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HANDOUTS

EUROPEAN ECONOMIC POLICY

-SECOND PARTIAL-

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This handout is written by students with no intention of replacing university materials.

It is a useful tool for studying the subject, but does not guarantee preparation as exhaustive and complete as the material recommended by the University.

European Economic Policy

2nd Partial Exam

Michele Rossini - BIEM16 - AY: 2024-2025

EU Budget and Next Generation EU

The size of EU Budget

The EU requires financial resources to implement its policies, and the EU budget is the primary tool for collecting and allocating these funds.

The EU budget amounts to roughly 1.2 % of EU GNI (Gross National Income), minuscule compared with national budgets (e.g. France's > 55 % of GDP) and accounts for just 2 % of total public expenditure across member states. Yet its **political importance is great**: debates over its allocation shape the EU's policy direction and the contours of integration. At about €0.95 per citizen per day, it often draws sceptical comparisons ("less than a coffee"), even though only 7 % covers administration and the remaining **93 % funds cross-border policies** rather than duplicating national spending.

Rationale for EU Budget

Funded by member-state contributions (ultimately EU taxpayers), **91 % of the budget is spent inside the Union**. Guided by subsidiarity, it **corrects *double market failures***, private under-provision and national under-investment in areas like:

- **Transport infrastructure**: markets omit unprofitable routes; governments eschew projects whose benefits spill abroad (e.g. a Franco-Italian tunnel helps Spain).
- **R&D**: firms underinvest due to spillovers; EU coordination boosts efficiency and reach.

Multiannual Financial Framework (MFF) vs Annual Budget

The **MFF** (first enacted with Delors I - 1988) sets financial guidelines over a **7y period**, defining:

- How to broadly **allocate resources within each yearly budget document**
- Where to source the money from

The **Council adopts the MFF unanimously** after securing the **European Parliament's consent by simple majority**. Though not a budget itself, it lays down political priorities and enforces fiscal discipline across the EU.

Key Features

- **Not the annual budget**: a planning tool imposing **multi-year expenditure limits**.
- **Expenditure ceilings**: fixed by category to guide each year's detailed appropriations.
- **Political priority-setting**: signals where future EU investments will focus.

Advantages & Drawbacks

- **PROS**: enables **multi-year planning** and enforces **EU-wide fiscal discipline**.
- **CONS**: **Parliament's role is weaker than the Council's**; unanimous Council votes give each state veto power, often skewing spending towards national interests.

Annual budget Procedure

Within MFF limits, the annual EU budget allocates spending to specific policies through 5 sequential phases:

1. **Proposal:** the Commission drafts and submits the budget to Council and Parliament.
2. **Adoption:** Council and Parliament negotiate; if Council approves but Parliament rejects, the draft fails; if vice versa, Parliament's consent prevails.
3. **Execution:** the Commission implements the adopted budget.
4. **Technical Control / Audit:** the Court of Auditors reviews accounts.
5. **Political Clearing / Discharge:** Parliament votes (50 % + 1) to approve the Commission's management; if the discharge is not granted, parliament may, with a overqualified majority (66 % + 1 vote) cast a vote of no confidence, which would lead to the dismissal of the Commission.

If annual adoption stalls, Article 315 TFEU authorizes monthly payments of **one-twelfth the previous year's budget**. While no commission has ever been dismissed this way, in December 1998, Parliament denied discharge for the 1996 accounts after a whistleblower alleged audit obstruction; Despite Commission President **Santer** declaring that the discharge vote would be treated as a vote of confidence, the Parliament **refused approval**. Santer announced the **mass resignation of the Commission**, preempting a formal vote of no-confidence. Later, in **2006**, French Commissioner **Édith Cresson** was found guilty of mismanagement of funds by the **European Court of Justice**.

Principles Governing the EU Budget

The budget adheres to fundamental principles:

- **Unity:** single document for all revenues and expenditures
- **Universality:** no ring-fencing; total revenue must equal total expenditure
- **Annuality:** one-year cycle within the MFF
- **Specification:** each line item has a clear purpose
- **Unit of Account:** The budget is denominated in **euros**.
- **Equilibrium:** Denominated in euros and always balanced—no deficits or debt.

This **rigidity limits fiscal flexibility**, preventing the EU from adjusting expenditure in response to economic downturns, unlike national budgets. The **Next Generation EU (NGEU)** initiative addresses this limitation but operates outside the MFF.

This annual-balance rule was deliberately chosen to **keep deficit spending and redistributive power at the national level**, **limiting the EU's fiscal autonomy**. While it guards against unchecked borrowing, it also constrains the Union's ability to stimulate the economy during downturns, leaving stimulus largely to member states. To reconcile multi-year projects with a one-year budget, the EU distinguishes between:

- **commitment appropriations**: the total funds pledged in a given year for multi-year schemes
- **payment appropriations**: the actual cash paid out each year.

EG a bridge project planned over seven years is fully committed in the year before work begins but paid out in annual installments as construction progresses.

EXPENDITURES

Although the Commission is legally responsible for implementing the budget, 76 % of funds are managed under ***shared management***, with member states administering funds directly.

Historically, EU expenditures have revolved around 5 broad areas:

- **Agriculture** (Common Agricultural Policy - CAP). In 1970 agriculture alone absorbed 92% of spending
- **Structural Policies**: Support for economic cohesion in poorer regions. Cohesion surged in the 1980s
- **Internal Policies**: Research, education (ERASMUS), energy, transport networks. Peak in the 1990s
- **External Policies**: Enlargement assistance, humanitarian aid, development cooperation
- **Administration**: EU institutional costs (approximately 55,000 staff members)

Today, cohesion and agriculture account for around 80% of expenditures, while administration costs remain 6-7%.

Under the **MFF 2021-2027,** this traditional structure is preserved but reprioritized to boost:

- **Single Market, Innovation, and Digital**: R&D, SME competitiveness, ERASMUS, connectivity.
- **Cohesion, Resilience, and Values**: Support for less developed regions.
- **Natural Resources and Environment**: Agriculture, fisheries, climate change policies.
- **Migration and Border Management**: Asylum, border security, justice policies.
- **Security and Defence**: Internal security and common defence initiatives.
- **Neighbourhood and the World**: Enlargement policy, development cooperation.

To tackle the COVID-19 crisis, **NGEU** adds €750 billion (borrowed by 2026, repaid by 2058) on top of the MFF: **€360 billion in loans** and **€390 billion in grants**. Its core instrument, the ***Recovery and Resilience Facility***, allocates funds by population, GDP per capita, unemployment and pandemic impact; disbursement **requires Council approval** and **alignment with EU green and digital milestones**. At least 37 % of NGEU spending targets climate and 20 % digital transformation.

REVENUES

The EU budget relies on **four own resources**, each reflecting a different principle of contribution and providing varying degrees of financial autonomy:

1. **Traditional Own Resources (TOR)**: **Customs duties on non-EU imports under the CET**. Collected by national authorities (which keep 25 % as a fee), TORs once made up half of budget revenues in the 1970s–80s; today they account for roughly **15 %**, following trade liberalisation and WTO commitments. As an automatic flow into the EU coffers, they remain the most direct form of Union funding.

2. **VAT-based Resource**: A **uniform 0.3 % levy on each Member State's harmonised VAT base** ($\text{VAT Base} = \frac{\text{VAT Revenue}}{\text{Weighted National VAT Rate}}$). **Capped at 50 % of GNI** when the base exceeds that threshold, this mechanism contributes about **12 % of total revenues.** While it ensures proportionality, critics argue it burdens poorer states disproportionately.

3. **GNI-based Resource**: Introduced in the 1980s to balance the budget (enforcing "revenue = expenditure"), this uniform rate, currently around 0.7–0.8 % of national GNI, now provides roughly **73 % of revenues**. Rebates for net contributors (Denmark, Germany, the Netherlands, Sweden, Austria) temper its impact, but heavy dependence on national GNI contributions limits the EU's fiscal autonomy.

4. **Plastic Own Resource**: Since January 2021, a **€0.80 per kilogram charge on non-recycled plastic packaging waste** adds an environmental incentive to revenue generation. Contributions are scaled to each state's non-recycled output, with compensations for those below the EU average GNI per capita, aligning budgetary needs with climate goals

Who benefits from the EU Budget?

The EU budget's core aim is **economic cohesion**: **funds flow disproportionately to less developed regions and to sectors**, like agriculture and infrastructure, **that deliver shared, cross-border gains**.

- Poorer Member States receive a higher percentage of their GDP in support
- Wealthier countries contribute more in absolute terms (each pays roughly 1 % of GDP).

There is no per-capita progression in contributions, underscoring that **EU spending pursues collective European priorities**, not individual fiscal equity.

Historically, **Italy** has been a **net contributor**, paying more into the EU than it receives. Despite helping finance bailouts in Greece, Portugal, Ireland, Spain and Cyprus, Italy itself has never required an EU rescue. The notion that Northern European taxpayers subsidise Italy is therefore **misleading**. Only under the exceptional **Recovery and Resilience Facility of Next Generation EU**—designed to address COVID-19's severe impact—has Italy briefly become a **net beneficiary,** a **temporary deviation** rather than a structural realignment.

The Debate on Net Balances

Net balances, whether a Member State receives more than it contributes, have become a flashpoint in EU negotiations, yet they are merely an **outcome of policy choices**, **NOT policy goals** in themselves. The **EU budget** is designed as a **positive-sum game**: investments in one country spill over to others

via the **Single Market** (allows for free trade, investment and economic integration), **shared infrastructure** (that benefit the entire bloc) and **political stability** (supported by EU funding). **Budgetary balances do not capture the full benefits of EU membership:** focusing on zero-sum outcomes contradicts the very rationale of European integration, which seeks shared prosperity beyond headline net transfers.

Equity Issues: Several structural quirks undermine fairness:

- revenue-side ***corrections*** (rebates to richer states) often counteract cohesion-focused spending;
- the VAT-based resource, even with a 50 % GNI cap, **disproportionately burdens poorer countries**;
- the **25 % customs collection fee** (up from 20 % pre-2021) **advantages major ports in Belgium**, the **Netherlands** and **Denmark** over smaller entry points.

