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Is the EU response to the Covid-19 economic crisis fit for purpose?

A big fiscal deal

As in earlier crises, the virus's economic ravages have split the EU's members given their uneven profiles. Rich countries with low government debt (such as Germany and the Netherlands) could cope fiscally mainly on their own. Some of the heavily indebted and infected countries (such as Italy and Spain) could not. Without fiscal aid, they have faced recession deep enough to damage the whole of the EU economically putting at risk the European project.

In such a context, the EU leaders reached a deal on the recovery package and the European budget in order to support the recovery and resilience of the Member States' economies. Indeed, EU leaders have agreed to a comprehensive package of €1 824.3 billion which combines the new seven-year €1.074 budget and the €750 billion recovery programme under the Next Generation EU (NGEU) instrument.

The €750 bn recovery plan entitled "Next Generation EU" strengthens the Union. The total is equivalent to 5 % of the EU's annual GDP[1]. For the first time, the EU will collectively borrow the plan's full amount from the financial markets and repay it from the EU budget over almost 40 years. The shock absorbing role for the EU is a real novelty and this EU fiscal deal may set a precedent for future crises to be met with collective debt.

The move towards fiscal cohesion and solidarity is reassuring: the European Commission acting on behalf of the member states becomes the legal borrower responsible for the servicing and the repayment of the issued bonds and no more a simple intermediary between the market and the borrowing state. In addition, €390bn of the €750bn will be distributed as grants[2], and hence will not add to governments 'debt loads. Spain and Italy could receive non-repayable grants accounting for about 4,5 per cent of their GDP over three years.

As the Treaty imposes the balancing of European budgets, the ultimate guarantee on the bonds issued by the Commission will eventually fall on all Member States. If a country, or several, were to default, other Member States would have to step in as ultimate and joint guarantors - a first European move towards the "Hamilton moment".

The "Next Generation EU" recovery plan is the second part of the EU's response to the pandemic. In mid-April the European Heads of State agreed on a three-layer safety net for workers, businesses and sovereigns totaling €540 billion.

A temporary solidarity Instrument (SURE) has been established to support protecting workers and jobs in the current crisis. Loans, backed by the EU budget, can be provided up to €100bn. The EIB is to create a pan-European guarantee fund of €25bn to support €200 bn of EU businesses, in particular SMEs throughout the crisis[3]. The ESM has also provided pandemic crisis support, in the form of precautionary credit lines not subject to macro-economic policy conditionality. A Member State that draws under these Enhanced Conditions Credit Line (ECCL) will commit to using the money only to cover corona related costs. Each Eurozone country can benefit from this support up to the benchmark amount of 2% of GDP[4].

However, Europe needs much more to fill its infrastructure gap, the goals of climate change, and other sustainable goals. Given its size and its duration, the next Generation EU plan will only partly cover these needs. More will be needed for Europe to escape the current trap of low trend growth. The EU plan is not designed to cover all investment needs but to help low-income countries narrow their gap. Among other key policies that must be delivered are the European Banking Union and Capital Market Union (CMU) without which the EUs' key political priorities will not be able to be implemented.

But the name of the game remains national

The EU safety net and the Next generation EU plan will help counter strains in the single market by allowing all governments to support workers and businesses through the recovery.

But the deal has come at a cost to other parts of the budget which will harm the EU in the longer term. To accommodate the insistence of the "frugal four" – Austria, Denmark, the Netherlands and Sweden- for limited grant funding, leaders agreed to slash top-up money for research and the green transition which are normally priorities for northern governments. For example, the European Defence Fund, which is intended to provide EU co-financing for joint industrial projects, will receive only EUR 7 billion, compared with EUR 13 billion requested. The "HorizonEU" – research and innovation programme is endowed with EUR 81bn, not the EUR 100bn initially expected. The Erasmus+ programme, will be less supported than expected.

The Frugal Four were also promised much bigger rebates on their budget contributions. By one calculation, France for example will now have to pay an extra €15bn into the budget due to this[5].

There is also no agreement on the ways for the EU to have revenue sources that are genuinely its own. Feasible options to help finance debt include new environmental levies (e.g. a levy on plastic waste, a "carbon border adjustment mechanism) and digital taxes but the

[1] Calculated on the basis of the 2019 EU GDP without including the UK GDP.

[2] The plan ensures the money goes to the countries and sectors most affected by the crisis: 70% under the grants of the Recovery and Resilience Facility will be committed in 2021 and 2022 and 30% will be committed in 2023.

[3] At least 65% of the financing will go for small and medium sized businesses. Up to 23% to companies with 250 or more employees, with restrictions applying to companies with more than 3,000 staff. Up to 5% to public sector companies and entities active in the area of health or health-research or providing essential services related to the health crisis. Up to 7% to venture and growth capital and venture debt.

[4] Should all 19 euro-area countries draw from the credit line, this would amount to a combined volume of around €240 billion

[5] In the final summit agreement, Austria managed to double its rebate to €565m a year, while the Netherlands won an increase from €1,5bn to €1,9bn, and Denmark from €222m to €377m.

EU July agreement offers only slivers of hope. Finding agreement on increasing the EUs own resources will be very difficult, meaning that the burden could well fall on the Multi-annual Financial Framework (MFF) in the future.

The EU safety net and the Next generation EU plan represent a fiscal response of around 8% of the EU's GDP, made available over several years and with loans and guarantees comprising the bulk of the support. This is a significant amount but not a game changer. The main name of the game still remains national.

By means of comparison, Member States have provided support for their economies to the tune of 25,5% of GDP, including direct expenditures, financing measures and public guarantees. These measures will push public deficits to deeper levels. Italian, Spanish and French public sector deficits are going to increase by EUR 139, 83 and 141 billion respectively in 2020. Their public debts are going to jump by more than 20 percentage points of GDP in 2020 to reach respectively 123% of GDP, 166% and 125% of GDP in 2020, according to the IMF June forecast. This is not sustainable, underlining the need for broad based structural reforms.

Another benchmark is the size of the recent German fiscal plans: all in all, the national stimulus in 2020 would amount to 6% of GDP.

So, the name of the game still remains predominantly national. Monetary policy cannot do everything- pushing too hard and too long on the monetary pedal generates financial vulnerabilities and imbalances - fodder eventually for the preparation of future crises. Likewise, there are limits to how far the boundaries between fiscal and monetary policies can be pushed without running the risk of undermining the central bank's credibility. High sustainable growth in Europe can only be achieved by reducing reliance on debt and reinvigorating productive economic activity through sensible investment.

This means that to restore growth in the EU, governments must stand ready to take corrective action to ensure a path of primary fiscal balances consistent with fiscal sustainability. It also means implementing structural reforms to lift potential growth rates, mitigating failures of healthy firms, orienting fiscal policies towards sustainable and digital investment…

The psychodrama of so-called austerity has to be arrested which has undoubtedly weakened certain States of the Union. In fact, it is the fiscally virtuous countries that have best prepared their economies for the challenges of this pandemic crisis.

In countries with too much debt, decisions must now be made to stop "walking on their heads» and to reduce fort-with unproductive and inefficient public spending. This is the only way to release the necessary resources for the productive sector. Just a few years of efforts mobilizing all the energies are all that is needed. Such fiscal policy requires a spirit of cooperation among different political parties and on a bi-partisan basis; examples abound in the Northern European Member States.

Written by Didier Cahen, Eurofi