

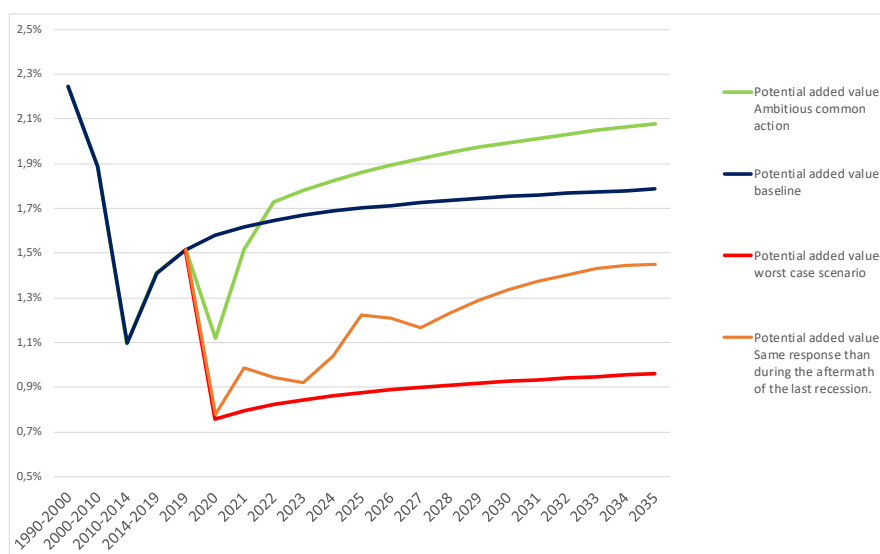
Added value of a common EU response to the economic consequences of the coronavirus pandemic

SUMMARY

In addition to the tragic loss of human lives, the ongoing novel coronavirus pandemic will have severe consequences for the European economy. Common action at EU level and coordinated long-term strategic action at international level is more necessary than ever before. In particular, in addition to the measures taken after the 2008 economic and financial crisis, a resolute move towards greater common policy action and a deepening of the single market, more strategic autonomy, increased common investment, and a reasonable deepening of risk-sharing within the economic and monetary union (EMU), could help to achieve a rapid, broad based and sustainable recovery. Our simulations, which use growth models based on long-term scenarios to 2035, indicate that the cost of complacency could be substantial.

In a pessimistic worst-case scenario, where the policy response is fragmented and where no risk-sharing takes place, potential added value growth would be reduced by 0.8 % in 2035. For 2020 to 2035, this would represent a cumulated €2.9 trillion of added value losses for the EU as a whole compared to the initial baseline. In a more optimistic scenario, we assume a decisive move towards more sustained common action at EU level. As a result, potential added value growth is initially less impacted and the common action boosts long-term growth prospects to levels surpassing the estimates from the baseline scenario. For 2020 to 2035, such a scenario would represent a cumulated gain of €0.5 trillion of added value for the EU as a whole compared to the initial baseline.

Figure 1 – Potential added value growth under various scenarios



Source: EPRS, using OECD data.

Background

In addition to the tragic loss of human lives, the ongoing coronavirus pandemic will have severe consequences for the European economy. Worryingly, and as stated by the French Minister of Finance,¹ without effective and long-term dedication to common action, the European project could again be in serious danger.

In the short-term, the health consequences of the epidemic and the complete lockdown of entire regions directly impacts the level of economic activity. Supply may be disrupted as some supply chains could be dismantled or even break down definitively. Investments will be postponed or cancelled and global trade will be heavily reduced. Simultaneously, as some workers lose purchasing power due to temporary inactivity or postponed contractual arrangements, consumption will be reduced, in particular for large items and services. Oil prices and financial markets have already been greatly affected, triggering a 'flight to safety', impacting interest rate spreads and disrupting the foreign exchange market.

In the medium- to long-term, uncertainty, lack of common action and cooperation could further exacerbate the economic impact of the crisis. If Member States act individually, those with an initially reduced margin of economic intervention could face extremely difficult conditions. As credit and budgetary conditions worsen, some businesses will have to halt their activity, while unemployment rises and social support deteriorates. Moreover, the reduction in the supply of liquidity could trigger wider economic consequences for heavily indebted business. Some banks could then face large losses, thus tightening credit further with potentially direct repercussions on sovereigns if common action at EU level is not taken. As a result, supply could be further disrupted and demand could remain severely depressed over the long-term.

