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Next Generation EU: Solidarity, Opportunity, and Confidence

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Summary

The European Council agreed in July 2020 to fund a €750 billion financial support mechanism to help Member States' recovery from the COVID-19 pandemic. In doing so, they not only revealed the breadth of European solidarity, but also created an opportunity to deepen European institutional integration. The new mechanism – called Next Generation EU – is temporary, and yet it creates European capacities that will be available should the need ever arise again. These symbolic and institutional implications are important.

Even though the Member States have been slow to ratify Next Generation EU, the expression of solidarity has strengthened popular support for European integration even as the confidence it has inspired in financial markets has created macroeconomic benefits. The challenge will be to build on those foundations. The Member States will struggle to manage their national recovery and resilience plans. Their success will determine whether Next Generation EU is a one-off experiment or a model for future European endeavours.

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1. Introduction

The purpose of this note is to take stock of the European Union's recovery and resilience plan – called 'Next Generation EU' – in light of developments since it was agreed in July 2020. The question is whether that agreement is as significant in hindsight as it appeared to be when it was made. There are many reasons to ask.

Next Generation EU has proven to be controversial both within countries and between them. It has also taken longer to ratify and to start than originally expected. And, for a variety of reasons, the amount of money it will involve has shrunk.[1] Meanwhile, the pandemic has worsened, Europe's vaccination efforts have taken off slowly, the damage to European economic performance has increased, and public tolerance for aggressive containment measures has diminished.

The note focuses on three different aspects of the recovery and resilience plan: the symbolism surrounding the agreement, its institutional implications, and its macroeconomic significance. The argument is that Next Generation EU remains an historic achievement across all three dimensions. The July 2020 European Council summit may not mark the foundation of a 'true' European federation, but the agreement reached there does three things we did not see during the global economic and financial crisis that started in 2007 and 2008.

Specifically, Next Generation EU underscores the breadth of solidarity across EU Member States, it consolidates an expansion of competences within the European Commission, and it lays the foundations for more effective pan-European macroeconomic stabilization. This foundation had a significant impact on macroeconomic performance, particularly in the bond markets, even before any money was spent. As a result, the next time European policymakers face a crisis of this magnitude, they will draw lessons from – and build upon – this experience.

2. Hard Bargaining

With hindsight it is easy to overlook how challenging it was for Europe's heads of state and government to come to agreement on how best to respond to the economic consequences of the Covid-19 pandemic.[2] The fast pace of events obscures the intensity of the bargaining. Where Europe's response to the global economic and financial crisis unfolded over a span of years, the pandemic response came together in only a matter of months. Somehow, this time around, Europe's heads of state and government seemed to be more decisive.[3]

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It would be more accurate to describe them as better informed. Almost nothing debated between March and July 2020 was new, apart from the novel coronavirus: everything in terms of policy had been discussed repeatedly; many of the policy measures had been on the table for almost a decade. Hence Europe's leaders easily accepted the need to suspend the rules for state aids and macroeconomic policy coordination, they recognized the benefits of relaxing bank capital requirements and providing credit guarantees, and they had a broad understanding of the importance of providing a backstop for national unemployment and employment protection arrangements. Indeed, they had built most of these elements into the institutions they created after the last crisis.[4]

There was nothing very surprising in the debate about debt mutualization either.[5] The nuance had changed over the course of the preceding decade. In 2010, the focus was on existing debt; by 2020 it shifted to new debt. But the basic principle of making a joint-and-several commitment to underwrite European borrowing instruments remained the same. Hence Europe's leaders could focus their attention first on whether such joint commitments are necessary and, if they are, on who would issue the debt, what conditions could be attached to the use of any funds that were raised, and how those funds would be repaid or financed.[6]

It did not take long for governments to realize that some common borrowing would be necessary. The bargaining that took place was not about the principle of support; it was about the practicalities. Some of the governments of those countries hardest hit by the pandemic – like Spain, Italy, and Greece – did not want to rely on the European Stability Mechanism (ESM), which is the institution created during the last crisis to raise funds to support Member State finances. These governments accepted that some European institution would have to issue any common debt – and, given the time constraints, that no new institution was likely to be created – but they would rather work with the European Commission. They also did not want conditions placed on the support they received, and they questioned why such support should take the form of back-to-back lending – where some European institution borrows from the market so that the member state can borrow from the European institution – rather than being financed directly through more general (meaning pan-European) instruments without having the member state government take ultimate responsibility for repayment of the loan.[7]

