
1 Europe in the time of Covid-19: A new crash test and a new opportunity

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After a period of hesitation, governments in Europe have reacted forcefully to the Covid-19 pandemic with various strategies combining social distancing, testing/quarantining, and lockdowns. During a pandemic, however, coordination is key, and in responding to the current crisis European coordination has proved as painful as ever. This chapter summarises the three axes of European-level support – monetary policy and banking, state aid and fiscal rules, and funding – and identifies the main difficulties that will appear down the road. It concludes that the EU Recovery plan that is taking shape looks promising and could represent a significant signal of European solidarity and unity.

A new crash test for European unity and the euro

Europe has been and will likely remain one of the most Covid-infected regions in the world, with a death toll exceeding 150,000. After a period of hesitation, national governments have reacted forcefully to the pandemic through various strategies combining social distancing, testing/quarantining, and lockdowns. Although doing nothing was not an option and would itself have disrupted economic activity, several weeks of strict lockdowns have triggered an economic crisis at least twice the size of the 2009 crisis. Furthermore, the recovery is likely to be slow due to depressed consumption and investment, and it will require fast reallocations in both the labour market and the capital market.

At the time of writing (mid-May) there is still a huge amount of uncertainty, both on the medical front and on the economic front. On the medical front, compared to what we do know, what we don't know still seems overwhelming. As economists, the best we can do is to envisage different scenarios, draw their economic implications and prepare for the worst:

- An optimistic scenario: there are only minor new outbreaks, which can be contained through tracking, tracing and isolating. In this case, life might go back to 'almost normal' very quickly. But even in this optimistic scenario, after governments have relaxed containment measures, a large number of people will still choose to remain cautious, avoiding crowds, public transport, and even offices if they have alternatives. Consumption remains subdued but markets and institutions are resilient. The debt overhang is manageable both in the corporate sector and in the official sector.
- An intermediate scenario: there are further waves and regional outbreaks that escape tracking and tracing and thus require new containment measures. This will be more difficult than the first time they were imposed for several reasons: tolerance for the containment measures will be lower, the economic cost will be more visible and the capacity of government to compensate the loss of income will be lower. Not only is activity more deeply affected, but financial, social and political institutions are under stress, with possible accidents. There is ample room for multiple equilibria, especially if progress is slow in the area of treatments and vaccines. The ECB is active in eliminating the 'bad' equilibrium, but it is increasingly challenged on legal grounds.
- A downside scenario: ongoing outbreaks, failure to coordinate medical measures across countries, continued restrictions of movement of people across borders, increasing divergence of countries' political reactions and economic measures, putting additional pressure on the Single Market and ultimately on the Union. In this last scenario, GDP is expected to remain lower for a prolonged period. Unless national and European institutions are able to adapt quickly, the probability of a major financial, social and political crisis is very high.

The last scenario could be lethal for the euro area and potentially also for the European Union; hence the importance of an appropriate European response in order to both reduce the probability of this catastrophic scenario and to help the market select the 'good' equilibrium in the intermediate scenario.

It should be kept in mind that although the euro area reacted quickly and adequately to the 2008 financial crisis and to the 2009 economic crisis, the treatment of the subsequent sovereign debt and banking crisis was more bumpy. The policy mix revealed itself inadequate in 2012-13 when a new, 'home-made' economic crisis hit the euro area,

and in 2015 Greece came close to being kicked out of the euro area. The euro area is still young and unfinished. At the national level, extensive social safety nets make it easier to shield an optimistic or ‘good’ intermediate scenario. But at the euro area level, the lack of fiscal backing of the euro creates a vulnerability that urgently needs to be addressed.

The failure for Europe to manage a bold, common response would further increase divergence and strengthen anti-European forces and populism. The debate over the financing of the euro safety net (e.g. ESM versus Coronabonds) has already been very bruising and has created the impression of lack of care and European solidarity. The German Constitutional Court’s ruling on the ECB’s past policy may also contribute to further polarisation. This is not the time to play with matches.

The shock being both exogenous and dramatic, one could have expected European politicians to temporarily forget their disagreements. Before the crisis, they were discussing whether the next Multiannual Financial Framework (MFF) – the seven-year budget of the European Union – would be set at 1.02%, 1.07% or 1.11% of gross national income. Just a few months later, we are talking about thousands of lives lost, millions of unemployed, and governments deficits in the order of 10% of GDP or more. To restate the obvious, during a pandemic coordination is key, as the virus disregards national borders and is powerful enough to disrupt cross-border supply chains. However, even under such obvious circumstances, European coordination has proved as painful as ever. Accordingly, pre-Covid weaknesses in the governance of the euro area have quickly come back to the fore.

