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RECOVERY INSTRUMENT: An epochal change in political economy

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Abstract

- The Recovery Instrument (RI) represents a change in the philosophy of political economy because it breaks the link between liability and responsibility which is the conventional basis of the market economy. This change in the economic rationale is justified by the fact that the current crisis did not have an economic origin. The use of this new Instrument should be inscribed in the lively ongoing debate on the reform of capitalism.

- The global economy incurs frequent, unpredictable shocks and with great effects of externalities. For this reason, economic policy needs to strengthen exceptional safeguards with funds from "outside" the current state budgets, such as the RI.

- The RI, by its nature, is also based on the ability to repay or remunerate the funds used. It is therefore based on the economy's growth capacity. Capitalism is showing that it has dynamic forces within itself to restart, but only in divergent measures between countries and sectors. Consequently, the use of the RI must be not only exceptional, but also aimed at raising the potential growth of the beneficiary country.

- The change in philosophy extends to relations between states. The breakdown of the relationship between liability and responsibility and the finalization of the funds towards the recovery of growth capacity of the weakest countries shows that from a relationship of "competition between States" we have moved to one of "sharing and co-participation among States".

The economic consequences of the pandemic crisis have the dimensions of the most serious recession documented in modern states in peacetime. Reflections on how to react to the conditions of instability, hardship and transformation of economic and social systems are underway and are shaping ambitious economic policy responses. The Recovery Instrument (or NextGenerationEU), designed by the European Commission and still under negotiation in the European Council, promises to be the most innovative initiative taken by western governments.

The character of the Recovery Instrument is to break the link between the emergency response and the individual states. The instrument also provides for the temporary issue of bonds to finance the needs to which the national budgets may not be able to correspond. Outsourcing the financing of economic policy modifies the usual logic of efficiency of economic systems. In conditions of necessity, resources are no longer found within a jurisdiction and not even through the temporal shift of charges directly borne by citizens (that is, through conventional debt), but through an external budget shared with other countries. In this perspective, the initiative of the European Commission poses a question about the nature of market economy regimes that are based on the known correspondence between liability and responsibility. This correspondence between cost and benefit in respect to the same subject is overcome by the new instruments for sharing the costs of the pandemic.

Since its beginning, the deep recession caused by the pandemic crisis has raised questions about the very nature of capitalism and globalization. In these pages, I will try to describe some of the questions on the validity of the market economy system in order to demonstrate how doubts are not always connected to the causes of the current crisis, the nature of which is health related and therefore exogenous. This partly justifies, from a logical point of view, the search for solutions outside the national economic system.

At the same time, however, I will try to underline the powerful novelty introduced by the establishment of a budget external to national jurisdictions - the Recovery Instrument - with the aim of stabilizing a capitalist system characterized by two factors: being exposed to extreme and frequent shocks; its stability depending on the economy's ability to grow. Without growth, stability would not be granted by conventional instruments for amortizing social and economic costs.

The exceptional nature of the Recovery Instrument's interventions and its functionality for the recovery of growth capacities determine its rules of use. In conclusion, some considerations follow on the coherent use of European resources, especially in Italy.

A question of reforming capitalism

The harsh economic consequences of the pandemic crisis have prompted radical reflections on the future of capitalism. In addition, the crisis comes shortly after a series of severe financial system failures during the twenty years before 2010. Furthermore, technology and financialization of the economic system have accentuated the tendency to increase inequalities between segments of the population and between geographical areas, weakening the hope that the market economy would lead to convergence conditions.

With the pandemic crisis, the imposition of public order rules dictated by the social distancing health priorities was interpreted as a "suspension of capitalism": a necessary freezing of the system of goods production and commercial exchanges that characterizes the market economies. The reasons for the criticism of capitalism already frequent in the reflections of economists and public opinion have become so embedded in the dynamics of the pandemic crisis that they have stopped the market economy machine, offering at least an opportunity to reflect on how the gears should start working again.

