IS THE EU RESPONSE TO THE COVID-19 ECONOMIC CRISIS FIT FOR PURPOSE?

Note written by Didier Cahen, EUROFI

The COVID-19 pandemic has led to severe socio-economic dislocations and hardship. In March 2020, the EU moved quickly to support countries by providing greater flexibility in their use of EU funds to combat the pandemic (Coronavirus Response Investment Initiative Plus), and by activating the escape clause in the fiscal rules and temporarily allowing state aid to firms. This was followed in May by a package of financing support worth over 4 percent of EU27 GDP.

Finally, in July, the European Council reached an historic agreement on the €750 billion Next Generation EU (NGEU) package. Once legislated, this temporary instrument will provide grants and loans to EU members over the next few years to help accelerate the recovery modernize EU economies, make them cleaner and greener, more digital and more inclusive.

Indeed, the NGEU recovery package could provide a meaningful boost to euro area growth, especially in some of the countries hardest hit by the pandemic if the funds are deployed for productive public spending and go hand in hand with effective national structural reforms. Funds fostering investments in innovation and research, to favor digital agenda, and supporting small and medium-sized enterprises are effective countercyclical tools, while funds that foster education and health have more important medium-term repercussions.

The Next Generation EU (NGEU) is a significant step forward, which complements the fiscal measures at the national level. 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 magnitude of the economic impacts of the NGEU investments will depend on the quality of the programmes implemented in the member states. But absorbing all these EU funds might prove a huge challenge for some countries. And in all cases the name of the game remains national.

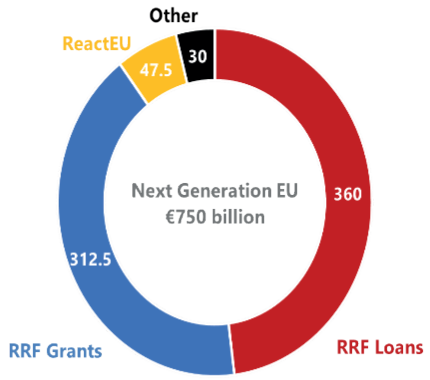
1. The historic NGEU recovery package could provide a meaningful boost to euro area growth, especially in some of the countries hardest hit by the pandemic

The NGEU recovery package entails the European Commission borrowing €750 billion to be used to finance €390 billion in grants and €360 billion in loans to members. These will be disbursed up to the end of 2026 and repaid by 31 December 2028 at the latest.

The main component is the Recovery and Resilience Facility (RRF), which will disburse all the loans and the bulk of the grants (€312.5 billion). The remainder of the grants will be used to top up other programs in the 2021–27 EU budget.

While many of the details of the NGEU package remain to be clarified - including how the debt incurred by the European Commission will be repaid- estimates suggest Southern and Eastern EU countries will benefit most from the grants.

Figure 1. Next Generation EU Recovery Package 1/



Sources: European Council (2020); and IMF staff estimates.

1/ RRF is Recovery and Resilience Facility. «Other» includes the Just Transition Fund, Rural Development, Invest EU, Horizon Europe, and RescEU.

NGEU comes in addition to the regular Multiannual Financial Framework (MFF) worth around €1 trillion over the next seven years and the EU agreement of April 2020. Indeed, the "Next Generation EU" recovery plan is the second part of the EU's response to the pandemic. In mid-April 2020, 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 has created a pan-European guarantee fund of €25bn to support €200 bn of EU businesses, in particular SMEs throughout the crisis[2].
- 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

1. Calculated on the basis of the 2019 EU GDP without including the UK GDP.
2. At least 65% of the financing will go to 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% will go 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% will go to venture and growth capital and venture debt.

country can benefit from this support up to the benchmark amount of 2% of GDP[3].

2. The Recovery and Resilience Facility (RRF) is the main element of the EU recovery plan and provides clear rules for spending the money and avoiding a misuse of the funds

This facility will make €672,5 billion (in 2018 prices) in loans and grants available to support reforms and investments undertaken by Member States. Member States have to prepare recovery and resilience plans that set out a coherent package of structural reforms and public investment projects for the years 2021-2023 and address the challenges identified in the context of the European Semester.

