DISCUSSION PAPER

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A Turning Point for Europe?

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Introduction

The European Union economy has been severely hit by the Covid-19 pandemic. The economic impact of the lockdown imposed by the majority of the European countries to mitigate the spread of the virus has been significant on most EU states.

Europe was once the epicentre of the pandemic, and several EU countries witnessed some of the highest death rates from Covid-19. Since the pandemic hit Europe, there has been Europe-wide criticism of the EU for its perceived inaction and ineffectiveness in assisting EU member-states mitigate the pandemic's impact.

After a shambolic display at the start of the Covid-19 pandemic, the EU's leading players are now on a mission to demonstrate that the European dream is still alive. To prove that solidarity, the President of the European Commission, Ursula von der Leyen, presented a recovery plan to the European Parliament which would allow the European Union and its 27 Member States to overcome the crisis caused by the Covid-19 pandemic.

The plan, which still needs the approval of the 27 heads of state and government and their respective parliaments, would be the first time that the bloc has raised large amounts of common debt on the capital markets, thereby bringing the EU one step closer to a shared budget that would be serviced through shared taxes. The idea is to set up a European-wide fund based on borrowing to guarantee liquidity to the states that need it most and thus prevent the most fragile economies from reaching a crisis point.

The purpose of this paper is to analyse the economic impact of Covid-19 on the EU and to discuss the recovery fund proposal that is expected to assist the member countries to overcome the challenges. The paper will explore what the proposal consists of; which countries are most affected?; why is this proposal unprecedented in the history of the EU?; and why the proposal is so crucial for the future of the EU?

The paper argues that despite the divisions over the EU Commission's recovery plan between the 'Frugal Four'[1] and the southern states[2], the proposal to deliver the fund in the form of grants is of vital importance for the European economy and the integrity of the EU.

The economic impact of Covid-19 is so severe that without a robust coordinated effort the already indebted countries of Euro-Zone will not be able to overcome the pandemic's effects.

[1] "frugal four" countries — Sweden, the Netherlands, Denmark and Austria
[2] includes Italy, Spain and France

Impact of Covid-19 on the EU Economy

The Covid-19 pandemic is forecast to plunge the European Union into its greatest recession since the Second World War (The World Bank, 2020). The EU Commission predicts the 27-member EU economy will shrink by 7.5 per cent this year and expand by around 6 per cent in 2021 (Weihua, 2020). The 19 countries that make up the Eurozone are set to experience a 7.7 per cent crash (European Commission, 2020). That would be a much larger decline than in the financial crisis of 2008 and 2009 (Tooze, 2020). To put the scale and speed of the current crisis in perspective, in February, the Brussels Commission had forecast an increase in economic output of 1.2 per cent for this and the coming year (European Commission, 2020).

While some countries initially prioritised keeping the economy open, they later turned to strict measures to mitigate the spread of the virus, albeit late. Recently, some countries that have applied strict measures have been pursuing remedies to ease the economic collapse. In several EU member states, businesses are reopening and children are back in school. In mid-June, numerous countries – including France, Germany, Italy, and Belgium – opened their borders to fellow Europeans and encouraged a return of tourism.

The pandemic also caused the temporary suspension of the Schengen Agreement, which provides for free movement between EU countries. Many member-states have initiated border checks, free movement has all but ceased, and blockages and malfunctions arose in the service and product supply chains that member-states rely on. For example, Covid-19 disrupted the functioning of the entire agricultural sector and all other sectors in the food supply chain (Rossi, 2020).

Italy and Spain were the hardest hit EU-member states. When southern European countries could not cope with the situation, they asked the EU for economic assistance. This request was subsequently vetoed by Germany and the Netherlands (Amaro, 2020).

Italian Prime Minister Giuseppe Conte harshly criticised the EU for not demonstrating what he referred to as "economic solidarity". "If Europe fails to come up with a monetary and financial policy adequate for the biggest challenge since World War Two, not only Italians but European citizens will be deeply disappointed (Togoh, 2020)", Conte said.

