The EU economy after COVID-19: Implications for economic governance

Maarten Verwey, Alan Monks 21 October 2021

On 19 October 2021, the European Commission adopted a Communication relaunching the public consultation on the EU's economic governance framework. This consultation had been put on hold in March 2020 in order to focus on the Covid-19 pandemic. The Commission communication assesses the implications of the changed circumstances for economic governance following the COVID-19 crisis and sets out additional questions for the public debate. All stakeholders are invited to engage in the debate, which must be wide-ranging and inclusive to build a consensus on the way forward well in time for 2023.

The COVID-19 pandemic resulted in an unprecedented economic contraction in 2020, with EU real GDP falling by 6.1%, more than during the global financial crisis. The EU response to the crisis was fast, forceful, and well-coordinated at all levels. EU Member States – backed by the EU SURE instrument (Figure 1) – provided strong support to business and workers, notably through short-time work schemes, in addition to substantial liquidity support to firms.

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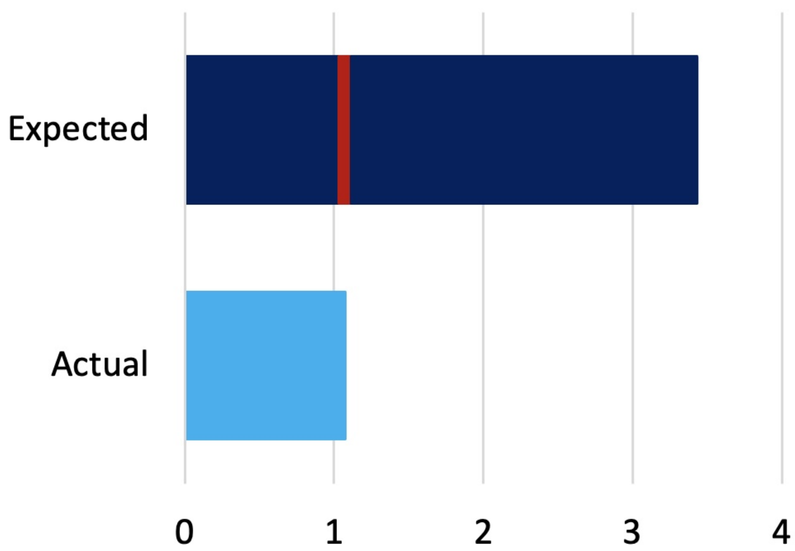
The ECB complemented the fiscal response with a *broad set of monetary policy measures*. This joint and coordinated policy response was successful: the economic impact of the crisis on workers and firms has been far less severe than originally anticipated.

Decisive EU-level action also ensured the *development, speedy procurement and coordinated distribution of COVID-19 vaccines*. Looking forward, the newly created EU *Recovery and Resilience Facility* (RRF) will promote an investment-rich recovery and growth-enhancing reforms by providing €338 billion in non-repayable support and up to €386 billion in loans (in current prices) throughout the period to 2026. The impact will be seen already in 2021 (Figure 2).

Figure 1 Increase in unemployment rate in SURE beneficiary Member States, 2020 (percentage points)



Maarten Verwey
Director General, DG Economic and Financial Affairs, European Commission

Alan Monks
Economist, European Commission

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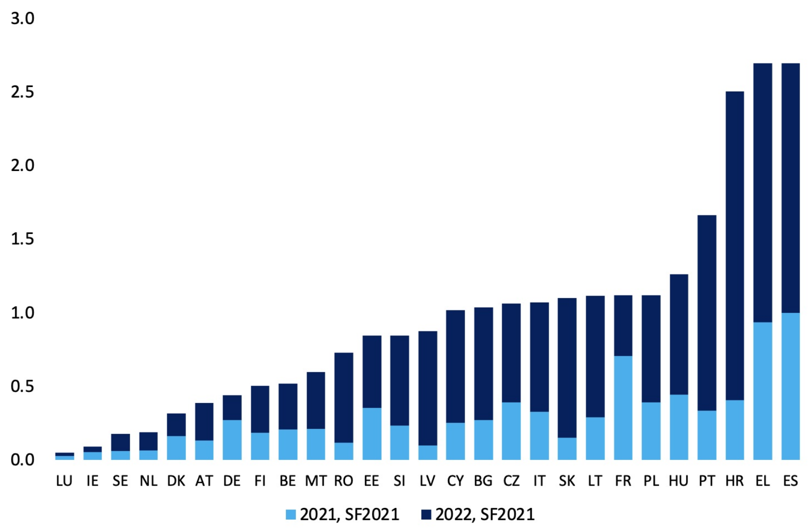
Source: European Commission calculations

Note: The expected increase in the unemployment rate reflects the historical relationship between changes in that rate and (negative) GDP growth

Figure 2 Expenditure financed by RRF grants, 2021 and 2022 (% of GDP)



