB's intervention managed to save the EMU in the post-2010 crisis, imposing austerity measures on fiscal policy resulted in depression and prolonged recession in the south of the Eurozone. On the other hand, in the pandemic crisis, stabilisation is also primarily due to the monetary policy. Additionally, the loosening of decentralised fiscal policy in Member States was intended to support the real economy, i.e. business investment and consumer demand. However, it has contributed to increased indebtedness, inflation and, consequently, to the growing threat of "stagflation" (i.e. a combination of high inflation and economic stagnation) (Roubini, 2021).

Therefore, the crisis impact on the Eurozone is almost a textbook example consequence of its asymmetrical institutional design, in particular of the lack of a centralised fiscal policy. We can also observe another effect of this asymmetry: the unequal distribution of costs and benefits within the Eurozone, namely the accumulation of costs in the south of the EMU, which, as a result of the monetary union, becomes more and more indebted with each crisis and bears higher macroeconomic and social adjustment costs. In this way, the design of the monetary union "favours the export-oriented countries and penalises countries that base their development on domestic demand" (Howarth & Quaglia, 2021, p. 1559). Thus, the capital accumulates in the countries with the highest economic competitiveness, central to the monetary union system, i.e. Germany and the Netherlands above all. What is worse, however, is that the subsequent crises increase divergence in the euro area (Hall, 2018; Johnston & Regan, 2016). Thus, the "failing forward" integration method is beneficial for some and costly for other European countries.

The highest price of macroeconomic adjustment has been borne so far by the economically and politically weaker countries, i.e. the southern periphery of the EMU.

As I mentioned earlier, the incompleteness and institutional asymmetry of the EMU has yet another effect – even when reforms are implemented, they never appear to be sufficient. Therefore, they trigger the next crisis as a painful hit on the monetary union, with the highest costs accumulated in the EMU periphery so far. In this way, the method of tackling economic disruption lays the grounds for another crisis (Howarth & Quaglia, 2021). This modus operandi must give rise to serious political tension, which is likely to be further aggravated by the democratic deficit, and the lack of democratic mechanisms to defuse social tension.

Experts indicate that the euro area has neither a joint budget nor debt mutualisation, although such proposals have been repeatedly submitted to academic and political debates. One form of debt mutualisation is the purchase of government bonds by the ECB. However, the "joint debt" issued by European institutions and guaranteed by the Member States or the Multiannual Financial Framework (MFF) can hardly be deemed as the mutualisation of debt. The latter means that the joint issuance of European debt covers Member State debt, and thus a certain pool of this debt becomes the collective responsibility of all other UE countries. This is what the so-called "Euro bonds" or "Corona bonds" were supposed to do. However, the joint debt as issued by e.g. the European Commission is only common safe assets[34], secured by the EU's Multiannual Financial Framework (MFF) or (and) by guarantees from Member States, but only to the extent to which it reflects the particular state's share in the EU budget. It is rather a form of debt securitisation, but not mutualisation. Therefore, safe assets do not solve the problem of excessive sovereign debt

[34] Safe assets are tradable financial claims purchased by the entities of the private sector that are deemed by investors to provide a convenient rate of return, to be highly liquid and tradable and, most importantly, to be secure. In the case of the EMU, such assets may be issued by the Union's institutions or the Member States.

in the euro area and may even aggravate it, if the safe assets are used to provide further loans to the most indebted countries (Costa Cabral, 2021).

The European Stability Mechanism (ESM) is an example of how safe assets are used. The ESM is an intergovernmental European institution acting on behalf of the EMU states experiencing problems, based on a separate treaty between the states concerned (and thus outside the EU law). Contrary to expectations, its debt issuance has not received the highest possible rating (AAA) from all agencies. It was only in August 2020 that S&P gave the ESM a long-term AAA rating and a short-term A-1+ rating for the first time. At that time, the ESM was also rated as AAA by Fitch and as Aa1 by Moody's (European Stability Mechanism, 2021a). Experts believe that a deterioration of the rating is likely if the Member States cannot quickly provide the capital payable on demand to the investors under the guarantees they have given for the issuance of these securities (Bauer & Herz, 2020). A downgrade would lead to higher interest rates on the ESM bonds, which would probably reduce market confidence in the stability of the EMU and aggravate a possible crisis. In addition, the problem with this institution is that it offers loans, not grants, to the strained countries, which pushes their indebtedness even further. According to adopted regulations, the ESM should not lend to countries with serious solvency issues, and therefore it is not an effective instrument for preventing the threat of bankruptcy or a severe debt crisis in the EMU Member States. This example shows that the reforms undertaken in response to the crisis are insufficient and may even generate further problems during the next crisis.

Moreover, it is also an excellent example that the effect of an increase in safe assets in the EMU or the EU on the bond issuance by the non-euro area countries is not necessarily negative. The examination of the issuing country's macroeconomic fundamentals and the economic policies pursued by that country is still the crucial factor for the assessment of debt issuer credibility. This assessment may be much more favourable for investors in many central European countries than in the euro area.

During the Covid-19 pandemic, the Member States were allowed to borrow from the ESM, but only for health care rescue purposes. The previous conditionality, i.e. the requirement to introduce structural reforms in exchange for a loan was also abandoned. Moreover, the EU created a new financial instrument, essentially based on the so-called safe assets – the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE). The relatively small financial pool (around EUR 100 billion) was used to provide loans to the Member States for supporting their national funds for the unemployed or those at risk of unemployment.

The major new instrument based on safe assets, i.e. a joint EU debt guaranteed by the MFF and the Member States, is the European Recovery Fund or the "Next Generation EU" (NGEU). Its main advantage over previous similar solutions is the new possibility for the Member States to receive not only loans, but also non-repayable grants (amounting to around 390 billion euros). In this way, some countries (mainly the so-called net contributors) will finance investments in other countries, the biggest beneficiaries of the NGEU (although the beneficiaries will also include the biggest contributors, such as Italy and France).

In terms of the Eurozone stability, the advantage of the NGEU fund is that its financial assistance mainly directed towards the southern Eurozone countries. Therefore, it is an example of an instrument that is financed by all 27 EU countries primarily to the benefit of the most vulnerable EMU countries. However, there has been much criticism of this solution. First of all, it is a one-off initiative and will only last for the next five years. It does not, therefore, represent a permanent mechanism for assistance to the southern EMU countries. The investment assistance is far from sufficient – in the first year of the fund's operation (2021) it is estimated to reach only 0.2% of the euro area's GDP, and over the entire five-year period this amount will not exceed 2% of the GDP in the EMU. Therefore, it is far below the expected financial scale needed to stabilise the monetary union, estimated at 10% of the GDP (Howarth & Quaglia, 2021). Moreover, the NGEU has always been treated as a barrier to curb much bolder ideas, namely those related to debt mutualisation within the EMU and the issuance of "Corona bonds".

The establishment of this one-off instrument (NGEU) has reduced the traditional EU budget, namely the multiannual financial framework. It is particularly true for the Cohesion Policy and the Common Agricultural Policy, in which the MFF 2021-27 allocations are in constant 2018 prices, almost 90 billion euro less than in the MFF 2014-20. It is especially unfavourable for Poland and other Central European countries. The MFF may be even smaller in the future, encumbered with the obligation to pay the NGEU debt. In the future, this will lead to a reduction in the EU's pool of resources for structural investment, which is likely to affect the Cohesion Policy budget for Central European countries in particular. Moreover, the planned European taxes, which are meant to accelerate the NGEU repayment, are controversial both within the Member States and outside the EU, and thus uncertain as a source of financing for the common debt.

The NGEU is a commitment of all EU Member States, but as mentioned earlier, it is mainly southern Eurozone countries that will be its beneficiaries. Nevertheless, due to the abovementioned reasons, experts believe that the NGEU is not a systemic solution to the problems of the euro area. It does not lead to a transfer union or a fiscal union (Howarth & Schild, 2021, p. 220), so it does not constitute a "Hamiltonian moment" for the EU (Howarth & Quaglia, 2021). It is seen as a "sticking plaster" approach rather than an effective systemic instrument to protect the EMU from another crisis (Howarth & Quaglia, 2021). The monetary union, severely weakened by successive disruptions, remains unstable and vulnerable to new, external shocks. The problems are not effectively solved here – on the contrary, they are actually building up (Feás, 2021).

3. Attempts to stabilise the banking system

The Banking Union (BU) may serve as an example of unfinished Eurozone reforms, which have betrayed the hopes to strengthen the Eurozone and solve its most urgent problems. This means that they provide inadequate protection against further economic crises. Some experts even consider the BU to be a worse solution than the status quo before the crisis, i.e. without any changes (Qualia, 2019, p. 966). Even if we find this opinion to be exaggerated, many experts suggest that the BU is incomplete, unstable (Qualia, 2019, p. 966; Asimakopoulos & Howarth, 2021) and, in its current form, unfavourable to the southern periphery of the euro area (Spain, Italy, Portugal and Greece) (Qualia, 2019, p. 966).

The BU had several major objectives, including the improvement of control over the banking sector. However, it was only partially successful. Banking supervision was split between the European and national institutions, which in some respects causes dissemination of the supervisory responsibility and fosters the differentiation of quality among the supervisory standards across the EU and the EMU. According to many experts, it may weaken the financial supervision at the national level, but does not adequately strengthen the control at the EU level, resulting in de facto insufficient supervision over the banking sector and diluted supervisory responsibility (Qualia, 2019). The European Central Bank (ECB) directly supervises 114 significant banks. These banks hold almost 82% of all banking assets in the BU countries (ECB, 2021c). However, there are still more than 3 000 banks in the EMU outside this supervision and covered just by their national supervisory systems (Skuodis, 2018, p. 103). Any banking crisis affecting these remaining institutions will actually fall outside the control and restructuring system of the European institutions. It means that many financial institutions in the EMU report to the Member States and remain under their national control and restructuring systems. This fact alone shows that the BU is not a sufficient safeguard in the event of another financial crisis.

The BU was intended further to restructure the weakest banks, preferably in a way that would not require the intervention of national budgets, especially in the countries that are most affected by the debt crisis. The idea was to ensure that the poor condition of the banking sector does not cause damage to the southern Eurozone countries in particular. By effectively narrowing the BU to only the largest banks in the EMU, it has become unrealistic to cut the link between the poor condition of the banking sector and the increased risk of insolvency of Member States. Moreover, the aim was to shift the burden of bank restructuring or liquidation onto the investors, bank owners and major depositors, while reducing the costs borne by national budgets or the EU aid funds. Great efforts have been made to secure the European funds from the involvement in restructuring processes as much as possible. The following order in which the restructuring costs are to be borne has been defined: first, the costs are paid by shareholders, investors and those with the largest deposits in banks (the so-called bail-in tool[35]), then by national institutions responsible for bailing out banks, followed by the national budgets of the Member States, and at the very end by European institutions, i.e. the Single Resolution Fund (SRF). The Fund itself is scarce and certainly insufficient to rescue the largest banks in the euro area. The funds that must be raised by 2023 from contributions made by financial institutions, totalling EUR 55 billion, account for only 1% of deposits in the banks participating in the SRF. By the end of 2020, EUR 42 billion had been raised (Single Resolution Board, 2021). No separate and sufficiently large European backstop fund has been established, nor was the ESM allowed to directly bail out banking institutions with regard to the BU restructuring procedures. Instead, in January 2021, the finance ministers of the Eurozone agreed to set up an emergency bailout mechanism for the SRF within the ESM, in case the former were not able to support bank restructuring and liquidation in a crisis (the idea is that this tool should come into force in 2022) (European Stability Mechanism, 2021b).

The countries of the "affluent North" have also blocked the possibility of establishing a guarantee mechanism for European bank deposits. There were fears of federalising the deposit protection in the EU, which could impose on the financial institutions in the so-called Northern countries (Germany, the Netherlands, Finland, Austria) too heavy a burden of responsibility for the condition of the banking sector in the southern states of the EMU (Schild, 2018, p. 109).

Thus, the BU is incomplete, and there is no political consensus about its full institutionalisation. The June 2021 Eurogroup meeting on this

[35] Bail-in is a procedure for the administrative remittance or conversion of liabilities as part of a forced restructuring of a financial institution.

issue made it clear that Berlin (and other Northern capitals) does not agree to proceed with the BU institutionalisation until the condition of the banking sector in the EMU South is stabilised, and in particular, the exposure of sovereign debt in domestic banking institutions in the region is reduced (Smith-Meyer, 2021). According to Lucia Quaglia (2019, p. 966), at this stage, the BU fails to fulfil the expectations towards its supervisory role and even weakens the supervision of banks in the EMU countries most exposed to the crisis. One indication supporting this view is the marked weakening in the health of banks beyond 2019. Asset quality has deteriorated across the sector. The cost of risk has risen rapidly and it is dispersed among banks (European Stability Mechanism 2021b).

The countries which are most responsible for problems in the banking sector are mainly the heavily indebted ones, which also have the weakest banking institutions, including Italy, Greece and Portugal. They are also, to a great extent, the purchasers of sovereign debt. The budgets of those countries will bear a better part of the responsibility for the restructuring or winding up of the weakest institutions (Asimakopoulos & Howarth, 2021). One of the trends is the weakness in capital buffers of the banks in the south of the EMU (Asimakopoulos & Howarth, 2021), which means that the banks cannot restructure effectively through the bail-in tool. So far, the restructuring operations carried out in the BU explicitly confirm this trend. Most acquisitions or mergers have taken place within national banks (the stronger banks acquiring the weaker ones), and the costs of these operations have been borne mainly by the Member State's taxpayers, and only to a limited extent by investors (Culpepper & Tesche, 2021). Sometimes the European restructuring rules were even ignored by national institutions, which preferred to apply their national laws, simpler and more favourable in this respect. Moreover, the problem in the southern periphery of the euro area is that their national deposit guarantee systems are not able to effectively protect the interests of depositors in case of a major banking crisis, even at the minimum level required by the EU obligations (Asimakopoulos & Howarth, 2021).

Due to this reason, some people consider that the BU fulfils the expectations of Germany and other rich EMU countries, who want to protect themselves from responsibility for the situation in which the weakest southern EMU countries find themselves. However, it does not offer protection, and therefore is far from favourable to the countries such as Italy, Spain, Portugal and Greece, i.e. the periphery of the euro area (Qualia, 2019). Some also believe that the purpose of the BU is to consolidate the banking sector, whereby the largest banks will grow in strength by acquiring the medium and smaller banks (Culpepper & Tesche, 2021, p. 141). So far, only a few restructuring processes have been held under the BU provision, mainly within the national banks. The state institutions made every effort to ensure that their national banks are not handed over to other national entities. However, the BU favoured the approach under which well-managed subsidiaries rescue their parent banks in other countries (Culpepper & Tesche, 2021, p. 142).

So far, the most effective instrument for stabilising the banking sector is the successive ECB programmes providing liquidity to the financial institutions. They entail additional risks, including those related to the growth of debt in the euro area, as well as an increase in the ECB's balance sheet, which has grown 25% to nearly EUR 570 billion in 2020 alone. However, the scale of the ECB's liabilities to financial institutions is much larger, amounting to EUR 8 trillion (ECB, 2021b). The joint risks to which the ECB is exposed are also increasing. At the end of 2020, for all ECB portfolios combined, the risks, as calculated by the ECB itself (according to the accounting method), amounted to EUR 12.8 billion, which is EUR 4.6 billion more than at the end of 2019 (ECB, 2021a).

Another indicator of this risk is much higher. It is the sum of net liabilities in the TARGET2 system, resulting from the ECB purchasing securities from the Member States and private entities (mainly banks). The scale of these liabilities increased EUR 103.8 billion in 2020 to a total sum of nearly EUR 400 billion. These Eurosystem liabilities show the growing scale of the imbalance of financial flows in the EMU between the affluent North and the indebted South, which is visible in TARGET2 liabilities and must be balanced by the ECB's monetary policy.

4. Capital accumulation

The liberal internal market of the EU favours Western European corporations over weaker Central European entities (American Chamber of Commerce to the EU, 2017, p. 35; Mion & Ponattu, 2019). It seems that subsequent Eurozone crises will strengthen the trend to support capital accumulation by Western European centres, based on the liberalisation of regulations, particularly in those segments of economic activity where Western companies enjoy the greatest competitive advantage, for example, the financial services. It may hinder the ambitious purpose to create financial centres in Central Europe. It will also be a result of the desire of Western European policymakers to offset their own costs of stabilising the euro area. The direction is also in line with the trend to shift EU aid transfers, so far directed mainly at Central Europe, to the indebted countries in the southern periphery of the EMU.

While the BU operates primarily within the EMU, although it remains potentially open to other EU Member States (e.g. Bulgaria and Croatia joined the European banking supervision in October 2020), the Capital Markets Union (CMU) is a project dedicated to the entire EU. It aims at capital accumulation in the Western European financial centres of Frankfurt, Paris and Amsterdam. However, it is heavily burdened with risks resulting from the uncertain situation in the euro area.

The Capital Markets Union is a plan to create a single capital market across the EU. It aims to ensure the flow of investment and savings between all Member States for the benefit of citizens, investors and businesses. However, if capital accumulation occurs, it will benefit mainly the countries where the financial centres reside. In 2020, the European Commission adopted another action plan to complete the Capital Markets Union, which it believes has become an urgent matter after the Covid-19 pandemic (European Commission, 2020, p. 3). The CMU seeks to improve the raising of financial capital for post-pandemic economic recovery as well as the "green economy" and digital transformation. The Commission intends to accelerate and deepen the regulatory actions initiated after 2015 (i.e. after the Commission's first action plan in this regard was announced). This proves that the project has been implemented quite reluctantly so far. This approach is further substantiated by the comparison of the scale of financial market operations and access to capital in the US and the EU, which is in many respects much smaller in Europe (Demertzis, et al., 2021).

Experts perceive the CMU as an attempt to deepen the liberalisation of the EU financial markets (Quaglia & Howarth, 2018). The risky approaches include the reduction of capital requirements or regulatory safeguards for financial services rendered in the EU, as well as the more widespread use of securitised instruments, which were one of the causes of the financial crisis in 2007. Therefore, the promotion of the CMU may increase the volatility of EU financial markets and, in particular, contribute to an increased risk in the euro area.

Another criticism of this union focuses on the favouring of non-bank institutions and the greatest financial players of the internal market, at the cost of reducing the competitiveness of traditional banks, especially the smaller ones. Another challenge is the CMU pursuing to open up national markets to external competition and reduce the "nationalisation" of state financial institutions (Quaglia & Howarth, 2018, p. 996). It favours the market expansion of the largest financial institutions from non-European countries and the Member States with the strongest financial sectors. On the other hand, it poses a threat to the countries where financial markets are smaller and those striving to increase the concentration of the financial sector ownership within their national institutions.

It appears that the debate over the progress of the CMU will show a strong trend in the most affluent Member States to protect their national interests. In practice, this will involve protectionism within their own or even European markets (i.e. against non-European competitors) and, simultaneously, attempt to allow the expansion of the biggest national champions in the internal market. Such a course of action creates the strongest growth incentives for the largest Western European corporations. At the same time, we may expect a trend towards reducing capital cushions and capital requirements for financial institutions, which is likely to increase the risk of crisis, given the volatility and vulnerability of the financial system in the EMU.

5. Conclusion

The troubles of the monetary union have had a growing impact on governance not only within the euro area but in the EU as a whole. They affect more and more the changes in the integration processes in Europe. I have devoted this paper to identifying three major trends in these changes, which stemmed directly from the experience and problems of the EMU. Firstly, there was the trend to involve all EU Member States in the responsibility for stabilising the monetary union, including countries that are generally less wealthy than the unstable southern euro area countries. Not only did they have to participate in the loans and grants directed primarily to the southern periphery of the Eurozone, but they also had to approve a partial re-allocation of EU aid transfers from the East to the South. Thus, this constituted an attempt to reorient these transfers more towards the countries losing most on the monetary integration, i.e. Italy, Spain, Greece, Portugal and France. The second trend was the increasing centralisation of governance in the EU, including the expansion of centralised fiscal instruments, which were largely intended to stabilise the EMU. The third phenomenon was an attempt to strengthen capital accumulation in the core states, i.e. the most affluent countries of Western Europe. It involved the introduction of regulatory changes, designed to increase the long-term economic benefits from these countries' integration in the internal market, e.g. as a result of strengthening the previous processes of capital drain from peripheral countries, primarily from Central Europe.

The EMU is not an optimal currency system, which is reflected in macroeconomic imbalances and other dysfunctions that could destabilise not only the euro area but also potentially the whole integration processes in the EU. Therefore, the attempts to reform the Eurozone have been going on for many years, primarily aimed at introducing fiscal transfers, joint debt and European taxes, in short – centralising the fiscal policy. In recent years, there have been efforts aimed to include also the countries outside the EMU, i.e. all EU members, in stabilising the Eurozone. One example of the above is the introduction of the NGEU and the first European tax to finance this fund, as well as the announcement of other EU taxes in the future. The centralisation of fiscal policy in the EU, as well as the transfer of the obligation to rescue the euro area to the entire EU, aroused political resistance, especially in the Northern countries described as "thrifty" or "parsimonious". At the same time, the rescue of the euro area by the new EU fiscal instruments was received with understanding and a sense of solidarity in the countries in central Europe.

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Reboosting European Convergence after COVID-19: The Case of Croatia's Monetary Integration

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ABSTRACT: Croatia, a high-income emerging economy, is still facing important economic, social and political transition challenges. As the newest EU Member State, Croatia's most significant challenge now is to balance the recovery from the COVID-19 crises and undertake the last steps toward the full integration into the Economic and Monetary Union. Therefore, we discuss the context of Croatia's path toward the EU and EMU, and we analyse the data which highlights how Croatia manages its nominal and real convergence. Although it looks like the introduction of the euro was most likely to occur before the outbreak of the COVID-19 pandemic, currently Croatia might either postpone the use of the euro or it may face additional economic and social pressure if it does switch to the single currency during the recovery period.

Keywords: Croatia, nominal convergence, euro, real convergence

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1. Introduction

Starting from the position of a small, open economy which experienced significant economic and political shocks, as well as fundamental changes in the last three decades, Croatia is a clear example of a country needing smart and effective policies in order to achieve economic and social convergence. With a population of less than 4 million people and an economic output of 151 billion USD in 2021,[36] Croatia is a high-income emerging economy, still facing important economic, social and political transition challenges. On the other hand, it looks like Croatia did not manage to find the right path for catching-up as most of the other EU Members from Central and Eastern Europe after they joined the European Union. Significant obstacles and challenges have not been kind to Croatia.

Since its inception, the European integration project implied important economic and social goals. The Communities were established to create wealth and prosperity for Europeans.[37] As the integration evolved, the economic and social differences grew with basically each enlargement.[38] These disparities threaten the unity and the future of the integration as different interests and priorities create disagreements and slow down the process of removing barriers to the EU's fundamental freedoms and its Internal Market. Therefore, it was (and still is) essential for the Member States to agree on the fundamental goal of economic and social cohesion, which is a prerequisite for economic and social convergence. Reducing economic, social and political differences between European countries brings everybody closer, which is especially important for countries using the same currency. Furthermore, it is

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[36] "World Economic Outlook Database, October 2020". IMF.org. International Monetary Fund. Retrieved: 17 September 2021.

[37] European Union (2022). Key European Union achievements and tangible benefits. Available: https://european-union.europa.eu/priorities-and-actions/achievements_en. Retrieved: February 2022

[38] Kandžija, V.; Cvečić, I. (2010). Ekonomika i politika Europske unije, Ekonomski fakultet Sveučilišta u Rijeci, Rijeka

not just about monetary unity and a single monetary policy, but the need for further integration and the establishment of a real economic union which will be based on joint and harmonized policies adapted to closely integrated and interconnected economies.

Clear evidence of such needs stems from the euro-zone crises and subsequent recovery and stabilisation programmes, which helped especially vulnerable Member States, such as Greece, Ireland, Portugal, Spain and Cyprus. But also, BREXIT and more recent crises and instabilities caused by the COVID-19 pandemic and other pressing challenges related to energy supply, climate change, migrations, disrupted value chains and growing risks of international conflicts are forcing Member States to look into joint actions and common solutions. The 'maturing' European Union and 'evolving' Economic and Monetary Union basically encouraged a rapprochement between opposing and distant governments, at least in those areas of common interest. So, new initiatives, policies and strategies were agreed and established in the last decade (or so), broadening and widening the competences of the Union and creating new solutions for the obstacles encountered by the integrated European economies.

2. Croatia on the path to the EU and the euro area

Some would argue that Croatia's journey towards the European integration started even before the country became an independent and internationally recognized state, as the European Community tried to lure former Yugoslavia in the 1980s to democratize and initiate demanding economic reforms. After gaining independence, Croatia endured a bloody war on its territory, with huge human and financial sacrifices. The GDP dropped by 30-40% in just two years, and the recovery was hampered by ongoing economic transition from a socialist to a free-market economy coupled with hyperinflation, destroyed infrastructure and industry, unsystematic privatization and uncertain investment prospects, a huge refugee crisis (both with internally displaced people and those from Bosnia & Herzegovina), and a much smaller market for Croatian products and services.[39]

Unlike Slovenia, and the Višegrad or Baltic countries, Croatia was 'stuck' for years in a politically and socially unpleasant and limiting environment. The integration process began in effect in the year 2000. Croatia finally started membership negotiations in October 2005, which resulted in EU membership since July 2013, making it the newest Member State.[40] As one of the 'poorest' members, Croatia's priority was to intensify the economic and social convergence, and to show investors and other Europeans that Croatia can be a good environment for investment and growth. However, the 'catching-up' process of Croatia was burdened by the repercussions of the global crisis, which began in 2007/2008, and resulted in a long recession. Despite the internal EU realignments and adjustments, Croatia finally started to recover and slowly converge two or three years after it became a full member of the EU. However, the COVID-19 pandemic resulted in another setback, severely affecting the Croatian economy and especially its tourism sector.

Nevertheless, the Croatian financial and banking system showed stability and resilience for more than two decades. This was mainly achieved through a coherent monetary and exchange rate policy, governed by the Croatian National Bank. The exchange rate of the national currency (kuna – HRK) is formally fluctuating freely on the market, but its close relations with the euro and occasional market interventions characterize it as a managed floating exchange rate system.[41] This, alongside a high degree of euroization, encouraged

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[39] Schönfelder, B. (2005). The Impact of the War 1991 – 1995 on the Croatian Economy – A Contribution to the Analysis of War Economies, FREIBERG WORKING PAPERS #14. Technische Universität Bergakademie Freiberg; ISSN 0949-9970, available: https://www.econstor.eu/obitstream/10419/22512/1/schoenfelder_14_2005.pdf. Retrieved: December 2021

[40] European Commission (2013). Croatia's accession to the European Union – Q&A Available: https://ec.europa.eu/commission/presscorner/detail/de/MEMO_13_629. Retrieved: February 2022

[41] Croatian National Bank (2015). Exchange rate regime. Available: https://www.hnb.hr/en/core-functions/monetary-policy/exchange-rate-regime. Retrieved: February 2022

Croatia's authorities to choose a relatively faster integration into the Economic and Monetary Union; perhaps as soon as in 2023. Therefore, Croatia's integration case is discussed here primarily in the context of the nominal and real convergence, as the country prepares to introduce the euro, regardless of the overwhelming repercussions of the COVID-19 crises.

3. Nominal Convergence of Croatia

In the process of joining the European Economic and Monetary Union (EMU), with the ultimate goal of introducing a common currency – the euro, the Republic of Croatia had to orient itself towards meeting the Maastricht criteria of nominal convergence. Key groups of nominal convergence criteria include:[42] (a) The price stability criterion; (b) The government finances criteria; (c) The interest rate criterion; and (d) The exchange rate criterion. Each criteria contains specific values and procedures that individual countries must comply with in the process of joining the EMU:[43]

(1) The price stability criterion or inflation criterion implies maintaining a high level of price stability, i.e. *"the inflation rate of a given Member State must not exceed 1.5 percentage points of the average inflation rate (measured with the Harmonized Index of Consumer Prices) for the three EU countries with the lowest inflation in the year preceding the review of the EMU candidate country."*

(2) The public finances criterion analyses the trends of public debt and budget surplus/deficit; according to this criterion, "*the share of gross general government debt in the GDP may not exceed 60% at the end of the previous financial year*", and also "*the share of*

[42] Kesner – Škreb, M. (2006). Kriteriji konvergencije, in Financial Theory and Practice, 30 (4), pp. 407-408.

[43] Ibidem.

the general government budget deficit in the GDP may not exceed 3% at the end of the previous financial year."

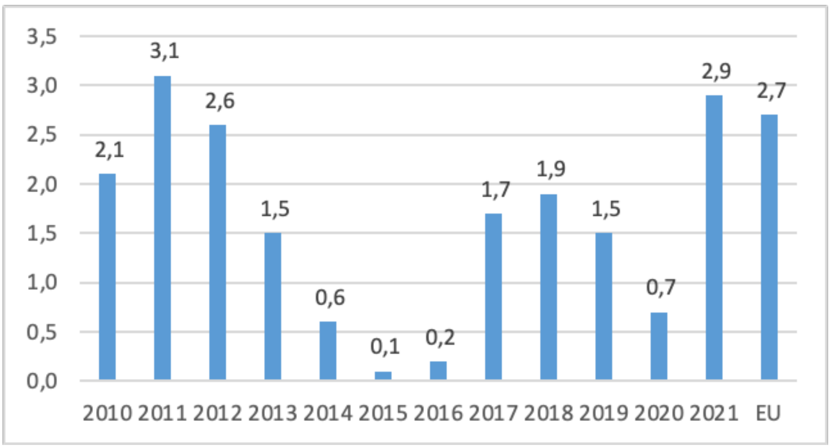
(3) The exchange rate criterion implies the country's participation in the *European Exchange Rate Mechanism – II (ERM II)*, i.e. maintaining stable exchange rate levels (without devaluation) for at least two consecutive years before joining the EMU.

(4) The interest rate criterion monitors the movements of long-term interest rates on government bonds, and according to this criterion the "*nominal long-term interest rate (on government bonds or similar securities) may not exceed the corresponding interest rate by more than two percentage points*", whereas the corresponding rate is calculated as an average rate of the three EU Member States with the lowest inflation.

In accordance with the aforementioned assumptions, a statistical overview of the nominal convergence criteria is firstly given for the 2010-2021 period (or 2010-2020, depending on the availability of data). Although the most significant emphasis for the EMU candidate countries is placed on the formally established nominal criteria, many contemporary authors point out that the emphasis should also be placed on real convergence, i.e. the stability of the real economy, as a necessary precondition for creating a stable and converging economy, which will be fully integrated in an economic and monetary union. Therefore, the following indicators of real convergence are also presented: (1) GDP growth rates (%); (2) GDP per capita (in US dollars); (3) Unemployment rates (% of the population aged 20-64). The data was collected using the Eurostat statistical database and the World Bank statistical portal.

The data in Figure 1 indicate that the Republic of Croatia has had varying levels of inflation in the observed period (0.1% in 2015; 3.1% in 2011), with an average rate of 1.45% per annum. However, the COVID-19 crisis and other shocks in the international economic and political environment afterwards also caused significant changes in the level of prices in Croatia. After 2020, when the reported inflation rate was just 0.7%, the rate shot up to 2.9% in 2021. However, this is not the biggest change since 2020, as the data from the Croatian National Bank suggest a sharp increase up to the level of 6.3% in February 2022,[44] this being a major challenge for Croatia's economy and its recovery from the pandemic.

FIGURE 1. **Inflation rate (HICP) in the Republic of Croatia during the 2010 – 2021 period (%)**



Source: Authors based on Eurostat data (Eurostat, 2022a).

As the data suggest, by the end of 2021 there was a notable increase in the average level of prices, positioning the Republic of Croatia above the EU average (2.7% for EU in 2021). Eurostat data[45] point at Greece (0.6%), Malta (0.7%) and Portugal (0.9%) as the EU Member States with the lowest inflation rates in 2021. Consequently, the nominal convergence reference rate of 2.73% did not help Croatia to satisfy the inflation criteria, which the current economic and political shocks in 2021 and 2022 only made worse.

During the observed period, the Republic of Croatia reached the average level of general government debt of 75.1% of its GDP. In 2020, it reached

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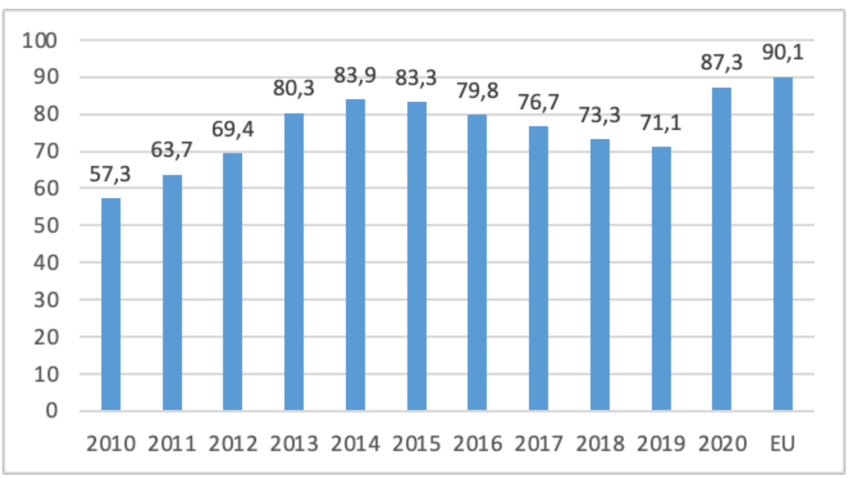
[44] Croatian National Bank (2022). Key indicators. Available: https://www.hnb.hr/en/pt_temeljne_funkcije_j ; Retrieved: February 2022

[45] Eurostat (2022a). HICP – annual data (average index and rate of change). Available: https://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=prc_hicp_aind&lang=en; Retrieved: March 2022

historical highs of 87.3% of Croatia's GDP. Although still below the EU average (90.1% for EU in 2020), it is not in line with the nominal criteria, which anticipates a level below 60%. Five years before the COVID-19 pandemic, Croatia had been managing a significant decrease of the public debt level, which would have probably led to a positive outcome: A drop ranging from 84% to 71% was achieved in just five years. This would have made it possible to satisfy the flexibility option of the criteria, which allows the EMU candidate country (as an alternative) to demonstrate the ability to reduce indebtedness at a stable pace. However, the current situation in the country (and across Europe) has exerted massive pressure on the fiscal policy and debt levels. Therefore, public debt is not performing as well as before the COVID-19 crises.

FIGURE 2. **Public debt in the Republic of Croatia during the 2010-2020 period (% of GDP)**

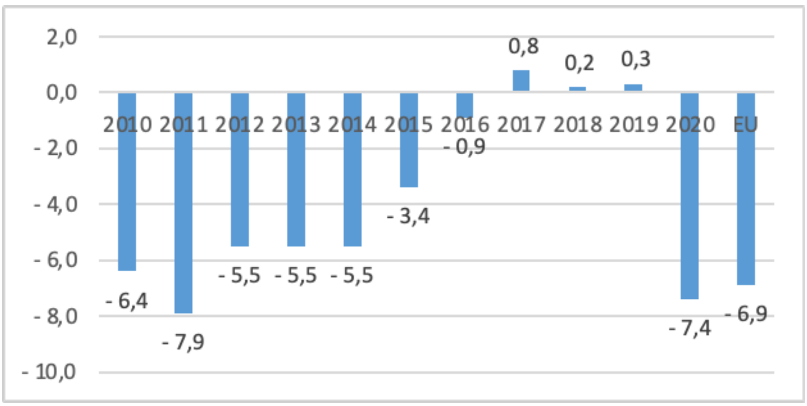


Source: Authors based on Eurostat data (Eurostat, 2022b).

The balance of the general government budget (Figure 3) is faced with similar circumstances. During the observed decade, the Republic of Croatia achieved an average level of government fiscal deficit of 3.75% of the GDP. Although, Croatia's balance had a positive trend, especially between 2014 and 2019, and it reported surpluses in 2017, 2018 and

2019, the effects of the COVID-19 crisis changed everything. After a consistent fiscal policy, which resulted in the fulfilment of the nominal criterion, in 2020, the trend switched completely resulting in a deficit of 7.4% of the GDP; above the EU average (6.9% for EU in 2020).

FIGURE 3. **Budget deficit/surplus in the Republic of Croatia during the 2010-2020 period (% of GDP)**



Source: Authors based on Eurostat data (Eurostat, 2022b).

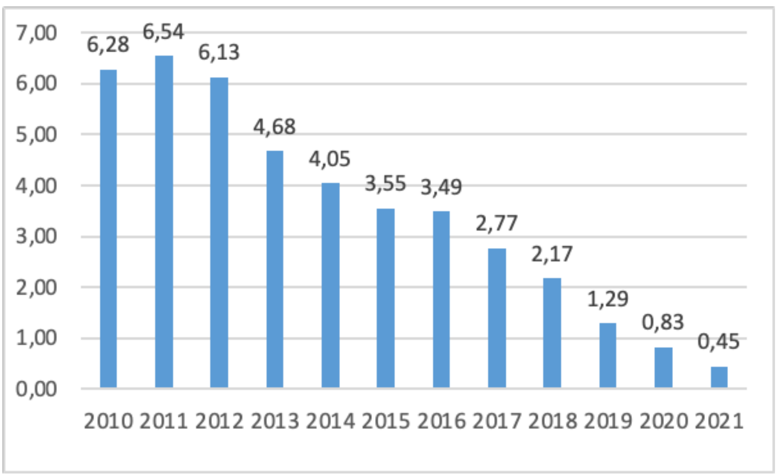
Figure 4 shows a continuous decrease in the long-term interest rates on government bonds in the Republic of Croatia during the observed period. In 2021 it reached a level of 0.45%, which is in line with the average rates of the EU Member States, and in line with the interest rate criterion of nominal convergence.[46]

The Republic of Croatia joined the European Exchange Rate Mechanism – ERM II in mid-2020, with central parity of the Croatian kuna (HRK) against the euro set at 1 EUR = 7.53450 HRK. The agreement on Croatia's participation in the ERM II mechanism creates an obligation of simultaneous accession to the Banking Union and the Exchange Rate Mechanism, as well as the full implementation of a set of highly relevant measures which

[46] Eurostat (2022c). EMU convergence criteria series – annual data. Available: https://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=irt_lt_mcby_a&lang=en; Retrieved: February 2022

would allow for undisturbed participation in the ERM II mechanism. Such measures relate to banking supervision, the macro-prudential framework, the anti-money laundering framework, the collection, production and dissemination of statistics, public sector governance and the reduction of the financial and administrative burden on the economy.[47]

FIGURE 4. **Long-term interest rates on government bonds in the Republic of Croatia during the 2010 – 2021 period (%)**



Source: Authors based on Eurostat data (Eurostat, 2022c).

Participation in the ERM II mechanism for (at least) two consecutive years without significant changes in the exchange rate of the national currency against the euro is actually the fifth and final nominal convergence criterion. Since July 2020 the exchange rate of the kuna has not exceeded ± 1% against the euro,[48] which is a continuation of the stable and consistent policy led by the Croatian National Bank since the introduction of the euro.

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[47] Croatian National Bank (2020). Communique on Croatia. Available: https://www.hnb.hr/en/-/communique-on-croatia. Retrieved: February 2022

[48] ECB (2022b). Euro foreign exchange reference rates. Available: https://www.ecb.europa.eu/stats/policy_and_exchange_rates/euro_reference_exchange_rates/html/eurofxref-

4. Real Convergence of Croatia

Data showing the current position of the Republic of Croatia in the process of integration into the EMU indicates clear disruptions and a slowdown that has emerged from the COVID-19 crisis. Identified trends were expected, and have arisen as a result of the slowdown in economic activity and the reinforcement of Government efforts to reverse the negative effects of the crisis. This provides the framework for the implementation of essential reforms and the efficient use of allocated/available financial resources by the EU under the recovery and resilience programmes. Nevertheless, as previously pointed out, the introduction of a common currency also requires the existence of stable macroeconomic foundations. Therefore, the current section presents some basic indicators of real convergence of the economy of Croatia toward the EU economy.

Table 1 suggests that the Croatian economy grew by an average rate of 0.31% per year over the period in consideration, while the EU economy's yearly growth was 0.9%. Over the whole of the last decade, it is important to note that in the first half Croatia experienced a long recession that was more troublesome than for most EU countries, slowing down the convergence aspirations during the period before full membership and the first two years of EU membership. However, from 2015 to 2019 the economy finally rebounded and it set out on the path of the long-awaited real convergence of the Croatian economy. The growth rates of Croatia were above the EU average. However, the COVID-19 pandemic, as elsewhere, caused a significant and sudden drop in 2020: -8.1 %.

For the Republic of Croatia, GDP per capita levels in the previous decade have basically not converged much (Figure 5). The lowest level was recorded in 2015 (11,933 USD), while the highest level for Croatia was reported in 2019 (15,311 USD). Despite the improvement of approximately 28% in four years, it needs to be emphasized that the GDP/pc for Croatia fell approximately 19% between 2011 and 2015, which means that overall

graph-hrk.en.html. Retrieved: March 2022 growth between 2011 and 2019 was just 3.7%. The EU economy also suffered stagnation during the same period, recovering merely 0.06% between 2011 and 2018. Therefore, significant differences persist in the case of Croatia and the EU average, where the level of GDP per capita is almost 2.5 times higher than that of Croatia. This is the key challenge for the process of real convergence of Croatia, which is one of the few new Member States that achieved slow progress during its membership (starting in July 2013), and again hampered by new and unexpected obstacles and challenges, such as the global pandemic, international conflicts, shortages of indispensable resources and glooming perspectives related to climate change.

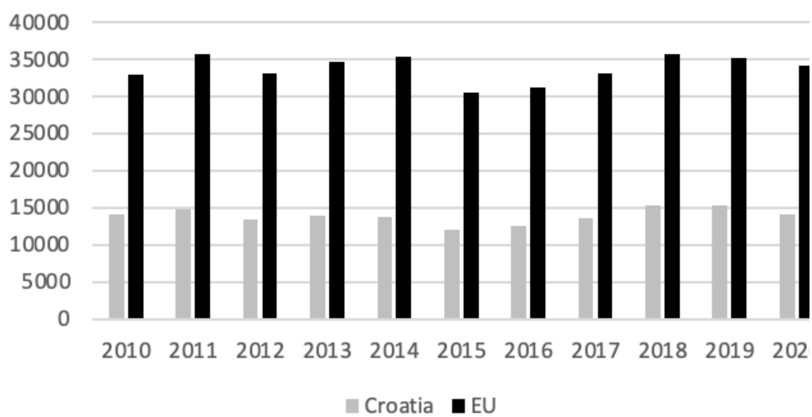
TABLE 1. **GDP growth rate of the Republic of Croatia and the EU during the 2010-2020 period (%)**

Year	Croatia	EU
2010	-1.25	2.25
2011	-0.09	1.86
2012	-2.28	-0.71
2013	-0.36	-0.03
2014	-0.35	1.58
2015	2.53	2.31
2016	3.53	2.01
2017	3.41	2.81
2018	2.90	2.07
2019	3.48	1.82
2020	-8.10	-5.96
Average	**0.31**	**0.90**

Source: Authors based on World Bank data (World Bank, 2022a).