Faced with an economic and financial crisis of such large proportions, the [European Commission](#) and the [European Central Bank](#) have begun to propose some responses to counter the negative consequences that have started to materialise. The [European Parliament welcomed these proposals](#) and has already adopted the new Coronavirus Response Investment Initiative, the extension of the EU Solidarity Fund to cover public health emergencies and has allowed temporary flexibility in the legislative framework. The European Commission has also stated that European institutions and Member States have together mobilised [€2.770 billion](#) to date to counter the effects of the pandemic, the most substantial financial response ever given to a European crisis. This is a welcome move, although [some argue](#) that most of this response remains fragmented along Member State lines, whereas a more common approach would have brought more added value and more direct solidarity. An [intense debate](#) has therefore commenced in the economic literature on the speed, size and composition of this support, as well as on the need to move decisively towards more strategic autonomy, greater risk-sharing, and increased common policy at EU level.

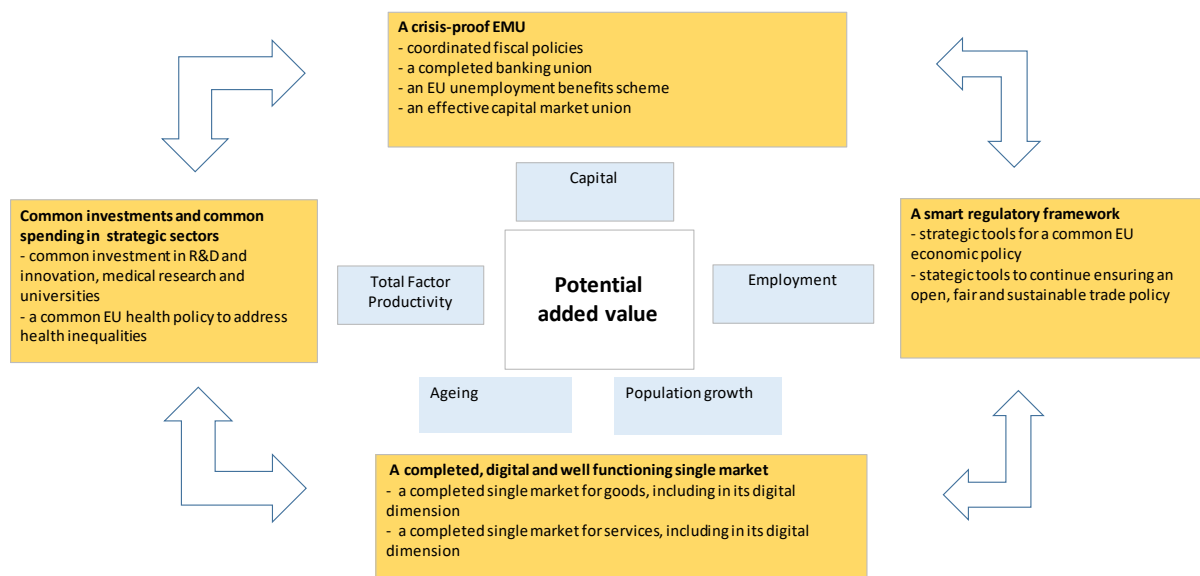
This paper seeks to shed light on these issues by building upon the extensive experience of the European Parliamentary Research Service's European Added Value Unit on evaluating crisis response² following the 2008 economic and financial crisis. In particular, we aim to estimate more precisely whether there would be an added value in a more common response to the ongoing Covid-19 pandemic. We also investigate the nature of the response and the related speed of adjustment to be expected under various scenarios.

Conceptual framework

Our analytical model follows a growth projection and accounting framework taken from the Organisation for Economic Co-operation and Development (OECD).³ This approach also has several advantages from the policy analysis perspective, as the model has been designed to examine the economic impact of policies and institutions. We look at potential added value as this allows us to capture the negative effect of the ageing population and to highlight the potential counterbalancing impact of policies to boost potential growth. More specifically, the approach

involves an accounting exercise that deconstructs potential added value, in changes, into the contribution from capital deepening (capital per person employed), total factor productivity per person employed (TFP), employment rate ratio, ratio of working-age population to total population, and population growth.

Figure 2 – The analytical model: Policy response and channels of transmission



Source: EPRS.

Description of policy areas

A crisis-proof EMU

The incomplete EMU architecture and its fragmented capital markets union (CMU) will continue to undermine the potential for the emergence of a crisis-proof EMU. A fully **completed banking union**, drawing on policies advocated by the European Parliament, would safeguard financial stability in Europe, breaking the vicious circle between banks and sovereign borrowing costs and reducing the duplication of regulations along national lines. Progress with the **capital markets union** would reduce the current fragmentation of European financial markets and remove the barriers which stand between investors' money and investment opportunities. It would also complement Europe's strong tradition of bank financing by providing alternatives to credit-based financing and a better access to stock markets.

