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A recovery plan for Europe

Maarten Verwey, Sven Langedijk and Robert Kuenzel provide a brief overview of the economic rationale for collective action and an assessment of the expected impact of the recovery plan proposed by the Commission

As member states start to ease restrictions linked to the COVID-19 pandemic on citizens and businesses, EU leaders and institutions have turned their attention towards the medium-term recovery of their economies. In late May, the Commission presented its proposals for a recovery plan. This column provides a brief overview of the economic rationale for collective action and an assessment of the expected impact of the recovery plan proposed by the Commission.

The ferocity of the COVID-19 pandemic has taken the world by surprise. To date more than six million cases have been confirmed globally and there have been almost 400,000 confirmed deaths. In addition, it has wreaked havoc on health systems and economies in Europe and around the world. Supply-side problems from production and trading restrictions have been compounded by a collapse in economy-wide spending and investment due to physical confinement, concerns about income and job prospects, worsening financial conditions, and pervasive uncertainty about the future course of the crisis (Bénassy-Quéré and Weder di Mauro 2020).

The Commission's Spring 2020 economic forecast suggests that real GDP in 2020 will fall by 7.4% in the EU, with only a partial recovery of 6.1% expected in 2021 (European Commission 2020a). A large majority of member states will still have lower real GDP levels at the end of 2021 than when the COVID-crisis erupted. Risks to the above forecast scenario are strongly tilted to the downside.

In contrast to previous crises, the economic policy response in the EU has been swift and sizeable. The ECB has acted immediately and forcefully through the Pandemic Emergency Purchase Programme. Member states have already extended fiscal support measures of around 3.2% of EU GDP to their economies for the year 2020, and the additional liquidity assistance tops 22% of GDP.

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Besides much-needed emergency spending on healthcare, EU governments have activated short-time working arrangements that have supported income streams for employees and eased labour costs for employers. At the EU level, rapid agreements have been reached on a number of important support schemes, including the SURE instrument proposed by the European Commission to support short-time work schemes, the ESM's almost condition-free Pandemic Crisis Support instrument, and the EIB's pan-European guarantee fund.

In the short term, these measures have prevented mass layoffs in Europe. However, as impressive as these measures are, they will not be enough to ensure a rapid recovery and to avoid permanent damage to the EU economy.

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For a genuine recovery, a concerted effort will be required. The package proposed by the Commission marks an important step on the path to recovery

Even in the EU, short-time work schemes are time-limited and often do not cover the full wages, nor all employment types. Household incomes are likely to suffer, both due to temporary cuts in earnings and permanent job losses — the latter are expected to drive up the unemployment rate to around 9.5% in the euro area and 9% in the EU in 2020 in the baseline scenario. Low-skilled and temporary workers are likely to be hit the hardest.

For companies, liquidity problems will increase the longer production is stalled, and the use of bridge financing from loans is difficult to sustain over time. Piling debt onto already stretched balance sheets is no durable solution, especially in a context of deep uncertainty and continued negative cash flow for many companies.

A fragile corporate sector means a slow and protracted recovery and fewer jobs. Insolvencies cause a waste of physical, human and financial capital. Business failures also disrupt international value chains; in short, they cause large negative second-round effects on investment, employment, growth and prosperity.

Higher short-term healthcare costs, fiscal support measures and the effects of the recession will take their toll on member states' public finances. The Commission's spring forecast expects the average government deficit in the EU to rise from near-balance in 2019 to around 8.5% of GDP in 2020.

Beyond the short term, countries will unavoidably be left with significantly higher debt to be financed in the future — a particular challenge for countries that already had elevated debt and deficit levels before the pandemic struck. This could act as a drag on growth and investment for years to come.

The case for EU-level intervention

To limit the damage to the economy, to minimise downside risks and to advance the recovery, continued policy support is necessary (eg. Bénassy-Quéré *et al*. 2020). A substantial part of this policy support should be organised

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at the EU level. Just as the COVID-19 disease effects some people far more than others, its economic impact on countries differs considerably too, depending partly on their sectorial composition.

Economies with large tourism sectors, for example, have been particularly affected. GDP losses in 2020 are expected to be particularly large in Greece, Spain, Italy and Croatia, at around 9.5% each, compared to recessions of between 6% and 7.5% in most other member states. The regional impact is more varied still (Figure 1).

Many of the EU countries hit hardest by the pandemic were already on a relatively weak budgetary footing and had low macroeconomic resilience due to a mix of legacy factors and policy choices. As a result, these countries have been less able extend discretionary support to their economies in the form of additional spending, tax relief and state aid[1].

