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CAN THE MUTUALISED EUROBOND SYSTEM ENSURE MORE STABILITY THAN THE EUROPEAN STABILITY MECHANISM?

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CAN THE MUTUALISED EUROBOND SYSTEM ENSURE MORE STABILITY THAN THE EUROPEAN STABILITY MECHANISM?

Abstract

Financial stability was not a primary concern when the framework of the European Monetary Union (EMU) was designed. This latter was indeed built as a machinery able to be functional in normal times with the hope for further integration in the long run. Nobody was expecting that in a few years the euro would have transitioned from an apparently latency period into a terrible storm and that the common currency area and the European Union (EU) would have had no means to face it. It therefore became clear that stability was a serious issue that required adequate defenses and that the Euro area would have to deal with the original structural negligence that had become fully-fledged vulnerabilities. The first response of the Eurozone to the severe instability within the area was the European Stability Mechanism (ESM), followed by the Next Generation EU in consequence of the 2020 crisis. However, institutional maneuvers seem to have missed the stability purpose, which instead may be achieved by fostering integration within the European Union through a genuine risk-sharing mechanism. The main stumbling block on the road to further integration is not a lack of adequate solutions to ensure stability, but European Union's current conditions that are preventing actual progress.

Riassunto sintetico

La stabilità finanziaria non era una preoccupazione primaria quando è stato progettato l’assetto dell'Unione monetaria europea (UEM). Quest'ultima è stata infatti concepita come meccanismo in grado di funzionare in tempi normali con la speranza di un'ulteriore integrazione nel lungo periodo. Nessuno si aspettava che in pochi anni l'euro sarebbe passato da un periodo di apparente latenza ad una terribile tempesta e che l'area della moneta comune e l'Unione europea (UE) non avrebbero avuto i mezzi per affrontarla. Divenne quindi chiaro che la stabilità era un problema serio che richiedeva difese adeguate e che l'area dell'euro avrebbe finalmente dovuto affrontare la negligenza strutturale originaria, che era nel frattempo diventata una vulnerabilità a tutti gli effetti. La prima risposta dell'Eurozona alla grave instabilità all'interno dell'area è stata il Meccanismo europeo di stabilità (MES), seguito dalla Next Generation EU in risposta alla crisi del 2020. Tuttavia, le manovre istituzionali sembrano aver mancato lo scopo di stabilità, che invece può essere raggiunto promuovendo un'ulteriore integrazione all'interno dell'Unione europea attraverso un vero e proprio meccanismo di condivisione del rischio. Il principale ostacolo sulla strada dell'integrazione non è la mancanza di soluzioni adeguate per garantire la stabilità, ma sono le attuali condizioni dell'Unione europea, che impediscono un reale progresso.

I. INTRODUCTION

Financial stability was not a primary concern when the framework of the European Monetary Union (EMU) was designed. This latter was indeed built as a machinery able to be functional in normal times with the hope for further integration in the long run. Nobody was expecting that in a few years the euro would have transitioned from an apparently latency period into a terrible storm and that the common currency area and the European Union (EU) would have had no means to face it. It therefore became clear that stability was a serious issue that required adequate defenses and that the euro area would have to deal with the original structural negligence that had become fully-fledged vulnerabilities.

The purpose of this thesis is to understand at what stage is currently financial stability in the European Monetary Union, in light of the tools developed to tackle the Sovereign Debt Crisis and the Covid-related crisis, and to verify the feasibility of an alternative instrument aimed at ensuring stability, a mutualized Eurobond system.

As such, this dissertation is structured as follows. Chapter 2 constitutes a prologue aimed at framing the condition of global interdependence and the effects of the widespread feeling of perpetual financial stability that led to the financial crisis of 2008. Chapter 3 starts with a description, with reference to Economist Charles Wyplosz, of eurozone's vulnerabilities that compounded financial instability when the international financial crisis outburst in 2008. It then analyses, through a brief historical overview, the measures adopted by the EU to tackle the Sovereign Debt Crisis (SDC), focusing on the European Stability Mechanism (ESM) and the European Central Bank (ECB)'s action, and to face the subsequent Covid-19 crisis, with a particular emphasis on the Next Generation EU (NGEU) programme. Chapter 4 explores the European Commission's Green Paper on the feasibility of introducing Stability Bonds to draft an ideal gradual transformation of the role of EU's fiscal policy aimed at ensuring proper financial stability in the foreseeable future, bearing in mind that social acceptability plays a role that exceeds that of the benefits arising from the implementation of such a proposal. Chapter 5 clarifies that

increasing divergencies and skepticism within Europe make it difficult to prospect a precise path in terms of further integration. However, NGEU's success is to be considered as a mandatory step for the creation of the conditions necessary to eventually achieve stability. Chapter 6, finally, concludes.

II. FROM THE INTERNATIONAL PREMISES OF THE FINANCIAL CRISIS TO THE SOVEREIGN DEBT CRISIS AND THE PANDEMIC CRISIS: A PROLOGUE

In his studies on the financial instability hypothesis, economist Hyman Minsky concluded that stability itself is destabilizing and it is precisely in stability times that the seeds of future instability could be planted. Economic stability conditions lead to increasing euphoria and risk appetite, and that is the moment when crises occur. This is exactly the incipit of the financial crisis of 2008.

A long-term deregulation in the United States encouraged financial institutions to widen their role at the beginning of the 21st century, when real estate companies started to form themselves as banks and existing commercial and investment banks entered the mortgage market. Also, global trading eased international capital flows, so financial institutions started taking on debt in low interest rate countries and investing in states with financial assets offering high yields. Meanwhile, mortgage lending became smoother and interest rates decreased, allowing the subprime market to borrow. In 2007, 60% of mortgages in the US were subprime.[1] The conditions described above together with apparently stable economic environment and high propensity to risk contributed to make prices soar. The United States housing bubble was on (Mankiw & Taylor, 2018). During the same period another process was taking root: securitization, which is a method of arranging credit packages secured by mortgage loans, called Asset-Backed Securities (ABS), to be transferred to outside investors. Through a method based on two procedures, called pooling and tranching, and with the aid of external societies, the special purpose vehicles (SPV), banks can build a capital structure on those assets using different layers with different rating. ABS are sold directly to investors or may be securitized in Collateralized Debt Obligations (CDO), with a similar tranche structure. The

[1] Mayer, Christopher J.; Pence, Karen M.; Sherlund, Shane M. (2009). The rise in mortgage defaults. *Journal of Economic Perspectives*, Vol. 23, No. 1, pp. 27-50.

output of the process of securitization is often used as collateral in the so-called repurchase agreements (Gorton & Metrick, 2009). As a result, «securities linked to subprime loans were accumulated in all the banks and on all the financial markets around the world» (Huwart & Verdier, 2013).

Meanwhile, eurozone countries were generating large current account imbalances by borrowing huge amounts from European financial institutions to finance current consumption. However, the economic expansion facilitated by this situation led to a bubble, largely in housing markets. The burst of the bubble annihilated lending: suddenly, heavily indebted countries were not able anymore to service their debts, to make up for the collapse of internal demand by exporting, nor to borrow additional money to cover their payments deficits (Frieden & Walter, 2017). A debt and balance of payments crisis started. But if since the Maastricht Treaty's approval eurozone's architecture proved to be effective in stability times, when this structure has been put under pressure it was found to be inadequate to guarantee the stability required to cope with major shocks.

The outbreak of the Covid-19 pandemic occurred when the world was facing economic stagnation. Started as an economic crisis with population lockdowns, the collapse of consumerism and firms, pressure on financial institutions, social issues, and widespread unemployment, a stock market crash followed, inducing a global recession. Once again, the European Monetary Union was caught unprepared.

III. THE EMU AND THE RESPONSES TO THE FINANCIAL CRISIS (2008) AND THE PANDEMIC CRISES (2020): A FLAWED ARCHITECTURE?

Starting from the above brief narrative of the two great crises of the 21st century, we can derive that the European Monetary Union's architecture was not solid enough to resist the shocks that have afflicted the old continent ten years apart from one another. Indeed, the euro area proved to be structurally flawed only nine years after its formation.[2] Specifically, six systemic defects were identified by economist Charles Wyplosz, who notes that the "apparent pragmatism" used by the EU policymakers was not only insufficient to handle the existing flaws, but also damaging (Wyplosz, 2016).

A. The six systemic defects

Fiscal discipline

The very first eurozone's imperfection concerns the fiscal rules elaborated to maintain public debt at sustainable levels without meddling in member states' fiscal stabilization policies. Fiscal discipline in the eurozone's architecture was supposed to be ensured by two pillars.