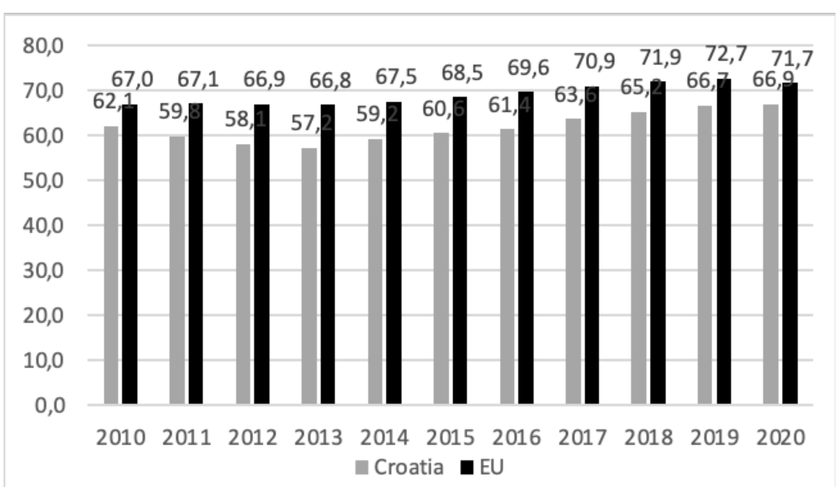
As the last contribution of this statistical overview, Figure 6 shows that during the observed period the level of employment of the population aged 20-64 of the Republic of Croatia increased, from 57.2% in 2013 to 66.9% in 2020. However, these values are below the EU average level, which amounted to 71.7% in 2020. These figures seem to point at the narrowing of Croatia's labour market gap, but a more thorough analysis would need to encompass several determining aspects, influencing jobs and workers, such as emigration, negative demographic trends, technological adjustments, undeclared work, etc.

FIGURE 5. **GDP per capita of the Republic of Croatia and the EU during the 2010-2020 period (in US dollars)**



Source: Authors based on World Bank data (World Bank, 2022b).

FIGURE 6. **The unemployment rate of the Republic of Croatia and the EU during the 2010-2020 period (% of the population aged 20-64)**



Source: Authors based on Eurostat data (Eurostat, 2022d).

The basic analysis of the real convergence usually relates to the assessment of the business cycle synchronisation between countries which make up the monetary union. This would help to determine whether the Croatian economy is moving through the same phases of the economic activity cycle at the same time as the euro area economy.[49] Harmonized business cycle contribute to efficiency and consistency of the single monetary policy oriented to the governance of the whole euro area. The common monetary policy would not be efficient in cases of asymmetric shocks, which impact parts of the monetary union that are not sufficiently integrated in different ways. Basically, if most of the euro area countries experience high inflation at some point, a restrictive monetary policy of the European Central Bank would almost definitely harm a country experiencing recession in the same period.

There are several ways to assess business cycle synchronisation, including the GDP dynamics, but it is also possible to analyse inflation and unemployment rates, for instance. Several research suggest Croatia's cycles were quite in line with the euro area, at least before the COVID-19 pandemic. Linking this with the Theory of Optimal Currency Areas, Croatia seems to be a good candidate if we assess the level of trade and financial integration, as well as the level of political integration.[50] Other criteria, such as economic diversification, might not give a clear answer. As Croatia is over-dependent on tourism, it is vulnerable to restrictive policies. For example, restrictions on travelling and vaccination during excessive infection waves and lockdowns. However, loss incurred in 2020 was compensated considerably in the summer of 2021, as a result of positive trends in Croatia and a relatively loose epidemiological framework which was introduced by the Croatian authorities.

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[49] MacroHub (2019). Indikatori uvođenja eura. Available: https://macrohub.net.efzg.hr/indikatori/uvo%C4%91enje-eura . Retrieved: December 2021

[50] Brkić, M.; Šabić, A (2017). Je li euro optimalna valuta za Hrvatsku: ocjena korištenjem teorije optimalnih valutnih područja. Pregledi P-36. Croatian National Bank. ISSN 1334-0085 (online)

5. Conclusion

Instead of summarising the above, we wish to conclude by commenting on excerpts from the most recent Convergence Report of the European Central Bank.[51] The report included the reference period before the COVID-19 pandemic and assessed non-euro countries of the EU, including Croatia. Croatia's nominal convergence looked quite promising, as the interest rates were favourable and HICP inflation was well below the reference value of the price stability criterion. But, as our analysis also showed, inflation has risen drastically in recent months. Accordingly, major fiscal and monetary policy measures were introduced to offset the economic damage brought by the COVID-19 pandemic and other recent shocks.

Croatia joined the ERM II in 2020, and it expected to meet the exchange rate criterion by 2022, especially because there was no significant change in the exchange rate against the euro, even in 2020 and 2021. In fact, the Croatian kuna against the euro was quite stable during most of the 21st century.

Regarding the fiscal criteria in 2019, Croatia's general government fiscal balance met the target, while the public debt ratio was above the reference value (although it had been falling since 2015). Because of the COVID-19 pandemic, a clear deterioration in the fiscal position of Croatia was inevitable, which has brought Croatia into a sensitive position that may cause the scheduled conversion to the euro to be postponed.

Besides the five nominal convergence criteria, the ECB and the European Commission monitor the implementation of all commitments agreed with Croatia. As the consequences of the COVID-19 outbreak and other recent crises are putting more pressure on Croatia and on all European economies, including its single currency, it is not clear what would be the optimal scenario for the coming year(s), as uncertainties and risks are manifold.

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[51] ECB (2022a). Convergence Report. Available: https://www.ecb.europa.eu/pub/convergence/html/ecb.cr202006~9fefc8d4c0.en.html#toc43 Retrieved: February 2022

Nevertheless, sustainable convergence requires stable economic policies and adequate structural reforms, especially since Croatia is experiencing macroeconomic imbalances. These policies and reforms should be addressed regardless of the final decision of whether or not to introduce the euro in 2023.

The final decision will have probably been taken by the time this chapter is published. The authors, however, got the chance to discuss the matter before it is.

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The Czech Republic: A Case of Economic Transition, Global Value Chains, and Structural Reform

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Abstract: The Czech Republic's position in the European Integration and its resilience is markedly influenced by its economic transition, which took place before it joined the EU in the 1990s. Swift privatization and opening up to trade invited rapid FDI inflows, embedding it firmly in Global Value Chains (GVC). With its traditional manufacturing industrial base, the Czech Republic deeply integrated the European and global trade and investment flows. This triggered both a nominal and real convergence process. Concerning standards of living, the country soon rose to the level of European peers. Recent crises, such as the Great Recession

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and Covid-19 pandemics, have drawn attention to structural weaknesses which are rooted in the quality of the Czech business environment, governance, and innovative capacity. Addressing these weaknesses will be a crucial challenge for maintaining the country's resilience and growth, while ensuring its ongoing contribution to the European Integration Project. The case study of these developments applies a new conceptual model of the interrelationships between the political, the economic and the technological domains, at whose intersection the Czech national political economy operates. It concludes with recommendations for a Smart Specialization strategy to face the challenges of the future.

Keywords: Czech Republic, Transition, Structural Reform, Global Value Chains, Technology

1. Introduction

After the Velvet Revolution in 1989, the Czech Republic represents a unique historical case of political and economic transition, framed by its association and accession process to the European Union and the Common Market. Political scientists have studied aspects of transition under the Copenhagen Criteria, such as the stability of institutions to guarantee democracy, the rule of law, human rights, and respect for the protection of minorities.

The aim of this chapter is to expand the current understanding from the perspective of business and economics with a short case study. Its methodology uses data like FDI flows and globalisation indices to analyse the country's position in the world economy, and show how participation within Global Value Chains accelerated growth and integration into "Factory Europe" (Baldwin, 2014). It proposes a novel conceptual model of the political, the economic and the technological domains, at whose intersection the Czech national political economy operates. The case study concludes with recommendations for a Smart Specialization strategy designed to face the challenges to future growth.

We begin by examining the details of structural reform. The establishment of a functioning market economy, and especially the capacity to cope with competition and market forces (European Commission, 2022), have posed considerable challenges to the institutions of the Czech Republic (and other CEE countries), and to their businesses. Immediately following its rapid opening, liberalization and deep structural reform led to the country's equally dynamic globalization, as measured by the KOF Globalisation Index, which increased from 64.09 in 1993 to 86.57 in 2007. It is currently 84.85, the 15th highest level in the world, outperformed only by twelve EU Members States (Table 1).

Czech Republic's integration into the EU and the world economy is inseparable from its intensive and specific type of participation in Global Value Chains or GVCs. Shocks like the Great Recession and the COVID-19 Pandemic marked a shift in the Global Political Economy of European Integration, raising questions about economic resilience which brought the governance of GVCs under critical scrutiny. These should be answered with a strategy which adequately accounts for the effects of economics, politics, and technology to strengthen the Czech Republic's position in the face of this shift. We apply Tooze's (2022) redefinition of the National Political Economy, a novel depiction of the interacting forces described in this chapter. The model foresees 3 interacting domains, whereby the National Political Economy is effectively the intersection of Geo-Political, Geo-Economic, and Geo-Technological forces (Figure 1).

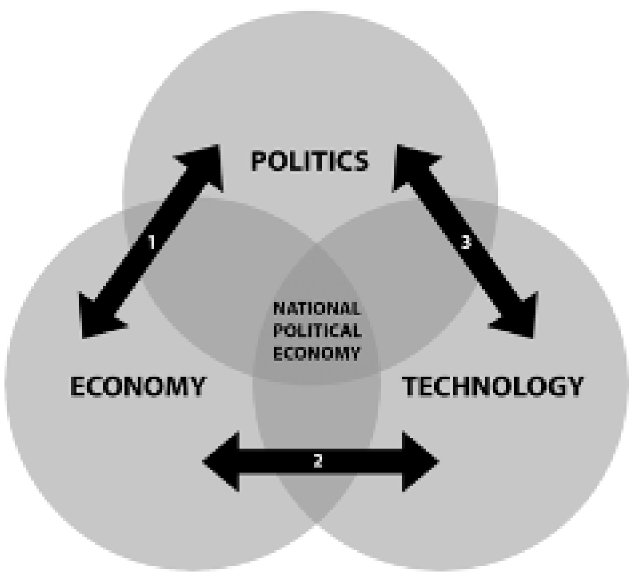
TABLE 1. **The world's most globalized countries**

Rank	Country	Globalisation Index, overall
1	Netherlands	90.91
2	Switzerland	90.45
3	Belgium	90.33
4	Sweden	89.44
5	United Kingdom	89.31
6	Germany	88.73
7	Austria	88.61
8	Denmark	87.80
9	Finland	87.68

10	France	87.63
11	Spain	85.87
12	Ireland	85.75
13	Norway	85.40
14	Portugal	85.22
15	Czech Republic	84.85
16	Canada	84.25
17	Hungary	83.83
18	Greece	83.65
19	Singapore	83.47
20	Luxembourg	82.98

Source: Gygli et al., 2019.

FIGURE 1. **The National Political Economy**



Source: Adapted from Tooze 2022 and Frey 2020.

Note: The National Political Economy is the intersection of the Geo-Political, the Geo-Economic and the Geo-Technological spheres with interactions flowing between the three domains. Flow 1 represents the interaction between economics and politics, which includes forces like European integration. Flow 2 is the interaction between technology and economic forces, like rising inequality, which in turn drives political changes, e.g. populism (flow 1). Flow 3 is the influence that policy can have on technology and innovation.

A closer examination of the interactions reveals that Flow 1, the interaction of economics with politics, is well-studied. Policymakers should, however, turn their attention to the interaction between technology and economic forces: for example, technology increases inequality (flow 2). This in turn drives political change, such as populism (flow 1). The urgent task at hand is to draft strategies for flow 3, the management of innovation at the service of national growth. The inclusion of technology in the conceptual model accounts for the impact of the most recent industrial revolution, in which transport and information technology have disaggregated the value added by the production function. Today, nations no longer trade finished goods produced by domestic sectors, but tasks and intermediates in a global division of labour and specialized skills (Baldwin, 2018). At the local level, according to Frey (2019), we cannot assume that technology is synonymous with social progress, but must distinguish between enabling or replacing technologies. In other words, when reflecting upon the future of growth within the EU's plans for strategic autonomy, nations like the Czech Republic must actively and strategically prepare for automation and its material impact on the country's economy and political landscape.

2. Transition according to the Copenhagen criteria

The Czech Republic's stance in the integration into Europe has been determined by its transition from a centrally-planned to a free-market economy in the 1990s. FDI inflows were directed to the country's traditionally-developed industrial base, driving growth. The economic convergence is measurable in both nominal and real terms, e.g., the country's real GDP per capita of EUR 17,340 now outperforms Portugal and Greece (traditional EU Members) and, with the exception of Slovenia, all EU newcomers (Eurostat, 2022). Even though the Czech Republic started with the highest share of state-owned enterprises among its V4 peers, the speed of its transition (namely in terms of small-scale privatisation) soon outperformed other countries. Gravity factors and skilled labour eased the country's restructuring towards a more modern service-based economy, which was quickly reflected by the FDI inflow structure (table 2).

The inflow of Foreign Direct Investment also induced structural and labour market changes. Investors benefited from the country's stable political and economic environment, the above-average pace of its transition process, as well as its geographical proximity to EU markets (De Castro & Hnát, 2017). "FDI facilitates the transfer of technology, know-how and skills, and helps local enterprises to expand into foreign markets" (Krkoska, 2001).

As Baldwin (2014) underscores, "The world economy is not global; it remains regionally segregated, such as Factory Asia, Factory Europe, and Factory North America. What matters is not value (added) but jobs, especially good jobs." The association process was an opportunity to outsource low-skill operations abroad, to import the necessary inputs from the CEE countries and to keep the mid-skilled processes on domestic soil (Hnát & Sankot, 2019). As a consequence, the CEE countries have developed into the largest players in intra-regional trade, accounting for more than 11% of intra-Europe exports of intermediate manufacturing goods in 2015.

TABLE 2. **Czech Republic Inward Foreign Direct Investment by Country 1993-1999 (%)**

Country	1993	1995	1997	1999
Western Europe				
Belgium	4.9	1.0	4.3	21.8
France	5.2	6.6	7.8	3.7
Germany	12.5	22.1	30.1	20.6
Netherlands	4.6	28.7	10.3	17.9
Austria	8.4	3.4	7.3	13.2
Switzerland	2.1	26.5	3.6	5.6
United States	39.0	3.9	7.6	9.2
Other	16.2	4.3	8.7	2.8
Total	100.0	100.0	100.0	100.0

Source: De Castro and Hnát, 2017.

Czechia is arguably a case study of growth enabled by European integration, and one of the world's most highly-integrated economies in Global Value Chains (GVCs), especially as suppliers to the German automobile industry. In other words, it is a major industrial player in Factory Europe. According to the WTO's index, its total GVC participation in 2015 was 58.6 % (Table 3), of which forward participation was 19.4% and backward participation was 39.3%. Domestic value added in manufacturing exports accounts for only 54% and is even lower in some sectors (45% in electronics and 46% in transport equipment). Until 2015, this participation was on an upward trend, exhibiting an annual change of 7% over a 10-year period (WTO, 2019).

TABLE 3. **GVC Participation Index (in %)**

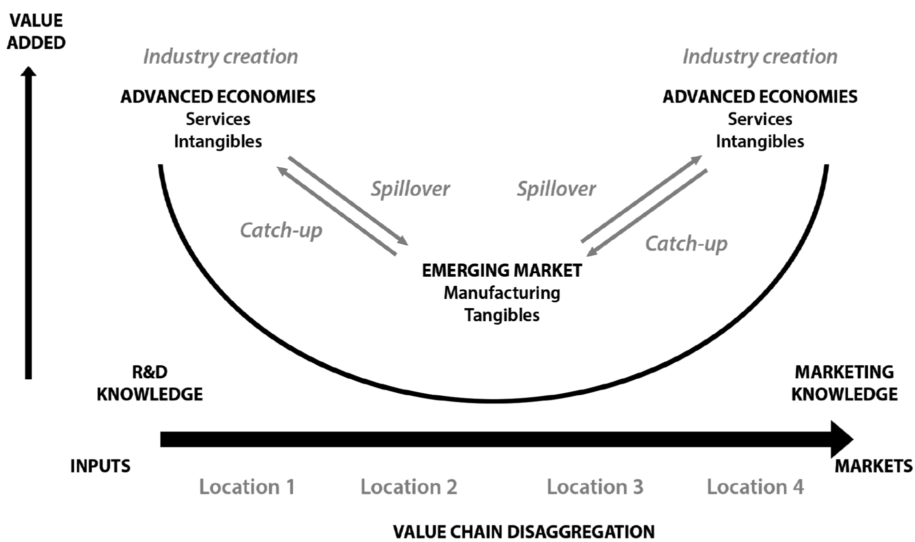
Year	1995	2005	2010	2015
Czech Republic	50.7	52.4	55	58.6
Hungary	45.9	58.1	60.7	59.2
Poland	35.3	44.7	47.2	48.1
Slovakia	53.6	60.3	60.9	63.6
Germany	34.4	39.6	42.4	42.9
USA	29.4	33.3	32.9	31.7

Source: Hnát et al., 2020.

3. Competing in an integrated European market

As remarkable as the developmental trajectory has been, the upward trend is not certain to continue and sustainable future growth will require a strategy which is deliberately managed. In spite of the measurable benefits of FDI and GVC participation, potential downsides of the way the Czech Republic does business today are becoming apparent. To begin with, under the current form of industrial organisation, a significant proportion of profits from the current account are repatriated, while the value-added in production by Czech industrial exports are comparatively low. Furthermore, the backward and forward participation index helps reveal where each country is located in its respective GVCs. According to the so-called Smile Curve of Value Creation, the highest value-added (like product design and service) is generated at the beginning and end of the chain (Mudambi, 2008), whereas activities in the middle of the chain, like manual assembly, generally add low value, and have higher backward linkages, which means that the valuable work is completed by upstream nodes.

FIGURE 2. T**he smile curve of Value Chain Disaggregation**



Source: Mudambi, 2008, p.11.

Data confirm that the Czech Republic has relatively low forward linkages, and the goods they export include a large share of added value (backward linkages), in the form of both intermediate products and services which originate in other countries. High-value services account only for 38% of gross exports, and less than half of these originated in the Czech Republic.

Studies of the domestic Czech auto industry reveal that its contributions add comparatively low value through labour-intensive activities. According to Mudambi (2008), this is typical of emerging economies which join a

GVC at the bottom of the smile curve, and then strive to catch up with advanced economies, which perform tasks of higher value, such as design and branding. Companies at the bottom of the curve, who compete on cost factors, have reason for concern, since rising labour costs can erode competitive advantage, and these tasks can be transferred to even lower-wage regions in the vicinity (i.e., Romania, Turkey or the Maghreb). At the same time, GVCs provide opportunities to compete on skill differences. Upgrading into tasks which add higher value can be facilitated by merely participating in a shared production and management process, in which knowledge transfers from core to the periphery on an ongoing basis. Over time, some suppliers may come to know more about the manufacturing process of its buyer than the OEM itself, implying that "the very process of outsourcing undermines the power asymmetries that were inherent in the original externalized relationship" (Buckley & Strange 2015, p.246).

Empirical evidence indicates, however, that strategic and deliberate upgrading has been an uneven process in Czechia, dependent upon the decision-making of TNCs headquartered abroad. "Industrial upgrading of foreign-owned subsidies only takes place if it increases the competitiveness of a particular TNC as a whole" (Pavlinek et al., 2009, p.61). While the Czech industrial system has benefited from the acceleration of joining an existing competitive GVC rather than slowly building its own industrial base (Baldwin, 2013), sustainable development in the future will need more than cost-based comparative factor advantages. It must implement consistent capability-building strategies at both regional and firm-level to develop sustainable competitive advantages. This demands work on flow 3 in figure 1.

4. Sources of Resilience during the global Covid-19 pandemic

The most recent Covid-crisis has seen the rise of heated public and academic discussion on resilience, globalisation and trade, implicating all 3 flows. It is unusual to see the public, policymakers and experts from all disciplines weigh in on why vital materials were unavailable to protect healthcare workers. As time passed, the stockouts of ordinary consumer goods became an unpleasant routine occurrence, albeit no longer life-threatening. The debate has become a populist call for state intervention into an apparently dysfunctional global system. Specifically, this means closing borders and restoring trade barriers, especially with China (Mason & Friese 2020; Schlesinger, 2020; Javorcik, 2020; Simchi-Levi, 2020). According to the global trade alert website, 83 nations imposed a total of 150 measures to restrict the trade of medical supplies in 2020. These measures did not significantly increase the availability of PPE. If policymakers take such action to appease populist sentiments, the pandemic would signal the end of globalisation as we know it, and end 30 years of unprecedented development and poverty reduction (Miroudot, 2020a), not least for the Czech Republic.

There are compelling arguments for why GVCs are the reason the present crisis did not turn out to be much worse than it actually was (Sandbu, 2020; Sheffi, 2020). As a form of industrial organisation which effectively assembles from the market the most competitive specialist to deliver a product or service, GVCs are set up to resolve disruptions faster than, for example, SOEs or national champions, a fact with which former communist states are too familiar. Supply chain disruptions are not new, and the experience from previous disasters indicates that GVCs are indeed resilient, although some sectors will be impacted more by a particular crisis than others (air transport or tourism). Furthermore, the shaky logic of retreating from "dependence" on global suppliers is increasingly apparent: "building resilience implies that countries should avoid putting all their eggs in one basket, and GVCs can play an important role in guaranteeing this. Adding to this, economic self-reliance comes at significantly higher production costs and a reduced ability to ramp up production" (Van Aasche, 2021, p.5). Self-sufficiency or domestic production is not the same as robustness. "If the objective is to build more robust supply chains (without promoting a new mercantilist agenda), a combination of international trade and local supply is what works best." (Miroudot, 2020b), which is one of the sources of economic strength of the Czech Republic.

5. Necessary structural reforms to support growth

The Covid crisis therefore confirmed that small, export-oriented economies like the Czech Republic could not maintain their living standards and current levels of growth without participation in GVCs. Populist sentiment should not distract policymakers from drafting a strategic plan for future competitiveness. A recent study by the ADB and the WTO sees the future of GVCs beyond manufacturing (ADB, 2021). The emergence of factoryless manufacturers like Apple are evidence of the power of intellectual property in the global system, depicted in the smile curve. Intangible assets are increasingly being traded by developed countries in exchange for manufactured goods in less developed ones. This presents a formidable challenge to the future of the Czech Republic, which is currently positioned as a manufacturing partner within Factory Europe. If the Czech business model continues to operate at the lowest points of value disaggregation, its competitiveness is at risk through technological change, and automation in particular.

Despite the marked progress that globalisation and European integration has brought the Czech Republic, its prevailing structural weaknesses render it vulnerable to the recent deglobalisation trends that were accelerated by the pandemic. The country has substantial potential for innovation and a number of competitive advantages that drive participation in global value chains. Yet in international comparisons it continues to lag behind the world's most competitive economies in real innovation. The Czech Republic belongs to the group of so-called "moderate innovators," and in these countries, the probability of new industries emerging outside the current knowledge base is lower than in economies from the group of "strong innovators." The causes lie mainly in the quality of Czech institutions, its infrastructure, and business environment. Together, the three factors are crucial for the development of innovation potential, yet they are not easily reformed. Compared to Western European economies, the poorer quality of Czech institutions is evident in low levels of trust in government, high levels of corruption or patronage, as well as the absence of a strategic vision for economic governance. While the rest of

Europe sees a resurgence in selective industrial policy, the Czech Republic suffers from the low trust that its entrepreneurs have in government intervention, both at the national and European level. This is aggravated by the absence of a clearly-formulated strategy to support important sectors of the domestic economy.

At the same time, traditional comparative advantages are under threat from rising costs, which make it vulnerable to labour-replacing technologies like automation. Applying Tooze's model, should the Czech Republic undergo the kind of "excessive automation" (Acemoglu and Restrepo, 2018) that has de-industrialized the U.S. (flow 2) and driven populism (flow 1), its successful history of growth through European integration may be negatively impacted. As low-skill manufacturing jobs are progressively automated, alternatives must be created in other sectors in order to avoid shrinking of the middle class and its negative political consequences (Frey, 2019).

Left to their own devices, market forces may leave behind a large population of workers. Old globalisation instruments like protectionism will deprive the Czech Republic of many of the advantages of GVC participation which accelerated its development. Instead, we recommend a Smart Specialisation strategy in which national or regional innovation plans set priorities for technological research in order to build competitive advantages. The definition of competitive advantage must match business needs, so that emerging opportunities and market developments are addressed in a timely manner.

The second critical component of national infrastructure which is needed for innovation is education. The declining quality of Czech education in mathematical and technical literacy, as well as at the apprenticeship level, has been flagged by the business community. Action must be taken to develop knowledgeable workers whose soft skills fit the ends of the smile curve. Smart Specialization will necessarily require close cooperation between private and public interests in both research and education to avoid duplication and fragmentation of efforts. Its strategic components must be developed, implemented and continuously evaluated to ensure alignment with business outlooks (Hnát et al., 2020). These would build upon existing strengths of a social system which, in contrast to the U.S., includes universal healthcare, a functioning apprenticeship system, and relatively inexpensive access to higher education. Since the required structural changes will become increasingly costly, policymakers in the Czech Republic must take proactive action now, in order to continue on its path of growth and European integration.

6. A new understanding of National Economy

The historical case study of the Czech Republic, from the Velvet Revolution through its integration into the European Common Market and Global Value Chains, provides a useful illustration of how the Geo-Political, the Geo-Economic and the Geo-Technological interact in a national political economy. The novel inclusion of the Geo-Technical in our model, understood as both the industrial (logical) organization of GVCs and the material forces of automation, permits a structured analysis of events like the Covid-19 crisis and its implications for the Czech Republic. This structure may provide useful to policymakers to learn from the past when planning for an uncertain future.

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What Future for Hungary after the Covid-19 Outbreak?

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ABSTRACT: Major economic, natural and social shocks always bring new insights, to regions as well, which call for new directions for development activities and related actions. The Covid-19 epidemic broke out, swept across the world in 2019, and has radically transformed almost every aspect of life. The change in meaning caused by the Covid-19 has also affected the rhetoric of countries and their role in the European Union. Isolationist processes have slowed down and fragmented integration into the EU. In this challenging period, we again witness a shift in the role of rural space (shelter, safe space) and its changing interpretation and also the reversal of negative connotations associated with the countryside: loneliness, self-sufficiency, distance. Therefore, the study focuses on the factors that have the potential to further enhance these positive values, and do not increase the resilience of rural areas.

Keywords: Hungary, Covid-19, rural areas, economic policy

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1. Possible scenarios for Hungary after Covid-19

For Europe and the integration, the last two years have been incredibly eventful. Many questions have arisen as to whether these emerging factors have helped deepen integration or are holding it back. During the Brexit process, the EU was surprisingly united. However, the Covid-crisis has had far-reaching political, economic and social consequences. Throughout history, major pandemics have been associated with a reduction in economic inequalities. The Covid-virus may be the only shock in the world that can be associated with a continuation or increase in current levels of inequality (Balázs 2020, DemNet blog). The pandemic has shown us the weakness of the EU's institutional systems, and the Member States have remained the key actors in crisis management. The lack of individual strategies and action plans and the lack of solidarity between Member States has led to serious difficulties in terms of integration (Molnár et al., 2020). The epidemic situation does not empower the EU institutions with more community competences, but at most – based on the experience of the last year and a half – helps Member States to develop crisis scenarios, such as recommendations for the accommodation and admission of patients across borders, the transfer and sharing of medical staff between Member States (Balázs, 2020). The isolationist politics of the Covid-19 has become a barrier to cooperation. Krekó et al. (2020) developed three scenarios for the future: Progressives' Paradise: Welfare and Democratic Expansion; The rule of Leviathan: Bureaucratic stranglehold; and Progress of hybrid regimes, Drifting.

In the optimistic scenario, the crisis could lead to achievements that would put an end to social injustices and the limitation of economic resources. A picture of a strong state would emerge, building on the current welfare systems of solidarity and democracy, and mitigating the damage through redistribution. In Europe, this is the direction that is unfolding in Germany, Austria, Denmark and Finland. The pessimistic vision predicts the completion of state centralisation, with the "abuse of power" (Krekó et al., 2020, p. 5.) in this particular crisis situation being intensified, thus providing opportunities for manipulation, citizen control and corruption.

Such trends can be observed in Poland, Hungary and Serbia. The third scenario is drifting, which is far from having a positive meaning. Weak state engagement leads to disintegration; new structures emerge alongside the current ones that are dysfunctional or failing, international cooperation capacity is weakened, and new types of political cooperation may emerge. Factors that contribute to the unfolding of all three scenarios can be found in each country. In Hungary, a good example of the optimistic scenario is the growing confidence in scientists and science and the disciplined behaviour of the population. Disappointing are the results of surveys (e.g. Tárki[1]) showing a deterioration of the personal circumstances, both in terms of income and psychological conditions.

1.1. Main social and economic impacts

In 2020, the EU's GDP will have fallen by 6.2% compared to the previous year. The euro area also suffered a recession of 6.6% (Molnár et al. 2021). The Hungarian economy has endured further the shocks of the economic downturn and restrictive measures; its GDP fell by 5.1%, second only to that of the Visegrad countries (Poland 2.7%). Construction (9.4%) and agriculture (6.7%) are among the sectors that fell most significantly in added value. Growth was more significant in two sectors: information and communication and financial and insurance activities. Hungary will receive 504 million EUR from Support to mitigate Unemployment Risks in an Emergency (SURE) (European Commission 2020). It can use the financial support received to cover part of the costs linked to the introduction or extension of reduced working time ("Kurzarbeit") at national level. The conditions for participation in the wage subsidy scheme introduced in the country were rather narrow, with little real help for companies and workers. Only retail or catering establishments whose employees were working full-time continuously from 2019 onwards, and were not dismissed

[1] More information about the research of Tárki: https://tarki.hu/2020

during the lock-downs, benefited from the support (Hungarian Blogs 2020)[2]. The government wants to boost tourism and catering primarily through direct transfers and employment incentives, but there is also a strong clientelism[3] approach behind these measures – which is clearly reflected in the list of the main beneficiaries of tourism subsidies (Krekó et al. 2020). The Hungarian Reinvention Programme consisted of 6-8 weeks of retraining, which taught unemployed jobseekers basic programming and IT skills. These courses existed before Covid-19, but are now available free of charge[4] (Bogóné Jehoda et al., 2021). In 2021, the average annual unemployment rate will be around 4%, with good figures forecast for the coming years. The damage from the mass redundancies in 2020 seems to be levelling off in the recovery phases. However, the very significant increase in the minimum wage at the end of 2021 (also driven by electoral considerations) has triggered a further large increase in wage costs. "It is doubtful how less productive and/or more vulnerable firms will be able to cope with wage increase demands and social pressures; this is one of the hard-to-measure risks for 2022" (Bod et al. 2021. p. 78.).

In some countries, the pandemic has also changed party preferences and levels of trust. In Hungary, support for the governing party has

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[2] For more details see Hungarian blogs: https://www.portfolio.hu/gazdasag/20200410/itt-a-kormany-unnepi-ajandeka-megjelent-a-magyar-kurzarbeit-szabalyozas-425460; https://g7.hu/kozelet/20200414/biztosan-nem-fogja-megmenteni-a-vallalatokat-amit-a-kormany-kitalalt/; https://www.napi.hu/magyar_vallalatok/bucsut-vehetunk-a-beremelesektol---ez-lesz-a-veszni-hagyott-100-ezernyi-munkahely-nyomaban.706509.html .

[3] In the clientelism model, the most important task of the municipality and local economic actors is the so-called "flattery or patronage", since this is how they obtain development funds from the state. Although centralised, governance is effective by supporting local initiative, where the role of the local community is active. In terms of the use of public funds the allocation of resources is subjective, based on individual judgement. In this model, the role of the individual is particularly important (László, 1998).

[4] More information: https://kormany.hu/hirek/ujratervezes-program-matol-ismet-lehet-jelentkezni-az-ingyenes-informatikai-kepzesre

remained high; the majority of people are satisfied with the government's response to the epidemic (Medián[5] and Publicus[6] research 2020).

2. Resilience during the coronavirus

Resilience, as a horizontal analysis criterion, has an impact on all areas of self-governance. The concept of resilience has covered a long path in the literature, from classical risk management to complex learning and adaptive capacity and sustainability in ecological, natural science, psychological, sociological and governance contexts (Welsh 2014). In the study, we do not limit the concept of resilience to natural disasters and economic shocks, but we analyse the capacity to adapt to change, based on social, economic and public capacities. The approach is also relatively specific in that we limit the governance dimension of resilience to the less researched local scale. The mainstream neoliberal approach argues that decentralised, community-dominated governance systems are not only more democratic, but also more effective (Pálné 2014), though the 2008 crisis and the Covid-19 pandemic, for example, have provided particularly strong arguments for those who argue in favour of a centralised, state-centred, neo-Weberian governance model. In fact, both the hierarchical and network mechanisms of coordination are present in governance (Bouckaert-Peters-Verhoest 2010), but the question is how the proportion of these is differentiated. Limited capacity for self-governance is also a feature of highly centralised governance systems in general, regardless of the size and status of local governments (Warner-Hefetz 2008). In local development policy and spatial planning, areas formed along different functions may create diverse networks by enforcing economies of scale and subsidiarity. Vanier (2008) refers to the spatial structure resulting

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[5] About Medián research: https://hvg.hu/360/20200610_A_jarvany_enyhulesevel_erosodott_a_Fidesz_de_a_30_ev_alattiak_kozt_elverezne

[6] About Publicus Institute research: https://publicus.hu/blog/partok-tamogatottsaga-2020-majus/

from these networks as ‘spatial galaxies’. The resilience of metropolitan areas is much more complex, relies on more substantial resources and has an international dimension. In contrast to the internationalising ‘new municipalism’ of metropolitan areas, Thompson (2020) assumes that the scope and geographical action of local governments in rural areas, with little power/connection and administrative capacity and limited competence, is much narrower, with reserves that can increase their capacity for self-government only in the area of local-scale, horizontal cooperation and social embeddedness. In rural spaces with a small urban centre, many of the conditions for self-governance are prominently lacking, which can be an obstacle to local economic development, but also to accessing EU development funds from the EU (Taylor 2016). The local self-governance capability encompasses the most important conditions for the functioning and development of local governments as self-governing entities (Finta 2019).

2.1. Vulnerability in rural areas in Hungary

Each country has responded differently in terms of governance measures; governance culture, structure and social relations have had a significant impact on response (Bouckaert et al., 2020). These processes required rapid decisions, which resulted in a new approach and implementation approach at European level in the city/county/state relationship. The OECD Reports (2020) have highlighted the benefits of using digital technologies, fine-tuning economic support, and the increased power of communication, discipline and awareness. Mayors have been shown to play a crucial role in local communication, as they have done in the past, and a number of measures were introduced to enforce social distancing. The vulnerability and social sensitivity of rural areas was repeatedly highlighted during the Covid-19 outbreak. The strength of local communities has worked well in previous crises; so, in this situation, they provided support in the areas of local food supply, health care support systems and the transition to digital education. Transport constraints have adversely affected rural areas, and labour-intensive sectors that relied on seasonal and guest workers[7] have been hit hard. From the social risk perspective, higher rates of ageing, insufficient health services, long distance to hospitals, more limited opportunities for teleworking and working from home (as digital infrastructure is not always adequate) are risk factors (Horeczki-Egyed 2021). As restrictions were eased, more people travelled to rural areas and moved there temporarily. The epidemic has led to new perspectives: commuting by car became also a symbol of a green environment, comfortable travel; most of the commuting was from the suburbs, within a 5-20 km radius of the major cities. Most of the total administrative area of these municipalities is green land (forest, arable land, gardens, vineyards) and not urban or industrial land. So, commuters could feel more like rural dwellers in these second homes than urban citizens in the real one. The small-town properties are cheaper and larger than in bigger cities (work-life separation due to changes in work patterns), small towns do not have to face the problems metropolitan cities face (crowds, noise, traffic chaos, etc.). Physical distance to prevent the spread of Covid-19 is easier to achieve and maintain in a small town: e-commerce has accelerated, mobile shops and home delivery (due to the closure of restaurants) are becoming common practice. However, statistics show that most rural areas are vulnerable in more than one way. The lack of general practitioners, paediatricians, basic infrastructure (e.g., sewers), fewer commercial and catering outlets (more crowding) are all extreme risk-factors.

The population of rural areas in Hungary changed significantly during the pandemic. Groupama's[8] (2020) survey showed that one in ten residents of the capital city (Budapest) spent weeks in their weekend homes during quarantine, and 50% of those surveyed planned to buy a holiday home or holiday property during the quarantine period, mainly

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[7] Mirror translation to the German word "gastarbaiter" or the Hungarian word "vendégmunkás". The real mean: Foreign national who is permitted to live and work temporarily in a host country.

[8] Read more about the survey: https://www.groupama.hu/hu/Sajtoszoba/Sajtokozlemenyeink.html?name=/hu/

in rural areas and small towns. A report by the Hétfa Research Institute (2020) estimated the number of holiday homes for domestic travellers, mainly from Budapest, during the pandemic period. The number of people moving temporarily to the countryside was expected to be high in the Lake Balaton area, the Venice resort area, the Gyöngyös district, and the Orfű and Siklós-Villány areas. A higher proportion of temporary migration to the South Transdanubian region could create a number of problems, as this is a peripheral region, whose economic backwardness and small village structure impact its infrastructure negatively. The construction of the M6, M7 and R67 roads has fostered the development of linear infrastructure. A fundamental problem in the region is the concentration of economic activity in the county capitals, the high number of slums and the negative change in the age composition. The region's settlement structure is characterised by a high proportion of small villages of less than 500 inhabitants, the region's 41 towns are evenly distributed, but the post-2000s urbanisation wave has resulted in a high number of small towns with a lack of urban functions. Institutionalisation and level of development can be treated separately for these towns. Institutional provision is characterised by the absence of the four main institutions: the document office, a bank branch, a secondary education establishment or a retail sector offering a wide range of products. The majority of small towns in areas of urban deprivation had one function (typically spa, resort, or other micro-regional roles). Institutions have been created by specialisation, e.g. the small towns on the shores of Lake Balaton have all the functions that are important for tourism (commercial services, accommodation, public safety, etc.) but not all or none of the other functions (e.g. education, public services, document offices, land registry, etc.). Small towns, located 30-50 minutes by road from the county centres, have emerged as a major travel destinations as the epidemic situation has eased. The health risk in the region is also reflected in the fact that the number of patients per general practitioner is increasing (1876 on average in 2018) despite the decline in population, and has increased significantly (by 18%) in all three counties over the last twenty years. The population served is particularly high in the Komló, Siófok and Pécsvárad areas. In terms of the number of paediatricians, the figures are much worse: the number of patients per paediatricians is almost three times higher than the national and county averages in the districts of Szigetvár, Lengyeltóti, Sellyei and Siklós. The number of pharmacies has increased significantly in the region since 2000, but the quality of care and the range of products available are limited.

A municipal survey (2020) conducted by the Institute for Regional Studies of the CERS assessed how the coronavirus epidemic was managed at different levels of the municipal hierarchy. The survey addressed 44 municipal leaders, twelve of whom manage traditional small urban areas in Transdanubia and two in the lowlands, six in small towns with a population of less than 10,000 inhabitants (small towns, of which are three district centre and three non-district centre). Response of the small urban areas in the survey to the epidemiological situation are presented below. Epidemiological measures in small towns can be divided into five main categories: restrictive (most of the tasks are centrally managed), facilitative (provision of services), organisational (tasks that determine reorganisation), information and health protection. Among the compulsory tasks, the following centrally defined tasks have been carried out: celebrations and events have been cancelled or not organised; restrictions have been imposed on customer services; crèches, kindergartens, community spaces – Library, Community Centre have been closed. Most of the support measures were targeted at the vulnerable age group: the municipality organised care for people in official quarantine, care for the population over 70 years and public catering. Municipalities were responsible for delivering services and had to organise themselves accordingly: employees were present in the office for matters requiring physical presence; the increase in the rent of municipal rental housing was postponed in the district municipalities; electronic administration was introduced where possible; the enrolment policy for nurseries and kindergartens was changed. Outreach measures have continued, and several small towns use social media to inform the population as widely as possible; websites have been used to indicate how many people are under official quarantine. In the field of health protection and prevention, the following tasks were carried out: provision of protective equipment (masks, hand sanitizer) for office workers, and for the entire population, with the involvement of civil society; disinfection in public areas and institutions; protective equipment was also provided for general practitioners. The survey also examined voluntary and compulsory tasks and priorities, prevention and social care being managed at local level by the municipalities, as identified by municipal leaders.

3. Summary

The pandemic has broken the fragile bonds of international cooperation within Europe and between member countries. The first reaction was isolation and the defence of internal borders rather than unity. Border controls were lifted again, including within Schengen area, to prevent the spread of the virus. The first shock came in the area of health, where the EU was not united in its approach to the virus. To make up for the latter, economic matters are now being addressed collectively. The situation caused by the Covid-19 will not only leave a lasting mark upon people's lives, but will change the balance of power and "power games".

Loss in the epidemic includes the lives that were lost, the social distancing that outlasted the epidemic, economic decline, the jobs that disappeared. Consumption and lost income are catching up as businesses and services reopen, but the general and local governments continue to be the main problem-solving organisations.

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PART III:

THE EAST "LOOK" OF EU CANDIDATE COUNTRIES

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Environmental, Social and Governance Risks – Microeconomic and Macroeconomic Aspects

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ABSTRACT: The present research focuses on the environmental, social and governance (ESG) risks and their microeconomic and macroeconomic characteristics. ESG factors are growing in influence on the global scene. This trend will continue during following years and decades. The microeconomic and macroeconomic impact is particularly significant. The research seeks to explore all important aspects of this strong and dynamic link and to provide the option and recommendations for overcoming the challenges to sustainability. The ESG factors, risks and management have strong impact on the various institutions, companies, individuals, sovereign, financial stability, economic growth, development and sustainability. ESG factors, risks

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and management are among the most important contemporary worldwide economic and financial challenges. The paper describes further measured and well-prepared treatment measures of the ESG risks for achieving sustainability and suitable microeconomic and macroeconomic conditions. The paper has submitted a hypothetical ESG rating scale and scoring example, which can provide useful elements, i.e. guidelines for developing ESG risk management further.

Keywords: ESG, Risk Management, Sustainability, Microeconomics, Macroeconomic.

1. Introduction

ESG risks and their microeconomic and macroeconomic aspects are in the focus of the many institutions and researchers. The ESG factors can be described as ESG elements that might have a positive or negative impact on the financial output or solvency of a – sovereign or individual – entity (European Banking Authority, 2021). The influence of ESG factors on the financial output and solvency of firms, countries, and individuals is increasing. ESG risks can be defined as any negative financial impact on the credit institution and investment firms (institutions) caused by the current or prospective impacts of ESG factors on its counterparties or invested assets (European Banking Authority, 2021). ESG factors are growing in influence on the global scene. This trend will continue during the coming years and decades. The microeconomic and macroeconomic impact is particularly significant. The research seeks to explore all important aspects of this strong and dynamic relation and to define possibilities and recommendations for overcoming the challenges to sustainability.

