The new European recovery plan: a giant leap for Europe and the Euro

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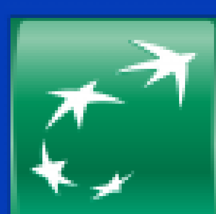

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The European recovery plan

The European Commission recovery plan as proposed on May 27th 2020 for addressing the need to repair for the Covid crisis and preparing for the Next Generation is revolutionary. It opens a new era for the EU and for the euro as a currency especially the "Next Generation EU" plan of €750 billion. Some commentators have described this as a "Hamiltonian moment" for Europe insofar that – if the EC plan is adopted in mid-July by the Member states – the EU will both borrow independently in an unprecedented way. The EU will also raise taxes directly hence gaining budget autonomy outside member contributions. "Hamiltonian" refers to the first time that, in 1790 under Secretary Hamilton, the 13 states of the US decided to borrow jointly. This moment has been a "point de bascule" for the US into a real federation. We are living an almost as historically important moment for Europe and it is remarkable that the Commission has put this plan together only a few weeks after the also historic Franco-German decision to push for a common recovery plan.

1. The main components of the plan

The analysis behind the plan is that the shock resulting from the pandemic is so large and violent that it needs an immediate and unprecedented fiscal response. High public sector indebtedness in most countries reduces the policy leeway and monetary policy cannot alone resolve the economic crisis. While the Commission does not express it as such, behind the plan is the recognition that the very low level of interest rates and the quality rating of the EU (AAA) give access to resources that should be tapped to engage into a massive stimulus plan geared towards investment.

At €750 billion, or 5.25% of GDP, the plan is comprehensive in size and in scope. The money will be invested in three pillars: (1) support to the Member States for their investments and reforms, (2) providing support to businesses and incentivizing private investment and (3) health-related initiatives.

The most creative and innovative part of the plan is the "Next generation EU": the EU will borrow on the financial markets €750 billion from 2020 to 2024 and with maturities of up to 30 years. The debt will be repaid with the Commission's own budget. To this end, resources will be created for the EU under the form of new taxes, giving autonomy to the European budget: a carbon tax or a digital tax are considered.

2. Implications for the euro and financial markets

The completely innovative feature of this proposal is this borrowing programme: the EU, in spite of its excellent financial standing, has never or seldom resorted to debt. We know why: it would imply a mutualisation of debts and there has always been strong resistance from the most parsimonious Member States. They always feared that such a mutualisation would create moral hazard and an unfair opportunity for more spendthrift countries to create new resources at their expense, *in fine* having to support their credit risk.

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The Covid crisis has caused this incredible and revolutionary idea: accepting that Member states borrow jointly in the name of the EU. EU is not yet federal in terms of institutions but it is a significant step towards financial federalism and the euro as an international currency.

For financial markets and the euro, this is extremely important. The strength of the euro as a currency depends on its international status for investors throughout the world. The creation of a single bond instrument, the "no risk" public debt instrument, that provides a safe asset and a reference for the market is a crucial milestone for the euro. Effectively when comparing the euro to the dollar, the US dollar supremacy is also the supremacy of its capital markets and of its non-risky investment: Treasury bonds.

The appetite of investors, whether domestic or international, for this new instrument will be huge. The interest rate is likely to be close to zero or even negative, depending on the maturity. Long tenors of 30 years are likely to be easy to obtain. In addition, the size of the programme at €750 billion will mean that the EU bonds issuance will be as large as the French treasury bonds issuance (circa €200 Billion a year). To give some benchmarks, outstandings of public debt from the Spanish Trreasury amounts to €1,225 billion as of Q1 2020. As the German debt is reducing year per year, one can estimate that in 5 years' time EU bonds will have replaced the German Bund as the liquid and attractive zero risk safe asset for the Eurozone.

When Europeans will realize how cheap and effective this way of raising money is, it is likely that the programme will not be a one shot response to an extraordinary crisis and will become permanent. Obviously, no policymaker will say this officially at this juncture but the euro needs a stock of AAA-rated securities to raise its international status.

The other revolutionary aspect of the plan is the course the Commission has set aiming at having the ability to raise taxes directly and resort to its own resources to repay its debt. This could take the form of a carbon tax or a GAFA tax. It opens the way to a much more meaningful EU budget in terms of percentage of GDP and towards an expanding European budget with more ability to decide investments directly and raise further debt in the future.

3. The challenges of the programme

Many components of the recovery plan still need to be finalised and it is likely that the mid July discussions will lead to amendments and further negotiations. The challenges of the programme are twofold: (1) money raised should be spent wisely and (2) conditionality on reforms and guidelines for Member States to get access to the grant portion of the plan (around 2/3rd of Next generation EU in the plan) must be set.

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As regards investments, the Commission has set objectives very clearly. It looks like of a revamped industrial policy coming back to the roots of Europe: a policy that will be directed towards Energy transition (the “Green deal”), digital transformation and health. On the latter, while the €9.4 Billion proposed are still not bold enough, this is the first time that Europe decides to select this topic as an element of its industrial policy. The key question then is to make sure that the money is well spent, that clear and strict criteria enable wise investments that create value for the future and future generations. Raising money to enable reckless investments or to compensate deficits of badly run governments would be an incredible waste and would pose enormous political risks. The responsibility of the European technocracy on the matter is enormous.

Another challenge is to make sure that the money invested creates convergence between Eurozone economies and reinforces internal trade. It must do so with conditionality clauses that are not like the “troika” measures on weaker countries while imposing the necessary discipline and democratic control by European institutions and the Parliament on the necessary reforms and transformation of the economies.

In conclusion, if the plan is adopted in July, Europe will be reinforced with a major step towards its ability to reinforce its sovereignty; the euro will further establish itself as a major international and reserve currency. This might not have happened without Brexit and the Covid crisis and we must thank Ms Merkel for having pushed, in a bold and defining move, this initiative in conjunction with President Macron. It is indeed a revolutionary moment for the European Union and the euro.

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A graduate of HEC and New York University, Sophie Javary is currently Vice Chairman CIB EMEA at BNP Paribas. An administrator of EuropaNova, she lectures at HEC. She is board member of at Elior, Euroclear and Adevinta. She has twice been rewarded with women's awards such as the Trajectoires HEC au Féminin (2008) and the Tribune Women's awards (2010).