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Failing forward in Economic and Monetary Union: explaining weak Eurozone financial support mechanisms

David Howarth [a] and Lucia Quaglia [b]

[a]Institute of Political Science, University of Luxembourg, Belval-Esch-sur-Alzette, Luxembourg; [b]Department of Political Sciences, University of Bologna, Bologna, Italy

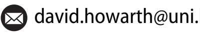
ABSTRACT

In this article, we apply the 'failing forward' approach to analyse the negotiations on and design of reforms to Eurozone economic governance to tackle the Covid-19-related crisis of Economic and Monetary Union (EMU). This crisis highlights both spill-overs from major asymmetries in EMU and weaknesses in the incomplete economic governance of the Eurozone. We focus on the financial support mechanisms agreed upon after intergovernmental negotiations in major crisis situations. These reforms represent compromise solutions that reflect well-entrenched disagreements among member states. We explain why more far-reaching reforms to Eurozone economic governance – notably, the adoption of mutualized Euro-denominated debt and the generalized use of grants over loans – have not been adopted, despite the severity of the Covid-19-related crisis. These reforms – notably the Next Generation European Union (NGEU) financial package adopted in July 2020 – fail to address and, rather, contribute to existing asymmetries, thus sowing the seeds of future crises.

KEYWORDS Economic and Monetary Union; Failing Forward; Covid-19; Financial Support Mechanisms; European Stability Mechanism; European Union Economic Governance

Introduction

The economic effects of the outbreak of the coronavirus (Covid-19, Covid) pandemic have been devastating for Europe and the world, leading to the worst economic recession since World War II, soaring unemployment and deteriorating public finances. Almost all European Union (EU) member states were faced with record public spending deficits. Particularly concerning was the sustainability of the fiscal situation of member states in the southern periphery of the Eurozone – and notably, Italy, Spain, Portugal

CONTACT David Howarth  david.howarth@uni.lu

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and Greece – already struggling with high government debt. This economic crisis has thus worsened major divisions in the Eurozone, threatening its survival.

Confronted with these challenges and following calls for resolute European intervention as well as major reforms to Economic and Monetary Union (EMU), the EU has responded by adopting significant institutional and policy changes. The 'Next Generation EU' (NGEU) funding programme was agreed to tackle the Covid-related economic crisis by establishing financial support mechanisms to help the most fiscally challenged Eurozone member states (de la Porte & Jensen, 2021). We argue that these reforms are politically significant but far from adequate both in real terms and in terms of tackling long-standing asymmetries in EMU. This presents a puzzle: Why have major reforms of the EMU framework – and, specifically, the establishment of sufficiently large financial support mechanisms – proven elusive in the face of the worst economic crisis to ever hit the EU?

We answer this question by adopting the 'failing forward' approach developed by Jones et al. (2016) and applying it to the Covid-related crisis. Methodologically, we take a longer-term perspective, even though the empirics focus on the current crisis. We argue that the incompleteness of EMU generated structural vulnerabilities in the Eurozone, which amplified the divergent effects of exogenous shocks (in this case, a health crisis), due to negative spillovers built into the system. As with the response to the 2010–2014 sovereign debt crisis (SDC), intergovernmental bargaining led to the adoption of EMU reforms that were incomplete, unbalanced and crisis-prone (Kelemen & McNamara, 2020). They fell short of what is needed to address the ongoing macroeconomic challenges linked to the single currency, given both asymmetric and symmetric shocks.[1] They represent 'sticking plaster' solutions that help to stop the 'bleeding', but do not address the underlying 'pathology' of divergence and asymmetries in EMU. They are instruments of crisis management and are less focussed on prevention, leaving EMU and its member states vulnerable to further crises (Feás, 2021).

Our article makes two contributions to the literature. First, it adds to the literature on EU macroeconomic governance and the reform of the EMU framework (Carstensen & Schmidt, 2018; Fabbrini, 2013; Matthijs & McNamara, 2015; Niemann & Ioannou, 2015; Schimmelfennig, 2015; Verdun, 2015), by examining the EU's response to the Covid-related macroeconomic crisis. Our article does so by examining previous reforms. We pay particular attention to the policy debate on financial support for member state governments and we argue that the recurrent crises of EMU, and the current threat of another crisis, have underscored the incompleteness of EMU, especially the absence of this support, which is one of three proposed mechanisms – in addition to tighter fiscal rules and non-conventional monetary policy – necessary to ensure the longevity of the single currency.

