EDITORIAL

THE EUROPEAN COUNCIL AGREEMENT: NOT PERFECT, BUT TRULY HISTORICAL

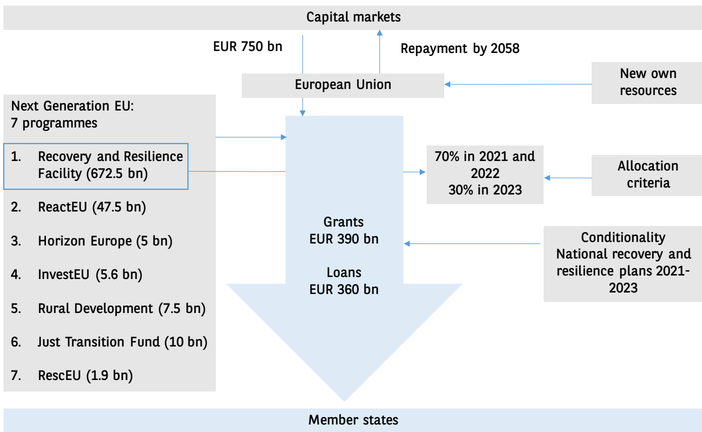
The European Council agreement this week on a recovery effort is, inevitably, a compromise but it is nevertheless historical. It consists of a combination of grants and loans to member states and is funded by debt issued at the EU-level. It sets a precedent for the management of future crisis situations with a better balance between monetary and fiscal policy. The possibility of such a two-pronged approach, reduces economic tail risk, which should structurally support confidence of households, companies and investors. The targeted allocation of the grants to countries which are in greater need, is another historical achievement and should generate a larger multiplier effect.

Like anything which is based on compromise, the agreement on the European Recovery effort reached this week within the European council is not perfect. Those who are concerned about moral hazard may very well consider the conditionality attached to the grants as light. Others will note that, on the one hand, certain countries have obtained rebates from their contribution to the EU budget whilst, on the other hand, amounts available for innovation and green transition have been cut within the Multiannual Financial Framework, the EU budget for 2021-2027. Finally, there will be frustration that the EUR 500 bn grants in the initial Commission proposal has been scaled back to 390 bn.

Yet, the agreement is truly historical and it has joined other momentous events since the start of the euro like the "whatever it takes speech" of Mario Draghi in 2012 at the peak of the euro area sovereign debt crisis, or the launch of the ECB's Pandemic Emergency Purchase Programme, which is structured in such a way as not to be tied by the capital key constraints of the 'normal' asset purchase programme. In both cases, the decisions were monetary in nature. Now, at long last, fiscal policy is where the big step forward is being made. This was necessary, considering that at the current very low to negative interest rates and with QE in full swing, there is only so much that monetary policy can do. Hence the countless calls to action to governments from ECB officials in recent years. There is an obvious urgency, considering the economic costs of the pandemic, in particular in economically less resilient countries. As explained by the Commission at the presentation of the plan end of May, doing nothing would increase the divergences between countries and end up weighing in on the functioning of the Single Market. For this reason, the horizon stretches well beyond a simple cyclical stimulus and the initiative is aptly called Next Generation EU.

The agreement is historical on many grounds. It has been reached quickly considering that the Macron-Merkel proposal of EUR 500 bn, which introduced the concept of grants, was formulated on 18 May and the initial European Commission proposal at the end of May. Barely two months have passed since then. The decision to provide grants would have seemed unthinkable only a couple of months ago and the same applies to the issuance of debt at the EU level. It reminds us never to say 'never'. Not only did it turn out to be possible to issue debt jointly but the long-lasting issue of solidarity versus moral hazard was also successfully addressed. One should also refrain from calling it a one-off. Admittedly, Covid-19 has created a unique situation, but a precedent has been set and this should be welcomed. It enhances the policy flexibility should the EU, at some point, again face a major economic crisis. For the euro area countries, this implies that crisis-fighting is no longer the exclusive remit of the ECB –in addition of course to national policy reactions- but that EU-wide fiscal policy can also be called upon. The possibility of such a two-pronged approach, reduces economic tail risk, which should structurally support confidence of households, companies and investors. The euro has strengthened recently versus the dollar, not without a reason.

NEXT GENERATION EU



SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

> The EU-debt financed recovery effort sets a precedent for the management of future crisis situations with a better balance between monetary and fiscal policy. The possibility of such a two-pronged approach, reduces economic tail risk, which should structurally support confidence of households, companies and investors.

In the shorter run, the prospect of EUR 750 bn being deployed over the next three years, should underpin confidence as well, thereby enhancing the effectiveness of the ECB's monetary policy stance. In this respect, the targeted allocation of the grants to countries which are in greater need, is another historical achievement and should generate a larger multiplier effect.

Another welcome consequence is the increased focus of EU-level policy oversight on structural topics. Countries asking for grants and cheap loans will have to present their 'recovery and resilience plans' and, for the disbursement of additional tranches, how they have scored versus the milestones. Criteria for the assessment by the Commission will be *"consistency with the country-specific recommendations, as well as strengthening the growth potential, job creation and economic and social resilience of the Member State shall need the highest score of the assessment. Effective contribution to the green and digital transition shall also be a prerequisite for a positive assessment."*[1] This implies that European Commission oversight and discussion within the European Council, which needs to approve by qualified majority on a Commission proposal the assessment of the recovery and resilience plans, has a clear structural policy dimension. A final illustration of the far-reaching nature of this week's agreement is the necessity to generate own resources for the EU in order to pay back the part of the debt used for the grants[2]. The Council document mentions in this respect new own resources based on non-recycled plastic waste, a carbon border adjustment mechanism, a digital levy, a revised Emissions Trading System and possibly a financial transaction tax. Although it remains to be seen which own resources will be created and for which amount, the necessity to do so will influence the EU's agenda, which is a positive side-effect of the agreement.

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1. Source: Special meeting of the European Council (17, 18, 19, 20 and 21 July 2020) – Conclusions
2. The part of the EU-debt used to provide loans will of course be reimbursed when the individual countries pay back their loans.