EMERGING STRONGER FROM THE CRISIS TOGETHER

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This is a translated version of the original German-language chapter "Gemeinsam gestärkt aus der Krise hervorgehen", which is the sole authoritative text. Please cite the original German-language chapter if any reference is made to this text.

KEY MESSAGES

- The temporary Recovery and Resilience Facility enables the EU member states to invest in productivity and growth, thus facilitating structural reforms.
- The sustainability of public finances, an effective fiscal framework, and the stability of the financial system are prerequisites for a Europe that will be resilient in the future.
- Strengthening the EU's Single Market can increase resilience to future crises. More diversified supply chains and a European system of inventory management can contribute to this.

SUMMARY

Since early 2020, the coronavirus pandemic has had a tight grip on the member states of the European Union (EU) and on many other countries worldwide. Governments have been taking economic policy measures on an unprecedented scale to cushion the pandemic's economic impact. After the immediate health and economic policy responses to the pandemic had been dominated by national policies, the EU member states agreed in July 2020 on a comprehensive Recovery Plan called **'Next Generation EU'**. This recovery plan and the challenges associated with coping with the pandemic have prompted the German Council of Economic Experts (GCEE) to **discuss the EU's future tasks and prospects.**

Following the immediate crisis response, the focus of European economic policy should now be on **growth and raising productivity** and on **resilience to future crises**. In view of the many measures taken by the member states, it is the EU's task to ensure competition in the Single Market. Furthermore, after the crisis the easing of aid and banking regulation should be reversed. Although the establishment of the credit-financed **Recovery and Resilience Facility** is not particularly suitable for cushioning the immediate consequences of the pandemic, it offers an **opportunity** to make productivity gains possible by investing in the green and digital transformation, to facilitate structural reforms in the member states, and thereby to strengthen the Single Market's resilience and growth potential.

The **fiscal policy measures** to mitigate the consequences of the coronavirus pandemic represent a considerable **financial burden** and will involve a sharp increase in the debt levels of European countries. Increased attention must therefore once again be paid to the **long-term sustainability of public finances** to prevent a renewed sovereign debt crisis. In the existing institutional framework, fiscal rules can make a contribution to this, but they do have certain shortcomings. A reform towards an **expenditure rule** could address these shortcomings. Up to now there have been **no immediate problems** caused by the pandemic in the **European financial system**, although credit defaults cannot be excluded. However, the medium- to long-term stability of banks should be further strengthened, and regulatory easing should remain an exception.

The potential **efficiency losses** for the common Single Market caused by **setbacks in European integration** are high. Temporary border closures and export restrictions vis-à-vis member states were used within the EU at the beginning of the coronavirus pandemic. The EU has an **important coordinating role** to play in keeping trade routes open, from which Germany in particular benefits greatly. Dismantling global supply chains is not a target-oriented way to reduce dependencies in foreign-trade relations and associated with considerable efficiency losses for the economy as a whole. Instead, the EU's resilience to future crises can be strengthened by a **greater diversification of supply** and a **common procurement strategy** in combination with a **European system of medical inventory management.**

I. EUROPEAN COOPERATION IN THE LIGHT OF GLOBAL CHALLENGES

248. The coronavirus pandemic has affected the member states of the European Union (EU) to varying degrees. The images of pandemic victims in Italy startled the member states, enabling some of them to respond at an earlier stage of the pandemic. This applies not least to Germany. The **varying severity of the pandemic** was subsequently reflected in **varying degrees of economic impact**. Some member states will probably even have to accept double-digit reductions in their gross domestic product (GDP) in 2020. ↘ ITEM 42

249. As an immediate response to the pandemic, member states began to close their borders and restrict cross-border trade in medical goods and equipment, thereby impeding Europe's Single Market. The European Commission subsequently ensured that the **Single Market was restored**.