Autonomy & Transparency: The EU's funding model is opaque and complex, making it nearly **impossible for citizens to trace who ultimately pays**. **Dependence on VAT, and especially GNI**, based own resources, collected by national Treasuries and recorded as national expenditures, fosters the perception that the **budget is just another line item in member-state accounts, fueling mistrust**. The **plastic levy is a welcome step,** but true fiscal autonomy demands simpler, more transparent own resources. The Commission is exploring new sources (carbon border adjustments, ETS revenue sharing, a multinational profits levy and potentially a financial transaction tax) to **replace parts of the GNI resource and enhance EU financial independence** (see Monti High-Level Group report, Dec 2016).

MFF 2021–27 & Next Generation EU: The core MFF 2021–27 continues standard multi-year planning. On top of it, Next Generation EU (NGEU) mobilises €750 billion (borrowed by 2026, repaid by 2058) as external assigned revenues, exempt from the budget's no-deficit rule. Although only 70 % was earmarked for 2021–22, at least 37 % of NGEU must fund climate action and 20 % digitalisation. Up to €360 billion can be disbursed as loans and up to €390 billion as grants, allocated by population, GDP per capita, unemployment and COVID-19 impact. Loans add to national debt and must be repaid by member states; grants do not, but net gains for traditional contributors are offset by their continuing own-resource payments.

The Recovery and Resilience Facility, the heart of NGEU, provides €360 billion in loans and roughly €312 billion in grants. National Recovery and Resilience Plans (2021–23) must align with country-specific recommendations and EU green/digital targets. Council approval, by qualified majority, follows each milestone. According to Commission guidelines, funds should drive seven flagship areas:

1. **Power up**: clean and renewable energy
2. **Renovate**: energy-efficient buildings
3. **Recharge & Refuel**: sustainable transport and infrastructure
4. **Connect**: rapid broadband and 5G rollout
5. **Modernise**: digital public services (justice, healthcare)
6. **Scale-up**: European data clouds and advanced processors
7. **Reskill & Upskill**: digital and vocational training across all ages

EU Funding "Headroom" & Future Own Resources: To guarantee NGEU borrowing, the MFF's commitment ceiling is raised to 1.46 % of GNI. Meanwhile, new own-resource proposals—plastic packaging levies (since Jan 2021), the Carbon Border Adjustment Mechanism (transitional since Oct 2023, with 75 % of revenues to the budget), ETS revenue sharing (30 % proposed), an OECD/G20-aligned levy on reallocations of multinational profits (15 % plus a 0.5 % notional base), and possibly a financial transaction tax—aim to provide the EU with genuine fiscal firepower and transparency, reducing reliance on national GNI contributions.

Economic and Monetary Union

Macroeconomic Refresher

A **UK investor** can choose only between **one-year domestic UK bonds** (yield i) and **US bonds** (yield i_t^*). He must factor in expected exchange-rate movements.

- Investing $£1$ in **UK bonds** returns $£(1+i_t)$ after 1 year.
- Investing in **US bonds** requires converting $£1$ into dollars at today's rate E_t, earning $\$(1+i_t^*)$, then converting back into pounds at the expected future rate E_{t+1}^e, for an expected payoff of $£\dfrac{E_t(1+i_t^*)}{E_{t+1}^e}$

Uncovered interest-rate parity holds when these returns are equal:

$$1+i_t=(1+i_t^*)\frac{E_t}{E_{t+1}^e}$$

Rearranged (for small rates),

$$i_t \approx i_t^* - \frac{E_{t+1}^e - E_t}{E_t}$$

so the domestic interest rate equals the foreign rate plus expected depreciation of the pound.

Intuition: **with full capital mobility**, if $i_t\uparrow$ ($\downarrow$), inflows $\uparrow$ ($\downarrow$), today domestic currency appreciates (depreciates), so expected exchange rate depreciation $\uparrow$ ($\downarrow$) tomorrow until parity is re-established.

The Impossible Trinity Principle

No economy can simultaneously enjoy all three:

- **full capital mobility**
- **fixed exchange rates**
- **independent monetary policy**

This trilemma explains **why Europe**, with free capital and a desire for stable intra-EU rates, **had to relinquish national monetary autonomy to create a single currency**.

Exchange Rate Regimes & Market Openness

The real exchange rate (ϵ) measures the price of domestic goods relative to foreign goods once both are expressed in the same currency.

Suppose the UK makes only Jaguars at £30 000 each, and the Euro Area makes only Mercedes at €50 000. With $E = 1.23€/£$, a Jaguar costs £30 000×1.23 = €36 900. Thus

$$\varepsilon = \frac{36\,900}{50\,000} \approx 0.738$$

Meaning one Jaguar costs 0.738 Mercedes.

In reality countries produce more than 1 good, so we need to construct real exchange rates that reflect the relative prices of all goods produced. In practice we use **GDP deflators**, an index for the prices of all final goods and services produced in an economy. We use P domestically and P^* abroad, to capture the price of a broad basket of goods and services. Formally:

$$\epsilon = \frac{EP}{P^*}$$

Where E is the nominal price of domestic currency in foreign currency.

We have:

- **Real appreciation** ($\epsilon \uparrow$) makes domestic goods relatively **more expensive**, eroding competitiveness
- **Real depreciation** ($\epsilon \downarrow$) makes domestic goods **cheaper**, boosting competitiveness.

These shifts can stem from relative price changes (ΔP vs ΔP^*), from nominal exchange-rate moves (ΔE), or both. For instance, a ***competitive devaluation*** lowers domestic interest rates, weakens the currency ($E \downarrow$) and drives $\epsilon \downarrow$, but forces a trading partner's $\epsilon \uparrow$, harming its competitiveness

In a Single Market, where goods, services, capital and labour all flow freely, such beggar-thy-neighbor swings impose real costs and underscore the need for macroeconomic coordination and exchange-rate stability.

Why a Single Currency, the €?

The EU's Single Market rests on 4 freedoms: **goods, services, capital and labour**, that imply **cross-border transactions should be as seamless as domestic ones**. Yet **exchange-rate volatility and the threat of competitive devaluations** (beggar-thy-neighbor policies) create **risk and distort trade**. Under **full capital mobility**, **stable exchange rates can only coexist with a common monetary policy** (the impossible trinity). Absent a supranational central bank, market forces would crown the country with the lowest inflation, Germany, as the de facto monetary anchor, which is politically untenable. **A single currency** (the euro) was therefore **the only way to guarantee both financial integration and exchange-rate stability across the Union**.

Two-fold mutually reinforcing effects of a single currency:

- **Micro**: one currency => **higher competition** (price transparency) => stimulate industry consolidation and investment in the EU => **growth**
- **Macro**: one (independent) CB => **low inflation** in a context of **low interest rates** => **stability**

Historical Path to EMU

From Bretton Woods to Snake

After WWII, the 1944 Bretton Woods system **pegged currencies to the US dollar** (convertible into gold) with ***fixed but adjustable*** parities, **preserving monetary autonomy** via capital controls. The system was consistent with the trilemma as most countries made abundant use of capital controls.

When controls eroded in the 1960s, the **system collapsed.** Exchange rates had to be freed or authorities had to give up monetary policy autonomy. Most governments refused to make such a choice. The dollar became overvalued and in 1971 the US suspended dollar-gold convertibility and **in 1973 fixed rates were abandoned**.

Europe's first regional remedy was the ***Snake*** (1972), which **confined intra-European exchange-rate fluctuations to ± 2.25 %** (tighter than the global ± 9 %). Though many left after the 1973–74 oil shock exposed divergent national policies, the Snake introduced two lasting innovations:

- A firm **commitment to intra-European rate stability** regardless of global turmoil
- **Mutual definitions of currencies independent of the dollar**—paving the way for the later European Monetary System.

The EMS

Launched in 1979 to curb disruptive exchange-rate swings that threatened the Single Market, the EMS rested on its **Exchange Rate Mechanism (ERM)**: a **web of bilateral parities**, **each currency allowed to fluctuate ± 2.25 % around its central rate** (wider ± 6 % bands for high-inflation Italy, Spain, Portugal and the UK). Parities were defined symmetrically against the **European Currency Unit (ECU)**, a basket of member currencies, and defended by coordinated central-bank interventions or, if necessary, unanimous realignments.

When a currency hit its band limit, **national central banks**, via foreign-exchange reserves or overnight borrowing under the **Very Short-Term Financing Facility (VSTFF)**, bought or sold ECU currencies to restore parity; alternatively, they could hike domestic interest rates, though at the cost of reduced growth.

ERM crises and lessons for monetary integration

Between 1979 and 1987, diverging inflation rates forced twelve realignments. As capital controls fell and speculative pressure rose, weaker-currency countries suppressed inflation to converge on **Germany's Bundesbank–led standard**; from 1987 to September 1992 no realignments occurred, effectively rendering the system asymmetric.

German reunification's inflationary impact in 1990 prompted restrictive German monetary policy that others, denied by Denmark's Maastricht rejection, did not match. In **September 1992 speculative attacks** overwhelmed Italy and the UK, forcing them out of the ERM; contagion devalued Ireland, Portugal and Spain and widened bands to ± 15 %, turning the "tight" ERM into a de facto float.

The **1993 post-crisis ERM** resembled a **floating regime** more than a fixed one, yet it survived as a **convergence tool: Maastricht's entry criteria** required two years of ERM membership, now retooled

to define parities exclusively against the **euro**, with undefined fluctuation margins and unlimited, but **ECB-governed,** interventions.

The EMS marked the first time European states anchored their currencies to one another rather than to an external reserve (gold or the dollar), forging unprecedented sovereignty-sharing. Yet the experience underscored the **impossible trinity**: once capital was fully mobile, defending fixed rates with independent currencies proved untenable. The recurring crises convinced policymakers that genuine monetary integration, and ultimately a **single currency**, was the only viable path to lasting **exchange-rate stability** in Europe.

The Maastricht Treaty

Building on the Delors Committee (1989) and the EC document (**One Market**, **One Money**) the Maastricht Treaty (Dec 1991) laid out:

- in great detail how the system would work, including the statutes of the **EB)**;
- the **entry conditions** (inflation, interest-rate, exchange-rate stability, and debt/deficit thresholds, with opt-outs for the UK and Denmark);
- the **timeline** for monetary union and the conditions under which the monetary union would start

By May 1998 all aspirants except Greece met the criteria. On 4 January 1999, 11 currencies were ***irrevocably* fixed**, and monetary sovereignty passed to the **European System of Central Banks (ESCB)**. Euro notes and coins followed in January 2002; by 1 January 2023 twenty countries had adopted the euro.