The ESG factors and risks have strong impact on the various institutions, companies, individuals, sovereign, financial stability, economic growth, development and sustainability. ESG factors and risks are among the most important contemporary worldwide economic and financial challenges. In the Europe, ESG factors, risks and management are one of the pillars for the continuation of the successful European Integration process. It is important to establish further measured and well-prepared treatment measures of the ESG risks for achieving sustainability and adequate microeconomic and macroeconomic conditions in the coming decades.

The coronavirus disease (Covid-19) circumstances required partial slowing down of the ESG risk analysis in the first period of the pandemic. However, now it is obvious that ESG risks need and have received full attention of the stakeholders (corporate, institutions, sovereigns, individuals, etc.). This is especially important looking from the perspective of the European Integration in the time of the Covid-19 pandemics. Very interesting recent studies on ESG factors, risks, its micro and macro effects and other related issues were conducted by the several authors (Bouyé & Menville, 2021; Breitenstein et al., 2021; Ferriani & Natoli, 2021; Semieniuk et al., 2021; Zhou et al., 2020). A few years earlier, other interesting studies were published (Farmer et al., 2015; Syed, 2017).

Based on the methodology, aim and period, the risk register relevant for the finance and modern economy was somewhat changed. A typical actual risk register is presented below (see Milojević & Redzepagic, 2021b).

1. Credit risk
2. Liquidity risk
3. Interest rate risk
4. Market risk
5. Credit valuation adjustment (CVA) risk
6. Concentration risk
7. Investment risks
8. Country risk
9. Operational risk
10. Compliance risk
11. Reputational risk
12. Risk of money laundering and terrorist financing
13. Business and strategic risk
14. Macroeconomic risk
15. Model risk
16. Information security risk
17. Other risks

Now, the ESG risks must be included in total risk management. The following paper chapters highlight a strong connection between several risks mentioned and the ESG risks. The strongest ESG impact is usually related to the credit, liquidity, market, operational and reputational risk.

The starting research hypothesis is that using worldwide experience, published papers and databases, microeconomic and macroeconomic aspects of the ESG factors and risks can be defined. The second research hypothesis is that based on the stated, recommendations and proposals for successful implementation of ESG risk management can be formulated aimed at achieving maximal positive results (and avoiding negative outcomes) in the microeconomic and macroeconomic field.

The methodology applied in this research is dominantly characterized by the following. Respectable publicly available historical and current worldwide experience, research results, analysis and databases were used during this study. Furthermore, many scientific papers of experts, and other publicly available documents were examined. The study addresses developed and developing economies, from the micro and macroeconomic perspective. The following methods were used for gathering practical and research evidence: descriptive, inductive – deductive, analytic – synthetic and comparative analysis. These methods made it possible to achieve the research goals highlighted previously.[9] The paper has submitted a hypothetical ESG rating scale and scoring example, which can provide useful elements, i.e. guidelines for developing ESG risk management further. The improvement in ESG performance at the company level can have positive macroeconomic effect, e.g. GDP increase. Positive productivity and GDP results can be useful for other important macroeconomic elements, such as financial stability, sustainability and economy prosperity.

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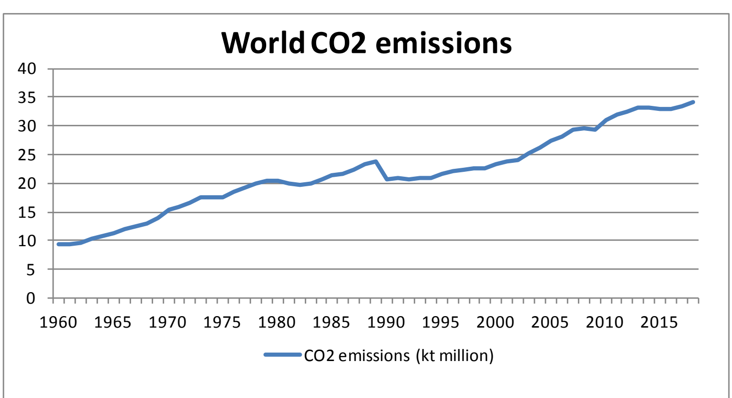
2. Environmental factors and risks

There is a strong synergy between ESG factors. This is also why they are treated as one set of factors and risks. The environmental factors can be described as environmental elements that might have a positive or negative impact on the financial output or solvency of a – sovereign or individual – entity (European Banking Authority, 2021). The focus is on the natural environment and system quality and functioning. The environmental factors have many important elements (Basel Committee on Banking Supervision, 2021). For the purpose of this research, we have focused on the following:

1. Air and water pollution;
2. Fresh water scarcity;
3. Land contamination;
4. Biodiversity and ecosystem loss;
5. Deforestation;
6. Energy consumption;
7. Waste management.

All of the aforementioned factors are important and strong. As an illustration of this, the air pollution factor is addressed in the form of global carbon dioxide (CO2) emissions.

FIGURE 1. **World carbon dioxide emissions**



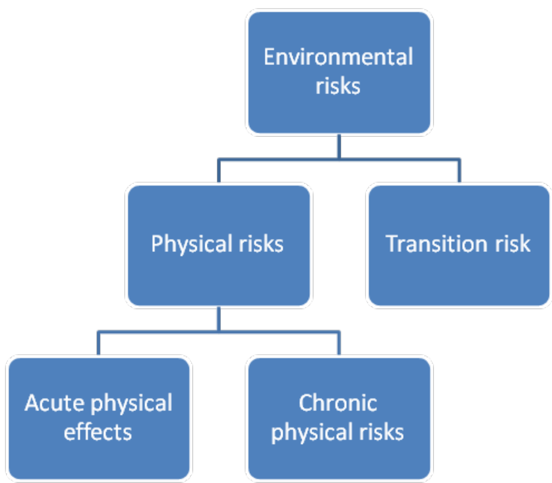
Source: Authors, based on World Bank data (2021b).

The strong CO_2 emission increase during last decades is obvious, but this is just one of the strong environmental factors.

Environmental risks can be defined as any negative financial impact on the institution caused by the current or prospective impacts of environmental factors on its counterparties or invested assets (European Banking Authority, 2021).

There are two big groups of environmental risks: physical and transition risks (see Breitenstein et al., 2021, for more detail).

FIGURE 2. **Environmental risks**

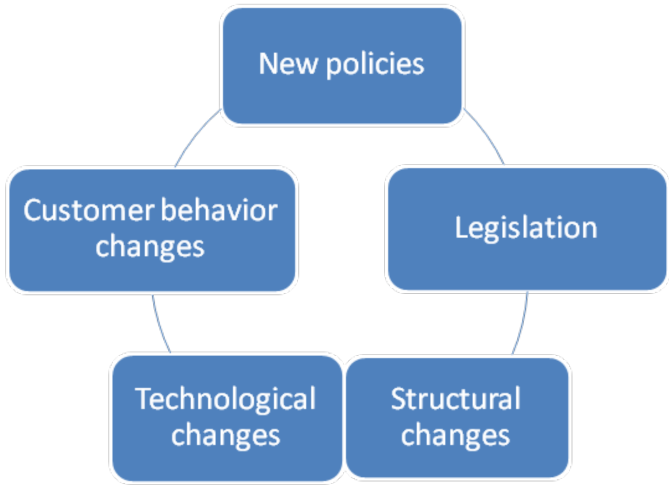


Source: Authors.

Acute physical effects such as droughts and fires, storms, floods, etc. can cause production and supply chains to collapse. Chronic, long term physical effects such as climate, temperature changes, sea level rise, reduced water availability, biodiversity loss and changes in land and soil productivity are bringing additional negative impact on the financial output and solvency.

Environmental transition risk is related to the necessary new policies, legislation, changes in the elements such as structure, technology and customer behaviour.

FIGURE 3. **Environmental transition risk**



Source: Authors.

All stakeholders must focus in particular on the transition risk, i.e. timing and speed of the adjustment process.

3. Social factors and risks

Social factors and risks are the second component of the ESG factors and risks. Social factors are elements that could positively or negatively influence the financial output or solvency of an entity, sovereign or individual. The risks connected to the stated factors are related to the negative financial influence on the institution caused by the current or prospective impacts of social factors on its counterparties or invested assets (European Banking Authority, 2021; Ferriani & Natoli, 2021).

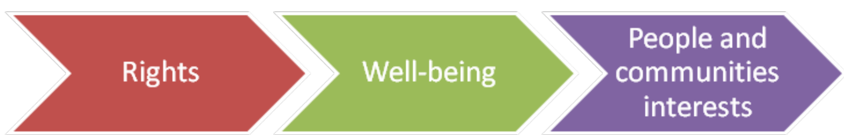
Social factors are specially related to the:

1. Equality,
2. Health,

3. Inclusiveness,
4. Labour standards and relations,
5. Workplace standards,
6. Customer relationships,
7. Product and service safety.

Typical examples of the social risks are noncompliance with the safety, health, labour and industrial standards.

FIGURE 4. **Social factors**



Source: Authors.

4. Governance factors and risks

Governance factors and risks are the third component of the ESG factors and risks. Governance factors are elements that could positively or negatively influence the financial output or solvency of an entity, sovereign or individual. The risks related to these factors concern the negative financial influence on the institution caused by the current or prospective impacts of governance factors on its counterparties or invested assets (European Banking Authority, 2021; Ferriani & Natoli, 2021).

Factors such as ethical considerations, strategy and risk management, inclusiveness and transparency can create governance risks that have strong connection with the reputational risk, but also with other risks, such as environmental risk.

FIGURE 5. **Governance factors**

Source: Authors.

5. Micro aspects of the connection of ESG risks with other risks

The impact of ESG risks on the traditional risks that have been present for a long time in risk management is growing.

The strongest ESG impact is usually related to the following risks:

1. Credit risk,
2. Liquidity risk,
3. Market risk,
4. Operational risk and
5. Reputational risk.

Nevertheless, ESG risks can be tied in with other risks.

Financial institutions must suitably manage all the risks that they are exposed to. This requires adequate availability of capital for risk coverage (Milojević, 2014, 2016; Basel Committee on Banking Supervision, 2017; Adrian, 2018; Milojević & Redzepagic, 2020, 2021a, b).

FIGURE 6. **The connection of ESG risks with other risks**

Source: Authors.

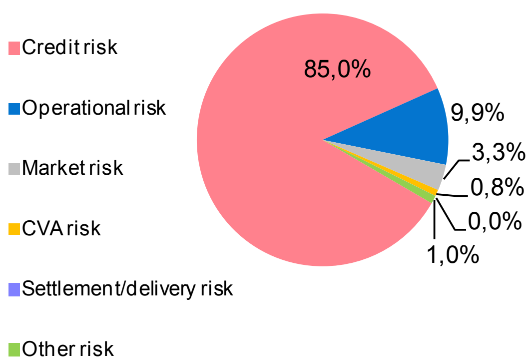
Based on the standard financial supervision perspective risk weighted assets (RWA) has the following components: credit, market and operational risk. ESG risks can impact all 3 risks. In the Basel standards, the Internal Capital Adequacy Assessment Process, i.e. ICAAP (Basel Committee on Banking Supervision, 2006) requires credit institutions to factor into capital adequacy calculation all other material risks that they are exposed to (Milojević & Redzepagic, 2021b).

Figure 7 clearly shows that credit risk has first place in the total exposure of the European Union (EU) credit institutions capital adequacy calculation. This dominance has been present for a long time in the global finance.

This is the reason why ESG impact analysis focuses particularly on the credit risk as the best example how ESG risks impact the traditional risks in finance.

Through the credit portfolio ESG risks have strong impact on the whole institution. The more exposed the institution's clients are to ESG risks, the higher total credit risk will be. Consequently, in credit analysis, credit risk measurement, identification, monitoring and management, including collateral management and other related segments like stress testing (European Central Bank, 2021a, for more details regarding stress testing), ESG risk treatment is gaining importance. This is the reason why this topic is important for the ongoing successful European Integration process. The maintenance of the Covid-19 circumstances cannot change this fact (see Ferriani & Natoli, 2021, for more detail regarding ESG risks in times of Covid-19).

FIGURE 7. **The structure of the exposures by risk related to the capital adequacy of the European Union credit institutions in the Q2 2021**



Source: Authors, based on European Central Bank (2021b).

In this process the role of ESG is increasing. In previous decades, three specialized agencies were in charge of external credit rating in the global economy: Standard & Poor's (n.d.), Fitch (n.d.) and Moody's (n.d.).

Credit ratings developed significantly in the last decades. Such was the case of external ratings, but also internal ratings that are the responsibility of the institutions like banks and other institutions that are interested in having their own rating systems.

Today, the following are some of the companies specialised in ESG ratings: MSCI (n.d.), Sustainalytics (n.d.), Beyond Ratings (n.d.), RepRisk (n.d.), Robeco (n.d.), Arabesque (n.d.), Institutional Shareholder Services (n.d.), Refinitiv (n.d.) and Ecovadis (n.d.).

We expect the ESG rating systems to develop further and grow in importance in the future (Bouyé & Menville, 2021). ESG internal ratings can be expected to develop in a similar manner to external ratings (see Syed, 2017, for more detail regarding interesting ESG criteria).

Related to this, one of this paper's main contributions is table 1, providing a hypothetical ESG rating scale and scoring example, which can be one of the useful elements, i.e. guidelines for further development of external and internal ESG ratings.

TABLE 1. **Hypothetical ESG rating scale and scoring example**

ESG letter rating	ESG numerical score	Risk level
AAA_IRS	601-700	The lowest ESG risk
AA_IRS	501-600	Very low ESG risk
A_IRS	401-500	Low ESG risk
BBB_IRS	301-400	Lower medium ESG risk
BB_IRS	201-300	Medium ESG risk
B_IRS	101-200	Very high ESG risk
CCC_IRS	0-100	The highest ESG risk

Source: Authors.

IRS abbreviation in our hypothetical ESG rating scale and scoring example stands for internal rating sustainability. The idea is that with such rating markers the institution can differentiate between ESG ratings and similar rating markers for the credit ratings (either external or internal) in its IT core system and in the internal reporting. In our example, the lower ESG numerical score means lower ESG rating and higher ESG risk.

Non-financial statements, i.e. reporting of the companies and institutions that contain plenty of valuable information on ESG, help to develop

ESG ratings and scoring worldwide further. European Banking Authority reporting provides a comprehensive and detailed overview of ESG factors, indicators and metrics that can be useful for the scoring development (European Banking Authority, 2021). Here we highlight few of them as an example of the indicators that are useful for the scoring.

Environmental indicator: Emissions of air pollutants (weight in tonnes).

Social indicator: Workplace health and safety (rate of accidents).

Governance indicator: Convictions and violations of anti-corruption and anti-bribery laws (number of cases and amount of fines). More useful details about stated and other ESG indicators and metrics can be seen in the European Banking Authority report (see European Banking Authority, 2021, but also Bouyé & Menville, 2021).

In which concerns the weight of the environmental, social and governance indicators in the ESG internal risk model, in general we would advice the balance between environmental, social and governance component (see Bouyé & Menville, 2021, for the variations). On the other hand, a good approach would be that the institution which is developing internal ESG rating model consider the specificity of its portfolio and if it is necessary to give more weight to one of the 3 major components. If environmental risk dominates the institution portfolio, while social and governance risk indicators of the company are showing lower risk, than this institution should think about the indicators proportion in the ESG rating model; that is, considering stated specificity.

All ESG stakeholders are interested in ensuring adequate ESG risk management. Adequate ESG risk management (e.g., environmental risk management; Breitenstein et al., 2021) should produce significant positive microeconomic effects, such as the mitigation of:

- Asset damage,
- Supply chain collapse,
- Costs increase,
- Demand reduction,
- Losses, and
- Profit decline.

More than positive micro effects, adequate ESG rating management should give macroeconomic contribution.

6. Macroeconomic features of ESG risks

In addition to the microeconomic effects mentioned, ESG risks have dynamic macroeconomic characteristics. Usually, when the ESG macroeconomic effects are highlighted, environmental component is the first to stand out. Nevertheless, the social and governance components have also very dynamic and important macroeconomic characteristics.

FIGURE 8. **ESG factors and risks with microeconomic and macroeconomic effects**

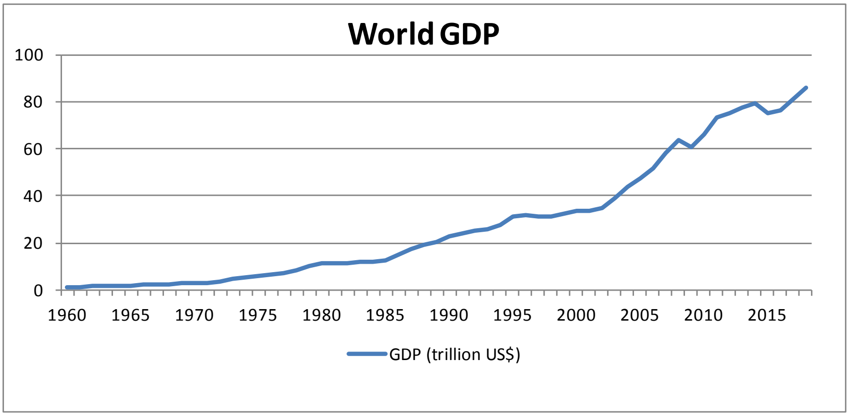
Source: Authors.

Some of the most important macroeconomic aspects that must be taken into consideration during ESG analysis are the changes in productivity, investment behaviour, prices, etc.

To illustrate the strong macroeconomic effects of ESG risks, the World Bank concluded that some regions in the world could be faced with GDP growth rate decline of up to 6% until 2050 due to water-related losses associated with agriculture, health, income and prosperity (World Bank, 2021a).

Since this only concerns ESG factors, then it is obvious how serious the macroeconomic aspects of ESG are and how strongly they will shape the future worldwide.

FIGURE 9. **World GDP in trillion US$**



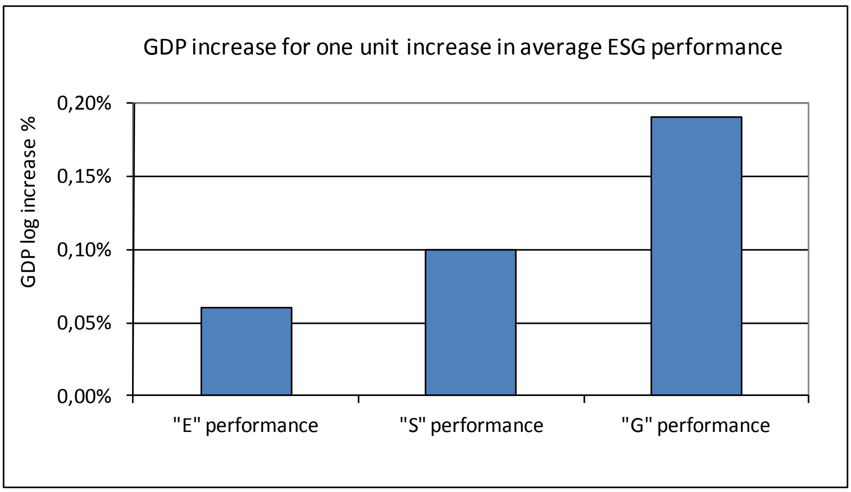
Source: Authors, based on World Bank data (2021b).

Figure 9 highlights the level of world GDP in the last decades. Taking into account scales of ESG impact, one may ask what the world GDP movement will look like in the coming decades (see World Bank, 2021a, for more detail). ESG risks can bring negative macroeconomic effects, if they are not adequately managed, but significant potential exists for the macroeconomic positive effects, if the ESG risks are adequately managed (see Syed, 2017; Breitenstein et al., 2021; Ferriani & Natoli, 2021; Semieniuk et al., 2021, for more detail) and if the ESG potential and factors are properly used.

One of the interesting researches into these issues is the one by Zhou et al (2020). They have found that improvement in ESG performance at the micro level, i.e. company level can have positive macroeconomic effect, measured by the increase in GDP (Zhou et al., 2020).

Their comprehensive empirical analysis is based on company data in 30 countries (19 developed countries and 11 emerging countries) over the 2002-2017 period. Companies' ESG performance is measured on a scale of 0-100 (100 being the best ESG score). It is interesting that both groups, developed and emerging countries, have in general positive macroeconomic effects (i.e. GDP growth of the national economy), from the improved ESG practice, although the emerging countries have in general more significant positive results (Zhou et al., 2020).

FIGURE 10. **GDP increase based on ESG performance increase**



Source: Authors, based on the data from Zhou et al. (2020).

These results are a very encouraging sign that investment in ESG performance can have a positive effect overall. Positive productivity and GDP results can be useful for the other important macroeconomic elements, like financial stability, sustainability and general national economy prosperity.

Our recommendation is that during further ESG performance and risk management improvement the following issues be taken into account:

- Definition of the comprehensive, detailed and adequate ESG risk management implementation.
- Monitoring of the implementation.
- Regular and extraordinary microeconomic and macroeconomic effect analysis, as well as stress tests.

- Involvement of all stakeholders is important for successful ESG risk management and achieving adequate microeconomic and macroeconomic effects and sustainability tasks.

7. Conclusion

The study has comprehensively analysed contemporary development related to ESG factors, risks and their microeconomic and macroeconomic characteristics. This is very important for the institutions, companies, individuals and sovereign governments. The paper concludes that the impact of ESG factors and risks on the entity, sovereign and individual financial output and solvency are increasing. In the near future, and in the next decades, this trend will continue. In Europe, ESG factors, risks and management are pillars for the continuation of the successful European Integration process. This is especially important looking from the perspective of the European Integration in the time of the Covid-19.

The microeconomic and macroeconomic effects of ESG factors and risks are significant. The impact of ESG risks is growing compared to the traditional risks that have been present for a long time in risk management. The strongest ESG impact is related to the credit, liquidity, market, operational and reputational risks. Nevertheless, the connection between ESG risks and other risks is visible.

Through the credit portfolio ESG risks strongly impact the whole institution. The more exposed institution clients are to the ESG risks, the higher total credit risk will be. In the credit analysis, credit risk measurement, identification, monitoring and management, including collateral management and other related segments such as stress testing, ESG risk management is gaining importance. In this process the role of ESG ratings is increasing. Related to this, the paper has submitted a hypothetical ESG rating scale and scoring example, which can provide useful elements, i.e. guidelines for developing ESG risk management further.

Adequate ESG risk management should produce significant positive microeconomic effects, such as mitigation asset damage, supply chain collapse, cost increase, demand reduction, losses and profit decline.

The improvement in ESG performance at the company level can have positive macroeconomic effect, e.g. GDP increase. Positive productivity and GDP results can be useful for the other important macroeconomic elements, such as financial stability, sustainability and general national economy prosperity.

During further ESG performance and risk management improvement, it is very important to lay out a comprehensive, detailed and adequate ESG risk management implementation framework. The same is valid for monitoring the implementation thereof. The focus should be on regular and extraordinary microeconomic and macroeconomic effects analysis as well as stress test conducting. The involvement of all stakeholders is important for ensuring successful ESG risk management, achieving adequate microeconomic and macroeconomic effects and conducting sustainability tasks.

The paper results can be applied to the risk management development of the financial institutions and other ESG stakeholders. It could influence positively further academic research on ESG risks. The study has potential to enable and encourage new research on this topic, methods and management.

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The Role of Macro Prudential Policy during the Covid-19 Crisis

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Abstract: In this article we strive to present the role of macro prudential approach during the Covid-19 pandemic and the macro prudential measures and others implemented to mitigate the negative effects on economic and financial stability, considering contribution of regulatory relief measures and supervisory authorities along the same lines as that of the post Great Financial Crisis reforms. As the global economy recovers from the unprecedented contraction caused by the Covid-19 pandemic, the gradual rebound in activity offers the right moment to evaluate the contribution of macro prudential policy interventions with the aim to mitigate the fallout from the pandemic. Also, it is the right moment to look forward and address the challenges and risks emerging in the recovery from this crisis. Consequently, we find a wide scope of bank-based and borrower-based measures, which have been implemented with much success. In addition, we have presented a set of forward-looking challenges and risks the world is facing in the post

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crisis phase, emphasizing the need to strengthen respective frameworks for analysing vulnerabilities and monitoring risks and develop measured policy response to address them. As a final conclusion, we find that macro prudential tools could be good complement to other policies of all sorts, bearing in mind two very important facts, first that macro prudential tools cannot be introduced in any type of crisis, and second that it cannot be the only and main tool in the response to all sorts of crises.

Keywords: macro prudential policy, financial stability, financial risks

1. Introduction

The pandemic has been extreme and unusual in many respects. We have seen worldwide synchronised policy response as never before. Although it would be premature to claim that we have successfully overcome the crisis we must be pleased with many actions taken. The experience from the corona pandemic has shown the effectiveness of the central bank's monetary policy toolkit in stabilizing financial markets and mitigating over a limited period of time the negative impact of the pandemic on the inflation outlook. Almost all researchers and academics agree that macro prudential intervention that facilitated credit extension and ensured that banks remained resilient played a key role. Thanks to the reforms of the past decades, banks were better equipped and, above all, better capitalized to absorb shocks. Considering the nature of shock and the huge degree of macroeconomic uncertainty which the pandemic created around the world, macro prudential policy has been unable to manage this task alone. Significant fiscal and monetary policy measures were needed to reduce uncertainty and safeguard liquidity. The natural protagonists are fiscal and monetary policy with macro prudential measures playing an important supporting role in complementing the overall package (Carstens, 2021).

Due to broadly acknowledged macro stabilization role of central banks and maintaining credit flows to companies and households, authorities have adopted fiscal and monetary measures in a largely expansionary stance, and some have also resorted to instruments that were rarely employed in the past. Some pre-existing instruments allowed central banks to swiftly calibrate and implement innovative policy measures that were tailored to the specific circumstances faced by the economy. New instruments and measures have proved to be adaptable to the challenges we have been facing. In particular, the flexibility and mutually reinforcing effects of these measures have been crucial in providing sufficient room to counter the impact of the crisis. Considering the unusual nature of the crisis, response measures have also been unusual. Supervisory authorities had to face difficult trade-offs, as the macro and micro dimensions of prudential policies may well clash with each other. Experiences also differ across countries, especially in the Europe and Middle East (EME) region. When the pandemic shock hit, numerous EMEs were in a generally good cyclical position on a positive growth trajectory and inflation was under control.

Lockdown and mobility restrictions during the corona pandemic have created the sharpest fall-off in economic activity and employment in decades. After the deepest decline in output in the post-war period, the recovery was also much steeper than in other sharp recessions. The pandemic is not yet over. Almost all measures are active under mandatory regime. It seems that challenges and risks are now significantly bigger. Appearing structural inflation, low interest rate policy, further fiscal support, duration of virus uncertainty, vaccination rules, huge household debt (especially mortgage debt), huge public debt in some countries, digital transformation, digital assets, demographic change risks, climate change risks and macroeconomic risks are open issues for high level of respect and potential pressure on systemic financial risks. Our outlook on the inflation index must change. We must embrace a wider concept that includes real estate prices if we expect macro prudential policy to be effective.

Each time, analysing different countries and experiences, and consequently measures adopted by different bodies, we have in mind different starting positions which significantly affect the design of policy response. At the outset of the pandemic each economy was in a different situation, but also there were some similarities. Regarding the European Central Bank (ECB), its monetary policy response to this extraordinarily deep crisis has been tailored by adapting its toolkit in an innovative way. In this case monetary and fiscal policies complemented each other, unlike in any previous crisis. This time, the most significant fact is that worldwide policy response has probably been the boldest and most synchronized ever. This reassured other countries around the world that they are a respectable and stable part of the global financial system, and that they can count on unlimited support.

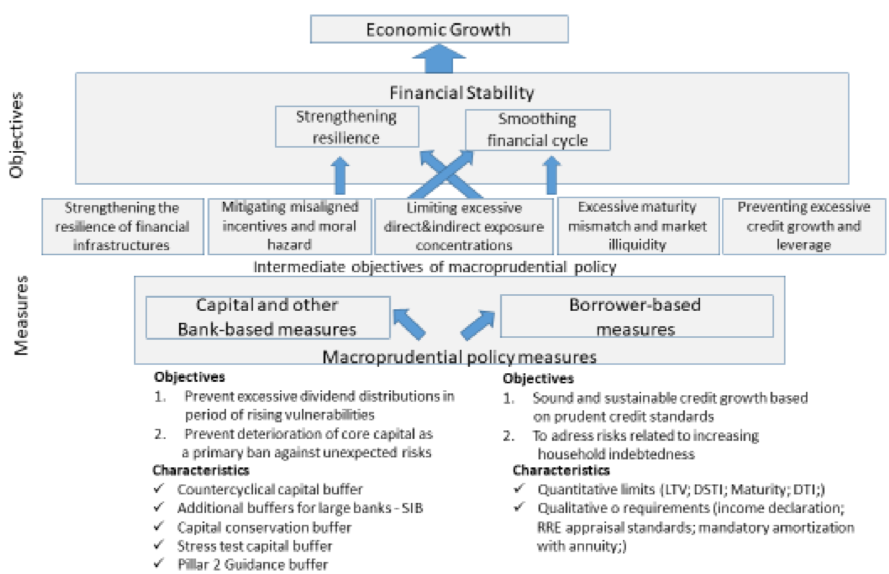
The role of the Financial Stability Board (FSB) and its members during the last decade is worth mentioning. FSB members have been working alongside one another for more than ten years to improve tools for resilience. On a wide platform, members built trust among themselves, and were transparent about their actions. Early in the crisis, as the Covid-19 pandemic unfolded, the FSB provided forum where members met regularly to exchange information, actions, and areas where the potential for spill overs need to be addressed. Given the openness of information sharing, FSB members were able to quickly identify areas of concern that required action. They used real-time input to focus on four critical nodes of the global financial system: financing of the real economy, access to USD funding, meeting financial intermediary liquidity demands, and monitoring counterparty risks (Quarles,2021).

2. The role of macro prudential policies/tools during economic crises

As a health (non-economic) crisis, Covid-19 did not originate in the financial sector, but, it has a financial stability dimension, as all crises ultimately do. Over the last two decades, policymakers have been paying increasing attention to the macro prudential approach to the financial stability policy. This approach involves the use of prudential policy measures/instruments from a system-wide (“macro”) perspective. It is fair to say that the Great Financial Crisis (GFC) has given a major boost to this perspective, as a complement to the previously dominant micro prudential perspective, which focuses on the resilience of individual institutions considered on a stand-alone basis (Carstens, 2021).

The main task of macro prudential policy is to pay special attention to mitigating systemic risks that either build up over time because of the pro-cyclical behaviour of the financial sector or relate to the concentration of risk in a few systemically important components. Smoothing financial cycle and strengthening resilience are the main objectives that have to be in a function of economic growth. Its main focus has been on risks arising from financial factors. Indeed, the recession would have been much deeper and longer without the provision of credit to households and companies seeking to bridge the sharp drop in their activities and income. In line with these objectives, prudential policy intervention was two-fold: to ensure that banks remained resilient and to facilitate credit flow extension. (Carstens,2021).

FIGURE 1. **Macroprudential Policy Measures**



Source: Author's own compilation.

Policy response to Covid-19 has added a relatively new view. It has shown how the macro prudential perspective and the corresponding deployment of tools can also be useful in addressing the financial strains that can originate from an unpredictable shock ultimately caused by non-economic factors. This time regulators have accepted an explicit macro-stabilization role –not only aiming to preserve the safety and soundness of individual financial institutions, but also to keep credit flowing to the real economy sectors through all phases of the cycle (Carstens, 2021).

Throughout the Covid-19 event FSB members convened every day in Basel, and regularly presented data for members to consider and discuss. The FSB formed several expert groups to examine and assess specific issues as they unfolded. This coordination enabled swift and bold action that kept markets operational globally. Many of the supervisors in the FSB provided banks with flexibility for their capital and liquidity buffers and encouraged banks to work with borrowers on loan modification. The FSB also supported the delay of non-critical work to reduce the operational burden on companies and authorities. Collectively, these steps sent a strong signal about our resolve to lessen the economic fallout from the pandemic and helped prevent a disorderly sale of assets. The FSB also took stock of the thousands of steps members took to respond to the pandemic to prepare playbook of sorts for the future (Quarles, 2021).

On the other hand, great attention has been given to non-bank financial intermediation as an area deemed critical for financial stability. It could not be left aside bearing in mind short term funding markets, money market fund sector and the wide scope of other linked risks. In the past ten years the non-bank financial sector has grown considerably and it has become increasingly relevant for funding the real economy. Structural vulnerabilities and the increasingly interconnected nature of the non-bank financial sector both pose a considerable risk to the wider financial system and the real economy. In the ECB Financial Stability Review (ECB, 2021), some of these risks have been highlighted, including growing liquidity mismatch, increasing duration risk and emerging evidence of pockets of high leverage in certain funds. In particular, the investment fund sector is now more exposed to credit risk, duration risk and liquidity risk than it was before the pandemic (De Guindos, 2021).

Macro prudential policy is a relatively new toolbox. It would be fair to say that theory was lagging behind practice prior to the GFC. To be clear, the tools themselves are not particularly new. Many, such as bank capital requirements, have been playing from the beginning of micro prudential policy a basic role especially in EME countries. Others, such as loan-to-value ceilings, had already been deployed extensively in some jurisdictions. The new element is the toolbox itself that is the framework within which tools are organized for deployment and the perspective guiding their calibration (Carstens, 2021).

A major contribution of the post-GFC policy reform agenda was the formalization of the macro prudential framework, both domestically and internationally. This came with the introduction of new tools, such as countercyclical capital buffer and additional buffer requirements for systemically important institutions (SIB). Together with the development of a coherent perspective guiding their use, theory caught up with practice. However, policy continued to focus primarily on dealing with financial shocks and mitigating the risks for systemic stability.

3. The use of macro prudential tools during the Covid-19 episode

The Covid-19 shock presented unique policy challenges that push the use of macro prudential policy for new goals (Carstens, 2021). Policy response was extraordinary and it involved the rapid deployment of the full range of instruments – including some tools used first time – on an unprecedented scale.

3.1. Monetary and fiscal policy

One key factor has been the substantial support from monetary and fiscal policy. Regarding policy the monetary and fiscal authorities have adopted a largely expansionary stance, and some have also used instruments that were rarely employed in the past. The public action underwrote, to a substantial extent, banks' exposures to pandemic-hit borrowers. Guarantees, together with other more direct fiscal support measures, helped to contain banks' credit risk and provided an incentive for lenders to keep credit flowing. And central banks mitigated banks' liquidity risks through ample funding support. They also cut policy rates substantially and, for the first time in many jurisdictions, actively used their balance sheets. Comprehensive government measures helped ensure that financial markets could continue to function, despite high level of economic uncertainty.

The COVID-19 pandemic provided an opportunity to test the post GFC reform agenda and framework in a new type of economic crisis. The pandemic shock presented unique policy challenges that pushed the use of macro prudential policy for new goals. Policy response was extraordinary: it involved the rapid deployment of the full range of instruments – including some central bank tools used for the first time in some countries. Immediately after the outbreak of the pandemic crisis, prudential authorities took bold actions to reduce incentives for banks to retrench on their willingness to approve credit to the private sector (BCBS, 2020). On the other hand, due to GFC major reforms in 2009, 2010 and 2011, not least Basel III, convinced us the banking sector was in a strong financial position when the crisis struck.

Everyone agrees that the framework with the range of instruments passed the test successfully; however, some issues related to the framework's functioning in the medium term – namely, its efficiency and transparency – have been revealed. Stress testing of the financial sector has shown the extent to which the post-GFC regulatory framework is likely to achieve its objectives (Restoy, 2021). The first observation is that, as shown in the actual stress tests conducted in major economies, the financial system seems generally able to absorb the pandemic's impact even under the severe scenarios of a prolonged health crisis and economic contraction. This is largely thanks to the ample capital and liquidity buffers built up by financial institutions to comply with the Basel III reforms.

From the onset of the crisis policymakers have sought to maximize lender's ability to supply funding and save the resilience of banking capital. However, the focus of policy remained primarily on dealing with financial shocks and mitigating the risks to systemic stability. Respecting monetary and fiscal policy measures, and already deployed tools like capital requirements or Loan-to-Value (LTV), the new element is the toolbox itself, which is a framework of tools organized for deployment and includes guidance on their calibration. Bank-based measures or borrower-based measures through macro or micro prudential policy are all orchestrated to support credit supply and preserve minimum capital. We propose to go through some of the most important ones.

3.2. Capital buffers

Many central banks allowed banks to tap into their macro prudential buffers – like capital conservation buffer (CCoB), and additional buffers for systemically important banks to leverage their capital base. Another important area for reflection by regulators is the Basel III buffer system, and how well it works. In particular, it makes sense to analyse whether buffers are contributing, as intended, to preserve minimum capital and mitigate the impact of the downturn on credit supply.

Probably the best illustration and presentation of recommended buffers has been given by Fernando Restoy (see table below) – Chair, Financial Stability Institute, BIS. (Restoy, 2021). In the Basel Framework, Pillar 1 (P1) establishes the minimum capital all banks have to hold. Pillar 2 (P2) includes capital add-ons to cover entity-specific risks not captured in Pillar 1. In addition, all banks must meet a combined buffer requirement composed of a homogeneous capital conservation buffer (CCoB), a systemic risk buffer (SIB) if they meet specific criteria, and a countercyclical capital buffer (CCyB) that can be imposed and released by macro prudential authorities in response to economic developments and, especially, credit growth (FSI, 2019).

FIGURE 2. **Capital requirements**

	P1 +	P2 +	SIB +	CCoB +	CCyB +	Sup buffers (SB) • P2G in BU • PRA-B in UK • STCB in US
Basel III	✓	✓	✓	✓	✓	x
Micro prudential	✓	✓	✓	✓	x	✓
Usable in bad times	x	In some cases	x	✓	✓	✓
Releasable	x	x	x	x	✓	x
Penalties/restrictions	✓	✓	✓	✓	✓	In some cases

Legend: P1:Pillar1 requirements; P2: Pillar 2 add-ons; SIB: (global or domestic) systemic buffer, CCOB: capital conservation buffer, P2G: Pillar 2 guidance buffer, PRA-B: PRA buffer, STCB: Stress-test capital buffer.

Source: Fernando Restoy, 2021.

To judge how the buffer system is performing in the current crisis, it is necessary to acknowledge a wide variety of approaches followed in practice to establish buffers above the minimum capital requirements (see table). Such heterogeneity arises in part from the different interpretations and calibrations of the Basel Pillar 2 (Duckwitz et al., 2019). In addition, discrepancies have emerged from the differences in national or jurisdictional overlays (supervisory buffers (SB)) on top of the Basel III capital stack.

In jurisdictions such as the European banking union, the United Kingdom and the United States, supervisors expect banks to meet additional buffers (P2 Guidance, PRA buffer and the stress test capital buffer, respectively), which are calculated as a function of the capital depletion that banks would suffer in the adverse scenarios of different types of supervisory stress tests. Such jurisdiction-specific buffers are set annually for each institution as part of the supervisory cycle and can be used to absorb unexpected loss. A key feature of the current – arguably complex – buffer system is that the only instrument that plays a well-defined macro prudential role is the CCyB (Restoy,2021). Indeed, its official magnitude is regularly calibrated by the supervisor as a function of prevailing economic conditions.

The other buffers (such as the CCoB or supervisory buffers) are deemed to protect minimum capital in bad times, although they can also indirectly help mitigate corrections in credit supply. Although their official target size is not adjusted as a function of cyclical conditions, banks are allowed (or are currently encouraged) to temporarily deploy them to absorb loss in bad times without the need to constrain credit. The depletion of those buffers below the target size may be subject (as in the case of the CCoB) to restrictions on dividend pay-outs, coupons on Additional Tier 1 (AT1) instruments and variable remuneration for employees.

Following the latest research (Carstens,2020) we found that CCyB was unable to deliver the stabilizing power required. Therefore, regulators had to rely mainly on micro prudential instruments to meet a macro prudential objective. The reason is pragmatic from the banks' side, as banks have generally shown a reluctance to use their buffers. In this regard, there could be several options for improving the current framework. A more ambitious approach would be to establish a larger macro prudential buffer that could be released at discretion during bad times. Such a buffer would replace the current CCyB and would be at a positive level in normal times for accommodating unexpected shocks such as a pandemic. This adjustment of the current framework would allow target and instrument to be more clearly aligned (Restoy, 2021). The macro prudential buffer would be set exclusively on macro prudential policy grounds (to help keep up orderly provisioning of credit to the real economy), while the micro prudential buffers (CCoB and SB) would be calibrated to meet purely micro prudential objectives to ensure that individual financial institutions have sufficient capital in all phases of the economic and financial cycle.

3.3. Liquidity buffers

Similar to capital buffers, liquidity rules were relaxed in view of the financial system's strong starting position and central banks' resolve to supply abundant liquidity. In addition, some swap arrangements among central banks (cross-board) and among banks (in-board) gave support to solving liquidity problems in foreign currency. The initial capital outflows were quickly reversed, supported by the immediate response of the central banks of the major currencies to provide other central banks with foreign currency liquidity, including through swaps agreements. Due to liquidity needs in the real economy, lending to enterprises was soaring.

3.4. Risk-Weighted Assets

At the same time, the crisis has shown that other components of the post-crisis reforms may have had some unanticipated effects. For example, risk weights for SME loans were modified and exposure limits increased. Banks in some jurisdictions were incentivized to supply bridge loans to help companies pay salaries. Generally-speaking if we break down the CAR (capital adequacy ratio) into Capital and Risk-Weighted Assets (RWA), we should notice that each element of denominator and numerator in this equation has been object of observations and measures. Relaxing RWA on the one hand against relaxing Capital quantity and quality with prescribed buffers – all was in function of credit flows and minimum capital amount. In some jurisdictions, crisis-related loans were partially backed by government guarantees and thus come with lower risk weights. On the other hand – regarding supporting measures – the adjustment of SME supporting factor was brought forward by one year, causing the relevant RWs and hence RWA to decrease (Buch, 2021). It means that capital can stay the same by decreasing RWA lead to higher CAR.

3.5. Accounting standards – Asset quality indicators and expected credit loss provisioning

Furthermore, the expected credit loss provisioning standard was meant to reduce the pro-cyclicality of banks' income by requiring them to anticipate loan loss provisions before actual delinquencies took place. The pandemic has shown that, while this is normally the case, when there is an unexpected common shock, accounting rules based on expected loss tend to force all banks to sharply increase their provisions more or less at the same time. This convergence of provisioning efforts across time and entities may generate pro-cyclicality. This explains why regulators – including accounting standard setters (IFRS, 2020) – have issued guidance for banks to apply the new standard in a pragmatic way and, in some cases, have opted to postpone the compulsory application of the new accounting rules. For instance, relaxing the rules for bank recognition of non-performing exposures only for those borrowers experiencing demonstrable difficulty in servicing their loans due to the impact of Covid-19. Importantly, the announced measures were introduced for a limited period and linked to the development of the crisis.

Regarding asset quality indicators, the flexibility provided for the classification of assets as non-performing or forlorn made it challenging for supervisors to monitor the evolution of asset quality. We found that some EME jurisdictions have gone as far as to freeze the classification status of all credit exposures prior to Covid-19 (IMF and World Bank, 2020). Similar to relevant researchers, we found that policy actions and supporting measures for households and companies' ratios of non-performing exposures had barely been affected by the pandemic crisis. In many countries they remain at very low levels. In any case, heterogeneity of provisioning approaches across banks and jurisdictions made asset quality review processes a key priority for supervisors.