The criticism of the capitalist system has targeted at least five shortcomings: 1) it has emerged that social security and health needs must be superimposed on the freedom and decentralization of the choices of economic operators, producers, intermediaries or consumers; 2) the market also seemed unable to resolve on its own the needs for the supply of indispensable medical material in a short time; 3) the structuring of capitalism on a global scale meant that health problems in a country interrupted or delayed the supply of products and services along the global value chains, highlighting their inefficiency in emergency conditions; 4) the sudden recession exposed the weaker parts of society, in particular precarious or self-employed workers, to the most severe consequences; 5) the weaker states found it more difficult to finance themselves to counter the consequences on their social system, as if market logics contributed to divergence rather than to the convergence of not only economic but also social and human conditions.

These are relevant considerations and they should remain in the public discourse and in the political debate even if the current crisis is considered to be of exogenous origin to the functioning of the market economies or if it is shown that the market economy itself remains the best institution for the problems of production and distribution of goods and services.

To understand the nature of the ongoing crisis, it is necessary to proceed with a brief description of what happened.

The health crisis and the consequences on economic policy

To explain the economic policy response to the recession caused by the pandemic, I will offer a list of observations with each being the consequence of the previous, although it would be imprudent to structure them too systematically.

1) The first consideration concerns the origin of the shock that produced the recession. In recent decades we have become accustomed to two different types of recession: the first induced by monetary policy with the aim of moderating the level of economic activity; the second type of recession was instead a consequence of financial shocks. In this second case, the origin of the recession was linked to imprudent

choices in managing economic cycles or to reckless choices in the administration of regimes for regulating financial systems in an overlapping of private and public debt. As regards the recession of 2020, it was instead the consequence of extra-economic precautionary measures primarily aimed at containing the health risks. It is therefore not easy to draw direct conclusions from the "suspension of capitalism" on the functioning of the market economy system.

2) The main economic policy response - the suspension of activities involving social interaction - was also dictated by extra-economic reasons. The effects of the social distancing measures, however, have manifested themselves in varying ways depending on the structure of the economy. For example, sectors and professions that require intense interpersonal relationships were hit more quickly. The causes and effects of the measures undertaken by the public authorities have depended substantially on the health policy choices more than on any other consideration concerning efficiency, equity or stability. Not only the causes of the recession, but also the response to it, therefore, are not related to the economic system.

3) Furthermore, it is difficult to evaluate the economic policy responses already adopted in terms of cost and benefit because the evaluation horizon is not clear. In other words, the timing for the solution to the health emergency is not clear, nor the availability of vaccines, nor that of anti-viral medications. It is also unclear whether the pandemic proceeds linearly, whether it dies out by itself, or whether it proceeds in cycles and, if so, whether a second wave is to be expected in the short or medium term. For this reason, it will be possible to assess ex-post the adequacy and proportionality of the policy measures adopted.

4) However, the exogenous nature of the shock and its eventual exhaustion cannot entirely exculpate those who must produce economic forecasts with the aim of regulating a country's political economy. The type of political economy response, a binary response (everything closed or everything open) depended on the sudden invalidity of the forecast models available. As an example, it is calculated that the variability of the results of the American labor market corresponds to a multiple between 50 and 70 of the standard deviation of the models, a magnitude that is completely impossible to estimate on the basis of conventional data bases.

5) Although the size and speed of the 2020 crisis makes it completely exceptional, what has happened questions the ability of economists and governments to react promptly and correctly interpret the available data. The case of the US unemployment figures released at the beginning of June, which instead of recording an increase showed a marked decrease, exemplifies the difficulty for a political decision maker to refer to reliable statistical indications. The availability of adequate data is part of the core of the discussion between supporters of the market economy and supporters of the planned economy. However, if in the first case the weak reliability of data is a serious problem, in the case of those who propose to plan the functioning of an economy it can be an existential problem.

6) In addition to the data, the post-pandemic recession is casting doubt on the extent and effectiveness of traditional economic policies. It is currently unclear how effective monetary policy can be beyond its extensive employment already underway as a consequence of the global financial crisis. Central banks

responded to the 2008 crisis - with different delays between the United States and Europe - by bringing interest rates to the zero lower bound. They were able to respond to the 2020 recession with guarantees through the banking channel, as well as with monetary intervention through the purchase of both public and private bonds. The limits of monetary policy action are set by the uncertain response of inflation, which for more than a decade has not been responding directly to the money supply of central banks. It is equally difficult to imagine what additional margins are available for fiscal policy since public debts, which started in many countries from high levels, are already reaching unprecedented levels.

