Policy Brief

Everything will be different:
How the pandemic is changing EU economic governance

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The pandemic will completely shake up the EU's economic governance in five ways: EU debt is possible and will become a reality; the EU and the Eurozone get a fiscal capacity; the European Semester will be history; the crisis managament architecture is politically questioned; and the Eurozone loses its relevance for EU decision-making. Taken together, these five lessons from the pandemic will render the old pre-pandemic Eurozone reform agenda obsolete. EU institutions should use the coming 18 months to prepare a new reform agenda for EU economic governance that can deliver tangible results before the next EU long-term budget will be negotiated.

Before the Covid-19 pandemic, the discussion on the future of the Eurozone's and the EU's economic governance was stuck in a rut. Since the euro crisis, significant progress has only been visible in the area of banking union. Debates on a closer fiscal union or on more binding coordination in the economic policy arena had repeatedly come to a standstill. The latest case-in-point was the Franco-German project for a Eurozone budget, which had been whittled down to a macro-economically meaningless and largely symbolic project right before the pandemic struck.

The last year has profoundly changed the contours of any future reform discussion. Within just a few months, agreement has been reached on the Recovery Instrument (RI), through which the EU will finance additional expenditure in the triple-digit billion range over the next few years. These funds will be raised as EU debt on financial markets. This step - completely unthinkable a year ago - is limited in time and confined to the consequences of the pandemic. And yet it changes everything.

The old Eurozone reform agenda of the 2010s had essentially pinned all its hopes on banking union and capital market union. It had put fiscal policy issues on the backburner and thus relegated them to the political sidelines. The old agenda has now been overtaken by reality. **The past year has taught us five lessons that raise fundamental questions and require a systematic rethink of the reform agenda**.

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Lesson 1: EU debt is possible and will become a reality

We now know unequivocally that the European Union can incur substantial debt for the purpose of additional common expenditure. Whether the Union could do so legally was disputed for decades. Even amongst many EU experts, the misguided opinion that the EU could not take on any debt in any circumstances prevailed. This debate has now been settled definitively. The fact that the current EU debt issuance is limited in time and scope does not alter that finding. The legal basis used for the Recovery Instrument is not limited to the pandemic. Put simply: what could be done once can be done again.

From this diagnosis follows a central policy question for the coming years: **under what conditions should the EU be allowed to finance expenditure through common debt issuance in the future?** Economic, political and legal arguments will have to be carefully balanced in finding an answer. But the question is now inescapably on the table.

Knowing that EU debt is feasible also changes the set of available options to answer a number of other questions. If you want an EU safe asset, you do not have to construct complicated and synthetic financial products to do so. The EU can issue bonds. If the EU wants to increase public spending at the regional level or across the whole EU in a crisis, then neither an intergovernmental construction nor a pre-emptively filled rainy-day fund is necessary. The EU can issue bonds.

Finally, the debate will be shaped not only by the mere knowledge that EU debt is possible but also by the existence of EU debt itself. **The EU will issue up to 850 billion euros worth of bonds through the Recovery Instrument and the so-called "SURE" loan programme**. These will create a new reality in financial markets. European and international investors will hold these bonds and the ECB will use them for its monetary policy operations.

The EU will have to decide in the next few years whether it wants to withdraw these EU safe assets from the market again according to the planned redemption schedule. This would force investors to renationalise their portfolios or transfer them into other currencies such as the US dollar. Indeed, this would run contrary to the declared goal of both the EU Commission and member states to strengthen the international role of the euro.

Lesson 2: The EU now has a fiscal capacity and must decide on its future

The debate about a fiscal counterpart to the ECB's common monetary policy is at least as old as the euro itself. Under the names of "fiscal capacity", "unemployment (re)insurance" or "eurozone budget", various models were discussed in the search for an instrument that would help cushion recessions in the EU and Eurozone alongside monetary policy. The only consensus was that the EU budget would not be able to fulfil this task due to its rigid structure.

The Recovery Instrument, in particular its centrepiece, the Recovery and Resilience Facility (RRF), has now settled the debate on the design of the fiscal capacity. It provides significant additional funding to member states for spending in a crisis. In its distribution, it takes into account the asymmetric effects of the common shock. It stabilises different countries to varying degrees. The fact that 13% of the funds are paid as advances underlines the importance that member states and the European Parliament have attributed to this stabilisation effect. The European Union has become a macroeconomic player.

Of course, the macroeconomic stabilisation effect of this instrument is much weaker than that of a quasi-laboratory-designed stabilisation instrument. However, the idea that EU member states would at some point agree on the most clinically precise instrument for the sole purpose of macroeconomic stabilisation was never particularly realistic. Historically, macroeconomic stabilisation - in Europe as in the US - has always been a by-product of public spending choices. This is what happened now in the case of the Recovery Instrument.