EMU Framework

- **Irrevocable exchange-rate** fixing paved the way for a **single physical currency**.
- **Monetary policy** is fully **centralized** in the **ESCB/ECB**, while fiscal policy remains decentralized yet coordinated under common rules.
- Many of these rules, such as central-bank independence and debt/deficit limits, are codified economic insights (e.g. Kydland–Prescott's time-inconsistency).
- **Fiscal policy remains decentralized** (i.e. in the hands of national governments) but is increasingly coordinated.

In order to optimize the working of the EMU, both monetary and fiscal policies within the euro area have been subject to a number of rules. These rules are firmly grounded in economic theory (Nobel-awarded pieces of economic research have been legally 'incorporated' in the Maastricht Treaty)

Under TFEU Art. 127, the **ESCB's mandates** are to:

1. **Define & implement** Union monetary policy.
2. **Conduct** foreign-exchange operations.
3. **Manage** official foreign reserves.

4. **Ensure** smooth payment systems.
5. **Supervise** credit institutions.

The **ECB's structure**:

- **Executive Board** (President, Vice-President, four members): executes policy.
- **Governing Council** (Board + 20 national central-bank governors): sets interest-rate and liquidity guidelines.
- **General Council** (Board + 27 governors): harmonizes non-euro-area coordination.

Economic Theory and the EMU: The MONETARY side

Price Stability and Time Inconsistency

It is widely acknowledged that **price stability underpins investment and growth**. To secure it, CBs must focus squarely on **inflation** and remain **independent of political cycles**. If they instead chase employment, perhaps due to government influence, they succumb to the **time-inconsistency problem**: **agents anticipate post-wage-fixing stimulus, so actual unemployment doesn't fall, but inflation rises**.

ESCB Objective & Institutional Safeguards

- Clear commitment to **price stability**, echoing the Bundesbank's credibility.
- It **may support broader Union policies** ONLY if **unaffected by its anti-inflation mandate**.
- High **CB independence**
- **Strict no bail-out clause** curtail moral hazard.

ECB Strategy Evolution

- **2000–03 "Double-Pillar" Strategy**:

1. **Direct inflation targeting**: 0 – 2 %
2. **Monetary targeting**: M3 growth capped at 4.5 %

Persistent M3 overshoots and concerns over excessive tightness prompted a rethink.

- **May 2003 Revision**: refocused on "below, but close to, 2 %" inflation; formal M3 ceiling dropped (though still monitored).
- **2021 Symmetric Target**: commits to a 2 % medium-term inflation goal, treating deviations above or below as equally undesirable to anchor expectations and ward off deflation.

There are **3** main **problems** related to a **too low inflation target**:

1. **Zero-Lower Bound for nominal interest rates**: too low inflation, too low nominal rates, limited room for cuts in recessions (necessitating **QE**).
2. **Measurement Error**: slight **deflation** may **masquerade as minimal inflation**, risking **recession**.

3. **Relative-Price Rigidity**: moderate inflation greases real wage/price adjustments, avoiding painful nominal cuts, a vital buffer after financial crises.

EG: it is easier for a country to regain competitiveness in a context of moderate inflation rather than in a context of stable prices, as the latter would imply nominal decreases in prices/wages. Hot issue in the aftermath of the financial and sovereign debt crisis!

Policy-Rate Corridor & Transmission

The ECB's ultimate aim is to steer the **interbank market rate,** since this rate feeds through to the borrowing costs facing households and firms, this is the **monetary transmission mechanism**. To do so, the Governing Council sets 3 policy rates, which together create a corridor that bounds overnight interbank rates (e.g. EONIA or EURIBOR):

- **Main Refinancing Operations (MRO) rate**: provides the bulk of system liquidity. Pre-crisis it was a minimum-bid auction rate; post-crisis it has been administered as a fixed rate
- **Deposit Facility rate**: **floor** for banks' overnight deposits with the Eurosystem, no bank will lend below this.
- **Marginal Lending rate**: **ceiling** for overnight Eurosystem credit—no bank will borrow above this.

Although these policy rates do not mechanically determine interbank rates, **they strongly influence their path**: overnight lending rates always remain within the corridor defined by the Deposit and Marginal Lending rates, clustering around the MRO rate. By adjusting these levers, the ECB shapes overall monetary conditions in the euro area.

Commercial Banks vs CBs:

- **Deposit Facility**: Banks park excess reserves overnight at the ECB's deposit rate (corridor floor).
- **Interbank Market**: Banks lend to/borrow from each other at market rates (EONIA/EURIBOR).
- **Main Refinancing Operations**: Banks post collateral to obtain central-bank money at the MRO rate (regular liquidity).
- **Marginal Lending Facility**: Banks access overnight credit at the marginal lending rate (corridor ceiling).

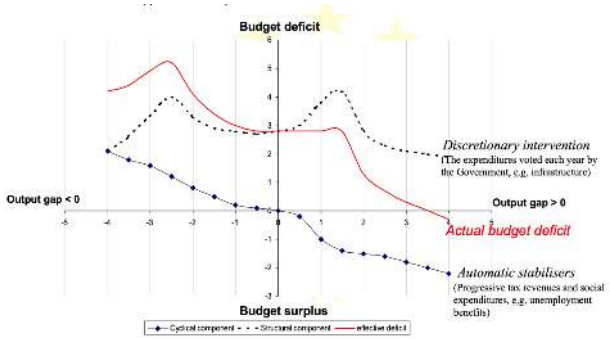
Economic Theory and EMU: The FISCAL Side

Fiscal Policy in a monetary union must smooth the business cycle, running deficits in downturns and surpluses in booms, to **stabilize consumption over time**. By design, national budgets carry a cyclical component, whereas the EU's annual budget is balanced each year. Yet every government faces an **intertemporal budget constraint**: today's tax cuts or spending hikes require tomorrow's surpluses. If deficits are monetized ***printing money*** inflation accelerates, especially when the CB lacks full independence. Higher deficits thus ↑ inflation expectations and actual inflation, eroding credibility and crowding out private investment, which undermines long-term growth.

In EMU, two features magnify this risk:

- **Negative Spillovers**: one country's deficit pushes up euro-area interest rates, penalizing fiscally sound partners.
- **Moral Hazard**: a shared central bank may be tempted to rescue any member, weakening each state's discipline.

Political dynamics, fiscal illusion, political-business cycles (Alesina & Perotti 1995) and coalition bargaining (Persson & Tabellini 2003), have driven Europe's post-1960 deficit bias, demonstrating that without strict rules, debt can become unsustainable.



Two are the **key objectives** of the EMU fiscal policy:

1. achieve **solid, lasting budgetary discipline**;
2. achieve a **strong coordination of national macroeconomic policies**.•The Maastricht Treaty states that ***member States shall avoid excessive government deficits***:

- $\frac{\textbf{Deficit}}{\textbf{GDP}} \leq 3\,\%$

  Buti & Sapir (1998) showed that, across 1961–1990, Europe's automatic stabilizers (unemployment benefits, tax revenues, etc.) would never push a structurally balanced budget beyond a 3 % deficit in normal cycles. Only ***extraordinary circumstances*** (GDP contractions > 2 %, or 0.75–2 % at discretion) justify temporary breaches. Moreover, 3 % roughly equals Europe's public gross capital formation, implying that routine investment can be debt-financed by future generations.

- $\frac{\textbf{Debt}}{\textbf{GDP}} \leq 60\,\%$

  A constant 3 % deficit is sustainable if nominal growth (real + inflation) averages about 5 % per year (2 % inflation + 3 % real GDP growth). Under these conditions, a 60 % debt/GDP ratio remains stable over time.

- An excessive deficit procedure (**EDP**) to enforce compliance.

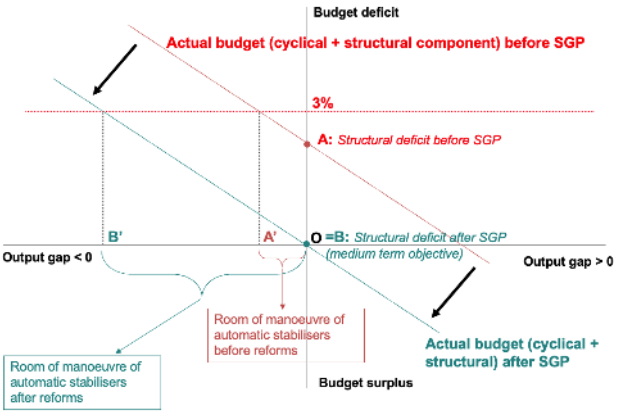
However, a strict **3% ceiling** limits automatic stabilizers in mild recessions. To provide breathing room while preserving discipline, the 1997 **Stability and Growth Pact** introduced:

- A **PREVENTIVE Arm**: each state commits to a **Medium-Term Objective (MTO)** ***close to balance or in surplus,*** which is **stricter than the 3 % deficit ceiling.** To achieve this they submit **annual 5y stability programmes** detailing structural-balance paths. MTOs are set in **structural terms** (i.e. cyclical- and one-off-adjusted) and may factor in **transitory elements** (labour, pension, R&D

reforms) and **other country-specific circumstances**, a flexibility that allows **political compromise but risks ambiguous application**.

- A **CORRECTIVE Arm**, the 3 % $\frac{\text{Deficit}}{\text{GDP}}$ and 60 % $\frac{\text{Debt}}{\text{GDP}}$ **ceilings** remain inviolable.
  - **Automatic exceptions** apply if GDP contracts by > 2 % (or 0.75–2 % at Council discretion)
  - **non-automatic waivers** cover deficits from deep or prolonged downturns.
  - **Enforcement**: **Breaches** trigger the EDP in ECOFIN (TFEU Art. 126), requiring corrective measures within a set timeline;
  - **Sanctions**: Continued non-compliance incurs fines of 0.2 % of GDP (first breach) or 0.5 % (repeated failures). The Pact's crisis-era reforms further strengthened both arms.

By coupling **decentralized fiscal autonomy** with **centralized monetary policy**, these rules guard against inflationary shocks, cross-border spillovers and moral hazard, essential pillars for a **resilient Economic and Monetary Union**.