Second, our article assesses the applicability of the 'failing forward' pattern (Jones et al., 2016) with reference to new empirics. We argue that although the solutions adopted are not based on the lowest common denominator (LCD) – as claimed in the 'failing forward' approach – intergovernmental agreements always involve incomplete solutions which, in turn, reinforce, rather than effectively address, existing asymmetries and lay the seeds for future crises. Thus, the reforms adopted by Eurozone member states to ease the financial difficulties created by the Covid-related crisis fail to address both the current financial difficulties facing Eurozone member states and persistent asymmetries across EMU.

This article is organized as follows. In the next section, we outline the 'failing forward' approach. We also present three criteria to evaluate the EU/Eurozone's response, while recognizing that the entrenched divisions among member states prevented potentially more effective reform. The subsequent sections apply the 'failing forward' pattern to the empirics of the Covid-related macroeconomic crisis to explain the EU/Eurozone response and limited institutional and policy changes adopted. We conclude by reflecting on the explanatory added-value of the 'failing forward' approach. Many but not all the reforms adopted in 2020 concern all 27 member states – including countries outside the Eurozone. However, we focus upon these reforms in terms of their contribution – or lack thereof – to tackling the strains within the Eurozone created by EMU asymmetries.

The 'failing forward' pattern and EMU reforms

Analytically, this article builds on and refines the 'failing forward' approach developed by Jones et al. (2016), as elaborated in the introduction to this special issue (Jones et al., 2021). This approach, which also speaks to historical institutionalism (Pollack, 2019), is articulated in three main steps: first, negative spill-overs from previous incomplete integration trigger a crisis in the EU; second, intergovernmental bargaining takes place to deal with the crisis; third, LCD solutions are adopted at the EU level and lay the seeds of future crises. 'Failing forward' identifies a pattern that frequently occurs, but is not deterministic – it does not claim that the EU always fails forward or only fails forward. Rather, there is a pattern that the EU often fails forward. The 'failure' is not due to unexpected events. Rather, it results from a design flaw that many European and national government officials and experts recognized in advance could lead to trouble, but that was difficult politically to fix. When 'failure' comes, the design flaw is fixed in part (moving forward), but the 'fix' is both limited and imperfect.

We apply the 'failing forward' pattern to shed light on reforms adopted to cope with the Covid-related crisis of EMU in 2020. The pandemic is a crisis that did not stem from the operation of EMU. However, the impact of the

health crisis exposed the incompleteness and asymmetry of the institutional design of EMU, which creates structural vulnerabilities in the Eurozone, whereby any exogenous shock increases the economic divergence among the member states and puts strains on the single currency. Thus, the Covid-related crisis of EMU is more endogenous than it appears because the seeds of the macroeconomic crisis that the pandemic provoked were baked into the incompleteness of the existing institutional framework.

We apply the three steps of the 'failing forward' pattern by first teasing out the negative spill-overs from previous incomplete reforms of EMU, explaining how and why they worsened the macroeconomic effects of the pandemic in the Eurozone periphery. Second, we identify the preferences of the main member states and the intergovernmental negotiations on EU solutions to the problems at hand. Third, we explain the incomplete nature of the reforms agreed, which will likely contribute to future crises in EMU. Borrowing from Kapoor (2020), we identify three criteria to evaluate the adequacy of the EU's macroeconomic response and its significance in terms of the 'failing forward' approach: size – was it big enough?: the speed of delivery – was it timely?; and likely long-term economic impact. The 'failing forward' pattern would suggest the failure to meet all three criteria.