250. The **European Central Bank (ECB)** quickly provided the markets with **additional liquidity** to mitigate the economic impact of the pandemic. ↘ ITEMS 105 FF. At the level of the EU and the European Monetary Union (EMU), health and economic policy programmes were adopted in addition to national efforts. The **member states** initially agreed on a **triad** consisting of a European short-time-working allowance (Support to Mitigate Unemployment Risks in an Emergency, SURE), a further credit programme of the European Investment Bank (EIB), and easier access to loans from the European Stability Mechanism (ESM), which are tied to only minor conditions.

251. Finally, member states agreed to a comprehensive Recovery and Resilience Plan called '**Next Generation EU**', which aims to provide grants and loans to help member states particularly affected by the pandemic to better manage its economic impact. To this end, the EU has been given a temporary debt facility. The main aim of the recovery plan is to increase the competitiveness of member states by making them better equipped to face challenges such as climate change and digital structural change. It is important to take advantage of the resulting **opportunities** in order to **emerge stronger from this crisis together**.

252. The EU is also facing major challenges from **global developments** in environmental and climate policy, the declining willingness of the United States to provide global public goods, e.g., in security and defence policy, China's growing expansionism, problems of multilateralism and increasing migration. These are strong arguments in favour of **enhanced European cooperation** – for several reasons.

While the EU for many people is primarily a political project designed to bring the people of Europe together and maintain peace on the continent, the benefits of the European Single Market and the EMU often remain in the background or are taken for granted in public debate. Moreover, economic problems in member states are often projected onto the EU, even when the member states themselves are responsible. However, through its **single-market policy** the EU sets important regulatory standards, thus promoting **growth and prosperity**. Moreover, in the face of globalisation and geopolitical challenges, the EU has increasingly become an actor that enables the European community of states to defend their interests in a global context. This needs to be strengthened.

253. From an economic perspective, **tasks** should be assigned to **the European level** if the shift in competence offers efficiency or cost advantages over purely national actions, thus **creating European added value** (Alesina et al., 2005; Feld, 2005; Bassford et al., 2013; Bertelsmann Stiftung, 2017; Heinemann, 2018). This aspiration, which was already laid down in the Maastricht Treaty as the subsidiarity principle, forms the basis for European activities. In that regard, heterogeneous preferences of member states need to be reconciled with community tasks (Alesina and Spolaore, 1997; Alesina et al., 2017). In its proposal for the Multiannual Financial Framework (MFF) 2021-2027, the European Commission (2018) has consistently identified European added value as central to defining its spending areas.

254. For a realignment it is necessary to identify the **tasks** that would be better carried out at the **EU level** and to distinguish them from those that should remain at national level in accordance with the principle of subsidiarity. In the common Single Market, foreign trade, competition policy, climate protection, financial-market supervision and the Capital Markets Union, the EU has already shown in the past that it can achieve European added value. Nevertheless, the EU should **further strengthen** its **cooperation** in these fields (GCEE Annual Report 2018 item 52).

Further added value is offered by the development of a European infrastructure, for example in rail transport or electricity and hydrogen networks, the implementation of the digital single market and increased cooperation in basic research. From the viewpoint of positive economies of scale, a common defence policy and a form of common European medical inventory management could generate cost advantages for member states. A European foreign and development policy could exert a strong international influence. A common migration and asylum policy and the fight against cross-border organised crime, such as money laundering, are likely to be more beneficial than national action (GCEE Annual Report 2018 item 52). However, other areas where no or hardly any positive effects can be achieved should remain the responsibility of the member states or be shifted back there.

255. Building on the experience gained in the financial crisis, a reform process has already been initiated in the EU which has produced concrete progress in the resilience of the European financial system in the form of the Banking Union and joint financial-market supervision. The momentum of the coronavirus crisis can be used in a similar way. The EU's institutional framework should be designed in such a way that the member states are **better placed to deal with economic crises in the future**, while at the same time providing incentives to prevent crises both independently and at the European level. Permanent transfers to states

without corresponding control by the European institutions would weaken this incentive.

However, the aim of this chapter is not to discuss the architecture of the EU or the euro area. Rather, the focus is on **crisis management and ensuring resilience** in future crises, as well as on the further development of the Single Market. The large financial resources available to member states in the coming years from the temporary Recovery and Resilience Fund should be used to achieve these objectives.