Moreover, following the last financial and sovereign debt crises, considerable research has been devoted to the setting up of an **EU common unemployment insurance scheme**. Such a scheme could act as an automatic stabiliser during a serious economic downturn, as unemployment benefits are by nature counter-cyclical and very responsive to shocks. Announced by the European Commission, the current proposal for a temporary instrument worth up to €100 billion for [Support to mitigate Unemployment Risks in an Emergency \(SURE\)](#), to help protect jobs and people in work, is an encouraging step towards an EU common unemployment insurance scheme.

Furthermore, unless fiscal policies are coordinated effectively, there can indeed be significant negative 'spill-over' effects between the Member States participating in an economic and monetary union. The current EMU arrangements would thus be enhanced by pursuing credible and sustainable coordination of public finances. As proposed by the European Parliament,⁴ an **EU Treasury** would equip the Union with greater capacity to apply the existing economic governance framework and to optimise the development of the euro area. The resulting improved fiscal coordination would increase sustainability and resilience in Member States and confidence

between them. It would then make solidarity measures easier to apply and more efficient, should they be needed in times of economic and financial crisis.

A completed, digital and well-functioning single market

The European **single market for goods** is one of the greatest achievements of the European integration process to date, benefiting millions of businesses and consumers on a daily basis in what is now the largest combined marketplace in the world. Nevertheless, delays persist in the adoption of harmonised rules in Member States' national legal frameworks and infringements sometimes hamper further integration. If remaining barriers were eliminated and existing European laws were applied effectively, the [single market for goods could still yield substantial additional benefits](#) for the EU economy.

In addition, completing the **single market for services** is crucial to raising potential EU added value in growth and employment. Since the adoption of the EU Services Directive in 2006, thousands of excessive requirements and rules have been abolished. However, despite the real progress made, the cross-border provision of services is still largely under-developed, as the regulation of services remains fragmented and some excessive requirements persist. In practice, providers in several services sectors thus still face a wide array of barriers when they want to establish themselves in another Member State or deliver services on a temporary cross-border basis.

Finally, the **digitalisation of the economy** is progressing rapidly, generating changes in many aspects of people's lives. Whether in communications, shopping or manufacturing, the digital revolution is a driver of transformation, offering significant potential for the European economy. It proves even more crucial in the ongoing crisis situation, offering possibilities for teleworking for millions of workers and wide access to goods and services for the most vulnerable. Completing the digital single market is a key priority for the European Parliament.

Regarding public procurement, yearly public expenditure in the EU on goods, works and services represents nearly one-fifth of EU GDP (around €3 trillion). A common **EU public procurement agency** could provide an additional strategic tool to ensure a level playing field and more efficient public procurement.⁵ In addition, an EU public procurement agency could also help correct some vulnerabilities at Member State level. In particular, for health expenditure and access to health goods, a centralised agency would have greater bargaining power when negotiating with large global suppliers. This could potentially complement the potential establishment of a European health policy.

Common investment and common spending in strategic sectors

The 'Juncker plan' made extensive use of the guarantee offered by the EU budget and of the European Investment Bank's (EIB) financing capacities. The new temporary SURE instrument built upon this logic, with a guarantee of €25 billion from Member States. Beyond this policy area, and given the limited amount of guarantees that could be derived from the current EU budget, this solution alone seems insufficient to provide enough funding for further common ambitions. The EU has therefore to overcome some of its current areas of fragmentation and find common approaches towards providing more of the growth-enhancing common goods that are a distinctive feature of the European approach.

Boosting **common investment in research and development (R&D) and innovation, medical research and universities** is a policy area that could still greatly benefit from greater common EU investment. The lack of additional funding at EU level for large innovative transnational projects and for encouraging research at all levels remain key challenges. The EIB estimates that €130 billion per year of spending (including €70 billion of private spending) is still needed to meet the EU target of 3 % expenditure on R&D. The EU could directly and efficiently contribute to public sector expenditure contributions towards reaching the R&D target by further funding the budget allocated

to Horizon Europe, in line with the levels provided by some global partners. This would allow more active support for fundamental research and breakthrough, market-creating, EU innovations.

Moreover, additional funding could be earmarked for **investment in a potential common EU health policy to address health inequalities**. The European Parliament has expressed strong support in favour of the establishment of such a coherent EU public health policy. The EU currently only has a supporting competence in health policy. At present, EU spending on health is set out in the 2014-2020 multiannual financial framework (MFF), with a total budget of less than €3 billion per year. As a result, EU health policy focuses, in a limited way, on objectives such as fostering good health, protecting citizens from serious cross-border health threats, supporting dynamic health systems and facilitating access to better and safer healthcare for EU citizens. The provision of health care in Member States still varies significantly, with differences in the amounts of public money spent, as well as healthcare system design and access to basic and advanced prevention. A medium-term increase in common resources for a potential European health policy and for disease control and prevention would be welcome, as access to quality healthcare in all EU regions and better coordination and promotion of best practice between Member States could bring considerable benefits.