This combination of factors – a more severe recession and a weaker policy response – entails a real risk of increasing economic divergence in the EU. In the longer term, economically weaker countries may also face lower rates of investment and growth, higher and more persistent unemployment, and less favourable debt dynamics.

Not only would this prevent some countries from adequately supporting their citizens and businesses; it would also jeopardise competition, trade and investment across the Single Market. It would drive living standards further apart, and undermine the social, political, economic and financial stability of our Union.

A coordinated EU-level investment stimulus would counterbalance these centrifugal powers, while giving at the same time a strong boost to the recovery in all member states.

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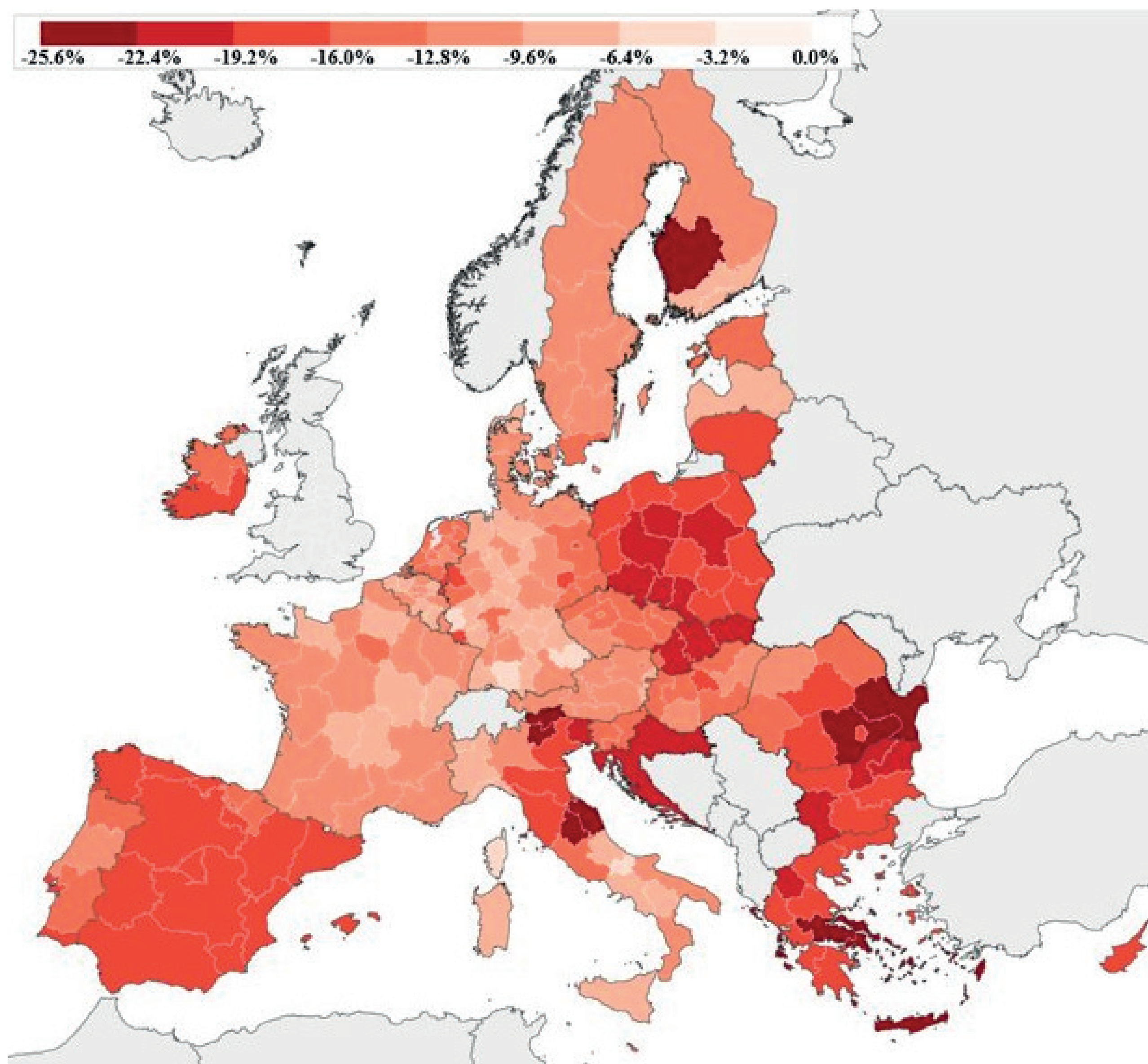
Figure 1. GDP impact at regional NUTS 2 level excluding the impact of policy measures



Note: Shading shows estimated GDP growth in 2020 in %. The analysis is carried out using the RHOMOLO macroeconomic framework, a numerical-spatial general equilibrium model based on regional account data and a set of fully observed bilateral final and intermediate shipments consistent with the national accounts. The economic disturbances implemented in RHOMOLO are consistent with the 2020 Spring Forecast.