We lack space to consider alternative theories, some of which run in parallel to or are subsumed under the 'failing forward' approach. Neofunctionalist approaches (Niemann & Ioannou, 2015) explain spill-over dynamics that encouraged the development of support mechanisms but downplay the importance of intergovernmental bargaining in the design of these mechanisms. Intergovernmentalist approaches (Fabbrini, 2013; Schimmelfennig, 2015) downplay the importance of spill-overs, the role of supranational institutions (Smeets et al., 2019; Verdun, 2017) and path dependency (Gocaj & Meunier, 2013; Schimmelfennig, 2016; Verdun, 2015) in the development of support mechanisms, as well as the importance of ideas in member state preference formation. Constructivist approaches (Matthijs & McNamara, 2015) emphasize the battle of ideas in the development of support mechanisms or lack thereof but underplay material interests.

Negative spill-overs from an incomplete EMU

Our starting point is the incompleteness of the institutional framework of EMU: namely, the uneven degree of centralization assigned to the 'monetary' and 'economic' (notably, fiscal policy) elements (Dyson, 2000; Verdun, 1996). EMU, as envisaged in the TEU in 1992 and eventually established in 1999, set in place a full monetary union, characterized by a single currency managed by a highly independent European Central Bank (ECB). At the same time, the TEU incorporated macroeconomic policymaking characterized by less centralized governance and national margin of manoeuvre despite supranational rules. In particular, EMU lacked a mechanism for fiscal transfers.

A single interest rate set to contain inflation for the entire Eurozone is unable to counter the macroeconomic effects of asymmetric shocks in parts of the currency area. To compensate, many economists and political economists recommend fiscal transfers – either through taxes or welfare state measures as automatic fiscal adjustment mechanisms – and transfer payments targeted principally at parts of the currency area hit harder than others by an asymmetric shock (see Allard et al., 2013; De Grauwe, 2020). The absence of common European tax and welfare state measures, combined with the limited effectiveness of other non-fiscal adjustment mechanisms and, notably, labour migration – has placed greater emphasis upon the need for transfers payments to ensure a sustainable EMU.

The incomplete institutional design of EMU has had two main implications: it contributes to increasing economic divergence among the member states (although it is not a cause of this divergence) and constrains their ability to cope with economic shocks. To begin with, the institutional design of EMU favours countries that have export-led growth models, while penalizing countries with domestic consumption-oriented growth models, particularly those financed by debt accumulation, as in Southern Europe (Hall, 2018; Johnston & Regan, 2016). Furthermore, EMU is 'skewed toward deflationary adjustment policies in hard times, leading to falling incomes and employment in the periphery' of the Eurozone, as during the SDC (Matthijs, 2016). Data on unemployment, growth rates and public finances highlight the persistent and rising economic divergence across the Eurozone since its inception, which, in turn, contributed to the SDC (see Table 1).

Second, given its incomplete institutional design, the Eurozone has been unable to articulate a fiscal response to economic crises. However, the Eurozone has been able to deploy a monetary response via the ECB – despite Treaty provisions against the monetary financing of government debt. In response to the SDC, the ECB engaged in quantitative easing through sovereign debt and corporate asset purchases, pledging to do within its mandate 'whatever it takes to preserve the euro' (Hodson, 2013; Verdun, 2017).

In response to the Covid-related crisis, the ECB launched a massive Pandemic Emergency Purchase Programme (PEPP). On both occasions, during the SDC and the pandemic, the ECB prevented excessive Eurozone instability, but it also eased the pressure on Eurozone governments to reach an agreement on larger financial support mechanisms. Yet, the monetary response has not always been sufficient – especially in the context of rapidly rising member state debt burdens and rapidly expanding central bank balance sheets (Jones, 2020). Furthermore, non-conventional monetary policy has met with stubborn political opposition in a number of Eurozone countries.

In response to the SDC, the policy debate began to focus on financial support mechanisms in EMU (see Jones, 2020). After heated intergovernmental bargaining and temporary fixes, the member states agreed in 2012 to a

Table 1. Growing divergence in the Eurozone (five largest national economies).