A smart regulatory framework

An EU that aims at autonomy in some strategic sectors should move towards a more holistic approach, encompassing the links between value chains and global interdependences. Updated and more complex tools at EU level for a renewed and more strategic EU economic policy have to be developed.

In that perspective, the development of a **smart regulatory framework supporting a renewed EU economic policy** could bear significant fruit and help a faster, broad based and more sustainable recovery. In particular, in recent years, the changing nature of competition has rapidly redefined a certain number of established positions and redistributed the value added across economies. The changing nature of competition also has a profound impact on existing production and distribution networks in almost all industries and services. Regarding competition policy, in the short term, the [temporary flexibility in the European State aid regime](#) announced by the European Commission, which allows Member States to provide support to some of the businesses most affected by the Covid-19 pandemic is a welcome step under the current difficult circumstances. In the medium term, in an interconnected and rapidly changing environment, concepts such as market definition and the notion of [dominance and abuse](#) may need rethinking.

Regarding taxation, the power to introduce, remove or adjust taxes is in the hands of the Member States, provided they comply with EU rules. EU action on corporate income tax (CIT) thus focuses only on measures linked to single market principles. The 2016 corporate reform package contained three new proposals to achieve a more modern and fairer tax system for business. The relaunch of the common consolidated corporate tax base (CCCTB) project was also part of this package. The CCCTB seeks to offer a fair and level-playing field and reduced costs and administration, support investment and R&D, thus contributing to increase potential added value growth.

Concerning foreign direct investment (FDI), the EU has one of the world's [most open FDI regimes](#), providing a main source of and destination for FDI. Recently, the structure and sources of FDI to the EU have changed significantly, sometimes through companies with state ownership or ties to governments. In 2019, the European Parliament agreed to set up a [mechanism at EU level to screen foreign direct investment](#) on security grounds, to protect strategic sectors. The measure includes a cooperation mechanism to include exchange of information. An enhanced common EU approach to foreign investors in strategic sectors would bring further clarity and harmonisation, while supporting foreign investments.

The **smart regulatory framework** could also be reinforced to continue ensuring an **open, fair and sustainable trade policy**. Currently, one in seven jobs in the EU is supported directly or indirectly

by exports, and the EU accounts for a considerable share of global trade flows (almost 17 % of the world trade in goods and services). As part of the EU trade policy toolbox, the multilateral front is the best avenue to achieve a broad based set of trade rules, promoting EU trade interests. This is particularly relevant for the EU approach to trade relations, as the EU always strives to ensure that trade goes hand in hand with respect for human rights, and labour, environmental, health and safety protection standards. Global disagreements have however recently increased and the current disruptions due to the pandemic could see large negative effects materialise if trade tensions escalate further. The EU trade defence instruments were recently reinforced with better protection against dumped or subsidised imports. Going further, it will be essential for the EU to continue pursuing a level playing field and a global environment that bring benefits to all to ensure sufficient productive capacities in strategic sectors and to put the EU economy back on the path to sustainable added value growth.

Evaluating the added value of common action to reduce the economic impact of the ongoing crisis.

A series of studies by the European Parliamentary Research Service's European Added Value Unit (EAVA)⁶ have demonstrated the potential added value of common action at EU level. An enhanced EMU would lead to a significant reduction in the loss of potential added value during a crisis scenario. In particular, it would prevent rapid and large changes in credit flows to the most affected Member States, while preventing deposit flight and ensuring adequate levels of capital adequacy ratio. A completed, digital and well-functioning single market would allow for greater solidarity in times of crisis and for better circulation of resources, thus avoiding costly fragmented competition for scarce supplies and limiting the negative impact of adverse economic shocks in the aftermath of a crisis. Additional funding for investment in a common EU health policy to address health inequalities have also been identified as likely to contribute to a more resilient and dynamic European economy. Finally, the regular updating and upgrading of some strategic tools could support enhanced common EU economic policy. This could ensure a level playing field and a more competitive EU economy, while preserving strategic sectors. In line with the European Parliament's advocacy of global free trade that respects certain principles, sustainable trade liberalisation has been shown to provide significant added value.

Based upon these results, the following sections detail the scenarios that result from our research. We calculated the impact in terms of additional potential added value growth,⁷ assuming an ambitious level of common action in each area. Subsequently, we quantified more precisely, under various scenarios, the economic impact of corresponding measures that could potentially be implemented in response to the current Covid-19 pandemic. With regard to a coordinated fiscal policy, a completed banking union and an EU unemployment scheme, the timeframe for the materialisation of the full impact is fixed at two years after the shock.⁸ For the remaining policy areas, the materialisation of the full impact is predicted for the end of the simulation horizon.

