BRIEFING

European Parliament

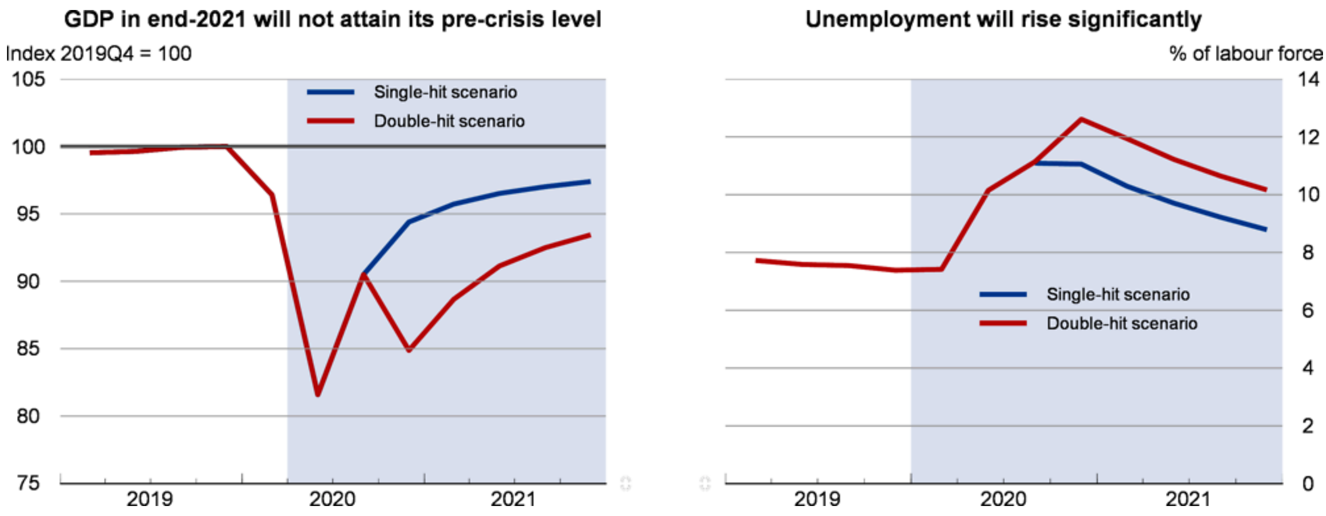
The economy and coronavirus: Weekly Picks

This paper provides a summary of recent analyses of the economic and financial effects of the coronavirus, an overview of the proposed new temporary European Union Recovery Instrument, and some policy recommendations made in the public domain to mitigate the negative economic effects of the pandemic.

OECD economic estimates for the Euro Area (10 June 2020)

According to the OECD forecast released on 10 June, the lockdown measures to suppress the COVID-19 pandemic have led to a major recession in the Euro Area in 2020. If a second pandemic wave takes place later this year (the double-hit scenario), GDP is projected to contract sharply by 11.5% in 2020, and the unemployment rate will exceed 12% by end-2020, despite widespread use of short-time work schemes. If the virus remains contained after the end of lockdowns in spring 2020 (the single-hit scenario), GDP will fall by over 9% this year, the unemployment rate will reach double digits and average Maastricht public debt will exceed 100% of GDP by the end of the projection horizon. Substantial monetary and fiscal support will underpin the recovery once the lockdowns are lifted, but output and employment will still be much below pre-pandemic levels by end-2021, especially in the double-hit scenario, thereby heightening risks of persistent scarring effects, including larger divergence across the area.

Graph: Two scenarios for the Euro area



Source: OECD Economic Outlook 107 database.
StatLink https://doi.org/10.1787/888934139290

Please see a separate EGOV documents for a comparison of recent forecasts for the Euro Area as a whole and for a comparison between the Euro Area and the United States.

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Eurostat latest data on Industrial production (12 June 2020)

In April 2020, the COVID-19 containment measures widely introduced by Member States continued to have a significant impact on industrial production. The seasonally adjusted industrial production fell by 17.1% in the euro area and by 17.3% in the EU, compared with March 2020.

