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EU ECONOMIC POLICY RESPONSE TO THE CORONAVIRUS PANDEMIC

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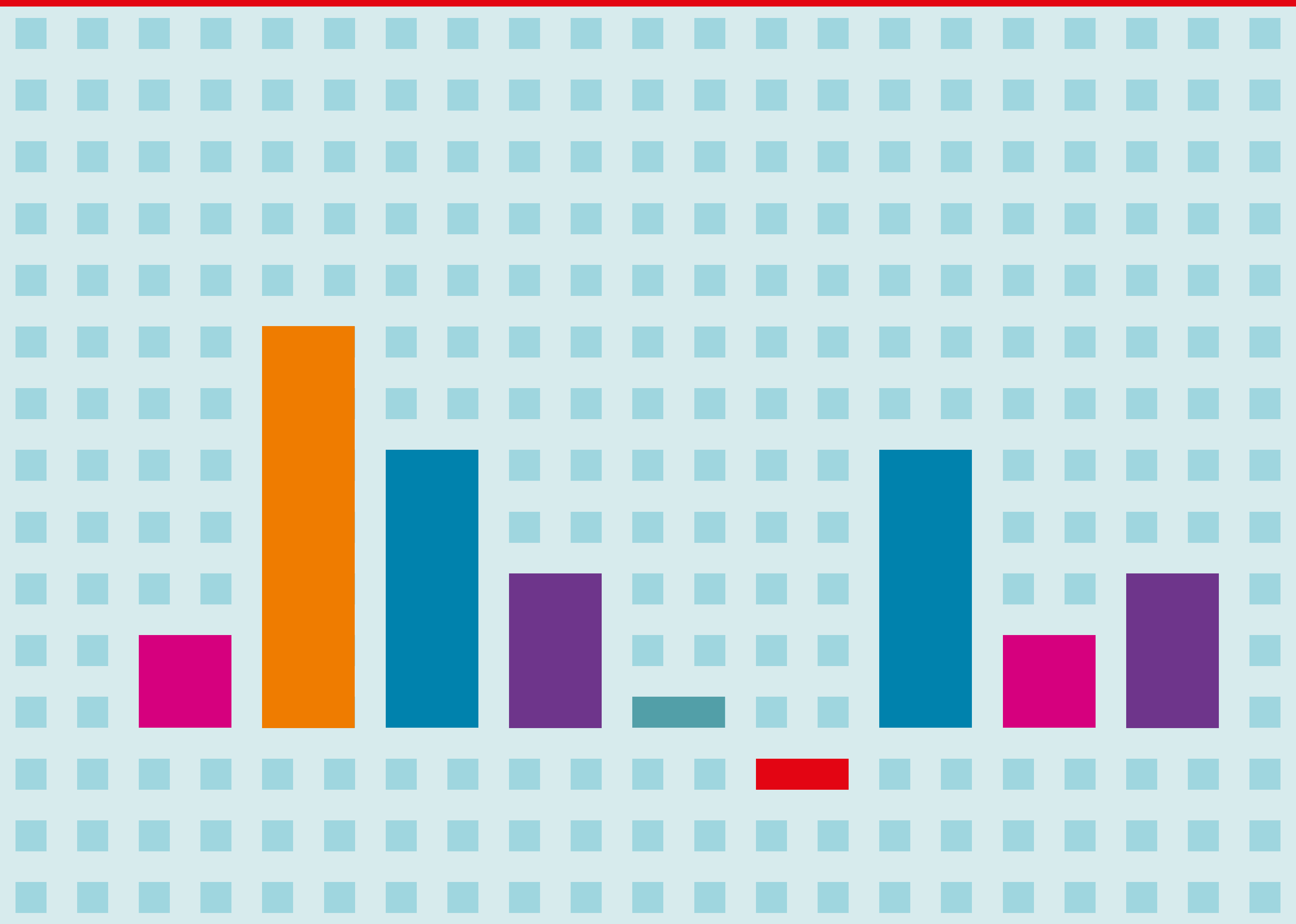

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The coronavirus pandemic came out of the blue in early 2020. Originating in China it has steadily spread around the world. In addition to the cost in terms of human health and lives, the virus has taken a wrecking ball to the global economy. Initially workers stayed away from work due to illness or out of concern about getting infected. People avoided unnecessary contacts, hitting social consumption. Governments introduced lockdown measures of various degrees of stringency to limit the spread of the disease. Firms were shuttered, workers made redundant or put on short-time working schemes. Complex global production chains unravelled such that even where workers might have been able to continue operations by maintaining distance, stoppages occurred due to missing inputs or disruption to downstream activities including final sales.