The pandemic had neither economic nor financial origins, but it hit both aggregate demand and supply, severely and suddenly. The recession would have been much deeper and longer without the provisioning of credit to households and companies seeking to bridge the sharp drop in their income. In Europe, fiscal measures supported around 1/3 of new lending (ESRB, 2021). In particular, lending to small enterprises (with moratorium on their matured obligations) and to sectors hit hard by the crisis have benefited. Minimizing the immediate damage to production processes and to working relationships also reduced the economic scars and prepared the ground for a swift rebound. In line with these objectives, prudential policy interventions were in two-directions: to facilitate credit extension and to ensure that banks remained resilient.

Overall, the financial system responded in the desired way. It avoided a catastrophic credit crunch, which would have deepened the crisis (primarily decline in production and employment), and remained resilient. In most banking-based economies the role of macro prudential policy was particularly important, given the dominant role of banks in intermediation. Central bank purchases of corporate bonds used in other jurisdictions would have had only limited effects on the real economy. Of course, prudential policy could hardly achieve this success alone.

4. What future challenges and risks does the financial sector face?

Unlike the global financial crisis of 2007-2008, the pandemic did not stem from the financial system. The stress threatened to spill over into the financial sector by way of rising credit risk, as many companies and sectors of the real economy saw their liquidity and solvency directly jeopardized by lockdown measures. The corona virus pandemic is not completely behind us just yet, but the course of future economic developments is already taking shape. Structural change in the real economy is likely to pick up speed – digital transformation, demographic change, and climate policies pose challenges for the real economy and the financial sector. Higher debt levels in the private and public sectors, boosted by low interest rates, are making the macroeconomic setting vulnerable (Buch, 2021).

Now, the economy has returned to the pre-pandemic growth trajectory in almost all countries. The first task is now to shift from recovery to sustainable growth. In order to do this, it is necessary to overcome the negative effects of the pandemic, and above all, to deal with soaring inflation and other challenges. Undoubtedly, inflationary pressures are building up globally. Monetary policy is facing some tough trade-offs. Bottlenecks in production and logistics networks, higher commodity prices and labour market frictions have pushed up prices in food, energy and some manufacturing products this time. Rebound in demand came with a change in its structure. This time we are facing three-dimensional (3D) inflation – demand, cost and structural. Growth in real estate prices is particularly interesting. Central banks are now facing new serious challenges – sustained higher inflation will require a policy response as would a build-up of financial imbalances. Some leading economies have begun raising policy rates. In addition, we have to review regulation and reengineer the entire framework. There is no controversy as to the need for robust and well capitalized financial and non-financial institutions to maintain financial stability and ensure the functioning of the financial system. This will ultimately protect the real economy and economic growth.

The period of the Covid-19 pandemic has been a real test of the financial stability framework in an economic crisis. Everyone agrees that the framework passed the test successfully. However, some issues related to the framework functioning in the medium term – namely, its efficiency and transparency – have been revealed. Despite the positive growth outlook there are many emerging risks. What is therefore needed is good management and effective supervision to identify banks' risks in their current business. The corona pandemic has demanded a lot of banks and supervisors. From the point of view of financial stability, implications of different banks' economic, business and operational models for risks in the system as a whole must be assessed (for example: open banking, BaaS, etc.). It is now important to find the right moment to switch from crisis management mode to crisis prevention mode. The following are the main challenges and risks we see lying ahead:

4.1. Harmonization – Regulation

As the EU-level discussions on possible minimum harmonization of borrower-based measures are currently ongoing, now is the perfect time for assessing the role of borrower-based measures played during the pandemic. We need to look further into the changes that could be made to the macro prudential framework and its application to make it more effective, fair, and fit for the world of tomorrow (Šimkus, 2021). The European Commission is in the process of considering inclusion of borrower-based measures into EU law by: (i) introducing harmonized definitions; (ii) enhancing the availability of data needed for their effective application; (iii) introducing a minimum, harmonized borrower-based measure toolkit. The global regulatory framework has done right. Uncoordinated regulation can create gaps, flaws, fragmentation and arbitrage opportunities. Although extraordinary support measures are still necessary to mitigate the impact of the Covid-19 pandemic, further implementation of G20-endorsed reforms help ensure resilience and general financial stability.

4.2. Real Estate – House Prices

Real estate prices are booming in almost every economy as the impact of the Covid-19 pandemic was weathered better than initially expected, in part due to forceful monetary and fiscal-policy response to the pandemic. The contribution of building real estate – construction industry in some economies – to GDP is above 35%. We should be wary of house price growth turning into an unsustainable boom. To date, the best tools we have to address the risks arising from housing market instabilities fall under the macro prudential framework. A central question for policy makers today is how to respond to fluctuations in the housing credit market? Should we calibrate our borrower-based measures to increase or decrease mortgage lending, depending on where we are in the credit cycle?

Some of countries (like New Zealand or South Korea) have widely publicised the decision to expand the monetary policy mandate, which now includes the task of supporting more sustainable house prices. In the euro area, housing prices are not part of the monetary policy targets, as residential property price changes are not included in the Harmonized Index of Consumer Prices (HICP) – the most appropriate measure for assessing price stability. In the recent strategy review of the European Central Bank, we recognized the need to include the costs related to owner-occupied housing in the HICP to better represent the inflation relevant to households.

Some central banks (economies) announced a plan to introduce a sectoral systemic risk buffer requirement to banks applicable to their overall mortgage portfolio. This sectoral systemic risk buffer would contribute to financial sector resilience to housing market turbulence.

Low interest rates and emerging inflation pushed people to spend money on real estate (invest), with primary interest in renting such houses, flats and apartments to obtain additional revenue. Under the pressure of house prices and incoming inflation, households are spending money on real estate. The term structure of deposits is changing. There are more and more sight deposits on banks' balance sheets. The square meter is expensive in Western Europe, but far cheaper in some other countries.

Here we should also mention the role of the ever-present issue – money laundering – in boosting real estate prices.

Elevated valuations of risky assets and soaring property prices are two examples. In several economies, rapid growth of property prices on the back of low borrowing costs together with a surge in household savings as a result of the contraction in consumption are becoming a potential risk to stability. In fact, some central banks, such as the Bank of Korea, are taking measures to lean against them.

Considering revising real estate taxation policy many countries could contribute to effective results. In many countries real estate tax is still very low, thus encouraging people to purchase houses and apartments – especially for those owning multiple residential properties with a plan to rent them. In this way, if fiscal and macro-prudential policy work together, they have the potential to achieve maximum impact.

4.3. Climate change risks

Even as we address the most acute vulnerabilities, the highly interconnected and innovative nature of our global financial system requires constant vigilance to ensure stability. We must learn more about the entire spectrum of new risks to financial stability that is less well understood. One of these risks is climate change-related financial risk. FSB has developed for the G20 a roadmap to help guide global efforts to understand and address the financial risks from climate change. Through non-financial reporting, banks are now kept busy with ESG, sustainable growth and UN principals, as well as climate change.

4.4. Digital transformation

The advent of the 4th industrial revolution means a step up in the new financial world of open banking and new business models. Digital E2E transformation creates new ways of delivering financial services and new ways of earning income. The introduction of digital payment methods has a huge impact on competitive structures in the financial sector. Many fintech companies are taking on banks' core business. The competition is cruel. More innovation, more risks.

4.5. Crypto assets and stable coins

We see particular risk in crypto currency trading versus stable coin trading. Marketing of these assets is huge and tremendous. Platforms are account in billions now. In October 2020, the FSB released high-level recommendations for the regulation, supervision, and oversight of global stable coin arrangements. Technology and innovation continue to advance rapidly. We need to be mindful of whether our regulatory and supervisory approaches appropriately address risks while preserving the benefits that innovation can bring.

4.6. Demographic change risks

In coming years, demographic change will be a key driver of macroeconomic developments. On the one hand, more and more young people do not need to work. They live off their parent's money. On the other hand, due to structural changes, we need people with new skills and education, who are flexible and ready to work from home. Some of the latest reports tell us that more than 40% of them are so called 'nomads'. Many sectors are disappearing. New ones are developing. Some economies do not have enough truck drivers, while some have a surplus of other occupations. Banks offer products according to the age structure of the population, because the type and form of wealth accumulation and financial needs change over a lifetime and according to lifestyle.

4.7. Non-bank regulatory framework

Authorities need to take a comprehensive approach to strengthening the macro prudential policy framework for non-banks. Such a framework should adopt a system-wide perspective with a focus on building resilience ex ante, rather than relying on ex post measures.

4.8. Government finances and public debt

Fiscal space is also more restricted. The major crisis-induced fiscal stimulus has resulted in substantially higher debt-to-GDP ratios. Sovereign risk could become much more prominent in the years ahead, and could severely constrain monetary and prudential policy, especially if the pace of recovery disappoints. In this scenario, unstable government finances and weak banking sector balance sheets could give rise to powerful damaging spirals. Banks are directly exposed to the government through bond holdings and public guarantees on pandemic-related loans. And they also have indirect exposures through major influence of the state of public finances on the economy and on the private sector's cost of funding, including from international sources.

4.9. Private sector debt

In keeping with the system-wide and through-the-cycle perspective of macro prudential policy we should be aware and turn to the risks ahead, because they are important for understanding the role of policy in crises. These risks are related to the standing effects of the pandemic on private and public balance sheets and on the pace of economic recovery. The pandemic is also leaving higher private sector debt in its trail. Households and companies that borrowed to manage the economic blow will have to service their debt as relief measures and moratoriums are gradually lifted. For those already in a weak position at the onset of the crisis, the burden might not be sustainable, especially in the hardest-hit sectors, whose longer-term prospects have deteriorated. In some countries mortgage debt has increased significantly. Exposure is huge. Banks will have to manage this challenge while the gradual lifting of the emergency prudential measures will also raise the bar of the standards they will have to meet.

4.10. Spill over effects for small open economies

For small open economies, the external sector can add to the domestic risks. Global financial conditions (on balance very easy given the nature of the shock) could suddenly reverse, especially if central banks in major currency areas tighten policy and international investors become concerned with country risk. The weaker banks in economies that are dependent on foreign funding could come under stress unless their economy has recovered fully.

Bearing in mind all of this, macro prudential authorities must strike a delicate balance. On the one hand, banks' capital and liquidity buffers must be replenished where needed, and the transition to the full adoption of new prudential and financial reporting standards must be resumed as soon as the crisis is over. On the other hand, pandemic-hit borrowers may need continuing support in view of the inherent uncertainties along the recovery path. Indicative of these trade-offs are concerns with imbalances fuelled by exceptionally accommodative financial conditions. Striking the right balance requires different policies to act in a concerted way and look beyond the short-term. Macro prudential tools can play their role in gradually nudging the financial sector to rebuild its buffers and making sure that the balance sheet scars of Covid-19 heal properly and promptly.

We would like to believe that we have chosen the right path. As we remain vigilant to these known risks and vulnerabilities, in the last quarter of 2021 the FSB rolled out a new forward-looking surveillance framework for monitoring and assessing vulnerabilities. The surveillance framework reflects the lessons learnt in the past decade and prepares us to face the challenges of an ever-evolving financial landscape. This new framework will better account for our resilience to shocks, in order to better appraise net vulnerabilities and identify gaps. It will also systematically scan the financial landscape to better capture new and emerging vulnerabilities and emphasize those that may prompt cross-border spill overs. The indicators will be dynamic and will include asset prices and asset quality, funding, liquidity, leverage, complexity, cross-border linkages, and operational considerations. The framework also incorporates monitoring of the balance sheets of the non-financial sector, such as household, corporate and sovereign (Quarles, 2021).

5. Conclusions

The pandemic crisis has been a kind of test – to how we can use all policies, tools, instruments and measures developed in the last two decades to respond to a different set of circumstances, challenges and unusual crisis, especially non-economic. This time it has been confirmed that macro prudential policy can be very useful in addition to the financial stability policymaker arsenal in dealing with non-financial crises. Like many authors, we see macro prudential tools as a good complement to other policies when a sudden non-economic shock requires rapid and forceful policy response. We found that policy response during the pandemic crisis appears to have been very successful. Success always depends critically on credibility, and the successful use of macro prudential tools in crises is greatly dependent on the strength of the overall policy framework, including all stabilization policies.

We agree that macro prudential policy cannot be the main tool in the response to a crisis like the one triggered by the pandemic. The natural pacemakers are fiscal and monetary policy, with macro prudential measures playing an important supporting role in complementing the overall package. Macro prudential policy measures should be part of a stimulus package and help to mitigate a damaging credit crunch along strengthening resilience. Consequently, macro prudential policy offers more strategic options and flexibility to policymakers. They can reinforce the efficacy of other policies.

More than decade has now elapsed since we started to create and implement new regulation. We have developed a set of very useful and efficient bank-based and borrower-based macro prudential measures. Now, with Covid-19 pandemic experience, we are able to assess the impact of reforms, the side effects, and the gaps in regulation. Assessments show that financial market reforms have had no relevant undesired effects and that thanks to the resilience of the banking sector, inter alia, lending in particular has not suffered. In the post-crisis era and considering new coming financial and non-financial risks, we should now strengthen the existing framework and replenish all buffers to be ready for new challenges. Next challenges are certainly on the way. Soon we shall try again to defend confidence in the financial system.

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Socioeconomic Impact of the COVID-19 Pandemic in the Context of Increasing Gender Inequality

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ABSTRACT: The COVID-19 pandemic has negatively affected the economy of many countries, exposing the socioeconomic vulnerability of women and the relevance of gender disparity issues. This is expressed in the pay gap, lack of equal access to finance, full employment opportunities and limited access to digital technologies. This study of the impact of the pandemic on gender equality focuses on statistics relating to the problems of women's informal employment, the high volume of unpaid work performed, employment in less paid sectors more affected by quarantine measures.

Keywords: gender pay gap, gender inequality, pandemic recession.

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1. Problems of gender disparity

The consequences of the COVID-19 pandemic have negatively affected the economic downturn in many countries, exposing the socio-economic vulnerability of women and the relevance of gender disparity issues. The pay gap, lack of equal access to finance, absence of full employment opportunities and limited access to digital technologies are proof of this. Studies conducted in the Republic of Moldova (RM) and other countries also confirm negative impact of the pandemic on gender equality, the problems of informal employment of women, the high volume of unpaid work and employment in sectors where lower salaries predominate.

The distribution by sectors of the economy shows a higher proportion of women employed in less well-paid sectors of economic activity: HORECA (hotel, restaurant, coffee shop) – 71.8%, financial intermediation and insurance – 72.1%, education – 82.2%, health care and social assistance – 80.2%, cultural activities and leisure – 59.9%[10]. Therefore, during the pandemic and the compelled implementation of quarantine measures, which led to the closure of many enterprises in the HORECA sector, women employed in this sector were the first to suffer.

Greater childcare obligations due to forced holidays or the transition to online classes in schools has affected the need for both parents to adapt to the new conditions. The pandemic has also demonstrated that some parents have not coped with the increased threat of poverty due to restrictions on movement and, as a result, a decrease in seasonal migration.

Because of these negative factors, the level of domestic violence has increased. This phenomenon was called a "shadow pandemic". Before the pandemic, the indicators in the countries of Eastern Europe reached a maximum level of 17% of the total number of women subjected

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[10] Statistical portrait of women and men in the Republic of Moldova. Biroul Naţional de Statistică // Comunicate de presă (gov.md)

to violence. During the pandemic, this indicator in the Republic of Moldova rose to 46% and was the highest in this group of countries[11].

The recession during the pandemic also affected parents who are raising children alone, which make up 1/5 of the total number of households in Moldova. The vast majority of single parents (99%) are women who have limited access to the labour market and, as a result, face the problem of income decline and lack of funds to care for their children.

1.1. Causes of gender inequality in the economy

1.1.1. Gender pay gap analysis

An analysis of the gender pay gap based on the difference between the average monthly gross wages of men and women showed that women earn on average 14% less than men[12]. Moreover, the biggest gap in the incomes of women and men are observed in the financial, information and communications and industrial sectors.

This is due to the fact that management positions in these areas are occupied by men, who do not need to work part-time jobs to take care of children and relatives. This is related to gender stereotypes about traditional “female” and “male” responsibilities in the family. As a result, in recent years, the gender pay gap in the Republic of Moldova was about 14%, the pension gap was 33%[13].

Women earn less than men in most types of economic activity. In 2020, the following were the largest differences by type of activity: financial and insurance (women earned 44.6% less); information

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[11] OECD, Gender, Institutions and Development Database, from https://stats.oecd.org /Index .aspx?DataSetCode=GIDDB2019

[12] OECD, Gender, Institutions and Development Database, from https://stats.oecd.org /Index .aspx?DataSetCode=GIDDB2019

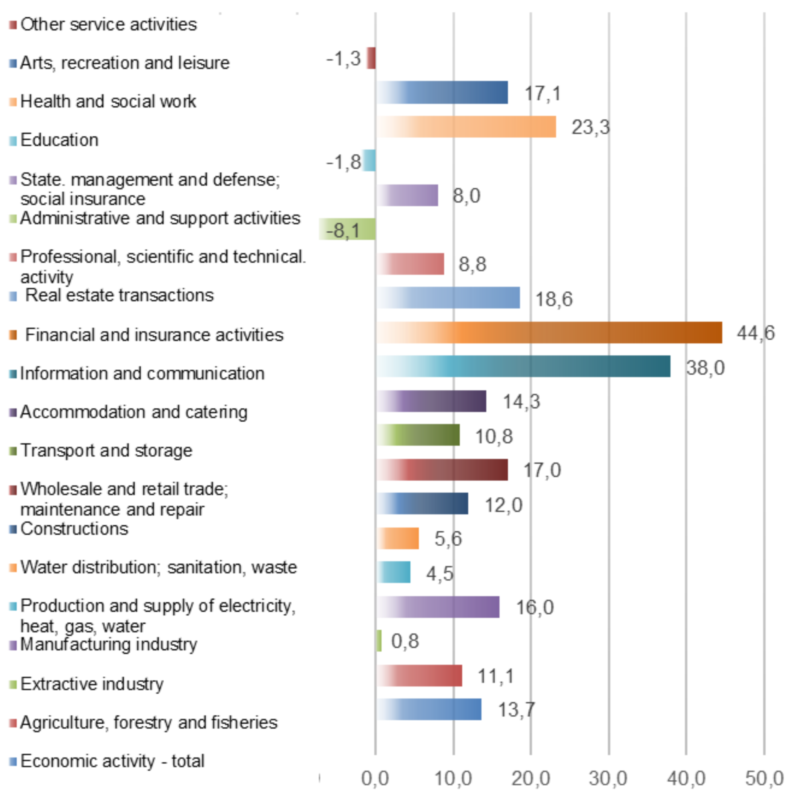
[13] Statistical databank. Gender statistics, from https://statbank.statistica.md/ PxWeb / pxweb/en/50%20Statistica%20gender/

and communication (women earned 38% less); healthcare and social assistance (women earned 23.3% less) (Fig. 1).

1.1.2. "Maternity tax" effect

The average proportion of officially employed women is 48.7% of all women of working age and this is directly linked with childbearing under the age of 16. Thus, the employment rate of women aged from 25 to 49 with a child under the age of 16 is 49.7%, and for women without children it is 59.6%[14].

FIGURE 1. **Gender pay gap by type of economic activity, (2020)**



Source: Compiled by the authors based on data from: Gender statistics. URL:https://statbank.statistica.md/.

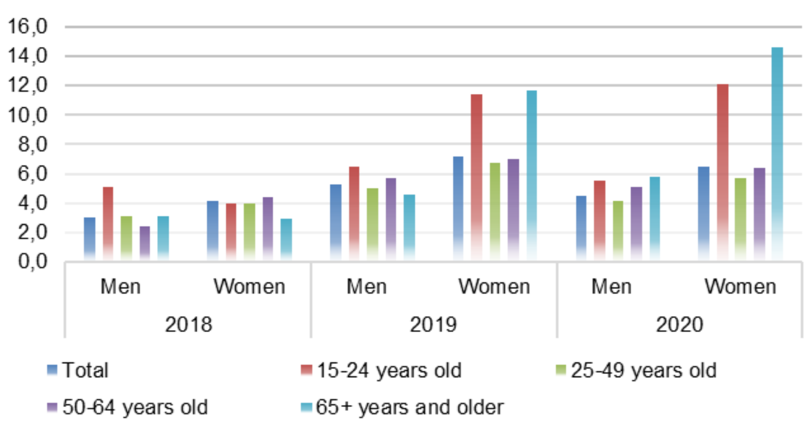
[14] Statistical portrait of women and men in the Republic of Moldova. https://statistica.gov. md/newsview.php?l=ro&idc=168&id=6934

This phenomenon has been called the “maternity tax”, taking into account that following the logic of a civilized society mothers with children should earn more to ensure a decent standard of living for their children. According to the National Bureau of Statistics (RM), 97% of women are inactive in the labour market due to family responsibilities, and only 3% of men mentioned family responsibilities as the reason for their not working full time.

1.1.3. Involuntary part-time work

It should also be noted that women are more likely to choose part-time work than men. This leads to an increase in income disparities. The gap has widened quite remarkably during the pandemic since 2019: the number of part-time unemployed people almost tripled from 4% to 11.4% in 2019 and to 12.1% in 2020 (among 15-24 year old); from 4.6% to 11.7% in 2019 and to 14.6% in 2020 (among 65 year olds and more) (Fig. 2).

FIGURE 2. **Share of persons employed with a part-time work program by marital status, age and sex, 2020**



Source: Compiled by the authors based on data from: Gender statistics. URL:https://statbank.statistica.md/.

There are two categories of part-time employees: those who want to work full-time, but for a given reason cannot, and those who willingly work part-time. The share of women who switched to part-time work was 16% higher than for men.

The proportion of women affected during the period of quarantine measures is 60.5% of the total number of people left without work, while men only accounted for 39.5%[15] of all unemployed people during the pandemic. An analysis of employment by career status and gender highlights women's preference for paid work and formal employment.

During the COVID-19 pandemic, teleworking has helped save jobs, and limited the loss of economic activity. Around 40% of European workers began working at home[16]. In the second quarter of 2021, 33% of women in RM switched to telework or "hybrid format" (compared to 14% of men) and at the same time increased the number of hours of unpaid work at home. In this regard, it is necessary to ensure equal rights for remote workers, workload comparability, including safe conditions and health protection.

1.1.4. Unpaid family workers

In 2020, 84.2% of all working women were hired as officially employed workers, against 72.5% of men (Fig. 3). The proportion of women performing unpaid family work was 6.6%, –against 2.2% of men. The proportion of men employed as private entrepreneurs was 24.8%, whereas women are three times less (8.9%[17]).

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15 Childcare, women's employment and the impact of COVID-19: the case of Moldova. https://unece.org/sites/default/files/2021-11/Childcare _WE_Covid-19_Moldova.pdf

16 EESC (2021), Opinion of the European Economic and Social Committee on 'Challenges of teleworking: organisation of working time, work-life balance and the right to disconnect', 2021/C 220/01.

17 Statistical portrait of women and men in the Republic of Moldova. URL: https://statistica .gov.md/newsview.php?l=ro&idc=168&id=6934

FIGURE 3. **Structure of the employed population by professional status and gender, 2019-2020**

Source: Compiled by the authors based on data from: Gender statistics. URL:https://statbank.statistica.md/.

In addition, the high percentage of informal workers who, as a rule, do not have social security and insurance guarantees should be noted. Most often women are informally employed in agriculture, sales of agricultural products in spontaneous markets, sewing and hairdresser services, etc.

Lockdown brought these activities to a halt and dragged people closer to the poverty line along with the lack of state support. According to the United Nations prognosis, relative poverty in the informal sector will rise from 34% to 80%[18] as a result of pandemic and economic impact restrictions.

[18] Childcare, women's employment and the impact of COVID-19: the case of Moldova. ILO (2021), COVID-19 crisis and the informal economy, from https://www.ilo.org/wcmsp5/groups/public/---ed_protect/---protrav/---ravail/documents/briefingnote/wcms_ 743623 .pdf

1.2. Ways to mitigate the negative impact of the pandemic

Thus, the negative impact of the pandemic marked those gender gaps that existed before, but became especially acute during the pandemic and affected women who:

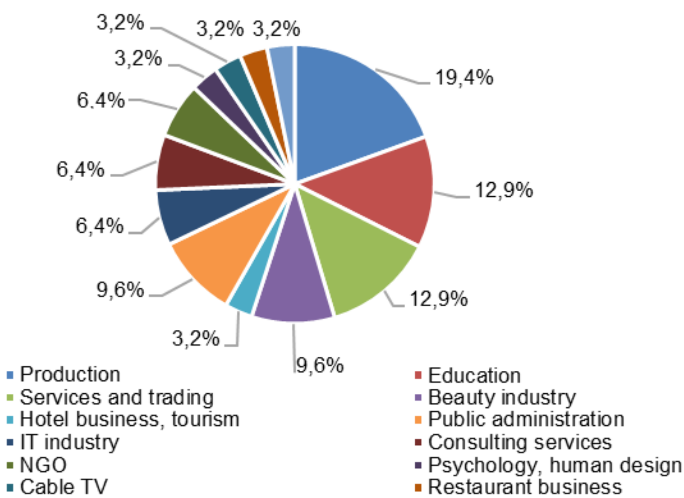
- Are employed mainly in low-paid sectors, in less paid (subordinate) positions most affected by the enforcement of quarantine measures;
- Were forced to reduce working hours to take care of their children, which especially affected single mothers (more than 90% of the total number of single parents);
- Were forced to increase the number of unpaid housework hours, out of need to care for relatives (about 40% of women performed less paid work);
- Received less social protection due to the high level of employment in the informal sector, which was prevented by quarantine measures;
- Have fewer physical and financial assets and savings, thus become more vulnerable to financial hardship and poverty when their income decreased;
- Experienced domestic violence (from an intimate partner), which increased to 46% during the quarantine period due to the pandemic.

To alleviate the negative impact of the pandemic, it is necessary to take a number of measures: control government measures in the framework of the implementation of gender-sensitive policies; create a solid foundation for the elimination of all forms of discrimination against women in the labour market; develop mechanisms for ensuring the balance between professional activities and personal life; expand the population's access to social services that reduce the amount of unpaid work; invest in the development of a child care system; develop and implement programs that provide financial literacy and access to financial resources for women entrepreneurs, especially those affected by the pandemic.

2. Study of the pandemic impact on the women-led businesses

In order to assess the impact of the COVID-19 pandemic on business in the ATU Gagauzia (Autonomy Territorial Unit in the south of RM) the authors conducted the study of 62 women entrepreneurs. Most of the respondents – 52.2% – are the heads of companies, 47.8% are directors, hired managers and specialists. The distribution of the interviewed women by areas of activity was as follows (Fig. 4):

FIGURE 4. **Scope of activity of interviewed women – entrepreneurs and (women) working in private structures of ATU Gagauzia**



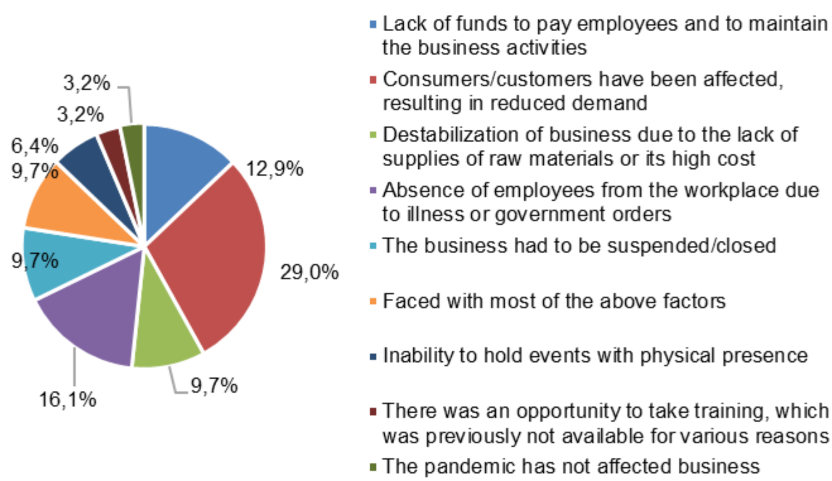
Source: developed by the authors.

The majority of respondents mentioned "production" – 19.4%. Fields of activity as "services and trade" and "education" were mentioned by 12.9% of the respondents, and 9.6% of the respondents answered public administration structures. Employment in the beauty industry was also indicated by 9.6% of respondents. Consulting services, NGOs and the IT sector accounted for 6.4% of the answers. Cleaning, hotel business, television, restaurant business, psychology and human design correspond for 3.2% of the respondents.

2.1. Business restrictions during the pandemic

To the question "How have restrictions during the pandemic affected your business/field of activity?" the following answers were provided (Fig.5):

FIGURE 5. **Restrictions affecting the field of activity of women entrepreneurs and working in private structures ATU Gagauzia during the pandemic**

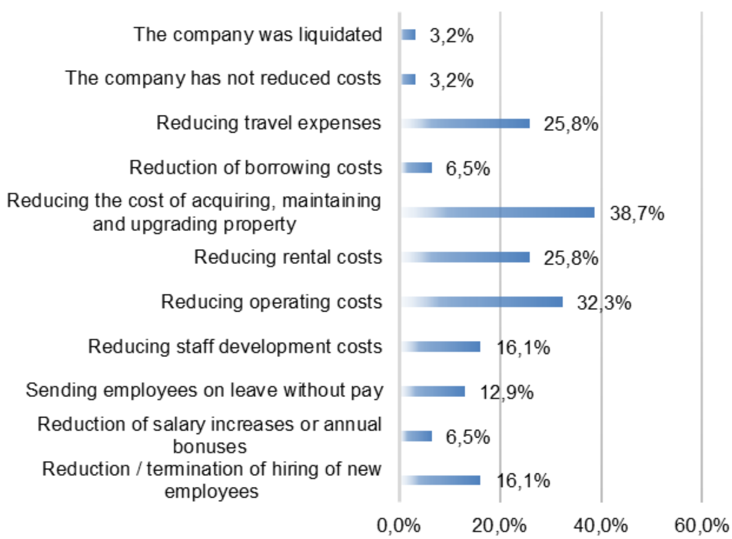


Source: developed by the authors.

"Customers have been affected, this led to a decrease in demand" was noted by the largest number of respondents (29%), "lack of funds to pay employees and to maintain business activities" was noted by 12.9% of respondents and "absence of employees in the workplace due to illness or government orders" accounted for 16.1% of the women respondents' answers.

Such problems as the "business had to be suspended/closed", "faced with most of the above factors" and "destabilization of business due to short supply of raw materials or its high cost" were noted by 9.7% of participants. "The inability to hold events "face to face" was noted by 6.4% of respondents. Measures taken by the respondents to reduce costs in the company during the lockdowns due to the pandemic are presented in Figure 6.

FIGURE 6. **Types of expenses cut by women entrepreneurs and working in private structures ATU Gagauzia during the pandemic**



Source: developed by the authors.

It should be noted that some of the interviewed women highlighted the positive impact of the pandemic on their activities. For example, 3.2% answered that the pandemic had provided an opportunity to finish educational programs that had been out of reach for various reasons, and 3.2% highlighted that the pandemic had not affected their business.

The most popular measure to reduce corporate costs among the respondents was "reducing the cost of acquiring, maintaining and upgrading the property" (38.7% of respondents). The next most popular measure to reduce costs in enterprises was "reducing operating costs". This measure was noted by 32.3% of respondents. The reduction in travel expenses and rental expenses was mentioned by 25.8% of respondents.

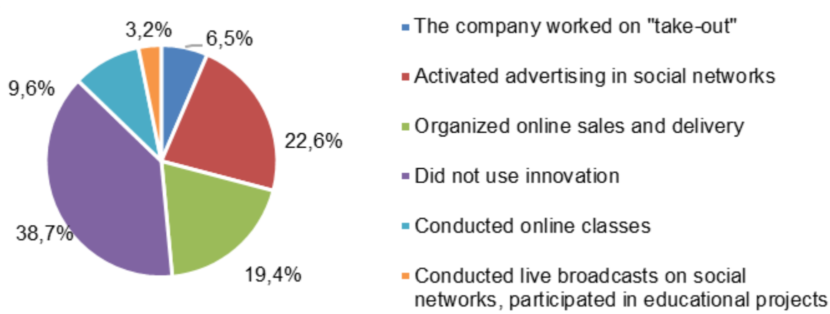
Staff development costs were reduced by 16.1%, another 16.1% stopped hiring new employees. Vacation without pay was the choice of 12.9% of respondents and 6.5% of respondents chose to increase the salary or annual bonuses less. Of all respondents, 3.2% stated that the costs of the enterprise have not changed and 3.2% declared the liquidation of the enterprise.

2.2. Business recovery directions

2.2.1. Business Innovation

The following answers were delivered on a question regarding the use of innovative working methods during the pandemic (Fig. 7): 6.5% of respondents worked in «take-out», 22.6% of all women took up advertising in social networks, and 19.4% organized online sales and delivery.

FIGURE 7. **Innovation in business processes used during a pandemic period**



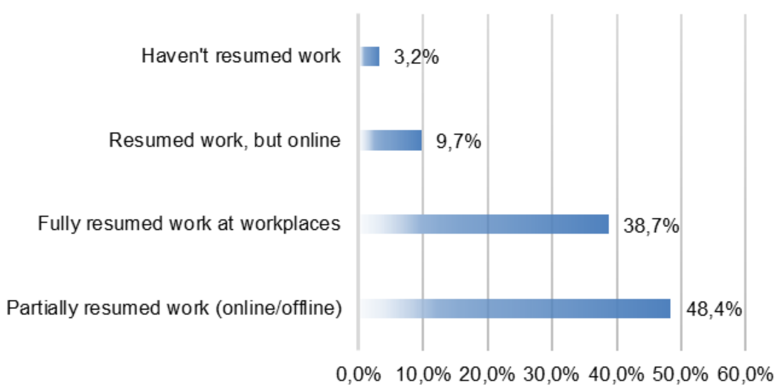
Source: developed by the authors.

In general, companies that introduced innovation in business processes before the pandemic adapted to new conditions faster and suffered less loss. Live streaming on social networks, participating in educational projects and conducting online consultations accounted for 3.2% of the answers, 9.6% of respondents taught classes online. However, 38.7% of respondents did not use innovation at all.

2.2.2. Business recovery speed

Almost half of the respondents (48.4%) stated that the activity of the enterprise was partially resumed, 38.7% of respondents went back to working full-time at their workplace, but 9.7 % of respondents continued to work online, and 3.2% of respondents did not resume work (Fig. 8).

FIGURE 8. **Has your business resumed its activities after the restrictions imposed by the authorities were lifted?**



Source: developed by the authors.

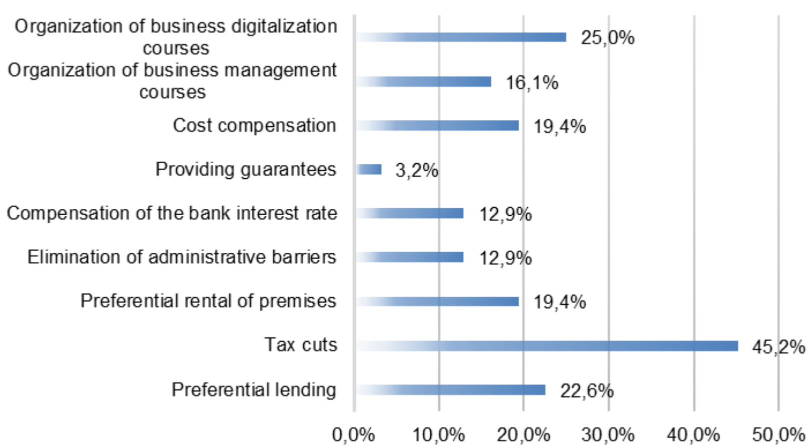
Regarding the time that took for the business to fully recover, 38.7% of the respondents said it took less than 30 days, for 25.8% of the respondents it took from 31 to 60 days, the same number of respondents needed more than 90 days and 9.7% of respondents needed about 90 days to resume activities.

To the question "have you applied for state support during the pandemic", 61.3% of respondents answered that they had not used state support, 22.6% reported that state support did not apply to their companies, 3.2% said that they did not know about state support and only 12.9% took advantage of state support during the pandemic.

2.2.3. State support measures

Women's opinions regarding state support measures that can improve the situation of women entrepreneurs during the pandemic were divided as follows: 45.2% of respondents noted "tax cuts", 25% took "courses on digitalization of business", 22.6% answered "preferential lending", 19.4% resorted to "preferential rent of premises" and "cost compensation", 16.1% took "business management courses"; 12.9% focused on "elimination of administrative barriers" and "compensation of the bank interest rate", 3.2% answered "providing guarantees".

FIGURE 9. **State support measures during the pandemic**



Source: developed by the authors

3. Conclusions and recommendations

Among the main challenges to business development to date, we highlight:

- About 62% of respondents did not use state support during the pandemic lockdowns, 22.6% noted that state support does not apply to their enterprises, 3.2% said that they did not know about state support, and only 12.9% used state support during pandemic time;

- Difficulties in doing business under restrictions due to the pandemic, as well as the need for additional costs for antiviral measures, were highlighted;
- Slow transition of SMEs to digitalization and new methods of doing business and promoting goods and services due to the lack or shortage of training programs;
- Participants identified a group of problems related to the low level of awareness of women in business and, as a result, inertia and unwillingness to take risks;
- Lack of a regional program to support women in business (for pre-incubation, incubation and existing business).

Recommendations

Expanding support from government agencies:

- Improving the effectiveness of existing and newly announced state support measures for SMEs, which will improve the situation of business with the funds already allocated (however, additional support measures will also be required);
- Creation of a single platform for dialogue between the business and the state, which will identify the most relevant areas for support and lay the foundations for long-term sustainable growth;
- Reducing the number of control and oversight activities and easing administrative pressure;
- Use of monetary methods to restore SMEs after the pandemic, for example, the introduction of “tax holidays” for the most affected industries, concessional lending, deferral of loan repayments, etc.

Lifelong learning:

- Support in the field of business digitalization, education in e-commerce, SEO & SMM promotion;

- Educational programs on legal issues of business registration and accounting, efficient management (distribution of functions, efficient delegation);
- Training in financial management, effective distribution of funds;
- Training in the field of tourism and hospitality: tourist guides, promotion of tourism services and artisans;
- Collaboration with banks to provide assistance to SMEs in choosing flexible loan scheme and insurance, education in financial management.

Improving tools to support women in business:

- Development of outsourcing services to provide services to start-up entrepreneurs in ICT, accounting, advertising, etc.
- Support for women on maternity leave – opening temporary accommodation places for children (2 – 4 hours) in business support and educational structures (business incubators, colleges, university), support for opening private kindergartens, provide kindergartens, thematic camps for the summer period.
- Creation of a platform for advocates and promotion of women's opportunities, encouraging the development of associations, clubs, holding forums with the obligation of presenting "success stories", showing videos and visiting enterprises for promoting women employment in highly-paid sectors.

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STRATEGIC PLANNING AND MANAGEMENT AT THE LOCAL LEVEL IN MONTENEGRO

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ABSTRACT: The aim of this paper is to analyse the reform processes in Montenegro based on the theoretical concept of new public management, which has proven to be successful in practical terms in most developed countries. The new approach to management, both at the central and local levels, requires the development and implementation of strategic documents that represent an important product in modern aspects of management. The implementation of strategies in Montenegro has not shown adequate and expected results so far, because of the shortcomings in terms of quality and educated human resources, lack of money, time aspects of implementation, clearer action plans for the implementation of strategic documents and insufficient attention.

Keywords: new public management, good governance, strategic planning, strategic governance

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1. Introduction

The 1980s were crucial for the emergence of entrepreneurial states, and thus entrepreneurial local governments. After the fall and collapse of communism in Europe, accelerated technical and technological development fostered intensive movement of people, goods and capital, and accelerated the globalisation process. Due to the interconnectedness of different societies, nations and cultures, the world has come closer to the creation of a global society. Issues such as global pollution, space exploration and nuclear energy have been transferred to supranational integrations (European Union, American region). The changes that have affected the nation-state relate to the loss of sovereignty, globalisation of state borders and transfer of competencies from higher to lower levels of government. In such circumstances and processes, the modern state abandons the concept of a "strong" state and monopolistic provision of public services. The new, entrepreneurial state introduces competition, privatises public services, introduces service quality standards, measures the degree of citizen satisfaction with the quality of services provided and introduces public and transparent work. Reform processes have enabled the best and most successful business solutions to be implemented in the public sector, such as flexible organisation and needs to ensure better quality, efficiency and effectiveness of service delivery and production. The state develops partnerships with all levels of government, civil society, public and private organisations, with the aim of actively involving everyone in the creation of development strategies and project implementation. Essentially, the modern state and the authorities were faced with the question of how to find ways to solve the accumulated problems, what needs to be done to make services cheaper, better and delivered faster. In the new modern age, the most important resources of modern management are occupied by information and experts who know how to recognise, process and adequately apply them. Information has no borders, it comes from outside and from within, and at the same time it is an important segment of power and authority. All these changes have led to the development of a modern system of total quality management (Total Quality Management, TQM), which is taken over from the private sector and relies on the active participation of employees, and encompasses all work processes.

Competition between the private and public sectors, as well as individuals, as one of the most stimulating principles of the market is becoming an increasingly important factor in the organisation and functioning of government.[1]

2. The impact of new public management on government

The new public administration system has also experienced practical application through various reform models that can be divided into three large groups of models: Westminster (UK, New Zealand), American (USA) and Nordic (Denmark, Sweden, Finland) type of reform. Of course, reforms have been carried out in most Western European countries, and in the Far East. The government's reform activities focused on privatisation, market mechanisms, decentralization, focusing on effects and results, changing the organisation of work and transforming bureaucracy, managing the implementation of public policies and programs, information technology, changes in public finance and budget policy. The effects of the reforms were different. The best results were recorded in Ireland, the Netherlands and New Zealand, and the largest increases in public service costs were recorded in Switzerland, Japan and South Korea.[2]

The changes that have taken place at the national level have also affected local self-government. The nation state has become too broad a framework for solving the problems of citizens that can only be addressed through active cooperation and participation of local self-government, citizens, private and civil sector at the local level. Important social issues, including unemployment, job creation, the creation of private-public partnerships to implement projects that solve local problems, attract capital and encourage economic development,

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[1] Kettl F. Donald: The Global Public Management Revolution, Brookings Institution Press, Washington, DC 2000, 12.

[2] Kettl F. Donald, 34-55.

have been transferred to local authorities. The system's reform forced the local authorities to base their business on market principles, and the redistribution of funds was based on monitoring the effects of work, rewarding success, correcting failures and learning from one's mistakes. From such relationships came new ones, partnerships between central and local authorities that have led to a gradual improvement in the efficiency and quality of services provided. The changes have also encouraged and fostered competition between local authorities to attract capital and human resources. Local governments in the United States and Europe have begun to behave exactly as central governments have embarked on a process of public governance reform that has led to the creation of an entrepreneurial state.

The question is essentially how to govern better a country and thus appoint a more efficient and effective administration to manage the process. Necessary reforms were a condition for the creation of the so-called "Good Governance" which is a process that collectively solves problems and meets the needs of citizens in a society.