The financial support is not committed for ordinary budgetary expenditure to finance deficits but is intended to focus on investment and reforms. At least 37% of the allocation of each national plan has to support the green transition[4], and at least 20% the digital transformation (e.g. investing in the deployment of 5G and Gigabit connectivity, developing digital skills through reforms of education systems and increasing the availability and efficiency of public services using new digital tools).

Member States have until 30 April 2021 to submit their recovery and resilience plans to the Commission. These national plans will then be assessed by the EU Commission within two months of receiving them and approved by the Council by a qualified majority. Under the Facility, member states will be able to get pre-financing in 2021 of up to 13% of the grants provided for in their approved domestic plan.

Under the Recovery and Resilience Facility, payments will be linked to performance. The Commission will authorize disbursements based on the satisfactory fulfilment of a group of milestones and targets reflecting progress on several reforms and investments of the plan. Milestones and targets should be clear, realistic, well defined, verifiable, and directly determined or otherwise influenced by public policies. The national plans should notably present clear reform commitments that should be reflected in the milestones. They should also reflect a clear strategy for embracing the twin transitions and implementing reforms in line with the country-specific recommendations.

The RRF is expected to finance countries' public spending in line with the country-specific recommendations adopted by the Council in 2019 and 2020. These country specific recommendations, which are sent to all member states every year on how to improve deficiencies in their economies are usually ignored. But the RFF will use them as the basis for judging national recovery plans - European funds will only be disbursed if the Member States really take them into account -, which should give them more force.

In addition, the Commission needs to see effective systems in place to prevent, detect and correct conflicts of interest, corruption and fraud.[5] If the Member State has not satisfactorily implemented the milestones and targets, the Commission will not pay all or part of the financial contribution to that Member State[6].

This conditionality should encourage governments to tackle the key weaknesses that the crisis has exacerbated and increase economic growth potential by improving the business environment, the labour market and education, among other factors.

The Council agreement, which must be formally approved by European and national parliaments before entering into force[7], foresees repayment of the borrowing either with new EU revenues (a recycled plastic packaging waste tax, a carbon border adjustment tax, a digital levy, an emissions trading scheme, or a financial transaction tax), or by additional country contributions, over 2028-58.

3. Eastern and Southern countries would be the largest beneficiaries of the grants, as a share of their GDP

Over the entire period, a country's allocation will be proportional to its population size and inversely proportional to its per capita income level (i.e., richer countries get less). During 2021- 22, the allocation of 70 percent of the funds will also consider the unemployment rate in 2015 -19. In 2023, however, the allocation of 30 percent of the funds will reflect the economic impact of the crisis instead.

Under these assumptions, Eastern and Southern countries would be the largest recipients of grants, with Croatia, Bulgaria, and Greece estimated to receive between 8½ and 11 percent of their 2019 GDP (*see Figure 2*).

Italy and Spain, two large countries hard hit by the pandemic, would receive 3.7 and 4.8 percent of GDP, respectively (*see Figure 3*). Italy would receive €68.9bn in grants from RRF, ES 69.5bn.[8]

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

4. 100 per cent of European money must not harm the environment and the climate. Each measure proposed in a recovery and resilience plan will also have to respect the "do no significant harm" principle. Specifically, there are six environmental objectives to which no significant harm should be done: (i) climate change mitigation, (ii) climate change adaptation, (iii) water and marine resources, (iv) the circular economy, (v) pollution prevention and control, and (vi) biodiversity and ecosystems. This obligation applies to all reforms and investments and is not limited to green measures. The Commission will provide technical guidance to Member States giving further support on the application of this principle.