Source: JRC

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Financing the recovery

To facilitate informed decision making on the size and allocation of the Recovery Instrument, the Commission has analysed in detail the financial needs of the European economy. These include considerable investment, equity repair and sovereign financing needs[2].

Investment needs

The Commission estimates that the EU economy's investment needs for 2021 and 2022 are at least €1.5 trillion. These investment needs are combination of investment losses directly resulting from the COVID-19 crisis and existing urgent investment needs related to the green and digital transition.

Investments in the green and digital transition are particularly valuable as they carry the double benefit of providing much needed support for the recovery and preparing the EU for the future.

Equity repair needs

Using firm-level data from the ORBIS database, the Commission estimates that the accumulated losses of non-financial corporates in Europe could wipe out €720 billion of equity under the spring forecast's baseline scenario and as much as €1.2 trillion under the adverse scenario, in which restrictions on economic activity to control the pandemic last longer.

In the baseline scenario, between 25% and 35% of companies would experience a financing shortfall by the end of the year after exhausting working capital and liquidity buffers, respectively. In the adverse scenario, these shares could rise to 35% and 50%, respectively. This means that around 180,000-260,000 European companies employing around 25-35 million people could experience a financing shortfall should the adverse scenario materialise.

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The corresponding liquidity shortfall could range between €350 billion and €500 billion in the baseline scenario, and between €650 billion and €900 billion in the adverse scenario. This is after taking into account the existing schemes for solvency support through short-term work schemes. If left unaddressed, many companies will go bankrupt and those companies that manage to survive will see their capacity to invest severely impaired.

Sovereign financing needs

EU sovereigns, meanwhile, will need to finance an estimated €1.7 trillion extra to cover lost tax receipts and increased social spending in 2020 and 2021. These estimates do not yet cover the financing of the additional investments specified above or the expected losses on the liquidity guarantees provided by member states to their corporate sectors.

Next Generation EU

On 27 May the Commission unveiled a recovery package containing a reinforced long-term EU budget for 2021-2027, as well as the new Recovery Instrument, 'Next Generation EU'. Next Generation EU will raise money by temporarily lifting the maximum amount that the EU can request from member states to cover its financial obligations to 2.0% of EU Gross National Income.

This will allow the Commission to use its strong credit rating to borrow €750 billion on the financial markets. This additional funding will be repaid over a long period of time through future EU budgets – between 2028 and 2058. When adding Next Generation EU to the proposed size of the 2021-2027 MFF of €1.1 trillion, the total financial firepower of the EU budget reaches €1.85 trillion, equivalent to around 13% of EU GDP at 2019 levels.

From a macroeconomic point of view, this package has a number of desirable features. The size of the package is clearly macro-relevant. By design, the package ensures full coordination of the investment impulse, adding to its

