MKI PERSPECTIVE

European Federalists Remain Stuck in a Groove

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The emergence of the debate around the issuance of common EU debt from the publication of the Draghi report shows that the leadership class in the European Union are falling ever more out of touch with the realities facing the European economy. Draghi himself has stated that he regrets the amount of attention the issue is getting because it was only a peripheral aspect of the report[1]. The fact that commentators picked up on the issue of common debt shows two things. Firstly, that they are firmly stuck in the past, trying to push through a project that is not clearly relevant when considering the broader economic and geopolitical problems facing the EU. Secondly, that Draghi's report was not taken seriously by most commentators because it does not actually contain solutions to these problems and so the economic debate in Europe has fallen back into its old grooves.

In fact, the Draghi report barely mentions the issue of common debt issuance at all. The topic gets a single paragraph which states that "the EU should move towards regular issuance of common safe assets to enable joint investment projects among Member States and to help integrate capital markets" further clarifying that "the EU should continue to issue common debt instruments"[2]. Given that this was the only discussion of the issue it is not surprising that Draghi has responded to the debate by stating that "as I love this concept, it is not the main thing in the report… There are many good reasons for having it, [but] it is not an essential ingredient."

To understand the context around the discussions that this single paragraph has generated it is best to return to a speech that Draghi gave in 2023 entitled 'The Next Flight of the Bumblebee: The Path to Common Fiscal Policy in the Eurozone'[3]. Draghi's lecture is the 13th annual Feldstein lecture at the National Bureau of Economic Research and Draghi is quick to note that the namesake of the speech – the economist Martin Feldstein – was highly critical of the European Monetary Union (EMU). Common debt is seen by hardline proponents of the EMU as the capstone to the entire project. In the speech, Draghi is quick to acknowledge that the sovereign debt crisis that he played a prominent role in a decade ago left many critics of the EMU feeling vindicated. But Draghi states in the speech that they are misunderstanding the motivations of the EMU which were not so much economic as they were political. "The goal of building an ever-closer European Union ran very deep, born out of the ashes of the World War Two

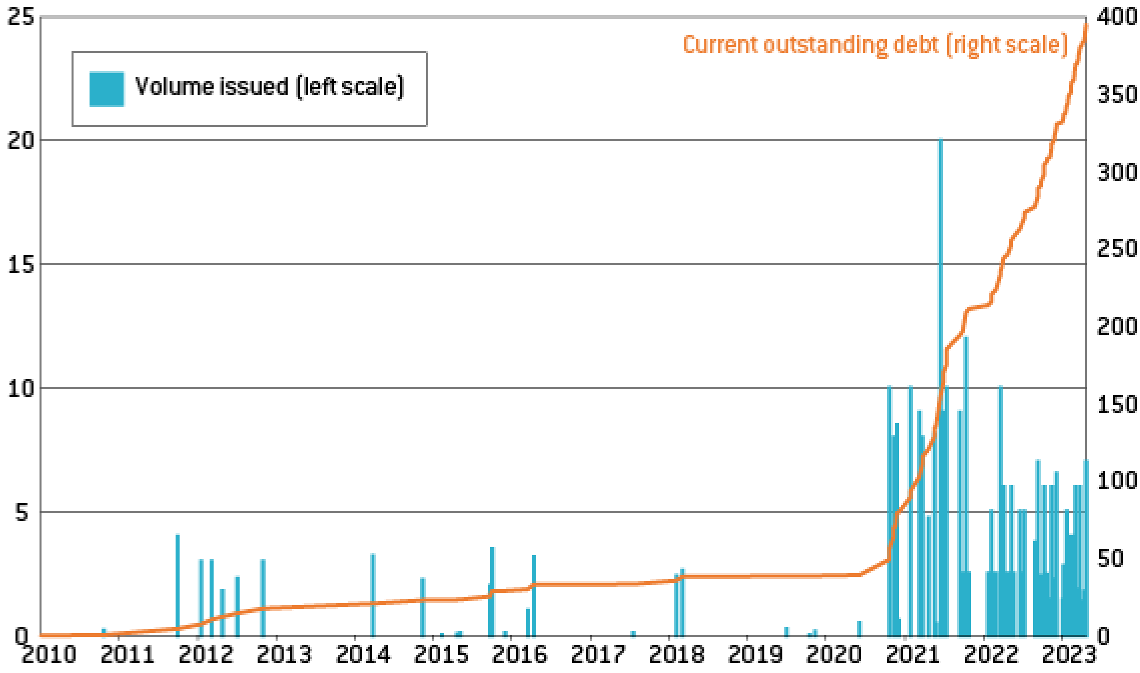
[1] https://www.euractiv.com/section/economy-jobs/news/common-debt-not-essential-for-eu-competitiveness-says-draghi/
[2] https://commission.europa.eu/document/download/97e481fd-2dc3-412d-be4c-f152a8232961_en?filename=The%20future%20of%20European%20competitiveness%20_%20A%20competitiveness%20strategy%20for%20Europe.pdf
[3] https://www.nber.org/lecture/2023-15th-annual-feldstein-lecture-mario-draghi-next-flight-bumblebee-path-common-fiscal-policy