5. V. Dombrovskis, Remarks at the ECOFIN press conference, 19 January 2021.

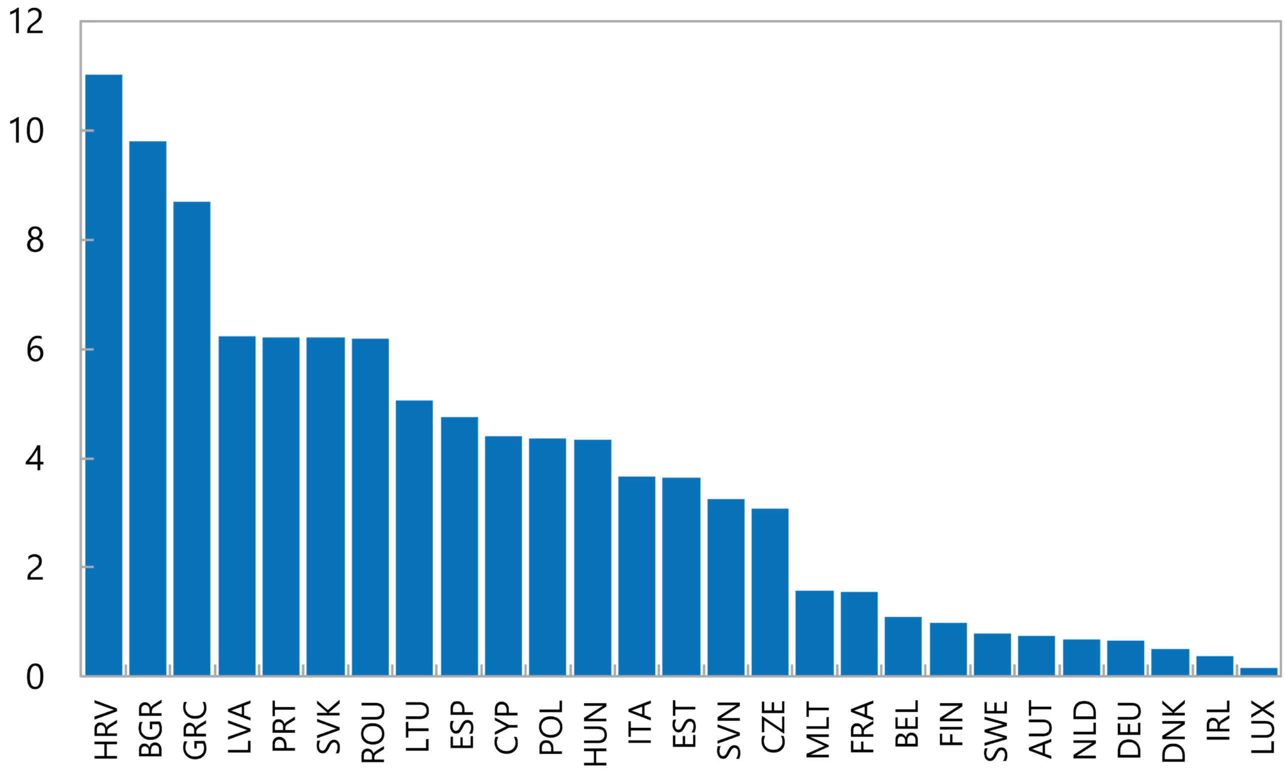
6. Upon completion of the relevant agreed milestones and targets indicated in its recovery and resilience plan, the Member State will present a request to the Commission for a disbursement of financial support. The Commission will prepare an assessment within two months and ask the opinion of the Economic and Financial Committee on the satisfactory fulfilment of the relevant milestones and targets. In exceptional circumstances where one or more Member State considers that there are serious deviations from the satisfactory fulfilment of the relevant milestones and targets of another Member State, they may request that the President of the European Council refers the matter to the next European Council.

7. The ratification process is not without risk: the 27 national parliaments (and regional parliaments in some countries) are called upon to decide and the absence of a single one would jeopardise the implementation of the EU Recovery Plan.

8. These figures are in current prices, and if dividing by current-price 2019 GDP Italy would get 3.8% and ES 5.6% of GDP. See page 50 of the following document: https://data.consilium.europa.eu/doc/document/ST-14310-2020-INIT/en/pdf.

