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A Marathon, not a Sprint: A Six Point Plan to Build Confidence, Create Jobs and Repair Public Finances

Dr. Eoin Drea

Coronavirus has fundamentally altered the economic and social environment for billions of people around the world. The tragedy of this immense human loss has been compounded by significant economic dislocation and severe social strains, arising from the required public health restrictions.

The record declines in European economic activity evident in Q2 2020 have now stabilised, and an uneven economic recovery is underway. However, the momentum of this recovery is stalling and is dependent on the evolution of the pandemic and the public health measures designed to manage its spread. The imposition of further restrictions across Europe in October 2020 significantly raises the risk of a double-dip recession. Economic activities are not currently robust enough to be self-sustaining, while activity levels in services industries remain highly volatile. This is due to low consumer and business confidence arising from the uncertainty of both the virus's trajectory and the likely imposition of further restrictions in the short term.

The return of "lockdowns" remains firmly on the table given the current trajectory of the virus. With global GDP still expected to fall by 4.5% in 2020, the associated impacts on employment and public debt levels will remain of an unprecedented scale in the medium term.

The economic response must be long term, consistent and adaptable

In this context, the initial forecasts of a widely embedded economic recovery by late 2020 will now not occur. Current estimates, even under the most favourable scenarios, indicate a significant economic loss well into 2021. As a result, the broader economic response of the EU to the pandemic (with the exception of direct healthcare priorities) must now focus on a considerably longer time horizon. Even the delivery of a scalable Coronavirus vaccine in 2021 will not automatically result in a return to pre-2020 economic norms. For many entire industries, such as aviation and tourism, the long-term prospects will remain far from certain.

Point 1:
Building confidence through policy certainty

In the short term, Europe's economic environment will remain highly uncertain. Deep fluctuations will occur based on the latest developments in virus circulation (particularly in larger economies), restrictions on commercial life, and developments surrounding the competing attempts to deliver a virus vaccine. Economic sentiment and global financial markets will exhibit a high degree of instability as long as the potential reimposition of more severe "lockdown" measures remains possible, or in some countries, increasingly likely.

To combat this instability, it is necessary for governments to build confidence through medium-term policy certainty. In this context, the broad extension of financial support to protect existing jobs and support Small and Medium Enterprises (SMEs) should be continued until the end of 2021. National Kurzarbeit, or short-time working schemes, should continue to access additional EU financing (through the SURE programme), if required. These supports should be gradually tapered and reduced as the economic environment improves.

Point 2:
More targeted and flexible job creation supports in 2021

It is important to recognise that irrespective of when this pandemic ends, the lasting impact on the jobs market will be profound and long-lasting. The Corona crisis has resulted in a generational structural shift in many employment sectors. Many jobs and businesses, including some of those currently financially supported by public funds, will not be viable in the post-pandemic environment. This will be the result of changes in how we work, live, use technology, and access good and services.

To ensure that public funds are effective in aiding this transition to job and business creation in 2021, the existing financial supports should become better targeted and more focused. Such measures should include:

a) A constant focus on assessing the eligibility of workers and companies for financial support to better match support with actual levels of economic activity;

b) Avoid the abrupt cessation of financial supports (especially for employees and SMEs) by tapering payments based on industry by industry analysis. This should result in a differentiated approach by economic sector;

c) Switch the focus gradually from firm support to household support, particularly for those who are most vulnerable (e.g. low income, non-permanent workers);

d) Job creation will be central to the economic recovery in 2021 and beyond. Reducing the administrative and regulatory burden for entrepreneurs and businesses (particularly SMEs) in expanding employment in emerging industries must become a key element of economic policy;

e) Utilise the Kurzarbeit framework to enable workers to combine limited work hours with retraining/further education while maintaining the majority of their income. This could be particularly relevant in sectors which may not recover fully from dislocation effects of the pandemic;

f) Governments should work together with universities, vocational bodies and other tertiary education providers to design flexible life-long training/educational opportunities for workers seeking to gain new skills and employment opportunities. Particular focus should be given to the digital, environmental and long-term social care sectors given the requirements in these areas in the years ahead; and

g) Continue to focus on measures to increase labour mobility, both nationally and at a cross-border level. In particular, enhanced investments in digital technology are required to increase “digital mobility” for workers across EU borders. High speed and reliable internet connectivity is a prerequisite for the future development of smaller towns and rural areas throughout Europe.