After briefly recalling where the debate on euro area economic governance was before the Covid crisis, we assess the decisions made so far at the euro area level. Finally, we touch on the fundamental weakness of the euro architecture – namely, that it is a currency backed not by one but by 19, or even 27, sovereigns – and delineate a few priorities for the future.

The pre-Covid debate

The fault lines of the Maastricht architecture are now widely recognised (e.g. Bénassy-Quéré and Giavazzi 2017). During and after the sovereign debt crises of the 2010s, several major reforms were carried out: the introduction of an emergency assistance scheme (the European Monetary Mechanism, or ESM), an extension of the ECB’s toolkit with Outright Monetary Transactions (OMT), negative interest rates and quantitative easing, reinforcement of fiscal and macroeconomic surveillance, and banking union.

Although these reforms were far-reaching, unfortunately the work was unfinished. As argued notably in the ‘7+7 report’ (Bénassy-Quéré et al. 2018), financial markets were still fragmented within the euro area, the ‘doom loop’ (i.e. the close relationship between banking risk and sovereign risk) was alive and well, macroeconomic convergence was a work in progress, inflation was too low despite monetary policy not having yet been normalised, fiscal policy had little room for manoeuvre in various countries and was inexistent at the federal level, and so on. In brief, despite its stronger banking system, the euro area was not ready for the next crisis.

Even more worrisome, the fundamental flaw of the euro area architecture was not addressed before the Covid crisis. Given that both monetary financing of government deficits and fiscal bailouts are prohibited by the Treaty, a country with plunging nominal GDP and rocketing government debt will likely need some form of debt relief. But debt restructuring is extremely difficult given the concentration of government debts in the balance sheets of the resident banks. Some banks may see their capital wiped out. They may also fall short of liquidity, since government bonds are routinely used to get liquidity on the repo market and from the central bank.

Before the Covid crisis, the euro area debate was evolving along three main lines:

- How to stabilise the financial sector through a smooth transition towards more diversified balance sheets, together with the introduction of deposit re-insurance and a ‘safe asset’ (Schnabel and Véron 2018).
- How to restore the fire power of macroeconomic policies, notably through a reshuffling of fiscal rules and the introduction of a European ‘fiscal capacity’ (Bénassy-Quéré et al. 2018, European Fiscal Board 2018, 2019).
- How to avoid a deflationary bias related to the asymmetric adjustment burden between surplus and deficit countries (Bénassy-Quéré 2017).

As the Covid crisis unfolds, the consequences of this unfinished work will progressively appear.

Overview of the main European measures

Since the outbreak of the pandemic, national governments have been at the frontline. However, they have been backed by European action on mainly three economic axes: (1) monetary and banking, (2) state aid and fiscal rules, and more recently, (3) funding. We present a brief overview of these three axes as of mid-May 2020 and underline the main difficulties that will appear down the road.

Monetary policy and banking

Since the beginning of the Covid-related economic crash, the ECB has reacted swiftly both in terms of monetary policy and as a bank supervisor, while banking regulations were also relaxed (see Box 1).

Box 1 The main actions of monetary policy

Refinancing operations

- Targeted: TLTRO III: funding cost = deposit facility rate - 25 basis points.
- Non-targeted: PELRO (Pandemic Emergency Longer-term Refinancing Operations), seven operations starting in May 2020, fixed rates (25 bp below main refinancing operation rate), maturities up to the summer of 2021.

Collateral policy

- Expansion of accepted collateral (guaranteed loans to SMEs and self-employed) + freeze of eligibility as of 7 April 2020 even in case of subsequent downgrade (provided >BB); waiver for Greek bonds
- Reduced haircuts (e.g. from 35% to 22% for credit claims)

Asset purchases

- Renewed asset purchases programme (including public sector asset purchases): €20 billion per month + reinvestment of maturing bonds
- Additional €120 billion up to December 2020
- PEPP: € 750 billion; flexibility with respect to capital key and share in issuance

This timely action by the ECB contrasts sharply with the slow and painful progress in fiscal action at the EU level (see below). The decision-making process of the ECB – an independent institution with a clear mandate – is of course faster than the complex interaction between European and national institutions, especially since unanimity is required for a number of decisions. However, the rapidity of the ECB in taking bold action is also related to the fact that it was better prepared with the wide toolbox developed over the last decade. Part of the action essentially consisted in amplifying and reiterating the use of tools such as the targeted long-term refinancing operation, a relaxation of collateral rules and, last but not least, its asset purchases programmes. There have been, however, two major innovations overcoming two previous taboos. The first was the readiness of the ECB to lose money on its targeted refinancing operations by lending at a rate below the deposit rate (Claeys 2020). The second innovation was the announced flexibility of the newly introduced Pandemic Emergency Purchases

Programme (PEPP) with respect to both the ECB capital key and the self-imposed limits to issue share limits.¹ Potentially, the ECB could be exposed to a portfolio allocation that would not correspond to the share of each government in the capital (hence on the seigniorage) of the ECB. Furthermore, its share in a given debt issue could be such as to give it a decision power in the event of debt restructuring.