256. The first step is to make it easier for **member states** to initiate national structural reforms that **make them more robust** and **increase their resilience** to future debt crises. This will require rebuilding the member states' financial buffers. Moreover, the new crisis-related instruments should only be temporary. They should not be made permanent without a clear renunciation of sovereignty by the member states. However, high priority should be given to **raising growth and productivity in the member states**. In view of the upcoming transformation process in both digital and green industries, there is a wide variety of opportunities that should be seized. Financing the costs of this structural change now can, in the long term, boost productivity in the member states and thereby increase the resilience and prosperity of the European economy.

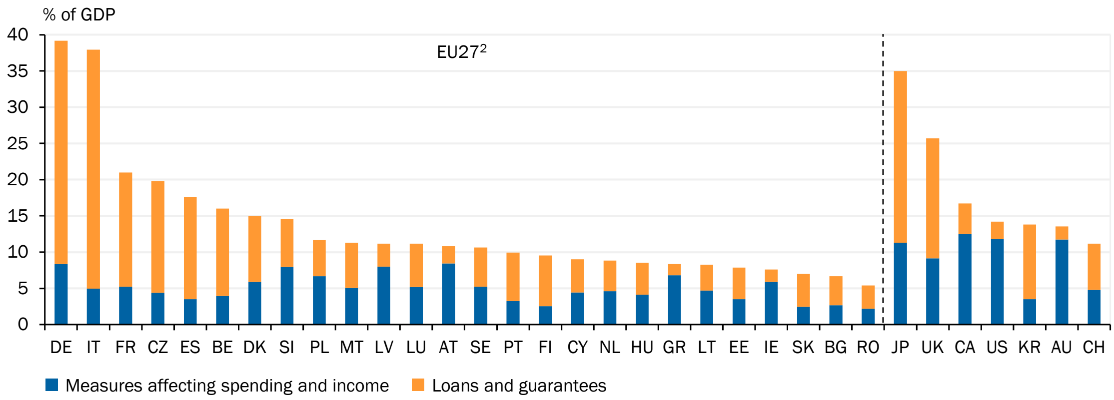
II. IMMEDIATE ECONOMIC POLICY RESPONSES TO THE CORONAVIRUS PANDEMIC

257. In addition to national fiscal policy measures in response to the coronavirus pandemic, the EU member states adopted additional measures at the EU level in May 2020. These were intended, on the one hand, to help **cushion the impact of the economic downturn** and, on the other, to **increase** the member states' **financing possibilities**. In addition, a number of monetary policy measures and relaxations in the field of banking regulation aimed to counteract a deterioration in financing conditions for households and businesses.

258. The **discretionary fiscal policy** measures provided **by member states** differ markedly in scope and design. CHART 48 Germany and Italy have launched relatively large aid packages, measured in terms of their gross domestic product (GDP). However, measures on the expenditure and revenue side, such as grants or tax cuts, which have a direct impact on the budget balance, should be distinguished from guarantees, sureties and loans, which do not have a direct budgetary impact. In particular, the provision of **guarantees and sureties increases** the **aid package** without directly burdening public budgets. At 8.3 % of GDP, Germany has compiled a relatively comprehensive package of measures compared to the rest of the EU, although loans, guarantees and sureties account for the biggest share of the assistance measures. Japan and the United States, by contrast, have taken more direct financial measures and provided fewer loans, guarantees and

↘ CHART 48

Discretionary fiscal policy measures adopted in the context of the coronavirus pandemic vary between selected countries[1]



1 – Announced measures, data from 26 Oct 2020. DE-Germany, IT-Italy, FR-France, CZ-Czech Republic, ES-Spain, BE-Belgium, DK-Denmark, SI-Slovenia, PL-Poland, MT-Malta, LV-Latvia, LU-Luxembourg, AT-Austria, SE-Sweden, PT-Portugal, FI-Finland, CY-Cyprus, NL- Netherlands, HU-Hungary, GR-Greece, LT-Lithuania, EE-Estonia, IE-Ireland, SK-Slovakia, BG-Bulgaria, RO-Romania, JP-Japan, UK-United Kingdom, CA-Canada, US-United States, KR-Republic of Korea, AU-Australia, CH-Switzerland. 2 – Without Croatia.