In 1997 EU member states committed to ensure the enforcement of fiscal discipline within the EMU by the Stability and Growth Pact (SGP). Germany lobbied for it to be introduced. This major purpose should have been achieved by the observance of the 3% deficit/GDP and the 60% national debt/GDP rules, with a maximum of 0.5% of GDP fine in case of failure to abide by them. However, only four years after its

[2] Economists had unforeseen these flaws and the threats they would have generated to the very existence of the EMU if not properly handled. See: Milton Friedman's article (1997) "The euro: Monetary unity to political disunity?", *Project Syndicate*.

come into effect, a period of fiscal relaxation[3] started due to the infringement of the deficit limit by Germany and France, that did not lead to any fine. So, in 2005 amendments to the Stability and Growth Pact involved the Multilateral Surveillance Regulation and the Excessive Deficit Regulation. A new subsequent wave of rigidity came when the first dreadful crisis burst in the EU. A patchwork of normative acts followed, consisting in the 2011 Six-Pack regulation, the 2012 Treaty on Stability, Coordination and Governance ("Fiscal Compact"), and the 2013 Six-Pack.

The other obligation on which fiscal discipline rests is the no-bailout clause, which is to be found in article 125 TFEU, aiming at containing moral hazard. But, given the fact that there is a collective interest in play, all EU member states are exposed to moral hazard (Atik, 2016), notwithstanding the affirmation that: «The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State […]».

The banking system

Economist J. Stiglitz affirms that R. Mundell, in its analysis of the conditions needed to create common currency areas overlooked banks, including central banks. An interesting point is that the eurozone crisis was partly a banking crisis (Stiglitz, 2016), caused by the "diabolic loop" between sovereign and bank credit risk originated in the periphery of the euro area (Brunnermeier, 2016). In summer 2011, indeed, when the crisis reached Europe and the fear that Europe would break down started, GIIPS[4] national banks started to buy their country's unwanted sovereign bonds. Eurozone was indeed following a decentralized model of banking system, which included some mixed centralized/decentralized traits. This outline

[3] Regulation (EU) No 1056/2005 of the Council of 27 June 2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ 2005 L 174/5.
[4] Greece, Italy, Ireland, Portugal, and Spain.

involved a common banking regulation, national supervision and resolution, and Emergency Lending Assistance (ELA) whereby national central banks' role as lender of last resort (LOLR) was admitted within fixed limits imposed by the Governing Council of the Euro system. This method, aimed at keeping all potential losses at the national level, created a strong link between bank's fate with their home country's fate. Proven the inefficiency of the previous centralized/decentralized framework, the banking system was therefore emended after the crisis, when a Banking Union became a partial move to the centralized solution. «It includes a Single Rule Book, a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and a Bank Recovery and Resolution Directive (BRRD)» (Wyplosz, 2016).

An incomplete central bank

The European Central Bank was well known as one of the most independent central banks in the world, «whose array of functions and jurisdictional domain are determined by a treaty instrument» [5] (Lastra, 2012). As the major EMU institution, which is responsible for the eurozone countries' monetary policy, it did only hold a price stability mandate. The SDC crisis played a crucial role in identifying financial stabilization as a major objective of central banks, and especially of the ECB, along with inflation targets (Zielińska, 2016). However, the limits determined by its mandate and the fragmentary policy making views of the Governing Council led to difficulties in designing the appropriate set of measures to tackle the crisis.

[5] Originally established by the Treaty of Amsterdam, the ECB is now regulated by the Treaty on the Functioning of the European Union (TFEU).

Sovereign debt relief

When describing "the diabolic loop" in subparagraph "*the banking system*", it has been mentioned that GIIPS national banks purchases of sovereign bonds created a strong bond between bank's fate and their home country's fate. The missing part of that description is that when the crisis unfolded the Troika supported a bail-out, rather than bailing-in creditors, because of a perceived systemic risk.

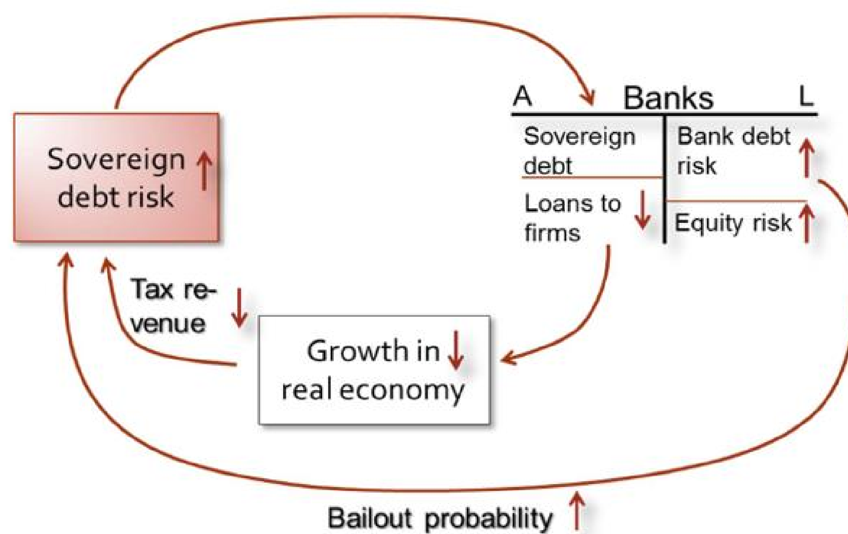


Figure 3.1: Feedback effects between sovereign and financial sector risk ("diabolic loop") (Brunnermeier, 2016)

The consequence of this policy choice was that debt sustainability in these countries has been pursued by requiring front-loaded austerity measures (increasing taxes and cutting government expenditures), which provoked recession and constantly growing debt to GDP ratios. In early 2012, it was evident that a Greek debt relief was needed. The euro area agreed a private sector involvement (PSI) deal with creditors. This bond exchange agreement consisted of an increase in the final nominal haircut to 53.5%. But at the same time Troika was launching its second

bailout, annihilating the attempt of debt relief. In December 2012 a new reduction in net present value of Greek debt occurred.[6]

Surveillance intrusiveness

As mentioned in subsection about fiscal discipline, during the SDC monitoring within the EMU has been reinforced, to the point of becoming a form of intrusion into member states' sovereignty, due to the concern of market discipline weakening even further. One of these is the Macroeconomic Imbalance Procedure (MIP), introduced in 2011 as part of the "Six-Pack". It is also essential to mention the obligations of structural reforms imposed by the Troika within the financial assistance programs. However, the complication of existing procedures designed to act as a deterrent through the threat of sanctions does only «lead to economically ineffective and politically dangerous intrusions into national sovereignty» (Wyplosz, 2016). It creates indeed a feeling of contempt for European integration along with increasing resistance to the pursuing of the fiscal discipline objective. Besides, it could not be otherwise, since «it had never been clear what was gained by imposing a financial penalty on a country that was already running a budget deficit» (Atik, 2016).

Governance

The sovereign debt crisis revealed a weak management, that had to face a trade-off between centralization and decentralization, as European institutions did not have any means to deal with unforeseen financial and economic crises. Since governments in the EMU had to manage the crisis on their own, decentralization led to Germany's takeover. It was indeed the most powerful country, which

[6] European Stability Mechanism, Cheng, G. (2020) *The 2012 private sector involvement in Greece*. Publications Office. https://data.europa.eu/doi/10.2852/782725.

implemented its on views without considering Southern European countries' conditions. These latter ended up being the main victims of the crisis.

B. EU's first approach in tackling the Sovereign Debt Crisis

When Portueguese, Spanish, Irish and Greek banks turned out to be excessively indebted due to a credit boom, encouraged by bank's capability to borrow in euro on international markets, and were on the verge of bankruptcy, governments decided to rely on public debt to finance the bank bailouts. The recession that followed started to affect tax income and public expenditure, increasing the size of budget deficits and of the deficit/GDP ratio. This escalation of events led to a deterioration of sovereign creditworthiness, which fed back causing a worsening of banks' financial standing (diabolic loop).