The swift action on the monetary front was complemented with measures to incentivise banks to lend. Not only would the latter benefit from a negative refinancing cost, but they would also benefit from a more friendly provisioning framework for non-performing loans, and various capital buffers would also be relaxed to make room for these additional loans (see Box 2). Adding the generous guarantees extended by national governments and by the European Investment Bank (see *infra*), all policy tools converged to prioritise liquidity provision to the corporate sector.

Box 2 Measures for the banking sector

Accounting

- Flexibility in the application of the new accounting standards (IFRS9) concerning expected credit losses (provisioning) when increased probability of default is expected to be temporary; discarding moratoria on loan repayments if they do not change the economic value of the loan; use of transitional arrangements in the calculation of CET1.
- Subtract moratoria in the calculation of non-performing loans (90 days past due) while still assessing credit quality

Prudential regulations

- Relaxation of capital requirements: capital conservation buffer, counter-cyclical capital buffer; possible use of Tier-2 capital to meet Tier-1 requirements.
- Relaxation of liquidity requirements (liquidity coverage ratio)
- Postponement of the implementation of the leverage ratio by one year
- Relaxation of concentration limits for bond holdings
- Relaxation of supervisory burden

¹ The issue share limits of the public sector asset purchase programme (PSPP), hence before flexibility was introduced, are detailed in the ECB's decision No. 2020/188, Article 5, 3 February 2020. For a given national signature in the euro area, the limit is set at 33%. See www.ecb.europa.eu/ecb/legal/pdf/celex_32020d0188_en_txt.pdf

Monetary or fiscal policies?

The swift reactions of the ECB and the banking regulators have enabled national governments to deploy their own bold responses. Their immediate priority was to subsidise short-term unemployment and firms' fixed costs in order to keep them alive, with the hope that after the lockdowns, activity could resume almost as before. With a looming financial crisis and no upward pressure on inflation, it was key to secure low borrowing costs for these hugely increased financial needs. However, these were mostly national fiscal responses, and they varied across member states in a way that did not match the severity of the crisis in the different countries.

Since the post-GFC sovereign debt crisis, the ECB has been urging governments to better coordinate their fiscal policies and come up with a common fiscal tool. However, there has been a tendency of governments to procrastinate for legal and political reasons, and the existential risk for the euro area being insured by the ECB's "whatever it takes" stance.

In a sense, the ECB has been a victim of its reactivity: the lack of bold fiscal response at the euro area level has forced it to conduct even more unconventional policies. In a period of excess supply of goods and services, fiscal and monetary policies are part substitutes, both aiming at raising the level of aggregate demand (as a way to increase inflation for the former, and to reduce unemployment for the latter). This situation looks like being the opposite to the traditional fiscal dominance argument, which states that, ultimately, money supply is determined by fiscal deficits (hence they are strategic complements). Here, there was no federal deficit and – for the period between 2011 and 2019 – national government deficits were also reduced. The rise in central bank holdings of government debts was not a result of fiscal profligacy but rather the result of fiscal austerity.

With the Covid crisis, the situation has shifted brutally, with rocketing national deficits but still no euro area federal budget. The lack of the latter makes it impossible to build a coordinated response of fiscal and monetary policies, like in the United States. From the ECB's viewpoint, large purchases are necessary in order to reach the 2% inflation objective. Conditional on inflation being anchored below 2%, the ECB's mandate is also to support the economy.² However, the fact that these purchases consist mainly of national debts rather than EU-level ones raises specific difficulties, especially if they do not follow the ECB's capital key. This is because, like any monetary policy, the ECB's

² It may be useful to recall the formulation in Art. 127 of the Treaty: "Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union."

policy has side effects, notably on financial stability. In theory, financial stability is taken care of by micro- and macroprudential policies. In practice, though, the ECB relies on commercial banks for monetary transmission, so it cannot ignore the impact of monetary policy on financial stability. The tiering system applied to the reserves of the banks since 2019, where the marginal deposit facility rate only applies to part of excess reserves, can be understood in this way. However, the side effects of monetary policy may become more difficult to handle when they are the result of sovereign bond purchases that are twisted in favour of specific member states. Even if the purchases follow the ECB's capital key, this is not equivalent to fully-fledged coordination between fiscal and monetary policy, since the head of the executive – the president of the Eurogroup – has little decision-making power on the aggregate fiscal stance.