Point 3:
The European Recovery Fund as an investment tool, not a short-term political fix

One of the unfortunate side effects of the establishment of the European Recovery Fund (ERF) has been its portrayal as a short-term fiscal stimulus to help struggling economies. The reality is that the ERF’s potential benefits relate more to its financing of longer-term structural reforms. Under 25% of the

ERF's resources will reach member states before 2023, and less than 10% in 2021. Even these projected allocations assume that ongoing negotiations on the required procedures, priorities, and relationship to rule of law concerns will be successfully concluded in the coming weeks. This is by no means guaranteed.

Rather than rushing to meet political pressure for quicker action, the ERF must be properly governed, have clear objectives, transparent assessment criteria, and significant economic benefits. The absence of any of these elements risks compromising the entire ERF concept, eroding trust between EU members, and weakening the wider financial infrastructure of the Eurozone. A poorly functioning, ineffective, or biased ERF will undermine the credibility of working towards deeper financial and single market integration. It also risks lumbering Europe's next generation with sizeable financial debts for very little in return.

In order to safeguard the integrity of the entire process, it is essential that:

a) To maintain credibility, the ERF must be subject to meaningful anti-corruption and rule of provisions which must be agreed at EU level. The European Parliament must also have a significant role in ensuring the governance and accountability of ERF actions;

b) The ERF should be explicitly recognised as an investment tool for achieving longer-term growth objectives, and not just as a short-term mechanism for fiscal expansion;

c) ERF funds should be wholly transparent in government accounts, and not treated as just another component of wider national expenditure;

d) ERF disbursements should be focused on long standing blockages in member states' structural reform proposals. Examples should include increasing digitalisation (including of public administration), modernising education systems, and helping attain climate change goals. The ERF is not a tool for realising the pet projects of national governments; and

e) The long-term sustainability of the ERF is dependent on the EU having additional own resources to meet further expenditures in the future. Currently, agreement only exists on introducing a single use plastic tax, which will not be sufficient to meet future financial commitments. Disbursement of the ERF should not commence until further additional sources of future revenue have been agreed at EU level.

One further issue relating to the future of the ERF and the wider EU institutional framework is relevant. There is an increasing risk of divergence between financial markets (who expect the ERF to lead to fuller fiscal union in time) and the political realities facing several member states (who view the ERF as a "one-time, short-term crisis response measure"). In a post-pandemic environment, these divergences (if unresolved) will provide a serious point of contention in how the financial markets interpret the future political economy of the EU.

Point 4:
A unique opportunity to strengthen Europe's banking and financial infrastructure

The Eurozone and Europe's banking sector have remained remarkably stable in 2020 given the severe economic dislocation caused by the ongoing pandemic. This reflects the consistent fiscal and monetary policy responses of national governments, EU institutions, and the ECB. It is also partially attributable to the reforms implemented in the aftermath of the banking and financial crises.

However, the Eurozone (and its banks) remain vulnerable to further unforeseen economic shocks. The longer-term impacts of the pandemic on banks' levels of unperforming loans remains uncertain. This Corona crisis is a wake-up call that further reforms are urgently required, if the Euro is to continue to act as the basis of growth and stability in the future. The accommodative fiscal and monetary policies implemented in 2020 have created a unique opportunity to strengthen Europe's banking and financial

infrastructure. In this context, the following measures should be prioritised:

a) Nearly a decade has passed since the EU began to reform Europe's financial infrastructure in the midst of the Great Recession. This work remains unfinished. Of immediate importance is the requirement to finally introduce a European Deposit Insurance Scheme (EDIS) for depositors across the Euro zone;

b) EDIS must be accompanied by effective regulation limiting the exposure of banks to sovereign debt of their home country;

c) The European Commission, through Commissioner Gentiloni, should immediately restart the process of simplifying the EU's fiscal rules (which was postponed early in 2020) with the goal of providing a more transparent and easily understood framework for the post-COVID recovery. Simple public expenditure rules accompanied by longer-term debt reduction target are one of many possible frameworks;

d) The European Commission's review of Eurozone governance must also be forward looking and address the wider political economy lessons of this virus crisis and the introduction of the ERF. In particular, a wider variety of potential development paths for the Eurozone should be considered, including but not limited to, a more decentralised monetary union; and

e) Real progress must be made on pursuing a Capital Markets Union that serves to develop a cross-border dimension on issues such as banking operations, financing of companies and insolvency frameworks. Such policies would reduce concentration of risk in national markets.