Spanish Prime Minister Pedro Sanchez stressed that the future of Europe is in danger in a post on his official Twitter account: "The future of the European project is in danger. We choose between a coordinated and sound EU and individualism. We are deeply European. We demand a common response to this emergency, guaranteeing a fair recovery (Sanchez, 2020). "

Will 2021 see a recovery?

If the pandemic is brought under control, the EU economy could grow by as much as six per cent next year. The Commission expects new growth of 6.25 per cent for 2021 after the drastic slump in 19 countries in the Eurozone. For the 27 member states of the European Union as a whole, the forecast for 2021 predicts growth of around 6 per cent (European Commission, 2020).

Not all economies will recover at the same pace

According to the EU's Economic Commissioner, Paolo Gentiloni, the shock of the pandemic has affected all EU countries, however, the drop in economic output varies - from 4.25 per cent in Poland to 9.75 per cent in Greece. The recovery in 2021 will also be different, and the bottom line will not make up for the losses (Boffey, 2020).

The impact of the pandemic has varied from country to country, and, at the moment, some are more affected than others. Relevant factors include the pace of the lifting of the lockdown measures, the degree of dependence of respective economies on tourism and the disproportionate impact on job losses in different countries is likely to create different implications for their resiliency with regards to the consequences of the Covid-19 crisis. Consequently, disparities in economic factors are likely to be exacerbated across Europe. These differences threaten the unity of the internal market and the Euro area. While some countries will recover quickly from the Covid-19 crisis, others will face a longer recovery and higher debt loads.

Unemployment set in increase significantly

The unemployment rate forecast in the Eurozone is expected to rise from 7.5 per cent in 2019 to 9.5 per cent this year. A decrease to 8.5 per cent is expected for 2021 (European Commission, 2020). For the entire EU, The EU Commission expects the unemployment rate to increase from 6.7 per cent last year to 9 per cent this year (European Commission, 2020). While a slight recovery is expected in unemployment figures in 2021, the unemployment rate will still be eight per cent in 2021. Young people, in particular, will find it much more difficult to find a job (European Commission, 2020).

Inflation is also expected to rise. The inflation rate in the Eurozone, which is measured using 'Harmonised Index of Consumer Prices', is set to be 0.2 per cent for 2020 and 1.1 per cent for 2021. For the EU as a whole, the corresponding values are 0.6 per cent this year and 1.3 per cent for 2021 (European Commission, 2020).

How significant are differences between countries?

According to the EU Commission, the crash and recovery will be markedly different across the EU. This is primarily related to the speed with which the lockdown measures are lifted, the different dependencies of individual economies on sectors such as tourism and the financial scope in national budgets (European Commission, 2020). European Commissioner for Economy Gentiloni warned that inequalities could threaten the unity of the internal market and the Euro area (European Commission, 2020). The Greek (minus 9.7 per cent), Italian (minus 9.5 per cent), Spanish (minus 9.4 per cent) and French economies have been (minus 8.2 per cent) hit hardest by the crisis. For Germany, the Commission predicts a 6.5 per cent drop in economic output (European Commission, 2020).

Because the member-states have spent billions of Euros on crisis management, national deficits are expected to increase sharply. The aggregate value for the government deficit of all member states, which in 2019 was only 0.6 per cent of GDP, a projected to skyrocket to 8.5 per cent in 2020. A value of 3.5 per cent is expected for 2021 (European Commission, 2020).

The debt level of the countries of the Eurozone as a whole is thus expected to increase from 86 per cent in 2019 to 102.75 per cent of GDP in 2020.

The EU Commission points out that the forecast is filled with extraordinarily significant uncertainties. The basis of the uncertainty is the expectation that anti-Covid 19 restrictions will gradually be relaxed. If the pandemic turns out to be more severe and longer, it could lead to an even greater recession in economic output (European Commission, 2020).