Other governments – like Germany, the Netherlands, and Sweden, some of which were also very hard hit by the pandemic – took a different view. Here too, however, the focus was on practicalities. They argued that governments in need should access the institutions created for that purpose, meaning the ESM for more general assistance. They also argued that support should come with conditions to help ensure that governments seeking assistance are better prepared to face future crises. And they insisted on back-to-back lending to reinforce this notion of national responsibility.[8]

3. Agreement, Not Consensus

These disagreements over practicalities revealed important differences of principle. For example, one group of governments opposed conditionality as a constraint on national sovereignty; another group insisted on conditionality to prevent moral hazard. These are principled arguments. The point is not that they were easy to resolve; it is only that the differences crystallized quickly. Neither side disputed the principle of solidarity. Again, it was easy to recognize that some common borrowing would be necessary. What each group argued was that 'true' solidarity required different institutional arrangements from what the other side was willing to accept.[9]

The emergency measures agreed by the European Council on 23 April 2020 represented an uneasy compromise between these positions.[10] The European Commission would backstop national unemployment schemes through back-to-back lending, and the ESM would support government finances more generally using loans as well, on the (very light) condition that any funds be used to finance health and related expenses. The European Investment Bank would leverage fresh capital to provide loan guarantees to small and medium-sized enterprises. Most important, the European Council agreed that the Commission would propose a more ambitious program to finance Europe's recovery from the economic consequences of the pandemic.

> 'Once again, the debate centred around the same three concerns – who would issue any common debt, how the money would be used, and how it would be financed or repaid.'

That decision to launch a recovery fund started another round of bargaining. Once again, the debate centred around the same three concerns – who would issue any common debt, how the money would be used, and how it would be financed or repaid. The same two groups formed around the same sets of preferences. The differences between the groups quickly crystallized around well-known themes and arguments. And as the debate became more polarized, these positions became more deeply entrenched.

Then the German government shifted its position. Instead of advocating national responsibility and arguing against the dangers of moral hazard, the German government agreed to instruct the European Commission to raise whatever funds might be necessary and to find a general formula for financing the common debt. That shift brought France and Germany together on one side of the debate and so tilted the balance of political power in the European Council against those on the other.[11] The effect was not decisive in any black-and-white sense, but it did move the focus of attention away from the ESM, and it also created space for the Commission to propose raising funds that would be repaid through the European budget (grants) as well as through back-to-back lending (loans).

As a result of this shift in the German position, the negotiations at the July 2020 Europe Council summit concentrated primarily on the balance between grants and loans and on the enforcement of conditions attached. There were other issues on the table as well. European leaders also debated the overall size of the fund and the allocation of resources across expenditure categories and Member States. What dragged out the negotiations, however, was simply the fact that the opposing sides stuck to their positions – with one group insisting on any support coming as conditional loans, and the other insisting that support should also come in the form of grants.[12]

4. Solidarity and Symbolism

The final agreement was difficult to reach. Nevertheless, by the end of the July summit, each of the three sticking points from the previous April – who would borrow the money, what conditions would be attached, and how that money would be repaid – were resolved. In contrast to the April agreement, the Commission plays the central role in administering Next Generation EU, the funds are available as grants as well as loans, and the conditions attached to using those funds are strict.[13]

Like the April agreement, however, Next Generation EU is temporary. This notion of 'temporary' is long – three years to commit the funds, six years to spend them, and another thirty year to pay them back either individually or collectively. But long is not 'permanent'. The legal basis rests on Treaty provisions that allow the European Union to act when faced with an emergency; such provisions lose force once the emergency passed.

The fact that the European Council could reach an agreement on Next Generation EU was enough to change the wider conversation about the European response to the pandemic and about the European Union.[14] That much was obvious already in April. The mood started to shift from pessimism to something more optimistic as soon as the European Council announced there would be a recovery program. That change gathered momentum when the French and German government released their joint initiative – and the German government signalled its change in position – on 18 May.