Date	Germany	France	Italy	Spain	Netherlands	Eurozone* average	Difference Highest – lowest country	Difference Highest–Lowest country as % of lowest	Difference between Highest and Eurozone average as % of Eurozone average	Difference between Lowest and Eurozone average as % of Eurozone average
GDP per capita**										
1999	27.0	25.6	22.0	15.8	28.4	22.3	12.6	41.3	27.4	29.1
2009	42.3	43.2	37.0	31.3	52.8	38.6	21.5	41.9	36.8	18.8
2019	46.5	41.9	33.2	30.0	52.7	39.1	22.7	38.2	34.8	23.3
2020***	45.5	39.3	30.7	26.8	51.3	37.1	24.5	49.5	38.3	30.5
Unemployment rate****										
1999	8.6	10	10.9	13.6	4.2	9.7	9.4	224	40.2	56.7
2009	7.6	9.1	7.7	17.9	4.4	9.6	13.5	307	86.4	54.2
2019	3.2	8.8	10.4	14.4	3.6	7.9	11.2	350	82.3	54.4
2020***	3.0	8.4	10.0	13.3	3.6	7.5	10.3	343	77.3	52.0
Government debt levels										
1999	60.1	60.5	113.3	60.8	58.6	71.4	54.7	93	59	17.9
2009	73	83	116.6	53.3	56.8	80.2	63.3	119	45.4	33.5
2019	59.6	98.1	134.7	95.5	48.7	84	86	177	60.4	42.0
2020***	67.4	114.1	149.4	110.1	55.2	95.1	94.2	171	57.1	42.0

Source: European Central Bank, Data Warehouse; IMF Datamapper.
*Eurozone of 19.
**US$ (thousands), current prices.
***End of third quarter.
****Unemployment rate (percentage of active population).

compromise solution by establishing a permanent European Stability Mechanism (ESM) to act as a backstop providing loans to ailing member states subject to conditionality (Gocaj & Meunier, 2013; Smeets et al., 2019). Despite a number of reforms to the ESM – notably, to widen possible purchases from primary-issued to secondary debt – this mechanism presented several shortcomings: lending amounts were limited (up to €500bn for the ESM), interest rates on loan amounts remained significantly above the Eurozone's lowest rates and individual member states maintained vetoes on lending decisions (Donnelly, 2021).

Other financial support mechanisms, notably mutualized debt instruments (Eurobonds) and an EU level unemployment re-insurance fund, were raised but made little headway. The French and Southern European member state governments pushed for debt mutualization, notably, through the emission of Eurobonds, while the German and other Northern European member state governments were opposed (Matthijs & McNamara, 2015; Schimmelfennig, 2015). The creation of a specific Eurozone budget to contribute to crisis prevention and tackle the effects of asymmetric shocks was proposed (French and German Government, 2018), negotiated over a year and a half, watered down to 'homeopathic insignificance' and eventually scrapped altogether in 2020 (Brunsden & Fleming, 2020). A strengthened set of fiscal policy rules were introduced by the six-pack and two-pack regulations of the Council and the European Parliament, as well as the Fiscal Compact, agreed through an intergovernmental treaty in 2012. However, member state margin of manoeuvre on deficits remained.

The EU's response to the Covid-related economic crisis

In 2020, the rise in Eurozone member state public debt yield-spreads during the first months of the Covid-related crisis similarly sparked debate and action on support mechanisms. Italy and Spain were hit hard during the first wave of the pandemic. As the Eurozone's third-largest economy, Italy was of particular concern: it had the second-highest debt to GDP ratio in the Eurozone and the third-largest nominal public debt in the world. The asymmetrical design of EMU and the limited nature of previous reforms created negative spill-overs because existing Eurozone financial support mechanisms were inadequate to assist countries with larger economies and absolute debt loads in dealing with the crisis. This inadequacy generated a neo-functionalist drive to reinforce existing financial support mechanisms and establish new ones.

Pre-Covid financial support mechanisms involved only loans and were to be 'fiscally neutral', because the loans received by ailing countries were to be repaid, albeit at below-market rates. Thus, when the Covid-related crisis began, the default option for the Eurozone was to rely on loans, first and foremost, via the ESM. However, a number of member states were reluctant to

request loans from this backstop created to tackle the SDC, even once conditionality on lending was reduced and debt maturity increased. Rather, the Italian and other Southern Eurozone governments called for instruments of debt mutualization, such as coronabonds or grants from the EU or a special Eurozone budget. As a number of national governments faced rapidly rising debt loads, the ESM became less effective in that its assistance contributed to increasing debt – even if ESM loans were excluded from official member state debt figures – and therefore worsened debt sustainability.