Figure 2. Recovery and Resilience Facility Grants

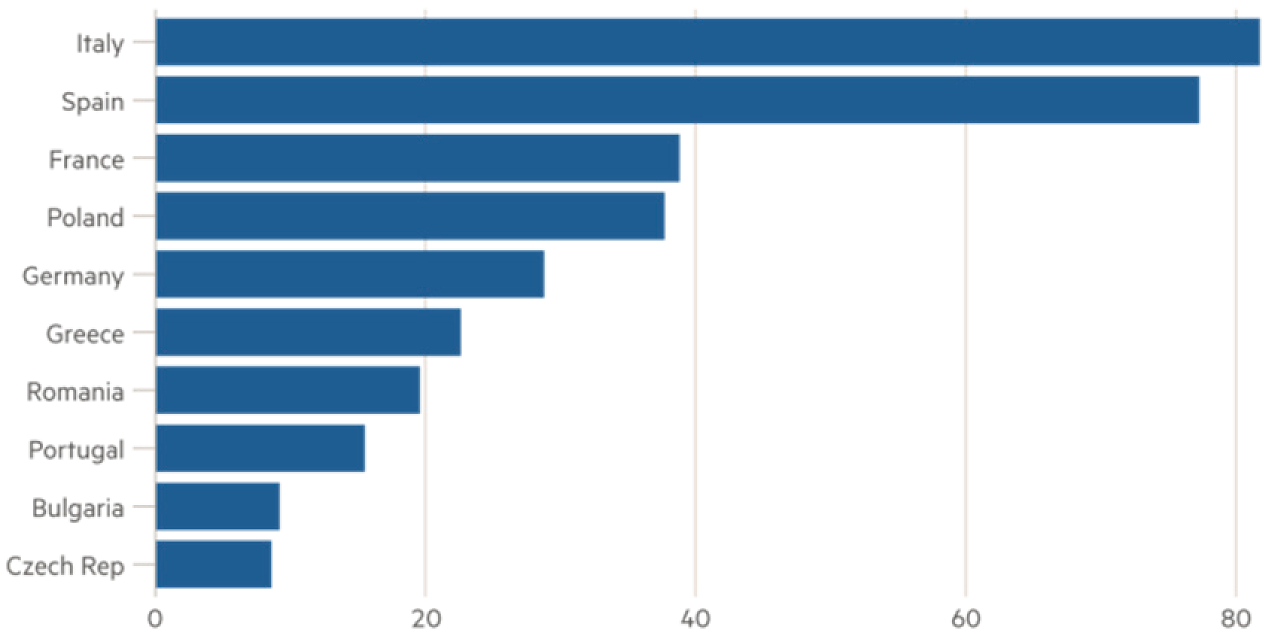
(Percent of 2019 GDP)



Sources: European Commission, IMF World Economic Outlook, and IMF staff calculations

Figure 3. Proposed grants for EU member states to counter Covid-19 recession

Top ten (€bn)



Sources: European Commission; Statista

4. The sheer volume of financial support available presents an absorption challenge

Spain and Italy could receive respectively €210 bn and €140 bn of EU recovery funds over three years.

But fund absorption rates from the last EU multiannual financial framework have differed a great deal between individual sovereigns. For instance, Spain and Italy have one of the worst track records for spending EU structural funds. In the 2014-2020 period, Spain managed to spend only 36% of these funds by last year, with Italy only a little better at 43%. By contrast, France's absorption rate was 61%, and Finland 81% (*see Figure 4 below*).