Fiscal Policy in EMU: Member States compliance & 2024 Reform

Since the SGP's 1997 launch, the Commission has repeatedly urged ECOFIN to open Excessive-Deficit Procedures (EDPs), particularly after 2002. However, Council politics often thwarted enforcement: in 2003, it blocked sanctions against France and Germany by abstaining on the Commission's recommendation. The Commission appealed to the EU Court of Justice, which forced an explicit vote; in turn, the European Council "encouraged" the Commission to propose SGP reforms granting ECOFIN wider "discretional waivers," a compromise that has left enforcement efficacy an open question.

- **2020–23**: SGP rules were suspended in response to COVID-19.
- **2024 Relaunch**: The Pact returns with substantial enhancements:
  - **Medium-Term Fiscal Plans**: each Member State sets a 4–5-year strategy (extendable to 7 with defined reforms).
  - **Reference Trajectories**: for countries with debt > 60 % or deficits > 3 %, **ensuring debt/GDP follows a downward path**.

- **Debt Sustainability Safeguard**: average annual debt/GDP reduction of ≥ 1 % if debt > 90 %, or ≥ 0.5 % if 60–90 %.
- **Deficit Resilience Safeguard**: structural deficit/GDP must improve by 0.4 % annually (0.25 % over 7 years) if deficit > 1.5 %.

Economic Theory and EMU: the COST Side

According to **Mundell's Optimal Currency Area** (1961), a region can sustain a common currency only if it meets four criteria:

1. **Synchronized business cycles** for effective centralized monetary policy.
2. **Fiscal capacity** to absorb **asymmetric shocks**.
3. **Flexible prices and wages** across the area.
4. **Integrated product and labor markets** to facilitate adjustment.

These **OCA conditions** underpinned EMU's design and earned Mundell the Nobel Prize in Economics in 1999—yet they also highlight the inherent trade-offs and coordination challenges of a multi-state currency union.

Maastricht Convergence Criteria

To adopt the euro, Member States must meet three nominal tests one year before entry:

1. **Price stability**: inflation no more than 1.5 % above the average of the three lowest-inflation EU countries.
2. **Interest-rate convergence**: long-term government bond yields no more than 2 % above the average of the three lowest-rate countries.
3. **Exchange-rate stability**: at least two years in the Exchange Rate Mechanism without devaluation —i.e. staying within ± 15 % of central parities.

Rationale: These nominal convergence criteria aim to ensure the elimination of costs associated with the synchronization of business cycles ("one monetary policy fits all?");

NB: The Treaty also caps public deficits at 3 % of GDP and debt at 60 % of GDP—often counted as two additional "convergence criteria," though they serve fiscal-discipline rather than nominal-stability purposes.

Optimal EMU Setup

A well-functioning Economic and Monetary Union combines:

- **Credible monetary policy**: a fully independent central bank, a clear price-stability mandate and a strict no-bail-out rule.
- **Coordinated fiscal policy**: decentralized budgets guided by medium-term balance-or-surplus targets, enforced via the 3 %/60 % rules and the Stability and Growth Pact to support price stability and limit cross-border spillovers.

- **OCA-cost minimization**:
  - Nominal convergence criteria align inflation and interest-rate cycles.
  - The SGP preserves room for automatic stabilizers and asymmetric-shock responses.
  - A deep Single Market integrates product and labour markets, enhancing adjustment mechanisms.

Monetary Policy in EMU: 1999-2008 Results

Over its first decade (1999–2008), EMU weathered a full cycle boom (1999–2000), dot-com bust (2001–03) and recovery with the following outcomes:

Monetary Policy & Inflation

The ECB's **refinancing rate** began at 3 %, dipped to 2.5 % then climbed to 4.75 % at the cycle's peak, before cutting to 2 % during the downturn and only rising again in late 2005. Interbank rates tracked policy until the crisis, then diverged. Throughout, the ECB built a strong **price-stability reputation**: in 42 of 110 months headline inflation stayed below 2 %, with "core" inflation deviations minor despite global food and energy shocks. Inflation expectations likewise remained anchored just above 2 %. Volatility fell—from 0.6 % in the 1980s to 0.3 % in the 1990s and 0.2 % after 1999.

Growth, Employment & Productivity

Average **GDP growth** was 2.1 %, on par with 1989–99 (2.2 %) but below the US (2.6 %). Small states outpaced larger economies, while **Germany** slowed from 2.5 % to 1.5 % and **Italy** hovered around 1.5 %. **Employment** growth accelerated to 1.3 % (vs 0.6 % in the previous decade and 1 % in the US), driving unemployment down from 9.3 % to 8.3 %—aided by labour-market reforms, service-sector expansion and wage moderation in a more competitive Single Market. Yet **labour productivity** lagged at 0.8 % (vs 1.6 % previously and in the US), reflecting low R&D, sluggish ICT adoption and outdated management practices despite the Single Market's integration.

Fiscal Discipline & Debt

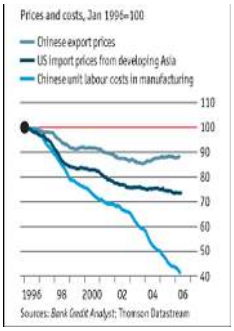
Under the SGP, the average deficit fell to 1.7 % of GDP (from 4.3 % in 1989–99) and stayed below the 3 % ceiling—an improvement partly driven by the convergence criteria enforced from 1992 to 1998. **Average debt/GDP** held at 68.6 %, though it rose above 60 % in France, Germany and Portugal while declining in heavily indebted states.

Consolidation Strategies

Several countries, most notably **Ireland**, the **Netherlands** and **Finland**, cut their **tax burdens**, and almost all reduced **expenditure**. However, in highly indebted nations most of the deficit reduction stemmed from **lower interest payments** thanks to the euro's low rates rather than from genuine structural spending cuts—a vulnerability that surfaced in later crises.

2008 Credit Crisis

Origins: the Globalization Shock



From the late 1990s onward, a confluence of global production and capital flows created both a benign disinflationary trend and dangerous financial imbalances:

1. **Positive Supply Shock**:
   - US and EU firms sourced ever-**cheaper** inputs and finished **goods from China**, where massive scale economies drove **unit costs down**.
   - This flood of low-cost imports acted like ***weapons of mass disinflation***, pushing headline inflation persistently lower across the OECD.
2. **Central-Bank Response & the Saving Glut**:
   - Faced with subdued inflation, the **Fed and the ECB cut policy rates** to support domestic demand.
   - Meanwhile, **emerging economies** ran **large current-account surpluses** and recycled those savings **into US and European bond markets**, a phenomenon dubbed the ***saving glut***.
   - The result was an **overvaluation of the $ and the €** even as official rates fell to historic lows.
3. **Consequences of Ultra-Low Rates**:
   - **Investment boom**: **Cheap credit** spurred firms and investors to expand capacity and chase yield.
   - **Housing bubbles**: In the **US**, rock-bottom mortgage rates inflated a **run-up in home prices** and **speculative lending**.
   - **External imbalances**: Countries like Greece, Spain and Portugal ran **growing deficits to finance consumption and investment**, while **surplus nations** (e.g. Germany, China) **accumulated foreign assets**.

In short, import-driven disinflation combined with a global surplus of savings kept real interest rates exceptionally low—fueling both productive expansion and reckless financial excess.

From Tightening to Subprime Meltdown:

By 2004–05 the initial disinflationary boost had worn off and headline **inflation began to ↑ again**. In response, both the **Fed and the ECB ↑ policy rates**, which around 2006–07 set off a chain reaction:

- **Housing cool-off**: Higher mortgage rates reduced buyer demand, causing home prices to peak and then decline.
- **Mortgage stress**: As **property values fell**, many subprime borrowers found themselves ***underwater*** and began **defaulting on their loans**.

- These localized defaults then spread system-wide through **CDOs** under the ***originate-to-distribute*** model:
  1. **Securitization**: **Banks pooled mortgages**, including subprime loans, into **CDO tranches and sold them to global investors**.
  2. **Default cascade**: **Rising borrowing costs** and collapsing home values **drove up subprime defaults**, **eroding the value of those CDO tranches**.
  3. **Market freeze**: As losses mounted, **interbank lending rates spiked**, **balance-sheet write-downs accelerated**, and **banks rushed to delever**, triggering a **full-blown credit crisis**.
- **Liquidity crunch & asset collapse**: Forced asset sales to meet funding needs drove prices down further, creating a vicious cycle of write-offs and margin calls.
- **Deleveraging and solvency shocks**: As banks cut back lending to rebuild capital ratios, the resulting credit contraction deepened funding pressures. Major failures (e.g. Lehman Brothers) and losses on CDS spread panic across institutions.
- **Credit crunch → Recession**: With interbank markets frozen and confidence shattered, firms and households faced soaring borrowing costs or no credit at all. The collapse in credit availability, coupled with steep wealth losses, slashed consumption and investment—taking the shock "from Wall Street to Main Street."

The Role of Banks in Amplifying the Crisis

A bank's BS hinges on 3 components:

- **Assets**: government bonds, other securities, mortgages, loans to firms and reserves.
- **Liabilities**: deposit accounts and debts (short-term or long-term) owed to investors or other banks.
- **Capital (Equity)**: the residual, A minus L, representing owners' funds and the **buffer against losses**.

When **asset values fall, losses are absorbed by capital**. If losses exceed capital (i.e. A < L), the bank becomes **insolvent**. To prevent this, regulators require banks to hold a **minimum capital ratio** $(\frac{\text{Capital}}{\text{Assets}})$.

- **Capital Ratio EG**:
  - Bank A: capital €20, assets €100 → 20 % ratio
  - Bank B: capital € 5, assets €100 → 5 % ratio

  A low capital ratio implies high leverage (assets / capital):
- **Leverage Ratio EG**: $\frac{\text{Assets}}{\text{Capital}}$

- Bank A: 100 / 20 = 5×
- Bank B: 100 / 5 = 20×

High leverage is tempting and dangerous because:

- **Higher expected ROE**: if assets yield 5 % and funding costs 4 %, then:
  - Bank A ROE: (100×5 % – 80×4 %) / 20 = 9 %
  - Bank B ROE: (100×5 % – 95×4 %) / 5 = 24 %
- **Tail risk**: a 5 % drop in asset values would wipe out Bank B's entire capital, triggering insolvency.

In 2007, many banks resembled Bank B—under-capitalized and over-leveraged. When housing-market losses materialized, these institutions quickly became bankrupt or required rescue.