Competing national preferences on financial support mechanisms

An Italy-led coalition argued for the creation of Eurobonds (or, specifically, coronabonds) – common Eurozone debt to mutualize risk (Michalopoulos, 2020; Segreti, 2020). A joint letter of 25 March, addressed to European Council president Charles Michel calling for coronabonds to finance healthcare investments, economic and other social policies, was signed by nine national leaders – those of Italy, Spain, France, Portugal, Greece, Belgium, Slovenia, Ireland and Luxembourg (Dombey et al., 2020). Alternatively, or additionally, a number of these member states called for EU funding in the form of grants that did not have to be repaid. A number of Eurozone national governments also supported the use of ESM loans free from conditionality (Bufacchi, 2020; von der Burchard & Tamma, 2020).

A German-led coalition – which included Austria, the Netherlands, Denmark, Sweden and Finland – initially opposed the creation of coronabonds and advocated the use of existing support mechanisms, notably the ESM, with conditionality (Chazan, 2020; von der Burchard & Tamma, 2020). The Dutch government was particularly outspoken against coronabonds and grants (Boffey, 2020; Khan, 2020a). German government opposition to debt mutualization in the form of coronabonds stemmed from long-standing ordoliberal concerns (Dyson, 2014; Matthijs & McNamara, 2015). At the domestic level, the governments of Northern European member states faced public opposition to any form of debt mutualization in the EU, as well as political competition from right wing-populist parties, especially in the Netherlands.

A significant shift in German government preferences on the need for grants to fund recovery took place over the spring of 2020, distancing Germany from other Northern European countries (see also Rhodes, 2021). The unprecedented devastation of the crisis, a shift in economic thinking in the German Ministry of Finance and through the efforts of the Social Democrat finance minister Olaf Scholz, as well as the shift in German public opinion during the unfolding of the pandemic help to explain the Franco–German proposal on grants discussed below (De Gruyter, 2020; Hassenkamp, 2020; Redfield and Wilton Strategies, 2020). France was in-between the two coalitions outlined above. Initially, the French government supported the

issuing of coronabonds and signed the joint letter. Subsequently, once it became clear that there was insurmountable opposition to the proposal, the French finance minister, Bruno Le Maire, proposed the creation of a one-off recovery fund limited to five or 10 years that could raise debt and issue loans to governments at lower than market rates to foster economic recovery (Smith-Meyer, 2020).

Distributional conflicts and intergovernmental bargaining

Corresponding to the 'failing forward' pattern, different member state preferences generated distributional conflicts that had to be reconciled through intergovernmental bargaining, which took place in the Eurogroup, the Council of Economic and Finance Ministers, and the European Council. The creation of coronabonds was hotly debated, but came to nothing. Similarly, as noted above, a Eurozone-specific budget that had been debated over several years was shelved altogether in May 2020. For Eurozone countries, this left the ESM and other more traditional lending options through the EU budget and the European Investment Bank (EIB). The principal debate here was on funding through grants that did not have to be repaid – demanded by the Eurozone periphery and France – and funding through loans. As funding through the ESM and the EIB could only be through loans, this left the European Commission as the only body that could offer grants.

ESM loans were unattractive for ailing Southern Eurozone countries for several reasons (Jones, 2020). From an economic perspective, these countries already had a high level of public debt as well as available market financing – also due to the ECB's non-conventional monetary policy. The ESM's support could have a negative impact on a country's reputation in the markets in terms of debt sustainability (Johnson et al., 2020). Politically, the use of ESM loans was controversial and, in particular, was actively contested by populist parties in Italy (Johnson, 2020; Sandbu, 2020). There were concerns about potential conditionality and the association of ESM lending with Troika (EU Commission, ECB and IMF) intervention in domestic affairs, as during the SDC. That a number of national governments refused in 2020 to make use of the principal existing Eurozone-specific financial support mechanism – even under less rigid conditionality – reflects a 'failing forward' from the design and operation of the ESM created in 2012.