This problem is made more acute when considering the structure of risk sharing. Although only part of sovereign bond holdings are kept on the ECB's balance sheet (80% of the risk being held by the national central banks), there are two sources of loss mutualization: (1) in the event of an increase in interest rate or of a debt restructuring, and (2) in the event a country leaves the euro (and is unable to repay its Target liabilities). Although a central bank can continue to operate with negative equity, in such an event the ECB would stop paying seigniorage to the governments. It is the task of governments rather than that of the central bank to proceed to one-off transfers to a region that is hit by a specific shock. Should they fail to do so, though, accepting risk makes it less unlikely that risk which is several orders of magnitude larger will materialise. Hence, the first best is clearly a fiscal response at the level of the euro area; but the second best is also clearly the PEPP programme rather than the euro area going bust.

As already stated, the response to the crisis so far has been much quicker and bolder from the ECB than from the Eurogroup and the Council. As of mid-May, though, things were starting to change. Paradoxically, the move towards EU borrowing could be accelerated by the ruling of the German Constitutional Court on 5 May 2020, which has accused the ECB of overreaching its mandate and of neglecting the 'proportionality' requirement with the PSPP programme (the PEPP programme has not yet been scrutinised by the German court).

Towards a European fiscal response

On the fiscal front, the European response started by easing the way for national policies rather than designing an EU-level response. Indeed, the Commission was fast to enact two important decisions:

- A temporary framework for state aid rules was introduced on 19 March 2020,³ and amended on 3 April 2020 and 8 May 2020,⁴ in order to help member states to support the business sector during the lockdowns and in their aftermath.
- The general escape clause, which was introduced in the Stability and Growth Pact (SGP) in 2011 as part of the ‘six pack’ reform, was activated by the Eurogroup on 24 March 24 2020.⁵

These two measures have created leeway for immediate support at the level of member states. At the level of the EU and of the euro area, though, progress has been much slower. The debate has developed along five main dimensions:

1. **Conditionality** is in the DNA of (young) European emergency assistance. There is a legal reason for this: due to the no bail-out rule, the Member states in principle cannot lend to a country whose debt sustainability is doubtful. The role of conditionality is to ensure that the loans will be repaid, hence that the emergency assistance is distinct from a bailout. However, the reluctance to lend without conditionality is also related to a perceived governance mismatch: whether the funds are granted by the EU (through its budget) or by an intergovernmental arrangement (through the ESM or an ad hoc special purpose vehicle), the creditors want to have a say on the spending. This concern may seem legitimate in view of the political pressures governments face internally. But it is also informed by moral hazard concerns and by the history of a protracted and polarised debate in the wake of the last crisis. In other words, the internal political discourse in a number of countries is still replaying the last financial crisis rather than confronting the present one.

Nevertheless, at the time of writing it seems that it has finally been decided to concentrate the conditionality on the type of spending: ESM and SURE credit lines should be used to finance Covid-related expenditures, whereas no further conditionality will be requested on top of the ‘regular’ European semester (see Box 3).

3 “Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak”, Communication COM(2020)1863, 19 March 2020.

4 “Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak”, Communication COM(2020) 3156, 8 May 2020.

5 See <https://www.consilium.europa.eu/fr/press/press-releases/2020/03/24/remarks-by-mario-centeno-following-the-eurogroup-meeting-of-24-march-2020/>

Box 3 Fiscal measures at the European level

Fiscal and state aid rules

- Suspension of the Stability and Growth Pact rules by recognising that the conditions for the general escape clause in the EU fiscal framework, namely a severe economic downturn in the euro area or the Union as a whole, were fulfilled (23 March, Eurogroup)
- Relaxation of state aid rules. A temporary framework allows for direct grants or tax advantages, subsidised state guarantees on bank loans, loans at subsidised interest rates, state-sponsored export credit insurance, subordinated debt and equity injections. These various instruments are capped and firms need to be viable as of end-2019.

Protecting firms: Pan-European guarantee (EIB)

- €25 billion of national guarantees; increasing by €200 billion the EIB's capacity to extend credit guarantees to commercial banks, national promotional institutions and national guarantee schemes; counter-guarantees; purchases of asset-backed securities from banks and some venture debt.

Protecting jobs (SURE)

- Loans to national governments in order to finance surges in expenditures related to short time work (*kurtsarbeit*) and support to independent workers
- Commission borrows up to €100 billion backed by EU budget headwinds + €25 billion of national guarantees, maximum repayments of €10 billion per year, to be discontinued after Covid crisis, Art. 122(2) of the Treaty (Eurogroup, 15 May 2020).