In April 2020, compared with April 2019, industrial production decreased by 28.0% in the euro area and by 27.2% in the EU.

In the euro area in April 2020, compared with April 2019, production of durable consumer goods fell by 47.7%, capital goods by 40.9%, intermediate goods by 25.5%, non-durable consumer goods by 14.0% and energy by 12.8%.

Among Member States for which data are available, the largest decreases in industrial production were registered in Luxembourg (-43.9%), Italy (-42.5%) and Slovakia (-42.0%)

EIB's assessment of the effects on EU corporates (June 10, 2020)

Building on the short-term analysis carried out in the previous EIB's report, this updated analysis goes on to assess the challenges firms will face in the medium-term, as revenues remain weak. In particular, months of inactivity followed by a slow return to normal will require European firms to make a trade-off between high debt and sharp cuts in planned investment.

EIB's analysis considers four different scenarios, combining views on the lockdown and the length of the recovery. Across the four scenarios, the median reduction in net revenues would represent 5% to 10% of total assets. The impact of the crisis will differ among firms, depending on the size: SMEs will be significantly more impacted than larger firms. Cumulatively, the crisis and the subsequent recovery process might lead to a decline of European corporate net revenues that could range from €1.9 trillion and €3.4 trillion (13% to 24% of EU GDP).

In one scenario analysed by the EIB, EU corporate investment would shrink by 31% to 52%, while corporate indebtedness rises by 4% to 6% of GDP. Losses in net revenues would result in lower investment on the one hand, but corporations could alternatively also try to increase external finance on the other. Assuming that the whole sample of firms in the EIB Investment Survey tap external finance, even those that would not do so in normal times, the EIB finds that the share of external financing would rise from about 30% to 60%. Investment would then decline by 31% compared to 2019 levels, or 4% of EU GDP, but indebtedness would increase by 6% of GDP.

Overall, firms will have to choose between higher leverage, potentially exposing themselves to solvency issues but allowing for some investment, or lower leverage and a more aggressive cut in investment. EIB's expects the impact on investment to be at least two times more than the 19% decline recorded during the 2007-2008 financial crisis. The EIB hence finds that, going forward, aid for the corporate sector will have to complement liquidity support with more long-term equity instruments, which avoid excessive leverage.

The European Union Recovery Instrument

On 23 April 2020, EU leaders agreed to work towards establishing an EU recovery fund and tasked the Commission to analyse the exact needs and to urgently come up with a proposal commensurate to deal with the COVID-19 crisis. Leaders also agreed that the fund "*shall be of a sufficient magnitude, targeted towards the sectors and geographical parts of Europe most affected, and be dedicated to dealing with this unprecedented crisis*".

On 27 May, the Commission proposed[1] a European Union Recovery Instrument (EURI). EURI would rest in a revised EU own resources decision (see below) and would provide the EU budget with additional financial means, i.e. on top of those proposed for the 2021-2027 Multiannual Financial Framework (MFF).

[1] As set out in the Commission proposal for a Council Regulation establishing a European Union Recovery Instrument. The Commission proposal is based on Article 122 of the TFEU, requiring adoption by unanimous decision of the EU Member States.

The EURI would be a one-off emergency financial instrument, put in place for a temporary period and used exclusively for financing recovery measures by the Member States. The Commission would be authorised to borrow funds on behalf of the Union up to the amount of EUR 750 billion (in 2018 prices) [2] on the capital markets[3]. Under the EURI proposal, the amounts available for financing are split among the relevant budgetary programmes, mainly to a new Recovery and Resilience Facility[4], (see also previous EGOV Weekly Picks).

Borrowings up to the € 750 bn ceiling is made possible on the basis of a Commission proposal[5] to increase the EU own resources ceiling[6] by 0,6% percentage points on an exceptional and temporary basis. This increase would come on top of an increase on the permanent own resources ceiling to 1,4% (currently at 1,2% of GNI) due to economic uncertainties and Brexit. As such, for a temporary period of time, the own resources ceiling would be set at 2% of GNI.