In April 2020, the Eurogroup agreed to increase the funding made available to the member states in the form of loans (Eurogroup, 2020). The ESM was expanded by establishing the Pandemic Crisis Support programme. Conditionality was significantly lowered on this lending and the only requirement to access the credit line was the commitment to use it to support domestic financing of healthcare-related costs due to the pandemic. Loans would be

up to two per cent of the GDP of each member state, for a total of €240bn. However, no Eurozone government proved ready or willing to seek ESM lending (Sandbu, 2020). The Eurogroup also agreed to establish a temporary loan-based instrument for financial assistance to protect employment. The 'Support to mitigate Unemployment Risks in an Emergency' (SURE) was to provide financial assistance to member state governments running employment maintenance programmes, in the form of loans on favourable terms, up to €100bn in total, building on the EU budget as much as possible, and on guarantees provided by member states (Eurogroup, 2020).

The European Council (2020a) endorsed the Eurogroup agreement on what it labelled 'three important safety nets' for workers (SURE lending), businesses (EIB guarantees for loans) and sovereigns (ESM lending) with total potential funding of €540bn. All these measures had no immediate cost for the member states and were intended to involve no redistribution among them, even over the long-term. The European Council also asked the Commission to put forward a proposal to establish a recovery fund of 'sufficient magnitude', 'targeted towards the sectors and geographical parts of Europe most affected'.

Throughout the crisis, as during the SDC, the Commission sought to reconcile the different preferences of the member states to find a viable solution. The Commission itself was divided on the issue of financial support mechanisms: Commission President, Ursula von der Leyen, appeared to side with the 'Frugal Four' – namely, Austria, Netherlands, Denmark and Sweden – by stating that 'the word coronabond is really just a slogan. Behind it, though, there is the larger question of guarantees. And there, the concerns in Germany, but also in other countries, are justified. The legal limits are very clear, that is not the plan' (Herszenhorn & von der Burchard, 2020). By contrast, the Commissioner for Economic and Financial Affairs, Paolo Gentiloni, was more supportive of coronabonds and the creation of a special coronavirus fund (Stevis-Gridneff, 2020).

In May, German Chancellor Angela Merkel and French President Emmanuel Macron announced their support for a €500bn recovery fund, with grants to be issued to EU member states in need – not specifically Eurozone member states – to be funded through Commission-issued debt (Fleming et al., 2020). This Franco–German proposal in favour of grants was a significant departure for the German government. However, the implications in terms of redistribution among member states, given the necessity to reimburse the debt issued, remained unclear. Merkel and Macron called upon the Commission to provide further details. In turn, the Commission proposed a massive €750bn Recovery Instrument (Next Generation EU, NGEU) consisting of both loans and grants and 'targeted reinforcements to the long-term EU budget for 2021–2027' (Commission, 2020). However, the Frugal Four repeatedly made it clear that they would only accept a recovery fund that

provided loans (Fleming, 2020). Subsequently, these governments joined with Finland, agreed to accept a smaller recovery fund involving fewer grants, while the Dutch government demanded a national veto on the allocation of funding (Khan, 2020b).

At an unprecedentedly long European Council of 17–21 July, European leaders reached a compromise on the Recovery Instrument in the context of an agreement on the EU's 2021–2027 multiannual financial framework (European Council, 2020b). The provision of grants was reduced from €500bn – sought by the Commission, France, Germany and Southern European member states – to €390bn. Of this amount, only €312.5bn would form specific support for pandemic-hit member states (the Recovery and Resilience Facility, RRF), while the remaining €77.5bn would top up existing EU programmes. Up to €360bn would be allocated as loans. The Commission was granted the power to raise up to €750bn on financial markets.

Compromises and incomplete 'sticking plaster' solutions

To summarize, the following measures were adopted to deal with the Covid-related macroeconomic crisis: the de facto suspension of the Stability and Growth Pact (i.e., EU fiscal rules); expansion of ESM lending, with the creation of a specific credit line with significantly lowered conditionality; establishment of SURE to provide loans to member states; and additional EIB guarantees to encourage lending to SMEs. These measures totalled up to €540bn. However, they were all loans – not grants as had been demanded by Southern European member state governments. The NGEU included €360bn in additional lending and €390bn in grants, with €312.5bn to be allocated specifically to assist member states to recover from the pandemic-related economic crisis.