Source: European Commission 2021 spring forecast

The recovery has taken hold but significant challenges remain

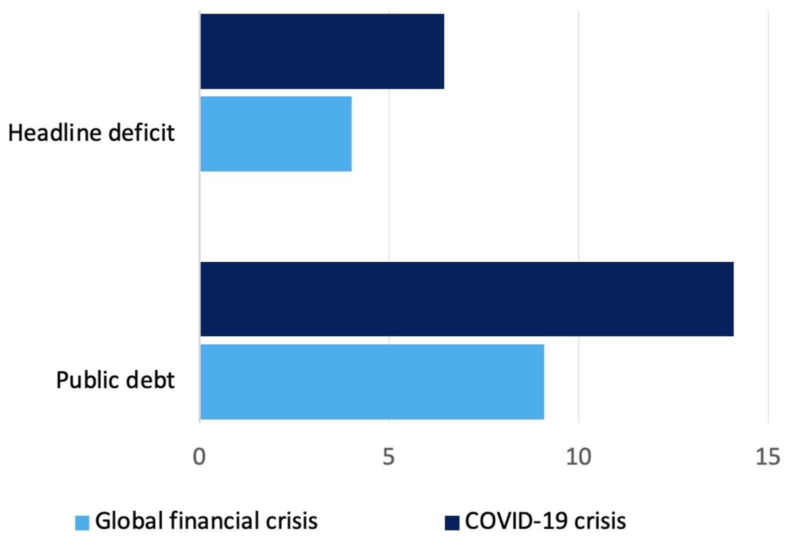
Thanks to strong policy support, accelerated vaccine rollout and, where possible, the gradual easing of pandemic-related restrictions, growth resumed forcefully in the EU in spring 2021. Recent data suggest that economic activity will remain strong for the quarters to come, though uncertainty remains high.

Despite the favourable short-term outlook, long-term structural challenges remain. Some of these pre-date the pandemic: the impacts of population ageing, weak productivity growth, and accelerating climate change. Rising income and wealth inequality, territorial disparities within and among Member States, and unequal access to education and skills were holding back economic growth and creating strain on the EU's social fabric. The pandemic has made many of these challenges more pressing and added others:

- **Public finances have taken a considerable hit and fiscal divergence between Member States has increased**. Deficit and debt ratios have soared in all Member States (Figure 3). High debt ratios are expected to persist, remaining above pre-pandemic levels over the next decade (Figure 4).
- **Investment needs are pressing**. The additional investment needed to achieve our climate and digital goals amounts to €650 billion per year over the next decade (public and private combined).
- **The COVID-19 crisis has aggravated a number of pre-existing vulnerabilities.** Internal imbalances related to high government and private debt have increased, driven by the recession and measures taken to address the COVID-19 crisis. Pre-pandemic dynamic house price trends persisted and mortgage debt continued to grow significantly in some countries. Current account deficits widened in countries dependent on tourism revenues and the correction of current account surpluses has stalled. Moving forward, new risks may emerge as a result of structural transformations accelerated by the COVID-19 crisis.
- **The challenge of boosting socioeconomic resilience has become more apparent.** Less-resilient Member States, territories and sectors found it harder to withstand and respond to the crisis. Differences in resilience across the EU have a bearing on social, economic and territorial cohesion, as well as convergence within the euro area and the effectiveness of the single monetary policy.

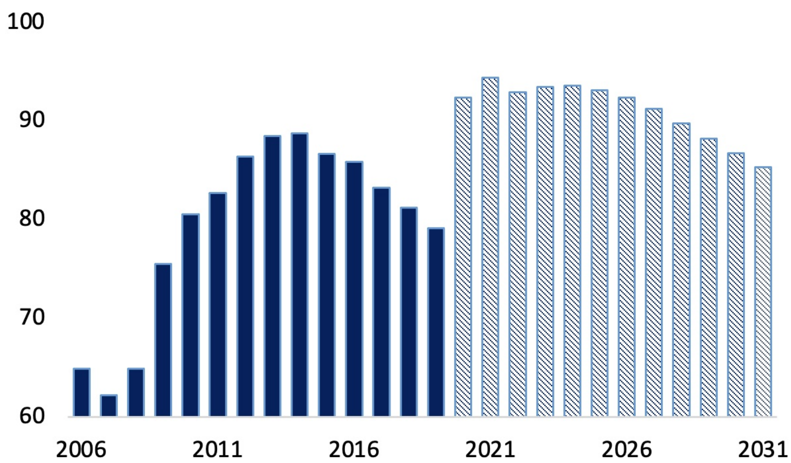
Addressing these challenges offers transformative opportunities but requires major investment and reforms. The €2 trillion firepower of the new Multi-annual Financial Framework and Next Generation EU, in particular the RRF, will support the recovery, while making our economies and societies more resilient. Good policies are also needed to strengthen resilience: effective and well-designed active labour market policies and social protection systems; investment in education and skills; and sound nances.

Figure 3 Public finance impact of the global financial and COVID-19 crises in the EU, 2009 and 2020 (year-on-year change, percentage points of GDP)



Source: European Commission 2021 spring forecast

Figure 4 Public debt in the EU, 2006-2031 (% of GDP)



Source: European Commission 2021 spring forecast

Lessons from the crisis must be drawn for the economic governance review

The EU governance framework should be tailored to the challenges the EU is facing, as set out above. The COVID-19 crisis has underlined the challenges facing the economic governance framework, making those identified in our February 2020 Communication even more relevant. Our latest Communication[1] does not seek to offer a roadmap for reform of the governance framework nor pre-empt the outcome of the public debate.