After the approval of a 200bn euro stimulus plan to help boost European growth following the global financial crisis in 2008, EU leaders had to face an increasing danger initially due to Greece's debt, closely followed by Ireland, Spain, Italy and Portugal. One of the eurozone's largest imperfections that came to light was indeed a lack of potential crisis management tools (Zielińska, 2016). In particular, the European Central Bank was initially a complete outsider to the problem of public deficits, as its mandate was confined to monetary competence, namely containing inflation, which was totally separated from a fiscal policy. The EMU had indeed adopted a fiscal moderation approach, safeguarded by the Stability and Growth Pact. Therefore, in the absence of previous agreements or instruments capable of handling the situation, Troika's (European Commission, ECB, IMF) first move was a 22bn euro safety net in March 2010, followed by 30bn euro emergency loans a month later and, in May 2010, a 110bn euro bailout package to rescue Greece. Bailout packages were approved for Ireland and Portugal as well in 2010 and 2011 respectively. These programs' framework followed IMF standards, while their focus was on architectural reforms and fiscal gaps, for the reason that ECB's monetary policy could not address needs and concerns of individual countries, as

its strategy focused on eurozone-wide aggregates. Once it was clear that this first approach was insufficient to reach the desired turnaround and stop the loop, new institutions have been created. These have been the first steps towards the creation of a permanent tool to tackle financial crises, which has been set up in replacement of two temporary EU funding programs: the European Financial Stability Facility and the European Financial Stabilisation Mechanism.

C. The European Stability Mechanism (ESM)

In December 2010 the European Council agreed that a permanent stability mechanism among eurozone countries was needed. Therefore, on March 2011 Article 136 of the TFEU was amended to add the following paragraph: «*The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality*». [7] Moreover, on 21 July 2011 a statement of the Heads of State or Government of the euro area and EU institutions decided to increase EFSF and ESM's flexibility linked to appropriate conditionality to improve the effectiveness of the measures and address contagion.[8] Also, in December 2011 they created an additional international agreement, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union ("TSCG"), with the aim of strengthening economic policy coordination, and made its ratification compulsory for the granting of financial assistance in the framework of ESM measures.[9] On 27 September 2012 the Treaty establishing the European Stability Mechanism entered into force with the purpose of mobilizing funding and providing stability under strict conditionality in close cooperation to the IMF to the

[7] European Council decision amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro, 25 March 2011, L91/1.
[8] Council of the European Union statement by the Heads of the State or Government of the euro area and EU institutions, 21 July 2011.
[9] https://www.consilium.europa.eu/media/20399/st00tscg26_en12.pdf

benefit of ESM Members under severe financing problems, with a maximum lending capacity of 500bn euro.[10] «At the center of the macroeconomic programs was austerity – a contraction in government spending and an increase in revenues.» (Stiglitz, 2016).

D. European Central Bank's measures

The market's decreasing liquidity and the perturbations generated by the Greek crisis on Europe's financial markets led to a growth in the interest rate spread between virtuous and GIIPS countries. On May 2010, the ECB announced an asset purchase program called "Securities Markets Programme" (SMP) as part of its interventions to tackle the crisis. The program's goal was "to ensure [market] depth and liquidity and restore an appropriate monetary policy transmission" (Eric Ghysels, 2017) by two waves of euro area government bonds purchases in Greece, Ireland, and Portugal's secondary market, and then in Italy and Spain's. After Draghi had become President, the ECB acted as a lender of last resort (LOLR) by conducting Main Refinancing Operations (MRO), and Long-Term Refinancing Operations (LTRO), which allowed it «to support the liquidity situation of euro area banks» (Draghi, 2011). [11] Moreover, it was with him that the institution decided on various reductions in the policy interest rate. «During the period from November 2009 through December 2011, indeed, market uncertainties worsened as policy reactions proved inadequate, often ill timed, and ineffective.» (Godby, 2016, p. 123)

Eventually, on July 2012 ECB's President Draghi introduced the Outright Monetary Transactions (OMT) program in replacement of the SMP with the "whatever it takes" speech. Through the promise of unlimited purchases of sovereign bonds on secondary markets (for countries under a conditionality program managed by the European Stability Mechanism), the ECB contributed to shifting expectations of

[10] https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en_1.pdf
[11] European Central Bank press conference held by Mario Draghi and Vítor Constâncio, 8 December 2011.

market participants and effectively eliminated redenomination risk from sovereign bonds. The setting up of a comfortable financial position for banks broke the diabolic loop. Even though the OMT had not been used, the ECB was unofficially overstepping its Treaty, which stated that the primary mandate of the institution was namely to maintain price stability and strictly prohibited monetary financing. However, acting as a lender of last resort was the only intervention for the ECB to quiet markets down. «It just took a long time for the ECB to act» (Wyplosz, 2016).

E. Quantitative easing

Immediately after the sovereign debt crisis, an additional delay in adjusting monetary policy had resulted in a risk of deflation between 2014 and 2016. Two manoeuvres followed: a further reduction of the policy rate (which reached the zero lower bound in the summer of 2014), and unconventional quantitative easing operations promoted by the Governing Council of the ECB in 2015. In March 2015 the large-scale asset purchase programme (APP) began and lasted until December 2018, with a total amount of €2590bn (figure 3.2 describes the QE pattern in terms of asset purchase amounts). On 12 September 2019, the Governing Council of the EU financial institution announced the decision of restarting asset purchases at a monthly pace of €20bn, in order to «reinforce the accommodative impact of its policy rates».[12] It is important to mention that both the APP and the negative interest rate policy are part of a compound strategy which includes forward guidance and T-LTRO as well (Benigno, Canofari, Di Bartolomeo, & Messori, 2022).

[12] European Central Bank press conference held by Mario Draghi and Luis de Guindos, 12 September 2019.

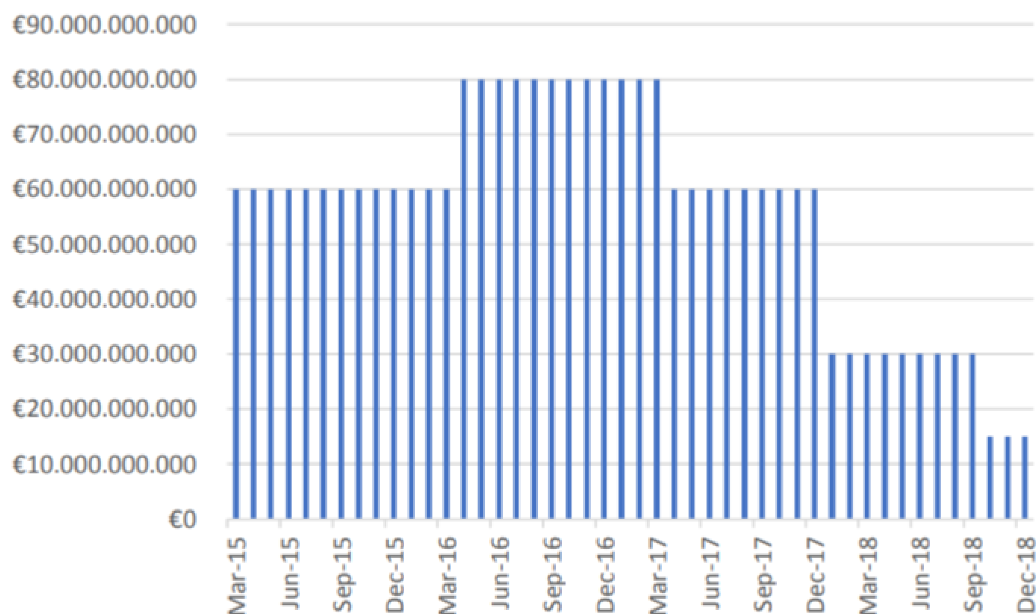
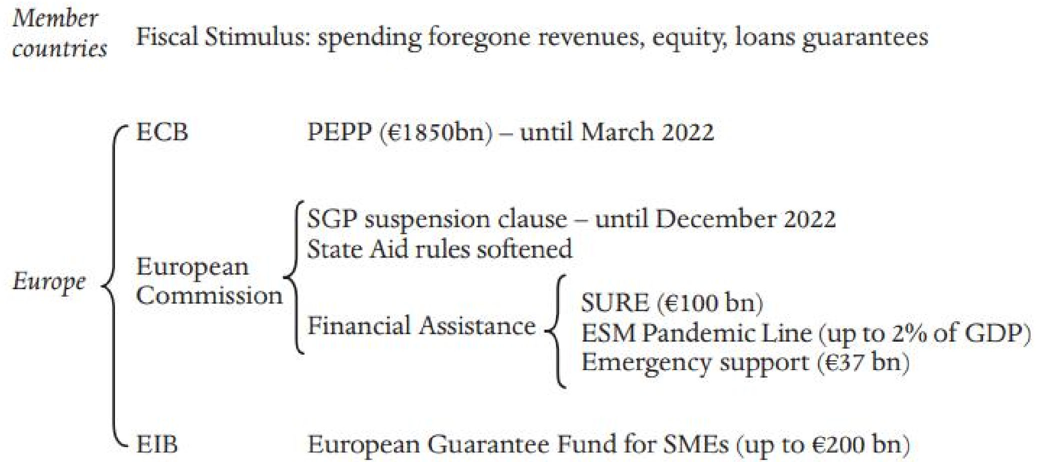


Figure 3.2: ECB decisions regarding QE (Bakiakoa Pedrosa, 2019)

F. The Covid-19 crisis

The outbreak of Covid-19 constituted a major challenge for the EU, and especially the EMU. As reported before, the main issues in sovereign debt crisis' management were the inadequate and incomplete eurozone architecture, and the «apparent untimeliness of decisions» (Villafranca, 2014). But from the SDC to the Covid-related economic crisis not much had been done in terms of spillover and systematic flaws adjustment. Therefore, the inadequacy of previous reforms generated «a neo-functionalist drive to reinforce existing financial support mechanisms and establish new ones». (Howarth, 2021) On the other hand, European policymakers had acknowledged the negative effects of slow decision making.

