Why is Next generation Eu an innovative plan
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COVID crisis has been a temporary exogenous shock leading to unimaginable responses such as the NGEU. The size of NGEU is still reduced, but it promotes the sustainability of the national sovereign debt through solidarity and reduces the risk of doom loops between banks and domestic sovereign bonds.

The Covid-19 crisis has been quite different from the 2007-2009 global financial crisis and the sovereign debt crisis in Europe in 2011-2013, where banks and sovereigns were, at least to some extent, responsible for the occurrence of the crisis. Covid-19 is an exogenous shock hitting the real economy both from the supply side due to severe disruptions in the global value chain and from the demand side due to lockdowns and other containment measurements, affecting households and firms.

The gravity of the situation has led to policy responses that were unimaginable in the previous crises. In Europe, one of the most ambitious fiscal programs put in place is the Next Generation EU (NGEU) economic recovery package. Although the NGEU is not the first European fiscal plan, it is remarkable in several dimensions: It includes a mixture of grants and loans, and it is considered a risk-sharing instrument, more than other tools used in the past. Moreover, it is financed directly through issuances of European debt, thus being a more efficient instrument than the regular contributions of the member states to the EU budget for the Multiannual Financial Framework of the EU.

In addition, NGEU has important implications for economic and financial stability. In particular, it can help achieve national sovereign debt sustainability and reduce the so-called doom loop between banks and sovereigns.

The Covid-19 crisis has led to significant increases in national sovereign debt levels due to high deficits combined with significant drops in GDP. According to Eurostat, the average public deficit to GDP in the euro area rose from 0.6% in 2019 to 7.2% in 2020, while the average government debt to GDP ratios increased from 83.9% to 98.0% in the same period, with the highest levels being reached in Greece (205,6%), Italy (155.8%) and Portugal (133,6%).

Despite the significant rise in indebtedness, sovereign spreads remain contained. For instance: the Italian spread versus the German Bund is around 120 basis points, compared to the 500-600 bp observed during the euro crisis. And the rating of the Italian sovereign debt has even recently improved. How is this possible, despite the higher debt levels?

All the public support measures introduced during the Covid-19 crisis help explain market confidence. In particular, NGEU and the Pandemic Emergency Purchase Programme (PEPP) of the European Central Bank, work as signals of reinforced solidarity among member states showing that countries are no longer alone in their fiscal policies, at least in some specific situations like Covid-19. Even more importantly, measures like NGEU aim at boosting growth, which is key for debt sustainability, in particular, if funds are used for productive public projects. Current estimates report that NGEU could increase real output in the euro area by 1.5% of GDP in the medium term, with some countries like Italy achieving 3% additional growth by 2016. Therefore, it is crucial to monitor the use of NGEU funds by member states and ensure these are not spent in alternative ways (e.g., for reducing debt or replacing debt with NGEU loans) to achieve higher growth.

NGEU could also have important implications for financial stability, particularly in terms of containing the so-called doom loop between sovereigns and banks. This word has a double connotation: it first refers to the risk that banks suffer in terms of market value when the spread on their sovereign debt increases significantly because of their extensive holdings of domestic sovereign debt. Second, it refers to the risk that domestic sovereigns have to bail out banks in trouble, even if these are large international banks.

In such a context, NGEU helps reduce the doom loop by delinking the relationship between banks and their sovereigns. As discussed above, NGEU improves national sovereign debt sustainability while the issuance of European debt to finance NGEU promotes the creation of a European safe asset that improves bank diversification.

In sum, the NGEU is a milestone towards EU integration. It contributes to create a solidarity framework, which helps contain national sovereign debt spreads as well as contain the doom loop between banks and sovereign. Yet, it needs to be complemented by the completion of the banking union and an effective capital market union before a real level playing field is reached in the Single Market.