Initial baseline scenario and worst case scenario

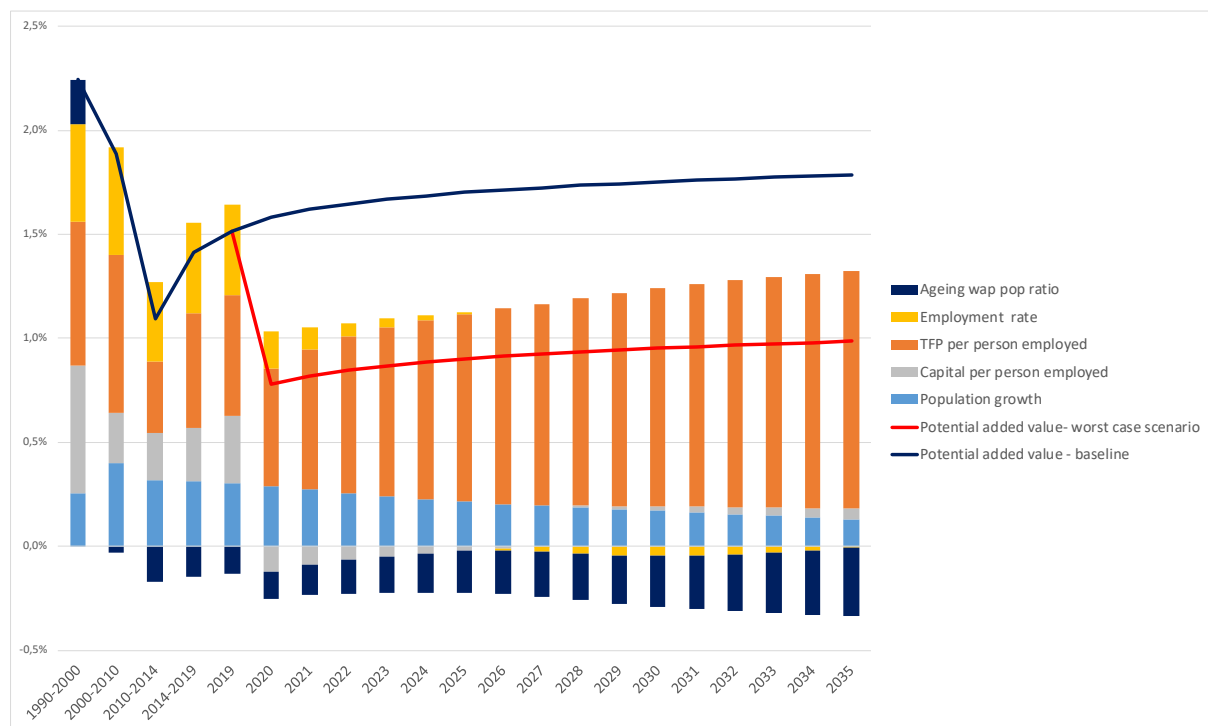
The initial **baseline scenario** serves as a reference for the evaluation of the economic impact of the ongoing pandemic and of various alternative response scenarios. The scenario is based on the prolongation of existing trends up to 2019, and as described by the OECD,³ the scenario assumes no change to initial institutional and policy-setting over the projection period. The results are presented in Figure 3 below. In line with our growth accounting framework, the potential added value growth rate, from 2019 to 2035, is set out in five components. Results for 1990 to 2019 are also presented, to serve as reference points when interpreting the projections.

Looking at the projection from 2019 to 2035, the declining evolution of the demographic components is increasing. With population growth declining (from 0.3 % to 0.1 %), the negative impact of ageing is growing (from -0.1 % to -0.3 %), while growth in the employment rate is

gradually reducing (from +0.4 to +0.1 percentage points), as the positive impact of the integration of young, female and migrant workers in the labour market is reaching its full potential. To counterbalance this outlook, the EU needs to revive growth in the TFP and capital deepening components. The baseline projections assume some improvements in that respect. Regarding TFP, the projection assumes a move towards the global technological frontier and an exogenous improvement in educational attainment. As a result, for the EU over the projection period, TFP growth increases from 0.6 % to 1.3 %. As for capital deepening, the growth rate is assumed to rise from 0.3 % to 0.5 % over the period, thus recovering gradually from the low growth observed in the recent period. However, the results show that this will not be sufficient to substantially increase potential added value growth. Compared with the values observed from 1990 to 2000, the EAVA projections emphasise a modest average growth rate of around 1.8 % in 2035.