and conceived above all to avoid conflict in Europe," Draghi told the audience, "And the single currency was seen as a fundamental step towards that goal." Furthermore, Draghi admitted that those who wanted to pursue this political program "moved forward, sidestepping our contradictions and knowing that there were serious economic concerns".

If Draghi had made these comments at the time of the European sovereign debt crisis, they would have proved scandalous. But the proponents for further integration of European political institutions have now become so confident in their project that they are willing to state their motivations publicly. In the case of the EMU this is due to developments that have taken place in the European monetary architecture since 2020, specifically the developments that took place related to the European response to the COVID-19 pandemic. Starting in 2020, the European Commission started to become an extremely large issuer of debt in Europe, and this has created an institutional template on which federalists like Draghi want to build.

The European Commission has been issuing bonds for many years to finance various projects. But until 2020, these were very small in scale. But in response to the pandemic, Bruegel[4] estimates that the Commission issued €98.4 billion in back-to back loans that were distributed to 19 countries between 2020 and 2022. The Next Generation EU (NGEU) borrowing program – the same borrowing program that Draghi mentions as a model of future common debt in the competitiveness report – has swollen to €385.8 billion in loans and €338 billion in grants to EU countries through the Recovery and Resilience Facility (RRF). It also provides €83.1 billion in additional support to six EU programmes under the Multiannual Financial Framework (MFF). This has led to total outstanding EU debt that is larger than the national debt of Austria and Greece and will exceed the national debt of the Netherlands by 2024. Behind this debt stands an enormous developing borrowing architecture that involves syndicated transactions and auctions and relies on an extensive primary dealer network.

[4] https://www.bruegel.org/policy-brief/rising-cost-european-union-borrowing-and-what-do-about-it



This debt pile becomes even more interesting from an institutional perspective if we look at how it is guaranteed. Bruegel states that although the Commission borrowing "represents direct and unconditional obligations of the EU to service its debt" there is "still a lack of clarity of which common resources will be raised at the EU level". Currently, the only explicit commitments to financing this debt are a direct guarantee from the EU budget and a commitment of each national government of up 0.6% of their gross national income if additional revenues are needed to make repayments. The inherent vagueness in this framework, together with the limited buy-in from members states, creates a huge opportunity for those who want to push for common debt to gain a foothold. All that needs to happen is for Commission borrowing to increase even further – perhaps in response to another crisis or recession in the future – and pressure will be put on the national governments to commit to more explicit guarantees.

