Policy Recommendations for Europe

INFLATION

Over the last decade, inflation was generally too low, and central banks including the ECB undershot a 2 percent target: thus some rise in inflation is beneficial. There is uncertainty about the extent to which the inflation hike created by supply chain issues and a rise in energy prices will last. At the same time, the ECB faces pressure to keep spreads under control in the interest of both financial and fiscal stability; but these objectives may conflict with price stability, and high rates of inflation would be a threat to both the goals of financial and fiscal stability. Drawing the lessons of the 1970s involves meeting a rise in inflation promptly, as disinflation was then (and will be in the future) much costlier the later it comes, or when and if higher inflationary expectations become entrenched.

EUROPEAN ECONOMIC AND MONETARY INTEGRATION

Markets are more efficient when they can cross country borders but, in the absence of common or coordinated policies, economic integration can generate inequality and instability, as evidenced by the European public debt crisis triggered by the Great Recession's asymmetric shock. The Next Generation EU joint borrowing program is a useful step towards coordination of fiscal policy, which, however, should not come at the expense of distorting monetary policy. The ECB should not be tasked with fiscal policy. To ensure financial stability, banking union needs to be completed and governments' financial problems should be dealt with by separate institutions, possibly expanding the size and role of the ESM.

GOVERNMENT VS. MARKETS

Regulation and dirigisme were problematic would-be solutions to the 1970s crisis. The pandemic emergency justified exceptional intervention in the form of fiscal stimulus, redistribution, and heavy regulation such as in lockdowns and vaccination. However, this should not lead to a permanent change of the role or size of government. Governments will need to deal primarily with two consequences of the crisis: high public debt and losses in education. High public debt implies solid public finances and economic growth should be higher on the agenda of economic policy than before. The educational losses require targeted compensating measures.

INCLUSIVE GROWTH

The changes in inequality that we have identified and their political consequences imply that inclusive growth should be at the forefront of the policy agenda. The pandemic has had further distributional consequences and a populist backlash is possible if inequality is not kept under control. Regulation and subsidies to those with endangered jobs are politically appealing, even if inefficient, and the way to combat demand for such types of intervention is through inclusive growth that allows for market-driven reallocation. Policy should target skills and employability. The educational losses that have occurred during the pandemic and that are closely related to family background need to be compensated through suitable schooling, and labor market policies should prioritize programs that foster employability of young individuals. If done properly, such policies would both boost growth and address inequality. Moreover, the distributional consequences of current policy priorities should not be ignored. While digitization can foster productivity growth and greening subsidies are needed to combat climate change and address supranational coordination problems, both are likely to favor the relatively privileged and should hence be accompanied by suitable education and labor market interventions.