To evaluate the potential economic cost in terms of a loss of added value related to the ongoing pandemic, EAVA carried out a second simulation, assuming that no coordinated response is forthcoming. This is naturally an unlikely scenario, but helps to better understand the relative magnitude of the added value loss in the baseline scenario. Such a scenario could be considered as similar to a **worst-case pessimistic scenario**, where the policy response remains fragmented, uncoordinated, potentially divergent and where no risk-sharing would take place.

Figure 3 – Potential added value decomposition – growth rate – Initial baseline and worst-case scenario



Source: EPRS, using OECD data.

To estimate the size of the correction, we assume that a potential growth shock similar in amplitude to that observed during the last economic and financial crisis will occur in 2020. This corresponds to a contraction of capital per person employed of 0.5 percentage points, a contraction of TFP per person employed of 0.2 percentage points and a contraction in the employment rate of 0.1 percentage points for the EU as a whole. Moreover, as we are interested in evaluating the loss of potential added value, we take a long-term perspective, thus calculating the cumulated loss from a 'no action' scenario until 2035, compared with the baseline. The impact of the simulated shock on potential added value and on its components is represented in Figure 3. As expected, capital per person employed and TFP are heavily impacted and recover only moderately over the simulation horizon. Potential added value growth is also affected significantly, falling to 0.8 % in 2020 and

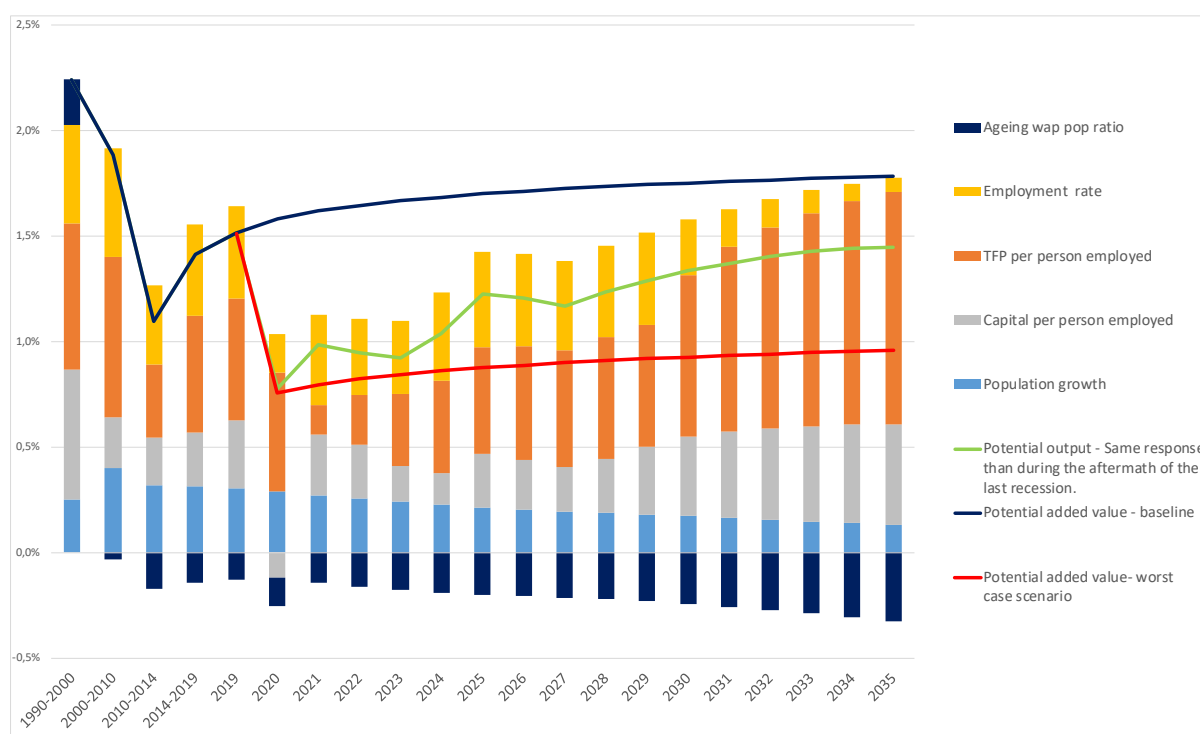
barely reaching 1% in 2035, some 0.8 percentage points below the initial baseline. Finally, employment rate growth becomes negative from year seven, contributing further to the weakness of the recovery. Compared to the initial baseline scenario, from 2020 to 2035 this would represent a cumulated **€2.9 trillion of added value losses** for the EU as a whole compared to the initial baseline scenario.