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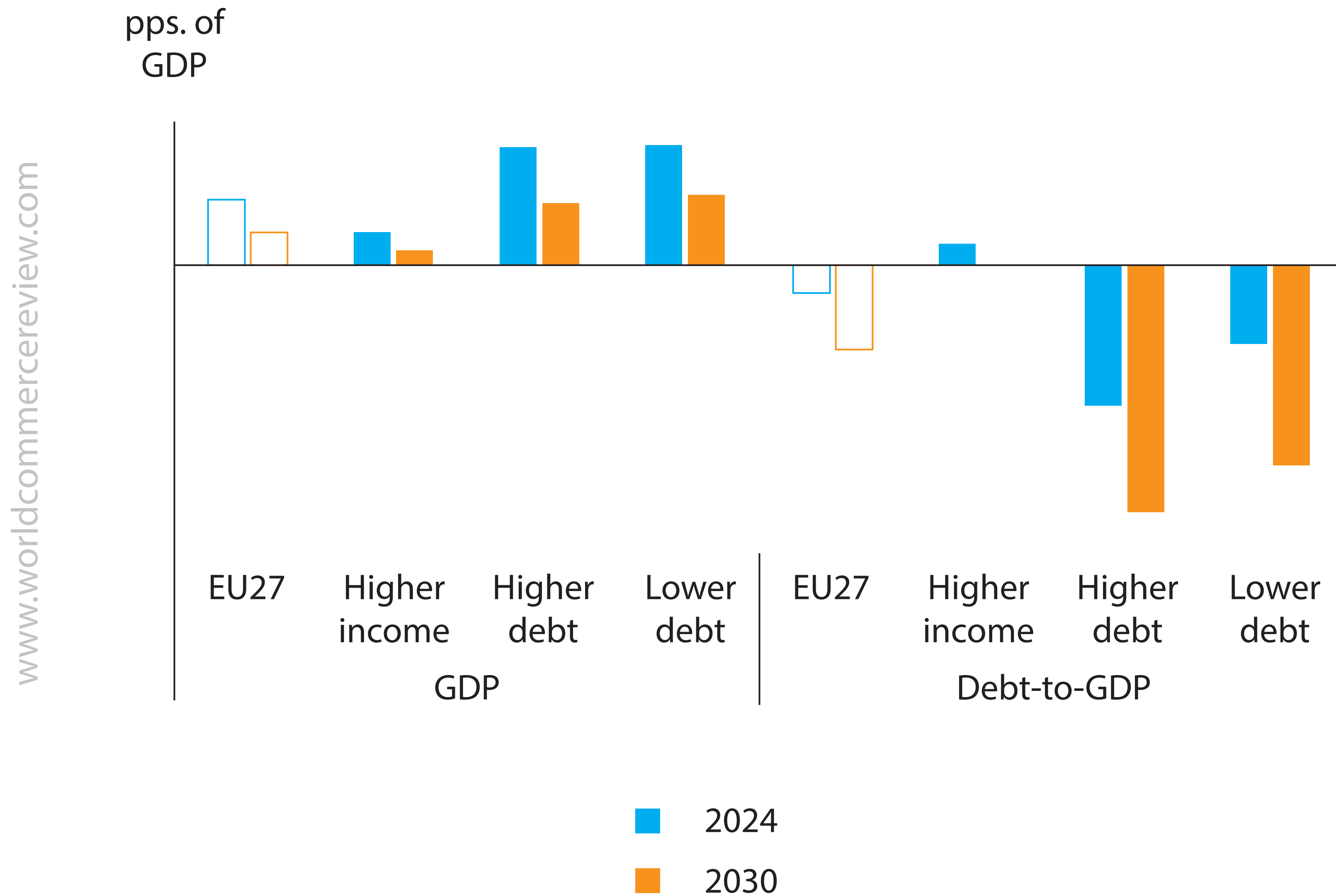
Figure 2. QUEST simulation results of impact of Recovery Instrument



Source: Commission services

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effectiveness. The package is heavily biased towards public investment. With interest rates at the zero bound, this is a particularly effective way to stimulate aggregate demand.

Finally, the proposed allocation of the package ensures that the funds will flow to those member states that are most in need. A stylised simulation of Next Generation EU using the Commission's QUEST model shows that it could raise real GDP levels by around 2% by 2024 compared to a baseline scenario. Even ten years later, real GDP levels are estimated to be at least 1 % higher. Up to 2 million additional jobs are estimated to be created by 2022, and thanks to a strong denominator effect it would leave EU government debt-to-GDP levels slightly lower, even in the medium to long term.

The package would contribute significantly to reducing the divergences in the Union and thereby to limiting the downside risks for the entire Union. Interestingly, it would also raise GDP growth in higher-income member states by increasing demand for their exports, increasing GDP by more than 1% compared to baseline by 2024 (Figure 2).

For a genuine recovery, a concerted effort will be required. The package proposed by the Commission marks an important step on the path to recovery. ■

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ABOUT THE AUTHORS

Maarten Verwey is Director General, Sven Langedijk an Economic Policy Adviser, and Robert Kuenzel is an Assistant to the Deputy Director General, all at the DG Economic and Financial Affairs, European Commission

Endnotes

1. Under its COVID-related temporary state aid framework, the Commission has taken 155 decisions approving 193 national measures notified by 26 member states and the UK. On this basis, the amount of more than €2.19 trillion of total state aid approved so far is a best estimate. Around 45% of state aid approved has been notified by Germany, with measures notified by Italy and France representing around 17% each of the entire amount of state aid approved. Aid notified by Spain represents 4.2% of the total amount.

2. Other financial needs, including for social spending, are also assessed in European Commission (2020b).

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