

REBOOTING EUROPE: A FRAMEWORK FOR A POST COVID-19 ECONOMIC RECOVERY

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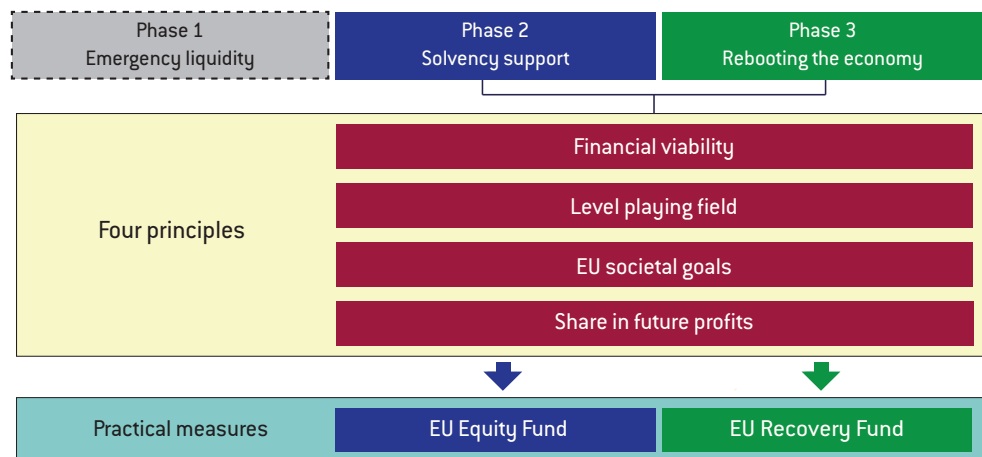
THE ISSUE

To slow the spread of COVID-19, European governments have adopted stringent containment measures. These have led to a severe recession and policymakers in European Union countries are providing generous support to help companies cope with the immediate consequences. The basic approach has been to provide generous and indiscriminate emergency support to help cash-strapped firms meet their immediate liquidity needs. But as lockdown measures continue and the recession gets deeper, a more comprehensive strategy for the future needs to be designed.

POLICY CHALLENGE

The success of support measures as COVID-19 lockdowns are relaxed depends on the type of recovery the EU wants to achieve. At the same time, decisions taken today will have long-term implications for the single market and government debt. How should further fiscal support provided to companies be structured? What implications will different approaches have for the single market, government budgets and the EU's climate strategy? Difficult trade-offs lie ahead: a speedier recovery could run counter to green ambitions; national rescues could hurt neighbouring markets. The hard choices in the next phases should follow a set of four principles, and the recovery effort should be structured around equity and recovery funds with borrowing at EU level.

A FRAMEWORK FOR A POST COVID-19 ECONOMIC RECOVERY



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1 THREE PHASES OF ECONOMIC RESPONSE TO COVID-19

COVID-19 lockdown measures have led to sharp contractions in economic output, household spending, corporate investment and international trade. European Union countries have seen an estimated average decline in annual GDP growth of up to 3 percentage points per month of lockdowns¹. The EU economy is predicted to contract by a record 7.4 percent in 2020 (European Commission, 2020).

The impact of COVID-19 on the European economy might ultimately turn out to be even greater than currently estimated. The health and economic impacts of the pandemic and the containment measures on sectors and countries have varied significantly. For example, tourism slowdowns have particularly hit Mediterranean countries and airlines. The construction sector has been more heavily affected in some countries than in others.

In the fiscal economic policy response to the pandemic, three phases can be broadly distinguished.

Phase 1 measures are meant to temporarily freeze economies as they were before the crisis, to shield healthy businesses from bankruptcy and to protect European firms from hostile takeovers by foreign state-backed enterprises. Phase 1 support has been crude and indiscriminate, and rightfully so. The motto is speed over perfection. The national economic measures taken in phase 1 are characterised by indiscriminate, national-based liquidity support to firms and workers. These measures are meant to keep firms afloat in the face of near-universal cash shortfalls, to prevent unnecessary lay-offs and to deter hostile takeovers (especially from non-EU state-financed enterprises). As early as 19 March 2020, the European Commission amended the EU state-aid rules with a so-called Temporary Framework to allow governments to undertake such measures. However, the size of fiscal responses in different EU countries has differed widely. For instance, immediate fiscal stimulus have ranged from 0.9 percent of GDP

in Italy and 1.1 percent in Spain to 10 percent of GDP in Germany (Anderson *et al*, 2020).