Source: IMF

sureties. However, the differences in the discretionary measures do not take into account the automatic stabilisers in the respective countries. In Germany, only the expansion of the allowance for short-time working is considered discretionary, but not the scheme that already existed before the crisis; in the United States, however, extensive expenditure on labour-market programmes was only added as a discretionary measure during the crisis.

259. Anderson et al. (2020) point out that **drawdowns** of the funds provided differ **markedly among the EU member states** and that, in Germany in particular, outflows have been comparatively small. ↘ ITEM 119 For example, the loans actually approved up to 26 October 2020 in Germany were relatively low at only 1.6 % of GDP of 2019, compared to Italy (6.0 %), the United Kingdom (3.5 %), France (5.0 %) and Spain (8.4 %) (Bruegel, 2020). Anderson et al. (2020) argue, however, that the provision of very large loan and guarantee schemes are nevertheless likely to have a calming effect on the markets and, furthermore, that the lower drawdown in Germany counteracts possible distortions of competition.

260. In May 2020, the European Council adopted **three safety nets** consisting of loans and guarantees totalling €540 billion to combat the consequences of the coronavirus pandemic. They include **€100 billion** to finance the member states' **national short-time-working programmes** (SURE). Since all member states have set up forms of national short-time-working schemes, all countries thus have an instrument of economic support available to them in addition to other credit lines. The level of funding for a member state depends on the public expenditure triggered by the extension of short-time-working schemes and similar measures for the self-employed. However, there is no predetermined allocation of funds per member state. By the end of October, the European Council had already approved €87.9 billion in loans for 17 EU member states under SURE (European Commission, 2020a). To finance the programme, the member states provide the European Commission with a guarantee system to enable it to raise

the funds on the financial markets. The permanent establishment of an unemployment reinsurance scheme is expressly not intended by SURE; the programme expires at the end of 2022 (European Commission, 2020b).

261. The EU package also adds **a new precautionary credit line** to the **European Stability Mechanism** (ESM). The **Pandemic Crisis Support Instrument (PCSI)** was designed along the lines of the existing Enhanced Conditions Credit Line (ECCL); it has a volume of €240 billion and is limited in time until the end of 2022. To reduce any stigmatisation effect caused by an application for the credit line, the new instrument contains a **blanket preliminary assessment** by the Commission stating that all member states are economically affected by the coronavirus pandemic (European Commission, 2020c). This allows each euro-area member state to apply for loans of up to **2 % of its GDP**. The loans have a maximum term of ten years and will include, in addition to the conditions paid by the ESM in the market, an annual premium of 10 basis points, an annual 0.5 basis-point service fee, and a one-off commitment fee of 25 basis points. The costs are lower than the usual conditions of an ECCL and for some member states they are lower than their refinancing costs on the market.

The ESM (2020a) stated in May that the conditions for own bonds were around 0 %, so that if the credit lines are used, interest savings could be expected over the next ten years, for example €2 billion for Spain and €7 billion for Italy. Including the premiums, these interest savings are likely to be lower in the meantime following the fall in risk premiums in many euro-area member states in recent months. The only **prerequisite** for drawdown of the PCSI is that it is **used for costs in the healthcare system** caused directly or indirectly by the coronavirus pandemic. Compliance with this use of funds is monitored by the Commission. However, as of October 2020, no member state has applied for the PCSI.

262. Up until now, the ESM has had two **instruments** to help member states that risk losing **access to financial markets** (ESM, 2020b): On the one hand, the ESM provides a Precautionary Conditioned Credit Line (PCCL), which can be obtained by member states whose financial and economic situation is fundamentally stable in relation to various criteria such as national debt, deficit limits or the state of the banking system. On the other hand, the ECCL is available where compliance with these criteria is not a prerequisite and, instead, corrective action must be taken to overcome the weaknesses. An adjustment of the instruments is part of the agreement in principle on the reform of the ESM dated December 2019. ↘ BOX 11

↘ BOX 11

Current status of the ESM reform planned for 2020

In December 2019, the heads of state and government of the euro area agreed in principle on a **reform of the ESM**, and ratification is planned for 2020. The ESM is to remain intergovernmental and not an EU institution.