7) The criticism of capitalism must be compared above all with cyclical data that come from the US economy and, in part, from the German economy, which seem to tell us a story that is more difficult to interpret than that which prevailed in recent months regarding the structural failure of economic systems. If the signs of recovery in June 2020 are confirmed in the coming months, the one caused by the pandemic could be not only the deepest recession in history, but also the shortest. In other words, the political and economic systems would have reacted with such vitality or despair as to put market mechanisms back into motion more quickly than expected.

8) The examination of the system's response does not stop at the impression of having to deal with random consequences of a chaotic condition, but must refer to political choices with a strong ethical connotation, positive or negative. In the American case, for example, the absence of structured social safety nets such as the European ones has prompted many workers to take a personal health risk in order to maintain their work income. The data on the lack of control of the spread of the virus in the US with respect to Europe seem to indicate that the continuation of the functioning of the economic system, entrusted to the self-limitation of personal freedom/responsibility by the individual, contemplates a much greater sacrifice of human lives. In the German case, it is clear that economic sacrifice is instead regulated by the public authority and charged to the public budget with the aim of both preserving the income and vitality of families and businesses, and supporting the neighboring countries of the European Union. Neither of two choices, however, the American and the German, very different from each other on the ethical-political level, has led to a radical revision of the capitalist model. The system appears to have demonstrated resilience in both "variety of capitalism" configurations. The latter should also be redefined due to the specific risk aversion of one community compared to another. In this case, the alignment of policies with "individual preferences" - even if in reality we may rather have to deal with "conditional" if not "forced choices" - depends on the policy's intervention.

9) The relatively effective functioning of market automatisms is perhaps less surprising considering that the recession caused by the pandemic came after the longest expansion phase in the history of the US economy, as shown by the data in table 1, collected by the National Bureau of Economic Research, and after a period of almost full employment in Germany and government budgets with wide margins of intervention. However, the fact that US firms made record bond issues again in March is an indication of the resilience of the US capitalist model. In the two critical months of March and April, there were also opportunistic capital increases that were made with the aim of strengthening liquidity on the balance sheet. Despite a significant increase in spreads depending on creditworthiness, access to markets remained open also to "fallen angels" and "speculative grade" bonds.

10) Capitalism's surprising response capacity, if it will reveal itself as such in the coming months, must be interpreted. Modern economies are circular systems in which families and businesses rely on the continuous generation of income through production and consumption. Unlike the classic economies, in which the accumulation of savings was decisive for the survival of businesses and families, in modern economies, not only has the State assumed an active or automatic stabilizing role, but in recent decades access to credit has made it possible to use market instruments to distribute the effects of shocks over time.

11) The economic policy response to the pandemic crisis was to guarantee the possibility of credit to businesses and consumers and at the same time to offer shock absorbers to those who, losing their jobs, did not have access to their main sources of income. For businesses, the availability of liquidity through the banking channel has been, and will be, all the more important the longer production will stand still. However, the provision of liquidity by economic policy institutions cannot be permanent in the absence of economic growth. Financial charges in fact grow over time and for a business that is unable to obtain revenues and that sees its cash flow decrease, they become increasingly difficult to sustain, even if the costs are minimal. Social safety nets for the support of workers who are left without income are also burdensome for the State and they too cannot be permanent if the economy is unable to grow again. The entire system depends existentially on the ability to grow. The issue of redistribution in market economy systems seems to depend on the functionality of economic development policy choices.

12) At this point a consideration could be introduced in favor of the planned economies, in which the choices of the operators - banks, investors, companies, consumers - are preordained and not voluntary. Indeed, the significant increase in public intervention in the spring of 2020 also in market economy systems has brought the two traditionally opposed models closer together, while preserving the decentralization of the choice of consumers and economic operators and giving State intervention an intentionally temporary character.