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By the time the European Commission delivered its formal proposal on 27 May, the symbolic expression of European solidarity was well established. Indeed, even those governments that chose to push back against France and Germany accepted the importance of European unity. In their counterproposal, the governments of Austria, Denmark, the Netherlands, and Sweden led off with the observation that:

> The COVID-19 crisis is affecting all EU Member States hard. Socially and financially. It is in the interest of all to restore growth to Member States' economies as soon as possible. This calls for European solidarity and a common recovery strategy.[15]

Writing on behalf of the group in the *Financial Times*, Swedish Prime Minister Stefan Löfven made it clear that: 'The EU has already taken bold decisions to mobilise historic amounts of money … and our four countries … are willing to do more. What we do in the EU is about solidarity, which goes hand in hand with sustainable European growth.'[16]

That assertion had deep roots in European public opinion (at least to the extent we can measure it). When Dutch respondents were asked in June 2020 whether EU Member States should stand together in the face of the pandemic, 70 percent said they should, and 50 percent agreed that the countries hardest hit should receive financial assistance.[17] Those polling respondents were far more likely to support the position taken by their government than the proposal offered by the European Commission, but that support did not rest on a lack of European solidarity. Instead, it reflected a belief that national governments should be responsible for repaying any assistance.

5. Crystallizing Issues

Popular support for having some form of European recovery plan continued to gain momentum as the intergovernmental negotiations culminated around the time of the July 2020 European Council summit. The European Commission asked polling respondents across the Member States whether 'the EU should put in place an economic plan to help all EU Member States recover' as part of its bi-annual *Eurobarometer* polling and roughly 88 percent of respondents agreed. The Estonians were at the low end of the distribution in support with 'only' 79 percent of respondents expressing their agreement with such a project; the Greeks were at the other end of the spectrum with support levels at 98 percent.[18]

Of course, such questions only have one answer in the midst of a crisis. It is hard to imagine making the case for not having a plan. Any opposition is more likely to reflect a lack of trust in the European Union than a reluctance to support a European recovery. Here it is useful to look at more general indicators of support for European integration. And when *Eurobarometer* pollsters asked respondents across the EU whether they believe their country 'could better face the future outside the EU', the responses were much the same as they had been before the pandemic. When asked about 'trust in the European Union', the share of respondents who 'tend not to trust' increased – largely because of a collapse of trust among Italians.[19]

Importantly, however, the crisis crystallized issues in the popular imagination, particularly with reference to the European budget. Where in 2019 polling respondents were evenly divided on whether the EU had enough financial resources (41 percent) or needed more to achieve its political objectives (40 percent), by the summer of 2020 the share of respondents who did not know or were undecided fell from 19 percent to just 8 percent. Those who previously had not been able to make a decision split unevenly in support of a larger European budget, giving that side of the debate a clear advantage – 48 percent in favour versus 44 percent against.[20]

The distribution continued to reflect the polarization in the argument, with respondents from the four countries most opposed to expanding the EU budget sharing their governments' positions. What is surprising, therefore, is that a majority of respondents in these countries did not begrudge losing the debate. Eurobarometer pollsters asked the following question in July and August of 2020: 'Thinking about the EU's response to the Coronavirus outbreak, to what extent do you trust or not the EU to make the right decisions in the future?' Among Danish respondents, 80 percent tended to trust EU decision making. That number was 68 percent in both Sweden and the Netherlands; it was 50 percent in Austria, against 46 percent who tended not to trust the EU to make the right decisions. The Austrians are closest to the Italians in that regard, even though the two countries were on opposite sides in the argument. And respondents in both countries were more likely to trust the European Union in making decisions about the future in light of the coronavirus pandemic than they were to trust in the EU as an institution.[21]

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What this public opinion data reinforces is the sense that Europe came to agreement and not consensus. Everyone accepted that something needed to be done. Those countries that took a more frugal position at the start of the debate also accepted that finding agreement to do something was more important than continuing with the argument. The positions of principle did not change either for government leaders or for their national publics, but the need for European solidarity was manifest and so was the necessity to act. That action had crucial significance, particularly for those countries most in need of support.

