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Next Generation EU: Germany's contribution to transforming the European Union

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It is almost cliché to say that the European Union has been born and integrated as a result of crises. Renewed evidence for this view came out of the current process of developing the Next Generation EU instrument. Initially on the defensive, the European Commission substantially strengthened its standing amidst the architecture of EU institutions as it was granted prerogatives previously reserved for the Member States such as capital market powers and the option to levy taxes and use them to generate own resources. Such instruments empower the Commission to define the economic policies of the Member States.

From bonds shared by eurozone countries to European Commission bonds

The process was founded on the presumption that the European Commission should support the Member States in battling Covid-19, even if such measures were never included in its remit. In early March, the prevailing belief was that aid would be delivered in the traditional form of preferential loans granted by the European Investment Bank (EIB) and the European Stability Mechanism (ESM). The ESM was originally founded in response to the eurozone crisis of 2010, shaped largely by the philosophy of the "Northern League" of countries operating under the informal leadership of Germany and by the premise that each EU Member State was individually responsible for balancing its national budget.

Within the two months between March 18 and May 18, the EU fully abandoned this philosophy. Its pivot was preceded by a short and turbulent spectacle of dramatic wrangling and “betrayals”, in which the Germans found themselves repeatedly switching sides.

The first sign of upcoming change was a shift in the monetary policy of the European Central Bank (ECB). On March 12, 2020, at a press conference following an ECB Governing Council meeting, Christine Lagarde argued that the rising spreads of government bonds in the euro area could not justify central bank involvement. Shares in European stock exchanges fell sharply while the Italian and German government bond spreads soared. Despite such reactions, Bundesbank President Jens Weidmann insisted on staying the course, claiming there was nothing else that the Council could do and that the front line was no place for central banks (Weidmann 2020). Only a week later, Weidmann revised his position. At an extraordinary meeting on the night of March 18, 2020, the ECB Governing Council resolved to “return to the front line” and unroll a program of purchasing €750 billion’s worth of debt securities. All barriers and restrictions that had still been in place under the 2015 Public Sector Purchase Program (PSPP) for debt securities and that applied to the quality of collateral, maturities and issue volumes, were also removed. Widening spreads served as a rationale for the ECB’s intervention in the face of monetary fragmentation and disruption of monetary policy transmission mechanisms.

Another twist in the plot came with France’s subscribing to an initiative of southern European leaders, who warmed up the idea of issuing common intergovernmental bonds which Germany had firmly rejected during the eurozone crisis. On the eve of the summit, on March 25, 2020, the heads of nine eurozone states made an appeal in a joint letter to launch an issue of coronabonds. The way Berlin saw it, France’s involvement in the initiative was nothing short of “treason” (Politico 2020). Despite the inter-governmental and inter-parliamentary consultation procedures agreed between France and Germany in Aachen in January 2019, Berlin seemed surprised by the move.

Against this backdrop, the summit of March 26, 2020 failed to produce an agreement. This did not go well with the European public. People called into question the very usefulness of having a European Union that was unable to help its members in such dire circumstances. The first compromise on the forms of assistance was reached at eurozone finance ministers’ meetings on April 7 and 9. Traditionally, the aid was comprised of ESM and EIB loans of €240 billion and €200 billion respectively. The novelty was a green light being given to establishing two funds: SURE, in the amount of €100 billion to mitigate unemployment risk in the Member States, and a recovery fund, whose details were still to be determined. At the following summit on April 23, EU leaders approved these proposals, tasking the European Commission with working out the details of the recovery fund by May 6. On May 13, European Commission President Ursula von der Leyen outlined the fund proposal for the European Parliament. However, she fell short of taking a stance on the most controversial issue, i.e. the manner in which funds would be disbursed, and specifically on whether they

would take the form of loans, as advocated by the "Northern League", or of grants, as proposed by a bloc of southern European states.

A breakthrough on the matter came on May 18 with a proposal tabled jointly by Angela Merkel and Emmanuel Macron. The two politicians opted for having a €500 billion fund disbursed solely through grants. The facility would be financed with EC bonds guaranteed by the Member States. This time around, it was the "Northern League" countries that decried Germany's new position as "treason".

