Is the EU response to the Covid economic crisis fit for purpose

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Fiscal risk in the monetary union

The main economic weakness of the euro area stems from unsustainable public and private debt in a number of Member States. Before the 2009 crisis, diverging debt developments were not a major concern for investors, but differentiation according to country risk has re-emerged since then. Following the experience of the last crisis, EU economic surveillance was reinforced via the so-called 6pack and 2pack legislation, with a view to reducing vulnerability to shocks. Yet the new toolbox has never been fully exploited, and the drawdown of public and private debt stocks in vulnerable Member States over the past years was not as ambitious as it could have been. As a result, some Member States are now in a particularly weak position to address the economic fallout from the COVID-19 crisis, calling upon the EU level to provide unprecedented support.

The key problem of the monetary Union is that an important constraint to the build-up of unsustainable debt has been eliminated, and none of the EU's surveillance tools has come close to reproducing the same disciplining effect. That constraint was exchange rate risk, which acted as a natural barrier for external flows to domestic economies. Under national currency regimes, differentiation according to country risk might have reappeared earlier in the form of currency risk, reducing inflows and preventing the accumulation of unsustainable debt. In the absence of the disciplining effects of currency risk, fiscal policy bears an even higher responsibility for economic stability. Yet at the same time, the rules of the Stability and Growth Pact have not been enforced to an extent commensurate to that responsibility.

It is often argued that monetary union without fiscal transfers is prone to failure. Yet this does not do justice to the enormous benefits from sharing a strong currency with partner countries. About half of all countries worldwide (and half of the non-euro area countries in the EU) voluntarily peg their currencies to that of another country, without having a say in the monetary policy of that country, let alone benefitting from fiscal transfers. Many of those countries that have subjected themselves to the monetary policy of another country are successful precisely because they have imposed the necessary fiscal, and in some cases macro-prudential, constraints on their governments and financial sectors.

> *In the absence of the disciplining effects of currency risk, fiscal policy bears a higher responsibility for stability.*

How can we address this apparent weakness of the euro area? The Recovery and Resilience Facility will soon make available unprecedented financial support from the EU budget to Member States' economies. Support under the Facility shall be used as a carrot for ambitious structural reform with a view to increasing growth potential, resilience and adjustment capacity in vulnerable Member States. Full compliance with the rules of the Stability and Growth Pact post-2021 shall be made an explicit requirement for grants from the Facility. The tools are there for the success of the monetary union, we just need to exploit their full potential. ●

Irene Tinagli

Chair & MEP, Committee on Economic and Monetary Affairs,
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The Recovery Package and the new priorities for the European Union

The COVID-19 pandemic is not just a dramatic health emergency. It also has significant impacts on our economies and our daily life. Since March, all EU Member States have taken relevant steps to support their national economy and to safeguard as much as possible the well-being of their households and firms. This effort was accompanied by important initiatives taken immediately by the Commission, the ECB, the EIB, the SSM and the ESAs.

The presentation of the Recovery Package was undoubtedly a fundamental step in this regard. Unlike what happened right after the 2008 crisis, this time the EU relaunch package had to be more than the mere sum of national plans. What was decided by Member States with the Recovery Package was - in a certain sense - an unavoidable choice.

The activation of the escape clause of the Stability and Growth Pact has facilitated the actions of national governments, which unquestionably helped avoiding the immediate collapse of the economy. However, as already described by the latest Commission's forecasts, these measures will likely lead to a sizeable, but uneven, increase of debt/GDP ratios across the different countries, adding on to the already existing disadvantages and discrepancies due to different spreads of the virus, and to different structures of the economies in the various countries. As a matter of fact, Member States will not be able to face the economic consequences of COVID-19 pandemic with the same instruments and with the same firepower, and this could lead to unavoidable and permanent divergent dynamics within the Euro area and the European Union as a whole.

The Recovery Package addresses this challenge building up on two clear priorities for the Union: the sustainable and the digital transformation. The Commission's proposal was ambitious not only in terms of size of the overall package, but also in terms of the range of legislative proposals that were put forward. In this sense, although the July European Council's agreement has to be welcomed, one cannot hide some disappointment for the heavy cuts in the financial envelopes or even with the deletion of certain programs that would have been key to support a harmonious and sustainable recovery of the Union.

In fact, despite the usefulness of the measures allowed by the temporary framework on State aid, one has to consider that not all Member States are able to afford them and provide a robust economic and financial support to their industrial sector. This obviously creates an unlevelled playing field that, along with entry barriers and further fragmentation, might undermine the functioning of the single market, driving further divergences between Member States. The Commission's proposal for the establishment of a European solvency support facility addressed precisely this problem by ensuring support for equity capital in those countries and sectors where more action would be needed. The European Council's decision to cancel this program is short-sighted and the European Parliament, while being perfectly aware of the difficulties of the negotiation on Next Generation EU and on the next Multiannual Financial Framework, has nevertheless decided to move forward because it considers this instrument as essential.