13) For the political decision maker it was a question of breaking the vicious circle that was consolidating between the two channels of shock (supply and demand), which feed each other reciprocally. A system of fragile firms does not hire workers left without employment and this reduces the demand for goods and services from the same firms. If the workforce remains unemployed for a long period, it can lose its professional skills and in some cases, even the existential motivation to resist and wait for new opportunities. A permanent job loss means a decrease in the future growth capacity of the economy as a whole. Physical capital can also deteriorate and intellectual capital can quickly lose its value. Under such conditions, firms tend to invest and hire less than what would have happened in the absence of the shock. Lower growth tends to affect marginal workers in particular, those who are often employed in precarious jobs. In the case of the pandemic shock, this coincided with the direct effects of the health crisis on some manual and low-skilled professions that cannot be carried out remotely.

14) The need to avoid hysteresis effects raises a demand for social protection that can put pressure on States' ability to finance their growing needs. In the two charts below, taken from the ECB's May 2020 financial stability report, we can see how European governments let their budget deficits increase in parallel with the expected drop in income (first chart). Budget policy's choice is to be considered correct,

but the result (according to the second chart) was the creation of very different conditions among the various countries, with the more fragile ones forced to increase the deficit more than the others, with the consequence of having the relationship between debt and GDP in market conditions that can make financing difficult increase more than proportionally.

15) The strong fiscal policy response from governments has nonetheless managed to stabilize household disposable income despite the dramatic drop in hours worked. The initial monetary restriction was promptly countered by central banks that made financial conditions less restrictive. The ability to control the spread of the virus in some countries, or the low sensitivity to human and health costs in others, has made it possible to resume activity in key sectors of the economy. Within two months, for example, US car production went from zero in April to 80% of the pre-pandemic level.

16) The traditional ideological opposition between economists in favor or opposed to state intervention in the economy has nevertheless taken on new aspects, as a consequence of the interdependence of modern economic systems. A relevant dimension in the economic policy response to the pandemic-induced recession has in fact been taken up by cooperation between States, even more than by specific public intervention at national level. The criticism of capitalism should therefore be grafted onto a political dimension which goes beyond the traditional national one. The multinational nature of economic policy has also characterized the global scale. Fiscal stimulus policies have been implemented in all the major world economies and measures of an even greater size have been implemented through public guarantees to firms operating in the jurisdiction, regardless of the enterprise's nationality. Aggressive monetary policies have been adopted almost simultaneously by all central banks. Informal forms of coordination have also been implemented in a context of poor political cooperation.

17) In the case of the euro area, economic policy response was strongly influenced by the – still ongoing – experience of the 2008 global financial crisis and the subsequent sovereign crisis after 2010. The EU institutions, as well as the governments of France and Germany, have clearly decided not to repeat the dramatic experience of 2011, when a more or less exogenous crisis (Lehman then, Coronavirus today) was followed by a serious debt crisis in Italy and Spain. The objective of keeping the debts of the two Mediterranean countries sustainable was pursued by trying to keep the cost of servicing debt below the economies' growth rate (i-g). The first objective was addressed by the European Central Bank with an ad hoc program for the purchase of both public and private bonds. The second objective was entrusted to various initiatives aimed at providing financing and support resources for investments and unemployment funds, in particular in the two riskiest countries.

18) The most innovative intervention in this regard is the Recovery Instrument (NextGenerationEU) with which the European Commission has proposed a series of instruments aimed at supporting and reforming the economies of the European Union. See Buti-Messori "Next Generation EU: An interpretative guide" (Luiss SEP Policy Brief, June 2020).

Considerations regarding the Recovery Instrument

Numerous novelties in economic policy dictated by the special emergency of the pandemic crisis emerge from this provisional review. It would be prudent to avoid drawing overly blunt conclusions, however, there are also elements of systemic importance that should be incorporated into policy functions to be prepared for the future.

As for the specific answer to the question of economic policy reform, it is probably necessary to take note of the fact that the forecasting models we have are not entirely reliable because in just ten years they have already been forced to operate twice outside the range of any previous experience. If we add to these exceptional events the known risks that have an unknown scale, such as that of climate catastrophe, the potential threat to the global relations system due to the ungovernability of cyber security and other risks caused by the lack of multilateral cooperation at global level raises questions about the need to permanently increase exceptional safeguards. In other words, building resources alongside the current budgets of the States in order to intervene in emergency conditions. At national level, this should take place by reconstructing the margins of maneuver of the government budget. At European level, the big news has been the preparation of emergency budgets, or rather non-permanent ones, such as the Recovery Instrument (NextGenerationEU) just proposed by the European Union in the context of, but not within, the Multiannual Financial Framework, the EU's seven-year budget.