The implications of these observations for the reform agenda are twofold: first, the Recovery Instrument has decided the race between possible designs of a fiscal capacity in favour of a common spending vehicle, and against insurance-based solutions. Some may regret this outcome. **But it would be delusional to assume that this step towards a common fiscal policy can now be wound down, while at the same time reviving the discussion on a fiscal capacity.** The EU, and thus the Eurozone, now has its fiscal capacity; its specific structure will have long-lasting policy consequences.

This leads to a second implication: **the fiscal capacity is conceived as a temporary measure, and will disappear without political action**. A debate is now needed on whether, and under what conditions, the Recovery Instrument can be made permanent; which revenues it should be endowed with in the future; and which expenditures can be financed through it.

Another observation from the last year should guide our thinking here: the regular EU budget's basic structures have once again proven difficult to reform. The interests of all member states are too strongly interwoven with the status quo of traditional spending programmes such as agricultural and structural policy. A decisive shift of expenditure from traditional to modern areas, such as R&D and climate change, was impossible to achieve. It seems even less politically plausible for the next multiannual financial framework, as an additional 15 billion euros per year will have to be found in the budget for the repayment of the RI loans. Against this backdrop, it seems that **a modernisation of EU finances can most likely be achieved by making the Recovery Instrument permanent**. In turn, a permanent instrument should then be used to finance joint investments in the future, for example to implement the Green Deal, and to stabilise member states particularly affected by crises.

Lesson 3: The European Semester is history

As a consequence of the euro crisis, the EU created the European Semester - a structured process to monitor and coordinate member states' fiscal and economic policies. The Semester, however, remained largely toothless. The country-specific recommendations (CSRs) addressed to the member states by the Commission and the Council were rarely heeded. The European Semester lacked the instruments, and member states lacked the political will to ensure a proper implementation of the recommendations. As a result, the process remained largely technocratic. Only the fiscal policy recommendations within the framework of the Stability and Growth Pact had some discernible effect.

The pandemic and the Recovery Instrument will, however, shake up the European Semester in two ways.

First, **the approval process for RRF funds will completely replace monitoring in the area of structural reforms**. In the coming years, the Commission will primarily focus on monitoring compliance with the member states' Recovery and Resilience Plans (RRPs). The RRPs are highly political documents that will emerge this spring following lengthy negotiations between the Commission and individual member states. Unlike for the largely meaningless progress evaluation of the CSRs, the disbursement of funds to the member states will depend on a positive evaluation. As a result, the evaluation of the implementation of these plans will also become a political act. This creates new dynamics: **a technocratic ritual will become a political process**. The decisive factor for the medium-term future of this process will be how credibly the Commission can encourage the member states to draw up ambitious plans and to implement them consistently.

Building this kind of **credibility will also be a key prerequisite for the long-term fate of the Recovery Instrument**. It will depend in no small part on the degree to which this new link between CSRs and financial incentives can increase the zeal for reform in the member states. Those sympathetic to deeper fiscal integration should therefore have a particularly keen interest in a robust assessment of the reform leg of the RRPs. In the coming years, the aim should be to transform this process into a permanent political procedure for economic policy coordination, whilst preventing a re-technocratisation.

Second, the fiscal fallout of the pandemic coincides with the upcoming review of the application of the Stability and Growth Pact, the 'two-pack'/'six-pack' review. This exercise would probably have had a scant chance of success in normal times, given that member states have diametrically opposing opinions on the application of the Pact. Now, in the aftermath of the pandemic, **the member states are forced to take a closer look at the fiscal rules and regulations**. After the pandemic, the debt level of the Eurozone is expected to exceed 100% of Eurozone GDP - far from the target of 60% set by primary law. Eight Eurozone countries will see their debt levels rise beyond 100%, with the heavyweights Spain, Italy and France ranging from 120% to 160%.

Re-applying the fiscal rules to the letter of the law would oblige these member states to reduce their gap to the 60% mark by one-twentieth every year for a long time to come. In the case of Italy, this would amount to an annual debt reduction of about five percentage points. Despite the need for debt levels of Eurozone member states to converge, **such a drastic consolidation course would constitute economic hara-kiri**. This would be all the more true if it were implemented simultaneously in several large Eurozone economies. That is not to even mention the low political chances of actually enforcing such a stringent consolidation course.

This leaves the member states with a choice: either they force the Commission to come to a politically and economically palatable application of the rules through further, often seemingly arbitrary, derogations and flexibilities. This would further undermine the credibility of the rules and the Commission's role as guardian of the treaties. Or alternatively, they could seize the opportunity of the upcoming review process to fundamentally reform and simplify the fiscal rules. The latter would clearly be the more desirable choice.