Raising funding on the financial markets would mean that Member States would not need to make significant additional contributions to the EU budget during the 2021-2027 period.

Repayment of the temporary funding

The Commission proposes that all liabilities of the Unions incurred by the EURI will be fully repaid by 2058 and that reimbursements should not start before 2028. The proposal does not spell out how much should be reimbused per year. Instead it proposes that in any given year the repayment of the principal shall not exceed 7.5% of the maximum amount of the sums borrowed. If the EU utilises the EURI to its full capacity, the repayment of the principal would never exceed around 56 billion euro (in 2018 prices) in any year from 2028 onwards; the repayments could be smaller if the full capacity is not used, or if the repayment schedule is stretched out over the full 30 year period.

Consequently, the future EU budget expenditures and/or national contributions would need to be adjusted to reflect these annual repayment obligations (for the 2018 EU budget, for example, a repayment of EUR 56 billion would have used up around 35% of total MFF commitments). An alternative option to fund the repayments would be to agree on additional new revenue streams to the EU budget (see below). Not agreeing on the repayment method well in advance of the due repayments may add a new dimension to the tensions to agree on the subsequent MFF (past liabilities may prove to be particularly tricky). On 15 May, the European Parliament underlined that the recovery plan must be embedded in an increased MFF that includes new own resources.

The role of new EU own resources

In order to facilitate the repayment of the funds raised on the financial market to finance EURI and reduce the pressure on national budgets, the Commission indicated that it will propose additional new own resources at a later stage, during the 2021-2027 financial period (see Boxes 1a and 1b). The Commission underlined that these new resources would come on the top of those proposed in May 2018 by the Commission as part of its original 2021-2027 MFF proposal. Not agreeing on the repayment method well in advance of the due repayments may add a new dimension to the tensions to find agreements on the subsequent MFF. In May 2018, the Commission already proposed to diversify the sources of revenues with

[2] Disbursements under the facility would be made until 31 December 2024.

[3] In total, EUR 500 billion (in 2018 prices) would be spent for non-repayable support, repayable support through financial instruments or for provisioning for budgetary guarantees and related expenditure. EUR 250 billion (in 2018) prices would be used to provide loans to Member States. The Union will bear contingent liability in the form of a guarantee for those loans until they are repaid.

[4] Legal base 175(3) of the TFEU and to be adopted by the European Parliament and the Council under ordinary legislative procedure

[5] As set out in the Commission proposal for an amendment to the Coucil Decision on the system of EU Own Resources, under Article 311 of TFEU: requiring an unanimous decision by EU Member States and ratification of all EU national parliaments to be adopted.

[6] The Own Resources ceiling determines the maximum amount of resources in any given year that can be called from Member States to finance EU expenditure. The payments ceiling under the Multiannual Financial Framework (i.e. EU's long-term budget) is the maximum amount that can be paid out from the budget. The difference between the two (plus the amount of other revenue, e.g. taxes on the salaries of EU staff and competition fines) is the headroom. The Commission uses the headroom as a guarantee for the borrowing. The increase in the Own Resource ceiling will expire when all funds have been repaid and all liabilities have ceased to exist.

new own resources, which would contribute to the EU priorities related to climate change, circular economy and fair taxation (See Box 2).

Box 1a: Current EU own resources

The current Own Resources system rests on three main categories of revenue: (i) so-called Traditional Own Resources (mainly customs duties); (ii) a Value Added Tax-based Own Resource; and (iii) the Gross National Income-based Own Resource. While Traditional Own Resources are a direct source of revenue to the EU budget and thus have been identified as a 'genuine' EU Own Resource, the latter two categories are in essence national contributions, to be made available by the Member States to the EU budget. The Gross National Income-based Own Resource was established as a 'residual' keystone of the Own Resources system to ensure full funding of the agreed expenditure. However, over time it has become the system's predominant component. It accounts for more than 70% of EU revenue. It provides stability and sufficiency, but its predominance perpetuates the perception that national contributions to the EU budget are a mere cost factor.