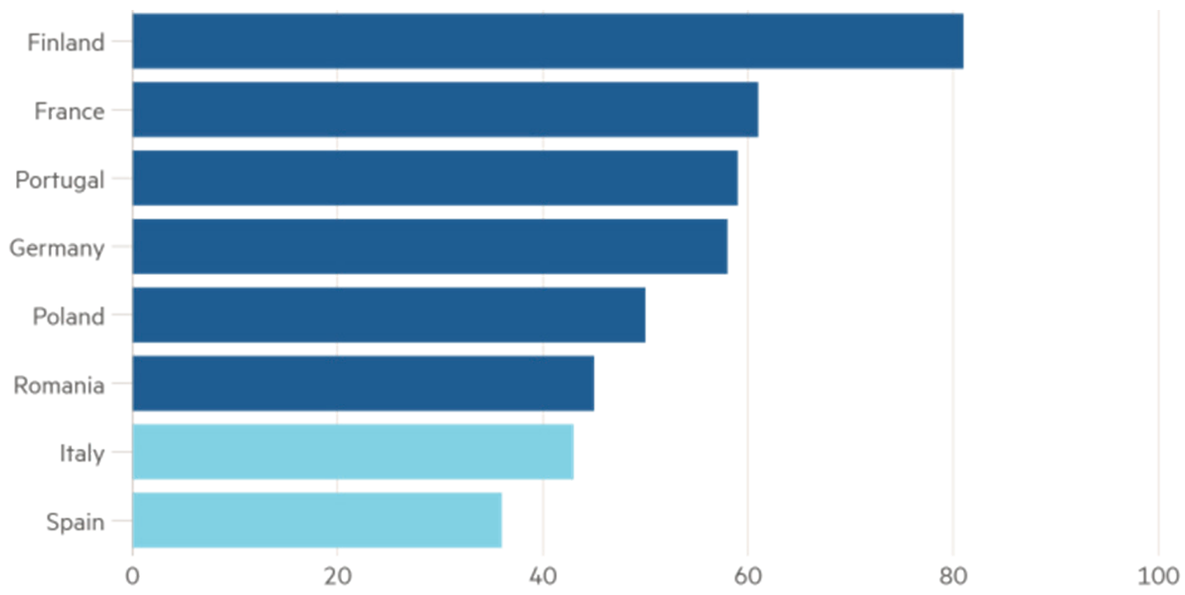
According to some experts, Italy's structural incapacity to spend money is related to the public sector's inability to make decisions, pursue transparent processes, and undertake auditing. Regarding Spain, a reform of the public administration also seems appropriate since "Spain 's large and compartmentalized bureaucracy – with 8000 entities spread over national, regional and local levels – combined with a complicated public contracting law cause an average lag of a year to adjudicate a contract[9]".

This suggests that faster deployment of EU funds in these two countries requires a strengthening of the public procurement framework and a reorganization of public administration to increase the speed, efficiency, and quality of spending.

Sufficient beneficiaries capable of developing quality projects in line with the green and digital transition will also be a key success factor of the EU Recovery package.

Figure 4. Italy and Spain struggle to spend EU structural funds fast enough

Share of structural and investment funds from 2014-20 budget spent by Sept 30 2020 (%)



Sources: European Commission © FT

Yet together Italy and Spain will receive no less than 40 per cent of the EU recovery fund harvest — dominating the spending programme. This means the reputation of the entire project rests on those countries' ability to come up with credible programmes that meet the Commission's green and digital priorities, minimize administrative bottlenecks, waste and fraud and promote efficient public-private sector collaboration.

Some officials hope the Next Generation EU project — which is officially designed to be temporary — could become a permanent feature of Europe's set-up. But that dream only has a chance if the money is well spent and certainly not wasted...

Furthermore, Europe needs much more to fill its infrastructure gap, the goals of climate change, and other sustainable goals. 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.

Faced with the "technological war" between the United States and China, Europe must also lay the foundations of its sovereignty for the next 20 years.

9. M. Khan &D. Ghiglione & I. Amount, "EU recovery plan faces bottleneck, economists warn", Financial Times, 5 January 2021

In the field of security and defense, reinforcing technological autonomy is essential. Sovereignty must also be exercised in the field of green technologies, and Europe must become the leader in this area. Technological challenges require a European industrial policy and strategy for technology funding. A holistic industrial policy marrying finance, research, industry, competition, trade, existing local eco systems and education is vital and urgent.

5. The name of the game remains national

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, in 2020, Member States have provided huge support for their economies: according to a Communication from the EU Commission to the Council[10], in total, fiscal support in the EU – automatic stabilisers and discretionary measures – in 2020 is estimated at about 8% of GDP - considerably more than the fiscal support provided in 2008-2009 – in addition to liquidity schemes of about 19% of GDP in the euro area..