European Banks & the Global Squeeze

- **EU banking sector**: the world's largest, heavily reliant on securitized products (CDOs) for yield.
- **Bank financing in Europe**: funds roughly 70 % of corporate investment (vs. 25 % in the US), making credit disruptions especially painful.
- **Early warning signs**: BNP Paribas halted two CDO funds in July 2007, marking Europe's first major tremor.

As US banks faltered and CDS losses mounted, panic and credit freezes spread to EU institutions, forcing governments on both sides of the Atlantic to inject capital and guarantee liabilities to avert systemic collapse.

2007/08: the Heart Attack Scenario

The credit crisis exploded in the **summer of 2007**, as ***BNP Paribas*** **defaulted on two CDOs funds**.

In November 2007 the **liquidity crisis** turned into a **solvency crisis** for some institutions: ***Bear Sterns*** (5th largest global IB) went bankrupt and has been **rescued by *JP Morgan*** with the help of ***FED*** lending 80 bn USD in exchange for toxic assets owned by Bear Sterns.

On September 15th 2008, ***Lehman Brothers*** (4th largest global IB) went bankrupt and has **not been bailed-out**.

Merril Lynch (the 3rd largest IB) in distress was acquired by ***Bank of America***, a commercial bank (decision taken in the same meeting organized to rescue Lehman…)

After Lehman and Merrill, the 2 remaining IBs (***Goldman Sachs and Morgan Stanley***) changed their statute to commercial banks and **accepted FED supervision**. Then crisis hit ***AIG*** (the greatest global mortgages broker), plus ***Fannie Mae & Freddie Mac*** (two federal mortgages institutions).

In the meantime, in the EU, several Banks had to be rescued: ***Northern Rock & RBS*** (UK), ***Landesbank Sachsen*** (Germany), ***Fortis*** (Belgium), ***Bradford & Bingley*** (UK), ***Dexia*** (France-Belgium), ***ABN-AmRO*** (the Netherlands)...

On **October 10th 2008** the global inter-banking market got stuck: banks do not trust each other anymore… there is **no liquidity exchanged**…

Interest rates divergence:

As losses mounted, the spread between the **interbank rate** (the rate at which banks lend to each other overnight) and the **central-bank policy rate** (e.g. the ECB's **MRO** rate) **widened dramatically**. Banks, fearing counterparty default, hoarded reserves instead of lending, and the interbank market stopped working properly.

From Finance to Main Street

The frozen credit markets rapidly transmitted distress into the broader economy:

- **Credit crunch**: With interbank funding stalled, banks sharply curtailed lending. Firms and households faced far **higher borrowing costs**, or **simply couldn't access loans**, causing **investment (I)** to ↓.
- **Wealth destruction**: ↓ **stock and house prices** wiped out household and corporate wealth, ↓ **consumption (C)**.
- **Confidence collapse**: As financial assets spiraled lower, business and consumer sentiment deteriorated, leading to further pullbacks in spending and hiring.
- **Trade collapse**: Strained liquidity and weakening demand abroad choked off export finance and ↓ **global trade flows (NX)**.

Together, these forces drove a **synchronized drop in aggregate demand** across advanced economies, a leftward shift of the **IS** curve of unprecedented scale.

Preventing Great Depression II

As the credit crunch threatened to tip the global economy into a second Great Depression, governments and CBs launched an **extraordinary, G20-coordinated arsenal of measures**, both conventional and unconventional, to **stabilize finance and shore up demand**.

1. **Conventional Monetary Easing**: **Policy rates** were cut by over 3 percentage points in just weeks, pushing **official yields toward zero** to revive C and I.
2. **ECB's Quasi-Conventional Tweaks**:
   - **Cash-dispenser MROs**: Switched **from competitive auctions to a FIXED-RATE**, full-allotment system so **banks could draw unlimited liquidity**.
   - **Corridor narrowing**: Reduced the spread between deposit and marginal-lending rates, forcing EURIBOR down by capping banks' top-end funding costs.
   3. **Longer tenors (2011)**: Rolled out multi-month refinancing operations (instead of standard one-week), ensuring stable funding over extended horizons. **Unconventional Monetary**

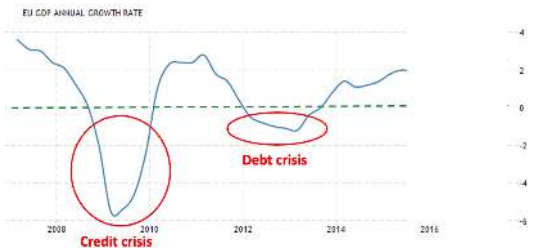
Policies (QE): using newly created central bank money for large purchases of an array of financial assets (also long term ones) aiming to boost demand for given i.

- **Asset purchases**: The Fed, BoE and BoJ bought massive volumes of **government bonds**, **MBS**, **corporate debt** and **other securities** to lower long-term yields and **recapitalize markets**.
- **Transmission logic**: Even at a zero policy rate, credit costs can remain high if banks hoard reserves. QE lifts asset prices and compresses borrowing costs across the curve, enriching holders and stimulating $C + I + G$.
- **Balance-sheet expansion**: CBs' total assets ballooned to 30–40 % of GDP, reflecting the scale of their intervention.

4. **FISCAL Interventions & Bank Rescues**: between 2008 and 2009, national public budgets throughout the world have been used for several banks' bail-out operations, with provision of special loans, guarantees, new capital.
   - **EU bank bailouts**: Governments deployed ~ 13 % of Euro-area GDP (2008–11) in capital injections, guarantees and loans—19 of the top 76 banks became majority state-owned under temporary State-aid waivers.
   - **US TARP**: Congress authorized ~ US $700 bn to purchase toxic assets and inject capital into financial institutions.
   - **Heterogeneous effects**: Euro-area firms, which rely on banks for ~ 70 % of funding (vs 25 % in the US), experienced varied relief depending on national rescue scales.
   - **Demand stimulus**: Simultaneous tax cuts and public spending packages sustained private consumption and business investment.

From Credit Crisis to 2012 Debt Crisis

After the credit crisis (2008–09), the debt crisis happened in 2010–13. This happened due to the combined effects of **fiscal stimulus** and the **cost of rescuing banks**, together with the **fall in GDP**, $\frac{\text{Public Debt}}{\text{GDP}}$ increased across countries. Investors began to **question debt sustainability** in some member states, driving **sovereign yields sharply higher** and feeding back into weaker growth.



Pre-2008 convergence: Italy, Spain, Portugal, Greece and Ireland all borrowed at yields around 4–6 %, closely tracking Germany and France.

Post-2010 divergence:

- Greece (GR): Yields spike above 25 % at the peak of its crisis.
- Ireland (IE) & Spain (ES): Yields climb above 10 %.
- Portugal (PT): Peaks around 12 %.
- Italy (IT): Rises to 6–7 %.
- Germany (DE) & France (FR): Remain around 2–3 %, viewed as safe havens.

This ***explosion*** of **borrowing costs** shows that while Euro-area bonds weathered the 2008 slump relatively well, after 2010 **investor fears about sovereign solvency ignited the debt-market crisis**.

The bank-sovereign negative feedback loop in EU

1. **Bank rescues & stimulus ↑ deficits ⇒ weaker debt metrics**.
2. **Banks hold large amounts of sovereign debt ⇒ ↑ yields**, **↑ banking risk**, **↑ their funding costs,** less credit to the economy and **BS value ↓**.
3. Credit to the real economy dries up ⇒ **growth slows**, **further worsening debt sustainability**.

A shift from a **liquidity-driven credit crisis** to a **solvency-driven debt crisis** in the **EMU**.

Normal Interbank Market:

- **Peer-to-peer lending**: Commercial banks lend reserves directly to one another, smoothing out temporary liquidity surpluses and shortages.
- **ECB's role as referee**: The ECB stands in the background, supplying or absorbing liquidity via:

- **Main Refinancing Operations (MRO)**: weekly auctions that top up system reserves.
- **Marginal Lending Facility & Deposit Facility**: ceilings and floors for overnight borrowing/lending.

- **Result**: A decentralized "circular" network where banks trust each other's credit and recycling of funds keeps short-term rates close to the policy corridor.

Crisis-Era "Hub-and-Spoke" Market:

- **Core vs Periphery split**:
  - **Core EU banks** (Germany, France, etc.) still transact among themselves.
  - **Periphery banks** (Greece, Ireland, Portugal, Spain, Italy) face skyrocketing sovereign spreads and are shunned by both core and fellow-periphery lenders.
- **ECB as sole hub**: With interbank trust evaporated, peripheral banks must go directly to the ECB's refinancing operations for funding.
- **Fire-sales & deleveraging**: Lacking interbank access, these banks sell whatever collateral they can, often sovereign bonds, further pushing up yields and deepening the negative feedback loop:
  1. **Sell sovereign bonds** ⇒ higher yields ⇒ weaker bank balance sheets
  2. **Strained banks** ⇒ less credit to the real economy ⇒ slower growth
  3. **Slower growth** ⇒ greater debt burdens ⇒ higher sovereign yields ⇒ back to (1)

EMU Crisis Management

The **bank–sovereign negative feedback loop**, whereby rescuing banks raises sovereign deficits, which in turn weakens banks holding that debt, **threatened the very survival of the euro area**. Yet Maastricht contained **no crisis-management toolbox**. Policymakers had to **innovate within the existing legal framework** (no-bail-out clauses, ECB independence, decentralized fiscal policy). In the beginning, it was not even obvious that the EU had to intervene!

Initial Policy Responses

Faced with an unfolding bank–sovereign spiral, Europe's first line of defense combined fiscal backstops with ECB market interventions:

- **Fiscal tools (Art. 125 TFEU)**: Member States could extend **mutual guarantees** to shore up sovereign debt. To operationalize this, the ***European Financial Stability Facility (EFSF)*** was created in May 2010 as a temporary fund:
  - **EFSF issues AAA-rated bonds on the market** (guaranteed by one EU **country**).
  - Proceeds **finance loans to distressed members** (EG Greece) **at below-market rates** (market yield + small premium).

- **Conditionality**: loans disbursed in tranches, each tied to a **specific reform milestone**; funds raised are used to **repay the EFSF bond**, and the premium covers **EFSF operational costs**.