Phase 2 will be about solvency support. As the lockdowns continue, firms must take on increasing amounts of debt and draw on equity reserves to meet their working capital and investment needs. At the same time, credit standards are tightening². For increasingly-leveraged firms, bankruptcy looms; solvency support through direct recapitalization is needed. This phase is expected to last roughly until the end of any lock-down measures. Lockdowns may well end only fully once full immunity or a vaccine is available, so possibly well into 2021.

Phase 3 will then be about recovering from the severe contraction phase that the likely on-and-off switching of lockdown measures will leave in its wake.

The European Council of 23 April 2020 tasked the Commission with designing a sizable recovery fund, targeting the sectors and geographical parts of Europe most affected by the crisis. But so far, no clear strategy has been presented. We discuss the key principles that should guide support measures in phases 2 and 3. One key consideration is that decisions taken in phase 2 – who gets bailed out, how and under what conditions – will determine who is left standing in the recovery phase. Conversely, predictions about the shape of the recovery and about policy measures enacted in phase 3 (such as demand support) could determine whether or not a company can be deemed solvent today.

As countries move to the next phases, taking account of EU cross-border effects will become increasingly important. Phases 1 and 2 have so far largely involved national fiscal policy. However, differences in state-aid disbursements and other support during phase 2 could well leave lasting marks as countries take different and uncoordinated decisions, whether because of fiscal space or preferences. Decisions taken now will thus shape the single market of tomorrow. In phase 3, economic outcomes will be shaped by budget decisions related to the EU's multiannual financial framework (MFF) and the

1. Each month of lockdown is expected to cause a decline in annual GDP growth of 2.4 percentage points in Germany, and of 3 percentage points in France and Italy.

2. As reported in the 2020 Q1 European Central Bank bank-lending survey.

EU recovery fund, alongside national recovery programmes. A comprehensive strategy for phases 2 and 3 is needed.

2 FOUR GUIDING PRINCIPLES FOR MANAGING PHASES 2 AND 3

Moving from phase 1 onto the next phases is not simply a matter of providing equity instead of debt. While phase 1 injections have been emergency measures, phase 2 requires a long-term plan. It also requires recognition of difficult trade-offs ahead: speedy economic recovery versus environmental goals; health of the private sector versus public indebtedness; solvency versus social cohesion. The job now for policymakers is to make clear the principles guiding their recovery strategies. Such principles should consistently inform policymakers' choices between the possible measures and the inevitable trade-offs. Can they ensure that rescue plans designed today do not cause unintended damage tomorrow?

But before reflecting on the principles that should guide future economic support, it is worth highlighting why such support is warranted in the first place. First, governments impose lockdown measures to achieve a public good: a healthy population. It is therefore appropriate that the public contributes to paying for the economic fallout from achieving that public good. Second, without further support, many jobs will be lost. Third, with numerous companies failing, invaluable tangible and intangible capital will be destroyed. Rebuilding that capital and founding new firms will take many years, during which human capital will be permanently destroyed.

However, governments cannot and should not rescue every company with unlimited amounts of cash. This would be fiscally irresponsible and could cost the single market. A careful balance must be struck between public welfare objectives and the social, economic and political risks of rescue programmes.

We consider four principles to be of utmost importance in this evaluation.

First, only financially viable firms

should receive solvency support, with financial viability assessed in terms of both the past and future.

Taxpayers should not support firms that were in bad shape before the virus-induced lockdowns but assessments of financial viability need to go beyond published 2019 financial accounts.