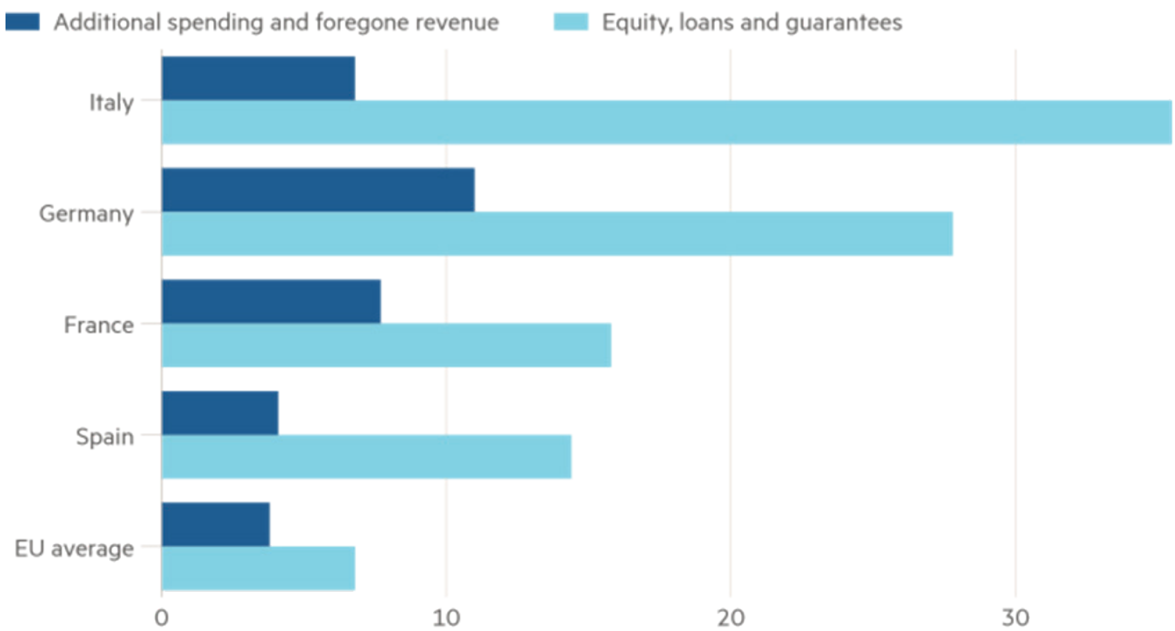
Member States took crisis related discretionary fiscal measures amounting to close to 4% of GDP in 2020 (*Appendix Table 1*) on top of already sizeable automatic stabilisers estimated at around 4% of GDP. The bulk of discretionary measures consisted of additional spending (3.3% of GDP). This included emergency spending on health care (0.6% of GDP), for example to increase the capacity of health systems, to provide protective equipment or to set up testing and tracing systems. Expenditure measures in other areas (2.7% of GDP) consisted of compensations to specific sectors for income losses, as well as short-time work schemes and other items. Tax relief measures accounted for an additional 0.4% of GDP.

Member States also provided sizable liquidity support (around 19% of GDP), mostly in the form of public guarantees for bank lending to businesses, markedly dampening the socio-economic impact of the crisis.

According to the ECB[11], these guarantees amount to around 17% of DGP for the euro area as a whole, but the size of the envelopes differs substantially across countries. The loan guarantees are contingent liabilities for governments and any amount of guarantees called on will therefore constitute additional public spending that raises government debt.

Figure 5. European countries' support for struggling companies

% of 2020 GDP



Source: Financial Times, Brussels Briefing European Union, 8 February

10. Communication from the Commission to the Council, "One year since the outbreak of COVID-19: fiscal policy response", 3 March 2021.

11. ECB, Fiscal developments, Economic bulletin, Issue 8/2020.

A study of CaixaBank highlights the differences in the scale and strategies of the fiscal responses between the various countries[12]. In Italy, for instance, the direct-impact fiscal measures announced so far (3.4% of GDP) have been much smaller than those announced by Germany (8.3% of GDP), while the amount of the guarantees proposed has been considerable. In Spain, the measures in all three categories seem timid compared to the rest of the major euro area countries.

These figures show that the fiscal space available was not the same in every country at the start of the crisis and how much the policy, particularly in Germany, of reducing the public debt-to-GDP ratio to the level prescribed by the Maastricht rules, has paid off. Starting with 60% of public debt, compared to more than 100% in other countries, Germany has been able to embark on a massive programme of aid to the economy while its neighbours do not have the same margin for manoeuvre.

