COVID-19 Recovery Plan: The EU's "Hamilton Moment"?

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The COVID-19 pandemic is turning the five plans of the EU's new executive, the Von der Leyen Commission, upside down. The Commission had set out a detailed policy program and plan of action for its fifth year in office. A "Green Deal," as well as a "digital strategy," were at the top of the list, but the plan also included many other proposals, reflecting the tall ambitions of the 27 Commission members, each anxious to have a significant impact.

COVID-19 has encouraged a policy process that is primarily focused on addressing the requirements of a post-COVID world. Most EU citizens also still believe that climate change and a digital strategy should remain top policy priorities as well and that COVID has only served to increase their importance. Finally, a more assertive and proactive role for the EU on the global stage also remains on the list of top priorities within the policy agenda, however, the realization of this last point will depend on how effectively the EU can cope with the economic policy challenges that have arisen as a result of the pandemic.

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The EU's ability to successfully handle the challenges COVID has presented, as well as assert itself more readily on the global stage, will be the determining factors as to whether the COVID crisis will turn out to become a new beginning for the European Union, a "Hamilton" moment, or if the ambitions will amount to nothing more than a "muddling through" of the issues, waiting for better times.

Member States Affected Differently

The virus outbreak that spread from China to Europe brought the EU economy close to a standstill for roughly four months, and as a result, the EU has suffered consequences that have been at least twice as severe as the 2008 financial crisis. In fact, in 2020, Europe experienced the deepest output contraction since World War II, with a fall in GDP close to 9%. It can only expect to recover its previous strength by the end of 2022, and only if it is not hit by a second wave.

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The COVID crisis was imported from abroad and affected all member states. Contrary to the financial crisis, individual member states could not be accused of prior reckless behavior. It was pure accident that COVID-19 first spread with devastating effect in northern Italy, the wealthiest of the Italian regions, well-equipped with modern hospitals and sanitary systems.

The economic effects on individual member states were not only determined by the intensity of the pandemic, but also by the extent to which important sectors were hit by fall in demand from abroad, as well as by the pre-crisis state of the economy. Both Italy and Greece suffered annual GDP falls of more than 11%. But while Italy – with Spain not far behind – was the country most severely affected in health terms, Greece experienced a much more benign attack. However, the Greek economy had just emerged from a decade of negative growth, and two main sectors of the economy, tourism and maritime transport, were deeply affected by the close-down.

The European Union was criticized for being absent at the start of the crisis, but the EU has little responsibility in terms of health issues; member states and their respective regions are charged with bearing the brunt of the domestic healthcare needs. The EU became more deeply involved only after member states, in panic, began closing internal and external EU borders without hard data to justify whether this would indeed effectively quell the spread of the virus. In addition, the shortage of PPE, like masks and ventilators, led to the introduction of local export controls, which were averse to the core EU principles of free movement of goods and persons. The European

Commission, in turn, reacted quickly to these moves with emergency "green lanes" for lorries to keep goods floating across internal borders, but it took three months before cross-border movements were once again close to "normal." Since then, the Commission has been busy ensuring that such a situation will not be repeated. This includes creating strategic stocks of medical supplies and making the EU less vulnerable to supply line interruptions. As such, the crisis has strengthened the EU's role in directly addressing health issues.

National Economic Policy Response

At the start of the 2008 financial crisis, a short-lived attempt was made by the Commission to promote a coordinated expansion of national fiscal policy, which ultimately fell to the ground as some of the weaker EU countries experienced financial difficulties. For more than a decade it was left mainly to the European Central Bank to keep the economy going through expansionary monetary policy, while the approach to fiscal policy was dominated by German thinking, with a main focus on bringing the national budget back to balance (the "Black Zero" on public finances). This policy suited Germany and the Northern European countries, who could count on strong export performance to maintain growth, but Southern member states suffered. When a country ran into trouble – like Greece in late 2009 – the EU prescription was strong internal austerity measures as the price to pay for financial support from the EU and IMF.

During this crisis, however, the reaction was very different. The EU quickly decided to suspend the constraints imposed on national budgets through the Stability and Growth Pact, that since the creation of the euro, has prescribed that a state's budget deficit cannot exceed 3% GDP and national debt not surpass 60% of GDP.

In addition to the relaxation of the macroeconomic rules, the Commission introduced major allowances in the EU's state aid discipline. All member states rapidly adopted fiscal stimulus measures to safeguard production and employment. Germany, which had previously been the poster child for fiscal conservatism, took the lead in boosting the economy through liquidity support and direct participation in companies, tax deferrals, and grants to SME's. Various measures to boost consumption like VAT reduction were also put in place. Overall, the German national fiscal expansion accounted for more than half of the total for all EU countries. In Greece, Italy, Spain, and Portugal, the fiscal impulse was only a fraction of what it was in Germany, reflecting the fragility of their public finances.