The Franco-German project became a basis for the Commission's proposal of May 27 to increase the instrument to €750 billion and split it into €500 billion assigned to grants and €250 billion to be provided in the form of loans. A July 21 agreement between heads of the EU member states modified the proportions between the loan and grant components. Ultimately, the Next Generation EU fund would amount to €750 billion, €360 billion of which would be allocated to loans with the remaining €390 billion to be divided between grants under the Recovery and Resilience Facility (€312.5 billion) and the existing EC budget programs (€77.5 billion). Funding will be provided based on government plans reflecting EU policy priorities in the fields of green transformation and digitization. Expenditures will be monitored using the Semester mechanism. The document has directly linked rule of law and fund allocation. The European Council has also established a multi-annual EU budget for 2021-2027 of €1.074 billion. During its plenary session on July 23, the European Parliament rejected the compromise forged by the European Council due to the allocation of funds to individual policies within the EU budget. The link between fund disbursement and the assessment of compliance with the rule of law that was envisioned in the Next Generation EU instrument was found to be overly tenuous. The European Parliament is due to resume its debate on the issue in September.

Is Next Generation EU groundbreaking?

It is too early to tell whether the instrument actually deserves to be called "Next Generation EU". While it is unquestionable that three structural changes have been made, views vary on whether the changes are going to be both durable and effective. One of the changes is going to make the European Commission a capital market operator on an unprecedented scale (Stubbington/Salay 2020). The EC bond issue is nothing new – a similar instrument has been used to finance the Juncker Plan. And yet, this time around, the scale of the facility is beyond compare. Such financing is allowed under para 122 of the European Treaties at "whatever-it-takes" moments. Some commentators, including Bundesbank President Jens Weidmann, emphasize that the instrument is temporary, its existence contingent on the occurrence of a crisis (*FAZ* 2020). However, the capital markets, which reacted enthusiastically to news about a compromise on the fund having been reached, saw things quite differently. The EC bonds are viewed as a game changer as they additionally address the structural weaknesses of the euro-denominated securities market. The EC bonds will benefit the market by ensuring a supply of additional triple-A-rated securities

(currently, of the 27 EU Member States, only Germany, Finland, the Netherlands and Austria in the eurozone and Denmark and Sweden outside the euro area, enjoy such top ratings), which will improve its liquidity and strengthen the euro as a reserve currency. In addition, long-demanded alternative assets will be established to make banks independent of the ratings of their governments. It is hard to imagine that once EU bonds mature, this type of assets might either disappear altogether or be largely abandoned, causing disruption in financial markets.

Secondly, for the very first time in history, the EC has been granted its own source of income: a tax to be levied on non-recyclable plastic products (mainly plastic bags) as of January 1, 2021. The plan also envisions taxing large technology companies (mainly US-based) for the benefit of the EU budget. Skeptics doubt whether such taxes will be approved. However, the consent of the Member States to tax citizens for the benefit of a political entity such as the European Commission would be a further step towards its strengthening in a process of gradual federalization.

Thirdly, making funding contingent on an assessment of compliance with the rule of law adds a criterion which, by virtue of not being based on metric or technocratic indicators, increases the scope of political discretion and, by the same token, the scope of arbitrariness allowed in relations between the European Commission and the Member States.

Germany’s change of position

The changes described above would not have been possible without a major shift in Germany’s policy. It is worth noting that this is not the first pivot observed during Angela Merkel’s long service as chancellor that so dramatically surprised political partners both at home and abroad. Equally unexpected were Germany’s prior decisions to abandon nuclear energy, accept same-sex marriage and overhaul migration policy. These radical course changes have allowed the CDU to reverse declines in voter support and maintain power, albeit leaving cracks in the party’s identity. By changing its position in the ongoing recovery fund debate, Germany relinquished not only its budget balancing policy but also the “golden rule of financing” that calls for the assumption of investment risk to go hand in hand with financial accountability for project outcomes. Grant financing contradicts this rule. Germany has also agreed to fully relax standards for securing euro issues. By abandoning all these principles, all of which stem from the philosophy of Social Market Economy, Germany departed from a model that had thus far formed the foundation of the economic development of the Federal Republic. A part of the public are convinced that Germany has thrown in the towel by incorporating into its monetary policy the “Italian tradition” of financing budget debt and the dirigisme that the French state employed in economic policy.

The pressing question therefore is what Germany has gained from the compromise. Germany’s dithering may be explained, at least in part, by the operation of the following factors:

1. Germany has ensured the controllability of intra-EU institutional changes. In response to opposition to the idea of joint intergovernmental bonds, the European public opinion reacted with anti-German sentiment. This significantly weakened Germany's position that depends largely on the country's ability to forge compromises and coalitions. According to commentators, anti-German sentiments, especially in Italy, were among the key arguments for changing Germany's stance [Kirst 2020]. By approving the fund, Germany was able to shake off its image as a tight-fisted miser and once again become a force that determines the fates of Europe.