How will a recession affect prices?

The European Commission expects a price increase of only 0.2 per cent for the Eurozone (European Commission, 2020). In southern Europe, the experts even see falling prices. On the one hand, this has to do with the fact that oil has become extremely cheap. On the other hand, consumer spending is expected to shrink because consumers simply have less cash and keep their money together. Permanently falling prices are a major threat to the economy. They can lead to buyer strikes because consumers are holding back on pending further discounts. This mechanism can continue to reinforce itself and deflation is very difficult to overcome. In any case, the European Central Bank's target of inflation of just under two per cent is a long way off.

Southern European member states' economies are expected to be hit harder. The Italian government debt is likely to reach just under 160 per cent of GDP by the end of 2020 (Lachman, 2020). Greece's dept-to-GDP ratio is expected to increase to almost 200 per cent and Spain's to almost 116 per cent (European Commission, 2020). An increase of the same order of magnitude has been forecast for France. Despite low-interest rates, this increases the financial burden that the states have to shoulder.

Hard hit by the Covid-19 crisis, European states have been forced to launch emergency plans to save their economies. After announcing measures for tourism and catering, the French government is working on a plan to help the automotive and aeronautical sectors, believing that more than 10 billion Euros is necessary (Patel & Horobin, 2020). For its part, Germany has announced a business assistance plan of 1.1 trillion Euros (Wires, 2020).

With these massive investments, countries are deepening their national debts. To help EU governments, the European Commission has suspended the rules of budgetary discipline allowing them to spend as much as they deem necessary to fight the pandemic and its effects.

Coronabonds

The term "Coronabonds" emerged from the idea of "Eurobonds", an idea conceived during the public debt crisis in 2010. A Eurobond is a bond issued by the European Central Bank. By offering bonds, debt securities that public or private investors (such as insurance companies, banks or investment funds) can subscribe to, the ECB enables European countries in the Eurozone to finance their deficits (Baechler, Leconte, & Verez, 2020). The objective of issuing these special bonds is to allow the contraction of debts, not only at the national level, as is the case today, but to be able to borrow on behalf of the European Union, more specifically on behalf of the Eurozone.

How will Coronabonds work?

Coronabonds are joint bonds issued by the Eurozone countries. Coronabonds are bonds that would not be borrowed jointly by the European Union but by the Eurozone or EU countries individually. From the perspective of investors, they would be comprised of fixed-income securities that are suitable for private investment. The advantage for the countries that support these bonds is that the EU/Eurozone countries together have a better credit rating on the capital markets than a country such as Italy alone. This would lower the interest rate for Coronabonds. Countries like Italy want to take advantage of this. The interest rate advantage comes solely from the fact that countries with better credit ratings like Germany are jointly liable for these bonds: If a country fails to repay, investors can request repayment from any other member-state. The supporters of Coronabonds regard this form of joint liability as a sign of solidarity among EU member-states.

What is the difference between Coronabonds and the European Stability Mechanism (ESM)?

The impasse dividing EU Member States revolves around whether Coronabonds or ESM financial assistance should form the core of the EU's Covid-19 response.

In contrast to Coronabonds, each country is not jointly liable for the ESM, but only according to the share it has subscribed to.

The ESM originally had around 705 billion Euros in shared capital, which consisted of deposits from EU countries in the amount of around 80.5 billion Euros and a callable credit line of just under 624.3 billion Euros. After loan aid to Greece, Portugal, Ireland, Spain and Cyprus during the financial crisis of 2008-09, the ESM can currently still lend approximately 410 billion Euros (Valero, 2020).

