Teneo

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# COVID-19 - Coping with economic emergency and rebooting the economy

## Summary

The EU's response to the economic impacts of the COVID-19 crisis is producing a series of effects on national and EU finances, and the legislative process, ultimately posing risks to the EU's internal market. First, major differences in the concrete **economic impact of Covid-19** on the different member states have resulted in highly divergent responses by member states, potentially distorting the EU's internal market. Stimulus measures by individual member states and the European Central Bank have represented the **"first line of defence"**. At **the EU level**, leaders have agreed on financial instruments totalling over EUR 500bn through the European Stability Mechanism (ESM), liquidity guarantees by the European Investment bank, and the SURE program aimed at limiting mass layoffs as a result of the crisis. The European Commission also plans to present a **European Recovery Mechanism** (worth EUR 500bn entirely in grants), which has already been backed by France and Germany. Overall, the current emergency is speeding up EU decision-making, accelerating processes that would usually take years to materialize.

## The economic impact of the crisis

The lockdown has led to an unprecedented economic downturn in the EU. Annual GDP for 2020 is expected to fall by 7-8 percent. The EU decisionmakers envisage three stages leading to the eventual recovery:

1. In 2020, the crisis will persist with a gradual tapering off towards the end, unless a serious second wave of the pandemic occurs.
2. 2021 will begin with a sustained contraction of GDP, with a gradual turnaround by the end of the year.
3. Finally, for the period 2022-2023, recovery and return to growth is expected.

A major challenge will be to manage the great differences the pandemic has on individual countries depending on the seriousness and duration of the virus outbreak, the relative economic importance of sectors particularly affected by the crisis (such as tourism), and a country's import- or export-dependency. The state of their economy and public finances before the crisis also plays an important role in determining the depth of the crisis in individual countries.

### Member State Examples

- *Italy and Spain*: Early and widespread contagion, high export dependency (incl. tourism) combined with a fragile economic and political situation before the crisis.
- *Greece and Portugal*: Less affected by contagion than other southern countries, but with a strong dependency on tourism. Economy and public finances are improving but still fragile.
- *Belgium*: Most severe COVID-19 situation in the EU (although the difference in the employed statistical method makes cross-country comparison more difficult) and an unstable political situation following federal elections in May 2019 with a caretaker government in place. Highly export-dependent with a high degree of exposure to the impact of Brexit.
- *France*: Widespread contagion. Recent improvements in the economy at risk from the economic impact of the crisis.

- *Germany*: Relatively low levels of contagion. Solid public finances and the ability to offer generous economic support to its industry. Highly export-dependent (e.g. cars).
- *Nordics and Central European Countries*: Relatively low levels of contagion. High export dependency in general, and in Central Europe a large dependence on sub-contracting by German industry. Public finances generally in good shape, but economically Central Europe is still catching up with Western Europe.

## The first line of defense

### National Governments

EU restrictions on national public spending (Growth and Stability Pact) had been suspended from the start of the crisis, resulting in a boost of national expenditures on a safety net for unemployed, liquidity support to enterprises and, in some countries, direct capitalization of firms (i.e. solvency support). On average, the increase in national expenditure amounts to 3 percent of EU GDP. However, there are great variations – 1 percent in Italy and Spain and 10 percent in Germany. The latter will create a positive macroeconomic effect in other EU countries but, at the same time, lead to divergences that could distort the internal market, unless the duration and purpose of the support is restricted by the European Commission, and national measures are gradually replaced by EU recovery intervention.

### European Central Bank

The European Central Bank (ECB) has been at the forefront in keeping the European economy afloat. The current plan is to spend around EUR 1trn in 2020 in quantitative easing, mainly through the purchase of national treasury bonds. The focus of the interventions is to suppress interest rates on bonds issued by fiscally weaker member states. ECB president Christine Lagarde is prepared to go even further if needed (and hopes that a recent judgment of the German Constitutional Court does not cause problems for her plans). From the start, Lagarde has stressed that under present monetary conditions (i.e. interest rates below zero), the ECB cannot keep the ship afloat on its own. There is an urgent need for EU fiscal measures to complement the ECB's efforts.

