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THE NEXT GENERATION EU: Opportunity and risk

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The COVID-19 crisis has dealt a further blow to EU convergence. At the same time, it offers a unique opportunity for a new policy approach. Next Generation EU (NGEU) is the flagship EU crisis innovation response programme. For some it constitutes a fundamental step towards a federal union.

The NGEU offers investment and reform potential, but is not free from ambiguity in its recovery and transformation objectives. If successfully implemented, above all in southern European countries, it may pave the way towards a fiscal and political union. Conversely, failure could render further EU solidarity politically unpalatable and threaten the eurozone's integrity.

The Spanish plan illustrates the dilemmas of this risky experiment. More accent is placed on the regularity of financial execution of the NGEU funds than on efficiency and effectiveness, the benchmarks on which are left unspecified. This begs the question of whether, given limited resources, the capacity exists to monitor implementation, both in Spain and in the Commission.

The COVID-driven crisis has created favourable conditions to complete the euro's construction and push towards its unrealised convergence objective through reform and investment. If this opportunity is missed, circumstances are unlikely to be so propitious in the future. This paper will examine a number of related topics to demonstrate this: the objectives and structural problems of the euro; the debt crises starting in 2008 and the subsequent EU response; the COVID-driven crises and the corresponding EU reaction. Each deserves their own separate paper, and are outlined here only by way of background.

Next Generation EU (NGEU) – the COVID-19 recovery package at the centre of the new EU policy response – has been hailed as a "Hamiltonian moment", with reference to the first US Secretary of the Treasury who replaced individual states' debts with US federal debt. As the NGEU enters its implementation phase, it is time to question the value of such a claim. This paper will explore the novelties and transformative potential of this instrument. Specific reference is made to Spain, as it may constitute a test case for the success of the initiative.

The euro and the convergence dream

The creation of the euro was the boldest step in European integration and the last utopia of the 20th century. Precedents existed of countries without their own coinage, but a stateless currency was a bold project. For the most ambitious, it constituted the prelude to deeper economic and fiscal integration and a step towards political union. The widely shared objective was to improve convergence amongst participating states, meaning price stability, balanced growth, converging standards of living, high employment and external equilibrium. The move had been carefully prepared through the Economic and Monetary Union, but its final stage is an asymmetric and unstable union, where a single monetary policy coexists with economic and fiscal policies in the hands of states. In this sense, the project was left deliberately unfinished. The drivers were aware of the limits of such an option: "A single currency … would require a high degree of compatibility of economic policies and consistency in other policy areas, particularly the fiscal field … a Monetary Union without a sufficient degree of convergence of economic policies is unlikely to be durable and could be damaging to the Community" (Committee for the Study of Economic and Monetary Union, 1996). It would prove a self-fulfilling prophecy.

At the time there was considerable discussion amongst economists about the concept of "optimal currency areas", which the then European Community – though smaller and more homogeneous than today's union – was not considered to be due to insufficient integration and inflexible product and labour markets. But the debate died out and what remained was the principle of convergence, considered both the desirable outcome (real convergence in per capita GDP) and, as agreed in Maastricht, the precondition for joining (nominal convergence on key monetary variables). This left room for political compromise.

> The euro crisis showed that the convergence objective had not been attained. The solutions found left nobody happy.

Convergence is a wide-ranging concept. Its key driver is productivity growth, which is linked to reforms. It also requires sound institutions, governance and policies. Within the EU these are in the hands of member states, with the union placed in a facilitator position through rules, regulations and surveillance like the Stability and Growth Pact. Moreover, if convergence is to be sustainable, it requires mechanisms to iron out undesirable divergences and respond to external shocks that may put it in jeopardy. However, the union was left without fiscal capacity and the European Central Bank (ECB) was given a limited mandate.

Spain joined the euro in the first batch. Political determination was strong, but it fell short of completing key economic reforms to deal with low productivity, a frail export base, high unemployment and weak public finance management. Italy's stance was more cautious, but it decided to follow suit – as a founder member of the Communities, it did not want to be second to a more recent member. Greece joined as well, after some data massaging and against the recommendations of the European Commission, which deemed it unprepared.

The early years of the euro were a fiesta. Interest rate differentials vis-à-vis the German bund drastically narrowed. In a context of controlled inflation, real interest rates reached historic lows, but were still attractive enough to draw investors to the riskier peripheral countries. Professional investors, not always as discerning as the adjective might suggest, seemed to ignore the absence of an ultimate guarantee by an EU treasury and the fact that the ECB was prevented from bailing out member states. A euro illusion prevailed.

