Europe must act now to prepare the aftermath of the pandemic crisis

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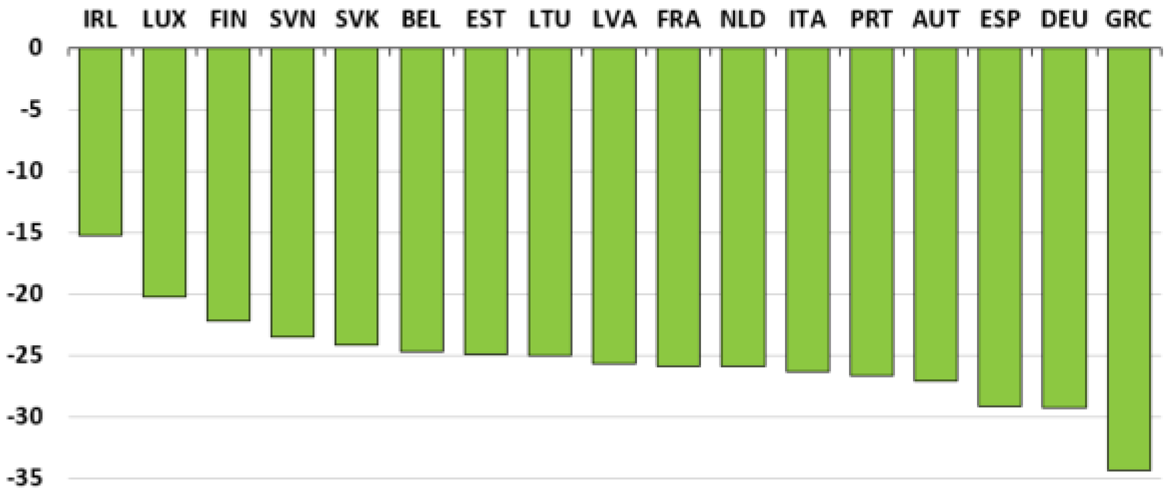
We are currently facing extraordinary challenges posed by the Covid-19 pandemic, due to which necessary health measures are shutting down part of our economies and precipitating a recession of unprecedented nature and magnitude.

In the immediate response to the crisis, governments increased health spending, but also introduced large fiscal support (e.g. short-time working weeks, extended unemployment schemes, tax and social security deferments, new credit lines, among others, see **OECD Policy tracker**) in an attempt to mitigate the social and economic impact of the pandemic. In addition, in Europe, the ECB launched a large program of asset purchases and a set of other unprecedented measures, and the European Commission temporarily shut down budget rules and exceptionally lifted state aid rules.

Still, given the magnitude of the crisis that we are facing, these measures and packages, albeit important and unprecedented, will not be enough for most European countries to address a post-pandemic world where debt levels will be much higher and the job losses tremendous. According to **OECD estimates**, the widespread shutdowns needed to contain the spread of the coronavirus and save lives will cause an estimated initial direct output decline of around 25% in many economies (Figure 1).This is equivalent to a contraction of about 2 percentage points of annual GDP per month of confinement. Thus, the 2020 output fall will far exceed that of 2009.

Figure 1 The potential initial impact of partial or complete shutdowns on activity in euro area countries[1]

In percent of GDP at constant prices[2]



1. Euro area countries that are also members of the OECD (17 countries).
2. The sectoral data are on an ISIC rev. 4 basis in all countries. The sectors included are manufacturing of transport equipment (ISIC V29-30), construction (VF), wholesale and retail trade (VG), air transport (V51), accommodation and food services (VI), real estate services excluding imputed rent (VL-V68A), professional service activities (VM), arts, entertainment and recreation (VR), and other service activities (VS). The latter two are grouped together as other personal services in the figure. Full shutdowns are assumed in transport manufacturing and other personal services; declines of one-half are assumed for output in construction and professional service activities; and declines of three-quarters are assumed in all the other output categories directly affected by shutdowns. Real estate services excluding imputed rent are assumed to be 40 per cent of total real estate services in countries in which separate data are not available.

Sources: OECD Annual National Accounts; OECD Trade in Value-Added database; and OECD calculations.

When the confinement is gradually withdrawn, European policymakers will have to do more to speed up the recovery and avoid massive unemployment and firm bankruptcies. The challenge will be significant: many euro area countries will have debt ratios above – and sometimes much above – 100% of GDP, and economic fundamentals will have been hurt. History shows that countries that invest in the recovery, rather than tighten too much too fast, not only accelerate the recovery, but are also able to bring debt down faster. Too rapid fiscal tightening in some countries in 2010/2011 weakened the euro area and left it with long-term scars, including an incomplete restructuring of the banking and corporate sectors, higher structural unemployment, low investment and low inflation, and a failure to revive structural reforms agendas.