Protecting sovereigns: Pandemic crisis support (ESM, euro area countries only)

- Loans to national governments in order to pay for Covid's direct and indirect healthcare and prevention costs, no conditionality, up to 2% of GDP, maximum average maturity of ten years, discontinued after December 2022 (Eurogroup, 9 May 2020).

Restarting the EU economy (Recovery Fund)

- Loans to national governments, direct spending on programmes and capitalisation of an equity fund, possibly totalling €500 billion and backed by future surcharges on member states' contributions to the EU budget and/or own resources. To be discontinued after the funds are repaid, possibly over a long period.

2. **Loans versus grants.** Here, again, there is a legal constraint. According to the Treaty (Art. 310), the EU budget needs to be balanced on a yearly basis. Art. 122(2) nevertheless allows the EU to borrow in order to extend back-to-back loans to a member state in case of “natural disasters or exceptional occurrences beyond [its] control”. As for the ESM, it only extends loans. Beyond the legal discussion, there is a strong economic case for a mixture of loans and grants. In particular, when a sovereign or a corporate is already highly indebted, adding on further indebtedness can lead to long run problems of debt overhang.

While the SURE initiative relies on loans (see Box 3), the European Commission and the Franco-German agreement of 18 May 2020⁶ envisage a large proportion of spending in the Recovery Fund. The Commission would borrow on markets but instead of lending the money to national governments, it would spend it on specific recovery programmes, as part an EU comprehensive recovery strategy within a temporarily inflated EU budget. Such proposal amounts to some form of ‘targeted grants’. One key element is that the most severely hit countries may contribute less to the repayment of the common debts, hence there would be one-off transfers across member states.

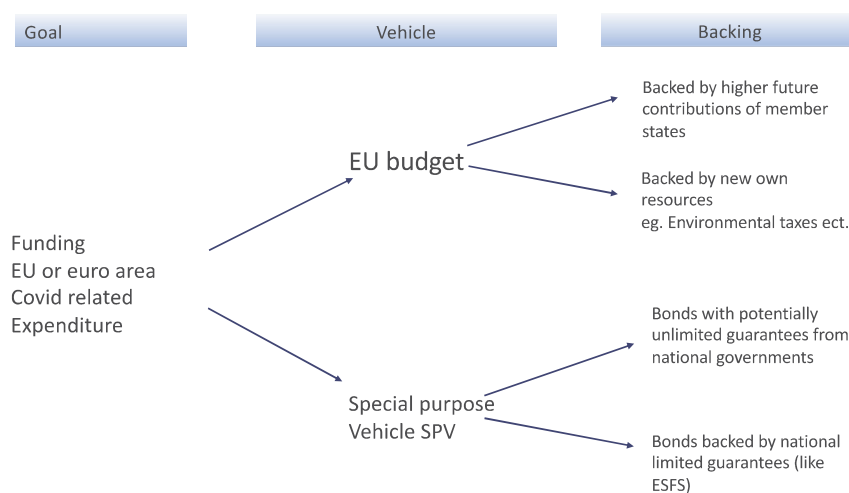
3. **European (EU Budget) versus joint and/or several borrowing (or ‘Coronabonds’).** This is the area where the debate has been most difficult and divisive. In principle, it is in the self-interest of each member state that (1) the other member states have enough resources to fight the pandemic (including with costly lockdowns), and (2) the pandemic does not trigger a sovereign debt crisis. Hence, each government should be able to borrow at low interest rates over long maturities in order to minimise the cost of the debt and the rollover risk. Also, European-level commons should be funded at the supranational level and in common. A key advantage of supranational-level borrowing is that it alleviates the pressure on national debts. Also, it would allow to create potentially large volumes of ‘safe assets’ that would stabilise the banking sector and also make the asset purchasing programmes of ECB easier. However, the different proposals have different implications in terms of liability, as described in Figure 1.

One way is to enable to European Commission to borrow on behalf of the EU, and to back the issued bonds with future higher contributions to the EU budget by the member states. An alternative (or complement) would be to back the debt at least partially with new own resources, like ETS proceeds, carbon taxes or other levies. Given that the annual gross national income (GNI) of the EU without the

⁶A French-German initiative for the European recovery from the coronavirus crisis, 18 May 2020 (see <https://www.diplomatie.gouv.fr/en/coming-to-france/coronavirus-advice-for-foreign-nationals-in-france/coronavirus-statements/article/european-union-french-german-initiative-for-the-european-recovery-from-the>)

UK is approximately €14,000 billion, the Commission could, for instance, borrow around €500 billion backed by a temporary surcharge of national contributions to the budget and/or own resources amounting to 0.5% of GDP over seven years (which corresponds to the 2021-28 MFF), 0.7% if the repayments only start in 2023 and continue through 2028, or a lower amount if the debt is more long term or rolled over.