2. EC bonds are a continuation of the forms of aid that originated during the eurozone crisis. Unlike the intergovernmental bonds proposed by France in a joint letter of nine eurozone state leaders of 25 March, the bonds do not constitute a qualitative change. In the intergovernmental bond scenario, each state was expected to guarantee the entire issue with its budget. This would constitute a leap forward in communitarizing the budgets of eurozone states and by-passing the EU institutions. Such a scenario would be a bitter pill to swallow for the majority of the German public. Aware of the predominant public sentiment in their country, no political force other than parts of *Die Linke* and the Greens backed the bonds in the proposed form. A bond issue would risk alienating large sections of German society towards the EU project. From the very outset, Germany's policy sought to transfer the provision of aid to the EU level. And although what Germany had in mind were ESM and EIB loans, the current form of EC bonds also requires the Member States to provide guarantees which, similarly as in the case of loans, reflect their contributions to the EU budget. The extent of their involvement is predictable, any possible costs are under control, and the instrument itself does not prejudge anything. Moreover, the EC bonds are consistent with the interpretation of the judgment of the Federal Constitutional Court of Germany of May 5, 2020 which barred issues of intergovernmental bonds as unconstitutional. This judgment has spectacularly delimited the scopes of both community action and the exclusive authority of national bodies. The statement of grounds for the judgment raised a constitutional barrier to any future attempts to launch European intergovernmental bonds.

3. Germany's hope is that by agreeing to back the recovery fund, it can count on support for its priority project, the "National Industrial Strategy 2030", unveiled in February 2019 and intended to alter the rules of competition on the common European market. The Strategy proposes to allow active state policies, including ownership stakes, to support the transition towards a digital and green economy. Germany hopes that state support will enable it to catch up with its competitors, the United States and China, on the technology front while preserving an ownership structure in which domestic entities dominate critical sectors.

Conclusions

It is difficult at this time to assess with much certainty the ideas for transforming the Union proposed in the Next Generation EU. Once again, the Monnet principle, whereby successful handling of crises requires placing further areas under Community man-

agement, has been confirmed. Indeed, the European Commission not only increased the scope of community authority by adopting two additional funds (SURE amounting to €100 billion and Next Generation EU of €750 billion) but also succeeded in gaining greater powers, not least on capital markets.

However, at the nation state level, the assessment is not quite that clear. The importance of Next Generation EU for the Member States, and thus the EC's influence, depends on the performance of their economies. With this respect, three categories of states can be distinguished: (1) states that depend on aid to retain their capacity to deliver public services – mainly the states of southern Europe; (2) states seeking economic convergence to happen as soon as possible – mainly the states of Central and Eastern Europe, and (3) states for which contributions to the fund are the price of "a ticket" of sorts that will allow them to achieve other goals – mainly Germany and the "Northern League". Each of these categories of states is confronted with different challenges. Two syndromes: (1) the so-called Dutch disease and (2) the so-called Mezzogiorno syndrome, pose risks for the first and second categories. The former syndrome consists in abandoning structural reforms (e.g. giving up on reforming the tax system in southern Europe or reforming the capital market in Central and Eastern Europe), which erodes competitiveness. Divergent development of individual eurozone economies is a good example of a symptom of this disease. The other effect, which the literature describes as the Mezzogiorno syndrome, relates to a mental dependence on external funding and a belief in one's own incapacity, which only strengthens secondary development. The third category of states may be tempted to alter common market architecture to promote their national interests thus undermining the stability of the common and open market, which serves all Europeans. With regard to the competitiveness policy, the proposed changes would effectively roll back the reforms that increased community powers and return such powers to nation states. The first symptoms of potential conflicts in this field have already been seen in the form of enormous differences in state aid used for crisis recovery. Suffice it to recall that the funds that Germany has allocated for this purpose have exceeded the size of Next Generation EU and that more than a half of the state aid permits issued by the European Commission have been granted to German companies, evoking criticism from Emmanuel Macron (*Financial Times* 2020).

Next Generation EU may be a step towards further federalization, said German Finance Minister Olaf Scholz, calling the formation of the fund a Hamilton moment in a reference to US history. However, seen from the German perspective, the process has also strengthened and secured the country's national sovereignty both by means of the aforementioned Federal Constitutional Court judgment and by accepting the active economic policy of the state.

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