Spain was one of the main beneficiaries of this bonanza. Tourism and real estate thrived, attracting a stream of foreign credit and investment. Immigrants flowed in to service the boom and became easy targets for lax bank lending. Nobody dared to call the party off. Spain was in full swing: "*España va bien*", said president Aznar. In late 2007, president Zapatero proudly announced that Spain had overtaken Italy in GDP terms, although the figures were corrected shortly after.

The EU debt crisis

The bankruptcy of Lehman Brothers in September 2008 as a result of the subprime loan crises in the US sent waves across the Atlantic and worldwide. Some banks were cut off from the interbank market, forcing the ECB to step in. Investors suddenly became risk averse, resulting in widening risk premiums that increased the cost of funding peripheral EU countries and eventually pushed them out of the market. What was originally a financial crisis turned into a full-fledged sovereign debt crisis and a major recession that the markets could not solve by themselves. The EU discovered that it was ill-equipped to respond.

Nowhere was the situation more severe than in Greece. In early 2010 a new government admitted having misrepresented its macroeconomic data to conceal deficit and debt. Greek bonds were downgraded, cutting the country from recourse to the ECB. A first ad hoc bail-out had to be hastily put together and others would follow to the tune of several hundred billion euros. Greece was on the brink of leaving the euro more than once, closer than any other country has been. It did not happen for fear of the consequences. The EU was scared of the drag effect on others, including major economies like Spain or Italy, which were too big to rescue. Greece, and particularly its population, did not want to become outcasts. After serious doubts, Germany tipped the balance in favour of continued support, in part for self-serving reasons, but also thanks to the European vision of Angela Merkel. In the future, a similar crisis might have a different end.

The Greek ripples reached other countries. Rescue packages had to be put in place for Ireland, Portugal, Spain and Cyprus. In Spain the fiesta ended abruptly as boom turned to bust, resulting in a banking crisis with the potential to mutate into a sovereign debt crisis.

The ad hoc response to the euro crisis

It was obvious that the convergence objective the euro was meant to bring about had not worked, at least for southern European countries. Most tellingly, those rescued featured amongst the largest recipients of EU structural funds, which were meant to reinforce convergence, but presented mixed results and often favoured clientelism. The country bailouts (economic adjustment programmes) were designed without a clear diagnostic of the heterogeneous causes and under the simple assumption that if you put your house in order, plus some roughly defined structural reforms, growth will automatically follow. The euro zone was preserved, but the results were uneven. The EU was criticised for doing too little too late on fiscal stimulus, for being too tough on austerity and too soft on reform. The ECB, the most federal of EU institutions, wisely pushed its mandate to the limit. The US – the origin of the crisis – weathered it much more effectively, combining federal and state tools.

The bailed-out European countries ended exhausted and their populations impoverished through "internal devaluation", in other words reductions in wages, costs and profits that were unavoidable if competitiveness was to be regained without recourse to devaluation. The recipe cooked up by the IMF, the European Commission and the ECB was based on cutting expenditure and raising taxes and did not give sufficient consideration to the negative effects on growth or society. This, in turn, bred populism and extremism. And fund providers were not satisfied either. They stigmatised the borrowers as "lazy and spendthrift", overlooking the early benefits obtained from them and ignoring their own part in the responsibility.

The EU strengthened the Stability and Growth Pact and established the European Semester (including country-specific recommendations) to facilitate economic coordination and fiscal supervision. But its real impact appeared limited in the absence of structural reform levers that would have required fiscal and political capabilities that were missing. It should be noted that the EU funds provided and the effective decisions came from member states or mechanisms under their control, with the Commission relegated to a subsidiary role and the European Parliament ignored.

> The COVID-19 crisis could also have infected European institutions. That it did not happen is to the credit of certain frequently reviled EU political leaders and institutions.

It should come as no surprise that by the time of the initial discussions on the EU budget (multiannual financial framework 2021–2027) before the pandemic, EU member states remained severely divided between the so-called "frugals" and others and were unable to agree on a solid mechanism to prevent and tackle future crises. The possible mobilisation of EU funds through some form of debt mutualisation remained a contentious issue. Supported by France, Italy, Spain and Portugal, it was strongly opposed by Germany and the "frugals", who were afraid of a permanent transfer union.

The different response to the COVID-19 crisis

If the previous crises were predictable, COVID-19 caught Europe by surprise. At least there could be agreement that its causes were external, common to the entire region and different from the past. The EU was, at the time, on the way to recovery, but the consequences of the previous travails were still felt by much of the population. Debt burdens and unemployment levels were excessively high, especially in the rescued countries. The disruptive potential of the new recession was magnified by its unequal impact across the EU, with the southern countries and Spain in particular mostly affected due to their own weaknesses and distinctive economic structures. Thus, the virus inflicted a further blow to convergence. The former Commission president Jacques Delors rightly warned as early as March 2020 that the union was in mortal danger. It was no exaggeration, as the virus could have infected European institutions as well as its people. That it did not happen is to the credit of certain frequently reviled EU political leaders and institutions.