The outcomes of the negotiations were the result of compromises between the different positions of the member states, but were often closer to the preferences of the most powerful player, Germany, which had a 'constrained veto power' (Bulmer & Paterson, 2013). Such power resulted from the size and relative stability of the country's economy. Germany was, however, constrained because, like the other Eurozone member states, it had a clear interest in avoiding disruptions to EMU and the collapse of the Eurozone. The German government's support for the NGEU was a significant policy shift, as was the Dutch government's acceptance of time-limited debt mutualization and the provision of grants, albeit subject to conditionality.

Three criteria, or benchmarks, can be used to evaluate both the economic significance of the EU's macroeconomic response to the pandemic and the applicability of the 'failing forward' approach to account for this response. The first criterion – speed of delivery – was not met. To offset the permanent economic damage caused by lockdowns, member state governments

needed additional EU funds from March 2020. However, NGEU grants and possible loans were only to be paid from 2021 – with grants in that year amounting to less than 10 per cent of the total to be provided over five years and grants to Eurozone member states reaching just over 0.2 per cent of Eurozone GDP (ECB, 2020) – while the relatively small SURE programme provided loans from October 2020. The disbursement of both loans and grants was to be spread over five years, ending in 2026. Furthermore, to obtain funding, the member states are required to prepare national recovery and resilience plans in accordance with country-specific recommendations and the roadmap for the green and digital transitions. These national plans are to be assessed by the Commission and approved by the Council by qualified majority. The disbursement of funds is to take place only if the agreed milestones and targets set out in the recovery and resilience plans are fulfilled. If one or more member state governments consider that there are serious deviations from the satisfactory fulfilment of the relevant milestones and targets, they can refer the matter to the European Council, delaying disbursement for up to three months.

The second criterion is size. The EU's response is not big enough. More than half of the offered funding is to be provided in the form of loans, not grants. The Recovery Instrument's grants amount to €390bn, approximately 2.2 per cent of EU GDP and 2.5 per cent of Eurozone GDP (ECB, 2020). The majority of EU national economies, however, were expected to shrink by over five per cent in 2020 and Italy and Spain more than 10 per cent. The two countries hardest hit by the first wave of the pandemic, Spain and Italy, were to receive grants of three and two per cent of GDP – €82bn and €89bn – respectively, with grants in 2021 limited to €7.3bn and €8bn (Darvas, 2020). Thus, EU funding was not macro-economically significant: it was a small percentage of total extra public spending in these two countries. Moreover, the focus of the Recovery Instrument, like most EU level support, was all 27 member states. Grants are to be allocated to all member states subject to a complex formula and not specifically to the struggling Eurozone periphery. The allocation of grants is according to the economic harm of the pandemic, excluding pre-crisis data on growth, unemployment and debt. In the wake of the first wave of the Covid pandemic in the spring of 2020, ECB President, Christine Lagarde, warning of the risk of 'divergence' among Eurozone member states, called for a common European fiscal response, which needed to be 'swift, sizeable and symmetrical' (Hall & Arnold, 2020). She argued that governments' response to the pandemic would result in additional funding requirements equal to ten per cent of total Eurozone GDP. In May 2020, a large majority of members of the European Parliament (2020) adopted a resolution calling for a €2 trillion EU recovery package to support member states.

The third criterion is the likely long-term economic impact of the EU's response. While pushing distributional conflicts aside in the short-term – given the Commission's issuance of debt to fund the grants – the compromise deal includes ongoing budget rebates for five member states, thus effectively decreasing redistribution through the EU budget over the medium to long-term. The measures adopted are temporary – there is no permanent increase in the EU's budget. Absent future political agreements on a new EU tax – which remains politically tricky – future debt repayments have to come from the EU budget. The adoption of an EU carbon border tax on imports could be challenged as protectionist by third countries – and notably, the US and China (Hook, 2021; Zachmann & McWilliams, 2020).