Even as the worst of the health crisis – or possibly merely of the first wave – appears to lie behind Europe, the extent of the economic damage has become apparent. In its Spring economic forecast, the European Commission pencilled in a massive hit to growth in 2020: -7.4% in the EU 27, -7.7% in the Euro Area, and even more substantial losses, approaching 10%, in the hardest-hit countries (Greece, Italy, Spain). While a partial recovery is foreseen for the second half of 2020 and into 2021, this is highly uncertain. Alongside the fundamental uncertainty surrounding the future course of the pandemic (including possible progress in finding a vaccine or effective treatments), outcomes will clearly depend on the economic policies that countries adopt.

In Europe, the short-term emergency response to the crisis has rested primarily on the shoulders of EU Member States. This is hardly surprising, as tools for common management of the business cycle are lacking and efforts to institute them will take time. Germany for instance announced a major package of measures to simulate activity and shield workers, the self-employed and companies from the effects of the shutdown. In early June a second package was announced. Other countries, though, found themselves in a less favourable fiscal position and thus risked being much more constrained in their policy response.

In this policy brief we focus on measures taken at European level, which in many respects set the legal and economic-policy framework within which the member states can and must act. In keeping with their respective mandates and responsibilities, the European institutions have already taken a range of measures to combat the economic impacts of the coronavirus crisis. At the time of writing, other measures are being finalised or are the subject of negotiations on the European Council, most recently and importantly the European Commission's proposal for a €750bn Recovery Plan for Europe.

The measures are reviewed briefly here, broadly in chronological order. The focus is on economic policy measures; actions taken in the area of public health and the issue of the imposition (and subsequent relaxation) of controls at national borders are not considered. In view of its potential significance we evaluate in some detail the Commission's Recovery Plan, even if it remains unclear in what form it will finally be adopted. The policy brief concludes by considering what additional measures the EU would need to implement in order to emerge strengthened from the crisis and address longer-term challenges.

EU state aid and fiscal rules loosened

Already in mid-March the European Commission triggered the Stability and Growth Pact's general escape clause. The classification of the coronavirus crisis as an "unusual event outside the control of government" meant that all member states are temporarily exempted from the constraints of the fiscal rules when formulating and implementing national policies to combat the pandemic and its economic impacts.

Similarly, the Commission acted swiftly to lift statutory restrictions on State aid that could prevent national governments from supporting businesses affected by the crisis. A "Temporary Framework" was created in order to accelerate the Commission's approval procedures for member states wishing to adopt national support measures (subsidies, guarantees, etc.).

These moves by the Commission created greater legal certainty and eliminated obstacles to the rapid provision by member state governments of financial support for businesses, including small and medium-sized enterprises (SMEs) and the self-employed. However, although both measures remove the immediate legal constraints, they do nothing to prevent the financial markets from imposing fiscal constraints. There is a danger that the increase in public debt as a result of the fiscal measures could cause investors to demand higher risk premiums for government bonds. And interest rate spreads did indeed increase as the crisis escalated in Italy and Spain. A combination of monetary policy support and fiscal solidarity is required in order to mitigate the vicious circle of rising interest rates and debt servicing difficulties, with all the dangers that this entails.

Further monetary policy easing

In terms of monetary policy support, the ECB initially responded with a package comprising measures to support banks by offering more favourable terms for long-term refinancing operations (LTROs), the expansion of targeted longer-term refinancing operations (TLTROs) and an expansion of quantitative easing (QE). However, these measures were deemed insufficient to prevent an increase in government bond spreads. As a result, on 18 March the ECB announced a new scheme known as the Pandemic Emergency Purchase Programme (PEPP), which significantly expands the ECB's QE programme by €750 billion in 2020; in early June this was increased by a further €600 billion and the scheme extended to mid-2021. Bond buying can temporarily deviate from the ECB's capital key, enabling targeted support for the worst-affected countries.