It is not hard therefore to see why those who are critical of further federalism are quick to jump on the short paragraph that Draghi included in the competitiveness report. Given the developments that have taken place since the pandemic, there is now a credible framework for which to issue common EU debt through and a credible path by which to do it. Yet even the way in which the debate has gone public strongly hints that the federalists in the EU are fighting the last war. Draghi is not wrong to argue that his competitiveness report was not about common debt issuance – and indeed common debt issuance has very little, if anything, to do with European competitiveness. Draghi's report was issued in response to an enormous shock experienced by the European economies and by the policymakers who oversee these economies: the Russo-Ukraine war and the sanctions policies that have emerged out of the conflict.

The entire project of the EMU is based on the idea of Europe as a serious competitive player on world markets. Europe's economic identity, more so than any other large economic bloc in the world, is based on being extremely open to trade. The European economy is currently around 2.8 times more reliant on external trade than China and around 3.9 times more reliant on external trade than the United States[5]. This is not by coincidence but by design. Going right back to the origins of the EU project, the union has sought to be a bloc that would be able to seamlessly integrate into a globalised world economy based on free trade. If the EU cannot do this then the fundamental premises of the entire project – premises that are *far* deeper than any issues related to monetary union or common debt issuance – collapse and the entire EU project lacks a rationale at a very basic level. It was in response to this that Draghi was tasked with exploring ways to maintain the EU's competitiveness.

But because the EU has now been trapped in an ongoing and seemingly accelerating geopolitical conflict – one that is increasingly fought at an economic level – the premises for its existence are disappearing. The first and most obvious blow here are the high energy prices that are currently destroying European and, especially, German industry. These high energy prices are since the EU has had to replace cheap Russian piped gas with expensive LNG from the United States (and now increasingly from Russia – ironically)[6]. LNG tends to be around 40% more expensive than piped gas due to compression and transportation costs and this premium is reflected in substantially and structurally higher European electricity prices that are leading to upward pressure on both wage costs and business costs in the EU. The second blow is the move on the part of the EU toward protectionism, especially against China. Some of this is motivated by the loss of competitiveness due to the lack of cheap energy, but much of it simply signals a very weak European leadership that tends to copy the policies of the United States without considering whether these policies are suitable for Europe.

These two issues represent an existential challenge for Europe. There is a strong argument to be made that the Draghi report has shown itself unable to address these core issues and has instead fallen back on secondary issues related to EU competitiveness. But even this argument assumes that commentators and policymakers actually engage with the Draghi report. Instead, what we are seeing is that these commentators and policymakers are completely stuck in debates from ten years ago – debates that are of peripheral relevance to the EU and its economy today. EU policymakers seem completely unable to face the realities that have been thrown up by the changes in the world order that have taken place over the past decade and so they are forced into engaging in debates that can only be described as nostalgic.

Five Key Points

[5] https://hiia.hu/wp-content/uploads/2024/08/0827_EV-Tariff-Policy.pdf

[6] https://www.highnorthnews.com/en/russia-still-second-largest-gas-provider-eu-after-norway-lng-imports-increasing

- The Draghi report has stirred up a discussion about the potential issuance of common debt by the EU, but this is unusual because the report only contained one paragraph on the topic and Draghi has stated that it is a peripheral issue to EU competitiveness.
- The response to the Draghi report must be understood in the context of the massive bond issuance undertaken by the European Commission in response to the COVID-19 pandemic and the lockdown policies in 2020 and in the years that followed.
- The European Commission now possesses a debt stockpile worth hundreds of billions and which is larger than the outstanding national debt of countries like Austria and Greece and which will grow larger than the outstanding national debt of the Netherlands by 2024.
- The rules surrounding financing this debt are sufficiently vague that they might be used to force through a move toward common EU debt in the event of another crisis and this is why commentators have homed in on the single paragraph in the Draghi report – a report that was at least trying to address the existential competitiveness issue facing the EU.
- Considering the recent geopolitical developments that have led to expensive energy destroying EU competitiveness and self-destructive tariffs aimed at China, the issue of common debt feels like a ‘nostalgic’ issue discussed by people who are dealing with problems that are a decade old and are peripheral in comparison to the existential crisis that the EU currently faces.