- **Monetary tools via the ECB (Art. 123 TFEU)**: To avoid an outright sovereign bail-out, the ECB stepped in with **secondary-market purchases** under the ***Securities Markets Programme (SMP):***
  - **ECB buys distressed sovereign bonds** with freshly created reserves, lifting prices and lowering yields.
  - Higher bond prices **strengthen banks' BS** (sovereign-debt assets appreciate), restoring confidence and easing interbank funding.
  - Once stress subsides, the **ECB "sterilizes" the injected liquidity to neutralize its impact on the monetary base**.

The crisis management tools after 2011:

In response to the deepening crisis in 2012, the EU and the ECB rolled out a **second wave of emergency measures**, both monetary and fiscal, and tightened the fiscal rulebook

Long-Term Refinancing Operations (LTRO), in december 2011 – February 2012, lends €490 bn + €530 bn to banks at 1% for 3-year. This helped flooded banks cut off from interbank markets with liquidity and enabled them to buy back sovereign debt, compressing bond yields and easing the credit crunch.

But the crisis gets worse over 2012. As a response, two main crisis management tools:

- **The European Stability Mechanism, a new EU Institution (fiscal tool)**:
- **The Outright Monetary Transaction program of the ECB (monetary tool)**:

These 2 tools come along with **strengthened rules on fiscal discipline**. Greater mutual support solidarity comes with more control on national fiscal policies. During 2012, the EU and ECB negotiate a new **Fiscal Compact**: treaty amendments aimed at further strengthening fiscal coordination and discipline across the euro area with a number of features. Most importantly the **European Semester**: national budget laws as well as national programs of reforms are drafted in April each year under the guidance of the EU commission, approved by the EU institutions in June and only then implemented by member states.

The European Stability Mechanism (ESM)

The ESM was set up by treaty in February 2012 and became fully operational in September 2012 as a permanent, Luxembourg-based institution to **safeguard euro-area financial stability**. Unlike its temporary predecessor (the EFSF), the ESM is **capitalized collectively**: each eurozone member subscribes a share of the €700 billion total capital, €80 billion paid in and the remainder callable, proportional to its GDP (***capital key***). This pooled guarantee allows the ESM to issue **AAA-rated bonds**, effectively **Eurobonds**, on financial markets at **very low yields**.

All euro-area countries participate in the ESM, and **non-euro EU members may opt in to specific support operations**. Decisions to extend stability support normally require unanimous approval (with

abstentions possible), but in acute crises threatening the monetary union's integrity they can be adopted by qualified majority (85 % of votes).

The ESM's toolkit is multi-pronged:

- **Sovereign loans** at preferential rates to governments under stress,
- **Precautionary credit lines** as an insurance buffer,
- **Primary and secondary market purchases** of member-state bonds to compress yields,
- **Financial-sector recapitalization loans** to shore up banks without relying on national budgets.

Every assistance package is bound by rigorous conditionality negotiated with the ***troika*** (European Commission, ECB and IMF). Funds are disbursed in tranches, each contingent on agreed fiscal and structural reforms. This approach ensures that euro-area solidarity comes with strong discipline.

Parallel to the ESM Treaty, the Treaty on Stability, Coordination and Governance (Fiscal Compact) embeds balanced-budget rules directly into national law and establishes the annual European Semester—an April draft, June review and autumn implementation cycle for national budgets and reform programs.

By combining a robust, treaty-based backstop with enforceable conditionality and tighter fiscal coordination, the ESM and its legal framework break the vicious bank–sovereign feedback loop and underpin the euro area's long-term financial stability.

The ECB Outright Monetary Transactions

The ECB's Outright Monetary Transactions (OMT) program was launched in September 2012 to restore the integrity of the monetary-policy transmission mechanism by ensuring that sovereign-debt market dysfunction in one member does not derail euro-area-wide policy. Unlike the earlier SMP, OMT operates under a **clear, rule-based framework**:

- **Strict conditionality**: **Purchases** are only made for **countries** that have **agreed** to a full macroeconomic adjustment programme under the **EFSF/ESM** (e.g. an Enhanced Conditions Credit Line). Programmes must explicitly allow EFSF/ESM primary-market bond purchases, and the IMF participates in designing and monitoring the conditionality. The ECB's Governing Council exercises full discretion, launching, continuing or suspending OMTs in line with its monetary-policy mandate, and ends them as soon as programme objectives are met or if conditions are breached.
- **Targeted coverage**: OMTs will be considered for future cases of EFSF/ESM programmes or for Member States currently under a macroeconomic adjustment program when they will be regaining bond market access. Transactions will be focused on the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between one and three years. No ex ante quantitative limits are set on the size of OMTs.
- **Equal creditor treatment**: The Eurosystem accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through OMTs, in accordance with the terms of such bonds => no penalization of private investors on existing traded securities

- **Full sterilisation**: To prevent an unintended expansion of the monetary base, all liquidity injected via OMT is fully withdrawn once market conditions normalize, just as under the SMP.
- **Transparent reporting**: Aggregate OMT holdings and their market values will be published on a weekly basis. Publication of the average duration of Outright Monetary Transaction holdings and the breakdown by country will take place on a monthly basis.

The legacy of the 2011-2013 financial crisis in Europe was a stagnant business cycle with deflationary pressures => need to structurally revamp the EMU with a coherent set of policies

EMU Crisis Resolution: The EU Four Arrows

Europe's crisis-resolution rested on **four** integrated **pillars**.

- **Monterey Policy**: **ECB's quantitative easing** rekindled inflation and anchored expectations.
- **Financial Policies**: **Targeted LTROs and the Banking Union** (SSM, SRM, EDIS) repaired bank balance sheets and reopened credit channels.
- **Fiscal policies**: shifted toward smart investment, via the **Juncker Plan**, and more flexible, growth-friendly budget rules under a revamped **Stability and Growth Pact**.
- **Structural reforms**: to labour and product markets lifted competitiveness and productivity. Together, these monetary, financial, fiscal and structural measures formed a cohesive, mutually reinforcing strategy to restore demand, stabilize the financial system and boost the euro area's long-term growth potential.

The ECB Quantitative Easing

In early 2015 the ECB launched its full-scale **Expanded Asset Purchase Programme (APP)** to counter persistent disinflationary pressures. Building on the private-sector purchases (asset-backed securities and covered bonds) that began in autumn 2014, the APP added **public sector securities**, including euro-area government bonds and EU institution debt, bought on the secondary market.

At peak intensity, the ECB acquired **€60 billion per month** (ramped up to €80 billion from March 2016 to March 2017), aiming to run purchases until headline inflation moved "close to but below" 2 %. As core inflation gradually recovered, net purchases tapered throughout 2018 and formally ended in December 2018, although the ECB maintained a **reinvestment policy**, automatically rolling over maturing holdings to keep its balance sheet size broadly stable.

Key parameters included:

- **Capital-key allocation**: Purchases were distributed among national markets in line with each country's ECB capital share.
- **Issuer limits**: No more than 25 % of any single government bond issue, and 33 % of total outstanding debt per issuer.

With the APP on pause, net asset purchases resumed in September 2019 and were rapidly expanded under pandemic emergency programs to safeguard liquidity, reinforce monetary transmission and shore up inflation expectations.

The long-term way out: solving the EMU trilemma

In a monetary union characterized by competitiveness differentials, only two of the three following features are compatible with a stable institutional setup:

- there is no monetary financing by the ECB (art. 123)
- there are no fiscal transfers across States (art. 125)
- commercial banks are dependent on their sovereign States.

The EMU has to decide which corner of the triangle it wants to cut in order to survive in the long run. Cutting all corners = United States of Europe

Banking Union shifts **losses away from taxpayers toward bank shareholders and creditors** ("bail-in"). There are 3 key pillars:

- **Single Supervisory Mechanism**: ECB as unified regulator and rule-maker.
- **Single Resolution Mechanism**: Common playbook and fund for winding down failing banks.
- **European Deposit Insurance Scheme** (Under design): Joint guarantee to protect depositors across the euro area.

Moving Toward a Fiscal Union?

Greater EU influence over national budgets already exists and may expand:

- **Next Generation EU (NGEU)**: €750 bn of joint borrowing and transfers in response to COVID-19, an unprecedented pooling of fiscal risk. Is it a one-off shock absorber or the embryo of deeper fiscal integration?
- **Pan-EU fiscal capacity**: Ongoing debates on establishing a permanent EU budget line with stabilisation functions.

Under the **Pandemic Emergency Purchase Programme (PEPP)**, the ECB again provided massive, flexible asset purchases to preserve monetary transmission and prevent self-fulfilling sovereign-debt spirals—affirming that only a central bank with broad powers can safeguard the euro in times of stress.

Cohesion

Under the TFEU, the Union must foster **harmonious development** by reinforcing its **economic**, **social** and **territorial cohesion**. It is tasked with **narrowing disparities** between regions and uplifting the **least-favoured** areas. In particular, cohesion efforts must target:

- **Rural regions**,
- **Territories in industrial transition**,
- Areas facing **severe**, **permanent handicaps**, including sparsely-populated northern zones, **islands**, **cross-border** corridors and **mountain** districts.

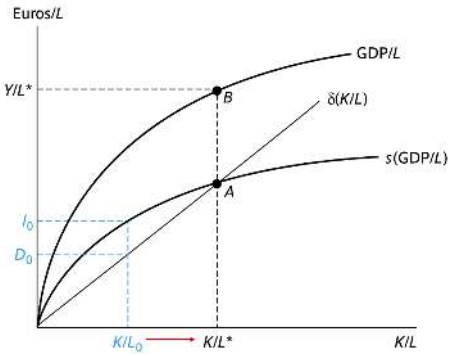
Economic Integration and Cohesion: Theory I

Is the process of European Integration responsible for the uneven distribution of economic activities across space/regions?

A number of theoretical approaches/theories deal with the regional distribution effects of processes of economic integration (i.e. lowering tariffs)

1. **Neo-classical Growth Theory** (***Solow***)
    - **Diminishing returns to capital (K)**: Every extra unit of capital you add to a region yields less new output than the previous one did.
    - **Exogenous tech growth**: There's a steady, outside pace of technical progress raising everyone's productivity over time.
    - **Different starting K-levels**: Poorer regions begin with less capital per worker than richer ones.

In a **fully integrated Single Market**, **capital flows toward those poorer**, low-K regions (where its marginal productivity is highest), pushing them onto a steeper portion of their ***production + investment*** curve. Over time they accumulate **faster growth** and move closer to the ***steady-state*** capital-to-labour ratio of richer regions.