The crisis may well alter consumer preferences and production systems. Public resources must focus on firms with business models that are expected to be viable in the post-crisis economy. Rescue plans should not be about preserving pre-crisis industrial structures. The recovery should be about jump-starting a healthy post-COVID-19 economy, which could mean letting some firms fail. Meanwhile, a forward-looking approach suggests financing the promising start-ups of the post-crisis economy. A key question here is who should conduct these forward-looking assessments?

We favour a mechanism in which the expertise of private investors is used to support decisions on the allocation of rescue funds. Such a system would be more transparent and accountable than if politicians and their administrations are left to decide unilaterally which companies to help. Involving private investors would help ensure that investments are viable in the long run, especially if they have a direct interest. Even so, credit tightening might lead to under-investment and the public sector therefore has an important role.

The local knowledge and analytical capabilities of commercial banks is already extensively used to distribute state guarantees and subsidised loans to firms and individuals. Further partnerships will be required for equity-based instruments, especially for the more arduous assessments of the viability of smaller companies.

Second, state support should not undermine competition in the EU's single market.

One of the EU's main strengths is well functioning competition within its single market. Fair competition across borders

ensures that the most innovative and productive firms thrive, rather than those that receive the most state support.

Relaxed state-aid rules allow EU governments to inject liquidity into cash-deprived registers (see Box 1 on the Temporary Framework introduced by the European Commission in March 2020 to relax state-aid rules during the COVID-19 crisis). Inevitably, some countries will provide more generous support than others (Germany accounts for approximately half of the approved COVID-19 state aid as of 1 May 2020). These differences risk distorting competition, especially if they continue during phase 2. At the extreme, fears of competitive disadvantage could trigger subsidy wars between EU countries, leading to huge wastes of public money (Motta, 2020). The more long-lasting differences are, the more the single market and therefore the foundation

of Europe's long-term growth will be affected.

Quantitative limits on the amounts of aid (eg the €800,000 cap on grants) impose some discipline (Neven, 2020). Nevertheless, some countries will deliver less than the maximum authorised amounts, while others will go beyond, taking advantage of the fact that aid provided under the Temporary Framework can be cumulated with other types of state aid³. Furthermore, quantitative limits on aid to individual firms do not prevent major differences in the scope of deployment.

Firms that operate in economically less-affected countries will be at a great advantage compared to firms that deal with insolvent suppliers and clients in their daily business.

Rules to restrain the behaviour of artificially-competitive firms also work to limit further distortions of

Box 1: What has been done: the Temporary Framework

As amended on 3 April 2020 and 8 May 2020, the Temporary Framework provides for the following types of aid, which can be granted by EU governments until the end of 2020:

- Measures that help businesses cover immediate working capital and investment needs:
 - Direct grants, equity injections, selective tax advantages, advance payments, zero-interest loans or guarantees on loans for a nominal value up to €800,000
 - State guarantees for loans up to 90 percent of risk on loans and for up to six years
 - Subsidised public loans with favourable interest rates for up to six years
 - Targeted support in the form of deferral of tax payments, suspensions of social security contributions and wage subsidies
- Subordinated debt
- Measure to support coronavirus-related research and development; support for the construction and upscaling of testing facilities to develop and test products (including vaccines, ventilators and protective clothing); support for the production of products relevant to tackle the coronavirus outbreak.
- Measures to recapitalise firms when no other appropriate solution is available.

State aid granted under the Temporary Framework must respect the following conditions, among others:

- Firms must be financially viable as of end-2019
 - Firms in the financial services sector are excluded
 - The amount of the loans and guarantees per beneficiary is capped at:
 - Double the beneficiary's 2019 wage bill,
 - 25 percent of the beneficiary's total turnover of 2019, or
 - With appropriate justification, the liquidity needs for the coming 18 months for SMEs (12 months for large enterprises).
 - Recapitalisations must not exceed the minimum needed to ensure the viability of the beneficiary, and should not go beyond the pre-crisis capital structure.
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3. For example, €200,000 of de minimis aid and aid under Article 107(2)(b), which permits governments to compensate firms for incurred direct damage.

the single market. To that end, the Commission's state-aid amendments prohibit aid-infused firms from engaging in aggressive commercial expansions and from acquiring rivals while they are repaying the state. These rules are welcome additions to the Commission's arsenal. However these new rules rely on vague behavioural notions that are not easy to enforce – when is a pricing strategy 'aggressive' and when is it pro-competitive? – and distortionary in their own right⁴.