On the health front, in spite of its limited legal and practical competences in this field, the European Commission managed to coordinate an EU response in record time that avoided border closings and a vaccine war with disastrous consequences. A package worth over €500 billion was put in place to address the health emergency and its immediate impact on economic activity and employment. Loans were offered through the European Stability Mechanism and the European Investment Bank, the latter to help small and medium-sized enterprises. The specific SURE programme provided loans aimed at financing the extraordinary spending on unemployment benefits. Excessive deficit procedures and state aid limits were lifted or relaxed to accommodate a much needed, simultaneous fiscal stimulus at national level.

Most importantly, President Macron and Chancellor Merkel settled their differences and presented a proposal in March 2020 that would form the basis for a Commission proposal two months later and the Next Generation EU (NGEU) package that was adopted by the Council of the European Union on 21st July 2020. The political decision stated that "The COVID-19 crisis presents Europe with a challenge of historic proportions … [and] requires an unprecedented effort and an innovative approach, fostering convergence, resilience and transformation" (EUCO, 2020: 1).

The importance of this historic agreement, reached by EU leaders on the verge of disaster after four days and four nights of agonising discussions, cannot be overestimated. The EU gave a new response to new crises. In part, too, it amended past mistakes and compensated for past damages. As a condition for approval, the "frugals" introduced a brake clause that gives member states a right of oversight on the correct use of the funds by individual countries. The final adoption of the NGEU would still be subject to threats of blockage over the rule of law clause.

The NGEU is in contrast with past solutions. It is innovative, though not free of ambiguity between recovery and reform objectives. It includes caveats in support of the rule of law.

Next Generation EU: the most important tool in the new box

The NGEU – which comes on top of national stimulus packages – amounts to €750 billion in total. It is to be spent between 2021 and 2023, a short period for a big sum, when compared to an EU budget of €1.2 trillion for 2021–2027. It is allocated to member states, favours those most badly affected by the pandemic and is substantial when compared to GDP (over 5% of the EU's total, and more than 10% in the case of Spain). These are larger resources than spent in past crises, although it remains to be seen whether they will be sufficient. The funds will be channelled through the EU's budget, with the European Commission given a prominent role. Roughly half will be grants and half loans, rather than exclusively loans as in the past. According to the ECB, if used for productive investment, the NGEU funds could increase real output in the euro area by around 1,5% of GDP over the medium term.

The NGEU makes key innovations. It does not impose austerity conditions, which would be counterproductive, although Stability and Growth Pact discipline will have to be reintroduced at a later stage. Instead, it contains policy reform conditionality as a fundamental aspect to be decided by each country, albeit necessarily in line with the EU's country specific recommendations and subject to rubberstamping by Commission and Council. It also entails a degree of debt mutualisation, since it will be financed by debt issued by the Commission in the name of the EU that will be serviced by additional resources to be raised by the EU budget until 2058. It should be noted, however, that the political decision to create the NGEU pre-emptively stated that it was "an exceptional response to temporary but extreme circumstances and that the powers granted to the Commission to borrow are clearly limited in size, duration and scope" (EUCO, 2020:1). Nevertheless, it is still in stark contrast with the EU approach ten years earlier.

The Council's agreement stipulates that the financial support has to be spent on financing public and private investment to drive "a sustainable and resilient recovery", "repair the immediate damage caused by the COVID-19 pandemic" and "support the EU's green and digital priorities" (ibídem), with the latter two accounting for more than half of the funds. The Commission has specified a few priority flagship areas. However, this ample definition uncovers some ambiguity in the area between the recovery (which could simply mean a return to the pre-crisis situation) and the most important reform objective (implying a qualitative lip). The Spanish plan bridges the gap, at least in its title, by referring to "recovery, transformation and resilience" (Presidency of the Government of Spain, 2020).

A sustainable, inclusive and resilient recovery requires transformation, in other words reform, particularly in the weakest economies. In terms of the green and digital priorities transformation is necessary everywhere. The ultimate judgement on the adequacy of the reform content in each national plan will be made by the Commission and Council, which have to approve them and review progress. However, this essential component of the NGEU may prove an elusive and difficult dimension to judge and track. Political determination and close monitoring will be required and it may benefit from peer pressure, including from the "frugals".

During the preparations for the NGEU the link between EU funding and respect for the rule of law and EU values came to the fore. This was a response to serious concerns about the democratic behaviour of some governments, notably Poland and Hungary, and to prevent the transfer of funds to corrupt governments. The issue had been raised in the original Council decision and made the adoption of the budget and regulation difficult. It was eventually established that payments can be withheld from countries in which breaches of the rule of law compromise the management of EU funds. This applies to both cases of corruption and fraud and systemic breaches of fundamental values such as democracy or the independence of the judiciary when they affect – or risk affecting -– the management of EU funds. It does not go as far as many would wish, but is a political breakthrough in the fundamental fight for EU values and an added novelty of the NGEU.