Part of the reform is a **change in the precautionary credit line PCCL**. To improve acceptance of this instrument, an agreement on reforms in the respective state will no longer be necessary. Instead, the only requirement is to be compliance with the access criteria. These are to be defined more clearly than hitherto so that there is no uncertainty in advance about the possibility of drawdown and conditionality. Since the precautionary credit lines are exclusively available to states whose economic and financial situation is healthy and whose public debt can be financed on a sustainable basis (ESM, 2019), the PCCL could function as a kind of 'seal of approval' for market financing. This should make it less likely that the loans will actually be disbursed, while at the same time protecting uninvolved third parties, such as other states, from contagion effects (Strauch, 2019). These adjustments are intended to increase the willingness of governments to use the precautionary credit lines. However, non-utilisation of this credit line could possibly be due to the fact that healthy states do not need this assistance, while states with financing problems do not meet the requirements for access (GCEE Annual Report 2018 item 75).

Furthermore, the reform assigns a **bigger role in future assistance programmes** to the ESM. Up to now, important tasks in the context of an assistance programme, such as the debt sustainability analysis, the reform agreement and the later monitoring of compliance with the agreement, have been undertaken jointly by the ECB, the European Commission and the International Monetary Fund (IMF). The ESM is now to be involved in these tasks in addition to its existing activities such as raising funds on the capital markets and disbursing them to the programme states. The Commission will be able to call on the ESM's expertise in its monitoring of EU member states' economic and budgetary policies and in assessing macro-financial risks (Aerts and Bizarro, 2020). The participation of the independent ESM, e.g. by publishing a separate country report alongside that of the Commission, could increase the political signal effect (GCEE Annual Report 2017 item 127).

Another part of the reform sees the ESM as a **fiscal backstop for the Single Resolution Fund** (SRF). At the same time, the instrument of direct recapitalisation of institutions by the ESM, which has not been used so far, is to be dropped. The SRF is managed by the Single Resolution Board (SRB), which oversees the winding-up of insolvent financial institutions in the member states participating in the Banking Union. The SRF is to have 1 % of the covered deposits of all financial institutions within the Banking Union. By July 2020, financial institutions' contributions to the fund amounted to some €42 billion of the €70 billion needed by the end of 2023 (SRB, 2020). However, should large or several institutions be wound-up at the same time, the SRF's resources might not suffice, so that a final guarantee from the ESM is supposed to safeguard the financing of the resolution mechanism. This is intended to enhance the resolution mechanism's credibility and thus strengthen financial stability (Aerts and Bizarro, 2020). The GCEE has already pointed out the necessity of such a backstop in the past. At the same time, however, progress by member states in risk reduction is needed to ensure that as many costs as possible are absorbed within the financial system. These include, for example, adequate risk provisioning for non-performing loans and building up capital buffers (GCEE Annual Report 2014 items 349 ff.; GCEE Annual Report 2017 item 115; GCEE Annual Report 2018 items 81 f.)

A fourth part of the ESM reform package is the change in the **voting modalities** in the **Collective Action Clauses (CACs)** for government bonds. If a restructuring plan becomes necessary for the bonds of a member state of the monetary union, up to now the majority of each individual bond issue had to be approved. Specialist investors use this arrangement to buy government bonds at high discounts in a crisis situation and prevent restructuring with a majority stake in an issue in order to be able to enforce repayment of their bonds at nominal value (ESM, 2020c). This leaves fewer financial resources for the other holders of government bonds interested in restructuring. The introduction of the Single Limb CAC aims to ensure that the majority of all bondholders will in future be sufficient for a restructuring plan (Aerts and Bizarro, 2020). This should facilitate restructuring in the event of financing difficulties and prevent investors from gaining speculative advantages in such situations. On the one hand, this could strengthen market discipline. On the other hand, the change facilitates the possibility of creditor participation as a prerequisite for ESM loans. This creditor participation could initially take the form of a credit maturity extension and, if necessary in a second step, a debt relief (GCEE Annual Report 2016 Box 2). However, the introduction of such CACs would only apply to new government bonds, so that total government debt would only be affected gradually. This would avoid a sharp rise in interest rates.