6. Consider Italy

The Italian case warrants close examination. Italy is the country where support for the European Union has fallen most consistently and precipitously over the past three decades. In March 2018, the two best performing political parties in national parliamentary elections were both anti-European (or Eurosceptical) to a greater or lesser extent. When these two parties formed a coalition government, their anti-European sentiments were the most important issue they had in common.[22] That coalition split over Europe in 2019, not because of any fundamental change in popular perceptions but because the more anti-European of the two parties – the Lega – achieved a decisive advantage over its coalition partner – the Five Star Movement (M5S) – in the elections to the European Parliament.[23]

The M5S remained deeply divided over Europe but managed to form a coalition with the more pro-European Democratic Party after the Lega tried to bring down the government. Italian attitudes toward Europe then worsened significantly during the onset of the pandemic. At one point in April, some pollsters found a plurality of Italians who said they would vote to leave the EU if given the opportunity.[24]

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The Italian prime minister, Giuseppe Conte, bet his political fortunes on a bid to win EU assistance. From April to July, he argued forcefully in support of a generous European recovery plan. Once that plan was agreed, Conte sold it back home as a victory both for Italy and for the European Union. The impact on public opinion in Italy was dramatic. Comparing polls done in April and November 2020, the number of Italians who believed they received adequate EU support strengthened, the belief that Italy was treated unfairly diminished, and the willingness of Italians to support Italy's permanent membership in the organization (rather than voting to leave) increased.[25]

The symbolism of European solidarity played well on both sides of the argument in the European Council. Next Generation EU may not live up to claims by commentators that the European Union experienced a transformation on a par with the consolidation of the federal government in the early United States, but it was a significant improvement in popular perceptions.

That successful symbolism does not mean, however, that Conte was the ultimate victor or that those advocates of a generous recovery program got everything they wanted. On the contrary, the program began to stumble almost as soon as it was agreed. The problem was not the lack of European solidarity. Rather it was the reality that organizing a recovery from the pandemic would be challenging under any circumstances; organizing such a recovery under the watchful eye of the European Commission would be even more daunting.

7. Institutional Requirements

Next Generation EU implies three different institutional requirements. The first is that the European Commission have the capacity to float and manage a large stock of debt – up to €750 billion in addition to the €100 billion allocated to the SURE program. The second is that the European Council agree on new revenue sources or larger national contributions to finance that debt, including the costs associated with issuing and placing the securities. The third requirement is that the Member States come up with national recovery and resilience plans that the European Commission can accept and monitor through their implementation.

Of the three, the debt issuance and management is the easiest to establish. The European Commission has the legal capacity. It needs only to expand its treasury operations. These operations will run through the thirty-six years of Next Generation EU's financing period. During that time, the Commission will issue debt across the full spectrum of maturities and it will use active debt management strategies to hold down borrowing costs and to support participation in the secondary market.

In doing so, the Commission will develop expertise as well as capability. Recognition of that fact is important. Where it may once have been possible to assert that the ESM is the only European institution built for the purposes of providing emergency finances for Member State governments, that will no longer be the case. In the future, the European Commission will be on more equal footing, at least in institutional terms.

The challenge for the Commission will be to start up its operations. The SURE program can be managed within the European Union's existing resources. There are costs associated with issuing and placing the debt, but they can be covered until Member States begin to make repayments. The charges on the back-to-back lending are high enough to cover both the administrative and financing costs of the program.

The same is not true for Next Generation EU. The loan components are self-financing through Member State repayment, but the other expenditures are not. Those expenditures – which includes both the 'grants' to the Member States and additional spending for EU programs managed by the Commission – need separate financing. The plan is to cover many of the start-up costs out of existing resources and with additional levies on the Member States. Very quickly, however, the European Council will need to agree on new instruments that can raise revenue to support the program directly. Moreover, those instruments will need to remain in place for decades.

The European Commission cannot begin to issue debt until those additional resources are agreed, either in the form of new tax instruments or in the form of larger national contributions.[26] Doing so would create the risk that the European Council might fail to agree on new financial resources and that any debt issued by the European Commission would have to be repaid through the regular budget (or multiannual financial framework). There is also a risk that the debt instruments themselves might not find ready buyers if the ultimate financing remains in doubt. The bonds issued to finance the SURE program are not a good indicator for market demand for Next Generation EU borrowing because the financing arrangements are so different.

Agreement on new financial resources is not easy, either in principle or with respect to specific tax instruments. The European Council mooted some possibilities in the July 2020 decision, but as of April 2021 the Member States have yet to ratify the principled decision to broaden the European Union's finances. In the meantime, the German Constitutional Court temporarily prevented the German president from formalizing that country's ratification of the 'own resources decision' until it could rule on whether the whole financial structure of Next Generation EU is consistent with both the European Treaties and German constitutional principles. That ruling cleared the own resources decision for ratification in Germany but raised questions about longer term budgetary constraints.[27]

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If (and when) the Member States finally ratify the European Council's own resources decision to finance Next Generation EU, that will be another important institutional milestone. That ratification will be enough for the European Commission to start raising finances. Any more specific agreements to develop new tax instruments will add to the momentum and expand the Commission's ability to issue more debt. The actual volume of money raised, however, will depend heavily on the programming requirements. The challenge is to ensure that money allocated is spent.