Third, state support should support and not undermine achievement of broader societal goals.

The EU and its members have set themselves societal goals including climate neutrality and social cohesion. It would be absurd if public funds now subsidised the business models that need fundamental change. As governments engage in bilateral negotiations with firms, they are in a uniquely strong position to push for the changes that normally require years of rule-making to implement. Support given to firms should be conditional on making the changes required to achieve the EU's societal objectives.

Putting conditions on state aid will require difficult technical questions to be addressed – around monitoring and enforcement, for example. Political disagreements, for example over conditions on dividends and bonuses attached to equity injections or environmental obligations, will have to be resolved. Indeed, a clear definition of broader societal goals needs to be agreed and supported by the entire EU. If the goals in different countries diverge too much, there will be a risk of further market distortions, with some firms held to much higher standards (for example on environmental protection) than others.

In light of these difficulties, and under pressure to act fast, it will be tempting to postpone these discussions until after the crisis⁵. But this would be a rare opportunity missed.

Fourth, taxpayers should receive

their share of the rewards of the recovery.

Generous support schemes funded by the taxpayer should give the taxpayer some claims on future profits. Moving beyond emergency rescues, interventions must be framed as worthy public investments, not expensive bailouts⁶.

3 APPLYING THE FOUR PRINCIPLES IN PHASE 2

Most of the public aid provided so far has been in the form of debt (loans and guarantees) and does not address solvency worries that will get worse as the crisis lengthens. At the microeconomic level, phase 2 will thus be characterised by the need for solvency support: direct capital injections into hard-hit balance sheets⁷.

Phase 2 has been characterised by a lack of EU coordination. While EU negotiations drag on in the background, national policymakers have no choice but to draw from national budgets to rescue their endangered economies. In this phase, EU competition law is the only effective tool for response coordination.

In this context, the principles discussed in section 3 suggest a large European equity fund should be created to ensure a single approach to recapitalisation measures and to protect the integrity of the single market. If well designed, this would not lead to systematic cross-border transfers because equity support would be given on condition of receiving a share of future profits.

A large European equity fund could operate under the control of the European Investment Bank (EIB). It could build on the existing InvestEU plan (previously known as the Juncker Plan), via which the EIB working with private investors and national banks invests in European firms (including SMEs) through a variety of instruments (including equity). However, the new fund would have to differ from InvestEU in that it would be based on significantly larger borrowing from the EU budget. The currently discussed steps in this direction, such as the newly-established

4. Knowledge that a rival is barred from aggressive pricing could be an open invitation for tacit collusion.

5. None of the rescue packages given so far to airlines have included green conditions. See: <https://storage.googleapis.com/planet4-eu-unit-state-less/2020/04/20200430-Eu-ropian-airline-bail-out-tracker-2.pdf>.

6. Loneragan and Blyth (2020) argue that 'bailout' is a misnomer in the case of COVID-19.

7. On 9 April 2020, the European Commission proposed to further extend the scope of the Temporary Framework to include direct recapitalisation measures, eg in the form of equity stakes and subordinated debt. See https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_20_610.

EIB guarantee fund, are insufficient⁸.

The fund would allocate capital according to the four principles set out in section 3. In particular, the centralisation of funds would allow for proportionate allocation and a consistent approach to helping firms in different EU countries, thus limiting distortion. Reliance on local partners, such as national promotional banks (such as KfW in Germany) and private financial institutions, would leverage local knowledge. Within an EU framework, the expertise of these institutions would help direct funds towards the firms most likely to be viable in the long-run.