Potential impact of the Covid-19 pandemic – alternative scenarios

Our **third scenario assumes a similar response to the economic consequences as following the 2008 financial crisis**, in its amplitude and coordination. As some progress has already been made, in particular regarding the resilience of the EMU framework, an exact replication of what was observed in 2009 is unlikely. However, the aftermath of the 2008 crisis serves as an example of a response where risk-sharing remains limited. In this scenario, the initial shock is identical to the worst-case scenario. The difference lies in the fact that from year two (2021), the recovery path is similar to that observed from 2010, following the potential added value contraction of 2009.

The impact of the simulated shock on potential added value and on its components is represented in Figure 4 below. Capital per person employed is recovering from year three, although at an inferior rate to that observed for the initial baseline scenario. The growth rate at the end of the simulation horizon almost reaches 0.5%, slightly below the result observed in the baseline scenario. The TFP also initially grows moderately, before finally recovering to 1.1% in 2035, a level still 0.2 percentage points below the level of the initial baseline scenario. Employment rate growth is sustained, but rapidly declines below the level observed for the initial baseline at the end of the simulation horizon. In such a scenario, potential added value growth is initially rather disappointing. This affects long-term prospects, as potential growth in 2035 reaches only 1.4%; still 0.4 percentage points below the value for the initial baseline. From 2020 to 2035, this would represent a cumulated **€1.8 trillion of added value losses** for the EU as a whole compared to the initial baseline scenario.

Figure 4 – Potential added value decomposition – growth rate – Same response as during the aftermath of the last recession scenario

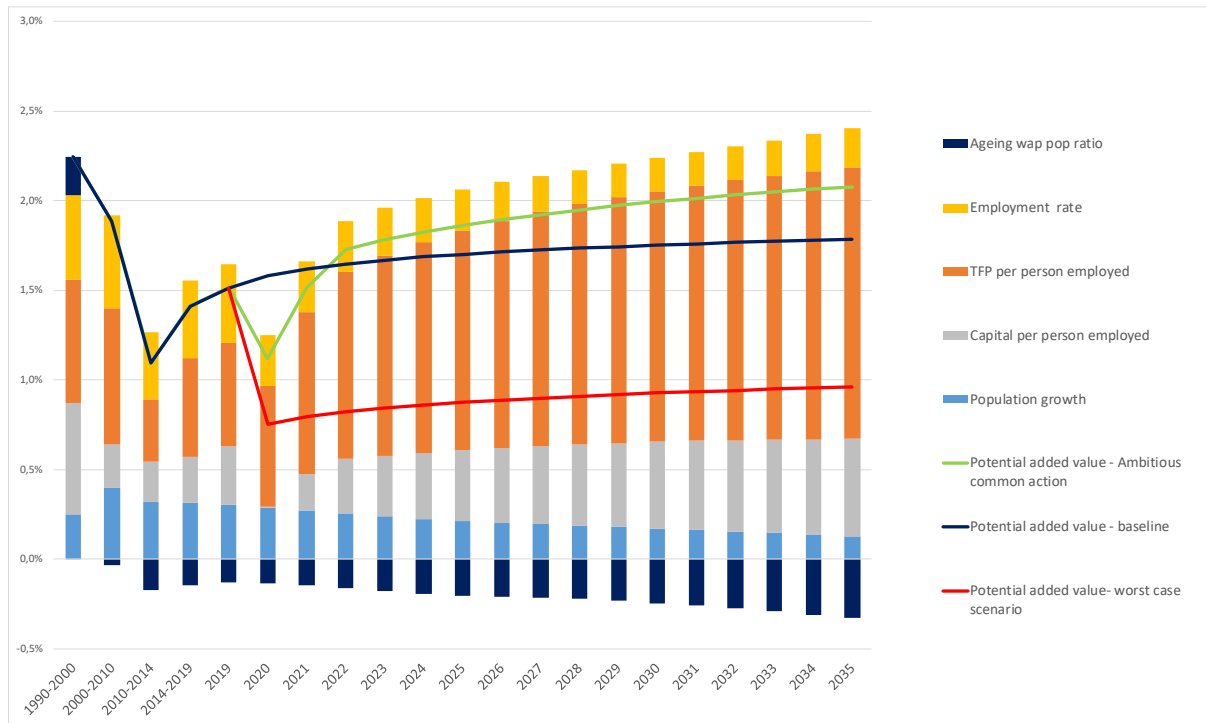


Source: EPRS, using OECD data.

As illustrated by the worst-case scenarios, in the current difficult situation, the risk of a fragmented response to the pandemic could prove extremely costly. In the case of a severe economic shock, one advantage of an ambitious common action is that it allows for a relatively less severe shock and a faster recovery to the initial potential added value growth path. A third advantage of common action is that it also ensures a higher level of protection against negative medium-term second round effects. Moving away from sterile dependency or isolationist postures, more common and concerted strategic actions at EU level are needed. **In this scenario**, we envisage that such a response is given and that **an ambitious level of common legislative and economic action** is rapidly agreed upon and implemented. The selection of policy areas considered in this exercise builds upon European Commission proposals to date and upon a series of studies by EAVA that have extensively analysed and quantified the potential added value benefits of more common action in more than fifty policy areas.