On April 9, the Eurozone finance ministers decided that countries affected by the Covid-19 pandemic could receive loans amounting to 2 per cent of their GDP from the ESM (Valero, Eurogroup agrees on €540 billion corona-package, 2020). In total, 240 billion Euros of the 410 billion Euros still available could be mobilised. In contrast to previous aid, such as the one mobilised for Greece, conditions that the recipient countries would have to meet in return for the loan aid would be waived, the only condition being that the recipient countries have to commit to using the ESM funds is for health care, where the crisis has revealed huge deficits and a lack of long-overdue investments. Italy has nevertheless rejected this ESM aid (Sera, 2020), even though the ESM would have the advantage that it could take out loan aid on the capital markets within two weeks. According to Angeloni (2020), "The Italian populist parties, the largest of which, the Five Star Movement, is in the government, oppose taking €36bn from the ESM, despite concessional terms and the need to support the health sector after a decade of deep cuts. Italian politicians are caught between a potential debt spiral and a loss of national sovereignty".

The ESM's loans have in the past been linked to strict reform requirements and strict monitoring (Zemskova, 2020). Aid programmes joined to the Euro rescue fund could also be interpreted by financial markets as a signal of massive financial difficulties and could bring speculators on the scene. According to Rediker & De Maio, "As the impact of Covid-19 had nothing to do with bad economic policy choices, but rather reflects the exogenous nature of an economic shock caused by a global pandemic, countries like Italy appeared to reject the use of ESM out of principle (and politics)" (Rediker & De Maio, 2020).

Opponents of the Coronabonds argue that common debts in the Euro area would make reforms in individual countries difficult. Highly indebted countries like Italy may be tempted to rest on Coronabonds instead of reorganising their national budgets.

Coronabonds are widely supported by the Italian Prime Minister Giuseppe Conte and by French President Emmanuel Macron and more generally by the leaders of the countries of the south who want these bonds to be issued to finance, among other things, unemployment insurance schemes, investments in infrastructure or spending associated with health care. However, northern countries fear that the idea of a common debt "replaces the essential efforts that countries must make to restore fiscal balance". Likewise, countries such as Austria, Denmark, Sweden and the Netherlands are firmly opposed to Coronabonds and prefer to rely on the ESM (Valero, Netherlands, Austria push for stricter conditions for corona-loans, 2020).

Why do Northern States Object?

The creation of common debt calls for reinforced solidarity within the Eurozone. Given the reluctance of many European countries, this solidarity cannot be exercised unconditionally (Valero, Netherlands, Austria push for tougher conditions for corona-loans, 2020). This is why Germany was so uncompromising towards Greece in the 2015 sovereign debt negotiations. The most indebted countries, who would be insured against the risk of having to assume the burden of their debt alone, could be tempted by the possibility of letting it slip away (Valero, Netherlands, Austria push for stricter conditions for corona-loans, 2020).

The resulting overall increase in common debt would outsource the burden to the least indebted countries. The pooling of European public debt, therefore, implies a consensus and the absence of deviant behaviour from concerned member-states. This entails that, while borrower countries would commit to the conditions, the individual debts of any one country would not increase as the borrower would be the collective whole. States in difficulty will have to pay interest, however, it would be lower than usual because they would be set to benefit from rates obtained on a European scale and guaranteed by the EU.

The possibility of obtaining preferential rates represents a boost for countries hit hard by the crisis. However, there is currently no unanimous agreement with the EU with regards to this issue. The so-called frugal four – Austria, Denmark, the Netherlands and Sweden - fear that more indebted countries, such as Spain or Italy will use this borrowing mechanism to plug holes in their respective deficits. Therefore, they are pushing for a “loans for loans” approach for the bloc’s Coronavirus recovery fund (Hekkila & Burchard, 2020).

Interest rates vary widely from country to country. Pooling debt on a European scale would be practically the same as to pooling interest rates. Economically stronger countries like Germany would thus see their rates increase (and exceed the 0% bar), while those like Italy - hardest hit by the health crisis - could borrow more quickly and cheaply.

The EU Budget and Recovery Fund Proposal

Chancellor Angela Merkel and French President Emmanuel Macron have presented an initiative for economic recovery in the EU in the wake of the Covid-19 crisis. They advocate an ambitious reconstruction fund worth 500 billion Euros (Boffey, Merkel and Macron propose €500bn EU rescue fund, 2020).