> *Unlike what happened right after the 2008 crisis, this time the EU relaunch package had to be more than the mere sum of national plans.*

In the final agreement of the European Council, a fully decentralized approach in the use resources has prevailed, and therefore it will be up to the Member States to define their national plans. However, I believe it is important that it remains clear to all what the objectives of the Recovery Plan are, namely to fill the gaps that emerged due to the COVID pandemic and, simultaneously, to address the structural weaknesses of the various economies, in order to foster integration and convergence while encouraging the sustainable and digital transformation of the European economy. The Recovery Package must be an opportunity to rebuild our economies on more solid grounds, capable of producing long-term growth that is both socially and environmentally sustainable through quality job-creation, which would allow the European Union to maintain and strengthen its position of global leader.

The role of the Commission will be crucial in this regard. Nevertheless, I believe that an enhanced role of the European Parliament would indeed be a natural and necessary complement to these important steps. I hope that the interinstitutional negotiations will take this into account.

Odile Renaud-Basso

Director General of the Treasury, Ministry of the Economy, Finance and the Recovery Plan, France

The European recovery plan to pave the way to a stronger, more sovereign and independent Europe

The EU economy is facing an unprecedented crisis, still surrounded by a lot of uncertainty. We are hit by a symmetrical shock, but with asymmetrical consequences among Member States, as they are not exposed to the same risks and vulnerabilities and because of different sequencings of the containment measures. Since the gradual lifting of these measures, our key challenge has been to reduce the sanitary risks to a minimum, in order to prevent or limit the second wave of the pandemic, restore confidence and thus maximize the effects of our economic support. Many other challenges remain ahead. The high degree of uncertainty we are facing is likely to delay the investment decisions of firms, which are also facing liquidity constraints as a result of lower revenues and a greater debt burden.

The increase in public debt will be substantial in the Member States, as they cover a large part of the losses related to the crisis. We also need to prevent further widening divergences, especially in the euro area. In our policy response, we need to ensure a proper transition between short-term support measures and accompanying measures, to sustain recovery without impeding economic adjustment to structural changes, and to ensure that the measures we take are properly designed to support longer-term objectives. These challenges are also an opportunity to further support public and private investments needs and incentivize reforms, especially in our priorities: green and digital transitions.

The agreement on a European recovery plan reached by the European Council in July (€750bn – or around 5 points of EU GDP) is an historic milestone towards more solidarity and a deeper integration of European economy, offering a visible signal to all citizens of the added value of the European Union. For the first time in the history of the European Union, this plan will be financed through common debt issuance, thereby maximising its counter-cyclical effect. It will provide for real budgetary solidarity towards the regions and sectors most affected by the crisis. Considering the interdependence of the EU economies and the dynamics within the Single Market, no country should be left behind the recovery support: the recovery in each Member State will affect positively the strength of the recovery of other Member States.

Beyond its ambition to stimulate and stabilise the economy, the Next Generation EU instrument aims to durably transform our economies and pave the way to a stronger, more sovereign and independent Europe. The funds disbursed under its Recovery and Resilience Facility (RRF) – amounting to €672.5bn, of which €312.5bn grants – will support investment and reform projects that enhance the growth potential, job creation and economic and social resilience from the next year onwards. They are also expected to contribute effectively and sustainably to the green and digital transitions, in line with the EU climate-neutral objective for 2050 and through the introduction of a 30% green spending target in the recovery package. From now on, we will have to deliver quickly on the implementation of our national recovery plans, that need to be consistent with the objectives mentioned above, so that the RRF could be disbursed swiftly, to fully play its countercyclical role.

> *The agreement reached by the European Council in July is an historic milestone towards more solidarity and a deeper integration of European economy.*

In the meantime, the agreement of the European Council allows us to relaunch public investment as of today - following the large-scale national recovery plans Germany and France already announced - as recovery expenditure committed by member states since 1 February 2020 will be retroactively eligible for funding under the RRF. Next Generation EU also includes other programmes, including InvestEU - €8.4bn of which €5.6bn via the recovery plan - specifically dedicated to supporting private investment in the European Union, which should generate, after leverage, investments around €300bn. Finally, the Covid19 crisis has exacerbated our companies' need for equity capital and the need to diversify sources of financing beyond traditional bank lending. In the wake of the recent report of the High Level forum, we are committed to strengthen the Capital Market Union to forge a true Savings and Investment Union as one of the pillars of our European Recovery Plan. We are also committed to support the turning of our financial industry towards a more sustainable and technologically advanced future.