While fiscal expansion by the rich can have positive spill-over effects on the poor, a discrepancy of this size creates the risk of major distortion of the single market, permitting companies from the stronger economies to gain market share or even take over companies in less fortunate member states.

The suspension of the rules for discipline on national budgets (stability pact) is in principle temporary, but it will take time to turn the clock back. It is doubtful if the same rules will be reintroduced. It makes no sense to operate with a 60% national debt limit when many of the member states (including some of the biggest) will have debt figures exceeding 100%. A greater balance will be called for in the obligations of those that struggle to reduce national fiscal deficits and those that have a comfortable margin. Even in Germany, the "Black Zero" rule has been called into question, and the lesson has been learned that constant excess savings compared to investments and balance of payment surplus is hurting Germany's interest in the long run. However, it is less certain that other Northern member states – especially the Netherlands – have drawn the same conclusion.

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The Central Bank's Crucial Role

During the 2007-8 financial crisis and the following European debt crisis, the European Central Bank took the main responsibility among EU institutions for keeping the European economy afloat. In turn, the crisis transformed ECB from a monetary institute with a focus only on keeping inflation down to a genuine central bank that also takes responsibility for the overall performance of the economy. In 2011, the German member of the Executive Board resigned in protest against the bank's Securities Market Programme. This did not hinder the Bank, and under the Presidency of Mario Draghi, the bank began purchasing sovereign bonds under the contested program and engaging in "quantitative easing," in line with actions taken by both the U.S. Federal Reserve and the Bank of England. Draghi's public declaration that the ECB "would do whatever it takes to save the EURO - and believe me it will be enough," is considered by many as the turning point in the debt crisis in Europe. The ECB was, in the same period, also extending its competences by giving authority over the new European Bank Supervisory body.

During the COVID crisis, the ECB (now under the Presidency of Christine Lagarde) has played an even greater role and launched massive emergency bond purchasing – now with the full backing of the German government and the Deutsche Bundesbank. The ECB has been able to minimize the spread between interest paid by the weaker and the stronger Member States. While Lagarde is as determined as Draghi to do "whatever it takes," she has communicated from the beginning that this time this will not be enough, insisting that a collective fiscal response from the EU will be required to fully address an environment with zero or negative interest rates.

Fiscal Response by the EU

The EU, for its part, has gradually built up a fiscal response from March to July 2020. In the first instance, member states were given unlimited flexibility in the use of allocated EU structural funds, and planned repayment of funds not yet used was canceled. In April, followed a package of measures that facilitated fiscal stimulus in the order of half a trillion EUROs to:

- support direct and indirect health care, cure, and prevention costs related to COVID-19;
- provide guarantees from the European Investment Banks to SME's to avoid insolvency; and
- support Member States' efforts to protect workers and jobs.

This first stimulus package was financed by loans that must be paid back by the recipients over the medium term. The loan facilities have been of special interest for the weaker member states that can profit from the EU's triple-A rating.

The third step was the most important. On the 19 to 21 of July, European Heads met for four full days in Brussels. They succeeded (despite internal tensions) to agree on a framework for EU's annual budgets for the next seven years, as well as an extraordinary package meant to help Europe cope with the economic consequences of COVID-19 that will run for four years. The European Heads overcame widely different interests and economic-political philosophies because of their collective belief that only a unified front would result in overcoming the immense challenges presented by the pandemic.

The total firepower of the final package was somewhat reduced compared to the original plan, but still of a size that makes a real difference in macroeconomic terms. The final result of the negotiations has been further concentrated on the most affected countries. A program entitled "New Generation EU" will, over the coming three years, provide the member states and regions most affected with €390 billion in grants and €360 billion in low-cost and long-term loans (running up to 2058). The funds will support the national interventions needed to protect livelihoods and foster sustainable and resilient growth. Special attention will be paid to investments in the transition to a green, low carbon, and digital Europe. Additional funding will be allocated to EU programs that can make the economies in weaker countries and regions more resilient and sustainable in the crisis repair phase, including repairing the labor market and supporting the building up of a health care system that will be more resilient if another pandemic should strike in the future.

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On the original EU budget, an agreement was reached on a €1.072 billion seven-year program. Again, ambitions had to be reduced, but it was still an achievement to agree on a financial plan that fills the hole left by the UK's departure and still maintains the movement away from spending on old policies (like agriculture) and instead increasing funding for climate and digital policy (the target is that 30% of the budget should promote the climate and the digital agenda), research, defense, and support to neighboring countries.

The Hamilton Moment?

The July 2020 decision was a historic step by engaging directly in a fiscal stimulation of the economy through the EU budget. It is also unprecedented to implement the fiscal boost by deficit spending financed by EU bonds floated on the market. The event has, by some, been termed the European "Hamilton Moment," referring to the historic compromise forged by the first U.S. Treasury Secretary, Alexander Hamilton, when the U.S. federal government in 1790 took over all the debt incurred by the States during the war of independence.