8. Recovery and Resilience Plans

This third institutional requirement – that the Member States come up with recovery and resilience programs that the European Commission can accept and monitor through implementation – is the most difficult to meet. The Member State governments will struggle to come up with programs to spend large amounts of money within a very tight time frame; they will also struggle to launch and manage those programs once they are agreed. If Member State performance managing

European structural funds is any indication, most will struggle to make use of much more than half of the funds they are allocated.[28] The reason is obvious for anyone familiar with public procurement: managing competitive bidding processes is hard, and so is contracting; supervising complex contractual relationships is even harder. Of course, governments could try to relabel existing programs to fit Next Generation EU objectives, but that is likely only to work for those countries that receive relatively small amounts of money. Even then, the European Commission will need to agree with the substitution of new European funding for existing national commitments.

For its part, the European Commission will have to collect, analyse, and comment on an enormous amount of planning information according to an even tighter calendar; the Commission will then have to set out procedures for regular monitoring of an unprecedented volume of activity.[29] The Commission has extensive experience with this kind of monitoring activity, running from the Maastricht Treaty through the Lisbon Strategy to the European Semester. The point is only that the Commission's existing responsibilities will not go away as a result of Next Generation EU; many of those responsibilities will fold into this new activity, but there will be more to do on top of that. The European Commission will need to expand its staff and raise its productivity to accommodate this increased workload.

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Perhaps the hardest part of this arrangement comes, however, with the enforcement of conditions on spending. The European Commission has made it clear that it will focus on a very broad notion of resilience, which encompasses country-specific recommendations made in 2019 and 2020 under the European Semester. The Commission will also look to ensure that national recovery and resilience programs meet European priorities in terms of the digital and green transformation. Hence, the Commission could find itself withholding funds from Member States for their failure to reform institutions that have little connection to the pandemic; it could also find itself rejecting projects that fall too far from European priorities despite having strong political support (or economic merit) within the Member States. These will be difficult conversations.

The European Commission has had difficult conversations with Member State governments in the past. The difference under Next Generation EU is the amount of leverage that the Commission will be able to exercise via the threat to withhold funding from projects that are either yet to start or already under way. Where it has been possible for Member State governments to ignore the Commission or to push back forcefully against European Commission guidance, such resistance will be harder to make.

9. Room for Manoeuvre and Rising Scepticism

At the same time, the Commission will have less leeway to offer lenience or to exercise discretion. The Member State governments represented in the Council of the European Union will also have a say in the monitoring and enforcement of conditions on funds used by Member State governments. A single Member State within the Council cannot override the European Commission's authority; the Commission needs only a qualified majority in the Council to support its recommendations. But a single Member State can slow down the disbursement of funds using an 'emergency brake mechanism' built into the approval process and so complicate program implementation. That mechanism is reserved for 'serious deviations' from program requirements and yet the scope of application extends to the fulfilment of country-specific recommendations.

National governments will be reluctant to call out one-another for their failings; they will also be eager to get money into the economy as quickly as possible. But that combination of reluctance and eagerness cannot be taken for granted over a six-year period. As a result, the conditionality attached to Next Generation EU has attracted considerable attention.

Already in September 2020, the Spanish and Portuguese governments made it known that they would not access the loan facility. They can borrow almost as cheaply on the markets as they can from the European Commission and with fewer strings attached. More important, they are wary of taking on additional sovereign debt that could make them vulnerable to changes in market sentiments.

Later that autumn, the focus shifted to rule of law considerations. Voices both in the European Parliament and in some Member States pressed for the European Commission to be able to withhold funding for reasons that relate more closely to human and civil rights protections than to recovery from the pandemic. This debate threatened to derail approval of the multiannual financial framework.[30] When it was resolved, the European Commission had an expanded remit but also a more complicated evaluation procedure.