… for the EU fiscal rules …

A number of key elements can be identified regarding the EU fiscal rules:

- **Reducing high and divergent public debt ratios in a sustainable, growth-friendly manner will be a key post-crisis challenge.** When economic conditions allow, resuming a path of reducing public debt-to-GDP ratios will be essential for maintaining sound public finances and avoiding persistent fiscal divergences between Member States. At the same time, an overly large upfront reduction in debt ratios would entail high social and economic costs and be counterproductive.
- **The stabilisation role of coordinated discretionary fiscal policy has proved to be crucial in the COVID-19 crisis.** The crisis has highlighted the positive role that counter-cyclical discretionary fiscal policy and European coordination can play in responding to large economic shocks and containing their social fallout. However, the ability to provide fiscal stimulus in bad times requires building fiscal buffers in good times. Reinforcing counter-

cyclicality in the EU fiscal framework could strengthen the medium-term dimension of fiscal policy and thus the ability of national fiscal policy to respond to economic fluctuations.

- **A growth-friendly composition of public finances should promote investment and support sustained, sustainable and inclusive growth.** Reflection is needed on the appropriate role of the economic governance framework to incentivise national investment and reforms. Promoting green, digital and resilience-enhancing public investment deserves special attention, given the long-term challenges facing our economy.
- **Achieving the overarching goals of simplification, stronger national ownership and better enforcement remains highly relevant.** This calls for simpler fiscal rules using observable indicators for measuring compliance. It also includes considering whether a clear focus on 'gross policy errors', as set out in the Treaty, could contribute to a more effective implementation. A simpler framework would contribute to increased ownership, better communication, and lower political costs for enforcement and compliance.
- Strong national fiscal frameworks can contribute to an effective economic governance framework. A possible strengthening of their roles and alignment with best practices across Member States are worth considering. This could go hand-in-hand with a refocusing on gross policy errors in the enforcement of EU fiscal rules.

...and the Macroeconomic Imbalance Procedure (MIP)

Returning to a path of convergence between Member States is essential. Preventing and correcting macroeconomic imbalances enhances Member States' ability to respond to shocks and supports economic convergence. A well-functioning MIP can help identify the build-up of imbalances in a timely manner so that they can be addressed early on. The MIP can also support policy coordination, as experienced in the swift and aligned response of Member States to the COVID-19 crisis. Many Member States have reduced the severity of imbalances over time and significant policy action has been taken in the context of Member States' Recovery and Resilience Plans, but the persistence of imbalances in some cases warrants further reflection on how the implementation and design of the MIP could be improved. Multiple surveillance streams partially overlap but the links have not always been fully exploited. MIP surveillance may also have insufficiently taken account of interactions between emerging economic challenges, notably related to climate change and other environmental pressures.

Lessons from the Recovery and Resilience Facility

Insights gained from the functioning of the RRF framework could also be relevant for the broader economic governance of the Union. This framework has involved constructive and intense policy dialogues between the Commission and Member States, leading to improved mutual understanding of challenges, while building trust and ownership. It is underpinned by a transparent assessment and monitoring framework. In the fiscal domain, where the objective of achieving prudent public debt levels remains fundamental, the trade-off between various objectives would need to be addressed at the planning stage, thus avoiding recurrent renegotiation of adjustment paths.

Relaunching the review

A wide-ranging and inclusive engagement with all stakeholders is necessary to build a broad-based consensus. The nine questions guiding the public debate that were included in our February 2020 Communication have been complemented by two additional questions, while one question has been slightly reformulated, as follows:

- *New question*: In what respects can the design, governance and operation of the RRF provide useful insights in terms of economic governance through improved ownership, mutual trust, enforcement and interplay between the economic and fiscal dimensions?
- *New question*: Considering how the COVID-19 crisis has reshaped our economies, are there any other challenges that the economic governance framework should factor in beyond those identified so far?
- *Reformulated question*: In light of the wide-ranging impact of the COVID-19 crisis and the new temporary policy tools that have been launched in response to it, how can the framework – including the Stability and Growth Pact, the Macroeconomic Imbalances Procedure and, more broadly, the European Semester – best ensure an adequate and coordinated policy response at the EU and national levels?

We are looking forward to your contributions to the debate. The online survey has been relaunched and citizens, organisations and public authorities are invited to submit their contributions by 31 December 2021.

' note: The authors would like to thank Sylwia Nowak, Alessandra Cepparulo, Christine Stefan Kuhnert, Gilles Mourre, Karl Scerri and Henk Van Noten for helpful inputs. We also

extend our thanks to DG ECFIN colleagues who are working on the economic governance review.

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Endnote

1 The Communication can be found at: https://ec.europa.eu/info/sites/default/files/economy-finance/economic_governance_review-communication.pdf.

Topics: Covid-19 EU institutions EU policies Macroeconomic policy

Tags: COVID-19, Next Generation EU, Recovery and Resilience Facility, European Union, EU economic governance

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