Figure 1 Possible options for funding



Another route is through some kind of ad hoc special purpose vehicle (SPV). This in turn could have two variants. The first is one in which the SPV borrows with a joint and several guarantee from member states (Eurobonds or Coronabonds). However, such solution is less secure legally (see Garicano, 2020) and difficult politically. Alternatively, the SPV could issue debt-backed limited (capped) guarantees of the member states (i.e. several, but not joint guarantees). This was the case of the European Financial Stability Facility (EFSF), a crisis resolution SPV created in 2010 to provide financial assistance to Ireland, Portugal and Greece. The EFSF was eventually superseded by the ESM, which also borrows with euro area member state guarantees, but has its own capital base and can call additional capital from the member states.

The structure decided for SURE funding is modelled after the EFSF, based on national guarantees. In contrast, the Recovery Fund could be backed by additional contributions to the EU budget. Finally, the ESM will rely on its own lending capacity.

4. **Loans versus equity.** Whether European or national, private or public, a debt needs to be repaid or rolled over. The debt overhang that will follow the crisis will create financial fragility and possibly slower growth due to reduced investment. This is especially the case in the non-financial corporate sector. Hence, some authors (Boot et al. 2020a,b) have proposed to set up a European equity or ‘equity-like’ fund whose mission would be to invest in corporate equity, in return for future capital gains or, in the case of very small firms, in return for future taxes. On the sovereign side, GDP-indexed bonds would provide an equivalent of equity, but this possibility has not re-emerged so far in the European debate.
5. **Own resources.** One key element of the equation in the post-crisis period will be the ability of the member states to raise taxes without blocking the recovery of the private sector. There are two ways to do this. The first is to look for a new, ‘own’ resource (Garicano, 2020). A carbon resource (revenues from the ETS market, carbon taxes) would be especially suitable as it would align the incentives of the governments on the Green Deal master project. A second avenue, which should be thought of as a complement to the first, would be to accelerate the tax coordination projects at the EU level – corporate income tax, notably for digital activities; a new VAT regime; digitalisation of tax administrations, etc. (e.g. Bénassy-Quéré 2019) – in order to plug the various cross-border leaks that together amount to more than 1% of GDP, and possibly to enforce more progressive tax systems.

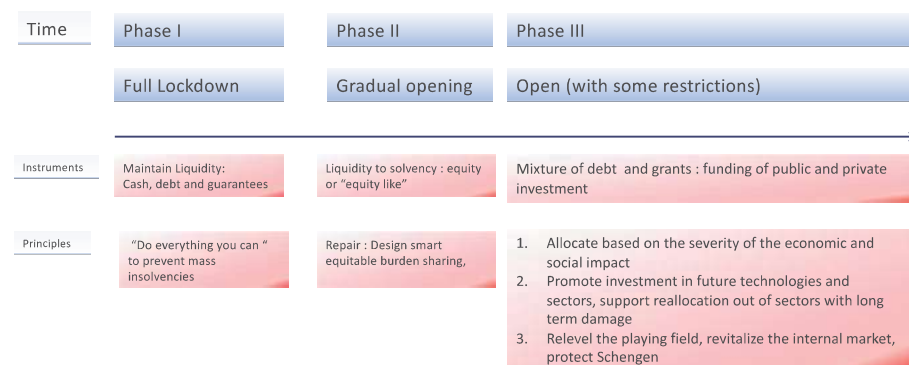
The next phase: Repair, reboot, recover

Figure 2, adapted from Anderson et al. (2020), illustrates the progression of the crisis over three phases.

The first was the acute phase of the medical emergency, with the economy in lockdown. In this phase, the first priority of governments was to avoid unnecessary suffering, the closure of firms and the loss of jobs. Governments’ and central banks’ actions were all about providing enough liquidity to households, firms and banks, and the guiding principle was “act fast and do whatever it takes” (Baldwin and Weder di Mauro 2020). In the acute emergency, governments have provided cash, loans and guarantees to compensate as much as possible for the losses incurred because of the lockdown. Considerations about firms’ future repayment ability (due to possible long-term changes

in demand patterns or because they may already have been unviable before this crisis) had to take a back seat. Similarly, the questions of long-run debt sustainability of firms and sovereigns were pushed into the future.