Point 5: Ensuring a recovery where everybody belongs

Current estimates show that the Corona crisis is having significant negative impacts on global poverty levels. Although heavily concentrated in South Asia and Sub-Saharan Africa, the prolonged nature of economic restrictions is also having considerable socio-economic effects in Europe. Lockdowns disproportionally affect temporary and part time workers, the majority of which are female. Lockdowns also impact more negatively on those with lower levels of educational attainment as there is a strong positive relationship between the level of education and the capacity to work under workplace restrictions (i.e. telework).

Although the ECB and others have highlighted the rapid rise in household savings in 2020, this generalised approach ignores the weakened financial status of many low income and non-permanent workers. Data indicates that those employed in the retail and tourism sectors are particularly vulnerable as they tend to have less than one month's income as a financial buffer. In most EU countries, more than half of households have liquid savings worth less than two months' income. This is a modern "precariat" where employment no longer guarantees financial stability.

In this context, it is important that the job creation supports that emerge over the course of 2021 (as identified in Point 2 of this plan) retain a strong focus on those in non-permanent employment. Particular additional measures will be required to allow for re-education and retraining opportunities for those workers seeking to upskill or change careers. The wider social impacts of the pandemic – including providing additional support for the increased risk of psychological problems, domestic violence, and abuse cases – should be prioritised.

Point 6: Repairing public finances is a marathon, not a sprint

The Corona crisis is having a very serious impact on public finances across the globe. Current projections (made before the increased restrictions imposed across Europe in October 2020) indicate that gross public debt for all states will rise considerably

in the medium term. The Eurozone's debt-to-GDP ratio is forecast to exceed 100% in 2020 (up from 84% in 2019) with a budget deficit estimated at 8.9% of GDP (compared to 6.6% in 2010). US debt will near 150% of its GDP by 2021.

The scale of this fiscal deterioration has been so dramatic as to endanger a necessary debate about the timing of measures to restore fiscal balance. However, the prolonged nature of this pandemic indicates that exceptional levels of public spending will be required until 2021, possibly 2022 (even under a best-case scenario).

In this context, it is important to understand that the process of public debt stabilisation (and reduction) will be a longer-term process. The lessons of Japan's experience over the past decade highlight the dangers of reducing government spending or raising taxes precipitously in an uncertain economic environment.

The IMF and the World Bank, among others, have explicitly argued for a continuation of fiscal stimulus to safeguard against a more permanent economic scarring. The argument is not that deficits do not matter (which they do), but that in the words of the economic historian (and World Bank Chief Economist) Carmen Reinhardt *"first you worry about fighting the war, then you figure out how to pay for it."*

In this context, the following recommendations are relevant:

a) The existing suspension of EU level fiscal rules to 2022 should be supported;

b) As set out in Point 4, the European Commission, through Commissioner Gentiloni, should immediately restart the process of simplifying the EU's fiscal rules (which was postponed due to the pandemic) with the goal of providing a more transparent and easily understood framework for the post-COVID recovery;

c) Economic growth must become the principal mechanism for reducing debt burdens in the medium term. A growth-induced debt reduction programme, underpinned by a commitment to a credible (and simplified) EU fiscal framework, could significantly cut debt relative to GDP. Belgium's debt reduction strategy in the 1990s provides an interesting template for further analysis.

d) As noted in Point 3, the European Recovery Fund must be correctly utilised as a longer-term tool for necessary public investments in areas such as digitalisation, combatting climate change, and modernising education systems. Political pressure for quicker action should not compromise the importance of necessary oversight and governance measures;

e) Rather than developing short term plans for debt reduction, members states (and the EU) should focus on reviving economic growth that will enable interest rates to rise above zero. Subsequent debt reduction strategies can then be based on a much more robust baseline of economic activity; and

f) The Corona crisis has shown clearly that the budgetary principle of creating fiscal buffers during periods of economic growth to facilitate additional spending in times of crisis is sound. It must become the vital underpinning of a future, normalised fiscal framework, as it allows greater fiscal space to counter unforeseen shocks without causing immediate debt pressures from the financial markets.

Dr. Eoin Drea *is a Senior Research Officer at the Wilfried Martens Centre for European Studies and Research Fellow at Trinity College Dublin.*

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Wilfried Martens Centre for European Studies
Rue du Commerce 20
Brussels, BE – 1000
http://www.martenscentre.eu