Tab. 3.1: Emergency response to the Covid-19 shock (Saraceno, 2021)



As shown in table 3.1, the first actors to adopt measures to counteract the pandemic have been the executive powers of the EU member states, «which was inevitable» as they have «exclusive competency on both public health and fiscal policy». (Saraceno, 2021). These measures, similar in terms of instruments used for all eurozone countries, were aimed at protecting businesses (e.g., liquidity injections, tax deferrals, and state guarantees[13]), and workers (among the main policy tools, job retention schemes[14]) in the affected industries. As a result, debt and deficits exploded everywhere in the EMU, but incomes and employment have fallen considerably less than GDP (Saraceno, 2021).

Among European institutions, instead, the first one that strove to handle the Covid-crisis was the European Central Bank, whose reaction to the Covid-19 crisis was likewise rapid and effective. This change in behaviour can be explained as a consequence of the ECB being the central bank of a monetary union between fiscally sovereign countries, which is a peculiarity that makes the ECB learn «more slowly than other central banks the effects that shocks have on the parameters of

[13] Haroutunian, S.; Osterloh, S.; Sławińska, K., The initial fiscal policy responses of euro area countries to the COVID-19 crisis, *ECB Economic Bulletin*, Issue 1/2021, 10 February 2021.
[14] For more information about job retention schemes during the Covid-19 crisis see: https://oecd.org/coronavirus/policy-responses/job-retention-schemes-during-the-covid-19-lockdown-and-beyond-0853ba1d/

the transmission of monetary impulses» (Morelli, 2021). On 18 March 2020, the ECB announced the launch of a new temporary €750bn asset purchase programme of private and public sector securities, called Pandemic Emergency Purchase Programme (PEPP), which was aimed at protecting the member countries' efforts. Moreover, the Governing Council increased the range of eligible assets under corporate sector purchase programme (CSPP) to non-financial commercial paper and eased collateral standards. Also, the decision-making body agreed on the flexibility of the programme launched, which was conceived as subject to change in extent, timing, and composition if that was necessary to make the action proportionate to the risks of the monetary policy's transmission.[15] On 4 June 2020, the ECB decided indeed to increase the initial envelope for the PEPP by €600 billion[16], and by €500 billion on 10 December, for a new total of €1850 billion.[17] This non-standard monetary policy measure helped to reduce interest rates, making debt more sustainable, and «greatly contributed to stabilize the financial markets» (Fabbrini, 2022). Also, the ECB's intervention avoided the risk of future bailouts (Armingeon, de la Porte, Heins, & Sacchi, 2022).

Another EU financial institution that acted was the European Investment Bank (EIB), which proposed a Covid-19 investment scheme of €40bn to alleviate small- and medium-sized enterprises (SMEs)' liquidity and working capital constraints.[18]

On 19 March 2020, the European Commission adopted a temporary framework for state aid measures to support the economy, consisting in the allowance for EU member states to implement aid measures in the form, among others, of direct grants, repayable advances, tax advances, guarantees on loans, subsidized interest rates for loans. [19] Meanwhile, the President of the Commission announced the institution's intention to activate the general escape clause of the Stability and Growth Pact (SGP), introduced as part of the "Six-Pack" reform in 2011 to facilitate

[15] European Central Bank press release "ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)", 18 March 2020
[16] European Central Bank press release "Monetary policy decisions", 4 June 2020
[17] https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html
[18] European Investment Bank press release "EIB Group Will Rapidly Mobilize up to $40 billion to Fight Crisis Caused by Covid-19", 16 March 2020
[19] European Commission Communication on "Temporary Framework for State aid measures to support the economy in the current Covid-19 outbreak", 20 March 2020, 2020/C 91 I/01.

the «coordination of budgetary policies in times of severe economic downturn»[20]. It consists of the suspension of the key deficit and debt rule, hence the possibility for member states to put in more financial resources in the economy to tackle the suffered supply and demand shocks. As for financial assistance provided by the EU executive, the 2012 ESM was adapted by setting up a €240 billion pandemic line[21], and a €100 billion European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) was created (based on article 122 TFEU). This latter was aimed at providing financial assistance in the form of loans to member states that adopted national measures related to short-time work schemes and similar measures to address the unemployment caused by the pandemic. In 2020 it started lending, while the ESM was declared an inadequate instrument for the Covid crisis by Germany, that concomitantly gave up its distinctive opposition to common debt. [22] Also, the Commission set up the Coronavirus Response Investment Initiative amounting to €37 billion of available cash reserves. [23]

G. Beyond the emergency: the Recovery and Resilience Facility

Germany's change of direction became concrete on May 2020, when French President Emmanuel Macron and German Chancellor Angela Merkel proposed a €500bn European Recovery Fund, consisting of a targeted facility connected to the EU budget, to be funded by borrowing on the markets, and to be provided as grants.[24] «The Franco-German initiative opened the way to the European Commission, and ultimately shaped the response to Covid-19, which was embraced by the European Council» (Fabbrini, 2022). A deal was indeed found that summer,

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[20] European Commission Communication on "the activation of the general escape clause of the Stability and Growth Pact", 20 March 2020, COM(2020) 123 final.
[21] European Parliament Briefing on "The ESM Pandemic Crisis Support", 28 August 2020.
[22] German Finance Minister Olaf Scholz, 'Interview 'Jemand muss vorangehen'', Die Zeit, 19 May 2020 www.zeit.de/zustimmung?url=https%3A%2F%2Fwww.zeit.de%2F2020%2F22%2Folaf-scholz-europaeische-unionreform-vereinigte-staaten.
[23] European Commission press release "Coronavirus Response Investment Initiative adopted", 30 March 2020.
[24] https://www.bbc.com/news/world-europe-52712370

when the 2021-2027 Multi-Annual Financial Framework (MFF) for €1100bn was approved, and the Next Generation EU programme worth €750bn was established. This innovative instrument gave the Commission competence in issuing debt on behalf of the EU, with the aim of exiting from the Covid-related crisis while pursuing the Union's long-term objectives[25] through a vast investment programme.[26] On October 2020 member states' representatives agreed with the Council on the amount of €672.5bn of subsidy mobilized through the centrepiece of the NGEU, the Resilience and Recovery Facility (RFF). This latter required each EU member state to prepare a national recovery and resilience plan (NRRP) in order to be eligible to receive support.[27] The fact that the allocation of resources has been done on the basis of member states' needs means that risk has been shared among countries, creating «an albeit temporary debt mutualization» (Saraceno, 2021). This seems to be the principle of a permanent EMU common fiscal capacity, even though it is still uncertain if member states will embrace the spillover.

[25] The general objectives set by NGEU are: 1. Promoting the Union's economic, social and territorial cohesion; 2. Strengthening economic and social resilience; 3. Mitigating the social and economic impact of the crisis; 4. Supporting green and digital transitions. See Commission staff working document "Guidance to member states recovery and resilience plans", 17 September 2020, SWD(2020) 205 final, PART ½.

[26] European Commission Communication on 'Europe's Moment: Repair and Prepare for the Next Generation', 27 May 2020, COM(2020)456 final.

[27] Council of the European Union press release "COVID-19: Council agrees its position on the Recovery and Resilience Facility", 9 October 2020.