263. The **European Commission's own room for manoeuvre in fiscal policy** is **limited**. The current MFF ends this year, so most of the funds provided by it have already been allocated. At the beginning of the crisis, the European Commission was able to mobilise €37 billion for an investment initiative, €8 billion of which consist of unused funds and €29 billion of funds brought forward and originally earmarked for other purposes (Fries et al., 2020b; GCEE Special Report 2020 item 126). The major fiscal measures, such as the funds for SURE and the ESM, required separate decisions and additional resources or guarantees from the member states. An important contribution should make the measures taken by the ECB. For example, the ECB was thus able to curb uncertainty on the financial markets in the short term, which is likely to have contributed to the economic recovery by improving financing conditions for companies. Furthermore, the programmes probably had a dampening effect on member states' refinancing costs. ↘ ITEMS 105 FF.

264. The **European Commission**, on the other hand, has **far-reaching possibilities** to respond to the crisis **by taking measures that do not require financial resources**. The more flexible interpretation of aid rules will enable member states to provide greater fiscal support to the economy. The application of the escape clause of the Stability and Growth Pact allows member states to deviate from the budgetary rules (European Commission, 2020d). The banking package is designed to ensure that the banking sector expands its lending to supply liquidity to businesses. ↘ ITEM 306 State export credit insurances were permitted to support export companies (Fries et al., 2020b). To address acute supply problems involving medical products and protective equipment, the Commission has temporarily suspended the collection of import duties and import VAT on these products.

265. The third safety net strengthens the **European Investment Bank (EIB)**. A guarantee fund of €25 billion, into which the member states will pay in accordance with their EIB capital key, should enable the latter to **secure loans** of up to €200 billion. Via the national financial intermediaries, these are intended to benefit primarily small and medium-sized companies that have a sound long-term base but have run into financial difficulties due to the pandemic. Similar national programmes are to be supplemented and extended by the EIB, with the states participating in the EIB's good rating and the conditions that are thus more favourable for many states. There are upper and lower lending limits for states that receive the most or least funding (EIB, 2020a). The guarantee fund launched in October 2020 comprises, as of 13 October 2020, approved financing of €2.6 billion, which should enable expected investments of €11.3 billion (EIB, 2020b). In addition, EIB emergency aid measures have made it possible to provide guarantee and liquidity assistance to banks to mobilise loans to companies amounting to €40 billion (EIB, 2020c). As of 9 October 2020, the EIB has used its coronavirus assistance to provide financing worth €18.5 billion within the EU and €3.9 billion outside the EU (EIB, 2020d).

III. OVERCOMING THE CONSEQUENCES OF THE PANDEMIC AND PREVENTING FUTURE CRISES

266. The **coronavirus pandemic** is an economic shock that impacts on the entire EU but has **asymmetric effects** on the individual member states. For example, tourism, which has been hit particularly hard by declining sales, makes varying contributions to GDP in the member states. Furthermore, economic activity has been restricted to different degrees due, among other things, to divergent infection patterns. As a consequence, the decline in GDP varies across the EU. ↘ ITEM 42 At the same time, the economies of the member states are closely interlinked through various channels. For example, a delay in recovery in one member state may have a negative impact on economic development in other member states (Hájek and Horváth, 2016; Potjagailo, 2017).