The following are the 8 key features of good governance:

- Participation-involvement of citizens and various stakeholders in the management process. Not all the interests of certain groups are in the forefront, which is why it is important that there is freedom of expression and association in the country, i.e. an organized civil society is necessary.
- Rule of law – objective law enforcement that includes an independent judiciary, impartial and uncorrupted police, and respect for human and minority rights.
- Transparency – making and implementing decisions in accordance with applicable rules and regulations. Transparency also means free and accessible information about the process for all those affected by the decision. An important prerequisite is the existence of free media for broadcasting information.
- Reliability – the implementation of decisions should be done within a certain period of time.

- Orientation towards consensus-good governance requires mediation between different actors that make up civil society and their different views on things, in order to come to a consensus on the interest of society as a whole and ways to achieve it. As a condition for the interest to be met, a good knowledge of the historical, cultural and social environment of the community and society is essential.
- Equality and inclusion-good governance should ensure that all members of the community feel part of a whole and are not excluded from being able to pursue their interests and promote their well-being.
- Efficiency and economy-successful problem solving combined with optimal use of available resources.
- Accountability – a key feature of good governance that implies accountability of all factors: government institutions, civil society organizations, the private sector. Who is responsible to whom depends on whether the decisions or actions in an institution are taken internally or externally. In principle, the organisation or institution is accountable to those to whom the action or decision taken will apply.[3]

This model represents an ideal situation, which very few countries so far have managed to achieve it in practice. The concept was developed by the World Bank, financial and donor organisations that require countries to adhere to the "good governance" characteristics when borrowing or lending to counties. Countries wishing to join the European Union must also adhere to this, although the European Commission itself published in 2001 a document entitled "European governance", based on similar characteristics: openness, participation, responsibility, effectiveness and coherence. The novelty is only

[3] United Nations, Economic and Social Commission for Asia and the Pacific: What is Good Governance?, 1-3,http://www.unescap.org/sites/default/files/good-governance.pdf (24-07-14)

coherence, which implies harmonisation of policies and actions at all levels of government and their comprehensibility.[4]

As a consequence of the improvement in the merit system, the administration's position has changed and it is now only in charge of law enforcement; its role now consists of creating specific policies, making decisions about them, monitoring, and measuring the effects and results of implemented policies.

The second part of the changes is the liability not only of the state sector and state bodies as it was before, but also of other non-state entities. For example, a state often appoints "Parastatal" bodies or agencies to do some work.

The state is politically responsible for their work (e.g. intelligence service, autonomous companies, etc.). In addition to them, private entities that act in the public interest have a significant role to play (e.g. private schools). There are also many international and local non-governmental organisations. All of these entities are conceptually located in the public sector – an area that includes not only bodies and organisations of state administration, but also other organisations that perform social affairs without stable mutual division of duties and powers, and are bound by a special regime of legal regulation and public funding.[5] How and in what way to set the "rules of the game" in the public sector has become a major concern. On the one hand, it is about how to prevent excessive regulation and coordination that would certainly reduce the motivation and drive of each autonomous unit in the public sector, and on the other hand to prevent increased costs that may arise in the midst of overlapping competencies, repetition or conflict of interests. Therefore, the study of public policy, the mechanism of decision-making the implementation of decisions (execution) and the measurement of effects (evaluation) is at the heart of administrative science. Capacity-building (strength) of the

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[4] European Governance :, A White paper, Commission of the European Communities, Brussels, 25.07.2001, COM (2001) 418 final,http://europa.eu/legislation_summaries/institutional_affairs / decisionmaking_process / l10109_en.htm (24/07/2014)

[5] Pusić Eugen: Administrative Science, Naklada "Naprijed", Zagreb, 1995, 35.

state is very important for the effective functioning and implementation of decisions.[6]

The United States is a "smaller" country than Sweden or Russia in terms of its scope of work, but it is extremely strong when it comes to exercising power and the legitimate use of force. It is logical that this be a criterion of the strength of the state – the possibility of exercising competence, and not the breadth of the scope of competence per se, because the essence of statehood is the use of force.[7] Therefore, public sector reform and the decentralization of tasks are needed if the central government is not able to perform them well, to the levels that other entities are able. All together, these are the processes that inevitably led to the development of new public management. The development of entrepreneurial countries and all the changes that took place in that field in the 1980s, bypassed Montenegro.

Public services are the essence of the modern functioning of the system of local self-governments everywhere in the developed world. This is achieved by changing the role of the state and understanding that its most important function is to provide services to citizens through public services. Over time this has been reflected at the local level, especially under the influence of the new public management, featuring strategic planning and management, private-public partnerships and significant citizen participation and influence in respect of more efficient provisioning of services by the executive.

3. Strategic planning and management (general guidelines)

Strategic planning is a systematic way to manage and build a society based on a broad consensus and a shared vision of a better economic future. It is a creative process for identifying key areas and agreeing

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[6] Dye R. Thomas: Understanding public policy, Upper Saddle River, Prenticehall, New Yersey, Florida State University, 2000, 32-54.

[7] Fukuyama Francis: Building the State, Filip Visnjic, Belgrade, 2007, 35.

on the most important goals and strategies. Through strategic planning, local business community leaders and local government representatives jointly plan how to improve the local economy and business climate in their community.[8] Strategic management was originally developed and used in the private sector. In the early 1920s, the Harvard Business School developed the Harvard Policy Model, one of the first strategic private sector planning methodologies.[9] The concept of management or governance emerged in the private sector in large companies. It grants private companies discretionary power at the highest level, and is placed between shareholders, on the one hand, and workers, on the other. The strategy laid the ground for the company's operations, which determined the structure of the organisation in order to achieve the best possible business results. At the same time, the strategy linked the company's resources, top management, market information, and corporate social responsibility and responsibilities. However, as early as the late 1950s, the role of strategic planning in enterprises focused on risk management, industrial production growth, and market sharing. The next phase in the field of strategic planning was the analysis of competitive power relations, which was based on determining the power of customers and suppliers, analysing the dangers of harmful products and services, and looking into the effects of new industries and market rivalries.

In the 1960s, strategic planning became a standard tool for almost all 500 large and smaller companies in the United States. Until the mid-1980s, strategic planning remained largely in the private sector.[10] Dynamic changes in economic conditions, changes in values, technological development, increased competition and increasingly complex regulations emphasize the importance of anticipation and adaptation to change, as well as the

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[8] The Urban Institute: Strategic plan of local economic development with implementation plan, The Urban Institute, Belgrade, 2006

[9] Blackerby Phillip: "History of Strategic Planning", Strategic Planning (Armed Forces Comptroller), 1/1994, 23.

[10] Šeparović Perko Inge: Challenges of Public Management – Public Administration Dilemmas, Golden Marketing, Zagreb, 2006, 101.

need for finding new forms of development management in the public sphere as well. The basics of strategic planning in public administration are mostly found in J.M. Bryson (John. M. Bryson), who defines it as a set of concepts, procedures and tools designed to help executives, managers and planners think and act strategically in order to improve results and establish effective planning. This type of planning includes strategic thinking and management. Such management is needed for taking important decisions that envisage the development of the organisation, and at the same time provide a systematic approach to planning future development, as well as providing the necessary funds for their implementation. The essence of this type of planning lies in deciding what to do, how and why and in implementing the decisions taken.

4. Strategic planning and management models

The process of strategic planning in the public sector must begin with the adoption of a national vision, which is a statement of the future of the state, based on broad political and social consensus, and provides a framework, guidelines and priorities for all other sectorial strategies and policies. Based on this vision, strategic goals for all segments of the public sector are adopted.[11] Most authors believe that the first step in strategic planning is to identify SWOT analysis and stakeholder analysis. SWOT analysis comes from the English words strength, weakness, opportunity and threat. Strength consists of the parameters for which one local community, province, or state stand out, and is divided into three key dimensions: environment, organisational structure and culture. Weaknesses prevent goals from being met, and chances are all the positive developments and events that can be useful. Threats are factors that can completely or partially prevent the achievement of goals.

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[11] Lazarević Bajec Nada: "Local Strategic Planning in Serbia: Evaluation of Results", Regional Development, Spatial Planning and Strategic Management, Institute of Architecture and Urbanism of Serbia, Belgrade, 2009, 127.

City and regional authorities were among the first to use SWOT analysis in the public sector in the 1980s. The aim of this analysis is to look at the situation on the basis of the systematisation of the collected information and to identify strategic issues in accordance with the previously defined vision. Strategic issues are defined as factors or tendencies that are relatively likely to affect the economic performance of a region (or municipality) and the realisation of a vision. They are most often on the negative side of the SWOT matrix – internal weaknesses that slow down regional or local economic development and external threats that may impact the regional (local) economy negatively. Strategic issues are classified and critical elements are singled out – those strategic issues that are most important for the realisation of the vision and that can be largely controlled by authorities. These two criteria are necessary to focus on priorities and issues that regional / local authorities can influence.[12] Stakeholder analysis is necessary because strategic planning is difficult to imagine without it, regardless of the level of education of employees or their work experience. The next step, after these analyses, is to define strategic long-term goals that should be realistic, achievable, limited in time and measurable. The next phase is to identify and lay down a number of medium-term goals under which one or more programmes are developed for achieving such goals.

On the other hand, one project can be part of two or more different programmes. Projects of interest to the wider community very often contribute to a larger number of programmes from different sectors, i.e. public administration. This is most often a feature of large infrastructure projects, which can be a component of various tourism, transport, development and other programs.[13] The next step is to determine the functional approach to project management (clarity of objectives, coverage, results, quality, budget, risks, staff and activities). This is followed by priorities which are set with clearly-defines and public criteria.

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[12] Lazarević Marija, Jandrić Maja: "Swot analysis and planning of regional development", Project management of organizations-new approaches, Association for project management of Serbia and Montenegro-YUPMA, Belgrade, 2006, 97-98.

[13] Obradović Vladimir, 93.

5. Strategic planning and management in developed countries

European countries began introducing strategic planning and management in the late 1980s. In 1995, Ireland launched the Strategic Management Initiative with the aim of strengthening public administration and making government decisions closer and more visible to citizens.

The United Kingdom, Canada and Germany have introduced the concept of strategic management in the public sector with an emphasis on action, consideration of a broad and diversified stakeholder group, and approach to external threats and weaknesses.[14] The Australian state of Victoria has developed Integrated Management Cycle (IMC), based on a schedule for planning, allocating funds, delivering and monitoring performance, reporting and auditing (critical evaluation). The goal is to endow the government with strategic guidelines in a changing environment, clearly outlining the responsibility of ministers and ministries, so that detailed control of the central agency is not necessary. The IMC connects the strategy with the budget process and this forms the basis for the overall and business plan of the ministry. The results are evaluated and are part of the input segments for the following cycle.

Different experiences in several countries show that they have implemented the most important segments of the new public management model through the work of executive bodies, and through the adoption or implementation of laws and strategic documents. In essence, each of these solutions, with the specifics of each country, contains the basic principles, principles and goals on which strategic planning and management are based.

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[14] Goldsmith Arthur: "Private-sector experience with strategic management: cautionary tales for public Administration", International Review of Administrative Science, Sage Publications, 1/1997, 25.

6. Strategic planning and management in Montenegro (central and local level)

Since the beginning of the 1990s, the practice of development planning has been generally neglected in Montenegro due to the fact that it was considered a feature of the previous socialist system, which was intended to end as soon as possible. Documents containing the state, city or municipality's visions for the future and long-term (social, economic, infrastructural, institutional) development goals have been completely neglected, and thus the harmonisation of medium-term and annual plans and programs has disappeared.

Modern management trends have long bypassed these areas. Modern management concepts has been almost completely absent in Montenegro in the last 15 years or more. In spite of a few bright examples, they are so rare that they can been considered an exception to the rule.[15] However, since the change of government in 2000, strategic planning has become an unavoidable segment of society's development. Various Governments of the Republic of Montenegro, as well as the National Assembly of the Republic of Montenegro, had adopted over 120 strategic documents and their action plans by mid-2014, in virtually all social areas and public policy sectors. Regarding the fulfilment of the methodology and the development of strategies, it cannot be said that there are any shortcomings, but there is no precise data on how far and to what extent they have been implemented in practical terms.

Most strategies represent very correctly written expert analyses of economic, developmental, legal and institutional barriers that should be overcome on the way to a developed market economy. The difficulty usually lies in the process of their implementation. Most of the strategic goals defined and agreed by the Government have not been achieved at all, or have not been achieved within the defined and agreed deadlines.[16]

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[15] Obradović Vladimir, 90.

[16] Pavlović Križanić Tatijana: Handbook for Strategic Planning and Local Development Management in Serbia, Center for Regionalism, Friedrich Ebert Stiftung, Belgrade, 2010, 11.

From 2005 until today, the Government of the Republic of Montenegro has adopted a number of strategic documents setting out development goals, measures and priorities and ways to meet them, which refer to the development of local self-governments. These strategic documents include: Public Administration Reform Strategy in the Republic of Montenegro, Social Protection Development Strategy, Tourism Development Strategy, Montenegrin Tourism Development Strategy, Vocational Education Development Strategy in the Republic of Montenegro, Regional Development Strategy of Montenegro for the period from 2007 to 2012, National Strategy for Sustainable Development, Sports Development Strategy in the Republic of Montenegro for the 2009-2013 period, Strategy for Encouragement and Development of Foreign Investments, Public Health Strategy of the Republic of Montenegro, National Employment Strategy for the 2011-2020 period, etc.[17]

According to the Law on Budget System, strategic planning and program budgeting must be linked in one process. In the process of drafting the program budget, a multi-year distribution of resources is carried out to ensure the optimal functioning of local self-government. This type of planning, which connects the planning goals and activities with the funds needed for their implementation, determines the basic development directions of the municipality and helps with the optimal allocation of ever meagre funding. The obligation to introduce program budgeting implies the adoption of a budget for a period of three fiscal years. According to the provisions in the transitional and final part of the Law, this provision has been applied to local self-governments since 2015. It is possible for local self-governments to have competencies in the field of providing conditions and frameworks for business development, as well as the adoption of local development programs and plans. Consequently, it is possible for all units of local self-government to allocate significant budget funds for these purposes (through programs that support employment, provide subsidies to the economy, deliver training and retraining of unemployed

[17] Law on Regional Development, Official Gazette of the Republic of Montenegro, 51/2009.

persons, etc.). The Law on Regional Development should help strengthen the institutional structures that are the basis of inter-municipal cooperation (primarily regional development agencies), and encourage the financing of quality inter-municipal projects and the adoption of packages of measures and incentives for regional development projects of national, regional and local interest for the Republic of Montenegro, improvement at the economic and technological level, access to new technologies, the promotion of research and development, raising regional competitiveness, improvement of infrastructure at national, regional and local level and improvement of inter-municipal and interregional cooperation of common interest.[18] In 2007 and 2008, existing local strategies and bodies were mapped for the implementation of the former in the municipalities of Montenegro (Strategic plus Group). It was determined that in Montenegro, 24 municipalities had developed some kind of strategic plan, while the total number of local strategic documents, strategic action plans was 396, of which about 20% belong to comprehensive socio-economic development plans, 14% are sustainable development strategies (which could also be treated as integral documents), while the rest are sectorial strategies (local economic development, environmental protection, strategies for youth, children, the Roma people, etc.). The analysis conducted on the basis of the survey was aimed at establishing the connection between national and local strategies and found compliance with about 1/3 of priorities and objectives in the Poverty Reduction Strategy (2002) and the National Economic Development Strategy (2006), significant compliance with The Regional Development Strategy (2007), the National Employment Strategy (2005) and other national strategic documents.29 In addition, the mentioned research found that significant funding for the development of security strategies came from municipal budgets (72-73%), and from donors (41%), of including important international organisations: USAID, UNDP, UNICEF, DFID, SDC, GTZ, EAR, UN-HABITAT, etc. In addition, the study found that significant funding for the development of security

[18] Pavlović Križanić Tatijana, 22.

strategies came from municipal budgets (72-73%) and from donors (41%), of which the most significant being international organisations: USAID, UNDP, UNICEF, DFID, SDC, GTZ, EAR, UN-HABITAT, etc. Their role was to provide material and professional assistance in the development of strategies and implementation of programs, provide a method of work and very often participate as leaders in the process. In a survey conducted by the Ministry of Public Administration and Local Self-Government together with researchers under the project "Capacities of Local Administrations for Good Governance" (2009), 4.5% did not say whether they have a development strategy. Most local units in Montenegro have a development strategy – 59 of them, ie. 69%. And 37.8% did not answer the question about the initiators and creators of the strategy. The initiators of the adoption of strategies for the development of local government are more often municipal authorities (56%), less often various domestic and foreign agencies (44%), such as the SCTM, USAID, GTZ, etc. As a rule, (84% of) local government units that have a strategy have individuals or teams in charge of their implementation, and citizens were greatly involved in the process of their adoption (91%). The question about the implementation of the strategy was not answered by 18%. A total of 50% of local self-government units said that part of the objectives had been met, 27% mentioned that operational programs had been developed and partially implemented, 15% believed nothing had been done, 4% found the results satisfactory, 4% answered that operational programs had been developed and are applied in a timely manner. Somehow, the answers to the questions about the strategy, its adoption and implementation. It is not clear from this research, but it is otherwise known, that donors require local government units to adopt strategies, as a condition for engaging and grating donations. So probably a lot of the strategies came from donors and not from local authorities' needs.[19] According to the latest data from the Standing Conference of Towns and Municipalities,

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[19] Prokopijević Miroslav: "Capacities of local authorities in the field of encouraging local economic development", Local government – state and potentials, Faculty of Political Science, Ministry of Public Administration and Local Self-Government, Belgrade, 2009

today there are a total of 150 strategies and plans at the level of local self-governments in Montenegro.

If we analyse the methodologies of preparation of local development strategies adopted so far, certain conclusions can be reached: 1) Most local self-government units place the greatest emphasis on strategies, on the analysis of the current situation in certain areas, and the execution and implementation deadlines of a large number of projects are very close; However, the problem with projects is that they often do not have a budgetary and spatial dimension and cannot simply be included in the urban and spatial plan of a local self-government unit; 2) The degree of horizontal and vertical harmonisation between the strategic documents of local self-government units is not at a satisfactory level. The practice is that strategies at the local level often emphasise compliance with national or international strategic documents, but not between municipalities, or at the municipal (city) level. The sectorial approach to documents shows that they are not so interconnected at the local level, and that problems often overlap and are similar. When it comes to vertical harmonisation, it is characterised by one-way communication and a lack of two-way cooperation with institutions at the national level in order to improve the development of local self-government units; 3) Most strategic documents do not clearly point to a specific body, public company, institution responsible for implementing strategic goals, or a clearly defined network of coordination and subordination between local executive authorities and other entities in charge of their implementation; 4) When setting priorities, there is a problem with the harmonisation of priorities between national strategies and local project priorities, and with the boundaries of action (it happens that the implementation of priorities requires inter-municipal cooperation and cooperation with central authorities); 5) Strategies contain a large number of general theses and generalisations, overlapping topics between different sectoral policies, content inconsistency between them, insufficient substantiation of the problem, lack of precision in funds allocated to programmes in the municipal budget; 6) Strategic goals have not been harmonised in time, and the strategic process has not been defined through the necessary and invested funds and the results obtained; 7) Although the research points out the significant participation of citizens in strategy development, this data should still be taken with a grain of salt. It also seems that there are no clearly defined mechanisms for citizen participation in the implementation of strategies as an for controlling local authorities.

One of the main reasons why strategies are not implemented is the poor level of education of the entities in charge of their implementation. These are complex problems, with which training cannot keep pace, since it requires knowledge that takes long to learn and to start applying (market functioning, costs and benefits, division competencies and responsibilities, defining rights and obligations). Management in local self-government should play a significant role here.

John Kingdon gives a concise overview of public entrepreneurs: the right or power to be heard and recognized by the public, which can have three possible sources: 1) expertise; 2) the right and ability to speak for others; 3) holders of powerful formal positions in the political composition.[20] Solving problems through integrated strategic planning and decision-making requires, above all, a comprehensive reform of governance patterns, i.e. strategic public governance.[21] Public management relies on expert knowledge obtained from long experience working in the market. In everyday public administration, new creative knowledge is provided that is relevant for decision-making. This is reflected in all aspects of public sector work. From the selection of staff, managers and economists to the choice of types of strategies that solve certain problems and instruments for their implementation and the delivery of services (contracts, partnerships, tenders. Unfortunately, it seems that the absence of quality management, primarily strategic management experts in local self-government units makes it necessary to search for these qualified professionals in the private sector. In addition, there is a lack of research

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[20] Kingdon John: "Britain", Comparative public administration, Chandler JA (ed), Routledge,London, 2000, 32.

[21] Steurer Reinhard: Strategic Public Management as Holistic Approach to Policy Integration, Vienna University of Economics and Business Administration, Vienna, 2005, 69.

showing how well local communities are able to monitor and manage the implementation of strategies. Also, an important aspect of improving strategic management and planning is creating a plan and choosing a strategy that should solve problems and lead to the desired results, The analysis and selection of key issues in local government development is equally important. All this together should lead to measurable results which are the ultimate goal of the implementation of strategic documents through maximising profits and reducing implementation costs. First of all, expertise in strategic management in local self-government units makes it necessary to search for such qualified professionals in the private sector. In addition, there is a lack of research showing how well local communities are able to monitor and manage the implementation of strategies. Furthermore, one of the important aspects of improving strategic management and planning is creating a plan and choosing a strategy that should solve problems and lead to the desired results analysing and selecting key issues in local government development is equally important. All of this together should lead to measurable results which are the ultimate goal of the implementation of strategic documents, in view of maximizing profits and reducing implementation costs.

Improving vertical coherence should be one of the highest priorities of both local and central levels of government. Significant issues (for example, land policy, spatial planning and construction sector) and the problems that occur because of this are most easily identified at the local level. However, the solution to these problems is of a systemic nature and falls under the remit of the central government. Vertical harmonisation implies the adoption of new legal solutions and national policies that will improve the entire management system (policy integration, coordination of work between ministries, participation of central authorities as partners in defining strategies and solving problems). In that sense, it is important that local governments establish criteria that need to be achieved in improving the efficiency and effectiveness of business.

The concept of strategic management of public services is relevant for the implementation of the activities of public agencies or services. However, the specifics of the public sector must be taken into account, as well as the need to integrate the implications of the rule of law. Strategic management in the public sector can only begin to be developed if outcomes are measured. Teams must base their key decisions on these outcome measurements for monitoring the actual activities and adapting them in conformity with monitoring results. When the "new public organisation" replaces the bureaucracy, the public organisation will have even more needs for strategic management.[22]

7. The impact of Covid-19 crisis in strategic management in local level

The impact of the Covid-19 pandemic on strategic planning at the local level depends on the extent of the virus's geographical spread. However, the pandemic has already negatively affected the development of local governments. As the situation develops, we see that local governments are taking thoughtful approaches to protect employees and mitigate financial and operational exposure.

Although the risk exposure is high, local governments have long maintained various agility plans to ensure continuity, disaster recovery and crisis management. Although these plans are effective for a number of other business stresses, during a global crisis such as coronavirus or other pandemic events, they can easily fail.

The first priority of local self-government during a pandemic should be the safety and well-being of employees. So, the critical questions they have to answer at the beginning of a pandemic are whether their employees are safe, followed by the question of whether they are available to perform critical functions. It is important for local governments to be able to monitor the situation, provide a secure job and offer their employees the support they need. Examples of employee support may include access to internal and external resources (eg, World Health Organization, International SOS, Centers for Disease Control and

[22] Lane Jan-Erik: Public Administration (Review of the model of public administration and public administration), Megatrend University, Official Gazette, Belgrade, 2012, 213.

Prevention), services (eg, extended care for children and the elderly, late-night transportation), and respect for employees who are commit to other areas as well, constantly communicating timely updates to raise awareness and establish health package standards for employees, where possible, providing support to sick staff or those caring for sick household members.

To enable timely two-way communication and follow-up of employees and disseminate key information, companies must ensure that emergency notification systems are in place and routinely tested. Alternative channels of communication, such as social media, can be used. In addition, companies should provide training on potential pandemic outbreaks to improve employee preparedness and alleviate any concerns on this issue. The pandemic requires employees to stay at home to limit exposure and prevent or slow the spread of the disease, requiring activation of the concept of telecommuting. Unlike the occasional weather event, which could cause some employees to work remotely, a pandemic can lead to the complete shutdown of an entire facility in an area, forcing large numbers of employees to work remotely over an extended period of time.

Local governments should invest in tools to enable employees to work remotely and virtually collaborate, as well as assess current coverage bandwidth to support telecommuting, conduct periodic network load testing, and identify solutions to key tasks that cannot be executed from home.Effective communication during any crisis is key to maintaining the trust of citizens, raising the morale and trust of employees and fulfilling obligations.

Local governments need to increase the complexity of existing scenarios used for testing and simulations to assess pandemic preparedness. This includes testing scenarios that assess their response to longer periods of emergency. In addition, local governments must try to manage and respond to crisis situations, including top management and delegations of authority at least two levels in relation to primary decision makers, so that delegates are well prepared to make timely decisions in case primary decision makers are not available. Establishing a pandemic command center can go a long way in enabling rapid decision-making, clear accountability, enhanced monitoring and reporting, and the dissemination of cohesive messages, internally and externally.

In the event of a crisis, there are cases where local governments need to deviate from standard policies and procedures to best meet the needs of citizens. Local governments must give in to certain policies within the areas of human resource management, finance, legal issues, business processes in order to adapt to certain critical exceptions and clearly communicate revised policies, criteria and processes to enable such changes in an accelerated manner. All potential changes to existing policies should be carefully reviewed by risk management and compliance with the law.

8. Conclusion

The modern and developed world has experienced several revolutions at the end of the last century, fostering technical, technological and global change. Information society, which is dominated by the use of modern technological breakthroughs (the era of the Internet), has replaced all available tools and means used by man. Information becomes the main source of successful action and quality results concerning public governance. Developed countries across the world have used all the achievements in theoretical and practical terms (through the private sector) to adapt new public management to the specifics of their national environments and implement reform processes with different and changing results. Montenegro has been overtaken somewhat by the technological and technical revolution.

The globalization did not take place in our country because it was isolated by the decade-long imposition of sanctions by the EU and the USA. The reform processes began only after the changes in 2000, but to this day reforms in the public sector have not been implemented, and would otherwise create healthier foundations for a more comprehensive development of Montenegrin society.

Strategic planning and management are important products of new public management, whose successful results could be seen in private companies many years before the theoretical aspects of this new way of managing all levels of government were outlined.

Realizing that most modern societies use strategies to more clearly define all segments of state development and determine goals and means to implement them, various authorities at the central and local level in Montenegro have adopted over 900 strategic documents in the last 10 year. Although most of these strategic documents were written in accordance with modern postulates of the scientific research process, their adequate implementation was lacking because insufficient attention was paid to human resources, time, budget and space dimension for their implementation, due to inadequate system coordination and division of competencies and tasks, as well as insufficient emphasis on measuring the effects of the implementation of the strategic documents.

Looking forward, it is important to engage professional staff or train existing human resources on how to implement the strategic documents in all their segments, emphasize the results and their effects, all the while reinforcing the model of cooperation, coordination and subordination.

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Economic Crises in the Context of the COVID-19 Pandemic: Case of Armenia

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ABSTRACT: The COVID-19 pandemic has become a real challenge for humanity in general and the global economy in particular. Last two years' events have forced the states of the world to actively pursue an anti-crisis policy, including support for business and the population. However, with the lockdown and many restrictions, economic activity in almost all countries has been hit hard. Due to the weakness of market institutions and the limited capacity of state budgets, developing economies have suffered greater loss than can be observed in developed countries. Within the framework of this study, an attempt was made to assess the economic and social effects of the COVID-19 pandemic on the Armenian economy, against the backdrop of the country's economic development over the past decade. The study focuses on the economic situation in the Republic of Armenia in terms of the consequences of COVID-19 and the Second Artsakh War. The methodological basis of the study was a review of Armenia's macroeconomic indicators in the past two years. The key goal of the study was an attempt to identify and assess the economic consequences of the COVID-19 pandemic for Armenia and the Second Artsakh War.

Keywords: COVID-19 crisis, economy of Armenia, conter-crises policy, integration.

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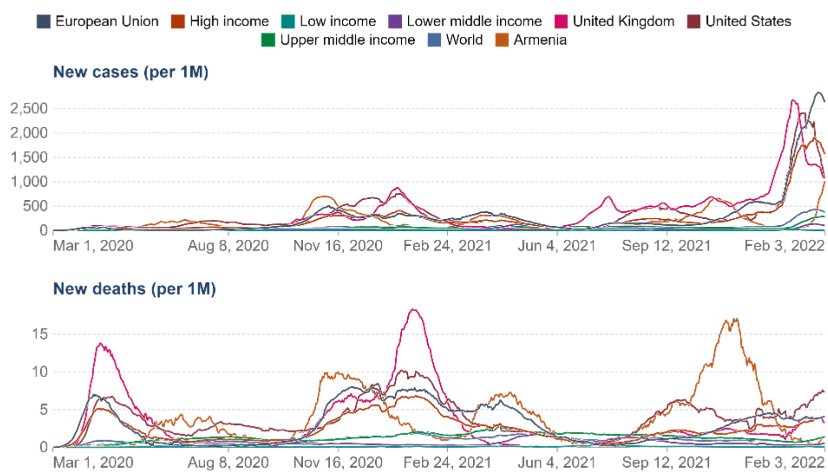
1. Introduction

In recent decades, the world economy has faced crises that differed significantly from previous economic crises known to science and practice. Both the global financial crisis and the COVID-19 crisis proved the need for a significant revision of approaches to macroeconomic regulation, since, as it turned out, the existing mechanisms for dealing with the crisis were rather poorly adapted to the modern structure of the economy, both at the level of national economies and of the global economy.

FIGURE 1. **Daily new confirmed COVID-19 cases & deaths per million people**



Source: Johns Hopkins University CSSE COVID-19 Data.

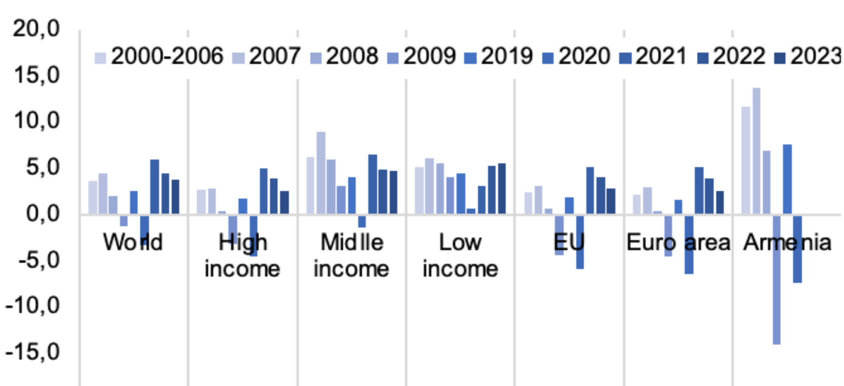
By assessing the social and economic consequences of the COVID-19 pandemic one should note the scale of both loss of human capital, which will certainly affect the global economy in the long term, and the global unpreparedness of humankind for such crises. In Figure 1, we can see the dynamics of the spread of COVID-19, as well as mortality rates. The cyclical distribution and mortality among the population is observed both in different regions of the world and in Armenia. However, it should be noted that according to many criteria, Armenia had a harder time overcoming the consequences of the COVID-19 pandemic, which indicates a lot of institutional distortions both in the healthcare system and in the state regulation system, especially in terms of anti-crisis policy. At the same time, the economic consequences for Armenia were also significant.

2. COVID-19 Pandemic: Implications for Economic Growth

Of course, the crisis associated with the COVID-19 pandemic has had very serious consequences for all the economies of the world, of both developed and developing countries. In response, the world's governments have been forced to take measures to contain and mitigate the effects of Covid-19, as well as to implement wide-ranging economic and financial policies to prevent economic collapse and protect businesses, jobs and livelihoods. Alongside the pandemic, Armenia also underwent the Second Artsakh War in 2020, which undoubtedly had grave consequences for the country's economy.

The first blow of the pandemic, as happens in a crisis, was the pace of economic growth. According to the forecasts of the International Monetary Fund (IMF), the global economy's recovery in the coming years will be highly dependent on the negative effects of investment and human capital in the context of the pandemic (IMF, 2022). Real GDP growth is forecast to be around 4.4% and 3.8% in 2022 and 2023, respectively (see Fig. 2).

FIGURE 2. **Economic growth during the global financial crisis and during the COVID-19 pandemic, %**



Source: World Bank Database – https://databank.worldbank.org/
Note: *Forecast.

According to various expert estimates, the damage caused by the COVID-19 pandemic, as well as the Second Artsakh War, to the Armenian economy can range from 7 to 11% of the fall in total output. Despite the fact that opinions and forecasts regarding the consequences of the COVID-19 pandemic, as well as the Second Artsakh War for the Armenian economy, differ significantly, it is obvious that some loss can already be observed in specific sectors of the economy.

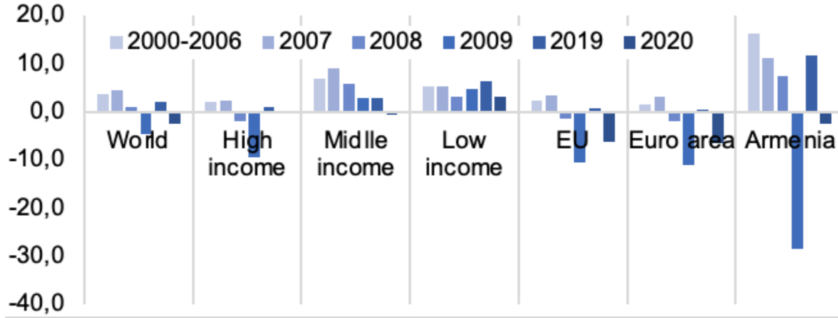
Loss in the global manufacturing sector of the economy according to the IMF outlook for 2020-2025 amounts to more than 22 trillion US dollars. Economic recovery will certainly vary widely across countries, due to the severity and duration of the health crisis, the effectiveness of political support, the extent of restrictions and lockdowns, and many other factors.

As we can see in Fig. 2, the biggest drop in economic growth is observed in Armenia, against the backdrop of high-, middle- and low-income countries, as well as global averages. While average economic growth rates around the world are -3.4%, in the EU and the Eurozone the drop in economic growth rates was -6% and -6.4%, respectively, and in Armenia the economic growth rate in 2020 was -7.4 %. At the same time, it should be noted that against the backdrop of the global financial crisis, the fall in economic growth in Armenia in 2020 was milder, while in the whole world, as well as in various sets of countries, the crisis of the COVID-19 pandemic hit economies remarkably harder than the global financial crisis.

The structure of Armenia's GDP has a rather inefficient diversification. Whereas in the period 1998-2008 the construction sector was the engine of the economic growth of Armenia, in the following 12 years, the pillars of its economic structure are the production, agriculture and trade sectors. The years 2020 and 2021 were marked by a certain reduction in some industries, which affected the volume of gross output and its reduction. The manufacturing sector in Armenia occupies a rather insignificant position. From 2020 onwards, the share of the manufacturing sector was 11.3% of GDP. Thus, in terms of share in GDP, Armenia, compared to the world average, and to middle-income countries, lags noticeably behind.

FIGURE 3. **Industry (including construction), value added (annual % growth)**

during the global financial crisis and during the COVID-19 pandemic

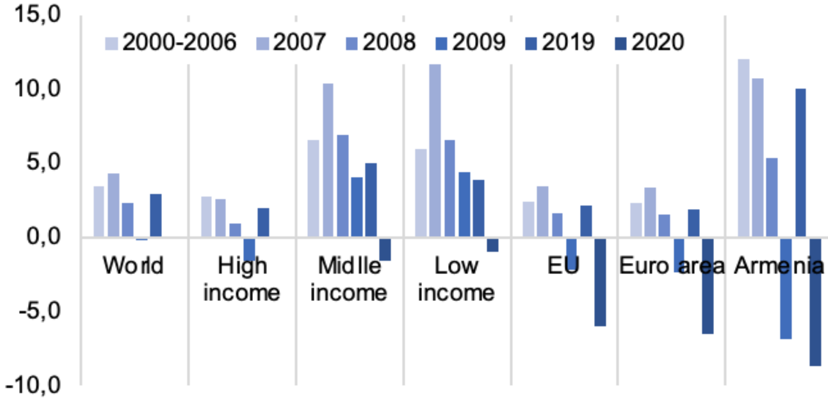


Source: World Bank Database – https://databank.worldbank.org/ .

At the same time, it should be noted that global production during the COVID-19 pandemic declined less than during the global financial crisis (see Fig. 3). In particular, the production sector in Armenia declined slightly, while the growth rate was only -2.5%, in 2009, following the global financial crisis, the growth rate of the manufacturing sector was -28.6%. However, the services sector has slowed down significantly more than we see during the period of the global financial sector crisis (see Chart 4). Armenia's performance stands out as the worst in this sector against the background of the considered groups of countries. While in the European Union the growth rate of the services sector decreased to -6%, and in the Eurozone to -6.5%, in Armenia this figure was -8.7%.

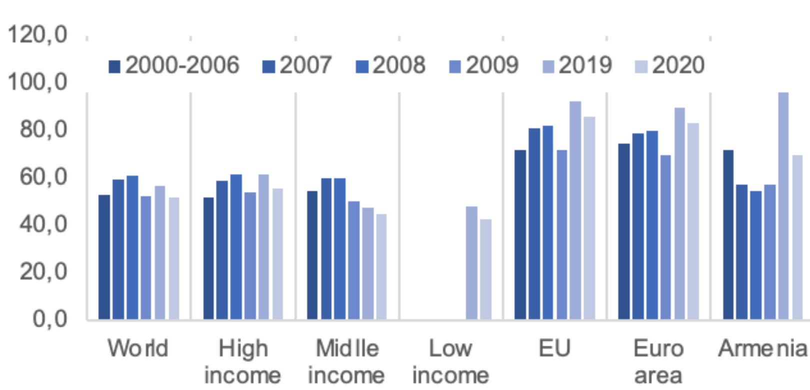
The trade sector has suffered the most. In Armenia, the trade sector shrank by about 20%. Comparing this indicator with a group of countries with high, middle and low incomes, as well as countries of the European Union and the Eurozone, Armenia shows the worst results. Especially considering that in Armenia the lockdown was announced for only a few months, while in most countries of the world the economy was frozen for a much longer period, which undoubtedly had a negative impact on the trade turnover. Such a reduction in the trade sector can also be explained by the Second Artsakh War, which, in addition to severe economic and social consequences, also increased the state of uncertainty among the population, impacting consumer spending and, accordingly, trade turnover in the country.

FIGURE 4. **Services, value added (annual % growth) during the global financial crisis and during the COVID-19 pandemic**



Source: World Bank Database – https://databank.worldbank.org/ .

FIGURE 5. **Trade during the global financial crisis and during the COVID-19 pandemic (% of GDP)**



Source: World Bank Database – https://databank.worldbank.org/ .

Thus, the total output of Armenia, and of most countries of the world, has significantly decreased in the context of the COVID-19 pandemic, which will certainly require significant efforts for further economic recovery. At the same time, one should take into account the limited resources of both the Armenian economy and the state budget, which will further complicate and slow down the process of economic recovery.

3. Social consequences

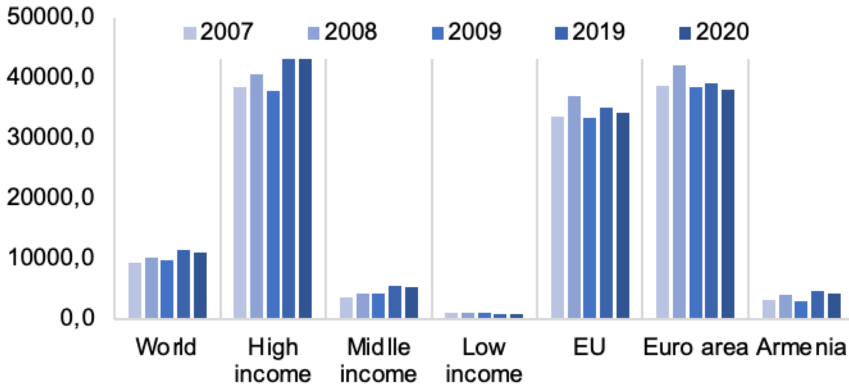
The consequences of the COVID-19 pandemic for the total output was bound to have a negative impact on the social sphere of life of the population of Armenia. Since the period of the global financial crisis, the standard of living and the level of GDP per capita in Armenia have not shown significant improvement. The COVID-19 pandemic, and the consequences of the Second Artsakh War, further aggravated the situation with low incomes in the country.

As we can see in Figure 6, the level of GDP per capita in Armenia is included in the middle-income group. During the global financial crisis, the level of GDP per capita in Armenia decreased significantly, while the reduction in this indicator in 2020 is rather insignificant. The same picture can be seen all over the world. However, it should be noted that the real consequences for the incomes of the population will manifest themselves in the coming years, since various state support programs were implemented in 2020 in almost all countries in the world.

In terms of price levels, Armenia ended 2020 in deflation, but already in 2021 inflation was 13%, which will undoubtedly affect the standard of living of the population both in 2021 and in the coming years. Forecasts for 2022 in terms of inflation are also disappointing.

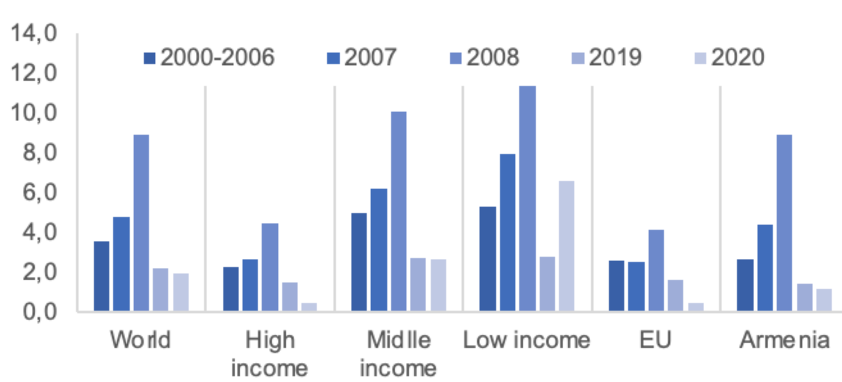
The COVID-19 pandemic has forced employers and governments to reconsider their approaches to organizing and regulating the labour market. As elsewhere in the world, Armenia is experiencing a reduction, if not a complete freeze, in some sectors of the economy, which has certainly led to a reduction in jobs.

FIGURE 6. **GDP per capita during the global financial crisis and during the COVID-19 pandemic, $**



Source: World Bank Database – https://databank.worldbank.org/ .

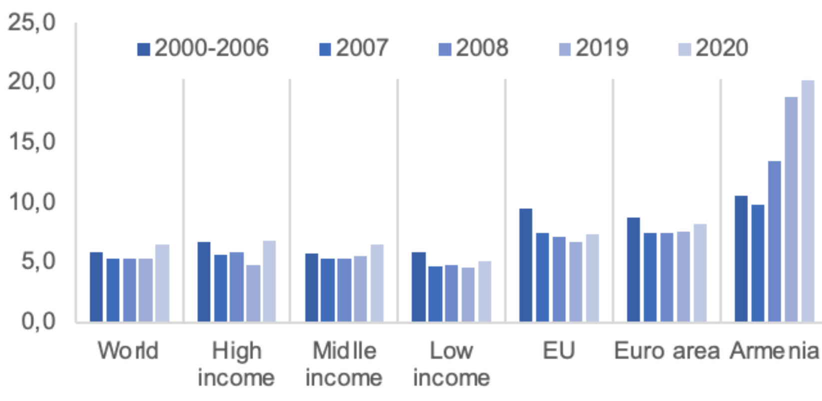
FIGURE 7. **CPI during the global financial crisis and during the COVID-19 pandemic, %**



Source: World Bank Database – https://databank.worldbank.org/ ,

IMF Database – https://www.imf.org/ .