## Collective EU Action

The EU has used a combination of looser fiscal rules and spending to stimulate the economy. The targeted measures include:

- **30 March 2020:** Member states were allowed to transfer EUR 37bn of unused EU-budget allocations for COVID-related spending.
- **23 April 2020:** EU leaders agreed three financial instruments totaling EUR 540bn (3 percent of EU GDP):
    - A pandemic support mechanism under the bank-bailout fund, European Stability Mechanism (ESM), creating up to EUR 240bn in long-term loans at low-interest rates to finance direct and indirect care, cure and prevention costs related to COVID-19. Contrary to normal ESM support, only a few conditionalities were attached to this support.
    - EUR 200 billion in additional support from the European Investment bank in the form of liquidity guarantees to SMEs.
    - Funding worth EUR 100bn under the SURE programme aimed at minimizing mass layoffs.

All three measures are based on a collective guarantee from member states, and a small amount of "seed money" from the EU budget, which allows the EU institutions to obtain the necessary loans in the market to finance the measures. The legal framework for the three programs is almost ready, which is an unprecedented speed in the EU's legislative procedure. Leaders also decided on 23 April that additional collective measures would be needed through an **Economic Recovery Fund** and asked the Commission to quickly make proposals.

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# EU budget, Multiannual Financial Framework (MFF) and the Recovery Fund

Since the end of April, the European Commission's senior leadership has worked on the blueprint for the **recovery mechanism:**

- To place the creation of the Recovery Mechanism inside the EU budget and the MFF.
- To direct investments towards achieving the EU's strategic goals regarding the European Green Deal and the digital agenda and ensure that the EU is not caught unprepared in future crises.

The crisis and use of EU funds for the recovery have sharpened the focus on reaching an agreement on the EU's budget framework (MFF), for which negotiations derailed in January. To this end, the Commission proposes to:

- Endorse the MFF proposal that the European Council President Charles Michel put forward in January, with an overall ceiling corresponding to 1.05 percent of EU GDP. Pre-empting concerns from fiscally conservative EU states, the Commission has pointed out that the decrease in EU GDP will reduce the budget by 7.5 percent in real terms.
- propose greater flexibility in the use of budgetary resources and front-loading of expenditure to the first years in the MFF.

On the top of the "normal" budget, the Commission proposes a recovery mechanism with a limited duration (5 years) that will provide grants and possibly loans to member states. The mechanism would be financed by the Commission borrowing directly on financial markets. This amounts to **a historic departure from EU-orthodoxy, which requires that EU's budget is in balance.**

To enable borrowing on the market on sufficiently attractive terms (credit rating AAA), EU leaders are considering an increase in the EU's 'own resources' ceiling (the maximum amount of money the EU can collect – i.e. its "tax base") from the present 1.2 percent to close to 2 percent. Several hundred billion euros will be raised in the short term (2021-22) and paid back later (after 2027). EU policymakers will also have an incentive to look at new own-resources funding streams such as digital taxation, particularly because revenues in the digital sector have skyrocketed during the crisis. Expenditures will be focused on three pillars:

- The bulk of the money would go to public investments linked to the European strategic goals (green deal, digital agenda, and crisis resilience).
- The fund would also help to kickstart the economy in key sectors and technologies including 5G, artificial intelligence, clean hydrogen, and batteries, as well as strategic autonomy in the pharmaceutical sector.
- Finally, it would also strengthen existing programmes such as RescEU, Horizon Europe, and a dedicated Health program.

The balance between loans and grants in these plans remains a point of dispute, tipping in favour of grants when on 19 May **French President Emmanuel Macron and German Chancellor Angela Merkel presented a joint proposal**. The Franco-German proposal also put a price tag on the recovery mechanism – **EUR 500bn entirely in grants** – to be concentrated on the regions and the sectors most severely hit by the crisis. The Commission will present its proposal on 27 May, at which point it will become clear if it has followed the French-German grants-only approach or maintained a loan component in the package. It will also need to decide which share of the money goes toward sectors hit by COVID-19 and how much is earmarked to fund new EU priorities.

## Next steps

After the presentation of the Commission's proposal, it will be up to the EU leaders to debate the matter at a summit on 18-19 June, which may take place on-site in Brussels or again via video conference. European Council President Charles Michel will prepare the ground in the meantime with video calls with EU leaders. The detailed preparatory work will be made by EU ambassadors, which will later be joined by 'sherpas' negotiating on behalf of EU heads of state. Ministers responsible for the EU, economy, and finance will also play a supporting role in the negotiations, which in principle take place at the highest political level. Normally the task at hand would take years to accomplish, but the pressure of the ongoing crisis demands that decisions are taken in a course of months, including ratification by national parliaments. As a result, interim measures may be invented to ensure the provisional application of the package before all the paperwork is complete.