Source: Commission (May 2018)

Box 1b: Possible new own resources outlined by the Commission (27 May 2020)

The Commission is committed to deliver on the Green Deal. In that context, green own resources could contribute to the recovery effort, while supporting the green transition of the European economy and society. Options could include an Emissions Trading System-based own resource including its possible extension to the maritime and aviation sectors, and a carbon border adjustment mechanism.

*An **Emissions Trading System** based own resource as discussed at the European Council in February 2020 would allow Member States to keep the same amount of revenue that they received from auctioning over a recent period. Any revenue generated by the European Emissions Trading System exceeding this maximum would go to the EU budget. Such own resource could generate revenues for the EU budget of about EUR 10 billion, depending on the evolution of the carbon price and the extension of the system to other sectors.*

*At the same time, it will be important to ensure that EU companies compete with non-EU companies on a level playing field. A **carbon border adjustment mechanism** would help to prevent carbon leakage, which undermines EU efforts to transition towards a carbon-neutral society. A carbon border adjustment mechanism could bring additional revenues ranging from about EUR 5 billion to EUR 14 billion, depending on the scope and design.*

***Companies that draw huge benefits from the EU single market** and will survive the crisis, also thanks to direct and indirect EU and national support, could contribute to rebuilding it in the recovery phase. This could include an own resource based on operations of entreprises which, depending on its design, could yield around EUR 10 billion annually.*

*A **digital tax** would build on OECD work on corporate taxation of a significant digital presence; the Commission actively supports the discussions led by the OECD and the G20 and stands ready to act if no global agreement is reached. A digital tax applied on companies with a turnover above EUR 750 million could generate up to EUR 1.3 billion per year for the EU budget.*

Box 2: New own resouces included in the Commission proposal (May 2018)

*A **Common Consolidated Corporate Tax Base** will provide stable and relatively large amounts of revenues to EU budget while not interfering with Member States' fiscal prerogatives. The proposed Own Resource based on Common Consolidated Corporate Tax Base would apply a call rate to the common consolidated base itself. With a call rate of 3 % for the EU, the Common Consolidated Corporate Tax Base could bring an annual average of approximately EUR 12 billion over the period.*

*A contribution from the **EU Emissions Trading System** to the Union budget as an Own Resource is proposed13. This would involve allocating a share of 20 % of certain revenues from the total of allowances available for auctioning to the EU budget. Estimated annual average revenues could vary between EUR 1,2 and 3,0 billion depending on the market price for EU Emission Trading System allowances*

*The Own Resource contribution would be proportional to the quantity of **non-recycled plastic packaging waste** reported each year to Eurostat. Member States' contributions to the Own Resource would be calculated by applying a call rate of EUR 0,80/kg call rate to this quantity, which could bring around EUR 7 billion per year.*

Policy recommendations in the public domain: Some picks from last week

C. Goodhart- Inflation after the pandemic: Theory and practice (13 June 2020)

The correlation between monetary growth and inflation has an historic pedigree as long as your arm. This column argues that rejecting the likelihood of (eventually) rising velocity following the current massive monetary expansion requires an alternative theory of inflation that has successfully eluded all of us thus far. Ignoring the potential inflationary dangers is the equivalent to an ostrich putting its head in the sand, and while the path towards disinflation may be well known, it simply isn't available today.

M. Pagano, C. Wagner, J. Zechner - COVID-19, asset prices, and the Great Reallocation (11 June 2020):

Whether COVID-19 will trigger a massive reallocation of capital and labour is a key question for policymakers and investors alike. As a result of the COVID-19 lockdown, entire sectors of the economy (e.g. travel and tourism) have been switched off overnight, while others have been spared and even thrived. Hence, since the outbreak of the pandemic, firms' resilience to social distancing has become crucial to their continued operation and profitability. This column shows that asset markets reveal large cross-sectional differences in the repricing of industries before, during, and after the onset of COVID-19. Firms that are more resilient to social distancing significantly outperformed in the six years before and during the COVID-19 outbreak. Looking into the future, stock options imply that investors require significantly lower returns from more pandemic-resilient firms. Governments would be unwise to ignore these signals, directing public financial resources mainly to prop up ailing low-resilience firms.