EU Commission President Ursula von der Leyen responded approvingly: "it acknowledges the scope and the size of the economic challenge that Europe faces, and rightly puts the emphasis on the need to work on a solution with the European budget at its core, and rightly emphasizes the need to work on a solution that focuses on the European budget" (Tidey, 2020).

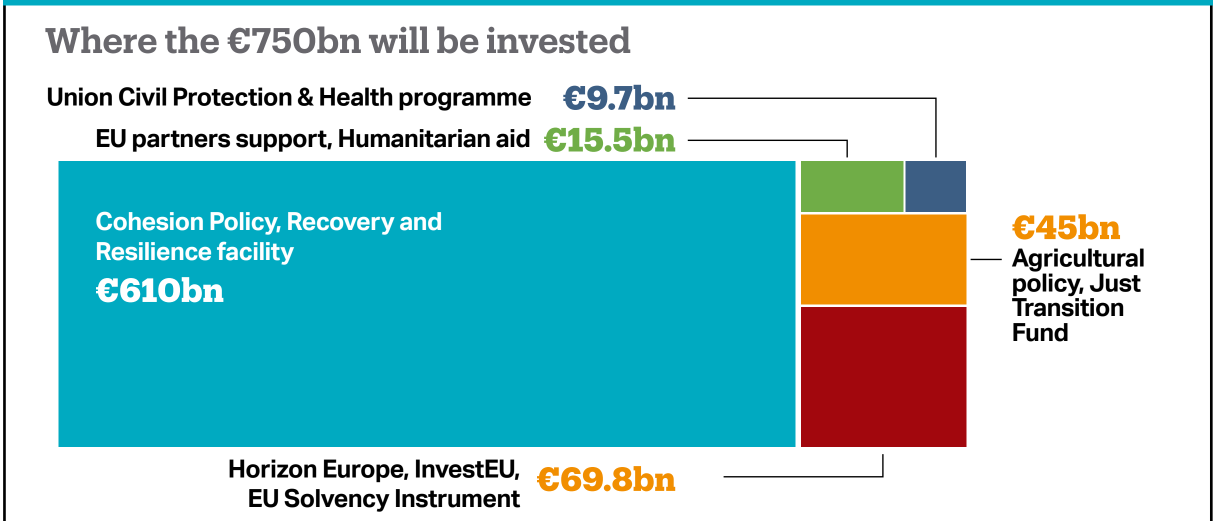
The 500 billion Euro recovery fund, which will be used in addition to the 1 trillion Euro budget envisaged for 2021-2027, was announced after several weeks of negotiations on how to mitigate the impact of Covid-19 on EU economies.

The Multiannual Financial Framework (MFF), which predetermines the annual ceiling of appropriations for expenditure items in the EU budget, aims to allocate resources in line with the EU policy priorities. The EU's current approximate 1 trillion Euro financial framework covers the 2014-2020 period. In the EU budget, income items come mainly from sources transferred by member countries. Negotiations for the EU budget for the 2021-2027 period are expected to be completed this year. The decision on the long-term EU budget must achieve a unanimous vote in the EU Council and the European Parliament (EP).

Concretely, the Commission plans to borrow on the markets on behalf of the EU to supplement the European budget. The money will be used to strengthen certain programmes and create others to deal with the crisis. It is the first time in the history of the EU that the Commission has proposed the issue of large-scale European pooled debt.

Von der Leyen explained that the recovery fund will be established by borrowing from the financial markets with the high credit rating of the EU Commission and that resources will be transferred to common priorities such as industry, health, digital transformation and climate-friendly technologies (European Commission, 2020).