Conditions could be attached to the disbursed funds, ensuring accelerated changes towards agreed common societal goals. Better still, the fund could be managed for the public's benefit, and the profits dedicated to financing societal goals, thus providing a clear social sharing of the upsides. European taxpayers would thus not be bailing out firms, but rather investing in them.

In terms of instruments, equity or equity-type instruments (eg transfers with remuneration contingent on future profits⁹) are preferable to pure transfers or subordinated debt instruments because they allow for a share in future profits. However, care should be taken to limit the distortionary effects of pure equity instruments. Equity should be: (i) without voting rights, (ii) with quantitative limits, (iii) with a timeline for government exit (of these three condi-

tions, only the third is required under the EU Temporary Framework). For SMEs, equity-type instruments may be preferred to pure equity because of the known problems associated with valuing equity stakes in closely-held SMEs.

Table 1 summarises the disadvantages and advantages of the various instruments currently being considered by experts, the European Commission and member states.

If such an equity fund cannot become operational during 2020, it should at least become fully operational in January 2021, when various lockdown measures are likely to still be in place.

Short of a pan-European fund, the most effective way to limit the distortionary effects of state subsidies is crude and mechanical: state-aid exemptions must be short-lived and enforcement must be biting. This would risk too little state support, without common societal goals.

4 PRINCIPLES IN PHASE 3: TOWARDS A STRONG AND SUSTAINABLE RECOVERY

Even if a COVID-19 vaccine becomes available, it will likely take several years until the level of economic activity of 2019 will be reached, for three reasons.

First, despite all the government support provided, many firms will have disappeared. Valuable physical, financial and human capital will have been lost. Rebuilding new productive structures

8. The EIB is in the process of setting up a €25 billion fund to guarantee up to €200 billion worth of loans for purposes related to COVID-19. This is far too little however, and is unlikely to ease market distortions to any noticeable degree. The EIB aims at a balanced allocation across participating countries. But €25 billion spread across member states is scant compensation for the more than €500 billion Germany has allocated to a similar guarantee programme. See Bruegel's database of fiscal measures: <https://www.bruegel.org/publications/datasets/covid-national-dataset/#germany>.

9. See the SAFE proposal: <https://voxeu.org/article/implementing-european-pandemic-equity-fund>.

Table 1: Comparisons of different instruments for recapitalisation

	Potential partner	Government share in upside	Seniority	Ease of implementation with SMEs	Distortionary effect on the single market
Subordinated debt	Commercial banks	No	Low	Reasonable	Lower
Equity-like instrument (SAFE proposal)	National promotional banks	Yes	None	Reasonable	Lower
Equity	National promotional banks, private venture capital & private equity funds	Yes	Lowest	Lowest: difficult to implement and to buy backs, especially in closely-held SMEs	Highest: value of the aid very difficult to assess, especially in uncertain times

Source: Bruegel.

will take time and investment.

Second, households have suffered a major shock to their incomes and have reduced savings. They will want to rebuild their savings as soon as incomes recover. It is therefore entirely possible that the private savings rate will be higher post lock-down, putting a drag on demand.

Third, global value chains could be significantly disturbed for some time because of the different stages of the virus and vaccination, and because of private and public responses to the experience. This could reduce productivity.

In phase 3, the EU must play a major role – through the MFF and the recovery initiative/fund – alongside national recovery programmes. As phases 2 and 3 are intrinsically linked, measures should be based on the same objectives. In light of that, we discuss the key principles of a recovery initiative/fund.

The recovery initiative/fund responds to the need to counterbalance the huge differences between the abilities of EU countries to boost their economies, arising variable fiscal room for manoeuvre.

Notably, such a fund should prevent two scenarios. First, by relying only on national borrowing, the debt of some countries could become difficult to fund on primary and even secondary markets. A rise in spreads would then render debt unsustainable in a self-fulfilling crisis. EU borrowing that is loaned to member states supports primary markets and is effectively also a support for sustainability as the interest rate advantage of EU debt can be substantial. Grants obviously would provide stronger insurance. Second, fearing market reactions, countries could borrow too little, supporting their economies insufficiently and doing long-term damage to both EU economic performance and political cohesion.