In this scenario, the first initial shock is again identical to the worst-case scenario. The impact of the simulated shock on potential added value and on its components is represented in Figure 5 below. We observe that, compared to the worst-case scenario, the policies related to ensuring a crisis-proof EMU significantly reduce the impact of the shock at the beginning of the simulation horizon. This was expected, as the positive effects of common action in this policy area materialise precisely during a crisis. Measures in the other policy areas also have a sizeable positive effect, although a more limited one in the short-term as the impact of these non-EMU related measures occurs progressively over the entire horizon period.

Figure 5 – Potential added value decomposition – growth rate – Ambitious common response scenario



Source: EPRS, using OECD data.

In total, as a result of these two effects, the negative impact of the shock is reduced by 0.4 percentage points in 2020. Potential added value growth increases to 1.1 % compared to 0.8 % in the worst-case scenario. After two years, potential added value growth surpasses the estimate of the initial baseline as the speed of the recovery increases and as the positive impact of common action further materialise. Capital per person employed recovers progressively from the shock. The growth rate at the end of the simulation horizon stands at 0.5 %, a level equivalent to that observed for the baseline scenario. The TFP also recovers, reaching 1.5 % in 2035 (+0.2 percentage points

above the level in the initial baseline scenario). The employment rate growth is sustained, reaching 0.2 % in 2035, again above the level observed for the initial baseline (+0.1 percentage points).

As a result, potential added value growth is initially less affected by the shock and the common action boosts long-term growth prospects to levels surpassing the estimates from the baseline scenario. Potential growth in 2035 reaches more than 2.1 % (+0.3 percentage points above the value for the initial baseline). For 2020 to 2035, such a scenario would represent a cumulated **gain of €0.5 trillion of added value** for the EU as a whole, compared to the initial baseline scenario. Compared with the worst-case pessimistic scenario where the policy response remains fragmented, uncoordinated, potentially divergent and where no risk-sharing would take place, a scenario of ambitious common action would thus bring significant net benefits for the European economy. A reaffirmed ambition would also ensure a faster and more dynamic recovery compared to the path that was pursued in the aftermath of the last economic and financial crisis.

Faced with an economic and financial crisis of large proportion, the European institutions have joined forces and begun to propose some common responses. It is nevertheless not the time for complacency, as more common ambitious actions could be pursued in a number of policy areas. Member States' responses and economic interventions must also be coordinated, as they could end up creating more divergence in the medium-term, putting the recovery at risk, in particular in the most vulnerable Member States. **Our results confirm that when it is united, Europe can deliver more**, more effectively and more efficiently, as common action provides a level of strategic depth that no individual Member State, nor any isolated group of Member States would be able to achieve. To attenuate and alleviate the negative economic impacts of the ongoing Covid-19 pandemic, we therefore conclude that a move away from sterile dependency or isolationist postures and more ambitious common and concerted strategic actions at EU level are needed. In particular, in addition to the measures taken after the 2008 economic and financial crisis, a resolute move towards more common policy action, greater strategic autonomy, enhanced common investment, and a reasonable deepening of risk-sharing within the EMU could help to achieve a more rapid, broad based and sustainable recovery.

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ENDNOTES

- ¹ Speech by French Minister of Finance, B. Lemaire, to the French National Assembly of 19 March 2020.
- ² See in References above: M-C. Frunza, 2014; G. Stull, 2012; M. Del Monte and T. Zandstra, 2014; G. Giraud, T. Kockerols, 2015; S. de Finance and R. Nieminen, 2016, and for a review and an update, A. Teasdale, 2019.
- ³ See Y. Guillemette and D. Turner, 2018 (in References above).
- ⁴ European Parliament, Resolution of [16 February 2017](#) on budgetary capacity for the euro area, 2015/2344(INI).
- ⁵ See L. Vogel, 2009 in References above.
- ⁶ See A. Teasdale, 2019 in References above.
- ⁷ The size of the shock is taken from [A. Teasdale, 2019](#) and converted to an annual potential added value impact expressed in percentage points, using 2019 as a reference point. The decomposition and the impact by channel of transmission (TFP per person employed, capital per person employed and employment rate) is based upon estimations taken from original modeling done by the [European Commission with the Quest model](#) and by the [Joint Research Center with the Rhomolo model](#).
- ⁸ In line with the estimations by M-C. Frunza, 2014; G. Stull, 2012; and G. Giraud, T; Kockerols, 2015 (see references above).

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