Going into the spring of 2021, increasing numbers of Member States expressed scepticism about taking up the loans available under Next Generation EU. Even the new Italian government under Mario Draghi said it would borrow only so much as it needed. Some governments, like the Netherlands, also chose to delay their application for the 'grant' portion of funding. Ostensibly, the Dutch government delayed because it was headed into national elections and did not want to bind a future parliament; when the Dutch government fell due to scandal, the caretaker regime was unable to map a national recovery and resilience program in any event. Once the elections were held, the Dutch parliament needed to wait for the formation of a new coalition government. In the meantime, prominent voices emerged arguing that the Netherlands should forego its entire share of Next Generation EU funding because the volume of funds available was not worth accepting the conditions attached.[31]

This series of controversies – surrounding the ratification of the own resources decision, the capacity of the Member States to use the funds they receive, the difficult relationship between the European Commission and the Member States, and the conditions attached to any spending – underscore the ambitious nature of the European Union's recovery and resilience framework. They also suggest the institutional changes underway. If the European Commission comes out of this process with expanded expertise in treasury operations, new income streams, and strengthened capacity to monitor the Member States and hold them to account, that will constitute a significant change. Even a partial expansion in each of these directions would mark an important shift in the pattern of European integration, particularly when seen alongside the powers the Commission gained during the last crisis.

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The question is what all this means for the volume of funds that is likely to be committed. If some Member States refuse to take up their loan allocations and – at least potentially – some also refuse to take up their grants, that will reduce the size of the overall package. Meanwhile the slow ratification of the agreement and difficult assessment of the national recovery and resilience plans is likely to stretch out any spending. The Commission may be able to raise funds by the end of the second quarter of 2021, but significant spending is only likely to start at the end of 2021 or the beginning of 2022 at the earliest. The institutional changes brought about by Next Generation EU are impressive, but that says little about the program's effectiveness as a response to the pandemic.

10. Macroeconomic Significance, Likely Alternatives, and Indirect Effects

A straight-up accounting of the macroeconomic impact of Next Generation EU is underwhelming – even whether the decisions taken in April and July 2020 are added together. The headline number is large. The 23 April agreement promised to add up to €540 billion in stimulus; the 27 July agreement promised another €750 billion. The sum of those two numbers is just under €1.3 trillion. But that headline figure is misleading. The €240 billion in loans from the ESM were never taken up. Demand for the credit guarantees from the European Investment Bank was only about 40 percent of what was on offer, and the actual credit created with those guarantees is unclear. That leaves only the €100 billion for the SURE program out of the 23 April agreement, of which €94 billion has been proposed and €76 billion has been disbursed.[32]

Meanwhile, the European Commission has yet to raise any of the money for Next Generation EU. When it does, the funds most likely to be spent are the €390 billion in direct expenditures, which includes €78.5 billion to be spent through the EU budget and another €312.5 in grants. This money will be spent over a six-year period. The goal is to frontload as much of that spending as possible, but a lot will depend upon how ready the Member States are to launch new projects. (If they simply relabel existing projects to replace national funding with European resources, that will not add macroeconomic stimulus). The fate of the €360 billion in loans is less certain. The SURE money was almost all used, but that had fewer conditions attached. Moreover, in contrast to the grant money, these European Commission loans still count as Member State sovereign debt.[33]

It is easy to come away from this kind of arithmetic thinking with a sense that the macroeconomic impact of Next Generation EU will be marginal. A few countries, like Italy, will stand to benefit from the program. The European Union will receive significant new investments in green and digital technology, infrastructure, and social services. But the direct implications for output, employment, or inflation will be small – particularly relative to the impact of the pandemic. If most of the loans do not get taken up and roughly half of the grant money remains unspent, the macroeconomic impact could be insignificant.

Then again, an arithmetic accounting may not be the most accurate way to measure the influence of the program. A better way might be to start by considering the alternatives. The best alternative to Next Generation EU would be the loan-based program advocated by the governments of Austria, Denmark, the Netherlands, and Sweden. Such a program would likely have been smaller than the volume of funds agreed by the European Council. The conditions on such a program would have probably been similar. If so, the take up would be more like what we can expect from the loan facility in Next Generation EU or like the take up of loans from the ESM, than the money deployed under the SURE program.