Figure 2 Phases of the crisis



Source: Authors elaboration based on Anderson et al. (2020).

In the second phase, the gradual reopening of the economy starts. In this phase, demand is still sluggish since people are cautious and choose to restrict their mobility. Social distancing and other regulations mean that some businesses and sectors do not recover quickly. They also have to pass on to the consumer the cost of the new distancing regulations, which contributes to depressing demand in some sectors. Uncertainty about longer-run prospects remains high and the wait-and-see attitude for private investment continues. This is also the time when some of the more long-term damage of this crisis starts to become more visible. Some firms are unable to repay the loans they received and insolvencies increase. Industrial restructuring plans start to be announced. The defining principle during this phase should be to repair corporate balance sheets and avoid the problems of a debt overhang, disincentives to invest and mass insolvencies. This suggests a different package of measures:

- **Cleaning corporate balance sheets.** This would involve moving from debt to equity or equity-like instruments. For the small and medium-sized firms, equity-like instruments would serve this purpose (Boot et al. 2020a,b). A European equity fund should serve to level the playing field across countries (compensating for unequal capacities at the national level to provide generous funding). It could also top-up national schemes, with the national government taking the ‘first loss piece’. However, a number of principles should be observed:

- Simple, transparent rules applying to SMEs. Given the number of firms in the European Union, and given that they mainly finance themselves through the banking sector (rather than directly on the market), it is advisable to channel government and EU interventions through banks and via national development agencies (such as the Cassa depositi e prestiti in Italy). However, it will be necessary to ensure that banks incorporate the social cost of bankruptcies in their decision-making. As suggested by Blanchard et al. (2020), public creditors could accept higher haircuts than private ones in case the debts of a viable firm are restructured. A standard scheme needs to be proposed in order to avoid lengthy negotiations and, above all, bottlenecks in commercial courts. In case of equity-like investment, it will be necessary to impose constraints on executive pay in order to circumvent the porosity between profit and labour income in small firms.
- For large firms, simple rules will not work. Given the large externalities for the Single Market (competition, value chains), the Commission should take the lead to organize the restructuring in the most affected sectors (e.g. airlines). In case of temporary nationalisation, contingency plans should be made for subsequent privatisation. Given the level of uncertainty and the necessity to recoup at least part of public investments, it will be difficult to set a precise timeline.⁷ The Commission should make sure that conflicts of interests are avoided. For instance, governments should not be, at the same time, active shareholders and active regulators.
- Finally, the (temporary) rise in households' savings rates should be relied on. Although risk aversion will likely be on the rise, share prices will be low, offering good opportunities for capital gains. Since sovereign rates will likely remain very low for a long time, it would be advisable to review existing financial regulations with the perspective of encouraging the development of diversified private equity products. This could be part of an effort to 'humanise' finance through regionalised and/or 'green' savings products. However, the bulk of equity will have to fall on the balance sheets of institutions with long horizons. It would be advisable to adapt the regulation of insurance companies and to accelerate the capital market union project (Demertzis 2020).

⁷ ABN AMRO, which was nationalised and restructured in 2009, was still 80% owned by the Dutch government ten years later.

- **Encouraging labour reallocations.** Jordà et al. (2020) find that, historically, pandemics have been followed by increases in real wages and falls in real interest rates. This result can be interpreted as the outcome of a lower labour force (due to the death toll and/or reduced participation rate) while capital is basically unaffected. During the recovery phase, demand will stay depressed in some sectors (e.g. restaurants), whereas it may recover relatively quickly in some others (e.g. construction). Within each sector, the demand will also recover unevenly (e.g. more e-commerce and fewer physical shops). Hence, we cannot exclude labour shortages in some sectors or sub-sectors while unemployment would stay high in others. Today, it is impossible to assert whether these effects would be transitory or permanent. Hence, we should perhaps think in terms of short-term flexibility and in terms of option value:
 - Short-term flexibility. Local arrangements where some workers are ‘lent’ by one firm to another firm for a limited period of time could be encouraged - for instance, from restaurants to groceries stores, or from airport security to shopping centre security.
 - Re-training. There is an option value of training the unemployed for new jobs, even if at the end they can recover a job in their initial occupation. Learning a second job could also be welfare-enhancing for the workers, for instance if this allows them to move to another, preferred location.
 - Training. A new generation of youth will arrive on the labour market in September 2020, some of them with limited skills. It is essential to incentivise companies in the relatively booming sectors to hire low-skilled young workers. Existing programmes such as the European youth guarantee or apprenticeship programmes need to be scaled up and adapted to the new context.