FIGURE 8. **Unemployment during the global financial crisis and during the COVID-19 pandemic, %**



Source: World Bank Database – https://databank.worldbank.org/ .

The decline in employment has led to some increase in unemployment. However, unemployment figures do not show very significant growth. This can be explained to some extent by a rather remarkable outflow of the population from the country after the war, and by the significant loss of human lives both during the war and due to COVID-19. In 2020, the unemployment rate in Armenia amounted to 18.2%, and it stood at 16% in the first three quarters of 2021. However, at the moment it is too early to judge the real consequences of the current crisis for the labour market, since it is obvious that the economy of both the world and individual states will undergo some transformation. And it can be argued that some sectors of the economy will inevitably either shrink to a minimum or disappear altogether, which will entail a new unemployment figure. Obviously, this will affect the tourism and hotel services, restaurant and related business, trade, as well as some other sectors of the economy.

4. Public policy

Most countries around the world pursued a policy of stimulating the economy, especially during the first period of the pandemic. On average around the world, the volume of budget subsidies ranged from 2% to

10% of GDP. Of course, developed economies had more opportunities to support the economy at the expense of the state budget. Aid in general was aimed at both social needs and support for the real sector, especially those sectors of the economy that were most affected by the lockdown.

The anti-crisis policy in the context of the pandemic in the whole world was approximately identical. Most countries poured money into the economy. Other mechanisms to deal with the effects of the pandemic are in the process of being developed and tested. For example, the EU adopted economic measures from the beginning of the crisis, among which should be noted the actions of the European Central Bank (ECB) to guarantee liquidity, in particular, under the Pandemic Emergency Procurement Program (PEPP) in the amount of 750 billion euros, as well as the creation by the European Commission of the Coronavirus Response Investment Initiative, transferring a total of 37 billion euros from other EU budget lines[1].

Almost at the beginning of the pandemic, the Government of the Republic of Armenia developed an anti-crisis program, which consisted of 22 key measures aimed at supporting the social and economic situation in the country. There were essentially two main sets of measures[2]: Measures to neutralize the economic consequences of the coronavirus and measures to neutralize the social consequences of the coronavirus. According to expert estimates, the volume of state support amounted to 150-160 billion AMD, or about 2-3% of the GDP. According to the results in the first two months of the implementation of the anti-crisis program, 84.4 billion drams had been distributed (Eurasian Economic Commission, 2005). The implemented activities did not bring sufficient effect, neither in terms of social support, nor in terms of supporting the real sector.

The measures taken to some extent managed to soften the blow from the economic consequences in the first stage of the pandemic. According to some studies, the number of firms in Armenia whose turnover has

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[1] ECB's dedicated website, URL: https://www.ecb.europa.eu

[2] https://www.gov.am/ru/covid19

decreased as a result of the COVID-19 crisis was almost 90% for 2020 (World Bank, 2020). However, anti-crisis measures also had significant shortcomings. Most of the measures were targeted, which, in theory, should have covered all those in need. However, poor administration resulted in many potential beneficiaries not receiving the assistance they were entitled to. Among the gaps, it is also worth noting the asymmetry of information, when not all potential beneficiaries were sufficiently informed about the availability of assistance.

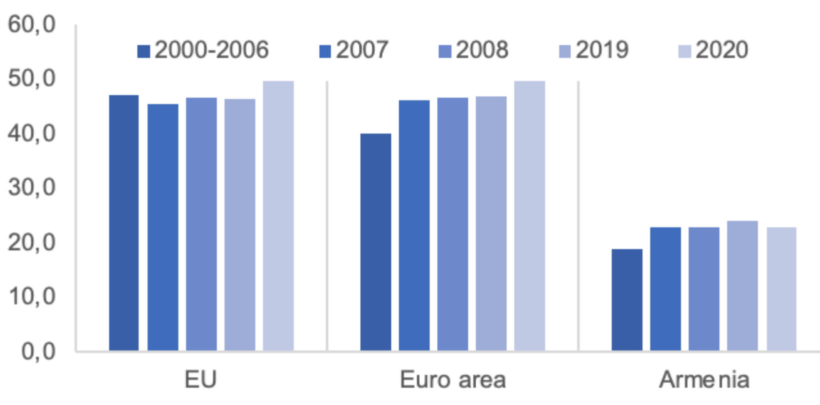
The maximum amount of financial assistance to enterprises amounted to 500 million drams (about 1 million US dollars). The additional SME support program introduced was targeted at the tourism, agriculture, food and manufacturing sectors. Small and medium-sized enterprises were given the opportunity to borrow from 2.5 to 50 million drams with a six-month grace period and no interest in the first two years (and 12% interest charged in the third year). In the first half of 2020, 744 enterprises resorted to such loans, and the total amount of loans amounted to about 17 million US dollars.

Sectoral measures include assistance in the form of interest rate subsidies and co-financing mechanisms in agriculture. At the same time, producers of grapes and wine and cognac enterprises were given the opportunity to receive loans, with the condition of full coverage of interest. In some sectors, the state covered loans in the amount of 75% of the total.

As elsewhere in the world, the expansion of government spending has led to an increase in the budget deficit and in public debt. Among the key items of the expenditure part of the budget, which increased the most, the expenditure on social protection of the population, as well as defence expenditure, in connection with military operations during the Second Artsakh War, should be noted. Public sector spending increased significantly, which was due to anti-crisis measures.

At the same time, as we can see in Figure 9, public spending over GDP increased markedly in the EU and the Eurozone, while in Armenia this figure fell in 2020, despite a significant increase in public spending during this period. Public spending in Armenia dropped 1%, while in the European Union and the Eurozone, public spending increased by about 7-8%.

FIGURE 9. **Government spending, % of GDP**



Source: Database of NSS of RA – www.armstat.am,
Database of Eurostat – https://ec.europa.eu/eurostat .

At the same time, government spending in the Armenian budget in the first three quarters of 2021 is almost equal to the total indicators for 2020, which allows us to conclude that government spending in 2021 grew significantly.

As in the rest of the world, the increase in public spending resulted in significant public debt increase of the Government of the Republic of Armenia (see Figure 10). The public debt of Armenia began growing in 2008 and continued throughout the subsequent period, until 2021. The cumulative increase in public debt in the world in 2020 compared to 2019 was 15%, in the European Union it was 7.2%, in the Eurozone it amounted to 14%, and in Armenia it stood at 13.8%. At the end of 2020, the level of the total public debt of Armenia amounted to 62.8% of GDP, and according to experts' forecasts for 2021, this figure will be 69.9% of GDP.

It should be noted that the dominant part of the public debt of Armenia is external borrowing, which at the end of 2020 stood at 51.2% of GDP[3]. At the same time, the policy of the Government of Armenia in the field of state regulation has led to a significant increase in domestic debt, which at the end of 2020 amounted to 16.1% of GDP.

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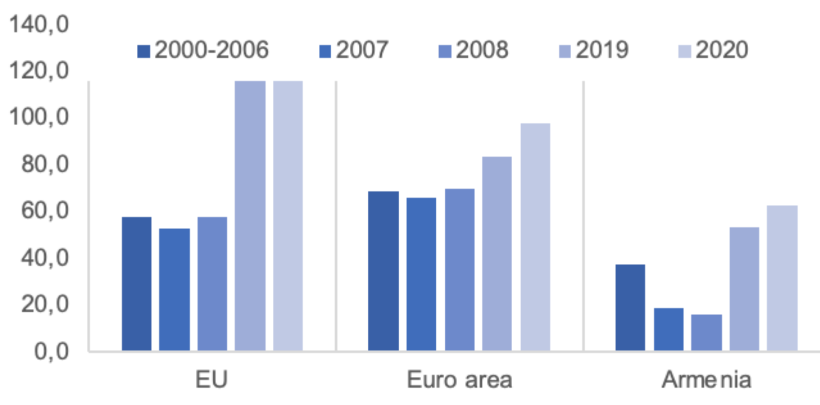
[3] Database of the RA National Statistical Service – www.armstat.am

FIGURE 10. **Public debt, % of GDP**



Source: Database of NSS of RA – www.armstat.am,
Database of Eurostat – https://ec.europa.eu/eurostat .

Of no small importance are the volumes of external debt over the whole economy, which have also increased in the last two years. At the end of 2020, the total debt of the economy amounted to 85% of GDP. Thus, in the last two years the indicators of borrowing both from the state and from the economy as a whole have significantly increased.

5. Conclusions

Summarizing the above analysis, it should be noted that, of course, Armenia, like all other global economies, suffered the remarkable consequences of the coronavirus pandemic in 2020-2021. However, at the moment it is too early to assess the real impact of the implementation of quarantine measures on economic growth and development in Armenia and in the world. Given the degree of uncertainty associated with the end of the pandemic, it is difficult to draw any firm conclusions about the extent of the economic and social impact of the COVID-19 crisis in the foreseeable future. The impact is likely to be long-term and will require significant regulatory intervention to sustain and restore the economy in the medium and long term. On the other hand, if developed economies are able to actively intervene in the economy and adopt various programs to subsidize and stimulate some parts of the real sector, then developing countries will face a serious budget deficit for these purposes.

Armenia in this sense is already in a rather difficult situation. The solution to the current situation can only be a reform policy that will affect all sectors of both the real sector and regulatory mechanisms on the part of the state. Only cardinal changes in the country's institutional environment can help overcome the consequences of both the COVID-19 crisis and the Second Artsakh War in 2020.

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European Integration of the Republic of Moldova: Crisis and Resilience after the Covid-19 Pandemic

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ABSTRACT: There is no place on earth today where the pandemic is not discussed, there is no place that has not been impacted by Covid 19. The sphere of international cooperation, including the countries which are preparing to join the European Union, illustrates how countries are embracing this global challenge.

The Coronavirus pandemic has created unprecedented problems in socio-economic life, both within the country and in relations with other states. A destructive impact of COVID-19 on the process of European integration of the Republic of Moldova also took place.

Keywords: European Integration, COVID-19, crisis, International trade, cooperation

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1. Introduction

The coronavirus pandemic has changed the normal way of life and the socioeconomic situation of citizens of many countries in the world, and the Republic of Moldova is no exception to that. Issues related to the pandemic and its impact remain relevant and need to be addressed.

The problems faced by governments before have been exacerbated by disruptions in supply chains that have left businesses struggling to survive. Wage cuts and workers being sent on self-funded leave have caused loss of income and livelihoods.

Note that countries around the world are facing a crisis. The priorities of all governments have shifted towards improving the readiness of health systems and taking emergency measures to support vulnerable populations. The effects of measures taken by businesses and government agencies to overcome the current situation are offset by the unfolding economic crisis, which has aggravated their vulnerability and has impact severely on productive capacity, institutional flexibility and entrepreneurial confidence. Restrictive measures around the world have had a negative impact on social and economic cooperation between countries. Thus, the study on the size of the impact of COVID-19 on European integration processes is very relevant.

The main goal of the work was to study the impact of the coronavirus pandemic on the status and trends of European integration and cooperation between the Republic of Moldova and the EU.

The key indicators of the status and trends in the development of international trade of the Republic of Moldova in the context of COVID-19 are given. The main key problems with the way the European integration of the Republic of Moldova is being conducted are outlined. The authors also highlight the issue of the European Union aid granted to the Republic of Moldova to overcome the consequences of the pandemic on the economy of the country.

The study concluded that the COVID-19 pandemic had serious economic and social consequences for the Republic of Moldova, the possibility of economic recovery was justified, and it was also revealed that, during the crisis, the EU countries were the best partners of the Republic of Moldova and provided a substantial humanitarian support.

2. Trends in the Development of Relations between the Republic of Moldova and the European Union

There are clear requirements and procedures for the extension of the European Union, and Moldova may at some point become formally part of the EU. However, actual experience has shown that this process is very long and laborious.

Nevertheless, Moldova is an integral part of the economy of the European Union in the context of the Eastern Partnership (this also includes Azerbaijan, Armenia, Belarus, Georgia and Ukraine) which the country joined in 2009. However, participation in the Eastern Partnership program does not imply and does not aim at full integration into the European Union.

Moldova does not have a clear prospect of joining the European Union, because our country has not received, so far, the status of a candidate country, but processes have been launched that help integrate, especially at the economic level (Carabet, 2021).

However, as stated on the official website of the Ministry of Foreign Affairs and European Integration of the Republic of Moldova, with the implementation of the Association Agreement, the liberalization of the visa regime and the gradual integration into the EU internal market, the de facto integration of the Republic of Moldova into the European political and economic space is taking place. The government is fully committed to the goal of modernization and development of the Republic of Moldova, which is offered through the European integration (Ministry of Foreign Affairs and European Integration of the Republic of Moldova, 2022).

At the moment, many agreements have been signed, one of the most significant being the Association Agreement between Moldova and the European Union (Azarenkova, 2018).

The legally binding basis for EU-Moldova relations is the Partnership and Cooperation Agreement which was signed on 28 November 1994 and entered into force on 1 July 1998 for an initial 10-year period, renewable by default.

The next step in the tightening of relations was the Republic of Moldova-European Union Action Plan developed within the framework of the European Neighbourhood Policy. The Individual Action Plan European Union – Moldova was signed on February 22, 2005 in Brussels within the framework of the Seventh Congress of the Cooperation Council of the Republic of Moldova – EU. The Action Plan set strategic goals for cooperation over a period of three years, which were subsequently re-expanded.

In June 2014, Moldova signed an Association Agreement and a Deep and Comprehensive Free Trade Area with the EU, which entered into force on July 1, 2016. Also, in 2014, some officials predicted that Moldova would become a full member of the EU in 2020. This agreement focuses primarily on deepening political and economic relations between the European Union and Moldova, with an eye on Moldova's integration into the EU.

In August 2017, a new association agenda for 2017-2019 was approved, containing short-term priorities and the framework for cooperation between the Republic of Moldova and the EU.

Attempts to implement the Association Agreement brought us closer to the European Union:

- Over 60% of our exports go to the EU. And 50% of imports into Moldova come from the European Union;
- A visa-free regime for citizens of the Republic of Moldova; although there is an opinion that, for countries outside the European Union, this is not a payment for European integration aspirations, but simply easing the receipt of cheap labour by European countries. However, since the liberalization of the visa regime, 2.4 million citizens have travelled to the European Union on their biometric passports, with more than 9.1 million cases of crossing the border when leaving the country.

– The European Union remains the main development partner of the Republic of Moldova, offering more than 360 million euros in 2020 alone under various assistance programs, including regional programs (Groza et al., 2021).

3. European Integration of the Republic of Moldova in the Context of Covid-19

First of all, COVID-19 brought to the surface the contradictions between European values and the nationalization of the interests of some states in the European Union. Individual interests in some European countries have muted common European values, and vice versa in others. This trend, above all other reasons, may become a factor in the reluctance of some European countries to further the process of European integration.

The situation with COVID-19 has shown that the European Union needs structural changes. The Schengen area periodically does not function, national economies are shaking, and the domestic market has begun to experience hard times. Europe was not ready for a cross-border crisis.

In this context, the European Union, quite justifiably, approaches further enlargement very carefully. New members in the EU are likely, but they will appear slowly and with a very strong eye on the careful evaluation of the results that such cooperation will generate.

In recent years, the frequency of shocks in the Republic of Moldova has increased, which is primarily caused by the processes associated with the pandemic, crises have practically become the new state of affairs, thus the framework of cooperation with the EU has become even more important.

For the Republic of Moldova, the restrictive measures triggered by the pandemic also gave rise to some processes that raised concerns about the path of the European integration.

The remote economy, which has intensified under the current conditions, in addition to new technology, can also lead to deepening of inequality, polarizing people with more skilled labour. Thus, the crisis in 2008-2009 produced commodity globalization, but after the current one, digital and financial globalization will accelerate. It is no secret that the Republic of Moldova has a significantly worse performance in these areas than most EU countries, which puts it in a rather unfavourable position.

A serious problem continues to be the unresolved Transnistrian conflict and the uncertainty of the status of the Pridnestrovian Moldavian Republic (PMR). Here it is appropriate to mention the coronavirus pandemic, which also complicates and slows down all kinds of processes taking place in the country, including negotiations with the leadership of Transnistria.

In addition, in the cooperation between Moldova and the European Union during the pandemic, positive trends are characterized by a number of significant events:

- Since November 2021, the Moldovan vaccination certificate has been recognized by the European Health Commission, as well as the test certificate, which has facilitated the movement of citizens of the Republic of Moldova in the Schengen area;
- More than 127 million euros were allocated by the European Union to support measures to combat the COVID-19 pandemic crisis and its consequences (Groza et al., 2021).

Therefore, it all depends on the speed at which Moldova meets all of the requirements outlined in the Association Agreement and consolidates its success. Only then will Moldova be ready to receive a European perspective. So far, it is a long way from this. At the same time, seven years of implementation of the Association Agreement have brought us closer to the European Union. This is evidenced by a number of significant facts:

- more than 60% of our exports go to the EU. And more than 45% of imports come from the European Union to Moldova;
- The EU actively promotes economic growth and job creation in Moldova;

- Structural reforms continue to stabilize the financial sector, including with the support of the European Union. In the field of public finance, in April 2021, the authorities issued for the first time 7-year government bonds with a fixed interest rate of 6.5% per annum. Prior to this year, bonds were issued for a period of 2 to 5 years. Extending the maturity of government bonds should grant authorities more flexibility;
- Road repair with EU funds;
- Optimization of public transport in Chisinau and Balti;
- New drinking water supply system was installed with the support of the EU;
- The EU is trying to support the strengthening of democratic standards, the rule of law and efforts to eradicate corruption in the highest echelons of power in Moldova;
- In 2019, an 8-million-euro program was launched to prevent corruption;
- The EU continues to actively support the development of civil society in Moldova.

As noted earlier, the Republic of Moldova has a number of unresolved issues on the path to of integration into the European Union. At the present stage, however, negotiations are underway to adopt the agenda for 2021-27. This will be the development of an action plan, but with more specific measures that the EU and Moldova have agreed to implement in order to fulfil the association agreement. The EU and Moldova meet every year to assess the implementation of these actions.

4. Assessment of International Trade Indicators in the Republic of Moldova in the Context of COVID-19: Strengthening of the European direction

During the crisis, the standard of living of the population of Moldova deteriorated significantly, which was hindered the development of the domestic market, and, accordingly, hindered the economic growth of the republic. In this regard, the recovery of the economy of the Republic of Moldova becomes possible through the development of international trade, especially the orientation of producers to the foreign market, and the subsequent increase in exports.

The Covid-19 pandemic has caused a major disruption to global trade, as production and consumption across the world have dropped significantly. First of all, total uncertainty has become an obstacle for international business, making it impossible to predict demand and plan production volumes. Protectionism in international trade has increased.

Open trade, while facilitating higher growth, leads to higher income, which contributes to the reduction of poverty and, consequently, to an increase in the level of GDP. The development of international trade increases access to capital and technology, and through increased productivity, also leads to higher living standards, including in developing countries. Trade can also help reduce inequalities by lowering the price of common foods consumed mostly by the poor (Faijgelbaum and Khandelwal, 2016).

Maintaining international trade flows in Moldova, as a low-income country with a rather weak healthcare system amid the impact of Covid-19, is paramount both to save lives and livelihoods.

Consider the dynamics of the main foreign trade indicators in the period from January to October for 2019-2021, both in absolute amounts of US dollars and in specific gravity in tables 1,2,3 for 1992-2002.

Evaluation of export and import indicators of the Republic of Moldova for the period under review shows unstable dynamics. Thus, total imports in 2020 compared to 2019 decreased by almost $473 million, and the reduction in exports in this period amounted to more than $307 million. The decline in foreign trade indicators had an indirect impact on the decline in the same period of the country's GDP by 7%, despite the fact that at the beginning of 2020 there were expectations of 3.2% increase in this indicator. Undoubtedly, the main reason for this was the restrictive measures caused by Covid-19.

The largest share of exports belongs to the EU countries which grew from 63.69% to 66.56%, and the smallest is represented by the CIS countries (mainly the Russian Federation and Ukraine), which experienced growth of no more than 15.5% in this period. Exports in the rest of the world in 2020 compared to 2019 decreased from 20.85% to 18.08%. Considering the share of imports, it can be noted that in European countries it amounted to almost 49% in 2019, and decreased to 45.83% in 2020. The share of imports to the CIS countries is also the smallest in this period, which amounted to just a little over 24%. Accordingly, the share of imports to the rest of the world in 2019 was 27.13%, and by 2020 it had increased to 29.52%.

It should be noted that the trade balance (export-import) in the specific gravity is positive for the countries of the European Union alone, and moreover, the excess of exports over imports to this country in 2020 increases from 14.83% to 20.73%. With all other countries, the trade balance is negative, i.e. imports outweigh exports. These dynamics allows us to conclude that, during the period when the most restrictive measures were adopted, the Republic of Moldova developed highest-quality trade cooperation with the European Union countries.

TABLE 1. **International goods trade of the Republic of Moldova by countries and groups of country in January-October 2019**

Countries of the Cooperation	**Export**		**Import**		**Trade balance (Export– Import)**	
	Amount, thousand US dollars	**Share, %**	**Amount, thousand US dollars**	**Share, %**	**Amount, thousand US dollars**	**Deviation in specific gravity, % points**
Total	**2294320,13**	**100**	**4798692,63**	**100**	**-2504372,5**	-
CIS countries-total	**354740,98**	**15,46**	**1152602,79**	**24,02**	**-797861,81**	**-8,56**
Incl. The Russian Federation	202793,21	8,84	547754,29	11,41	-344961,08	-2,57
Ukraine	65619,08	2,86	477622,96	9,95	-412003,88	-7,09
European Union countries – total	**1461288,11**	**63,69**	**2344405,6**	**48,86**	**-883117,49**	**14,83**
Incl. Italy	225728,97	9,84	336243,34	7,01	-110514,37	2,83
Romania	642132,56	27,99	701357,34	14,62	-59224,78	13,37

Other countries of the world – total	**478291,04**	**20,85**	**1301684,24**	**27,13**	**-823393,2**	**-6,28**
Incl. China	14407,51	0,63	493371,69	10,28	-478964,18	-9,65
Turkey	158573,43	6,91	323158,84	6,73	-164585,41	0,18

Developed by the author based on data from the National Bureau of Statistics // Foreign Trade (gov.md), https://statistica.gov.md/category.php?l=ru&idc=336&.

In 2021, restrictive measures around the world were significantly eased. Accordingly, this had an impact on the results of Moldova's foreign economic activity. Thus, exports in January-October increased to 2,455,618.68 thousand US dollars, and imports to 5,718,897.88 thousand US dollars. Predominant cooperation with the countries of the European Union has been stably preserved in this period. Also, exports to these countries exceed imports by more than 16 points.

TABLE 2. **International goods trade of the Republic of Moldova by country and group of countries in January-October 2020**

Countries of the Cooperation	**Export**		**Import**		**Trade balance (Export–Import)**	
	Amount, thousand US dollars	**Share, %**	**Amount, thousand US dollars**	**Share, %**	**Amount, thousand US dollars**	**Deviation in specific gravity, % points**
Total	**1986828,82**	**100**	**4325799,3**	**100**	**-2338970,5**	**-**
CIS countries-total	**305089**	**15,36**	**1066316,18**	**24,65**	**-761227,18**	**9,29**
Incl. The Russian Federation	179009,71	9,01	472842,78	10,93	-293833,07	-1,92
Ukraine	51857,65	2,61	432121,74	9,99	-380264,1	-7,38
European Union countries – total	**1322453,75**	**66,56**	**1982594,61**	**45,83**	**-660140,86**	**20,73**
Incl. Italy	169 895,62	8,55	277 658,81	6,42	-107 763,19	2,13
Romania	565 499,32	28,46	513 670,18	11,87	51 829,14	16,59
Other countries of the world – total	**359 286,06**	**18,08**	**1 276 888,51**	**29,52**	**-917 602,45**	**-11,44**
Incl. China	9 542,40	0,48	508 457,32	11,75	-498 914,92	-11,27
Turkey	129 835,78	6,53	302 650,34	7,00	-172 814,56	-0,47

Source: Developed by the author based on data from the National Bureau of Statistics // Foreign Trade (gov.md), https://statistica.gov.md/category.php?l=en&idc=336&.

Such positive cooperation characterizes, first, the effectiveness of the Association Agreement, which implies not only the mutual opening of markets for trade in goods and services, but also the gradual adoption of European standards and norms governing the quality of relevant products and services.

The existing problems of the Moldovan economy, as well as the presence of territorial conflicts, have become key factors underpinning its development, lagging behind the European countries. As one of the poorest European countries, Moldova, nevertheless, tries to strengthen its positions in international trade in goods and services, including trade with European countries.

TABLE 3. **International goods trade of the Republic of Moldova by country and group of countries in January-October 2021**

Countries of the Cooperation	Export		Import		Trade balance (Export–Import)	
	Amount, thousand US dollars	Share, %	Amount, thousand US dollars	Share, %	Amount, thousand US dollars	Deviation in specific gravity, % points
Total	**2455618,68**	**100**	**5718897,88**	**100**	**-3263279,2**	-
CIS countries -total	**372 346,45**	**15,16**	**1 435 080,00**	**25,09**	**-1062733,6**	**-9,93**
Incl. The Russian Federation	221850,67	9,03	751567,13	13,14	-529716,46	-4,11
Ukraine	73988,65	3,01	539846,45	9,44	-465857,80	-6,43
European Union countries – total	**1507209,78**	**61,38**	**2589041,92**	**45,27**	**-1081832,2**	**16,11**
Incl. Italy	192746,73	7,85	366018,07	6,40	-173271,33	1,45
Romania	653704,50	26,62	687971,20	12,03	-34266,70	-12,03
Other countries of the world – total	**576062,45**	**23,46**	**1694775,96**	**29,63**	**-1118713,5**	**-6,17**
Incl. China	10357,58	0,42	665041,90	11,63	-654684,32	-11,21
Turkey	238363,60	9,71	426756,74	7,46	-188393,14	2,25

Source: Developed by the author based on data from the National Bureau of Statistics // Foreign Trade (gov.md), https://statistica.gov.md/category.php?l=en&idc=336&.

5. Conclusion

Despite the difficulties caused by COVID-19 for global cooperation, today we can safely say that relations between the European Union and the Republic of Moldova are progressing well. Moreover, according to the economic indicators of mutual cooperation between Moldova and the European Union, such relations evolved quite favourably.

The main reason for the integration of Moldova into the European Union is the expected improvement not only for the economy, but also in the political situation of the country, especially with regards to democratic freedom.

Also, joining the European Union is attractive due to the social privileges that the EU countries enjoy: a high level of social protection, life expectancy, and many others.

Moldova, in comparison with other European states, has rather poor economic indicator. The country suffers from population exodus. Political criteria are also far from meeting EU standards.

It must be understood that achieving certain indicators in all of these areas is the opportunity for Moldova to join the European Union. We cannot count on that until the existing obstacles have been removed.

Moldova must resolve its territorial disputes and significantly improve diplomatic relations with Transnistria.

Determining the country's foreign policy also plays a huge role in the process of European integration. Thus, the change of power in Moldova brought the country's foreign policy back into the context of European integration. In contrast to the period when President Igor Dodon was in power, whose policy could be considered pro-Russia.

There is also the idea of uniting Moldova and Romania, which would significantly facilitate the process of European integration and accession of Moldova into Romania and the European Union, respectively. However, we note that a significant part of the population of Moldova does not support this idea. It is also important to note that despite the good relations with Romania, Moldova has repeatedly stated that it expects to become a member of the European Union directly through Brussels, and not through the mediation of Bucharest, whose authorities promote the idea of unionism.

The main driver in the process of developing European integration is that, in 2021, citizen confidence in the European Union has increased. According to the IPRE report in November 2021, more than 57% of the citizens of the Republic of Moldova support the accession of the Republic of Moldova into the European Union.

However, Moldova's accession depends not only on itself. Of course, the key role is played by the extent which Moldova fulfils its obligations to comply with the rule of law. Furthermore, the European Union has clear rules on this matter. So far, for the coming years, Europe is focusing on the entry of only candidate countries. Moreover, circumstances, including COVID-19, are making the process of joining the European Union increasingly difficult. Therefore, it will be harder for us than, for instance, for Poland or Romania, which joined the EU in the early 2000s.

Despite the fact that Moldova does not have a clear prospect of accession, this does not mean that Moldova should lose faith. For the time being, Moldova has a lot of hard-to-implement tasks and work to do. However, it is obvious that, in all directions, the relations with EU members are evolving in the best possible manner.

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PART IV:

THE VIEW OF THE REST OF THE WORLD

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Covid-19 Aftermath in Russia

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Abstract: This chapter analyses and estimates the main macroeconomic indicators affected by the Covid-19 recession in Russia. The study applies the ARIMA model to estimate GDP growth, trade balance, exchange rate, inflation, and unemployment rate, on Brent prices in Covid-19 aftermath. The indicators were chosen based on the highest impact of oil prices on them, on which the Russian economy is highly dependent. According to the results of the ARIMA model, the oil prices will continue to impact GDP growth, trade balance and exchange rate, with an indication of recovery in the next 10 months. The biggest challenge for the Russian economy in the Covid-19 aftermath will

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concern ruble volatility and international constraints (sanctions and international political pressures), which significantly affect the macro and business environment.

Keywords: Covid-19; aftermath; macroeconomic indicators; oil price; Russia

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1. Introduction

Russia's economy has been impacted by a recession caused by the Covid-19 pandemic, as was also the case of a large number of global markets. While the European Union (EU) has introduced solidarity funds to help its members weather the crisis, Russia's strategy is based on its own funds and policies, burdened by the sanctions applied by the EU, Great Britain, and the United States. Besides, the Russian economy is also dependent on the production and global commodity prices (primarily oil and gas), further complicating the strategy of economic policy in the initial shock of the Covid-19 recession. Given this situation, the Covid-19 aftermath in Russia is more challenging compared to the EU.

This chapter analyses the impact of the Covid-19 recession on the Russian economy and predicts its aftermath for main macroeconomic indicators, considering the dependence of the economy primarily on oil and gas prices. The objective of the chapter is to empirically test and estimate this nexus in the Covid-19 aftermath. The chapter begins by explaining the methodology and presents the results of the analysis (sections 2 and 3). First, this chapter explains the impact of the Covid-19 crisis on Russia, compared with neighboring European countries (section 1). At the end of the chapter, we draw some conclusions (section 4).

The first quarter of 2020 marked the beginning of a recession caused by the Chovid-19 pandemic almost worldwide. The initial shock brought financial market index prices down dramatically. For example, DJIA trimmed 40 percent from 29.348 on Feb. 19th to 18.591 on March 23rd, 2020, while S&P 500 cut back from 3.386 to 2.237 (according to MarketWatch, 2020; Vukovic et al., 2021; and S&P Global, 2020). Global demand has fallen sharply, strongly affecting the decline of almost all economic spheres, globally. The Covid-19 recession quickly spilled over into Russia, affecting first the oil and gas industry. At the same time, oil price war between Russia and Saudi Arabia caused the collapse of West Texas Intermediate futures for the first time from $17.85 a barrel to – $37.63 (Blas & Kennedy, 2020). BRENT suffered a similar situation, dropping to an average of $41.73 in 2020 (Chornenka et al., 2022). Bearing in mind that the Russian economy is mostly dependent on oil and gas exports, the Covid-19 recession has affected all areas of the Russian economy.

The negative impact of the global recession on the Russian economy was largely determined by the internal causes and peculiarities of its structure, with a strong dependence on exports of the raw materials industries. Sharp changes in oil prices during the Covid-19 led to the deterioration of the prices of oil and gas company stocks, which resulted in a decrease in the value of the companies and in domestic financing. The OPEC-related cuts to oil output shaved about 2% of Russia's GDP, the damage having spread over Q2 and Q3. GDP dropped 4.3% year on year in August. However, Russia suffered a smaller shrinkage than most major economies in the second quarter of 2020, GDP having dropped 8%. Some countries in Eastern Europe were faced with a similar situation. For example, GDP in Ukraine also decreased 8% in Q2 2020. In the same period, GDP in Spain was down 21.5%, Italy and France's GDP decreased around 18%, and in Austria and Belgium it dropped around 14% (Bolińska et al., 2022).

Russian Covid-19 recession is resulting from the sharp decline in the price of oil and the financial sanctions, unlike 2008-09 global financial crises, resulting in a sharp deprecition of the Russian currency Ruble. The Russian ruble crisis has implications for the companies and international investors in terms of demand, production level, political risk, dollar debts and others. With rising political risk, this challenge is largely impacting the value of the ruble.

In addition to the great impact of the decline in economic activity in Russia in the first half of 2020, due to the impact of the decline in oil price, small and medium-sized companies were also challenged during the crisis. These companies are based oncapital-intensive, financial, and manufacturing industries (Spitsin et al., 2022). On the other hand, all Russian companies located in the defensive industries (such as chemicals, food production, pharmaceuticals, and medical) reported sales growth (Drobot et al., 2020). Nevertheless, these industries are not the main growth drivers in Russia. Russian industry is mainly based on the export of raw materials, refining of oil and its derivatives, as well as the production of machinery.

Therefore, the defensive industries could not mitigate the negative effects of falling oil prices on the Russian economy. According to Ali et al. (2022), the Russian economy and its largest companies are very dependent on the oil price, creating spillovers (Brada et al., 2021) on the Russian ruble and economic policy. Furthermore, Ali et al. (2022) recently found that the Russian market and economy is significantly impacted by the Covid-19 period (including the oil price war between Russia and Saudi Arabia) with effects on the price of oil in both small and large scale. Their findings, supported by use of the wavelet-based Granger causality approach, are confirmed after a number of studies conducted previously by Jalolov and Miyakoshi (2005), Saleem and Vaihekoski (2010), and more.

In other Russian neighbour countries, the situation differed. In Baltic area countries, the impact of Covid-19 recession was strong, while Poland succeeded to avoid a falling contraction in output (Brada et al., 2021). Eastern European countries faced recession shock affecting shortfalls in all production factors (labor-capital-technology), with strong decline in output. According to Orlowski (2020), this situation decreased investment due to the reason that slump lowers the capital-labor ratio. Herewith, research and development decreased, together with investments in capital-intensive industry. Their recovery in the aftermath of the crisis will not be the same in all countries and depend mostly on the level of corruption, market structure and strategies (Brada et al., 2021; Iyer et al., 2014). Consequently, Brada et al. (2021) find that their regional spillovers will be strong due to the Covid-19 situation. Such a situation can be described as a common factor in Eastern Europe and Russia, resulting in the clustering of both high-performing and low-performing zones.

On the other hand, there is a significant difference in the post-Covid-19 period between Russia and Eastern Europe. Russia can only count on its own funds and independent strategy in the Covid-19 aftermath (like the Russian Direct Investment Fund – RDIF), while Eastern European countries (EU members) are supported by EU funds, focusing on structural change and flexibility (like EU solidarity instrument SURE initiative). Numerous studies show several effects of the Covid-19 aftermath. Sharif et al. (2020) addresses the aftermath with a focus on the geo-political risk of a country, while Brada et al. (2021) suggest regional effects of geo-political risks during and after Covid-19.

2. Data and method

To test dependency of main Russian macro indicators (GDP growth, trade balance, exchange rate and unemployment rate) on Brent prices, and to forecast their movement in the aftermath of Covid-19, the study uses autoregressive integrated moving average (ARIMA) model. The sample data are collected from the Thomson Reuters Eikon terminal (2022). The time series model is developed by Box and Jenkins (1970), with decades of evidence by a number of authors that it is effective and prominent in economic and financial time series management (Merh et al., 2010; Ariyo et al., 2014). For example, Hillmer and Tiao (1982) claim that ARIMA is an appropriate model for business cycle analyses. Some recent studies even prove good ARIMA features to be applied in time series analysis during the Covid-19 pandemic (Benvenuto et al., 2020). Considering the above, we define the model (according to Box and Jenkins, 1970, reprinted in 2015) as follows:

$$Y_t = \alpha_1 Y_{t-1} + \varepsilon_t$$

Where Y_t presents linear autoregressive function, with self-regression coefficient α_1 and noise ε_t. The model includes moving average process that could be explained as a linear function of grouping the current disturbance with one or more than one earlier disruption:

$$Y_t = \varepsilon_t - \theta_j \varepsilon_{t-j}$$

wheras θ_i a moving average coefficient. The expression can be extended to a number of variables, i.e.:

$$Y_t = \alpha_0 + \alpha_1 Y_{t-1} + \alpha_2 Y_{t-2} + .. + \alpha_j Y_{t-j} + \varepsilon_t - \theta_1 \varepsilon_{t-1} - \theta_2 \varepsilon_{t-2} - .. - \theta_j \varepsilon_{t-j}$$

ARIMA model requires to choose right number of lags for AR, MA, and difference components. To determine the correct number of lags, it is important to check the variables for stationarity. For this reason, the study applied Dickey-Fuller test to check whether the variables, that are being forecasted, are stationary. Additionally, authors tested for stationarity by plotting correlograms and by looking at ACP and PACP parts of the correlograms. Variables failed the stationarity test in both analyses. Hence, the next steps included the process of sorting through appropriate number of lags in each AR, MA, and difference components for the corresponding variables. Having isolated two most appropriate number of lags for ARIMA components, they were compared using AIC and BIC criteria for the final use.

TABLE 1. **Descriptive statistics**

Variable	N	Mean	SD	Min	Max	Skew	Kurt
GDP growth, %	84	.07	3.72	(12)	10.9	(.184)	4.88
Unemployment, %	83	5.19	.54	4.23	6.41	.191	2.18
Core Inflation, %	84	6.26	4.59	1.8	17.5	1.41	3.78
Trade balance, $ million	83	11749	4388	3673	23191	.329	2.59
Brent oil, $ per barrel	84	57.92	13.27	22.74	84.38	(.235)	2.66
USD/RUB	84	65.64	6.61	51.69	79.29	.134	2.18

Note: The table displays the descriptive statistics of the dataset with monthly data for the period 2015-2021. GDP growth, unemployment, and core inflation are reported in percentages. The trade balance is reported in millions of US dollars. Brent oil is displayed in US dollars per barrel, while the USD/RUB exchange rate is given in rubles per 1 US dollar.

Table 1 shows the detailed descriptive statistics of the variables that are used in the analysis. One of the main indicators of the economy – GDP growth – ranges from negative 12% to positive 10.9%. The monthly unemployment rate, being not so volatile, ranges from 4.23% to 6.41%. Along with GDP growth, the core inflation rate is highly volatile (between 1.8% and 17.5%). Negative GDP growth and low inflation rates are recorded in the beginning and during the pandemic of COVID-19. The trade balance of the Russian Federation, which is highly reliant on Brent oil prices, fluctuated between $3,673 million and $23,191 million, while the Brent prices dipped $22.74 per barrel at the beginning of the pandemic and recovered to about $84.38 per barrel.

3. Econometric analysis and estimates

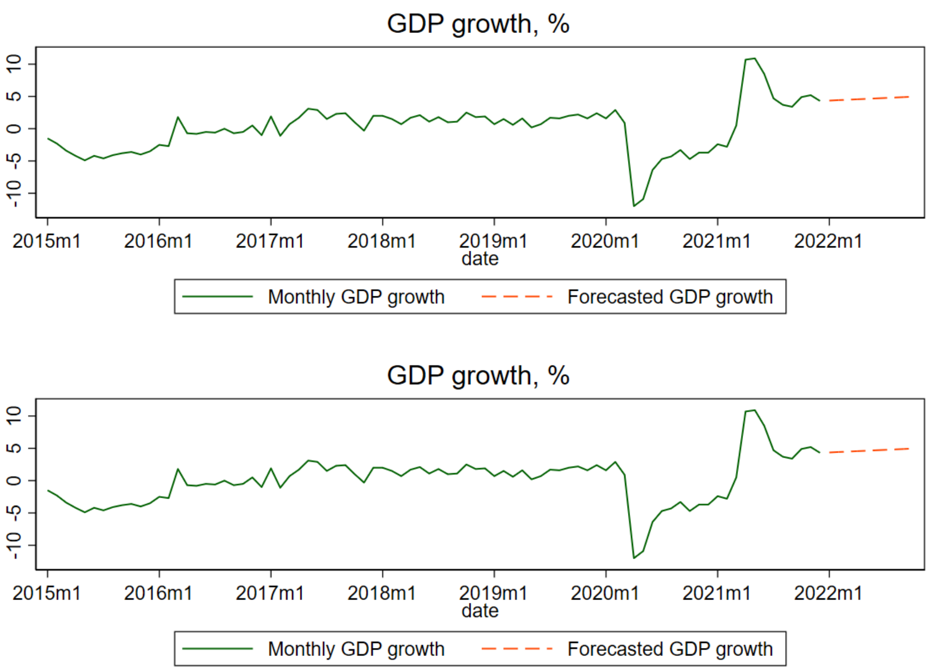
It is well-established that Russia's economy is reliant on the export of oil and other natural resources (Becker, 2016). Figure 1 indicates the dependence of the GDP monthly growth % on Brent prices. Over the period observed, the dependence was breached for a short period of time (e.g. drop in Brent prices in 2019), but in general the dependence can be clearly seen on the chart. The GDP growth was not volatile until March 2020, when itdropped to -12%. Similarly, Brent prices declined to almost $22.74 per barrel. The sharp decline in all assets and GDP growth of the whole economy in March-April 2020 can be explained by the overall shock of the market. However, from May 2020 onwards the recovery of the Brent prices led to recovery of Russian GDP by accurately reflecting the ups and downs of Brent prices.

In April 2021 oil prices returned to pre-pandemic levels and Russia's GDP grew almost 10.7%, which is record high for the last several years. Considering the period after the COVID-19 shock (March 2021), simple OLS[1] regression shows that 1 unit increase in Brent prices leads to 0.26% increase in Russian GDP growth, in % terms. Furthermore, ARIMA models were used to forecast the figures for GDP growth and oil prices. As can be

[1] OLS results are statisticaly significant at 5% level. GDP and Brent Price pairwise regression results are: Coef. – 0.26, St.Dev. – 0.25; T-stat – 6.63; P-value – 0.000 – significant on 5% level.

seen in Figure 1, ARIMA with 1 lag estimates that GDP growth stablelises at 4.66%, which is higher than the pre-pandemic figures. The Brent prices were forecast using the ARIMA with 2 lags and it indicates that the oil will be priced on average at $80.58 per barrel in the coming 10 months.