IV. A MUTUALIZED EUROBOND SYSTEM

In 2013, as eurozone financial markets were experiencing an increasing integration started at the beginning of the 21st century, Economist Maurice Obstfeld identified «a new policy trilemma for currency unions like the eurozone: once financial deepening reaches a certain level within the union, one cannot simultaneously maintain all three of (1) cross-border financial integration, (2) financial stability, and (3) national fiscal independence» (Obstfeld, 2013). The previous historical framework points out a precarious financial stability within the EMU, which exacerbates whenever a financial (or economic) crisis breaks out. Also, we highlighted the eurozone structural incompleteness matched by the unwillingness to adopt organic and permanent reforms.

In the previous chapter, the current EMU fiscal framework was illustrated citing the coordinated rules imposed through the Stability and Growth Pact (subsequently amended by the Treaty on Stability, Coordination and Governance and the Six-Pack), the no-bailout clause, and a relatively small EU budget (even though the 2021-2027 MFF has been increased), while the EU's fiscal capacity allows for some stabilization in a fragmented way, as it relies on different mechanisms outside a centralized EU budget (SURE, NGEU, ESM and the Banking Union). Instead, what the eurozone needs to fulfil the financial trilemma is a fiscal union, in which a centralized budget could leverage automatic stabilizers while ensuring redistributive and/or allocative functions (Mileusnic, 2022). Obviously, this looks like the culmination of an effective system in which lot has still to be done. For the EMU membership to be truly an added benefit for states, at least two minimum conditions have to be granted at this stage: «the first is that all euro area countries need to be able to thrive independently, the second is that euro area countries need to invest more in other mechanisms to share the cost of shocks», asserted former ECB president Mario Draghi in 2014. [28]

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[28] President of the ECB Mario Draghi speech "Stability and Prosperity in Monetary Union" at the University of Helsinki, Helsinki, 27 November 2014.

The unprecedented magnitude of the Covid-related crisis abruptly created new awareness, in particular it brought to light the need of increased solidarity amongst member states. As mentioned above, policies that move in this direction are the temporary Support to mitigate Unemployment Risks in an Emergency (SURE) and Next Generation EU, both constituting the principle, albeit temporary, of a common fiscal capacity. It seems therefore easier for the EU to accept more gradual measures of permanent stabilization of the financial situation in the area.

In 2011, the European Union itself had, through the European Commission, drafted a document on the feasibility of introducing the so-called "Stability Bonds" [29], evaluating the pros and cons of three options characterized by an increasing intensity of debt mutualization. As emphasized by the European Parliament in its 2012 report on the feasibility of introducing Stability Bonds, the three options can be cumulative, creating a path towards financial stability in the EU. [30] It is important to mention that these instruments were meant for the ordinary financing of the eurozone general governments through common issuance, and to be developed while moving forward in the process of political, financial, and economic integration. A brief overview of an hypothetical gradual transformation of the role of EU's fiscal policy may be useful to realize at what point we are eleven years on and what we should expect for the foreseeable future.

A. Limited substitution of national issuance by Stability Bond issuance with several guarantees

In European Commission's view this option would have been the least demanding in terms of implementation time and legal obstacles, as it was designed as a

[29] European Commission "GREEN PAPER on the feasibility of introducing Stability Bonds", 23 November 2011. The denomination "Stability Bonds" has been chosen because of the instrument's major role in granting financial stability within the euro area. However, public debate and literature refer to them as "Eurobonds". In this work both terms will be used in an interchangeable way.
[30] European Parliament "REPORT on the feasibility of introducing Stability Bonds", A7-0402/2012, 6 December 2012.

governance method with the ability of ensuring member states' fiscal discipline without any deterrent sanctions nor any other kind of intrusiveness. In this approach each country would indeed be responsible for both their national issuance and their share of Stability Bond issuance, that would be largely the same. In order to make this system work, an important role should be played by guarantees. Stability Bonds should be senior to national bonds (while finding solutions for the possible negative pledge clauses of existing bonds), and member states could provide collateral (in the form of tax receipts, cash, gold reserves). As a result, with no significant treaty amendment, this light version on Eurobonds could ensure a reduced level of moral hazard and an improvement in governance (it would be indeed possible to design fiscal targets coherent with the amounts meant to be funded through Stability Bonds, which could also create incentives to reduce debt levels), but it would be less useful in boosting market stability and efficiency. Both the ESM and the NGEU seem to shape this approach to some extent. The SDC resolution tool, however, proved to be far from effective to provide financial stability. This mechanism compounded the crisis, deepened states' debt situation, and had a negative role in preventing future shocks. On the other hand, the Covid-related Recovery and Resilience Facility reached a further level by creating the beginning of a central fiscal capacity while not giving up the EMU's feeling of adversity in building up a debt mutualization system.

The case of the ESM

The European Stability Mechanism was designed as a permanent bailout fund (vehicle for a bailout), capable of supporting member states under financial stress, which were unable to access market anymore. Its functioning was based on assistance programmes financed with money raised from investors by issuing bonds. Moreover, the ESM was given the power to intervene in the secondary market for bonds issued by the eurozone member states in financial difficulties. So, despite the necessity of a threat for the entire eurozone stability for the ESM to act, there is a similarity between the logic of the stability mechanism and Eurobonds

funding in the lighter version described above. Why was then this instrument unable to grant the benefits illustrated as consequence of a limited substitution of national debt by ESM issuance?

First of all, the main problem of the organisation established to help countries tackle the SDC crisis is conditionality itself, especially the austerity feature. The ESM was not indeed meant as a growth promoting instrument, in line with assistance programmes granted by the IMF to emerging countries. Instead, it promoted measures that led to economic slowdowns, revenues decrease and increasing social expenditures on welfare and unemployment interventions. Joseph Stiglitz affirmed that this set of political-economic policies inevitably leads to a situation in which «any improvement in the country's fiscal position is much less than expected, and the suffering is much greater than expected» (Stiglitz, 2016). In the short run, added the economist, austerity leads to higher unemployment, while in the long run it leads to lower growth (Stiglitz, 2016). The harmfulness of the ESM requirements seemed to be acknowledged, when the Pandemic Crisis Support facility was designed as a provider of resources under no conditionality but a social assistance characterization (Megliani, 2022): states were only asked to use those money to cover Covid-19 healthcare related costs. However, it was too late as the ESM was already carrying political stigmatization effects on borrowers determined by the past adjustment programmes linked to ESM assistance. As a consequence of this phenomenon, euro-skeptic and anti-austerity political parties arose and stopped their countries from accessing the ESM even in absence of harmful credit conditions (De Angelis, 2022). Secondly, the ESM system does not constitute a method of debt mutualization, and it lacks strong guarantees. The ESM, indeed, «more than mutualizes sovereign default risk; it effects a present transfer from certain states to others. » (Atik, 2016). On the other hand, it is true that bonds issued by the ESM are guaranteed up to fixed amounts by member states, but no joint guarantee is provided. This leads to the conclusion that, instead of being a mechanism capable of fostering stability, the ESM does only act as a limited lender of last resort, with no expertise to play preventive and counter-cyclical roles to guarantee long-term stability. And by preserving risk segregation, implementing

the functions of risk reduction and stabilization within the euro area seems impossible (Minenna & Aversa, A Revised European Stability Mechanism to Realize Risk Sharing on Public Debts at Market Conditions and Realign Economic Cycles in the Euro Area, 2018). Moreover, the modest amount of liquidity managed by the mechanism is too limited to serve as a "benchmark security" (Spurga, 2021), bearing in mind that the mechanism could always find itself in a liquidity squeeze, since less than 12% of the subscribed capital have been paid in so far, with the remaining 88% in the form of callable shares subject to Germany's veto.

To sum up, the European Stability Mechanism is a tool that carries around some fundamental flaws which are incoherent with the purposes for which it was created. It originates from a time of panic provoked by a deep financial crisis, when eurozone countries and EU institutions had an incomplete comprehension of the characteristics required for a common currency area to prevent or at least survive in periods of severe shocks, and the belief that the patsy of the situation was the profligacy of peripheral countries. Moreover, none of the euro area member states was ready to develop a sense of solidarity, even though it was becoming clear that EMU states' financial issues had a collective trait. This framework explains the architecture of the mechanism, whose largest capital subscriber was unsurprisingly Germany. Therefore, despite its name, the ESM could not in any case play the role of a tool able to guarantee long-term financial stability, but only of a lender of last resort, compensating for EU's incomplete central bank.