The EU recovery initiative/fund would thus be crucial in the recovery phase. It should be based on four guidelines.

First: the recovery fund needs to focus on broader EU societal goals.

The EU has committed to lead the transition to a healthier planet and a new digital world (von der Leyen, 2019), and

it is important that both demand and supply-support measures promoted under the recovery initiative/plan will be consistent with these broader societal goals. The planning work done so far on the European Green Deal, and on a new EU industrial policy, should represent the starting point for the design of the recovery. Trade-offs certainly exist between policies exclusively aimed at minimising the socioeconomic damage left by the crisis, and those also aimed at promoting broader societal goals. However, it is possible to design recovery policies that can deliver on both economic and societal goals and reduce the trade-offs¹⁰.

Second, the recovery fund needs to be financed primarily through borrowed money.

It is optimal to smooth the consequences of a large shock through time, ie through borrowing. Wolff (2020) argued that EU borrowing is the way forward to fund the costs currently being incurred. In the monetary union in particular, such EU borrowing would bring significant advantages and strengthen the euro-area macroeconomy, while helping overcome the problems of single-market fragmentation that result from primarily national responses. Purely national borrowing would weaken the single market and also render the monetary union more fragile.

Third, the recovery fund needs to strike the right balance between grants, loans and accountability.

Traditional European Commission schemes, from the Juncker Plan to InvestEU, up to the recently-proposed European Green Deal Investment Plan, tend to focus on financial architectures based on guarantees and loans, in order to trigger large-scale private and public investment initiatives. Such initiatives have been received sceptically in the past, given the uncertainties about their real additionality (Claeys and Leandro, 2016; Claeys and Tagliapietra, 2020). Given the unprecedented uncertainty

10. For instance, Hepburn *et al* (2020) showed that there is a set of fiscal recovery policy types that offers high economic multipliers and positive climate impact. These include clean physical infrastructure, building efficiency retrofits, investment in education and training, natural capital investment and clean R&D. Among others, the International Energy Agency (2020) and the Energy Transitions Commission (2020) have reached similar conclusions.

faced by companies in the COVID-19 crisis, these tools will be insufficient, even though their additionality is clearer now than it was because of the high degree of risk. Overall, EU debt must be large enough to be effective and not rely on leverage alone.

Both are helpful but grants obviously provide more insurance, though they also imply bigger transfers and are politically more charged and their legitimacy more difficult to establish. Ultimately, a system with large amounts of European grants requires in essence a European spending programme with central control and enforcement. Providing grants centrally while exercising spending decisions nationally is incompatible with legitimacy and accountability.

Fourth, the EU budget's structure and allocation methods should be rethought.

President von der Leyen claimed she can turn the EU's budget into the "mothership" of the European recovery (European Commission 2020). The MFF is indeed the EU's main tool for engineering transfers via grants. But in order to deliver on the objective an effective economic recovery aligned

with broader societal goals, the EU budget needs a structural rethink. In particular, it cannot only rely on increased contributions from member states. The 2014-2020 EU budget was predominantly focused on the Common Agriculture Policy (CAP) and Structural and Cohesion Funds (together making up 71 percent of spending; Moes, 2018). The economic literature shows that the CAP provides good income support, especially for richer farmers, but is less effective for greening and biodiversity and is unevenly distributed. The literature also shows great uncertainty over the real size and effectiveness of cohesion policy (Darvas and Wolff, 2018). In the wake of COVID-19, the EU budget should be targeted more at the sectors of the future – such as green and digital – and made more efficient and effective. Finally, the way MFF resources are allocated really matters. A significant part of MFF spending should be targeted at the European regions most affected by COVID-19¹¹. To do so, it will be essential to introduce into the MFF allocation methods a set of parameters that prioritise regions that have been impacted most by COVID-19, in both health and economic terms.

11. Wolff (2020) discussed whether and to what extent this creates moral hazard concerns.



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