Axel Weber

Chairman of the Board of Directors, UBS Group AG

Creating a stronger, greener, and more integrated Europe

According to the World Bank, the COVID-19 global recession will be the fourth deepest since 1870 and the most severe since the end of World War II. While posing serious challenges, the pandemic at the same time offers a great opportunity for EU leaders to address major outstanding issues which we have not been able to address so far, among them the deepening and strengthening of the Single Market and the transformation of the EU economy towards a more sustainable growth model.

Unlocking the Single Market's full potential and the full range of its benefits, especially in financial services, will provide the much-needed funding to support economic recovery and finance a sustainable transformation.

A key challenge to overcome in the deepening of the Single Market for financial services has been regulatory fragmentation. While important progress has been made, hundreds of millions of EU consumers, businesses, and the bloc's overall economy are still not reaping the full benefits of the single market.

In a first step, national "options and discretions" in the prudential framework should be further harmonized in order to avoid unwarranted ring-fencing practices and let banking groups allocate capital and liquidity across multiple legal entities as needed and economically sensible. Although a lot of progress has been made already, there are still more than 30 provisions which require further harmonization.

Second, further efforts should be made to harmonize regulation and establishing a level playing field around innovative technologies in financial services. This would span across areas such as digital identity, which is a key technology of the future, including the fight against financial crime, as well as the usage of data to harness the full potential presented by new technologies.

Thirdly, further steps to complete the Banking Union are needed. In particular, a single EU crisis management framework is the conditio *sine qua* non for further risk reduction measures and a common deposit guarantee scheme, thus strengthening the credibility of deposit insurance and reducing the bank-sovereign vicious circle.

Furthermore, EU depositors should be able to move and use funds across and in different countries seamlessly and without additional charges. IBAN discrimination and the fragmentation of card schemes along borders need to be overcome to establish a truly integrated single European payment platform, which is the backbone infrastructure of the financial system.

When it comes to financing the transition towards a more sustainable European growth model, the Capital Market Union (CMU) is the key complementary project to the Banking Union. Strong and well-functioning economies need capital market funding to complement bank lending. As recently highlighted by the ECB, this is particularly relevant when it comes to financing the greening of our economy, given the high capital intensity, high risks, and long-term horizon of most projects. The EU urgently needs to make faster progress towards creating a true CMU, also to support a sustainable transition.

> *Deepening and strengthening of the Single Market and transforming the EU economy towards a more sustainable growth model as key opportunities.*

To further drive a sustainable transition of our economy, the EU should accelerate carbon pricing. The EU's emission trading system (ETS) is the world's largest carbon market, but currently it only covers economic sectors that together account for less than 50% of total carbon emissions in the EU, whereas the remaining sectors are subject to a patchwork of non-harmonized measures across the EU. Greater harmonization would facilitate the transition towards a low-carbon economy.

By creating the "Next Generation EU" fund, one of the most important milestones since the introduction of the single currency, EU leaders recently have shown that a common response can be achieved in a timely fashion. EU leaders should use this momentum and shape the recovery further, delivering on the pending issues mentioned above. This will allow Europe to emerge stronger from the current crisis and create a greener and more integrated Europe. ●

Pierre Heilbronn

Vice President, Policy & Partnerships,
European Bank for Reconstruction and Development (EBRD)

We are all in this together

In the face of the COVID 19 pandemic, Member States, under extreme time pressure, adopted various national emergency measures to confront the immediate impacts of the crisis. The EU stepped up in its coordination role and mobilisation of resources through EU institutions followed soon after, with ECB, the ESM, EIB, EBRD and European Development Finance Institutions putting together ambitious economic crisis response measures. Now, the EU must ensure that funding the European recovery, is supported by practical steps on the ground.

IFIs, including the EBRD, and the EU financial industry are a key conduit to translate European solidarity principles into practice. It is for this kind of crises that multilateral institutions were established. To invest where others will not. To be counter-cyclical. To provide a bulwark against economic – and possibly even political – maelstrom. As the economic and social impacts of the pandemic magnified, IFIs introduced immediate crisis response programmes focussing on a) strengthening health infrastructure; b) supporting viable businesses; c) assisting financially vulnerable households; d) offering working capital support to existing clients including banks. Lending and technical cooperation projects in 2020 and 2021 have been redirected toward the crisis and, importantly, to build the foundations of the eventual recovery.

EBRD has already delivered an evolving and dynamic 4 billion Euro "Solidarity Package", providing the operational framework and leverage for the Bank to invest an ambitious 21 billion Euro over 2020 and 2021. Given the magnitude and severity of the crisis, the key to its successful resolution is coordinated responses targeting the more efficient mobilisation of investment funds at both the aggregate level and toward specific financially stressed actors such as SMEs. Resilience of the financial sector is crucial to resolution of this emergency and capital market reform must continue with added haste to facilitate this. Governments will need to fund their expenditures through increased bond issuance and long-term fund investment will be needed to meet heightened and altered infrastructure needs.