Overall, the SURE initiative will shortly have to reinvent itself by moving from compensating short-time work to encouraging flexible labour arrangements and on-the-job training programmes. This will be all the more necessary as the Recovery plan will likely increase the demand in some sectors such as housing renovation or IT services. Not quickly building up sufficient skilled capacity to serve the demand would lead to a mere increase in prices, with little gain in terms of production and employment.

The second and third phases of the crisis will likely overlap. The third phase will however be characterised by return to a ‘new normal’, in which social distancing and other restrictions remain in place for as long as immunisation has not been achieved. This may be a long phase of recovery, in which the EU will kick start its Green Deal

and digitalisation strategies, while at the same time having to still support some injured sectors of the economy. During this phase, a few guiding principles on EU level spending should apply:

1. It should be directed towards the most severely impacted regions and individuals.
2. It should promote the growth of future technologies and sectors (e.g. green, health and digital) while at the same time supporting the reallocation of people out of sectors where the recovery chances are slim.
3. It should serve to relevel the playing field, revitalise the internal market and protect the Schengen area.

The pandemic may well have a long-lasting impact on the distribution of demand between consumption and investment. To the extent that collective preferences have shifted in favour of preserving the environment and investing in health protection, the new growth regime will rely on more public and private investment, and less consumption. The Recovery plan should accompany this structural shift through facilitating factor reallocations, supporting public investment, incentivising private investment and mobilising households' savings.

Conclusion

At the time of writing, the EU Recovery plan is taking shape and the contours that are becoming visible look promising. If enacted as foreseen by the Franco-German agreement (€500 billion of spending along a few strategic priorities, backed by the EU budget with possible own resources), it would indeed constitute a quantum leap for EU-level fiscal policy action. Indeed, fiscal policy starts when the budget can be in deficit in bad times and in surplus in good times. In this sense, the Recovery plan would signal the birth of nothing less than a European fiscal policy, although at this stage the budget would remain modest. The de-correlation between national contributions (based on each country's GDP and/or on own resources) and the allocation of spending (based on the needs) is not entirely new since it is at the core of structural funds. However, it will de facto entail one-off transfers from the least affected countries to the most affected ones. This will be a significant sign of European solidarity and unity.

Of course, a Franco-German agreement is clearly not enough to obtain a consensus among the now 27 members of the EU, and the topic remains highly controversial. However, things are moving that could unlock a number of other topics, notably the financing of the green strategy and the re-balancing between monetary and fiscal policy. Putting together the ESM pandemic credit lines (up to €240 billion), the EIB credit guarantees (€200 billion), the SURE initiative (€100 billion) and the tentative

Recovery fund (€500 billion), we could possibly arrive at a total exceeding €1 trillion, or 7% of EU's GDP. This is still low compared to the budget of existing federations, but sizeable compared to the expected deepening of national fiscal deficits. Furthermore, these borrowings will constitute 'safe assets' that could oil the wheels of the banking sector and the ECB.

Going forward, a number of issues will have to be addressed, notably:

- **The Stability and Growth Pact.** Before the Covid crisis, the fault lines of fiscal rules were widely discussed and understood. In order to avoid the same pro-cyclical fiscal tightening as that carried out after the global financial crisis, the SGP will have to be adapted. The jump in debt-to-GDP ratios will make the debt rule even less workable than before the crisis. Conversely, off-balance sheet liabilities will have to be monitored. For a while, it may be advisable to think more in terms of gross financial needs than in terms of financial or structural deficit, and to develop contingent fiscal planning in case some risks materialise. At a later stage, expenditure rules could replace the pre-Covid SGP as a way to monitor sovereign deleveraging over a long period while allowing for counter-cyclical fiscal policies.
- **Taxation.** National governments should not shift brutally from heavy subsidisation to heavy taxation. The only way to avoid such a self-defeating strategy while raising resources to service the new debts would be to broaden existing tax bases. Hence, anti-avoidance rules, efficient cooperation across national tax administration (for instance, on VAT), fair taxation of digital activities, and the elimination of the various tax holes and exemptions will be crucial elements of the recovery. Stronger cooperation would also be desirable so as to allow for more progressive tax schedules, since low-paid workers will have suffered relatively more from the crisis.
- **Convergence.** The crisis will likely have long-lasting effects on some sectors like car making, aeronautics or tourism, less on others like business services, agriculture or utilities. To the extent that these various sectors are unevenly distributed across the EU, the shock will have asymmetric effects, calling for relative price adjustments, labour mobility or temporary transfers. Some of the instruments put in place during the Covid crisis may need to be prolonged and adapted in order to address this legacy. Failing to do so would raise the discontent with sector specialisation that is at the core of the Single Market.

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