267. In the euro area, a centrally managed common monetary policy covering the entire currency area **requires national fiscal policies to respond to asymmetric shocks** (GCEE Annual Report 2018 items 344 and 426 ff.). In order to allow for a large enough response from member states to overcome the consequences of the pandemic, sufficient room for manoeuvre can be created at the European level for national responses and for supporting them with joint tools and measures. ↘ ITEM 287

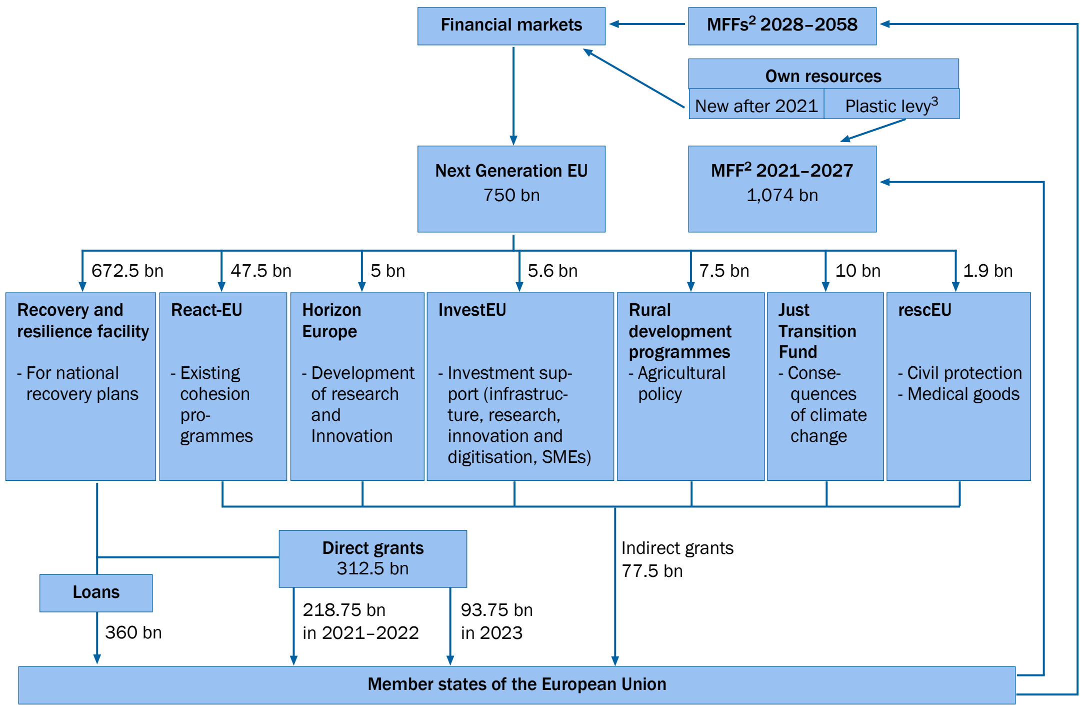
268. The joint measures should enable member states to manage recovery more quickly and to **increase their resilience to future crises**. In particular, investments and structural reforms by member states are needed to increase productivity and support a transformation towards digitalised and carbon-neutral economies. At the same time, fiscal and financial reserves should be rebuilt, sovereign debt crises prevented, and the stability of the banking and financial system enhanced.

1. Use the European Recovery Plan

Credit-financed grants and loans

269. After the member states agreed on the €540 billion credit package in May as an immediate response to the economic consequences of the coronavirus pandemic, ↘ ITEM 260 a **credit-financed Recovery Fund** amounting to €750 billion **was agreed** in July (European Council, 2020). The European Council's (2020) declared objectives are crisis management and strengthening convergence, resilience and change in the Union. A total of €390 billion in grants is earmarked for this purpose, of which €77.5 billion will be provided through various existing EU programmes. The remainder will go into the Recovery and Resilience Facility, which includes €312.5 billion in direct grants and a further €360 billion in loans for the member states. At the same time as the Recovery Fund, the member states agreed on the **next MFF for the years 2021-2027** amounting to €1,074.3 billion. ↘ CHART 49

↘ CHART 49
The recovery plan[1] includes direct and indirect grants and loans (Euro)



1 – All figures in euro; as of July 2020. 2 – Multiannual Financial Framework. The loans are repaid to the financial market via the Multiannual Financial Frameworks from 2028 to 2058. 3 – Will be introduced on 01.01.2021.