The failure to meet these three criteria renders secondary to this analysis any discussion of the precedent-setting nature of the EU's fiscal response to the pandemic and specifically the NGEU. The latter cannot be considered as the first step in the creation of a 'Fiscal Union' or 'Transfer Union': it is not a 'Hamiltonian moment'. Although the Commission's borrowing will create an EU safe asset that could affect capital markets, this is time-limited. The EU Cohesion and Structural funds already entailed indirect transfers among member states. There are existing financial support mechanisms, notably the ESM, that borrowed to assist troubled members, albeit through loans, not grants. Last but not least, the NGEU is designed as temporary. Although it is possible that these arrangements could be extended over time or made permanent, such reforms depend upon future intergovernmental negotiations, which will likely require the spark of macroeconomic crisis.

There is 'failing' for a number of reasons mentioned above, notably, the fact that additional EU financial support is based principally on loans, rather than grants – hence failing to diminish significantly the rapid rise in government debt in Southern Eurozone countries. Moreover, the NGEU measures agreed are limited in duration – the NGEU is to be a temporary mechanism that can offer no assistance to protect member states against the next crisis. Finally, there is conditionality attached to Recovery Instrument loans and grants.

At the same time, there is also movement 'forward' because more generous terms on lending were agreed – through the ESM, SURE, EIB and NGEU – as were €390bn worth of additional grants funded through a time-limited form of debt mutualization. While the ECB did the heavy lifting through its non-conventional monetary policy, these additional funds contributed marginally to the prevention of debt default in Southern Europe and the collapse of the Eurozone. Thus, the additional financial support mechanisms should be understood as a step forward from the mechanisms agreed in response to the SDC, which, in turn, were a step forward from the initial institutional design of EMU.

Conclusion

This article begins with the presentation of an empirical puzzle: why is it that in the face of the worst economic crisis since the start of European integration in the 1950s and the existential threat to the Eurozone, major reforms to EMU – and, notably, adequate financial support mechanisms – have been explicitly blocked or significantly watered down? We answer this question by applying the 'failing forward' pattern to the current macroeconomic crisis. During the Covid pandemic, negative spill-overs from an incomplete and asymmetric EMU (cf. Donnelly, 2021) exacerbated what was an economic shock because existing EU/Eurozone financial support mechanisms were not able to mitigate the macroeconomic crisis, which affected the member states in dissimilar ways and to different degrees. In response to the crisis, member states engaged in intergovernmental negotiations to reform EMU, but they had fundamentally different preferences – rooted in domestic political and political economy considerations – on how to tackle the crisis.

On the one hand, the reforms adopted in 2020 were politically significant and worked to dampen a brewing economic and political crisis – while the ECB undertook the heavy lifting through its sovereign debt and asset purchase programme. The ESM reform in effect moved the EMU construct forward – even though Eurozone member states refused to use its additional lending capacity. On the other hand, these reforms were 'sticking plaster' solutions: they were at best crisis management mechanisms rather than decisive crisis prevention tools. The time-limited nature of the NGEU and SURE, and the limited potential additional loans made available through the reformed ESM failed to equip the Eurozone with the tools to prevent a future sovereign debt crisis and failed to address the underlying structural vulnerabilities of EMU. Although the NGEU is widely presented as significant (cf. Rhodes, 2021), more EMU-specific transfers and permanent mechanisms are needed, while additional borrowing is highly problematic for a number of member state governments. Hence, any solution that is temporary and linked principally to loans on generous terms is not a contribution to reverse the asymmetry between the monetary and fiscal elements of EMU and the growing divergence between North and South in the Eurozone. The recurrent crises of EMU – to date, the sovereign debt crisis of 2010–2014 and the Covid-related crisis, with more to come – reveal a pattern that propels EMU and the EU more generally onward by default rather than by design.

Note

1. Symmetric shocks affect all regions or sectors in a broadly similar manner, unlike asymmetric shocks.

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Notes on contributors

David Howarth has been Professor of Political Science, European Union Studies since 2012 and head of the Robert Schuman Initiative at the University of Luxembourg since 2018. He was previously a Jean Monnet Chair at the University of Edinburgh.

Lucia Quaglia is a Professor of Political Science at the University of Bologna, Italy. Previously, she was professor at the University of York in the UK.

ORCID

David Howarth http://orcid.org/0000-0003-2697-165X
Lucia Quaglia http://orcid.org/0000-0001-8816-0583

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