There are 2 ways to judge **convergence**:

Measure	What it asks	How to spot it	Why it matters
β-convergence	Do poorer regions grow more quickly than richer ones?	In a scatterplot of "initial GDP per capita" (x-axis) vs "subsequent growth rate" (y-axis), a downward sloping regression line signals β convergence.	If true, capital is indeed chasing high returns and poorer areas are catching up.
σ-convergence	Does the overall spread of incomes across all regions shrink over time?	Compute the standard deviation (or coefficient of variation) of per capita GDP at two dates. A decline means σconvergence.	This tells you whether, in aggregate, the rich-poor gap is actually narrowing.

Key point: β-convergence (poorer → faster) is **necessary** for σ-convergence (less dispersion), but not sufficient. You can have poor regions growing fast (β) yet still see widening inequality if, say, some rich region jumps ahead even more or a few poor regions stagnate

Graphical Intuition of the Solow Diagram:

1. Output per worker $(\frac{Y}{L})$ on the vertical axis vs. Capital per worker $(\frac{K}{L})$ on the horizontal.
2. The investment curve $sf(\frac{K}{L})$ is concave, flatter the more $\frac{K}{L}$ you already have.
3. The break-even investment $\delta(\frac{K}{L})$ is a straight line through the origin.
4. Their intersection at point A is a poor region's steady-state capital ratio; at point B (further right) is a richer region's.
5. **After integration**, capital ***jumps* from A toward B**: the arrow to the new equilibrium shows the poor region accumulating faster.

Why We Care:

- **Policy design**: If β-convergence is strong but σ-convergence falters (or reverses), mere market integration may exacerbate disparities. That's where **Cohesion Policy steps in** to subsidize infrastructure, human capital, etc.
- **Timing & shocks**: Convergence patterns can reverse in crises (EG post-2008) or in the face of large asymmetric shocks, so we need **both measures to monitor the true evolution of regional inequality**.

EG:

Year t: GDP_A per capita $= 100$, GDP_B per capita $= 200$

Year $t+1$: GDP_A per capita $= 200$, GDP_B per capita $= 100$.

Overall, between t and $t+1$, there was β-convergence (catch-up) but NOT σ-convergence (spread unchanged).

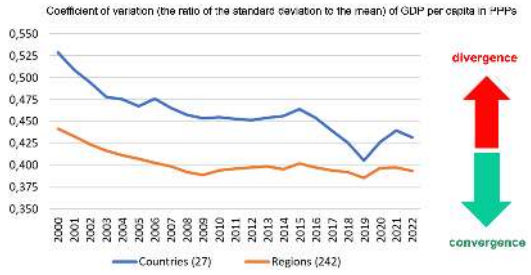
Before 2008 crisis:

- **Countries**: clear β-convergence. The poorest Member States (e.g. many in Eastern Europe) grew faster than the richest.
- **Regions**: also clear β-convergence. Poorer NUTS-2 regions across the EU grew faster than richer ones, pulling national dispersions down (σ-convergence).

After the crisis:

- **Countries**: β-convergence persists, albeit dampened by the crisis. Most poorer countries still outpaced richer ones on average.
- **Regions**: β-convergence vanishes. Poorer regions no longer systematically grow faster. In fact, income dispersion across regions stabilizes or even widens again. Early gains were driven by Eastern EU; Southern periphery regions fell behind.

So: **national incomes continued to converge** in the post-crisis decade, yet **within-country regional gaps often opened back up**.



Economic Integration and Cohesion: Theory II

New Economic Geography explains **spatial concentration of economic activity** through two opposing sets of forces:

A. **AGGLOMERATION Forces (encourage clustering)**:

- **Demand Linkages**: Larger markets attract firms because more consumers can be served at lower per-unit trade costs.

  South market is larger, hence more consumers can be served at lower costs if a firm locates there.

  1. **Production Shifting**:
     - **Motivation**: Firms want to minimize shipping costs to customers.
     - **Mechanism**: If the southern market is larger, it's cheaper to locate plants there to serve customers at lower per-unit transport cost.

- **Immediate Effect**: The share of firms based in the South rises relative to the North.

Hence even more firms locate in the South to reduce shipping costs in serving customers…

As more firms locate in the South, still more are drawn there, a positive feedback loop.

2. **Expenditure Shifting**:
   - **Motivation**: Jobs and wages follow factories.
   - **Mechanism**: More firms in the South create higher local income; that income is largely spent locally, expanding the southern market further.
   - **Immediate Effect**: The share of total market demand in the South ↑.
3. **Self-Reinforcing Loop**:
   - **Production → Market**: Locating production in the South cuts costs and attracts additional firms.
   - **Market → Demand**: Higher local income in the South enlarges its consumer market.
   - **Demand → Production**: A bigger southern market then makes it even more attractive for firms to locate there.

   This dual loop ("production shifting" and "expenditure shifting") can lock the economy into a growing core (the South) and a marginalized periphery (the North).

- **Cost Linkages**: High local supplier availability reduces input costs and supports economies of scale.

  South market is larger, hence provides more intermediates that can be exploited at lower costs if a firm locates there

  1. **Production Shifting**:
     - **Motivation**: Firms want to take advantage of a wider range of intermediate inputs at lower cost.
     - **Mechanism**: If the South hosts more suppliers, the variety of parts and services is greater there, so locating plants in the South cuts per-unit input costs.
     - **Immediate Effect**: The share of firms based in the South rises relative to the North.
     - **Feedback**: "Hence even more firms locate in the South to take advantage of cheaper intermediates…", as firms cluster, supplier networks grow, reinforcing the South's appeal.
  2. **Cost Shifting**:
     - **Motivation**: Firms' outputs often serve as inputs for other firms.
     - **Mechanism**: When firms relocate to the South, they expand the local intermediate-goods market. At the same time, the North's supplier base shrinks.

- **Immediate Effect**: The cost of producing in the South falls compared to the North (red arrow down).
- **Feedback**: Lower production costs in the South attract yet more firms.

3. **Self-Reinforcing Dual Loop**:

   - **Production → Cost**: More firms in the South → larger supplier network → lower input costs in the South.
   - **Cost → Production**: Lower input costs in the South → stronger incentive for additional firms to locate there.

   This dual feedback traps the economy in a **growing core** (the South's supplier–producer hub) and a **marginalized periphery** (the North).

B. **DISPERSION Forces (encourage spreading)**:

- **Rising Land and Rent Costs**: High demand for limited space increases location costs.
- **Higher Service and Labor Costs**: Competition for workers and local services drives up prices.
- **Congestion and Pollution**: Negative externalities reduce locational attractiveness.
- **Intensified Competition**: Local market saturation limits firm profitability.

The balance between agglomeration forces and dispersion forces will determine the observed allocation of economic activities across regions and countries. Any change in trade costs, technology, institutions or infrastructure can tip this balance, and thus reshape where firms locate.

EU integration as a shock to Location Incentives

European integration acts as a major shock to firms' location decisions by slashing trade costs both within and between member states. This reshapes the two key forces at work:

1. **Impact on Agglomeration Forces**: Firms cluster to reap 3 main benefits:

   - **Lower trade costs** to serve a large local market
   - **Denser supplier networks** (cheaper, more varied inputs)
   - **Knowledge spillovers** from nearby innovators

   Effect of integration:

   - By reducing transport and border-compliance costs, distant regions become almost as attractive as the historical ***core***.
   - **Weakening of the agglomeration pull**: firms no longer need to be in the biggest city or country to serve its consumers efficiently.

2. **Impact on Dispersion Forces**: Firms disperse to escape:

   - High land and rent prices in crowded hubs

- Congestion, pollution and over-competition

Effect of integration:

- Peripheral regions lose their "quiet niche" advantage because serving them from a central hub is now cheap.
- **Diminishing of the dispersion push**: the incentive to locate away from competitors fades.

3. **Net Implications**:
   - **Both agglomeration and dispersion incentives decline**. Which effect dominates, and thus whether firms become more clustered or more evenly spread, depends on:
     1. **Relative strength of each force** in a given industry
     2. **Timing** (early vs. late phases of integration)
     3. **Spatial scale** (country-level vs. intra-regional)
4. **Empirical Evidence in the EU**:
   - **Regional level**: In many phases, the **erosion of dispersion forces has outpaced the weakening of agglomeration forces**: greater clustering within countries.
   - **Cross-country vs. cross-region**:
     - **Between countries**: **poorer** member **states** (EG Poland) have **converged** toward the EU average GDP per capita.
     - **Within countries**: **richer** metropolitan **regions** have surged ahead of their own national peripheries → **rising regional inequality**.
5. **Origin and Rationale of Cohesion Policy**:

   A fully integrated Single Market, left unchecked, would tend to:
   - **Concentrate activity in large, well-endowed regions** (***core***)
   - Leave **less-developed areas** (***periphery***) further **behind**

   Cohesion policy was designed to:
   - **Compensate poorer countries and regions** for integration's agglomeration bias
   - **Level the playing field** by **funding infrastructure**, **human capital** and **innovation** in lagging areas
   - Create **win–win outcomes.** **EG**: Better roads in eastern Poland boost local incomes, Poles buy more German cars, Germany gains from higher exports.

Funding

Cohesion policy is implemented through **3 complementary funds**, each targeting different dimensions of regional and social development:

1. **European Regional Development Fund (ERDF)**: Strengthen economic and social cohesion by **correcting imbalances between regions**.

   Eligibility:

   - **Less-developed regions**: GDP < 75 % of EU average
   - **Transition regions**: GDP 75–100 % of EU average
   - **More-developed regions**: GDP > 100 % of EU average

   Key Priorities:

   - SME competitiveness and innovation
   - Research & development, technology transfer
   - Digital and low-carbon infrastructure
   - Urban development and sustainable cities

2. **Cohesion Fund (CF)**: Assist **Member States whose per-capita income is significantly below the EU average** to catch up (GDP per capita < 90 % of the EU average).

   Key Priorities:

   - Trans-European transport networks (TEN-T)
   - Environment and resource-efficiency projects (water, waste, air quality)
   - Cross-border and interregional connectivity

3. **European Social Fund Plus (ESF+)**: Promote **high-quality employment**, **social inclusion** and **skills development** across all regions.

   Scope: Funded actions may be implemented in any Member State or region, regardless of average GDP.