EU stimulus composition

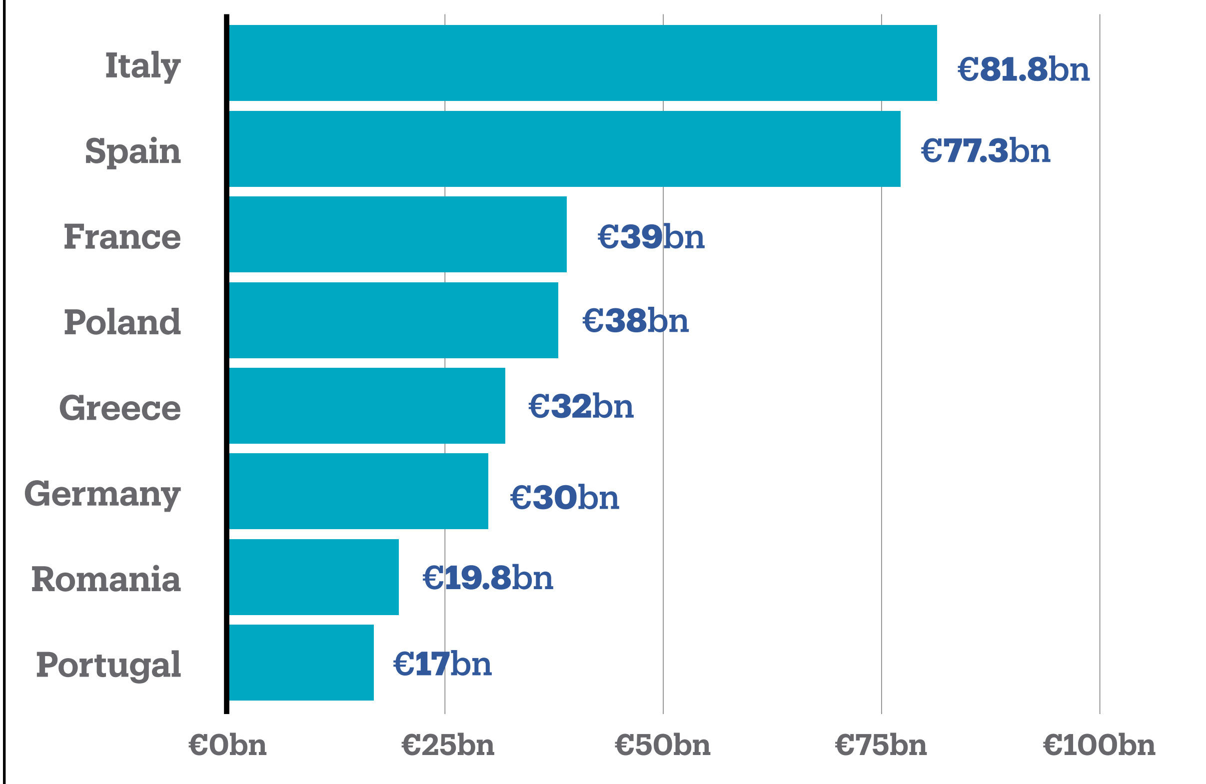


Source: European Comission

According to the proposal, the total size of the EU's budget in 2021-2027 will be 1.1 trillion Euros. A fund to be established by borrowing from capital markets will be integrated with the guarantee of the EU Commission member countries. The total size of the economic recovery fund will be 750 billion Euros. Of this, 500 billion Euros will be grants, and 250 billion Euros will be loans (European Commission, 2020). The remaining 250 billion Euros would be made available in the form of loans to countries that apply for them, coming with more scrutiny and conditions, and would be added to a country's debt load (Stevis-Gridneff, 2020).

The number of grants and loans from the recovery fund will be distributed in accordance with the severity of the Covid-19 impact on the economies of EU member-states. Italy, as the most affected country, will receive the highest amount, estimated to include 81.8 billion Euros in grants and 90.9 billion Euros in loans. Spain will receive 77.3 billion Euros in grants and 63.1 billion Euros in loans. France is set to receive 39 billion Euros in grants and 63.1 billion Euros in loans (Gambaro & Massara, 2020).