The case of Next Generation EU

Eight years later, another severe shock has struck the whole world, and, once again, the EMU had no action plan. As outlined in the previous chapter, in the aftermath of the SDC, incomplete reforms have been promoted to cope with the systemic features referred to as architectural flaws by economist Charles Wyplosz, and nothing has been done to implement the stability purpose. Therefore, along with the economic crisis, negotiations began.

The recovery plan for Europe approved in July 2020 came after the request, submitted to the EU in March 2020 by a group of nine euro area member states – Belgium, France, Greece, Ireland, Italy, Luxembourg, Portugal, Slovenia, and Spain -, examine the possibility to adopt a debt mutualization instrument «to raise funds on the market on the same basis and to the benefit of all Member States». [31] Eurobonds have once again been refused: it was still asking too much to core countries, that came out a few months later with a softer instrument, even though it already seemed to contain a novelty. The new assistance instrument, indeed, not only gave up on the austerity approach promoted for so long by the most creditworthiness countries of the EU, but adopted a growth-enhancing perspective, based on the allowance of using money borrowed to finance budgetary expenditures. As mentioned in paragraph "The Covid-19 crisis" of Chapter 3, the condition imposed to countries in order to receive funding is to draw up national recovery plans coherent with the EU long-term objectives based on the European Green Deal. Examples of this conditionality are the required commitment of 20% for digitalization programmes, of 37% of funds for green growth in NRRPs, and of the remaining part for supporting economic recovery, while little attention has been put on the economic and social damages provoked by the Covid-19 pandemic. The plan cites 360bn euro to be provided as loans and 390bn euro to be offered as grants (which will be repaid by the EU budget [32]) through the Recovery and Resilience Facility: a limited moderate amount of money, partially representing fiscal transfers among EMU states, to support investment and reform within the sovereign states, with the borrowing countries as the only actors responsible for the borrowed funds repayment. It seems clear that core countries had acknowledged both the necessities of promoting growth and cooperating to sustain each other within the euro area. But there was still no intention to risk paying directly for irresponsible countries' reckless behaviour. Actually, even after the NGEU approval, a divergence between euro area countries persists: in many occasions Northern countries' leaders highlighted the temporary character of the tool, which is not intended to lead to any

[31] Joint letter of Belgium, France, Greece, Ireland, Italy, Luxembourg, Portugal, Slovenia and Spain to the European Council President Charles Michel, 25 March 2020.
[32] https://ec.europa.eu/info/strategy/eu-budget/eu-borrower-investor-relations/nextgenerationeu_en

further integration, while Southern European politicians «occasionally framed the NGEU plan as heralding deeper forms of fiscal integration» (Miró, 2022). It is therefore evident that also in this case no joint debt liability has occurred, as member states are only responsible via their contributions transferred by each state to the EU budget. However, whilst the logic of issuing new EU debt on the financial market remains consistent with the ESM functioning, NGEU debt is intended to be repaid «through an increase of the headroom in the own resource ceilings, and prospectively the introduction of new EU taxes» (Fabbrini, 2022), such as a carbon border adjustment tax, a digital tax, a plastic tax, and potentially a financial transaction tax. [33] This is in contrast with the earlier period, as for the first time the EU has been endowed with supranational fiscal powers, a feature consistent with federal systems. This gamechanger notwithstanding, as noticed before it is still unclear if this step will lead the EMU to deeper integration or it will disappear as the pandemic recedes. This unusual solidarity within the EU is indeed to be explained as consequence of the crisis nature. As opposed to the SDC, the pandemic related economic crisis was characterized by an indiscriminate spread, by reasons beyond countries' control and by a highly sensitised public opinion. Supposedly, when returning to normality, solidarity may wear off. But literature on fiscal federalism shows that with the acquirement of new fiscal powers and the ability to manage resources, institutions tend to make them a permanent feature of the system.[34]

B. Limited substitution of national issuance by Stability Bond issuance with joint and several guarantees

As was pointed out previously, the NGEU tool does not create a genuine safe asset nor provides enough liquidity. Its main objective, after all, is to foster reforms and investments to set the stage for a resilient recovery. What for the financial stability

[33] European Council Conclusions, 17-18-19-20-21 July 2020, EUCO 10/20.

[34] See: R Henning, M Kessler (2012) 'Fiscal Federalism: US History for Architects of Europe's Fiscal Union', Bruegel paper 2012.

purpose, ECB's unconventional intervention has been crucial. But now the institution is resisting fiscal dominance, since rising inflation placed it in front of a choice: either price stability or financial stability. «The only instrument that would fix this problem is a mutualised Eurobond» (Münchau, 2022). Here is where the two further Stability Bonds approaches of the European Commission come in.

Also known as the "Blue and Red bonds approach", elaborated by Delpla & Weizsäcker in 2010 [35], it constitutes a kind of intermediate mutualization, in which the European Commission envisages a partial substitution of national issuance by Eurobonds (Blue Bonds), which would be underpinned by joint and several guarantees. This approach is not intended to cover the full refinancing needs of all euro area members by consolidated existing debt, therefore the remaining part would keep on being subject to national guarantees (Red Bonds). This would create a seniority, making national bonds junior to Stability Bonds and accountable for different market yields, due to each country's liquidity and credit choices. The concentration of credit risk in the Red Bonds, which should be explicitly excluded from bailout procedures or any other rescue mechanism, would provide fiscal discipline without being intrusive. Another salient point of this proposal is the determination of the proportions of the two kinds of bonds: Delpla & Weizsäcker asserted that the optimal quota of Stability Bonds is up to 60% of GDP of member states' debt (reflecting the 60% debt to GDP rule of the SGP). The Red Bonds quota would be characterized by different degrees of risk concentration, as the higher the share of Stability Bonds issuance, the more risk is concentrated on the residual junior issuance. For this reason, further analysis would be needed to identify the optimal parameter in order to avoid excessive credit risk in national issuance, given the fact that a credible and fixed ceiling for the Stability Bonds issuance is essential to avoid political pressures and to reduce moral hazard. However, since the higher risk of Red Bonds, providing fiscal discipline, would increase a demand for Blue Bonds producing a liquidity effect, explained the authors, this scheme would reduce overall debt. Moreover, the partial debt mutualization would mitigate collateral

[35] See: Delpla, Jacques and von Weizsacker, Jakob. (2010) The Blue Bond Proposal. *Bruegel Policy Brief 2010/03.*

discrimination that affects monetary policy transmission mechanisms, while ensuring higher long-term stability.

C. Total substitution of Stability Bond issuance for national issuance with joint and several guarantees

Lastly, we mention the most ambitious option drafted by the European Commission, considering a complete substitution of national bonds by the issuance of Eurobonds, which could rely on a decentralized basis or, more efficiently, on a centralized debt management office (DMO). As a high mutualization scheme, there would be no autonomous debt policy, and high economic and financial integration is assumed, along with an efficient supervisory system managed by the EU, in order to prevent states from excessive financial indebtedness. However, it is still a framework that excludes a central fiscal capacity since member states would keep their taxation capacity and a separate budget. The institution envisages merging the existing debt of individual countries indistinguishably with that of all other EMU member states and envisages sharing responsibility of the entire consolidated debt as well. Clearly, this hypothesis would eliminate the chance of another sovereign debt crisis and the collateral discrimination risk, while guaranteeing solid long-term financial stability. Moreover, the lack of liquidity of existing resolution mechanisms would also be overcome, and European bonds could act as an attractive "safe haven" for the international liquidity (Minenna, Boi, & Verzella, Mutualisation of the Public Debt and Fiscal Transfers, 2016). This approach would therefore deliver all the benefits of a mutualized eurozone, along with major risks. Firstly, moral hazard would result in the need for a strict budgetary discipline framework and an intrusive surveillance system, that we know creates resistance in unions among sovereign states, even more so in the EMU, characterized by a lack of solidarity and by the Northern countries' mistrust towards highly indebted members. Furthermore, changes to the Treaty would be necessary, lengthening the implementation time and creating political agreement issues. For these reasons,

financial and economic integration only may be insufficient for this last approach to be deployed, and cultural and political barriers should be overcome first.