D. Gros - Europe's New Deal Moment (10 June 2020):

Many believe that the recent Franco-German proposal for a European recovery fund – to be financed by bonds issued by the European Union – could be the bloc's "Hamiltonian moment." The equation "Hamilton = Eurobonds now" does not hold. Arguably the most relevant US historical parallel for Europe today is President Franklin D. Roosevelt's New Deal of the 1930s. Then as now, the key issues were unemployment and poverty relief. The New Deal did not simply override state competences in those domains, but instead provided states and municipalities with large federal funding for public works and unemployment compensation In a similar vein, the €750 billion ($852 billion) "Next Generation EU" fund, proposed by the EU Commission on the heels of the Franco-German proposal, would channel EU funds through member states and regions. And the bloc's €100 billion SURE initiative to mitigate unemployment risks in hard-hit member states, which has already been agreed upon, also carries echoes of the New Deal. FDR's reforms have stood the test of time and are now accepted as an essential part of the US "economic constitution." The longer-term challenge for the EU will be to implement its COVID-19 crisis measures in such a way that they, too, come to be seen as useful economic stabilization tools when more normal times return.

E. Jones - Can Europeans Afford to be Optimistic? (8 June 2020):

June 4 brought two important pieces of good news. The first was an agreement within the German grand coalition government to add €130 billion to its fiscal response to the economic consequences of the coronavirus pandemic. The second was the decision by the European Central Bank's (ECB) governing council to add €600 billion to its pandemic emergency purchase program, to extend that program to June 2021, and to maintain or rollover any holding in that program through 2022. Europeans can still afford to be optimistic. Even if they turn out to be inadequate, this collection of policies shows that Europe's leaders have mastered the lessons from the last crisis and are determined to respond to the current crisis in an effectively coordinated fashion. Lesson 1: German fiscal stimulus is good for European macroeconomic performance. The German stimulus package is the kind of leadership that was missing in early European responses to the last crisis. Lesson 2: The European Central Bank is here to close the spreads.The ECB has now internalized the lesson from the previous crisis and as a result, it does 'whatever it takes' more quickly and decisively. Lesson 3: There is no substitute for effect policy coordination. This is where the European Commission's proposal for a 'next generation EU' recovery fund becomes important. That proposal does not have to be perfect in all dimensions; what it needs to do is bring focus to the conversation. The goal of that conversation is to make sure that all European member states work together to construct a common fiscal response that can in turn be used to complement those efforts taken at the national level (i.e. in Germany and elsewhere), and within the European Central Bank. The recovery will be difficult, time-consuming, expensive, and conflictive. Europeans should be proud of how well their policymakers have responded. But Europeans cannot afford to allow false optimism to cause their commitment to effective coordination to falter.

J. E. Stiglitz, H. Rashid - Which Economic Stimulus Works? (8 June 2020):

Governments around the world are responding forcefully to the COVID-19 crisis with a combined fiscal and monetary response that has already reached 10% of global GDP. Yet according to the latest global assessment from the United Nations Department of Economic and Social Affairs, these stimulus measures may not boost consumption and investment by as much as policymakers are hoping. Today's stimulus measures have understandably been rolled out in haste – almost in panic – to contain the economic fallout from the pandemic. Without a massive injection of emergency liquidity, there probably would have been widespread bankruptcies, losses of organizational capital, and an even steeper path to recovery. Governments also should consider issuing spending vouchers to stimulate household consumption. Poorly designed stimulus programs are not just ineffective, but potentially dangerous. Bad policies can contribute to inequality, sow instability, and undermine political support for government precisely when it is needed to prevent the economy from falling into a prolonged recession.