Table 1. Fiscal measures announced by the main European national governments

	Direct fiscal mesures	Tax defferals	Guarantees
Spain	3.8	4.3	13.3
Germany	8.3	7.3	24.3
France	4.4	8.7	14.2
Italy	3.4	13.2	32.1

Source: CaixaBank Research, based on own estimates (Spain) and estimates by Bruegel

These disparities are also connected with the structure of the economy, the weight of the services sector, of tourism that the Covid- 19 crisis hit in particular, or the average size of companies. Some euro zone countries are more exposed to these sectors than others.

Furthermore, the national measures will push public deficits to deeper levels. Italian, Spanish and French public sector deficits are going to increase by EUR 145, 100 and 160 billion respectively in 2020. Their public debts are going to jump by more than 20 percentage points of GDP in 2020 to reach respectively 160% of GDP, 120% and 116% of GDP in 2020.

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 forthwith 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 State.

12. A. Leandro, "The fiscal response to COVID-19 in Europe: will it be enough?", Monthly report, CaixaBank, January 2021.

Appendix

Table 1. Overview of national fiscal measures in response to the COVID-19 pandemic

EU-27	2020		2020-2021		2020-2022	
	bln EUR	% of GDP	bln EUR	% of GDP	bln EUR	% of GDP
Initiatives by the Member States[1]						
A. Measures with a direct budgetary impact [2]	**497.8**	**3.8**	**364.7**	**2.6**	**83.1**	**0.6**
1. Expenditure	**438.5**	**3.3**	**322.2**	**2.3**	**65.9**	**0.4**
1. a) Health care	80.8	0.6	58.9	0.4	14.9	0.1
1. b) Other	363.0	2.7	264.5	1.9	52.3	0.4
2. Revenue	**59.3**	**0.4**	**42.5**	**0.3**	**14.1**	**0.1**
B. Automatic stabilisers [3]		± 4				
C. Liquidity measures without a direct budgetary impact	**2505.9**	**18.9**				
1. Tax deferrals	206.5	1.6				
2. Public guarantees (available framework)[4]	1877.0	14.2				
of which current take-up (actual contingent liability)	456.0	3.4				
3. Others	422.4	3.2				

[1] The amounts included cover the impact of nationally-financed measures, net of funding provided e.g. by EU initiatives

[2] The impact of the measures is given in increments compared to 2019 in accrual terms (ESA2010). GDP projections are based on the Commission 2021 winter forecast.

[3] The impact of automatic stabilisers is estimated as the residual after subtracting the estimated impact of fiscal measures from the change in the primary balance

[4] Figures refer to the maximal public funds involved if all of the available guarantees were taken-up. Guarantees to EU and international level instruments are excluded. For Germany, the size of available guarantee schemes is included, while the overall guarantee framework is actually unlimited.

Euro Area	2020		2020-2021		2020-2022	
	bln EUR	% of GDP	bln EUR	% of GDP	bln EUR	% of GDP
Initiatives by the Member States[1]						
A. Measures with a direct budgetary impact [2]	**422.3**	**3.7**	**339.4**	**2.9**	**57.9**	**0.4**
1. Expenditure	**368.8**	**3.3**	**298.6**	**2.5**	**42.3**	**0.3**
1. a) Health care	74.0	0.7	51.8	0.4	7.8	0.1
1. b) Other	295.7	2.6	248.0	2.1	35.7	0.2
2. Revenue	**53.5**	**0.5**	**40.8**	**0.3**	**14.9**	**0.1**
B. Automatic stabilisers [3]		± 4				
C. Liquidity measures without a direct budgetary impact	**2164.8**	**19.2**				
1. Tax deferrals	112.3	1.0				
2. Public guarantees (available framework)[4]	1790.9	15.9				
of which current take-up (actual contingent liability)	448.4	4.0				
3. Others	261.5	2.3				

[1] The amounts included cover the impact of nationally-financed measures, net of funding provided e.g. by EU initiatives

[2] The impact of the measures is given in increments compared to 2019 in accrual terms (ESA2010). GDP projections are based on the Commission 2021 winter forecast.

[3] The impact of automatic stabilisers is estimated as the residual after subtracting the estimated impact of fiscal measures from the change in the primary balance

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Source: European Commission 2021 winter forecast