Policy work within the EU addressing access to finance for SME such as the European Secured Note initiative and equity finance solutions are actively supported by the EBRD and the final investment products will augment our existing suite of financial and risk sharing products including our bond investments, commercial loans, Trade Facilitation Programme, and credit lines to local banks. With the support of various financial sector partners, we are also targeting the development of new financial products to address short-term emergency finance needs and aid in NPL resolution. Although the COVID 19 response is currently taking centre stage, an essential part of any rebuilding must address the long-term fundamentals of building a sustainable market economy.

EBRD already reflects this through the "tilt to Green" in our Solidarity Package, our new Green Economy Transition approach for the period 2021 to 2025 and our work on Greening the Financial Sector in the Baltics, Greece, Hungary and Poland to create a more flexible capital market and encourage greater issuance of green and social instruments.

IFIs and EU financial sector are a key conduit in translating European solidarity from principle to practice.

The COVID-19 crisis will have significant short and long-term consequences for our region comprising some of the EU smaller states. EBRD commits to step up and play a systemic role in maintaining well-functioning markets, helping governments shape their policy responses to minimize distortions to well-functioning markets, and protecting transition. This means ensuring the resilience of the private sector to prevent value destruction; retaining our focus on inclusion through gender mainstreaming, workforce restructuring/employment retention; tilting the recovery towards green and promoting good governance given the increased role of the state.

Frédéric Oudéa

Chief Executive Officer, Société Générale

Europe can no longer afford a muddle through approach to its financial system

Europe's single currency continues to surprise its sceptics, showing resilience in crises and delivering a safe store of value to its citizens. It is fair to say, however, that the euro has fallen short of its potential, and not least due to its fragmented financial system. Completing Banking Union and building out Capital Markets Union (CMU) are commonly agreed goals, but paths have divided on how to achieve this, at no small cost to jobs and growth, and overburdening the ECB in the process.

The Covid19 crisis has dramatically compressed the timeframe to deliver, not only due to the unprecedented growth shock but also by accentuating several pre-existing trends. In a world where protectionism and the willingness to use finance as a diplomatic weapon is only increasing, the absence of a strong financial system threatens both Europe's ability to recover and its economic sovereignty.

European banks entered the current crisis well capitalised and this, combined with the swift action by governments and the ECB, has helped protect the supply side of the economy from the initial liquidity shock, and not least at a time when foreign banks have tended to pull back.

Ensuring sufficient European bank capital to finance recovery will require that the finalisation of Basel III does not result in an excessive capital burden and that banks can continue to access a diverse pool of private investors. Near-term, visibility on temporary measures including dividends would help ease investor concerns, but the key metric ultimately is profitability.

The prospect of losses due to Covid19 is something that banks share globally, but Europe's fragmented and cumbersome approach, be it tackling NPLs, bank resolution, the regulatory framework or future integration adds significant pressure. The detrimental effects were already all too visible pre-crisis, holding back the transformation of financial system even as Brexit loomed.

Consolidation of the European banking industry is central to securing economies of scale and freeing up resources for the much-needed digital transformation. Early July saw the ECB launch a public consultation on its supervisory approach to consolidation and this marks a positive step, but far more work is required to secure the single jurisdiction key to any Banking Union.

Equally critical is delivering CMU. It is evident from the current crisis that non-financial corporations need more equity capital. Excessive reliance on debt not only leaves non-financial corporates more vulnerable to refinancing risks but may arguably also be holding back more productive investments, thus weighing on trend growth. Accessing a diverse pool of equity financing requires deep capital markets and consideration should also be given to the securitisation framework, the coordination of supervision, and the relative tax and regulatory treatment of debt and equity.

A single safe asset is often seen as a bellwether to finalising Banking Union and delivering CMU. The landmark Council agreement on Next Generation EU, will pending parliamentary approval, allow the Commission to raise €750bn of debt on capital markets and marks important progress; but this is not the genuine single safe asset that the euro area needs and overcoming the political hurdles will take time. Even absent a single safe asset, there is room for considerable progress on CMU and the recent conclusions of High Level Forum offered a welcome tangible roadmap.

> *The absence of a strong financial system threatens both Europe's ability to recover and its economic sovereignty.*

The time to act is now. The ECB has already taken its rates to exceptionally low levels and the existence of a reversal rate, where the effects of further monetary easing turn contractionary, is well accepted. While its level is yet unknown in practice, finding out could trigger a new major crisis that Europe cannot afford. It's no wonder that the ECB continuously calls for greater financial integration and a stronger international role for the euro.

It's no exaggeration to say that the euro's future today depends on its financial system; absent a strong and unified system, Europe will struggle to finance recovery and not least one that prioritises its goals of a greener and fairer society. The option to continue to muddle through and rely excessively on foreign banks, third-country financial centres and the dollar is simply no longer viable. ●