Lesson 4: The crisis architecture is under pressure

Paradoxically, of all the Covid-19 support instruments that Europe made available, the one that was permanently created for use in major crises is likely to go unused: the European Stability Mechanism (ESM). Member states recognised the nature of the pandemic as an exogenous crisis not of their own making and were prepared to considerably ease the conditions for access to the ESM. Yet, **drawing on ESM funds turned out to be politically untenable in a number of affected member states**. So far, not a single country has applied for ESM support. The fact that debates on ESM bailouts have become too politically toxic in some member states may be considered irrational in other corners of the EU. But the mere fact that this toxicity poses a potential threat to European financial stability makes it a problem for all member states. It should therefore also be tackled jointly.

The ESM reform that was recently adopted after years of negotiations will not address this issue. The reform turns the ESM into the backstop for the European bank resolution fund, thereby providing a critical ultimate safety valve for the banking system. However, the reform also effectively tightens access to preventive ESM credit lines and strengthens the ESM's role in programme monitoring, which in many countries is perceived as implying even more direct control by countries like Germany.

It is possible that this reputational problem of the ESM will dissipate in the long run and that in the meantime, the ESM will fulfil its function as a lender of last resort in the case of asymmetric shocks to smaller member states. However, there is a great danger that even in such a case, the request for assistance from the ESM will be made too late. This would make adjustment programmes unnecessarily costly and painful, which in turn cannot be in anyone's interest.

At the same time, **the pandemic shows that loans from the EU are not in and of themselves politically unviable**. The 100 billion euro loan programme SURE, labelled as an EU short-time work scheme, was tapped by 18 member states and almost completely exhausted within months. And it is to be expected that the loans part of the Recovery Instrument will also be used actively by member states. The conclusion to be drawn from this is that liquidity support in crisis situations is legally and politically palatable within the EU legal framework; it can even be allotted by a qualified majority of member states. Accordingly, a new attempt should be made to bring the ESM under the umbrella of the EU treaties and to consolidate its instruments with a possible successor instrument for SURE.

Lesson 5: The Eurozone dimension is losing relevance in EU decision-making

The pandemic has called into question the focus on the Eurozone as the central locus for reforms of the EU's economic governance. This is in no small part the consequence of the UK's exit from the EU. The room for quick fixes that involved the EU budget in any way was extremely limited before Brexit. **The Recovery Instrument would most certainly not have been possible with the UK in the Union**.

Moreover, the political balance in the EU has shifted: **the non-euro area bloc of countries has lost considerable importance as a result of Brexit**. Even before the pandemic, this led to political alliances between euro and non-euro states in the so-called Hanseatic League which staked out common positions on the Eurozone architecture. For the same reason, the Eurogroup and the Euro Summit now meet in the “inclusive format” on essential issues, i.e. with the participation of the non-euro area countries. This further blurs the border between the Eurozone and the EU-27.

Last but not least, the foreseeable enlargement of the Eurozone to 21 member states will cast further doubt on the raison d'etre of the Eurogroup as a format.

The pandemic was, and is, primarily a shock to the real economy. The EU-27 framework was the right venue for the policy reaction. However, acting in this format and thus exclusively within the framework of Union law has had an additional decisive advantage in terms of decision-making: in this context, it is often possible for the Council to make decisions by qualified majority. This applies for example, to the allocation of funds from the Recovery Instrument. This would hardly be manageable if pay-outs were subject to unanimity and possibly also to the respective approval by national parliaments, as it is the case for ESM programmes. This is also true on a broader scale: in principle, member states have an interest in keeping their veto for certain policy areas. But if everyone keeps their veto in some policy area, this ultimately threatens the Union's ability to act in all areas. This suggests that unanimity requirements should be consistently pushed back, implying that the EU framework should be chosen over a Eurozone institutional setup wherever possible.

The Eurozone format has thus already lost most of its importance; and there are good reasons why it should not regain it. **The Eurozone reform agenda should be replaced by a reform agenda for overall EU economic governance**. Of course, there are still areas, especially financial stability and the interplay with the common monetary policy, where closer collaboration of Eurozone countries makes sense. But there is no reason not to move this common action into the framework of the Union institutions whenever feasible and to at least open it to those non-euro countries that have a serious interest in a joint capacity to act.

What's next?

The five lessons from the pandemic illustrate that the old Eurozone reform agenda has been rendered obsolete by the events of the past year. Instead, **a new reform agenda for EU economic governance is needed**. This reform agenda should lead to an agreement in principle on where the common journey should be headed before detailed work on the next Multiannual Financial Framework begins in earnest.

Over the next 18 months, both the German parliamentary and French presidential and parliamentary elections will take place. During this period, political progress on contentious issues is very unlikely. These 18 months thus offer the European institutions a window of opportunity to **prepare a comprehensive reform discussion based on these five lessons and to lay out an appropriate process likely to achieve viable results**. The clock is ticking.

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