The next best alternative would have been to stick with the facilities agreed on 23 April while allowing national fiscal authorities to do the rest. This arrangement would be less equitable given that the impact of the pandemic was initially stronger in some countries than in others, and that many of those countries hardest hit were also already more heavily indebted. But this arrangement would still have included some version of the €1.1 trillion European multiannual financial framework and so it would have contained those common investments and redistributive mechanisms that already exist. In other words, even the second-best alternative to Next Generation EU included some European spending.

What the prospect of a common recovery and resilience fund added to this mix was an important dose of market confidence. The macroeconomic significance of this confidence is hard to disentangle from the many other factors at work, including the very accommodative monetary policies of the European Central Bank. Nevertheless, there are two elements to suggest that this market confidence was important both to economic performance and to the macroeconomic policy mix.

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The importance for macroeconomic performance can be seen in the movement of long-term nominal interest rates (or yields) on European sovereign debt instruments. The focus is on the difference between the yield on German debt and other countries like Italy, Spain, or France. The pattern is the same in all three cases. The spread peaks on 22 April only to fall to a new plateau once the European Council summit announces the package of measures and the determination to draft a joint recovery plan; it falls again and more significantly and remains low after the Franco-German proposal is made on 18 May. This kind of event analysis suggests that the policy announcement had a powerful influence on market sentiments.

11. Monetary Support

The second element comes from the European Central Bank itself. The ECB began to call for joint European fiscal measures already in early March 2020; the reason was that the ECB's Governing Council did not feel it could respond effectively to the crisis on its own and without fiscal support.[34] Central banks can lend money, but they cannot force firms to borrow or to spend. In periods of heightened uncertainty, even extraordinary monetary accommodation cannot stop the economic downturn. Worse, central banks are not good at redistributing funds across different parts of the economy. They can use direct asset purchases to try to prevent the monetary policy transmission mechanism from breaking, but that will not increase the effectiveness of monetary policy in stimulating economic activity.

The weakness of the ECB was on full display between March and April of 2020. Although the Governing Council promised to spend unprecedented sums purchasing sovereign debt, it could not prevent the spreads between Italy, Spain, France, and Germany from widening between the announcement of its pandemic emergency purchase program in late March and the European Council summit a month later. Moreover, the ECB was purchasing sovereign debt in a highly disproportionate manner during that period, buying much more from Italy, Spain, and France, than it bought from Germany.[35] After the spreads started to fall, the ECB could begin to buy sovereign debt more proportionately; eventually, the ECB could also slow down the rate of purchases. And while the Governing Council expanded its pandemic emergency purchase program twice, it also made it clear that it would only spend whatever is necessary to preserve the monetary transmission mechanism.

The minutes of the Governing Council's monetary policy meetings make it clear that the joint recovery program played an important role in stabilizing the markets. They also make it clear that the Governing Council wants Next Generation EU to come into action quickly to reinforce that strengthened market sentiment. Time and again during the second and third wave of the pandemic, the ECB's Governing Council has called on the European Union to complete the ratification process and move to the more active phase of the program. The record of the December 2020 Governing Council is illustrative insofar as: '[t]he key role of the NGEU package and the importance of it becoming operational without delay were reiterated.'[36] Although the Member State governments have succeeded in extending their emergency supports to firms and households, the concern is that only joint action at the European level can consolidate market sentiment and so give the recovery momentum.