With this measure, the ECB has taken a big step towards mitigating the immediate danger to individual countries' public finances from self-fulfilling prophecies. It should be stressed that this is a temporary measure and falls short of the ECB fully assuming the role of lender of last resort. It remains to be seen for how long and to what extent deviations from the capital key will be permitted. Moreover, if a country's credit rating is downgraded to below investment grade, it will have to apply to the ECB for a waiver such as that already granted to Greece. The recently reignited dispute between the ECB/ECJ and Germany's Federal Constitutional Court casts a further shadow over a European strategy that relies chiefly on monetary policy.

In view of the above, the only solution is to reduce the burden on the member states' national budgets by providing fiscal support at European level. However, the discussions concerning fiscal support have been held up by political disagreements.

Difficulties in agreeing meaningful European fiscal support

The Commission initially announced that it intends to reprioritise certain budget items in order to provide support e.g. for SMEs. However, the extent of these funds is limited. The scope of the EU Solidarity Fund, which was created for natural disasters, could be extended to include the coronavirus crisis. However, less than €1 billion is currently available through this fund. The Commission proposed to make a much larger sum available (around €37 billion in total) by drawing on unused Cohesion Fund money. However, there are doubts about the extent to which this will actually enable additional expenditure and whether it will ease the burden on budgets where this is most urgently necessary.

The role of the European Investment Bank (EIB) has been strengthened with the establishment of a Pan-European Guarantee Fund on top of the €40 billion package announced in March. By providing €25 billion of extra guarantees, the member states will support an additional €200 billion of EIB lending. These loans will primarily be made available to SMEs.

A third element is the European Commission's proposed SURE programme (Temporary Support to Mitigate Unemployment Risks in an Emergency). Established to provide financial support for national short-time work schemes and other similar measures, the programme has a sizable budget of up to €100 million. The member states provide guarantees and are not required to provide capital upfront. Only subsidised loans are provided, not grants, however. This means that national debt burdens will only be reduced to the extent that the interest rates and terms of these loans are more favourable than on the bond market. For as long as the ECB is ready to keep yield spreads within narrow margins via PEPP and other measures, it is hard to see how the fiscal support provided by the improved credit terms can be macroeconomically significant.

Debate on the provision of fiscal support was for long focused on the European Stability Mechanism (ESM), an intergovernmental institution founded after the euro crisis to help countries that have lost access to the financial markets to finance necessary public spending. As with the IMF, ESM loans are subject to conditionality and thus constrain national economic policy. This made using the ESM attractive to member states concerned about debt mutualisation, such as the Netherlands and Austria, but politically toxic in others.

Following tense negotiations, a compromise was struck making ESM crisis loans available to all euro area member states up to an amount of 2% of their GDP, without the usual conditionality. However, this new credit line (Pandemic Crisis Support) will only be available until the end of the Covid-19 crisis, without it being clear how this endpoint will be determined. It will also be restricted to financing of direct and indirect healthcare, cure and prevention costs. Yet such costs account for only a small percentage of the expected impacts on the public finances, most of which will result from the decline in economic output. Moreover, these fiscal effects will endure long beyond the end of the immediate public health crisis.

As in the case of the SURE programme, the expanded ESM facility will in principle do little more than offer low-interest loans in a situation where, thanks to the ECB, market access and interest rates are not the main problems. The obligation to repay ESM loans will limit the options of fiscal policy in coming years. Moreover, domestic political opposition and the prospect of being stigmatised on the financial markets mean that there is very little incentive for countries to take advantage of these loans.

Pressure grew for the EU to respond to the coronavirus crisis by making changes to its seven-year budget, known as the Multiannual Financial Framework (MFF). The EU budget is equivalent to approximately just 1% of the European Union's GDP and has only a limited redistribution effect and a negligible impact in terms of stabilisation (Pasimeni and Riso 2016). Since the next MFF (for the period 2021-2027) was in any case being negotiated, there was an opportunity to rethink and adapt it in the light of the current challenges. Policymakers have been discussing various proposals involving a significant temporary increase in the budget contributions, to as much as 2% of GDP. This could also create space for the EU Commission to borrow on the markets and distribute funds, as grants or loans, to the individual member states. The joint debt would be serviced out of the EU budget. This would constitute an alternative to issuing joint bonds: there have been proposals for joint-and-several-liability coronabonds or recovery bonds in various shapes and forms (Bofinger et al. 2020; Grund et al. 2020), but these have met with considerable political opposition.

The Spanish government took the lead with a proposed €1.5 trillion recovery fund that would be financed in this way.[1] On 18 May the French and German governments issued a joint proposal which included a €500 billion recovery fund providing grants to hard-hit countries (Presse- und Informationsamt der Bundesregierung 2020). Shortly after, on 27 May, the European Commission presented its recovery fund proposal, under the title Next Generation EU, which will be the basis for negotiations in the coming weeks (European Commission 2020a).