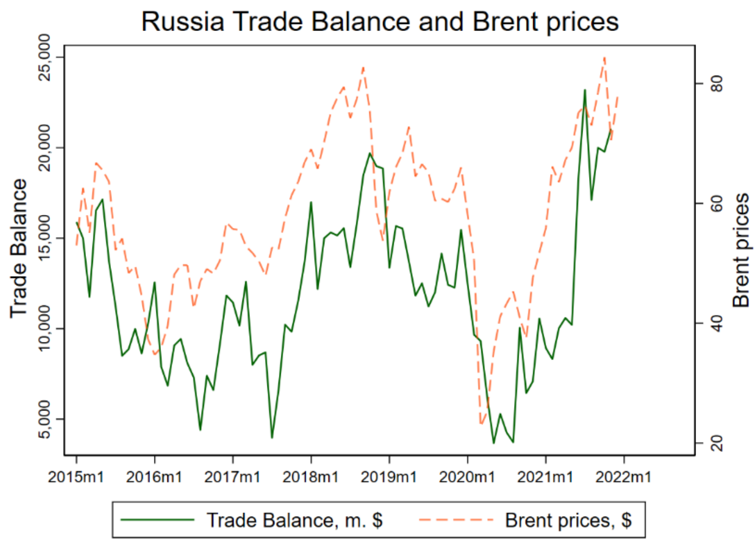
FIGURE 1. **Russia GDP growth, % and Brent prices**



Source: Author's calculations for data collected from Thomson Reuters Eikon terminal (2022).

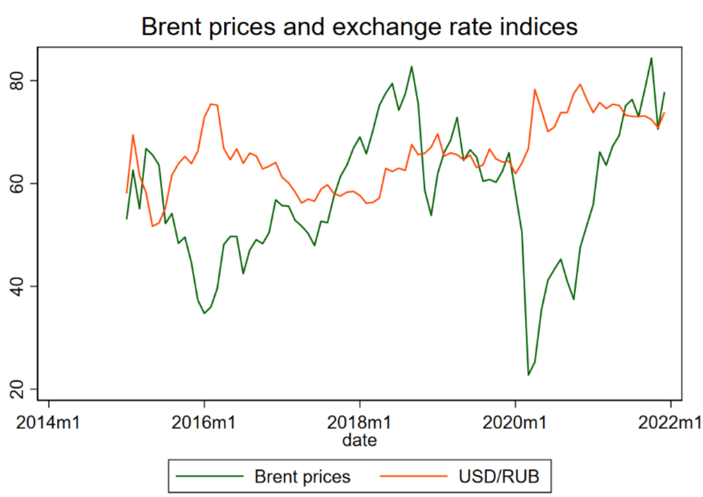
Figure 2 shows the identical type of analysis from the trade balance perspective. The dependence of the trade balance on oil prices is clearly observable throughout the analysis period. Compared to GDP growth, volatility of the trade balance has always been in line with the oil prices. That is, even before the pandemic, the trade balance was severely affected by the moderate decline in oil prices (see, e.g., 2016m1 – 2018m1). As one of the components of the GDP, the trade balance reflected the same pace of recovery after the shocks of Q1 2020 by reaching its record highs in mid-2021.

FIGURE 2. **Russia's Trade Balance and Brent prices**



Source: Author's calculations for collected data
from Thomson Reuters Eikon terminal (2022).

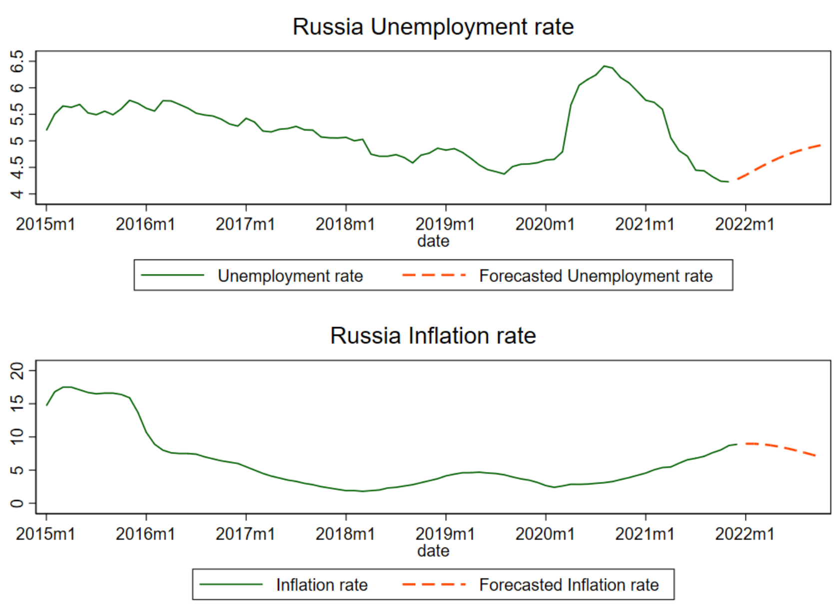
FIGURE 3. **Oil prices and exchange rate indices**



Source: By author's calculations based on data collected
from Thomson Reuters Eikon terminal (2022).

In spite of the well-established relationship between Russia's GDP and oil prices, another vital factor that influences Russia's income is the exchange rate. In 2014 Russia introduced a flexible exchange rate regime and inflation targeting. Flexible exchange rate regime could help the Russian economy to overcome cheap oil prices. As shown in Figure 3, in general, the USD/RUB pair and Brent prices had a negative correlation. It means that falling prices for oil consequently raised the price of oil in Rubles. Precisely, sharp decrease in oil prices at the beginning of the pandemic depreciated the Ruble to almost ATH of 80 Rubles/Dollar, but with the flexible exchange rate policy Russia could benefit or balance low oil prices through the depreciation of the Ruble. It affects the governmental budget, since Russia exports oil in USD.

FIGURE 4. **Russian unemployment rate and core inflation rate**



Source: Author's calculations based on data collected from the Thomson Reuters Eikon terminal (2022).

Historically, the unemployment rate and inflation have been the main indicators of economic performance. Similarly, both have maintained a negative correlation. Figure 4 shows that the unemployment rate has been gradually declining since 2015, but then spiked to almost 6.5% on the grounds of the pandemic. At the same time, the indicator of core inflation (inflation rate excluding food and energy prices) declined to 2.4% in February 2020. However, the core inflation rate started to gain momentum straight after the initial shocks of the pandemic, while the unemployment rate reached pre-pandemic figures only at the end of 2021. The ARIMA model with 2 lags forecasts that the unemployment rate will be on the average level of pre-pandemic figures for the future 10 months. The same model with 2 lags forecast that the core inflation rate, on the other hand, will decrease and stabilize at around 4.5-5% for the following 10 months.

4. Conclusion

This chapter analyses and estimates Covid-19 effects on GDP growth, trade balance, exchange rate, inflation and unemployment rate, considering strong dependence of the Russian economy primarily on oil and gas prices. While most of these indicators are highly dependent on oil price movements (GDP growth, trade balance, and exchange rate) and at the same time showing high volatility, unemployment rate remains stable.

According to the study estimates, oil prices will continue to impact GDP growth, trade balance and exchange rate, with an indication of recovery in the next 10 months. High volatility of the Russian ruble is the most significant Covid-19 aftermath risk, because it creates uncertainty in the business environment for Russian companies and generates high interest rates that make borrowing more expensive. On the other hand, weakening the ruble increases the international competitiveness of Russian oil exporters, which in turn generates GDP growth. Yet, caution is needed regarding the volatility of the ruble, due to negative effects on interest rates, funding, and trade balance.

To get out of the Covid-19 recession, Russia will continue to depend on its own funds and an investment strategy created under complex international conditions (sanctions and international political pressures). The external environment which Russia has become accustomed to over the past seven years has a much greater impact on the Russian economy than the Covid-19 recession itself. Hence, the impact of the Covid-19 recession was felt in the first half of 2020, but Russia recovered more quickly compared to other European countries (excluding the impact of a deteriorated international business environment).

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Recent Trends in Personal Income and the Impact of Covid-19: Case of Russia

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Abstract: Russia is a rich country, classified by the World Bank as upper-middle income economy, but the majority of Russians have rather modest current incomes. Inequality in income distribution in Russia is comparatively high.

The study found that the pandemic has accelerated the decline of Russia's middle class and has had a particularly strong impact on business income. The national government measures were primarily designed to protect employment and provide financial support to low-income families. In the context of the pandemic, the risk of financial deterioration was higher for higher-educated individuals, employees and entrepreneurs.

Keywords: personal income, Russia, inequality, middle class

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1. Introduction

The first case of COVID-19 in Russia was reported at the end of January 2020, and the virus began spreading massively in March 2020. By mid-April 2020, the disease affected all regions of the country, the capital Moscow accounting for the largest number of infected individuals. According to the Centre for Systems Science and Engineering (CSSE) at John Hopkins University, by the end of February 2022 there were more than 17 million confirmed cases in Russia with 2.1% observed case fatality ratio[1].

The national government took strong measures to prevent the disease from spreading further. Restrictive measures were introduced to stabilize the functioning of the healthcare system and prevent numbers from rising higher. At the same time, the federal and regional governments provided financial and material support to the population and businesses to reduce the economic impact of the pandemic.

In 2020, the largest number of restrictive measures were introduced, which also affected economic performance. According to Rosstat (the Federal State Statistics Service of the RF) estimates, the nominal volume of GDP in 2020 amounted to 106,606.6 billion roubles. The index of its physical volume relative to 2019 was 96.9%, and the GDP deflator was 100.7%. The 3.1% decline in GDP in 2020 was due to the restrictive measures introduced to combat the coronavirus infection and the fall in global demand for energy resources. The share of wages in the structure of the GDP increased from 46.3% to 49.5%, which was due to more payments made to healthcare workers and other industries involved in the fight against the pandemic, among other reasons. The decrease in the share of net taxes is caused in large part by an increase in subsidies related to government support measures for businesses.

According to the World Bank estimates, GDP per capita in the Russian Federation in 2020 was 26,456 international dollars at constant 2017 prices, which is 2.8% lower than in 2019.

The aim of this study is to assess the immediate reaction of personal income in Russia to the COVID-19 pandemic, considering current trends in the structure and distribution of personal income.

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[1] https://coronavirus.jhu.edu/data/mortality

Personal income is income that people obtain from wages and salaries, social transfers and other government benefits, dividends and interest, business ownership, and other sources. The source of data is Rosstat, which provides detailed information about the structure of personal income, income distribution, accrued wages of employees and other statistics. In this study I consider only personal income in cash.

To assess the impact of the COVID-19 pandemic on self-reported personal finances and sources of income I use data from The Russia Longitudinal Monitoring Survey – Higher School of Economics (RLMS-HSE)[2]. The RLMS-HSE are a series of nationally representative surveys designed to monitor the effects of Russian reforms on the health and economic welfare of households and individuals in the Russian Federation. The project has been run jointly by the Carolina Population Centre at the University of North Carolina in Chapel Hill. The longitudinal files cover data from 1994 to 2020 on both individuals and households.

The chapter is organised in sections. The next section provides a detailed description of the current incomes of Russians, an analysis of the distribution of income and the dynamics of real income of the population. It has been shown that the trend towards declining real income and shrinking middle class was made worse by the pandemic. The third section analyses the results of the population survey. The difference in average income between different groups of the population is shown. Regression analysis is used to identify factors that increase the likelihood of a deterioration in personal finance against the backdrop of the pandemic.

2. Personal income structure and recent trends

The money income of the population consists of business income, wages, income from investments in financial assets and other cash receipts (including hidden wages), as well as tax-free social benefits (pensions, allowances, etc.). Let us first look at the income structure in Russia.

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[2] http://www.hse.ru/rlms

2.1. Income structure

Wages and salaries account for the most part of personal income of the population in Russia (more than 57% in 2018-2020, Fig.1). Labour income shapes the lives of 70.7 million workers and their families. Moreover, for many, their work is a key source of income.

Note that nominal labour income was not affected, in average, by the pandemic restrictions. The volume of income received increased by 2% in 2020 compared to 2019, mainly because of wage growth for medical and social workers. Several measures were introduced in 2020 to support employment both at the federal and regional levels. According to researchers from the All-Russian Research Institute of Labour (Zabelina & Sergeeva, 2022), support of employment accounted for 83.8% of total financial support from the national government to businesses and people.

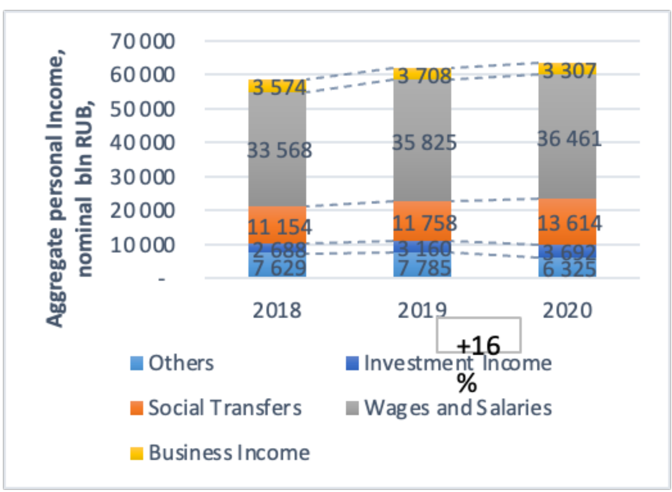
At the same time, the distribution of the total amount of accrued wages by groups of employees is extremely uneven in the Russian Federation. According to Rosstat, 10% of workers who earn the highest salaries account for one third of total salaries (excluding small businesses) and this share has not changed since 2009. The pandemic has not altered the structure of the distribution of labour income that has developed over the past 10 to 12 years. As studies of inequality in employees' earning show, such disproportions are features not only of developing countries or countries with state capitalism, but also countries with developed markets (for example, see Simões *et al.* (2020). As many researchers argue, inequality can lead to social and political tensions, with negative consequences for productivity and, in the long run, for economic growth.

Entrepreneurial income, which in 2013 accounted for 7% of aggregate personal income, has been declining since 2014, but its share dropped most significantly in 2020. Business income includes income of self-employed workers, income from rental of property or land, royalties, remuneration and the like. This part of total income dropped by 11% in 2020 compared to 2019. Many researchers and experts noted that the support that the national government granted small and medium-size companies was insufficient, which was reflected in lower business income, inter alia.

A remarkable feature of 2020 is a considerable increase in social transfers (almost by 16% compared to 2019 in nominal values). Social payments (pensions, allowances, scholarships, and other payments) in cash averaged 11% of the country's nominal GDP in the period 2013-2019. However, in 2020 this ratio rose to 13%. Due to social payments, the nominal amount of cash received increased in 2020 compared to the previous year. This is a positive example of tax-benefit policy, which was not as successful in previous years (Popova *et al.*, 2018).

Rosstat provided a preliminary estimate of personal income for 2021. The volume of social payments in 2021 was estimated at 14.52 trillion roubles, compared to 13.61 trillion roubles in 2020. This resulted in an increase of 6.7 per cent. The volume of income from entrepreneurial activities grew by nearly 24%. Overall, total monetary income of the population increased by 10.3 per cent in 2021, reflecting economic recovery.

FIGURE 1. **Sources of personal income in the Russian Federation**



Source: Federal State Statistics Service data (http://www.gks.ru/).

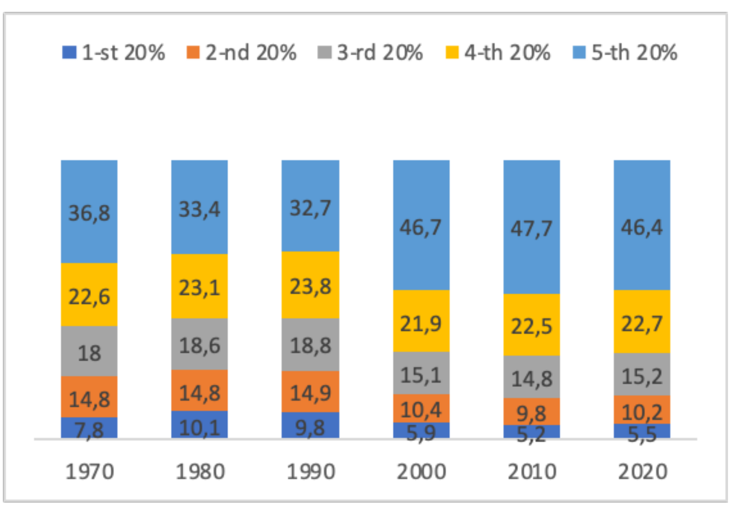
In Russia, nearly 80 per cent of total household income is consumed. Under COVID-19 mitigation restrictions, the share of consumption fell in 2020, but the share of savings increased. This change was due to the deferred demand of wealthy Russians (mainly, the expenses of Russians abroad have fallen), but the majority of Russians kept their expenses constant or slightly below previous levels. The increase in debt on loans in 2020 was lower than in previous years.

Thus, in 2020, Russians reduced their consumer spending and increased their savings, including investments in securities. This distinguishes the behaviour of Russians from the behaviour of residents of other countries, such as the United States. In many countries, loan debt rose and savings dropped (Hodbod *et al.*, 2021; Çolak & Öztekin, 2021).

2.2. Income distribution

In Russia, inequality in the distribution of income grew significantly in early 2000 (Fig.2). According to Rosstat, from 2013 to 2019, the bottom 20% of the population, sorted by nominal cash income, received 5.3% of total money income, and the top 20% – about 47%. In 2020, the share of income of the richest slightly declined due to a small increase in the share of income of the poor.

FIGURE 2. **Income distribution in Russia (up to 1990 – the Soviet Union), 1970-2020**

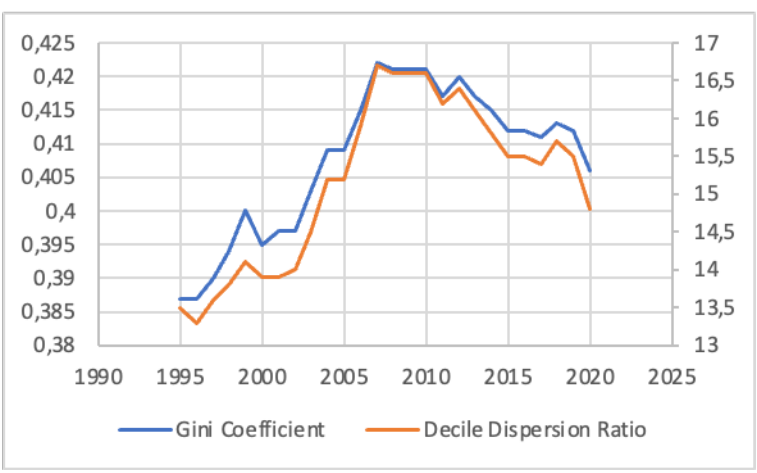


Source: Federal State Statistics Service data (http://www.gks.ru/).

Income inequality skyrocketed in Russia after market liberalisation reforms in the early 1990s. Following the global financial and economic crisis income inequality in Russia stabilized above the world average: the average Gini coefficient of seventy-eight advanced and developing countries in 2010 was 0.38 (Lustig, 2016). The Gini coefficient has declined in the last ten years (Fig.3) in Russia, albeit at a very slow pace. The cross-country analysis showed that the higher Gini coefficient is associated with a lower share of labour income in gross domestic product (Matyushok & Balashova, 2021), which in turn enhances inequality.

On the other hand, the Decile Dispersion Ratio, which presents the ratio between the average income of the richest 10 percent (the 90th percentile) and that of the poorest 10 percent (the 10th percentile) declined rather sharply in 2020 compared to previous periods. This does not mean that the incomes of the poor have increased, but rather that in 2020 the richest lost more of their income. The situation seems to be the same as it was in 2014 (Lopez-Calva *et al.*, 2017).

FIGURE 3. **Income Distribution Inequality. Gini Coefficient and Decile Dispersion Ratio (right axis) based on before-tax income distribution**



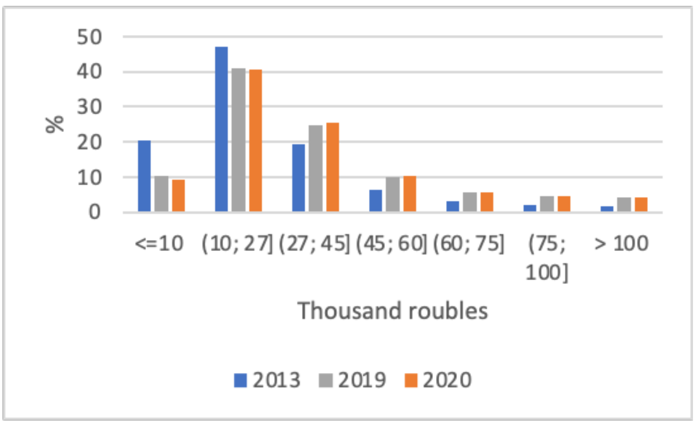
Source: Federal State Statistics Service data (http://www.gks.ru/).

Figure 4a depicted the distribution of nominal values of per capita income. We can see that the median nominal values of per capita income slightly increased from 2013 to 2020.

However, median real per capita income has not changed during this period, but the share of wealthy people has decreased (see Fig 4.b).

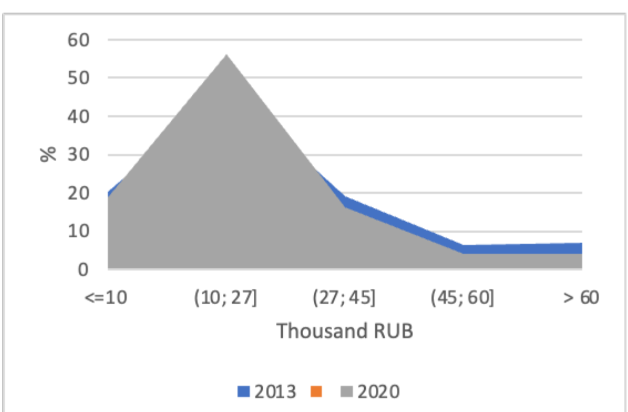
Thus, from 2013 to 2020, there was a shift in the distribution of income in Russia towards an increase of the share of low-income households.

FIGURE 4A. **Population distribution by per capita monthly income, nominal values**



Source: Author's calculation based on Federal State Statistics Service data (http://www.gks.ru/).

FIGURE 4B. **Population distribution by real per capita monthly income, constant prices 2013, thousand roubles**



Source: Author's calculation based on Federal State Statistics Service data (http://www.gks.ru/).

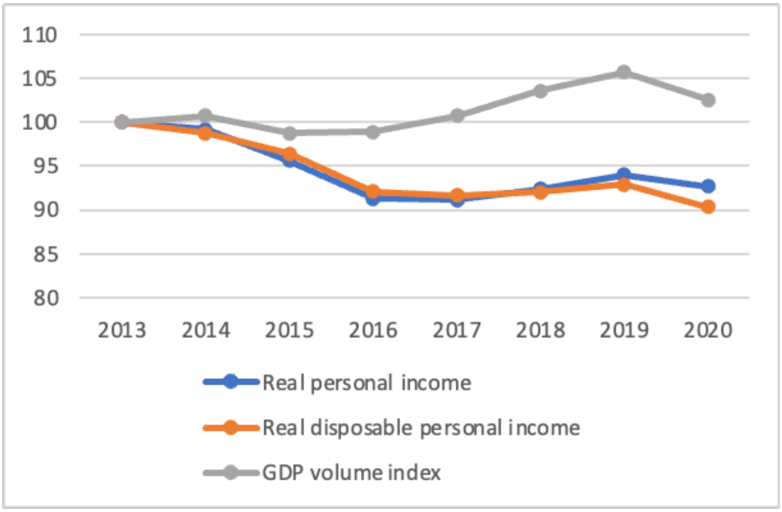
In 2020, the proportion of people living below the poverty line was 12.1%, or 17.8 million people. This number is higher than in 2013, but it is the lowest since 2015. According to official statistics the number of poor people decreased in 2021 as well. Note, however, that in nominal terms the subsistence minimum increased in 2020 compared to 2013, while in constant 2013 prices the difference is minimal (7,306 roubles in 2013 and 7,364 roubles in constant prices in 2020).

If we use the definition of "middle class" which is provided by the World Bank (a group of people whose income ranges from $10 to $50 per day (at 2015 PPP)), then in Russia the middle class is quite large – about 70% of the population. However, this definition of the middle class is too broad: $10 a day is below the subsistence minimum, which in 2020 was 11.3 thousand roubles per month in current prices (or $461.4 PPP per month using OECD converter). If we use the Barro approach (Barro, 2000; Easterly, 2001), calculations show that the share of middle class (2-4 quintiles per capita income) is 48% of the total population and approximately the same in the past 10-12 years.

However, according to approach of Russian sociologist N. Tikhonova (Tikhonova, 2018), which is based not only on income, but also on the structure of expenses and property ownership (mainly apartments or summer cottage ownership), the middle class starts at 1.25 x the median income in Russia. Based on the all-Russian survey under the program ISSP "Levad Center" (2019) the middle-income class accounted for about 32.4% of the population in 2019. This class has been shrinking in the last 10-12 years due to demographic trends (retirement almost automatically moves a person from the middle class to the low-income population class) and because of the decline in real personal income.

Real personal income has been declining in Russia since 2014 (Fig. 5), as has real disposable income, which has been enduring long-term stagnation. Note that even as GDP grew, real personal income continued to decline.

FIGURE 5. **Real personal income, real disposal personal income and GDP volume index (2013=100).**



Source. Author's calculation based on Rosstat data.

3. The impact of the pandemic on self-reported personal finance.

Covid-19 has caused profound changes in the economy and lifestyle of people all over the world. The survey, conducted by a group of researchers (Khetan *et al.*, 2022) showed huge financial implications for different groups of people in different countries.

This section includes an analysis of data on a subjective assessment of changes in personal income in 2020 in the Russian Federation. These data are retrieved from The Russia Longitudinal Monitoring Survey conducted by the Higher School of Economics (Moscow, Russia). The survey provides vast information about changes in socio-economic development in Russia (Kozyreva & Sabirianova Peter, 2015). More than 12 thousand individuals in different regions of Russia, from a range of social and age groups participate in the survey each year.

For further analysis, I used the answers of the respondents 15 or more years old, cleaned of outliers. The number of observations in the 2020 sample is 9,793, and in the 2019 sample it is 9,924.

I have focused on a few issues. The first question of interest is how different groups of people (men and women, employed and unemployed, entrepreneurs and employees) assess their monthly income and whether they feel improvement or worsening of personal finance. The second question of interest is to find statistically significant difference between 2019 and 2020 in self-reported finance resulting from the COVID-19 pandemic. The third issue concerns the marginal impact of various factors on income self-assessment and the probability of feeling worse financially.

3.1 Results of Descriptive Analysis

The descriptive statistics of the 2020 and 2019 samples for monthly income in cash and self-assessed changes in personal finance are reported in Table 1. I have divided the whole sample into several groups and conducted appropriate statistical tests on mean and median equality. Statistical tests prove that women earn significantly less than men, occupied (currently employed) have significantly lower income than un-occupied (pensioners, students, unemployed and other nonworking respondents), the level of income of entrepreneurs is significantly higher than the sample average. It is worth noting that the median of reported income of occupied respondents (which was 30 thousand roubles in 2020) is very close to the estimation of Rosstat (which is 32.4 thousand roubles including personal income tax). However, the mean of self-reported income over the whole sample is much lower than the official per capita income (25 thousand roubles vs. 35.7 thousand roubles from Rosstat in 2020).

The difference between self-reported monthly income in 2019 and in 2020 is not excessive. However, in 2020 almost 29% of respondents reported that their household finances have deteriorated in the past year (compared to 21.5% in 2019). As shown above, real personal income of Russians has declined since 2013. However, against the backdrop of COVID-19 restrictions, the financial situation of employed and entrepreneurs has worsened considerably: 48% of entrepreneurs and 30% of employees believed their finances had deteriorated, which was not the case in previous years. It is worth noting, however, that only 1.3% of the respondents are entrepreneurs and about 44% are employees.

TABLE 1. **Subjective assessment of income and changes in household finance in 2020 and 2019**

	Female/Male	Occupied /Un-occupied	Entrepreneur/entire sample
Mean of income (roubles per month)			
2020	22,382/28,847	34,360/15,987	46,118/25,022
2019	21,613/27,683	33,575/14,681	45,382/24,115
Median of income (roubles per month)			
2020	19,000/24,000	30,000/15,400	38,500/20,000
2019	18,000/22,200	28,500/14,560	40,000/20,000
Family finances have worsened over the past year (% of respondents)			
2020	29.2/28.6	30.1/27.6	48.8/28.9
2019	22.2/20.5	19.1/24.0	19.5/21.5
Family finances have improved over the past year (% of respondents)			
2020	10.8/12.5	11.4/11.6	10.4/11.5
2019	17.2/18.6	19.8/15.8	22.8/17.8
Observations			
2020	5,794/3,999	4,816/4,977	125/9,793
2019	5,834/4,090	4,955/4,969	123/9,924

Source. Author's calculations based on The Russia Longitudinal Monitoring Survey – Higher School of Economics

As mentioned before, the Russian government has made many efforts to keep unemployment low and to preserve jobs. However, many companies have changed their employees to part-time work or reduced wages to the minimum level. Thus, employment remained at the level of 2019, but the income of workers dropped.

In 2020 the share of respondents reporting an increase in family income is much lower than in 2019.

3.2 Results of regression analysis

Delving into the analysis further we wonder whether a bachelor or master's degree affects personal income and if the diploma helped counter the reduction in income during the pandemic.

The following regression models are used. The first model links the self-reported monthly income (denoted as INCOME in the following equations) to the respondent's level of education, controlling for sex, age and other variables:

$$\log(INCOME) = \beta_1 + \beta_2 EDUC + \beta_3 MALE + \beta_4 JOB + \beta_5 BUSI + \\ + \beta_6 MALE \cdot JOB + \beta_7 AGE + \beta_8 WORSE + \varepsilon \quad (1)$$

The second equation is a logit model for estimating the probability of deterioration of the household finances

$$p = \frac{1}{1+e^{-WORSE}} \quad (2a)$$

where the variable *WORSE* is equal to 1 for those individuals who reported worsening of last year's finances, and 0 for others. The function is as follows:

$$WORSE = \gamma_1 + \gamma_2 EDUC + \gamma_3 MALE + \gamma_4 JOB + \gamma_5 BUSI + \\ \gamma_6 MALE \cdot JOB + \gamma_7 AGE + \gamma_8 \log(INCOME) + \vartheta \quad (2b)$$

In (1) and (2) such notations are used: EDUC is a dummy variable equal to 1 for an individual with any kind of higher education degree, and 0 otherwise; MALE is equal to 1 for men, and 0 for women; JOB is equal to 1 for a currently working individual; BUSI is equal to 1 for an entrepreneur and 0 otherwise; AGE is an individual's age in 2020.

The first equation is estimated by OLS with heteroscedasticity consistent standard errors. The logit model is fitted by maximum likelihood estimation with Huber-White standard errors of the coefficients. The regression output is shown in Table 2. The explanatory power of the models is not very high, but Fisher and LR tests show the significance of the estimates obtained.

TABLE 2. **Evaluation of models for income and the probability of income decline**

Explanatory variables	Dependent variable	
	Log(INCOME)	*WORSE*
EDU	0.29*** (0.01)	0.15*** (0.05)
MALE	0.10*** (0.02)	-0.06 (0.07)
JOB	0.72*** (0.02)	0.22*** (0.07)
BUSI	0.28*** (0.06)	0.90*** (0.18)
MALE · JOB	0.21*** (0.03)	0.15 (0.09)
AGE	0.013*** (0.001)	–0.002 (0.002)
WORSE	–0.13*** (0.02)	–––
Log(INCOME)	–––	–0.31*** (0.04)
C	8.78*** (0.05)	2.05*** (0.34)
R – squared / LR statistic	0.31	120.6
Obs	9111	9111

Note: *** denotes significant coefficients at 1% level. The significance of an individual coefficient of equation (2) is evaluated via its asymptotic t statistic. Robust standard errors are in parenthesis.

We can interpret the regression coefficients of the first equation as follows. Controlling other variables, individuals with higher education degrees tend to earn about 30% more than individuals without a degree, but of the same age, sex and other characteristics. Note that our estimate shows the influence of sex on income and the difference between working and not working in terms of expected income which is totally in line with descriptive statistics.

Before interpreting results of logit model estimation, we need to do some calculations. The usual method for summarising the effect of explanatory variables on probability is to calculate the marginal effect at the mean value of the explanatory variables. According to computations, being educated increases the probability of worsening of finances by 3%, being the entrepreneur increases it by 18%; being employed increases it by 6%. A decrease in income leads to an increase in the considered probability, however, sex and age do not influence the likelihood of the financial situation deteriorating.

It is worth noting that the results of the logit model for 2020 are quite different from previous years' estimations[3]. The positive effect of education and occupation is a feature of 2020.

4. Conclusion

Russia is a rich country, which the World Bank has classified as upper-middle income country, but the majority of Russians has rather modest current income. Inequality in income distribution in Russia is rather high.

Traditionally, in Russia women earn less than men, and pensions and social transfers for unemployed or other categories of unoccupied individuals are not much higher than the subsistence minimum.

Since 2014, the real income of the population has been declining. This trend was reversed in 2019 and Russians were hoping for income growth in the following year as well, but the Covid-19 pandemic stopped the trend. The most significant decline in income has affected the middle class and, in particular, entrepreneurs. About 30% of respondents in the longitudinal survey reported that the financial situation of their families had deteriorated in 2020 amid Covid-19. Not only entrepreneurs (among them, almost 50% reported a decrease in income), but also currently employed respondents have experienced a reduction in their family finances. In 2019, only 19% of employed respondents had provided the same answer.

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[3] Can be provided by request

At the same time, national government support for low-income families helped maintain the income level of this category of the population. And the decline in the income of the wealthy led to a slight decline in income inequality in 2020.

As the results of the quantitative analysis highlight, higher education contributes to higher income in Russia. However, during the pandemic, the threat of deterioration of the financial situation of this category of population has increased.

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Angola and Europe – An Inevitable Partnership

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ABSTRACT: The present chapter seeks to briefly describe how Angola can be a frontier market for Europe now that these two partners are preparing to implement a recovery plan for their economies after COVID-19. In view of a European audience, the document begins by outlining Angola's geographical, demographic and economic features, and addresses its economic history, which explains the reasons why Europe has always been its main economic partner.

It is proposed that Europe can be a key participant in the process of diversifying the Angolan economy, which is dependent on one commodity – oil. As historical partners, Europe and Angola must consolidate their relationship through an instrument called the Economic Partnership Agreement, firmly anchored on sustainable development objectives and development cooperation for both partners. Europe and Angola can capitalise on the fact that the latter has a significant amount of arable land that can contribute to food security in Angola, Europe and, perhaps, other markets. It is further proposed to invest in Angolan human capital using European knowledge, especially through different types of technology such as artificial intelligence, big data, machine learning.

Keywords: Europe and Angola, Economic Diversification, Artificial Intelligence, European Economy, Angolan Economy

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1. Introduction

The present chapter touches on the past and future of economic relations between Angola and Europe. It seeks to briefly describe how Angola can become a frontier market for Europe now that these two partners are preparing to implement a recovery plan for their economies, after the harshest phase of the COVID-19 pandemic has been overcome.

In anticipation of the fact that most readers will be Europeans that have little or almost no knowledge about Angola, the document begins by outlining the country's geographical, demographic and economic features, and addresses the economic history of Angola, which serves to explain the reasons why Europe has always been its main economic partner.

After describing the historical economic relationship between Angola and Europe, this chapter proposes ways for Europe to become a key participant in the process of diversifying the Angolan economy, currently heavily dependent on the production of one commodity, oil.

As historical partners, Europe and Angola must consolidate their relationship through an instrument called the Economic Partnership Agreement, firmly anchored on sustainable development objectives, human rights and development cooperation for both partners.

More specifically, Europe and Angola can capitalise on the fact that the latter still has a significant amount of arable land for the cultivation of crops that can contribute to food security in Angola, Europe and, perhaps, other markets.

Finally, the chapter considers how Europe can contribute to developing Angolan human capital by using technology such as artificial intelligence, big data, machine learning, applied to the various sectors of the economy with a view to increasing productivity and, consequently, the competitiveness of the Angolan economy.

2. Brief Characterisation of the Angolan Economy

This chapter of the book addresses ways in which Angola, one of Europe's most important trading partners, can contribute to consolidating this relationship. Angola is certainly a frontier market that Europe can continue to bet on, now that it is resuming economic activity and aims to reach pre-COVID-19 levels. In the next paragraphs, Angola and its economic history, the relationship with trading partners and prospects for the relationship with Europe is described.

Before characterising the Angolan economy, it is important to introduce the Republic of Angola: an area of 1 246 700 Km^2, located on the southwest coast of the African continent. It is a member of SADC, an economic community of 16 countries [1]. It is divided territorially into 18 provinces and *Luanda* is its capital city. Angola shares borders with the Republic of the Congo and the Democratic Republic of the Congo to the north, Zambia to the east, Namibia to the south and the Atlantic Ocean to the west.

According to the latest population census conducted in 2014, Angola had about 25 million inhabitants. According to the National Institute of Statistics of Angola, in 2022 the country is projected to have 33 086 276[2] inhabitants, 51% women and more than 60% under 24 years old.

The latest Economic Report of the International Monetary Fund on Angola, published in January 2022 (IMF; 2022), indicates that the estimated Gross Domestic Product for 2021 was USD 73.7 billion and USD 2 307 in per capita terms. Consequently, Angola is one of the largest economies in sub-Saharan Africa, alongside Nigeria, South Africa, Kenya, Ethiopia and Ghana.

With regards to the unemployment rate, it was 32.9% at the end of 2021[3], with more than half of the economically active population being unemployed and young. Finally, the annual inflation rate in 2021 was 27.03%, according to the Angolan National Institute of Statistics. The food and non-alcoholic beverages category, accounting for 55% of the consumer price index, contributes the most to inflation in Angola (INE, 2022).

Angola is historically a small open economy. A small open economy means an economy that participates in international trade, but because of its negligible weight in the global economic and trade context, the

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[1] Southern Africa Development Community

[2] See INE (2016) at https://www.ine.gov.ao/inicio/estatisticas.

[3] Source: Idem

policies implemented by it do not alter prices, interest rates or world income. For this reason, Angola, like all other small open economies, is a price taker.

In order to understand how the Angolan economy was, is and will be integrated into the European economy in general and the Portuguese economy in particular, one must learn more about its economic history.

2.1. Economic History of Angola

For a good understanding of Angola's economic history and how it fits into the global economic context, it is worth learning more about the history in three fundamental periods: (i) before the colonial period, (ii) during the colonial period, and (iii) after independence.

2.1.1. The Angolan Economy Before the Colonial Period

The first contact of Europeans with "Angolans" occurred in 1482, when the Portuguese navigator Diogo Cão reached the mouth of the Congo River and sailed up the river. When Diogo Cão arrived in the territory that is now known as Angola[4], he met several Bantu peoples, organized in kingdoms, who had migrated to this region from the territory now known as the Cameroon. The Khoisan, organised into clans, were the first people to inhabit Angola. They came from the south of the continent and settled in the southwest region of Angola.

The Khoisan remained in southern Angola while the Bantu settled across the territory. They were farmers in the North, shepherds in the South, farmers and shepherds in the Centre (Pacheco et. al, 2018).

At that time, trade between Europe, mainly Portugal, and Angola was characterised by the exchange of goods for slaves. But it was not the search for slaves on the part of Europeans that triggered the beginning of slavery and, consequently, the exchange of human beings for goods and services.

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[4] The current territorial boundaries of African countries were set at a conference organised in Berlin between late 1884 and early 1885.

It is true that at the beginning of the establishment of kingdoms in Angola there were no slaves. The agricultural fields belonged to the entire clan. Over time, the communities were organised in social classes, and prisoners of war or debt holders were turned into slaves (Pacheco et al., 2018).

The slave trade between Angola and Europe, having as its main destination the American continent, was widespread in the sixteenth century, but it is worth mentioning that it was not an exclusive activity of Europeans. This is confirmed by a letter that D. Afonso, King of the Congo, sent to the King of Portugal, D. Manuel I, on May 26, 1517, requesting a ship for slave trade. (Miller, 1976; Hilton, 1985).

According to Andrade and Ollivier (1971) and Ferreira (2012), it is estimated that between 1512 and 1867, 11.6 million slaves travelled from Africa to the Americas and were sold by Europeans.

The end of global slavery coincides with the beginning of Portuguese and other European investment in the Angolan territory. The railway link between Portuguese, Belgian and English colonies, necessary for the exploration and transportation of natural resources, marked a new phase in the relationship between the European and Angolan economies.

2.1.2. The Angolan Economy in the Colonial Period

The commercial relationship between Angola and Europe, mainly, Portugal, changed when the latter decided to consolidate the process of colonising Angola by investing in transport infrastructure, bearing in mind the creation of conditions for the exploration, development and export of primary resources to Europe.

That is why the construction of railways connecting the interior of Angola to port infrastructure sites on the coast began in the last quarter of the 19th century and in the early 20th century. In fact, the construction of the Railway of *Luanda*, connecting the capital city (*Luanda*) to the city of *Malange*, in the interior of Angola began in 1886[5]. The objective of

[5] See Caminhos de Ferro de Luanda (2019) at https://cflep.co.ao/historia/.

this railway was to transport agricultural products to the main consumer centre, *Luanda*, but also for the export of raw materials to Europe.

Investment in trade-oriented infrastructure between Angola and Europe would serve not only Portugal, but also other countries such as Belgium and England. Thus, the *Benguela* railway was built in 1903 with the aim of exporting the copper ore produced in Zambia, an English colony, to the international markets. This railway infrastructure was built by Robert Williams, under the orders of Cecil Rhodes. The railway line connected Zambia to the port city of *Lobito* on the coast of Angola. Finally, a third railway line was built to connect another port city located on the Angolan coast – *Moçâmedes* – to *Menongue*, for the exploration of several ore mines, including iron.

In addition to the railways, under the guidance of Governor Norton de Matos, Portugal invested heavily in road networks for the same purpose of connecting production areas to export infrastructures.

The investments made in infrastructure were concomitant with those made in the production areas in the countryside of Angola. In the last half of the 19th century and the beginning of the 20th century, the agriculture sector developed, specifically the following crops: corn, cassava, sweet potatoes, jinguba, wheat, rice and citrus fruit. At the same time, the production of certain crops for export, such as coffee, cotton and rubber, also began.

The Portuguese occupation drew up a territorial development plan for turning Angola into an export economy of (typically tropical) crops and by-products. Thus, the production of peanuts, palm oil and rubber increased. In 1908, rubber accounted for 65% of Angola's exports (Valério & Fontoura, 1994; Figueiredo, 2014).

The advent of the Second World War ultimately impacted Angola's trade relations with Europe and the world. From 1939 to 1945, Angola's foreign trade grew significantly and exports in tonnage increased at an annual rate of 2.5% (Gonçalves, 2011). The main export products during and after the second war were diamonds, coffee, sisal and cotton.

It should be noted that the production of the crops mentioned before were largely export-oriented. The Colonial Act of 1930 prevented large scale development of industry in Angola. This context only changed when the Portuguese Economic Area (PEA) was created in 1961, under pressure from the Angolan independence movement. The PEA aimed at greater integration between the Portuguese colonies and Lisbon, including the development of the secondary sector – manufacturing industry – in countries such as Angola. This is how the textile industry developed in Angola in the early 1970s, accounting for a significant part of the GDP. Soon after, an event impacted significantly trade relations between Angola and Europe, including Portugal – Angola's independence.

2.1.3. The Angolan Economy in the Early Days of Independence

On November 11th, 1975, Angola declared its independence from Portugal. Angola's independence occurs in a political environment with *sui generis* characteristics and with significant impact both on the structure of the economy and on Angola's relationship with its trading partners.