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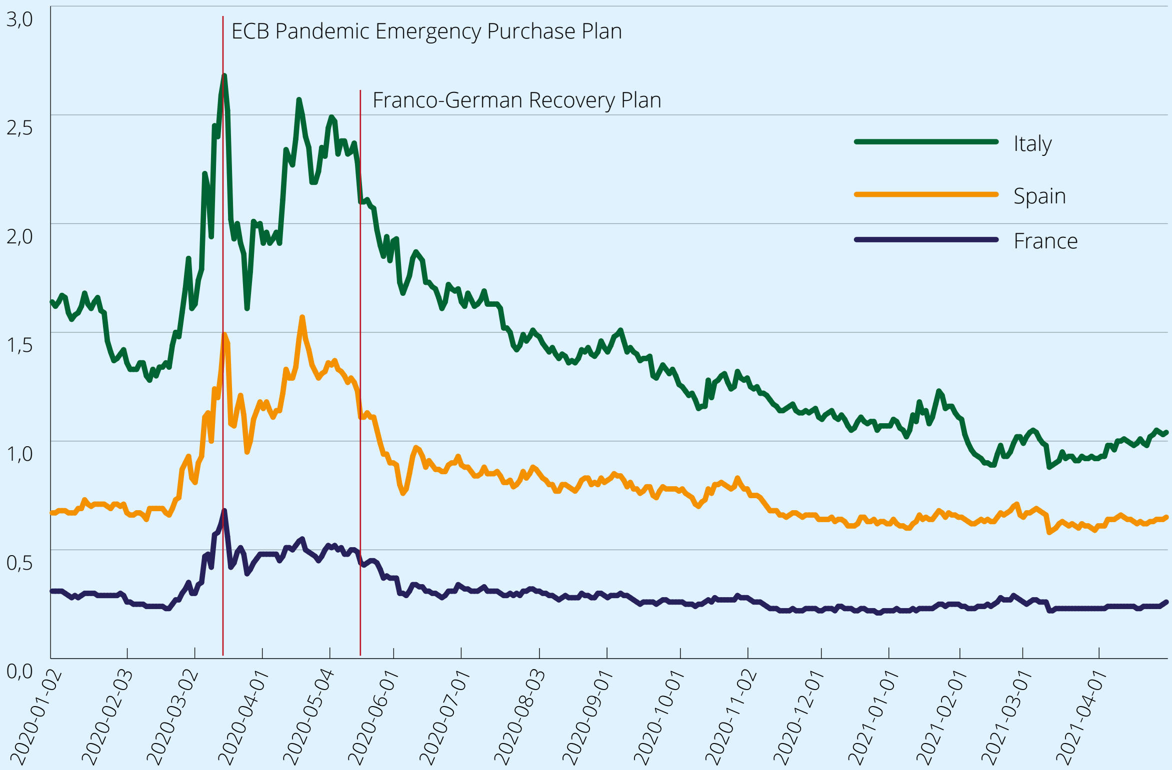
The Member State governments share that concern, particularly in Italy, Spain, and France. Those governments worry about rising levels of public indebtedness.[37] Nevertheless, they recognize that failure to extend temporary support measures will result in significant damage to firms and households while at the same time triggering political unrest. The prospect that Next Generation EU will provide some relief once those funds start flowing is an important part of the calculation to run up public debts in the interim. The goal is not to borrow unsustainably – which is a large part of the reason Spain and, increasingly, Italy are reluctant to take up the loan portion of the recovery and resilience funding. Rather the goal is to hold the economy (and society) together until the pandemic has eased enough to allow them to restart economic activity.

12. Implications

Next Generation EU is important as a symbol of European solidarity. It is also important as a source of market confidence and as a complement to fiscal efforts at the national level and monetary policy at the European level. These are all significant achievements. Indeed, they mark a sharp contrast with the divisions and confusion that marked important moments in the last crisis. The result

Figure 1. 10-year Sovereign Debt Yield Spread over Germany



Data source: IHS Markit Group

may not be transformative in terms of European macroeconomic performance, but it is better than the alternative policies of either a loan-based initiative or relying more exclusively on national fiscal authorities with some support from the European budget.

Next Generation EU also promises to introduce important institutional changes. It will strengthen the European Commission's ability to raise and distribute funds; it will also strengthen the Commission's capacity to evaluate and coordinate Member State policies. These changes will be controversial, but they are also likely to prove useful. When the next crisis strikes, the European Commission will be better equipped to facilitate a European response. In this sense, even a temporary support measure like Next Generation EU can be transformative.

There are other implications that will be more controversial. One of these concerns the agreement on new financial instruments and the ratification of the 'own resources decision'. This controversy has the potential to prevent Next Generation EU from happening. If so, the impact on market sentiment would be significant, and so would the implications for institutional development within the European Union.

Another controversial element concerns the evolution of Member State finances. The debts accumulated during the current crisis will take a long time to pay down. There is no guarantee that the next crisis will not arise before those fiscal balances are consolidated. The challenge will be to strike the right balance between stimulating the economy and paying down the debt.

Next Generation EU has created an opportunity for the Member States to recover more strongly from this crisis than they did from the last one. It has also set a pattern for European responses that is likely to be repeated. But such a pattern will only work if Member State governments accept responsibility for their actions. European solidarity has to exist on both sides of the argument if it is to be effective in holding the Union together over the longer term.

Notes

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[30] De la Porte and Jensen, 'The Next Generation EU.'

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[37] Jones, 'The Coming Debate.'