There are valid points of similarities with these historic events. The 1790 U.S. debt was the result of a war against a common enemy. Several European leaders have termed the fight against COVID-19 as a war. The cost of wars has during history often been financed by issuing long-term war bonds. This was also the case with the reconstruction help to Europe offered by the U.S. in the Marshall Plan after WWII, at a time when the U.S. was already burdened by a historically high public debt. The Marshall Plan accounted for less than 3% of the combined GNI of the recipients. The measures agreed upon by the EU in 2020 involve an unprecedented transfer of money from the least to the most affected member states, at a time when they have all seen their public debt reach historic heights. Poorer European Union countries and those hardest affected economically by the pandemic could obtain, over the coming four years, up to 15% of their GNI in grants and guarantees through the recovery instruments.

The Hamilton operation led to the creation of the U.S. dollar, which for a long time has been the world's most important reserve currency. The EURO was only created at the beginning of this century, and it has been struggling to establish itself as a major global currency and has been on a downward trend since the financial crisis. The coming years are likely to see a battle of supremacy between the U.S. dollar and the Chinese Renminbi to become the world's leading currency. This is a political as well as an economic battle. Over recent years, Europe has seen the U.S. engage in extraterritorial sanctions such as their withdrawal from the Iran nuclear deal. Europe has struggled to counteract, inter alia, because of a weak position of the EURO as an alternative currency that could be used in trade with Iran. One of the deficiencies of the EURO has been the lack of a large and elastic supply of safe assets denominated in EURO. The bonds that will be issued to cover the €750 billion recovery package, as well as bonds from the loan schemes established earlier in the year, could become attractive as safe EURO-denominated assets, especially since the ECB has ensured that these bonds be given a safe asset status, taking an important step in promoting the EURO's international role.

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Some European federalists see the adoption of the recovery package as the first step towards the creation of an EU Treasury capable of conducting fiscal policy for the EU and engaging in deficit spending when necessary. Those federalists are likely to be disappointed, however, as the legal basis for the adoption of the recovery package is a treaty article that can only be used in cases of emergency like the present pandemic; it is not for everyday use. Even at the height of the disbursement of funds under the package (2021-2023), the impact will only amount to 3-4 % of GDP – less than a tenth of the size of national budgets. This large disparity between the national budget and the EU budget is not going to diminish in the foreseeable future. It is also unlikely that the EU will obtain direct taxing power any time soon. The new taxes discussed during the budget talks (plastic waste tax, carbon border tax, digital tax) will (if they are agreed to) mainly go to national coffers, and only a part will be transferred to the EU budget.

Putting aside historical parallels, the decisions taken in 2020 on their own constitute an important moment in the continuous process of European integration. It is encouraging that European leaders are in harmony with the sentiment of its citizens who believe (expressed through numerous polls) that the EU should play a greater role in the most important issues that confront Europe in today's world. The process the EU went through during 2020 also increased its internal cohesion. Previous divergencies in economic philosophy have somewhat diminished. The EU has rediscovered Keynes on economic policy. Member states that had started looking towards China as a source for support have realized that, when the chips are down, it is the EU that counts. All of this could facilitate the EU's ambition to create a more coherent and assertive foreign policy.

This does not mean that everything will be smooth sailing from now on. Internal divisions continue to exist in the EU. The North, represented by the "Frugal Four" (Netherlands, Austria, Denmark, and Sweden) played a prominent role during the July negotiations in reducing the ambition, as these member states don't believe in the virtue of deficit spending or heavy public intervention in the economy. However, this camp has been weakened by the departure of the UK and the shift in German thinking, which is likely to survive Angela Merkel's departure as Chancellor next year. The center of German politics is moving towards the left through the rise of the Green Party. The traditional free-market German economic philosophy shared in the North could come under pressure when issues like competition policy, protection of strategic sectors, or free trade come up for discussion.

The Southern European countries were offered an unprecedented show of solidarity welcomed by the great majority of member states, led by Germany and France, that - at least for the moment - have regained their traditional role as the driver of European integration.

In any case, these decisions must work and promote a long-delayed modernization of the weaker economies. This is especially true for Italy, which has long been suffering from internal political instability and – contrary to the other Southern European members – has a poor record of efficient use of funding received from the EU.

Finally, regarding the Central European countries, the decisive July 2020 summit almost broke down on the plans to introduce a mechanism that would allow for a cut-back on EU financial support in case of infringement of rule of law (clearly aimed at Hungary and Poland). Once more, the Hungarian leader, Viktor Orban, showed his political skills and diffused the issue (for now). However, preserving the rule of law goes to the heart of the European construction, and the issue will not go away. The future risks to the fundamental principles of the European Union may concern values as much as the economy.

The pandemic is not yet behind us, but the show of solidarity demonstrated by EU leaders' decisive and coordinated response amidst a time of great crisis bodes well for the future actions and decisions the EU will need to make in response to the many challenges still ahead.

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