In the context of the considerations made, the use of NextGenerationEU resources should be of a non-cyclical nature and such as to respond to exceptional conditions. In such a case, the options to use the resources to cut taxes for one or two years seem completely ill-conceived. Similarly, the hypothesis that the plan's investment projects are not approved on the basis of their contribution to increasing the potential growth of the Italian economy represents a serious mistake. The system will not be sustainable without a return to growth levels that are higher than those which preceded the pandemic crisis.

Ideally, the instruments prepared by the European Commission should be designed so that they can be activated in emergency conditions or with the aim to prevent these conditions, for example, with appropriate policies and investments in favor of the environment, which is facing a climate risk.

When fully operational, under normal conditions, it will instead be necessary to significantly strengthen the automatic stabilizers and to regulate precarious employment relationships. To this end, budget policy must rebuild the margins of maneuver that have proven useful in countries such as Germany.

Obviously, the distinction between conditions that require exceptional fiscal measures and "normal" conditions is very ambiguous. It is sufficient to remember the flexibility clauses systematically applied since 2015 within the European semester. But also previous reforms of the Stability and Growth Pact envisaged taking into account exceptional conditions that justified budget policies in derogation from the pursuit of the medium-term objective.

For this reason, it is important to adequately insert the new "exceptional" instruments, conceived after the pandemic crisis, in the context of the "European semester", the exercise coordinating the economic policies of the euro-area countries. To a large extent, this exercise has remained ineffective. The recommendations issued by the European Commission were either sufficiently general, so much so that countries could consider them as the "good intentions" that the reality principle rarely allowed to materialize, or too deeply rooted in statistical exercises that circumvented the most political issues and therefore also the responsibility of governments.

The introduction of the Recovery Instrument makes the specific recommendations of the European Commission for a country much more difficult to overlook. The significant resources made available by the Recovery and Resilience Facility will in fact be provided only on condition that the national reform plans that each country must send to the European Commission in the spring are aligned with the recommendations and that this alignment is actually recognized by Brussels. The reforms must not only be designed, but implemented and verified with the contribution of the Commission itself. Should the Commission not give its approval, the country concerned would not receive funds that correspond to several percentage points of its GDP. The political motivations of the national government would be to obtain the consent not only of the Commission, but also of the other countries that would be called upon in the common institutions to exercise control over each other. In fact, while the contribution of each country to the common instruments is determined by pre-established keys (the size of the GDP of the individual countries), the distribution of resources depends on assessment factors, including qualitative ones. Considering that the "reforms" will be at the center of these exercises, we will see valuations on not only technical, but above all political aspects, although aspects founded on the most solid possible empirical bases. It is conceivable that a development in this direction of the European Union's common governance exercise implies a more transparent politicization of the economic coordination process, right up to the establishment of common responsibilities, with a European Finance Minister supervised by the European Parliament.

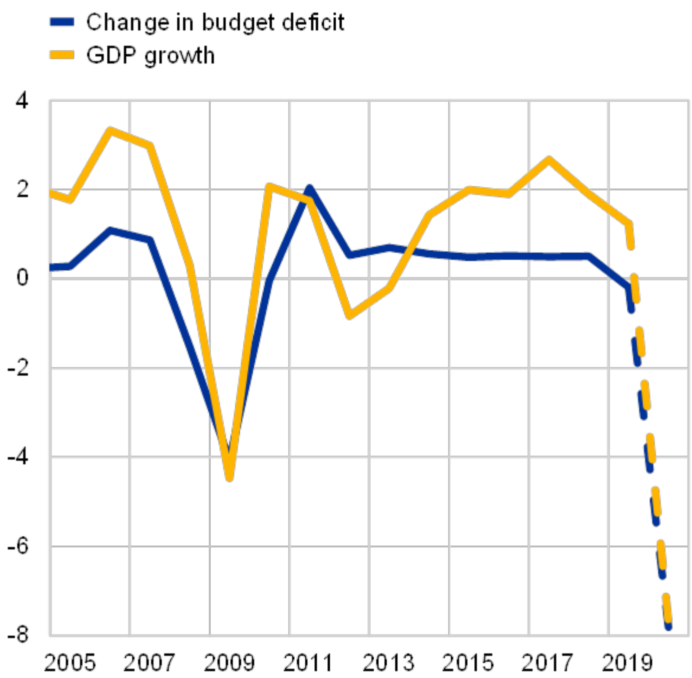
The conventional conclusion is that, rather than a revision of capitalism, the crisis triggered by the global pandemic requires the strengthening of social and financial embankments within each country, embankments that must contain risks, which are not always foreseeable on the basis of our knowledge of the economy's dynamics.