The European Recovery Plan

The Commission's plan takes on board the substance of the Merkel-Macron statement, and embeds the recovery fund in the EU budget, but it goes beyond it in some respects. The additional budget "headroom" would be used as a guarantee to permit the Commission to raise €750bn on financial markets, half as much again as in the Franco-German proposal. These funds will then be transferred (€500bn) or lent (€250bn) to member states. The maximum funding available to each Member State is calculated as a function of population, GDP per capita and unemployment, (rather than the shorter-run crisis impact. Spending is to be channelled using existing EU programs (such as structural and cohesion funds) and following national recovery plans drawn up by the member states and approved by the Commission. This latter fact seems set to give greater importance to the country specific recommendations addressed by the Commission to the member states – but so far largely to little avail (Koll/Watt 2018: 11ff., Dullien et al 2020: 17ff.). The disbursement is frontloaded to the period 2021-2024. Reimbursement is foreseen to begin in 2028 for a duration of 30 years. If the Commission will not have succeeded in obtaining additional own resources (such as a web tax, plastic tax, or carbon border levy), member states will need to increase their contribution to the EU budget.

The MFF-based proposals culminating in the Next Generation EU initiative of the EU Commission represent a major breakthrough for two reasons: first, they put in place a common macroeconomic stabilisation capacity; second, they establish the principle that this capacity is used according to need rather than to the size of contributions. While the Recovery Fund is explicitly conceived to be temporary, it can be used as blueprint for future discussions about a permanent Eurozone fiscal capacity.

The proposal is, however, still awaiting approval from the Council, which will need to be unanimous. Opposition is confined to a small and dwindling number of smaller member states, but some loss of ambition is to be expected in the final version accepted by member states. Because the Fund is based on European transfers (or loans) to national governments there has, predictably, been considerable debate on whether each country will get its "fair share"; the venerable juste retour debate rears its head once more. Perhaps deliberately, identifying the extent of likely benefits for each member state is not an easy task as the specifications – provided in a Commission Staff Working Document (European Commission 2020b) – are complex and patchy: they vary across different elements in the package and are lacking for some. Darvas (2020) makes an attempt, in spite of the

[1] https://english.elpais.com/politics/2020-04-20/spain-proposes-a-15-trillion-coronavirus-recovery-fund-financed-through-perpetual-eu-debt.html

uncertainties and with recourse to some assumptions, to compute the likely distribution from Next Generation and the larger EU budget. Overall he concludes that the distribution of the grants is at least as much driven by the goal of cohesion (countries with low GDP per capita receive most as a share of their output) as by that of offsetting the impact of the pandemic (those with the biggest downward revision in output get the most). The distribution of the loans cannot be calculated as take up is not clear: but it will disproportionately benefit those countries whose market rate of interest is high. In terms of grants and guarantees, Italy and Spain are set to benefit most in Euro terms; as a percentage of gross national income, Bulgaria, Greece and Croatia are the biggest beneficiaries, followed by central and eastern European countries. Here the estimated impact is quite substantial 6-10% of annual output spread over several years.

Evaluation

It appears that lessons have been learned from the Euro Area crisis. The ECB reacted swiftly, massively increasing liquidity support and relaxing its bond purchasing rules. The European Commission has relaxed potentially restrictive rules and begun to mobilise resources at EU level to combat the immediate impacts of the Covid-19 crisis. However, almost all the support measures actually implemented – the Recovery Plan has yet to be agreed – come in the form of loans. In practice, any benefits for the countries in question will be mainly confined to the difference between the interest rates (and terms) of the loans made available through these different programmes and the conditions that they could have obtained on the financial markets. If the ECB’s current measures go unchallenged, the actual level of support provided to countries through these loans is likely to be relatively minor in macroeconomic terms. Such loans do, though, offer additional security to member states that their borrowing costs will not suddenly rise as a result of a crisis of confidence.. Moreover, the measures serve to take the pressure off the ECB and supposedly demonstrate the member states’ political will to take action. This makes it easier for the ECB to carry on with the same policies, which in the wake of the ruling by the German Constitutional Court is important.