EU stimulus by country



Source: European Comission

The amount allocated to the stimulus fund and the conditions to benefit from it remains to be finalised. The beneficiary countries will likely have to present an investment and reform plan compatible with the political priorities of the European Commission: energy transition, digital technology and greater European sovereignty. The implementation of the recovery plan will also depend on the borrowing capacity of Brussels. Ursula von der Leyen wants to increase it by raising the theoretically available revenue in the budget - amounts that the EU can legally require from member states - to 2% of the EU's Gross National Income (GNI), against 1.2% currently, according to a Commission source (European Commission/press release, 2020).

However, obtaining unanimity from member-states, which is compulsory to validate the budget, looks difficult. Already in February, the 27 EU member-states had failed to agree on a budget of around 1,000 billion Euros for the period of 2021-2027. The current crisis has accentuated the divisions between the countries of the north and those of the south, the most affected by the pandemic (Brzozowski, Fortuna, & Valero, 2020). The so-called frugal four continue to militate for financial support which rests only on loans which will, therefore, have to be repaid, and refuse the principle of grants (News, 2020).

The negotiations are set to be long and stormy. Once concluded, the agreement will be voted on by the European Parliament. Whatever happens, the new budget will not come into force until 2021, so a solution will have to be found to have financing available in the fall to support economies threatened by recession.

The 750 billion Euro stimulus fund (around 5.3% of EU GDP) will help member-states cope with a slowdown which is expected to reach -7.4% of EU GDP this year. In 2009, the worst year of the Great Recession, the drop was 4.3%.

Conclusion

The economic crisis brought on by the Covid-19 pandemic is unprecedented in that it has severely affected both supply and demand. Many economists are predicting an economic shock far greater than that of the 2008 financial crisis. The recovery fund proposal worth nearly 550 billion Euros put forward by EU finance ministers should make it possible to finance, at least in the short term, unemployment measures and to keep companies on artificial respiration. However, further measures are needed to counter the unprecedented economic crisis facing the EU.

In the countries whose economies have come to a standstill as a result of the Covid-19 pandemic, the criticism that the EU could not manage the crisis economically and could not provide sufficient assistance was expressed loudly.

While France, Italy and Spain have favoured aid in the form of grants to fight the effects of Covid-19, the so-called frugal four, which continue to emphasise the importance of fiscal discipline, prefer to use the debt mechanism. Southern European countries have warned that Italy, which is already heavily indebted, would be dragged into an economic crisis in case of further debt. The agreement between Germany and France shows that the crisis is currently being approached in favour of southern European countries. However, the package still needs to be approved.

The recovery fund proposal still has to win the approval of all EU governments and parliaments, and officials expect negotiations to drag into July and possibly later. As European Commission President Ursula Von Der Leyen phrased it, it is Europe's moment. The recovery fund represents a significant turning point for the future of the EU.

European leaders have recognised the risk the pandemic poses to the very existence of the EU, some of whose pillars, such as the single market and the Schengen area, have been severely shaken by the heavy economic blow of Covid-19. The prospect of a sudden drop in the economies of the south, much more affected compared to those of the north, threaten the Eurozone.

If the EU's recovery plan is not approved, then the countries hardest hit by Covid-19 will eventually be compelled to take further loans from either the European Central Bank, the ESM or even the IMF to lift their economies out of recession. Countries such as Portugal, Greece, Spain and Italy have already accumulated significant debt from the last financial crisis in 2008. Additional loans will most likely overwhelm their economies and may lead to another financial crisis within the Eurozone.

Lastly, failure to reach an agreement on the EU's recovery plan will not only result in a damaging effect on Eurozone and the Schengen area but also will damage the trust and the feeling of European solidarity among EU member-states. Consequently, this will strengthen the hands of Eurosceptics within the EU and may further lead to possible. Brexit-like exits from the EU.

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