D. Solidarity prospect in the EU

From this overview, it emerged that when analyzing the different proposals of integration and mutual mechanisms of fiscal management, we have to consider not only the benefits that each measure would bring and the possible gaps, but also the feasibility in terms of social acceptability. As for the current European instrument previously analyzed, we can say that, apart from national considerations of those parties based on national interests, the determinant in NGEU's prospects is the tool's ability to reach policy goals. Perhaps, if run successfully, it will eventually lead to a permanent fiscal capacity. However, an analysis of the discursive dynamics among European elites highlighted the predominance of an egoistic conception of solidarity, based on expected economic benefits, rather than on the advantages originated by common solutions and trusting relationships. Politics in the EU seem to be framed in a new intergovernmentalist approach based on the notion of disequilibrium, a phase that makes us questions about «the legitimacy and durability of European fiscal integration» (Miró, 2022). So, not only we are unsure about the future of the actual weak mutualization system, but we call in question the aptness of a mutualization approach in Europe. Not in vain, in 1971, Economist Nicholas Kaldor predicted that it would have been a dangerous error to create a monetary and economic union before a political union, since community control over national budgets would have generated so much pressure that the whole system would have risked collapse. [36] Will the original sin be solvable?

[36] Nicholas Kalder (1971), The Dynamic Effects Of The Common Market, *New Statesman.*

V. A STEP BACKWARD TO ACHIEVE STABILITY: CULTURAL AND ECONOMIC CONVERGENCE

Our analysis so far showed the EMU got off on the wrong foot. When the euro project was designed, conflicts among euro area members prevented the set-up of any risk-sharing tools: Northern European countries did not want to bear responsibility of Southern countries' reckless behaviour.[37] Anyways, the European integration project was launched despite economists had wondered about the riskiness of pursuing a monetary and economic integration without political, cultural, and fiscal convergence (Kaldor, 1971), and about structural gaps of EU's institutional framework (Friedman, 1997) way before the outbreak of the two great crises that struck Europe and the entire world. In the first instance, the SDC revealed the inefficiency of the European banking regulation and fiscal rules' lack of credibility. Moreover, as a system designed to function in stability times, no preventive mechanism to solve crises had been developed. Consequently, along with the crisis, negotiations began, and the most powerful countries assumed the leading role, promoting front-loaded austerity measures. As a result, «the policies of the Troika have compounded the crisis, weakened the hard-fought bonds of European unity, and magnified the in-built frailties and flows of the eurozone's structure» (Stiglitz, 2016). From that moment onward, the ECB widened its initial price stability warrantor role, partial reforms have been promoted (i.e., the Banking Union, the Fiscal Compact normative act), the institutional framework has been expanded (i.e., the ESM), and many spillover projects have been developed (i.e., Eurobonds). However, everything was taking place without considering the prevailing public opinion. EU citizens had indeed «become less trusting of EU institutions and less tolerant of supranational interferences with domestic policies» (Alesina, Tabellini, & Trebbi, 2017). In the previous chapter, we underlined the advantages of a debt mutualization scheme to solve the damages of more than twenty years of operation of an incomplete structure, to provide long-term stability,

[37] See: Dyson, Kenneth; Featherstone, Kevin (1999), *The road to Maastricht: negotiating economic and monetary union*, OUP Oxford.

to remove the asymmetry of monetary and fiscal union and to offer a safe asset. But EMU's feeling of adversity in building up a debt mutualization system led to the rejection of any proposal implying a certain degree of debt liability merger. For that reason, other research investigated the possibility of ensuring stability without sovereign debt mutualization, while protecting the eurozone from moral hazard and increasing debt levels and preserving national sovereignty. [38] None of these, however, considered that the difficulties of progressing towards fiscal integration were due to a "democratic constraint" (Beramendi & Stegmueller, 2020). Indeed, «Europe's perpetual stasis has clear and traceable democratic origins», and any valid strategy should be addressed to solving initial error of creating a monetary and economic union before a political union. The outbreak of the pandemic crisis provoked a further crucial step that changed the previous prospects within Europe. The institutional architecture was turned upside down, the Stability and Growth Pact's logic was silenced through the activation of the general escape clause, the assumption of fiscal policy as national issue was turned into a temporary principle of common fiscal capacity with the NGEU tool, the normally modest EU budget was expanded. A change in frugal countries' position was not expected, until the acceptance of taking a supportive approach by virtue of the peculiarities of the latest crisis. This combination of factors led to the approval of an instrument that gave up the approach taken to tackle the sovereign debt crisis. And namely with NGEU, EU's bureaucracy may have identified a path coherent with the necessity of solving the "original sin", and with the assumption that sovereign debt does only have to be sustainable, not solvable. Therefore, promoting growth through interest rates lower than growth rates may be the solution to encourage an agreed spillover, guarantee stability and solve the Covid-related damages (Saraceno, 2021).

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[38] See: Bauer, Christian; Adolph, Marc-Patrick (2020), Structured Common Project Financing (SCPF): Efficiency without debt mutualization, Research Papers in Economics, No.
2/20, Universität Trier, Fachbereich IV - Volkswirtschaftslehre, Trier;
Amato, Massimo; Belloni, Everardo; Favero, Carlo A.; Gobbi, Lucio (2022), Creating a Safe Asset Without Debt Mutualization: The Opportunity of a European Debt Agency, CEPR Discussion Paper No. DP17217.

A. NGEU as a mandatory step towards stability

As mentioned above, nobody expected that the EMU would have enjoyed fiscal powers, since both European public opinion and leaders were opposing any kind of interference or further integration. Additionally, Next Generation EU constitutes a paradigm change in the architecture of EU economic governance. It indeed endowed the EU, for the first time, with a common budget to support its spending programs funded by own resources. Moreover, it is important to recall the intention of repaying NGEU debt from 2028 to 2058 through an increase in the own resource ceilings and the introduction of new EU taxes, first and foremost a national contribution on non-recycled plastic packaging waste. But how can this tool help the EU overcome the long-standing matters described in the previous chapter and provide the necessary conditions to promote the integration required to ensure future financial stability?

Firstly, it is important to analyze how money have been allocated. We previously mentioned that €723.8bn in loans (€385.8 billion) and grants (€338 billion) have been made available with the Recovery and Resilience Facility.

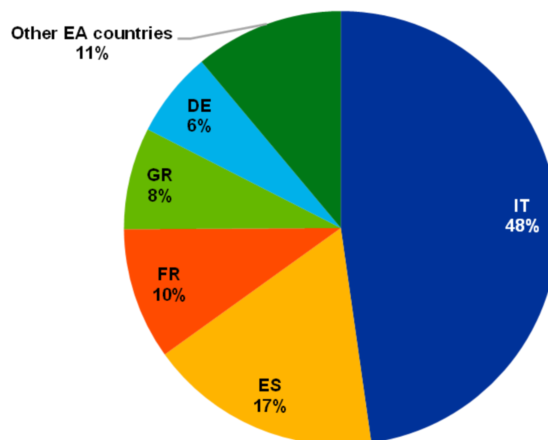

Figure 5.1: Volume of RRF funding (grants and loans) requested in euro area countries (2021-26). Source: European Commission and ECB staff calculations (Freier, Grynberg, O'Connell, Rodrìguez-Vives, & Zorell, 2022)

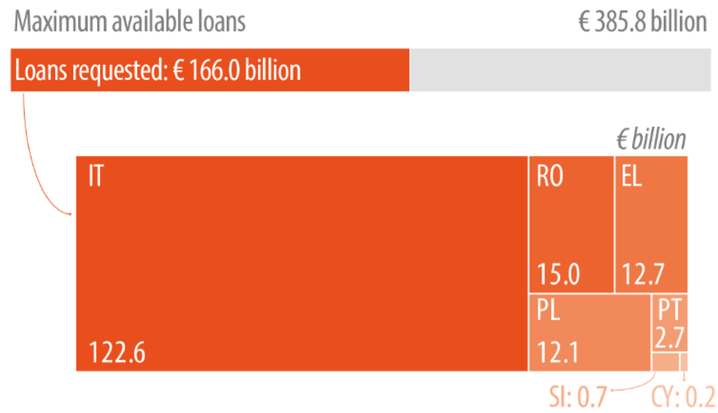

Figure 5.2: Distribution of RRF loans requested per Member State. Source: Recovery and resilience scoreboard of the European Commission

To the present day all euro area countries presented their NPPRs, and all of them expressed interest in making full use of the RRF grants, while only a few governments asked for loans too (Figure 5.2). As shown in Figure 5.1, financial contributions have been allocated asymmetrically among member states. The criteria originally employed to allocate 70% of the resources, indeed, «foresaw only population, the (inverse of) GDP per capita and the pre-pandemic unemployment rate» (Bisciari, Butzen, Gelade, Melyn, & Van Parys, 2021), while the following 30% tranche considered the economic damage caused by the pandemic crisis, even though subsequent adjustments have been made and others still may arise. As a result, Spain and Italy are the main beneficiaries in absolute amounts, receiving almost two-thirds of RRF funding in grants and loans. Right after, we see France and Germany, receiving together 16% of the available funding. Lastly, 19% of RRF resources has been allocated among smaller member states, with Greece in the forefront (8%).