   Main Areas of Action:

   - Upskilling and reskilling workers (lifelong learning)
   - Combating youth unemployment and NEETs
   - Reducing school drop-out rates
   - Fostering social inclusion and gender equality
   - Encouraging social innovation in public services

Five Strategic Policy Objectives

All 3 funds align with the EU's overarching priorities for 2021–2027:

- **Smarter Europe**: Fostering research, innovation and digital transformation.
- **Greener, Carbon-Free Europe**: Investing in the green transition, energy efficiency and renewables.
- **More Connected Europe**: Upgrading transport, energy and digital networks.
- **More Social Europe**: Strengthening social inclusion, education and health systems.
- **Europe Closer to Citizens**: Supporting community-led local development and bottom-up strategies.

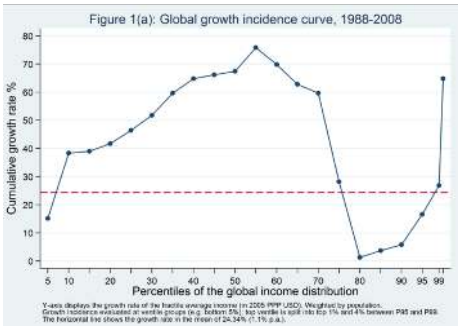
Economics, Brexit, and Nationalism in the EU

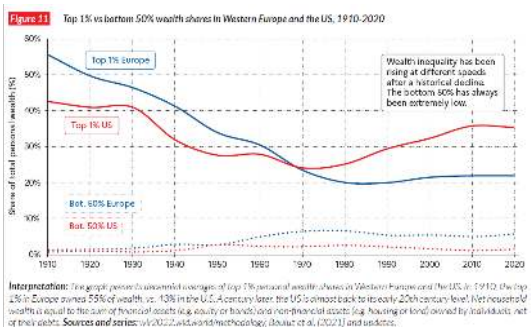
In recent years, Western democracies have witnessed the rise of **populist parties** and candidates who share a broad political narrative: they pit "the people" against a self-serving establishment. Yet these movements are **far from uniform** in their policy agendas. Among them, the surge of radical-right parties in Western Europe stands out for its insistence on **economic nationalism,** a fusion of protectionist instincts, conservative fiscal policies, and an emphatic defense of national sovereignty.

From Embedded Liberalism to Disillusionment

After WWII, the model of ***embedded liberalism*** strengthened European economic integration. **Trade liberalization** and **multilateral cooperation** went hand in hand with **generous welfare provisions** designed to buffer citizens from the dislocations of open markets. Western Europe's CU evolved into the Single Market, culminating in the **launch of the euro in 1999**. By the turn of the millennium, the EU had become both a powerful promoter of globalization, through the GATT, the WTO, and numerous regional trade agreements, and steward of robust welfare states that aimed to share its gains broadly.

Yet by the late 1990s public confidence began to wane. **Income inequality rose**, and the promise that globalization would deliver shared prosperity appeared hollow. **Mainstream parties lost credibility** as citizens questioned whether governments could sustain growth or protect them from the pressures of structural economic change.





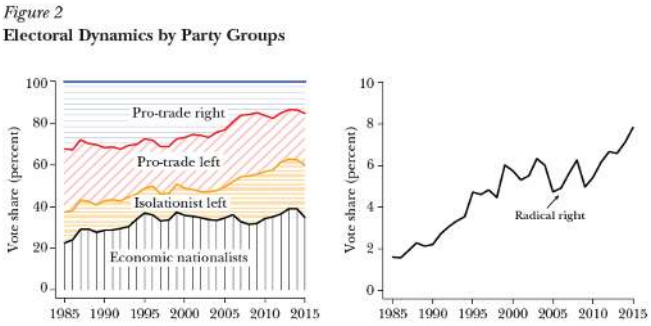
The Turn to Economic Nationalism

Disillusionment with the liberal economic order has fueled a shift toward economic nationalism, which combines 3 core elements:

- **Isolationism**: **Protectionist policies** on trade and investment, plus **opposition to multilateral and supranational institutions** such as the EU and WTO.
- **Economic conservatism**: Calls for **lower income taxes**, **limited redistribution**, and **skepticism toward the welfare state**, an appeal that resonates with middle-class voters.
- **A nationalist narrative**: Slogans like ***take back control*** emphasize **national sovereignty**, cultural cohesion, traditional values, and defense of a unique national identity.

This two-panel figure (1985–2015, ten-year moving averages) shows:

- **Left**: A stacked vote-share of four blocs across 15 Western European countries:
  - Economic nationalists (black) rise from ~25 % to ~30 %.
  - Isolationist left (yellow) inch up from ~20 % to ~30 %.
  - Pro-trade left (red) stays near ~25–30 %.
  - Pro-trade right (blue) shrinks as the others grow.
- **Right**: The radical-right's vote share climbs from ~1.5 % to ~8 %, highlighting its steady rise alongside broader shifts toward economic nationalism.



Structural Drivers: Globalization, Technological Change, and the China Shock

Colantone and ***Stanig*** point to **globalization** and **technological change** as **twin engines of economic transformation**, producing clear winners and losers across sectors and regions. For many workers, especially those in industries exposed to cheaper foreign competition, the pain of factory closures and **job losses outweighed the diffuse gains of aggregate growth**.

Individuals and communities hit hardest by these shocks typically react in one of two ways:

1. **Demanding compensation and redistribution**, or
2. **Yearning for a restoration of the pre-liberalization status quo**.

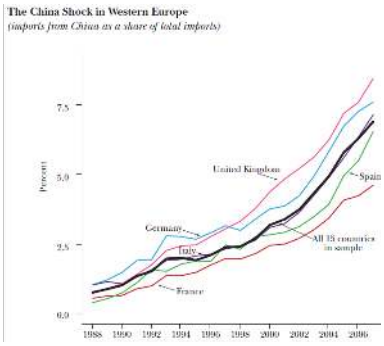
Since the 1990s, many Western European electorates have shifted toward the **latter**, supporting parties that promise to **roll back globalization**.

A striking example is the ***China shock***.

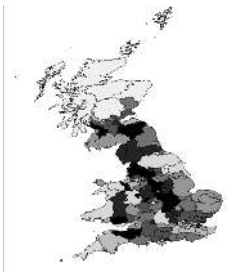
Rising Chinese imports (1988–2007)

The share of Europe's imports coming from China (thin colored lines for Germany, UK, Spain, France, Italy) climbs steeply from under 1 percent in 1988 to roughly 7 percent by 2007.

The thick black line is the average across all 15 Western European countries in the sample, it mirrors the national trajectories and, after China's WTO accession in 2001, accelerates sharply.



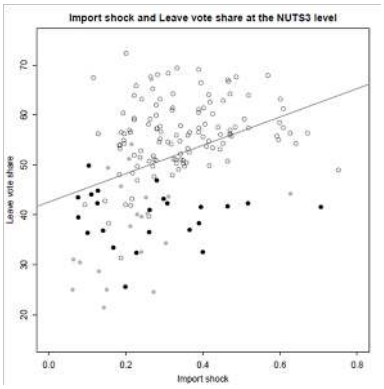
Geography of the import shock



Each NUTS3 region is shaded by the magnitude of its China-driven import shock (1990–2007): darker areas saw larger increases in Chinese competition.

Notice clusters of deep shock in former industrial heartlands of England, Wales, and Scotland.

Import shock vs. Leave vote share



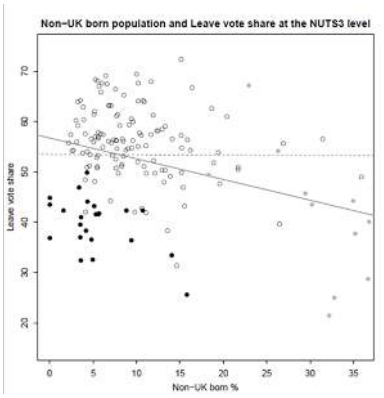
Horizontal axis: import shock intensity; vertical: Brexit Leave share.

Black dots = Scotland, **grey filled** = London, **open** = other English/ Welsh regions.

The **solid grey line** (OLS fit) slopes **upward**: **regions hit harder by Chinese competition** tended to **vote Leave more** (~40 % → ~60 %+ as shock rises).

This reflects a **sociotropic response**: voters react to community-level economic decline (factory closures, job losses), not just their own pocketbooks.

Immigration vs. Leave vote share



Horizontal axis: share of non-UK–born residents; vertical: Leave vote share.

The **downward-sloping grey line** is weak and driven by high-immigration London outliers. Excluding London (dashed line) flattens it further.

Conclusion: there's no clear link between local immigrant shares and Brexit support once you control for the import shock.

Bringing it together

Globalization's uneven costs: poorer, formerly industrial regions, once expected to catch up via trade-induced investment, have instead fallen behind in GDP per capita.

Sociotropic voting: even those not personally displaced vote based on the broader health of their local economy.

Three overlapping mechanisms drive **nationalist backlash**:

- **Anti-incumbent backlash**: "blind retrospection" against elites.
- **Anti-integration sentiment**: "take back control" of trade and borders.
- **Scapegoating immigrants**: job competition, pressure on public services.

Together, these dynamics show how the China shock fueled regional distress, and with it, support for Brexit and broader economic-nationalist politics across the EU.

Geography, Inequality, and Political Response

Economic theory once held that globalization would foster convergence as poorer regions attracted investment and grew faster than wealthier ones. Throughout much of the 20th century, gaps narrowed across U. states and European regions. Now, however, affluent areas are pulling away. A child born in the bottom quintile in wealthy San Francisco has twice the odds of reaching the top quintile as a similar child in Detroit; boys born in London's Chelsea can expect to live nearly nine years longer than those born in Blackpool. Such disparities trap many in places with dwindling opportunities and fuel resentment toward both domestic elites and international integration.

Three overlapping mechanisms help explain how **economic shocks translate into nationalist voting**:

1. **Retrospective anti-incumbent voting**: a ***blind*** **rejection** of **political and business elites**, even without clear understanding of where blame lies.
2. **Anti-integration sentiment**: a desire to **reclaim national control** over **trade** and **borders**.
3. **Anti-immigrant attitudes**: stemming from **competition for scarce jobs**, **pressure on public services**, and the **search for scapegoats**.

Together, these dynamics underscore how economic discontent, both real and perceived, has become a potent driver of nationalism within the EU.

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