G. Claeys, G. B. Wolff - Is the COVID-19 crisis an opportunity to boost the euro as a global currency? (5 June 2020):

The euro became an international currency when it was created two decades ago. However, the euro's internationalisation peaked as early as 2005 and it was never comparable to the US dollar. Its international status declined with the euro crisis. Historically, countries issuing dominant currencies have been characterised by: a large and growing economy, free movement of capital, a willingness to play an international role, stability, an ability to provide a large and elastic supply of safe assets, developed financial markets, and significant geopolitical and/or military power. The only way for the euro to play a major international role is to improve the institutional setup of the monetary union. First, the supply of euro-denominated safe assets from the monetary union should be increased. With its new purchase programme, the European Central Bank has ensured that euro-area sovereign bonds retain their safe asset status. Decisions by the Eurogroup also increase the supply of common European safe assets. The European Commission's proposal to issue up to €750 billion in EU debt to finance its recovery plan is a step in the right direction. It is essential to ensure a strong recovery for all countries and thus make the euro area an attractive destination for investment. A strong recovery will also be fundamental to preserve or even improve the supply of safe assets, as growth is crucial for debt sustainability.

C. Wyplosz - So far, so good: And now don't be afraid of moral hazard (4 June 2020):

Targeted support is needed to face the economic dislocation provoked by the combination of the epidemic, health containment efforts and anguished reactions of individuals, firms and financial institutions. But indiscriminately throwing large amounts of money is not an effective way to deal with the myriad of bottlenecks that stand to grip the economic machinery. The decisions unveiled so far generally focus on such measures, but what are the potential pitfalls? I can imagine five. First a bottleneck is like the weak link of a chain – the one that breaks when you pull hard. Second, removing all bottlenecks will be enormously expensive. Third, the crisis has arrived at the wrong time, as crises often do. Fourth, so far we face an economic crisis, not a financial crisis. Fifth, assume that all policy announcements are implemented, that all bottlenecks are identified and dealt with, and that central banks manage to nip a financial crisis in the bud, the production system will be ready to promptly resume its functions as soon asthe epidemic ends. Furthermore, Suspending the budget constraint, even for good reason, creates a moral hazard. The response is not premature austerity, nor is it ever lasting laxity. Finding the right balance will be challenging. In the absence of a fiscal union, providing support to firms and households is a national competence for the obvious reason that it is financed by national taxpayers. In addition, these targets are probably better understood and more effectively dealt with at the local level. However, there is a risk that some governments cannot borrow what they need because they are already overindebted. Given the amounts likely to be required, the risk of another debt crisis is serious because, as we now know, the euro is a foreign currency because member countries do not own their central bank, the ECB. This is where coordination is required. The only solution to avoiding a potential debt crisis is for the ECB to offer the same potentially infinite guarantee that national central banks offer their respective governments. It already did so with its "whatever it takes" announcement, but then it was subject to conditionality (pre-existing adjustment programmes focused on deficit reductions) that is incompatible with the current situation. Removing conditionality from the Outright Monetary Transactions (OMT) programme is the most needed form of coordination.

O. Blanchard, T. Philippon, J. Pisani-Ferry - A New Policy Toolkit Is Needed as Countries Exit COVID-19 Lockdowns (June 2020):

The measures that most governments took in response to the sudden collapse in economic activity during the COVID-19 lockdowns nearly exclusively focused on protecting vulnerable workers and firms. These measures included unemployment benefits, grants, transfers, loans at low rates, and tax deferrals. As lockdowns are lifted, governments must shift policies toward supporting the recovery and design measures that will limit the pain of adjustment while preserving productive jobs and firms. The authors propose a combination of unemployment benefits to help workers, wage subsidies and partially guaranteed loans to help firms, and debt restructuring procedures for small and medium-sized companies handicapped by excessive legacy debt from the crisis.

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- Banking Union: Corona crisis effects - Calendar week 22- June 2020
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An overview of the latest EU/EA level measures to mitigate the economic effects of the pandemic

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