Italy, Spain, Greece and Portugal, in that order, are to be allocated over 44% of the NGEU total for the 27 countries. The first three currently stand at their lowest GDP level compared to the EU average since the introduction of the euro. It is, therefore, fair to assume that their performance will greatly determine the overall outcome of the experiment. The Spanish plan illustrates the importance, as well as the risks, of the NGEU for the recipient and for the EU.

The Spanish plan and some open questions

The Spanish Recovery, Transformation and Resilience Plan is a unique opportunity to address the lingering structural weaknesses of the Spanish economy like chronic youth unemployment, low productivity and heavy dependence on tourism and over-construction. Despite apparently containing everything one would hope to see, the 350-page text, which has been approved by Commission and Council and is under implementation, lacks an overall strategic vision. Such a grand design should ideally have been forged through a state pact across the political spectrum, something that is unfortunately unrealistic in the current political climate. The prevailing attitude towards the plan amongst political, economic, social and regional leaders is of the "what can I extract" type rather than "how can we better use it collectively". This has not helped either.

The Spanish Recovery, Transformation and Resilience Plan offers a unique opportunity, but lacks a clear strategic vision on the long-term future. It leaves many open questions.

The reforms are only vaguely defined. The plan spreads the net too widely, attempting to satisfy too many constituencies (30 components and 212 measures), thus reducing its potential effectiveness. Unlike the closely coordinated German and French plans, it lacks an industrial strategy. The priority projects (strategic projects for the recovery and economic transformation, or PERTES in Spanish) are not yet listed, beyond the electric car. The breakdown of current expenditure and investment is unclear. There is a generic reference to the loan component without any detail on its use, which may indicate prudence vis-à-vis further indebtedness (even though more heavily indebted countries like Greece and Italy have requested loans) but also insufficient ambition.

More accent is placed on the regularity of financial execution than on efficiency and effectiveness, whose benchmarks are not spelled out. This begs the question of what capacity exists to monitor implementation with limited resources in both Spain and the Commission. All in all, the Spanish plan opens a window of opportunity but is vague about the landscape that lies beyond.

Preparing for the next crisis

The last two economic crises originated from west and east. When will the next one come, and where from? We have no answer, but one certainty: crises are recurrent. In this context, the best policy response to protect the EU appears to be:

1) To drive the reform agenda forward in every country, in line with green and digital priorities, while using the NGEU funds in well-targeted, productive investment, particularly in the countries lagging behind in productivity and institutional quality, especially in southern Europe.

2) To use the opportunity at EU level to pursue the completion of the Economic and Monetary Union, notably by working towards the establishment of permanent fiscal stabilisers that are capable of underpinning convergence and preventing and addressing major crises.

Achieving the latter requires the eurozone to be transformed into a fiscal and political union, with a commensurate budget and leverage to bring structural reforms in member states, which is not in the current political agenda. Seen in this light, the NGEU is not a Hamiltonian moment yet. However, if successful it may promote convergence and gather public support more effectively than any other EU instrument to date. This could in turn trigger the needed reform at EU level proposed here. Conversely, should the NGEU fail it may block progress, as public opinion, particularly in the "frugals" and in Germany, will gain new arguments to oppose a permanent transfer union.

Jean Pisani-Ferry (2020) warned early on about the high risk potential of the NGEU: "if the program fails to deliver on stated goals, if political interests prevail over economic necessity, federal aspirations will be dashed for a generation". Antoni Castells (2021: 20), in a thorough analysis, concludes with a gentler view: "if the endeavour goes badly … this initiative will have been of little use and a missed opportunity. This would make it hard to attempt any steps of a significant scale towards political integration for many years. This would probably not be the end of the world. In the past, the EU has made it through plenty of other extremely complicated situations. However, there would be a great loss of confidence among the members. All in all, it would contribute towards the stagnation of the process (once again)".

The NGEU is both a high-opportunity and a high-risk operation. The euro remains an unfinished project, as it has neither brought convergence nor completed its institutional and political construction. The current crises expose both of these shortcomings and yet the NGEU may contribute to their solution. We should not count on the availability of other "transformative" crises to do the job in the future, since the next one could be even more destructive. Moreover, should the NGEU result in failure, it could leave the EU unprepared or unwilling to react appropriately later on. The euro might survive, but perhaps not with all its current members, which could severely damage further EU construction. We might then bemoan that Hamilton did not show up and is no longer expected. Spain and others each bear their own share of responsibility for the outcome.

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