At the time of independence there were three independent political movements, the MPLA[6], the FNLA[7] and UNITA[8]. Independence was declared in Luanda, the capital city, by the MPLA without any prior alignment with the other two parties. The fact that the three parties had not agreed on how independence should take place triggered a civil war that would destroy the economic infrastructure we described previously. In an environment of war across the territory and the destruction of the main economic infrastructures, the Angolan economy and its position in the global economic context changed remarkably (Cacuto, 2001).

On the other hand, with the advent of independence, another phenomenon occurred. Most of the Portuguese human contingent left for

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[6] Popular Movement for the Liberation of Angola

[7] National Front for the Liberation of Angola

[8] National Union for the Total Independence of Angola

Portugal and other countries, and they took with them knowledge about and experience in the Angolan economy. Factories and agricultural fields were abandoned, and the financial sector weakened.

Although the Portuguese population and capital abandoned Angola during the decolonization process, the same did not happen with the capital of other countries, especially those that invested in the exploration, development and production of oil and diamonds. This happened, despite the economic model adopted at the time, socialism.

In the oil sector, large American (Chevron, Texaco) and French (Fina, Elf) groups continued to develop the oil sector soon after independence. It is also worth noting that oil production has always taken place offshore Angola. Onshore production was and is greatly reduced. On the other hand, the equipment needed to produce Angolan oil has always been manufactured in countries other than Angola. Hence, it is said that the oil sector is an enclave sector.

Since the country was at war and it had a thriving offshore oil sector, Angola became an exporter of a single product – oil – and importer of the vast majority of goods and services it consumed.

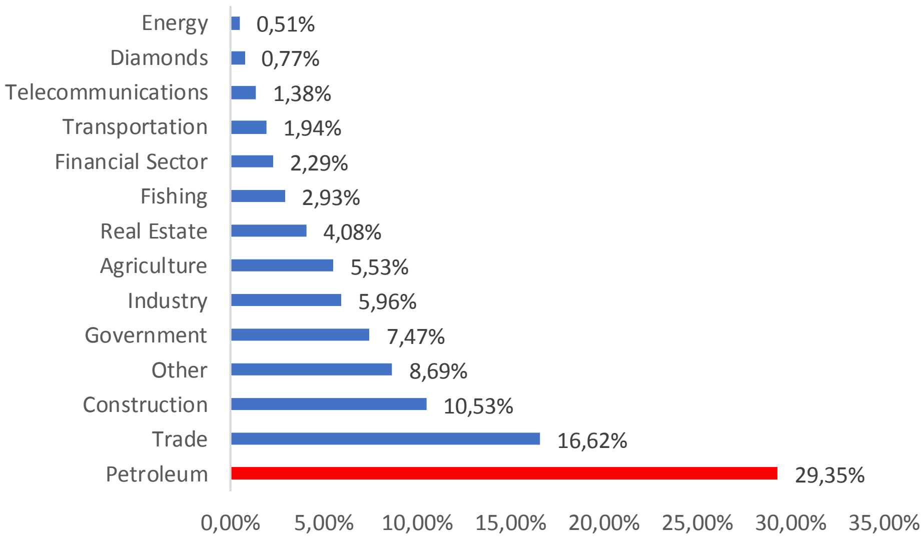
In this section we have briefly characterised the Angolan economic history to help readers understand why Angola is currently a less diversified economy, dependent on the export of oil and imports most of the goods and services it consumes.

3. Angola's Trade Relationship with the Rest of the World

Section 2 allowed us to infer that Angola's ancient and recent history has made it a typically exporting economy. With the arrival of the Portuguese, Angola exported slaves. During the colonial period, it exported agricultural products. And after independence, it exported oil.

Angola's recent history, marked by a military conflict of almost 30 years, has prevented the development of key sectors such as agriculture and onshore industry and has enhanced the development of an offshore oil industry.

FIGURE 1. **Structure of Angola's Gross Domestic Product**



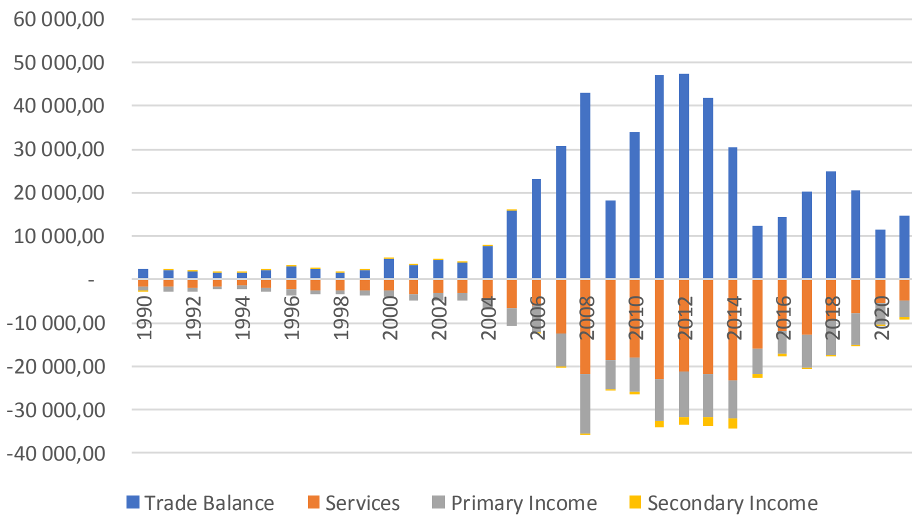
Source: National Bank of Angola.

Oil began to assume the greatest weight in the structure of the Angolan economy. Figure 1 shows the structure of Angolan Gross Domestic Product in 2018. It should be noted that that year oil accounted for almost 30% of the Gross Domestic Product, and the current situation is not much different.

Additionally, the civil war that lasted for almost 30 years after the independence did not leave room for much investment in education and health. The knowledge gap between the Angolan population and other countries, especially developed economies, widened. This was and still is reflected in Angola's trade relationship with the rest of the world and a brief analysis of some of Angola's balance of payments subaccounts points in this direction.

The following is a graph with balance of payments data that will help the reader understand the dynamics of Angola's trade relationship with the rest of the world.

FIGURE 2. **Current Account of the Balance of Payments (Million USD)**



Source: National Bank of Angola.

Figure 2 shows that there are accounts of Angola's balance of payments that are structurally loss-making. An example is Services. It should be noted that, throughout the time series in Figure 2, the balance of the Services account on the balance of payments is always negative, i.e. Angola imports more services than it exports. This account includes services such as consulting, construction, insurance, travel, etc. One of the factors contributing to the negative Services account is the lack of skilled labour and know-how, which must be imported for the proper functioning of the oil and non-oil activity.

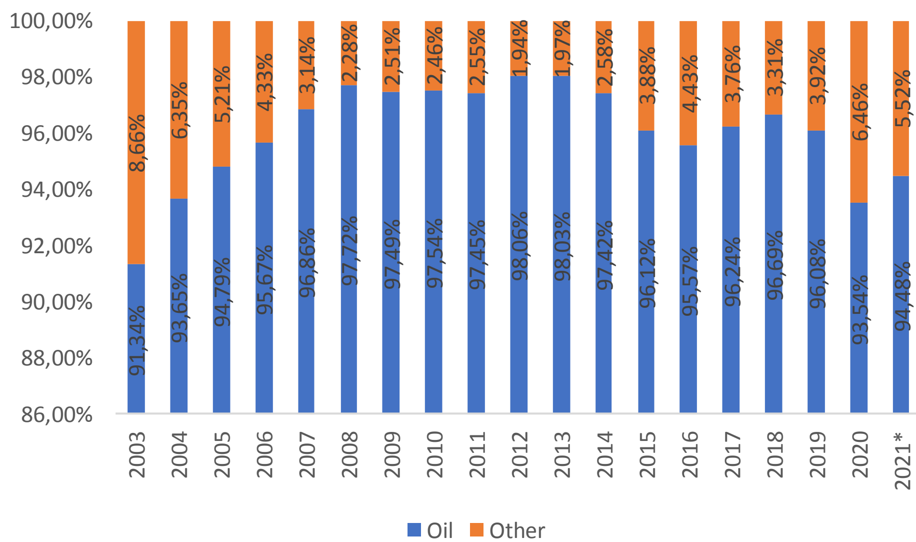
The figure also shows a positive Trade Balance, i.e. the value of exports of consumer goods and equipment is higher than that of imports. This is justified by the fact that Angola has benefited, simultaneously, from an increase in oil production and in the price of a barrel of oil on international markets.

The next paragraphs discuss Angola's relationship with its trading partners, in terms of exports and imports.

3.1. Destination of Angola's Exports

As mentioned above, the only industry that developed competitively in Angola, according to international standards, was the oil industry.

FIGURE 3. **Weight of Oil in Angolan Exports (Million USD)**



Source: National Bank of Angola.

The fact that the world's largest oil producing companies operate in Angola, alongside the largest suppliers of services in this area, meant that production of the oil deposits discovered has been growing since Angola's independence, making it the main export product. As shown in Figure 3, oil represents a significant share of Angolan exports, always above 90%.

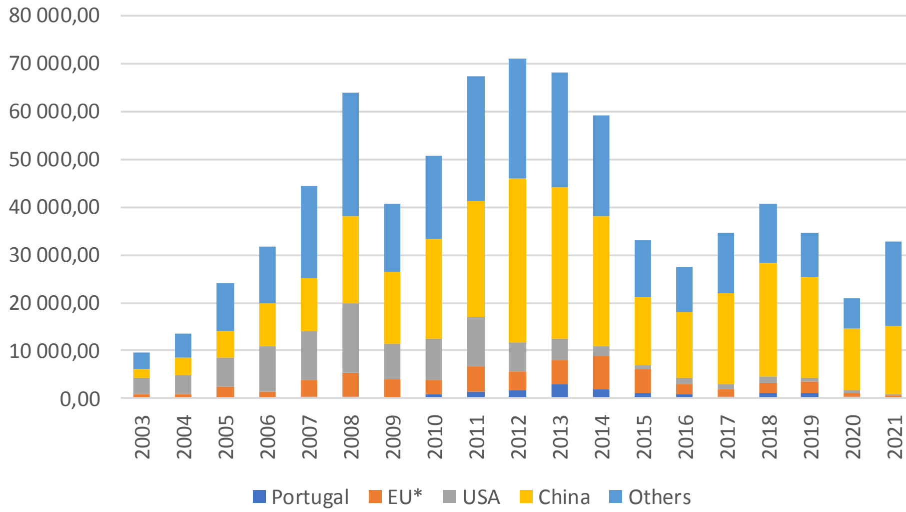
Due to the weight of oil in the export structure, it can be said that Angola is a single-export economy. Between 2003 and 2021, oil accounted on average for 96.77% of Angolan exports and, consequently, the main source of foreign currency that is necessary to cover expenditure on imports. And what are the main destination countries of Angolan oil?

TABLE 1. **Export of Angolan Crude Oil by Destination Country (Million USD)**

DESTINATION	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021*	Average
Total of Oil Exports	**8 530,4**	**12 441,9**	**22 583,2**	**29 928,6**	**42 351,8**	**61 665,7**	**39 270,8**	**48 629,1**	**64 538,6**	**68 871,4**	**65 611,2**	**56 363,9**	**31 393,8**	**25 577,4**	**31 064,9**	**36 539,4**	**31 396,2**	**18 296,5**	**20 048,8**	**37 637,1**
CHINA	1 837,0	3 711,4	5 590,9	8 996,8	11 166,0	18 337,0	15 110,3	20 820,0	24 324,2	34 160,0	31 688,8	27 346,4	14 075,2	13 865,1	19 156,0	23 715,9	21 232,7	12 917,0	14 158,3	16 958,4
USD	3 278,7	3 906,9	6 143,9	9 403,0	10 164,0	14 382,3	7 470,6	8 808,8	10 282,4	6 024,4	4 619,7	1 995,0	969,6	1 305,7	912,5	1 160,7	855,3	344,1	256,9	4 857,1
INDIA	274,2	606,6	526,4	602,6	2 340,9	2 660,2	3 680,0	4 912,1	6 879,6	6 926,4	6 764,2	4 694,3	2 666,9	1 946,6	2 630,9	3 245,5	2 828,5	1 135,3	1 429,8	2 986,9
OTHER	216,3	1 689,5	3 491,0	3 000,8	5 472,0	6 862,3	2 541,8	2 343,4	1 442,1	2 264,5	2 077,9	1 970,2	865,8	1 071,7	1 449,6	796,1	1 072,8	449,3	428,3	2 079,2
CANADA	117,2	88,3	1 364,3	1 644,7	2 479,6	3 180,5	2 129,3	2 829,4	5 584,6	3 429,8	3 305,0	2 596,3	1 034,6	873,0	1 078,9	682,8	0,0	91,0	206,5	1 721,9
TAIWAN	690,4	694,3	909,0	1 558,1	1 760,6	1 558,2	1 154,5	2 316,3	5 314,3	4 215,2	3 486,3	2 615,9	1 408,3	1 130,9	1 386,5	150,8	182,9	285,7	132,6	1 629,0
FRANCE	472,4	641,8	1 777,1	1 033,9	2 196,4	3 108,5	2 977,1	1 804,9	2 092,1	1 134,7	1 328,2	1 946,1	1 567,6	890,8	314,8	620,6	492,8	360,8	139,6	1 310,5
SOUTH AFRICA	37,0	165,0	340,1	543,1	1 639,3	2 503,4	1 241,1	1 521,5	1 686,2	2 874,5	1 753,6	1 934,3	1 349,5	1 266,5	1 338,4	1 121,4	359,2	156,6	352,3	1 167,5
SPAIN	57,0	181,4	546,4	286,5	673,1	1 607,0	681,4	887,6	614,4	1 476,0	2 443,6	3 483,9	2 210,9	816,7	913,6	1 168,3	1 092,7	384,9	139,6	1 035,0
PORTUGAL	127,0	0,0	28,2	0,0	424,5	464,5	207,5	865,9	1 518,7	1 720,6	3 072,2	1 907,9	1 189,4	796,8	280,1	1 057,8	1 101,0	265,9	64,3	794,3
NETHERLANDS	79,1	17,8	97,0	122,0	1 399,2	2 370,1	1 219,2	714,0	1 538,0	974,7	1 625,5	1 946,8	1 043,2	420,9	0,0	68,6	122,0	210,4	143,1	742,7
ITALY	266,0	23,3	34,1	57,1	485,2	121,3	0,0	219,9	2 385,6	1 199,0	1 029,0	1 341,5	1 102,8	479,6	450,2	474,2	740,9	261,9	398,4	582,6
CHILE	67,1	406,6	1 103,0	1 070,3	685,6	1 561,5	38,1	0,0	0,0	0,0	0,0	377,5	53,7	0,0	0,0	0,0	188,6	75,1	438,7	319,2
BRAZIL	43,0	0,0	115,5	344,2	793,9	1 879,6	118,2	378,6	215,0	261,2	395,0	1 032,8	0,0	0,0	0,0	0,0	0,0	0,0	0,0	293,5
ENGLAND	110,0	0,0	50,2	0,0	0,0	466,0	287,0	77,2	333,0	1 161,8	729,8	292,9	904,7	306,8	59,6	0,0	0,0	0,0	0,0	251,5
THAILAND	244,0	0,0	87,7	113,5	57,5	0,0	0,0	0,0	0,0	121,0	200,6	266,0	44,2	17,0	189,4	671,5	580,5	887,4	647,3	217,2
INDONESIA	0,0	167,6	0,0	0,0	0,0	0,0	0,0	0,0	214,8	319,7	215,1	204,4	548,2	286,2	414,7	601,5	0,0	0,0	381,6	176,5
SINGAPORE	74,0	0,0	105,4	0,0	0,0	0,0	0,0	129,5	0,0	93,8	458,2	97,7	205,9	0,0	135,9	379,2	242,5	359,4	544,0	148,7
JAPAN	154,0	52,4	63,2	665,0	130,6	95,8	120,1	0,0	0,0	290,5	320,4	214,7	103,2	0,0	187,9	201,0	55,8	41,2	63,3	145,2
KOREA	159,0	56,8	0,0	437,7	423,3	347,1	229,8	0,0	0,0	0,0	98,2	0,0	50,1	103,3	96,5	0,0	61,4	0,0	66,5	112,1
ISRAEL	144,0	32,2	97,0	49,3	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	69,3	423,5	186,8	70,5	57,9	59,5
GERMANY	28,0	0,0	0,0	0,0	0,0	160,4	64,6	0,0	113,8	223,7	0,0	99,3	0,0	0,0	0,0	0,0	0,0	0,0	0,0	36,3
PUERTO RICO	0,0	0,0	29,6	0,0	59,9	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	4,7
ARGENTINA	55,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	2,9
EQUATORIAL GUINEA	0,0	0,0	50,3	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	2,6
HONG KONG	0,0	0,0	33,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	1,7
SENEGAL	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
GIBRALTAR	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0

Source: National Bank of Angola.

FIGURE 4. **Destination of Angolan Exports (Million USD)**



Source: National Bank of Angola.

The latest information shows that China is the main destination for Angolan exports. This has to do with two main factors. First, the series in Figure 4 relates to a period in which the Chinese economy grew at a rate of 6% to 8% in real terms. This growth required a higher consumption of oil by China, with Angola as one of the main exporters to that country. Secondly, from 2004 onwards Angola began to benefit from credit lines from Chinese commercial banks directed towards the country's reconstruction process[9]. These credit lines were not structured as traditional loans normally repaid with cash. In this particular case, Angola repaid its loans by providing crude oil to China.

The period of reconstruction of the country's infrastructures that were destroyed during the civil war and its form of financing explained in

[9] Note: the civil war in Angola ended on April 4, 2002.

the immediately preceding paragraph, explain the fact that China is the largest destination for Angolan exports, which, as we have already seen, largely consist of crude oil.

In terms of average oil export values, between 2003-2021 (see Table 1), China is in the top position, with a sharp difference from other countries. The United States of America is next, to where Angola exports amounted, in average annual terms, to USD 4 857.1 million between 2003 and 2021. This is related to the fact that U.S. companies such as Chevron and Exxon were among the largest oil producers.

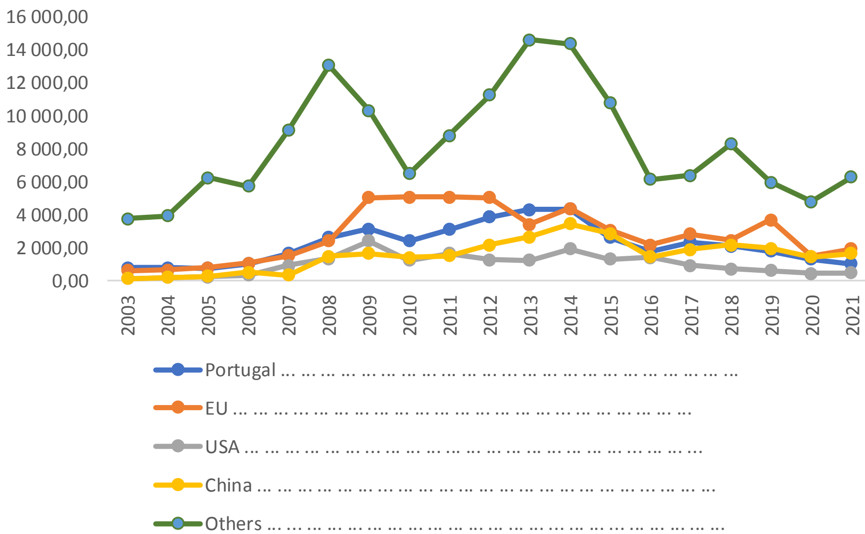
Analysing Table 1 we note that the European country to which Angola most exported oil is France. Angola exported, in average annual terms, USD 1 310.5 million to that country between 2003 and 2021. This can be supported by the fact that, as is the case of the United States of America, Total Energies is one of largest oil producers in Angola. As we will see later, Angola exported in average annual terms USD 794.3 million between 2003 and 2021 to Portugal, with whom Angola maintains a strong import relationship.

3.2. Origin of Angolan Imports

The fact that the Angolan economy is hardly diversified – the weight of oil is almost 30% – means that sectors such as agriculture, livestock, fisheries, etc. are not very developed. Consequently, there is a need for the external supply of consumer goods to complement the domestic supply. In addition, as previously discussed, the poorly qualified workforce of Angola in the most diverse areas of the economy, including agriculture, construction, industry and services, means that Angola imports qualified human resources to develop its economy. Therefore, it can be said that Angola imports almost everything it needs, from capital to consumer goods, as well as services.

Historically, Portugal has been the main source of Angolan imports. The following graph seeks to analyse the historical profile of Angola's imports in terms of their origin.

FIGURE 5. **Origin of Angolan Imports**



Source: National Bank of Angola.

Since the end of the military conflict in Angola (2002) until now, the annual average value of Angolan imports of goods has amounted to about USD 15 810 million. As Figure 5 shows, the European Union is Angola's largest trading partner from the perspective of imports. Over the same period, Angola imported from the European Union an average annual amount of goods of around USD 5 billion.

Among the EU countries, Portugal stands out as the main trading partner of Angola in terms of imports. From 2003 to 2021, Angola imported goods from Portugal with an average annual value of approximately USD 2,210 million.

After Portugal, the growing trade relationship with China is worthy of note. As we have seen in the previous section, China is the main destination of Angolan exports. In recent years, it has assumed an increasing weight in terms of country of origin of Angolan imports, and in some years the annual value imported from China has exceeded that of Portugal.

The increase in Angolan imports from China can be explained by the way Chinese credit lines to Angola are structured. Chinese banks grant financing in the form of export credit. Chinese companies benefit the most from payments made by Chinese banks for goods exported to Angola in the context of public works.

4. Outlook for the Europe-Angola Relationship

Currently, 9 out of 10 USD are invested in the oil sector in the form of foreign direct investment. The descending trend of oil production and the fact that oil is a non-renewable resource makes it urgent for Angola to diversify its economy. Since the European Union in general and Portugal in particular are Angola's largest trading partners, this relationship must be consolidated on the diversification of the Angolan economy. In other words, the relationship between the European Union and Angola should not be limited to trade only. It must also seek to promote the sustainable development of the Angolan economy through direct investment by European public and/or private entities, after mutually advantageous opportunities are identified.

The consolidation of this partnership relationship between the European Union (including Portugal) and Angola must take place under an Economic Partnership Agreement (EPA), firmly anchored in the objectives of sustainable development, human rights and development cooperation[10].

There are areas which European direct investment should address, offering win-win opportunities to Europe and Angola. For example, Angola has vast areas of arable land to cultivate. Through European investment and know-how, Angola can be one of the top contributors to food security in Europe and the world. Besides, the increase in domestic food production in Angola thanks to European investment

[10] https://ec.europa.eu/trade/policy/countries-and-regions/development/economic-partnerships/, accessed 28 March 2022.

can help stabilize prices, bringing Angolan inflation down to single-digit levels.

Another area where there may be direct European investment with advantages for both sides is that of technology, more specifically the use of it to increase the productivity of human capital and the competitiveness of local industries.

Concerning technology applied to human capital productivity, Europe's support to Angola could include the structuring of information necessary to lay out new career paths, existing and emerging skills necessary for different occupations and requalification options for different sectors as a consequence of the introduction of new technology. For endowing Angola with a competent and competitive workforce, it will be essential that its human capital master new technologies, such as artificial intelligence, big data and machine learning (AlphaBeta, 2020).

On the other hand, so that the diversification of the economy can have a positive influence on Angola in the medium-long term, an area of opportunity with mutual advantages would be the application of technology to industry and even agriculture. Angola can benefit from the extensive experience of European farmers and industrialists and use in its industry (as is already the case in oil) technology that allows the Angolan economy to be on an equal footing with others, in terms of the competitiveness of its primary and secondary sector.

5. Conclusion

In conclusion, Angola can be a market that contributes to European economic resilience in a post-pandemic period. The historical and cultural relations between both economic regions, fostered by the Portuguese language, and the fact that Europe is Angola's main economic partner, must be consolidated. In many ways, Angola can be a frontier market for Europe, especially on the path to achieving some sustainable development goals, based on a model that is mutually advantageous.

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EU-Brazil Relations: Navigating Normless Waters?

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Abstract: This chapter analyses how changes in the Brazilian foreign policy impact overall EU-Brazil relations in light of the EU's own strategies of external action. First, it highlights the key aspects of the latest Brazilian administrations in terms of continuity and change in the country's external action with a particular outlook on its policy towards the European Union and its Member States. Secondly, the chapter analyses the impact of the so-called "normless Europe" on EU-Brazilian relations, by examining two agendas: the EU-Mercosur trade negotiations and the EU-Brazil Human Rights Dialogue. In doing so, it argues that processes of change in Brazilian foreign policy and in the external action of the European Union are conducive of bilateral relations that are increasingly underpinned by pragmatic and low-profile initiatives.

Keywords: European Union; Brazil; Mercosur; Normative Contestation; Normless Cooperation.

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1. Introduction

This chapter aims to assess the impact of a normless European Union (EU) – or rather a EU that faces internal crises that challenge its norms and values – on its relations with Brazil, a country which has moved closer to illiberal principles since the beginning of the Bolsonaro administration in 2019. Therefore, it focuses on understanding the dynamics of a relationship between Brazil and the European Union as both face changes domestically and in the international environment around them. On the one hand, the new government of Brazil has led to a process of change in Brazilian foreign policy. In the EU, on the other hand, the gap between rhetoric and promotion is growing, as is internal norm contestation at the domestic level, with the rise of illiberal governments in countries such as Poland and Hungary. By assessing two forms of interaction, normative contestation and normless cooperation, this chapter aims to assay whether the latest political dynamics in both the EU and Brazil have transformed the normative nature of EU-Brazil relations.

Regarding the EU political dynamics, it may be observed that the EU has reduced its normative rhetoric in the past years (Duke, 2017), even though it continues to be bound by the promotion of human rights and democracy externally. At the same time, there is a growing gap between the norms promoted by the EU in its external action and the domestic affairs of many Member States. The multiple crises that the EU has had to face in recent years, in particular the migration and the Rule of Law crises, have been the most prominent when it comes to the internal and external challenges to the promotion and protection of EU values. However, is it accurate to refer to a normless EU in its external relations? By addressing the EU's relations with Brazil as a so-called strategic partner, we contend in this chapter that such analysis must be nuanced and that the relationship often fluctuates between normless cooperation and normative contestation.

This chapter is divided into two parts. The first reviews the main changes in the foreign policy of Brazil in the last decade with special attention to aspects that are relevant to the country's relationship with the EU. The second part sheds light on two forms of interaction, normless cooperation and normative contestation, and analyses the cases of the EU-Mercosur trade negotiations and the EU-Brazil Human Rights Dialogues.

2. Brazilian Foreign Policy in turmoil

When it comes to the political and foreign policy dynamics in Brazil, over the past decade we observe different rules underpinning the country's foreign policy, including different forms of contestation. The current administration in Brazil has promoted significant changes to Brazil's external priorities, for instance, sidelining South-South cooperation and reforms of multilateral institutions to openly challenge 'globalism'. In this sense, the current administration has been characterised by a combination of anti-liberal, anti-multiculturalism, closed society, and conspiracy-driven foreign policies, demonstrating a strong affinity with illiberal and authoritarian regimes across the globe.

Thus, like the European Union, Brazil has recently faced political turmoil. In the last four years, Brazil has been led by three Presidents from different political parties, drastically moving the country's ideological leadership from the left to the far-right. As one may observe, this sudden shift in partisanship had significant implications for foreign policy and Brazil's relations with its key partners, including the EU.

During Dilma Rousseff's Presidency (2011-2016), Brazil was already facing a decline in its international activism. The country's economic and political instability, in addition to the President's lack of charisma and interest in foreign affairs – unlike her predecessor – weakened Brazil's international performance (Cervo & Lessa, 2014). Nonetheless, when it comes to the relations with the EU, the regular activities under the EU-Brazil Strategic Partnership (set out in 2007) have not changed overall: the 5th, 6th and 7th EU-Brazil High Level Summits were held and the 2nd EU-Brazil Action Plan was signed. However, progress in the EU-Brazil relations was not able to overcome the deadlock of the EU-Mercosur association agreement, even though formal negotiations resumed in 2010. Although Brazil's public opinion has been overall in favour of the deal, the industrial sector in Brazil, but especially in Argentina, has shown strong resilience to the agreement.

Due to Rousseff's impeachment process, Vice-President Michel Temer took over as president of the country in 2016. In terms of foreign policy, although important continuity is observed in the overall principles of Brazil's foreign affairs, significant changes may also be identified, especially with regards to Brazil's stance on the crisis in Venezuela, and the role of South American organisations, such as Mercosur and Unasur. For instance, Brazil joined the 'Lima Group', an informal gathering of some American countries, which aimed to take a tougher attitude towards Maduro's government. Besides, Venezuela was suspended from Mercosur in 2017, initially because it did not internalise Mercosur's rules in due time and lately because it breached the bloc's democratic clause (Folha de São Paulo, 2017). Moreover, Brazil, (and other countries, including Argentina, Paraguay, Colombia, Chile and Peru) has suspended its participation in the Union of South American Nations (Unasur), a regional initiative lead by Presidents Lula, Chávez and Kirchner in the 2000s. It was considered by the new right-wing South American leaders as an 'ideological' and 'Bolivarian' project (Agência Brasil, 2018).

Furthermore, aligning itself with the priorities of Argentina's President Mauricio Macri, Brazil under Temer has revitalised Mercosur's external agenda, supporting trade negotiations with the European Free Trade Association (EFTA), Canada, Singapore and South Korea, whilst coming out clearly in favour of the conclusion of the historical association agreement with the EU. As argued by Temer's Foreign Minister, Aloysio Nunes, these steps represented a return to the principles of *open regionalism,* which had founded Mercosur in the first place. However, when it comes to the relations with the EU, Brazil's political instability resulting from by the impeachment process significantly hindered the progress of the EU-Brazil Strategic Partnership and of its sectoral dialogues. In contrast to previous years, no EU-Brazil High Level Summit was organised during Temer's Presidency, even though FM Nunes had paid a visit to High Representative Federica Mogherini in

November 2018 (Blanco & Luciano, 2019), politically stalling progress in the bilateral relations.

Although some important changes are visible in Temer's Presidency, especially with regard to Brazil's regional performance, the election of far-right president Jair Bolsonaro has led to the most striking transformation in Brazil's foreign policy, which had been traditionally conducted by the key role of the Brazilian diplomatic corporation (Itamaraty). For the first time in Brazil's contemporary history, the Head of State has challenged key principles of the country's external action. In his first statements, Bolsonaro's Foreign Minister, Ernesto Araújo, aligned Brazil with the populist governments of Hungary, Poland, Italy and the US, voicing strong criticism of the multilateral institutions and international regimes, which in his view are dominated by 'Marxist and globalist' ideology. Along these lines, he has expressed intention of withdrawing Brazil from multilateral initiatives that were established with Brazilian support, such as the UN Migration Pact and the Paris Agreement. He also cancelled the UN Climate Conference that should have been held in Brazil (COP25) (Frenkel, 2019).

At the regional level, Bolsonaro's foreign policy has so far followed in Temer's footsteps, by adopting a hard-line stance on Venezuela's Maduro, recognising the opposition's leader Juan Guaidó as Venezuela's legitimate President, and formalising Brazil's exit from Unasur, alongside other right-wing leaders (Agência Brasil, 2019). When it comes to trade policy, despite its initial nationalist rhetoric, Bolsonaro has so far maintained the approach of his predecessor and continues to support Mercosur's trade negotiations with third partners, including the association agreement with the European Union, which finally came to an end in June 2019. Nonetheless, EU-Brazil relations have not yet emerged from the standstill observed since Temer's administration. Apart from a meeting on Science and Technology Cooperation held in April 2019, the two partners have not engaged in any other high level political meetings, which makes us wonder what perception the EU and Brazil both have of themselves as 'strategic' partners.

3. EU-Brazil relations: towards a normless stance?

Brazil and the European Union have nurtured a long-standing and multidimensional bilateral agenda since the 1960s, when both sides initiated diplomatic relations. In 2007, this relationship was upgraded with the establishment of the EU-Brazil Strategic Partnership. Since then, EU-Brazil relations have been marked by a broad and vague agenda, with global ambitions but blurred objectives (Blanco & Luciano, 2019). Successive Action Plans and more than 30 sectoral dialogues have demonstrated the comprehensive nature of this relationship, which has covered key issues, such as peace and security; regional cooperation; science, technology and innovation; people-to-people exchanges; and sustainable development. EU-Brazil relations have also overlapped with other EU dialogues with Latin America and the Caribbean countries, in particular the EU-CELAC forums, which have covered relevant topics such as migration, and the EU-Mercosur Association Agreement (a priority when it comes to discussions on trade liberalisation).

Despite the multiple institutional channels set up by both parties, Brazilian stance towards a normative European Union – over the past years, but especially since the beginning of the Bolsonaro administration – carries entrenched scepticism. While Brazilian foreign policy recognises the EU's strong presence as a trade and economic actor, the EU's normative character is often seen as "perpetuating hierarchical Euro-centric relations" (Sandrin & Hoffmann, 2019), leading to an unequal relationship. Furthermore, the impact of a normless Europe in the Brazil-EU relationship is arguably reduced by the already prior perception of a gap between the EU's rhetoric and its present – but also past – actions.

Therefore, we consider two forms of interaction for the development of EU-Brazil relations as both sides experience change in their normative stances domestically and in their foreign policy:

1 – **Normless cooperation**: EU and Brazil should put aside clashing norms and focus more on their trade and investment agenda, particularly the implementation of the EU-Mercosur association

agreement. The EU-Brazil strategic partnership would be revitalised under these terms and less importance would be given to the issues which Brazil and the EU disagree on. Meetings on a more normative agenda, such as the Human Rights Dialogues, would partially lose their function and visibility over time.

2 – **Normative contestation**: Both sides should tone down their norms. There are differences of opinion about issues such as environment, human rights, rule of law, labour standards, which would reverberate in the positions taken at multilateral fora. As a result of such interaction, Brazil's priority would move away from the EU as a regional actor and would focus on bilateral relations with like-minded European governments, such as Hungary and Poland.

The two empirical examples below seek to assay whether any of these ways of interaction have been observed in Brazil and the EU's the concrete agendas over the past years. While the first case is in fact a bi-regional agenda, represented by the latest developments of the EU-Mercosur Association Agreement, the second case refers to the EU-Brazil Human Rights Dialogue.

3.1 EU-Mercosur Association Agreement

EU-Mercosur trade negotiations were launched in 1999, almost a decade before the EU-Brazil Strategic Partnership. They were put on hold from 2004 to 2010, and only resumed in 2016. In June 2019, a political agreement was finally reached, but the document is following the legal revision and translation process, before it is signed, ratified and fully implemented. Sensitive sectors, whose negotiations were stalled at the end of the 1990s, remain the same: in the case of the EU, the agriculture and beef sectors – especially concerning countries, such as France, Ireland and Poland – have resisted opening the European market up to Mercosur economies, fearing dire competition. On the Mercosur side, industrial lobbyists were traditionally against a sudden decrease in tariffs applied to EU industries sector. While progress has been made since 2016 when it comes to goods, the inclusion of new chapters on labour, animal welfare, and sustainable development & environment rules have brought new challenges to the conclusion of negotiations.

The past years have set the pace of EU-Mercosur negotiations due to political changes in both regions, especially in Brazil. After President Rousseff was impeached, the administration of her Vice-President, Michel Temer – supported by the right-wing president of Argentina, Maurício Macri – favoured speeding up trade negotiations with the EU to show that the country is not protectionist and that it had turned to the West as its priority. It is remarkable, in this sense, how open the EU was about concluding the deal before the elections in Brazil (October 2018), with an interim government, which took office after Ms. Rousseff's impeachment.

A similar tone was maintained by the Bolsonaro administration regarding trade liberalisation in Brazil. However, in stark contrast to both previous administrations, Bolsonaro's government has fostered change in Brazilian normative positions, relativising the protection of human rights and environmental laws. While left-wing administrations of Presidents Lula and Dilma in Brazil to some extent contested the trade elements of the EU-Mercosur agreement, Bolsonaro's position has moved from trade to normative contestation, neglecting or opposing the promotion of environment, sustainability and human rights norms in multilateral fora and in bilateral negotiations, such as the EU-Mercosur agreement. The most remarkable episode was Bolsonaro's clashes with President Macron of France, who publicly denounced Bolsonaro's lies about deforestation commitments and opposed to the conclusion of Mercosur negotiations in its current form (Politico, 2019).

Despite clear clash of norms between key EU and Brazilian policy-makers – which is aligned with *normative contestation* – it is worth mentioning that the European Commission is still focused on implementing the EU-Mercosur agreement, in spite of the resistance of civil society and of some EU Member States against the deal reached with Mercosur, which may be a relevant sign of *normless cooperation*. Nonetheless, normative concerns in Europe are nowadays the main impediment to the legal review and implementation of the agreement, given that the agreement needs to be ultimately ratified by the European Parliament and national/ subnational parliaments (Luciano & Junqueira, 2021).

3.2 EU-Brazil Human Rights Dialogues

In 2008, the first Joint Action Plan of the EU-Brazil Strategic Partnership (Brazil, 2008) called for "regular human rights consultations", which would address bilateral and multilateral issues at appropriate fora and in the context of a "high-level political dialogue between Brazil and the EU" (Brazil & European Union, 2008). The EU-Brazil High-level Human Rights Dialogues (HRD) were established under this bilateral framework. While regular EU-Brazil Summits were only held from 2007 to 2014 (except for 2012), the HRD began in 2009 and continue to take place every year with few exceptions. In December 2021, the tenth edition of the HRD dialogues was held in Brasilia. The dialogue is mostly seen as an opportunity for a peer-to-peer "wide-ranging exchange of views" (Ministry of Foreign Affairs of Brazil, 2021) on human rights topics and human rights developments at multilateral levels, such as the UN Human Rights Council. The HRD meetings are co-chaired by senior officials on both sides (e.g. the EU Special Representative for Human Rights, and a senior official such as a minister or diplomat of Brazil). They are attended by Brazilian government officials and diplomats, and by EU civil servants from the EEAS, the EU delegation to Brazil, and the European Commission. In each annual cycle of HRD, a Brazil-EU Civil Society Seminar is held in the same location.

The EU-Brazil HRD follow the EU Guidelines on Human Rights Dialogues with third countries (henceforth, guidelines) from 2001, and were revisited in 2009 and in 2021 with the goal of enhancing their "political relevance" (Council of the European Union, 2021). The guidelines lay down the modalities of dialogue and the standard practices of participation, communication and follow up. They also emphasise the quest for a balanced relationship with alternating location for the dialogues, site visits on both sides, and an agenda for discussion that reflects priorities for both parties. As such, the overall goal is to raise human rights issues on both sides, learn about the steps taken to address human rights violations and related challenges, and exchange best practices. The HRD, however, are part of a broader bilateral relationship that has been "marked by a broad and non-defined agenda, with global ambitions, but blurred objectives" (Blanco & Luciano, 2019, p. 469)

There are also structural obstacles to a balanced EU-Brazil relationship in the field of human rights and its dialogues. First, the EU has the initiative and the common framework for multiple human rights dialogues, which include not only guidelines, but also a longstanding human rights diplomacy (Keukeleire & Delreux, 2014, p.136) with dialogues as its "modus vivendi" (Smith, 2015, p.161). Secondly, while agenda topics are discussed jointly and reflect interests on both sides, the overall discussion is tilted towards exchanges on human rights issues in Brazil. This imbalance is most visible in the group discussions of the Civil Society Seminars, in which both the Brazilian and European civil society organisations focus largely on the human rights agenda in Brazil. Finally, a third structural challenge refers to the institutional asymmetries between Brazil and the EU. On the one hand, the Brazilian government has authority to legislate and enact policies in the field of human rights based on the country's federal constitution and is therefore responsible for its policies. On the other hand, the EU relies substantially on its Member States' national human rights policies, and regionally on mechanisms such as the European Court of Human Rights.

Comparing dozens of human rights dialogues sponsored by the EU, we find that Brazil and the EU are historically not far apart in their views on the global liberal order, democracy, human rights, and multilateralism (Pavese et al., 2014). Broadly speaking, Brazil's foreign policy is strongly rooted in the principles of sovereignty and non-intervention, while the EU is in favour of strong enforcement and compliance mechanisms. At the same time, Brazilian foreign policy in recent years, and especially under President Bolsonaro, has given less attention to certain human rights issues or refocused the approach and position in areas such as rights of LGBTI persons, indigenous peoples, and women. This new focus of Brazilian foreign policy at a time when the EU itself is rethinking its overall human rights promotion globally, the normative gap between both parties has widened. This growing normative gap puts the EU-Brazil relationship under stress, which could lead to normative contestation. However, contrary to the high-level summits, which stopped in 2014, the EU-Brazil HRD continue to take place, even during the Bolsonaro administration and despite a growing normative gap. Arguably, much of the normative contestation takes place behind closed doors, while the dialogues themselves largely keep a low profile with brief communications to the public. Transnational levels of the relationship, such as the Civil Society Seminars, see higher levels of normative contestation in the field of human rights and provide opportunities for cross-border cooperation of civil society organisations, but there is limited political follow-up.

4. Conclusion

This chapter sought to discuss how the EU-Brazil Strategic Partnership has navigated normless waters in recent years. Through the analysis of the EU-Mercosur trade negotiations and the EU-Brazil Human Rights Dialogue, two modes of interaction of the bilateral relations were analysed: normless cooperation and normative contestation. Regarding the EU-Mercosur negotiations, the fact that an agreement on the negotiations was reached allegedly in 2019, despite the clash of norms between the EU and Brazilian actors regarding sustainable development and deforestation, has indicated that commercial interests came first. However, the subsequent delays in the legal revision and ratification of the Association Agreement suggest that several European, national and subnational actors have contested the agreement due to the lack of commitments from Mercosur countries, especially Brazil, to sustainable development and the norms associated with the Paris Agreement, denoting instead a form of normative contestation. On the EU-Brazil Human Rights Dialogues, the current trends also point to growing normless cooperation. Following the trend, the regular dialogues are maintained, but contestation is kept at low levels thanks to diplomatic practices and the low public profile of the HRDs.

Political and social transformations in Europe, many of which are accelerated by the Covid-19 Pandemic, have been challenging the EU's external action capabilities. It is assumed that multiple crises undermine the domestic implementation of principles and norms that the European Union preaches and defends internally and externally. The rise of populist parties and rising nationalism in Europe is accompanied by a rule of law crisis in various Member States. The migration and refugee crises and its political framework as a security issue, undermine the EU's external promotion of human rights. The implications of these crises, and others, for the EU's contemporary external action remain anecdotal and understudied, especially when the other end of the relationship, such as in the case of Brazil, undergoes significant changes in foreign policy orientation. On the one hand, it is important to assess the internal impact of the growing gap between principles and events in Europe. Does it mean, for instance, that EU external action, goals and rhetoric are adapted? On the other hand, one needs to look at the external impact: how is this new context perceived by third parties and how it impacts external action in practical terms. This chapter has provided an analytical framework to shed light on the EU's external engagement in a spectrum between normative contestation and normless cooperation. Future research can look deeper into empirical cases to further analyse the impact of changes in its partners' domestic and foreign policies on EU external action.

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