However, the scale of the support implicit in the programmes that have been decided to date fails to come even close to what is needed to tackle the enormous challenges facing the member states. European policymakers have, though, at least recognised that, given the severity of the current crisis, if lasting damage is to be averted it will be necessary to communitarise (part of) the additional public debt accumulated by the member states as a result of the coronavirus pandemic. Not least in Germany, policymakers, and notably Chancellor Merkel, have been at pains to get the message across to voters that Germany cannot thrive if large parts of Europe are in penury. Such recognition of economic reality was sorely missed in 2011/12.

As discussed above, the Commission proposal for a Recovery Plan, if implemented, will mark a sea-change in European integration: Joint borrowing with a distribution of the proceeds in terms of need; the volume of around 5% of (annual) GDP; the considerable scale of redistribution both geographically and intertemporally. A few months ago no-one would have seriously forecast such a development in European fiscal relations.

However, even if the recovery plan is adopted in something close to its proposed form – this will hopefully be decided at a European Council meeting in the second half of July, but might well be postponed until after the summer – a number of questions remain. Will a fund providing something in the order of three-quarters of a trillion Euros, be sufficient? It represents around €1500 per citizen spread over a considerable number of years. If a recovery sets in towards the end of this year, prompted by vigorous national stimulus packages, and there is no further derailment from a severe second wave of the pandemic, maybe – at least in terms of the goals of repairing the damage caused and bringing about a cyclical recovery. But if the Corona virus raises its head again in Europe during the winter, even this unprecedented fund will quickly prove inadequate.

A second question relates to the links between the provision of EU funds and member state policies. There are concerns that the possibility for the Commission to withhold financial support could be used to force through, in an intransparent way, a one-sided vision of appropriate economic (and social) policies. Equally, though, in a monetary union, national economic policies have important cross-border externalities. There is an objective need for policy coordination, and the fact that policy recommendations under the European Semester have been largely ignored – the failure to sanction Germany for its persistent excessive current account surpluses being a case in point – is a serious weakness of economic governance. The way to resolve this dilemma is to reform the European Semester and the associated Macroeconomic Imbalance Procedure. As argued in more detail in Dullien et al. (2020: 17ff.), the MIP needs to be made completely symmetrical in terms of the set of indicators used. Country-specific recommendations should also be limited to those areas where there are clear cross-border implications; otherwise subsidiarity considerations suggest that member state autonomy should be respected (Watt 2019). At the same time, the Member States should coordinate their economic policies in national Macroeconomic Dialogues, in such a way that mutually consistent policy mixes are achieved that deliver balanced economic developments (Koll/Watt 2018: 21ff.) Greater involvement of the European Parliament to improve democratic oversight and transparency is also a priority; the CSR process can no longer remain a purely technocratic exercise and its essentially political nature must be fully recognised (see also Guttenberg/Nguyen 2020).

What is still lacking, above all, is a genuinely European answer to the longer-run, intertwined challenges facing Europe. All the proposals discussed in this policy brief amount to grants or loans to member states to facilitate the implementation of what remain – even if there is some coordination – member state policies. Still missing is a concrete programme of substantial, EU-wide public investment in areas such as the transport infrastructure, power grids and decarbonisation programmes, and, not least, public health.

In Creel et al (2020), concrete and costed examples of such projects in these fields are given, including for a high-speed rail network, an electricity grid to transmit emissions-free electricity and a coordinated public health strategy under the auspices of an EU agency. Alongside a packet of support measures for member states of half a trillion euros, the authors conclude that a ten-year investment programme containing such EU-level measures, with a budget of €1.5 trillion euros, could eminently be financed on the markets at very low interest rates. It would create a safe asset which would facilitate ECB monetary policy and provide private investors with a vehicle in which to place their funds safely, avoiding panics and breaking national sovereign-bank doom-loops. The associated investment would provide the necessary boost (also via an expectation-stabilising effect) in the short run, while making a major contribution to longer-run EU goals – raising living standards, promoting cohesion and accelerating the needed decarbonisation of economic activity.

What is encouraging is that, faced with the pandemic-induced crisis, just as in the financial crisis, old taboos are being broken. The EU that emerges is likely to be quite different from the EU that entered the crisis in 2020. Yet there is opposition, and much remains to be done to convince foot-draggers of the economic advantages, and in many cases the necessity, of coordinated action by the EU level itself. As founding father Robert Schuman already recognised back in the 1950s, it is by visibly delivering concrete public goods that citizens value that Europe is built.

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