However, the most significant novelty of the traumatic experience caused by the pandemic disease is the evidence of a shared fate among European Union countries, which instead of reasoning in terms of mutual competition - as it was common to say in the last twenty years - have learned to communicate with each other not only economically. This too - a relativization of competition between agents among whom common interests prevail - is an important reform of the logic underlying market economies, so much so that it takes on an innovative dimension in political philosophy. Not surprisingly, these countries are deciding not to leave market forces alone regulate mutual relations, but, having found a common destiny in the face of the pandemic, they have made themselves available to share the political decisions relevant to each of them.

BUSINESS CYCLE REFERENCE DATES		DURATION IN MONTHS			
Peak	Trough	Contraction	Expansion	Cycle	
Quarterly dates are in parentheses		*Peak to Trough*	*Previous trough to this peak*	*Trough from Previous Trough*	*Peak from Previous Peak*
	December 1854 (IV)	--	--	--	--
June 1857(II)	December 1858 (IV)	18	30	48	--
October 1860(III)	June 1861 (III)	8	22	30	40
April 1865(I)	December 1867 (I)	32	46	78	54
June 1869(II)	December 1870 (IV)	18	18	36	50
October 1873(III)	March 1879 (I)	65	34	99	52
March 1882(I)	May 1885 (II)	38	36	74	101
March 1887(II)	April 1888 (I)	13	22	35	60
July 1890(III)	May 1891 (II)	10	27	37	40
January 1893(I)	June 1894 (II)	17	20	37	30
December 1895(IV)	June 1897 (II)	18	18	36	35
June 1899(III)	December 1900 (IV)	18	24	42	42
September 1902(IV)	August 1904 (III)	23	21	44	39
May 1907(II)	June 1908 (II)	13	33	46	56
January 1910(I)	January 1912 (IV)	24	19	43	32
January 1913(I)	December 1914 (IV)	23	12	35	36
August 1918(III)	March 1919 (I)	7	44	51	67
January 1920(I)	July 1921 (III)	18	10	28	17
May 1923(II)	July 1924 (III)	14	22	36	40
October 1926(III)	November 1927 (IV)	13	27	40	41
August 1929(III)	March 1933 (I)	43	21	64	34
May 1937(II)	June 1938 (II)	13	50	63	93
February 1945(I)	October 1945 (IV)	8	80	88	93
November 1948(IV)	October 1949 (IV)	11	37	48	45
July 1953(II)	May 1954 (II)	10	45	55	56
August 1957(III)	April 1958 (II)	8	39	47	49
April 1960(II)	February 1961 (I)	10	24	34	32
December 1969(IV)	November 1970 (IV)	11	106	117	116
November 1973(IV)	March 1975 (I)	16	36	52	47
January 1980(I)	July 1980 (III)	6	58	64	74
July 1981(III)	November 1982 (IV)	16	12	28	18
July 1990(III)	March 1991(I)	8	92	100	108
March 2001(I)	November 2001 (IV)	8	120	128	128
December 2007 (IV)	June 2009 (II)	18	73	91	81
February 2020 (2019 IV)			128		146

Change in budget deficit and economic growth

(annual percentage changes)



Sovereign indebtedness in the euro area and expected changes in 2020

(percentages of GDP and percentage points of GDP)