This allocation showcases EU's intention to promote economic convergence among member states over the long term, by helping them recover from the Covid-related crisis and by fostering growth. Especially, the tool's coordinated action plan aims at enhancing the potential impact of cross-border spillovers. In support of the possibility of reaching this objective, research aimed at quantifying spillovers

produced by this innovative instrument, conducted using the Quest model, suggests a boost in real GDP by 1.2 to 1.5 percentage points compared to a baseline scenario without NGEU (Pfeiffer, Varga, & in't Veld, 2021). It goes without saying that these hypotheses depend on a number of assumptions, e.g. the additionality feature of investments made using these funds[39], their productivity, the possibility of using the funds to finance national fiscal transfers, the capacity of both governments and the economy «to deal with the investment impetus» (Bisciari, Butzen, Gelade, Melyn, & Van Parys, 2021). Therefore, even though ex-ante quantifications may still appear uncertain, the combination of MFF and NGEU is expected to produce a redistributive impact among EU member states in the long term, coherently with the existing cohesion policies (Fuest, 2021).

Simultaneously, NGEU plays an allocative role, since it is aimed at achieving a greener, more digital, and more resilient EU. Despite further guidance needs to identify the areas in which public spending my work better than the private market, the advantage of the tool's programme is a potential future convergence also in terms of green and digital transition among states, and among regions in the EU.

Additionally, EU's chance of borrowing more than €900 bn (including SURE) paves the way for achieving a significant role on the financial markets as a provider of safe assets in euro.

A combination of albeit temporary solidarity, long-term growth, economic convergence and progress, and potential EU's status empowerment seem to be the formula that may help the Union reach an ex-post cohesion. Even in terms of debt sustainability this looks like the optimal solution, since in the post-SDC era there is a consensus on debt solvency not being a governments' objective, but rather commitment on supporting the «capacity to service the stock of debt, that crucially depends on the interest rate it pays and on its capacity to generate resources (the

[39] See: Gros D. (2021), Next Generation EU: applying some basic economic principles, Executive education course on the EU Recovery Plan, School of Transnational Governance, European University Institute, Florence, 19 May.
The author argues that EU grants could be used by countries to finance investments that were already planned. As a result, beneficiaries may reallocate the money saved to increase public expenditure or to reduce public debt or to cut taxes.

growth rate of the economy)» (Saraceno, 2021). Moreover, this instrument has the peculiarity of providing benefits, even though asymmetrically, to almost each EU country, satisfying their opportunistic expectations. But the unknown in truly overcoming the long-standing issues and achieving further integration is once again democratic consent. We may consider NGEU's success as a «lifetime opportunity for the less resilient countries to help remedy their structural problems through investments and reforms» (Bisciari, Butzen, Gelade, Melyn, & Van Parys, 2021) and as a final round to convince people of the benefits deriving from fiscal and political integration. If run successfully, it could eventually lead to the overcoming of Northern countries' reluctance in pursuing a permanent fiscal capacity or to the executing of a risk-sharing instrument. Only a real mutual insurance mechanism, indeed, «could make it possible to guarantee stability and growth by operating alongside (and sometimes in place of) market adjustments» (Saraceno, 2021). Thereupon, financial stability in the euro area would not be a mirage anymore.

B. The challenge of democratic consent

Our argument so far assumes that bringing European countries together in economic terms with the aid of NGEU will close EMU's initial gaps and boost its structure, making it able to resist both internal and external shocks without any need of fiscal transfers nor makeshift resolution mechanism. But will this be sufficient to convince citizens of the benefits of being part of a common currency area? Alternatively, are cultural and institutional differences among countries so stark that the original structural flaws added to the debt and pandemic crises will preclude further developments of the area as a whole?

To provide a response to the last question, we mention Alesina, Tabellini, & Trebbi (2017)'s research, which pointed out that EU citizens have kept their cultural differences over the last thirty years, despite changes have occurred. However, the authors detected that all of Europe has become «more inclined to accept a larger

role of the state in risk sharing and redistribution» (Alesina, Tabellini, & Trebbi, 2017). As for institutional convergence, they observed a divergence in both quality of government and legal institutions. Also, institutional comparative advantages or disadvantages seem to have led to a change in the production structure and in the resulting allocation of resources. It is therefore evident that decades of economic integration and common currency have not encouraged other forms of integration, not even in this case, although this feature has no bearing on citizens' perception about Europe and EMU.

To sum up, cultural heterogeneity in Europe does not play but a minor role and democratic constraint does not depend on the cultural nor institutional feature. The research suggests that the main barrier to further spillovers consists of rising nationalist sentiments, which exacerbates each time the area faces a threat. National political parties, indeed, use euroscepticism as a tool to raise consent, giving the EU the role of «scapegoat for failures, debts and crisis in the nation-states» (Bedirhan & Ugur, 2021). This sounds coherent with the view that sees European countries as ruled by a nationalistic sense of solidarity (Miró, 2022). For this reason, to date, chances of obtaining Northern coalition's consent to deepen integration and make NGEU a permanent instrument are low. Nor measures of promoting social cohesion may be sufficient to manage citizens' perception of solidarity within the EU.

Nevertheless, empirical evidence shows European governance has already allowed temporary instruments to lead to innovations in the past (Saraceno, 2021). Therefore, we must once again underline that NGEU's logic constitutes an essential step in EU and EMU's path, since without it further integration must be assumed impossible. As for its chances of becoming a permanent fiscal capacity tool, we still have doubts. Increasing divergencies and skepticism within Europe make it difficult to prospect a precise path. Certainly, the programme's success may help population understand the advantages of the Union and the common currency area, refuting past concerns and strong nationalism that characterized the last decades. Also, a reduced economic power gap could possibly rebalance democracy at the institutional level. In the meantime, Saraceno's research (2021) suggests that a reorganization of the Union's financial assistance functions (aimed at fixing a

unique and precise credit lines offering mechanism) and the development of automatic stabilisers (e.g. a permanent version of SURE, a complete capital market union and a complete banking union, a revision of European fiscal rules) may facilitate the process of overcoming past failures and reaching further development.

VI. CONCLUDING REMARKS

The EMU was designed as an incomplete common currency area, devoid of a solid structure, an effective political machinery, and the prerequisites for pursuing further development without risking collapsing at the first sign of instability. Since then, it has passed through two severe crises, and for each a new stability mechanism has been developed. The first to be designed was the European Stability Mechanism, a permanent bailout fund based on a conditionality approach, that supported member states with the duty to implement a set of austerity measures. This approach turned out to be disastrous, as it compounded the crisis in states in difficulty, led to permanent economic damages and created a stigma effect. Cleary, financial stability was not achieved. Meanwhile, ECB's expansionist policy rescued the euro area. In the years that followed, several proposals of stability tools arose, evaluating the option of implementing debt mutualization or alternatives without risk-sharing. All of them have been refused: both public opinion and national leaders opposed. Citizens were reluctant of any kind of further integration. The outbreak of the Covid-related crisis followed and has driven the need of a new instrument. Surprisingly, Next Generation EU endowed the European Union with an albeit temporary fiscal capacity, with the aim of helping member states recover from the Covid-related crisis, of fostering growth and of promoting economic, cultural, and institutional convergence. Once again, the imminent realization of financial stability has been missed. However, NGEU's combination of temporary solidarity, long-term growth, economic convergence and progress, and potential EU's status empowerment arouse great expectations among countries in favor of pursuing a risk-sharing mechanism. Contrarily, Northern countries' leaders repeatedly highlighted the temporary character of the tool, which was not intended to lead to any further integration. Anyways, the pandemic resolution mechanism seem to be the perfect opportunity to fill in the original gaps and to possibly allow convergence and gain democratic consent, if run successfully. But it is still uncertain whether this gamechanger could bring the expected result since the EU is now at a crossroads: the prevailing public opinion is moving away from the European ideal.

Certainly, the current arrangement is still unable to provide financial stability, which remains a long-term issue, even though promoting further reforms while implementing the Next Generation EU tool with population's support may pave the way towards the enforcement of a mechanism capable of securing EU and eurozone's future. Therefore, if we ask whether a Eurobond mutualized system might be able to ensure more stability than the 2012 ESM, then the answer is affirmative. However, the conditions of the area are preventing any advancement in the foreseeable future.

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