There is an important positive element in the current crisis: by committing to “do everything necessary within its mandate”, the ECB has responded forcefully and much faster than in the previous crisis, contributing to and buying precious time for policymakers to work out a sustainable response to this symmetric shock.

Europe is building up a multi-pronged response to the crisis and the ensuing recovery, but some debate remains regarding the financial instruments that must be used for this purpose. The EIB is proposing substantial support to firms, and the Commission is proposing to support the unemployed, which seems to have met consensus. But the bulk of Europe’s fiscal response to address the “war effort”-like recovery remains largely individual or national. Unlike in the recent financial crisis, this exogenous shock is shared across countries. The debate is made more complex by some perceptions that the uneven situation across countries is due to different levels of responsibility at the national level, especially regarding fiscal policy. It may be fair to say that much of the debt legacy prior to the crisis is indeed individual countries’ responsibility. But this is not the case for the health and economic efforts resulting from the Covid-19 pandemic. Both **the widespread pandemic and the close integration of EU countries argue for a financial response that should be large and shared** . Such a response should be clearly differentiated from the stock of debt prior to the Covid-19 crisis.

It is imperative to bridge the gap between the existing options in the debate for a forceful response. Two options could provide the EU with the necessary fire power to address this crisis: a new financial instrument featuring joint issuance, and the European Stability Mechanism (ESM). We start with the latter.

The ESM was created by euro area members to mobilise funding and provide financial assistance to countries threatened by or experiencing severe financing problems. Its use involves a rigorous analysis of public debt sustainability and strict policy conditionality, because these difficulties were perceived as resulting from past policies having led to poor economic performance. Obviously, these criteria do not apply in the current crisis. In particular, the strong conditionality attached to financial assistance seems totally inadequate when the crisis arises from a pandemic or a natural disaster. Some are suggesting light conditionality. However, this approach may not be acceptable to those countries that believe that strict conditionality is an explicit requirement for accessing its resources. In addition, the 410 billion euros in unused lending capacity (3.4% of 2019 euro area GDP) seems modest when compared to the needs of the euro area as a whole. In addition, the ESM currently relies on short-term credit facilities having an initial maturity of one year, and renewable twice, each time for six months. Therefore, ESM credit lines provide only limited relief against medium-term rollover risks, which makes it more of a bridge facility to overcome temporary fiscal distress pending a medium to long-term solution.

For all these reasons, as it currently stands, the ESM is ill suited to provide widespread fiscal support to euro area countries to counteract the economic fallout of the pandemic. **If the ESM is to play a significant role in the challenges posed by the current crisis, its firepower will have to be substantially upgraded, the conditionality requirements will have to be significantly watered down and replaced by an allocation usage condition** (namely, fund all pandemic-related spending).

An alternative is the creation of European financial instruments that mutualise a large part of the fiscal costs and financing of the crisis. More specifically, **the launch of one-off, ad-hoc European debt instruments should help finance fiscal needs at a relatively low cost for all euro area members and for the euro area as a whole**. This would have the advantage of not adding directly to the national debt numbers, provided such a feature is part of the original design. This approach demands that several conditions are met:

- Ensuring the one-off, temporary nature of the fund: the credibility of the one-off nature of the instrument would be enhanced by dedicating a targeted tax flow to its payment over a very long period, such as, for example, the model of the German solidarity tax after reunification. Long maturities should help ensure that repayments will be spread over generations and not hamper the recovery efforts.

- The spending would cover only Covid-related expenditures, to address health risks and the associated recovery from the exceptional shutdown. The instrument would be governed by the European Commission, and overseen by the European Parliamentt.
- The supra-national nature of the bonds would allow the ECB to purchase up to 50% of the issuance, while anchoring the fiscal commitment of euro area countries to the recovery .
- Such instrument would increase the fiscal space in countries more sensitive to borrowing costs and accelerate the recovery for all.

The crisis faced by Europe is extraordinary and requires extraordinary responses. It is also a unique opportunity for Europe, and in particular the EMU, to consolidate its economic and financial architecture, and to promote Europe as the engine of “shared prosperity”. A significantly reinforced and revamped ESM or a new financial instrument based on joint issuance, as described above, would be possible vehicles to translate words into action. The ECB has bought European policymakers some precious time that they now have to use to devise a common approach.