Sources: European Commission, own illustration

270. The **European Commission** is authorised to **raise funds amounting to €750 billion** on the **capital markets** by the end of 2026 at the latest. Repayment via the EU budget will begin in 2028 at the latest and is to be completed by the end of 2058. Repayments by the member states that have taken out loans as well as possible future own resources will be used to repay the funds raised. ↘ ITEM 276 Should the €12.9 billion for interest payments under the Recovery Fund provided for in the MFF 2021-2027 not be used up, these funds will be used to repay the loans before 2028. The Own Resources ceiling will be raised by 0.6 percentage points of the member states' gross national income (GNI) up until 2058, thus ensuring sufficient coverage of the EU's liabilities under the Recovery Fund. Any other use of the temporarily increased Own Resources ceiling is excluded. The European Commission is empowered temporarily to call on more funds from the member states than would correspond to the share originally agreed. However, the final liabilities of the member states remain unaffected (European Council, 2020). The increase in the Own Resources ceiling significantly exceeds the size of the fund, which enables a good rating and low interest rates for the EU.

271. By the end of 2022, 70 % of the **direct grants from the Recovery and Resilience Facility** are to be allocated according to three criteria: the amount of the grants depends positively on the size of the population in 2019 and the unemployment rate in the years 2015 to 2019 and negatively on GDP per capita in 2019. This is to take account of the fact that the national room for manoeuvre in combating the crisis may be more limited for economically weaker member states. A

further 30 % of direct grants will be allocated in 2023. For that year, the unemployment criterion will be replaced by the decline in GDP in 2020 and 2021 (European Council, 2020). This means that the 2023 grants will be based more on the economic impact of the coronavirus pandemic and less on the economic situation before the pandemic.

272. The **loans** are not granted according to a fixed allocation key, but should not exceed 6.8 % of a member state's GNI. Since the terms and conditions of the loans are based on the EU's refinancing costs, member states that can obtain financing on better terms on the capital markets than the EU are unlikely to take out EU loans. At present, this is probably the case for Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, the Netherlands and Sweden (Deutsche Bundesbank, 2020a). ↘ CHART 50 If all the other countries were to make full use of their borrowing possibilities, around €352 billion of the €360 billion envisaged would be drawn down.

273. The funds from the Recovery and Resilience Facility are to be available for projects that are already being financed from February 2020. This requires member states to draw up **national reform and investment plans** for the years 2021 to 2023 which will be assessed by the Commission. The assessment is to be based on the country-specific recommendations in the context of the European Semester; on the promotion of growth potential, the labour market and economic and social resilience; and on the contribution to environmental and digital change (European Council, 2020). The plans will be reviewed in 2022 and, if necessary, adjusted before the funds for 2023 are allocated.

This assessment by the European Commission must be endorsed by the **European Council** with a **qualified majority**. The Economic and Financial Committee will issue statements on the plans' goals and the satisfactory fulfilment of milestones. If at least one member state there has doubts about satisfactory compliance, the European Council will discuss the member state's plans exhaustively at its next meeting (European Council, 2020). It is not yet clear whether this will remain a discussion within the European Council or whether a unanimous decision approving the plans and payment will be required.

274. The first member states are already presenting their plans for using the funds from the Recovery Plan. For example, the **French government** has launched a **€100 billion** recovery plan for its economy entitled 'France Relance'. Of this, **€40 billion** is to be financed **by EU funds**. As France is likely to be entitled to direct grants of around €38 billion, further funding from other EU funds is planned. The planned expenditure is divided into three areas: ecological change, sovereign and competitive economy, and labour market and regional development (French Ministry for the Economy and Finance, 2020). The Spanish government's 'Recovery, Transformation and Resilience' plan makes use of all the Recovery Plan funds available to Spain amounting to about €140 billion (Spanish Ministry of Economy, 2020).

275. **Grants via existing EU programmes** account for about 10.3 % of the Recovery Fund. The funds are allocated to structural and cohesion funds, investment and research promotion, support for ecological change, rural development and

civil protection. ↘ CHART 49 The aim of this increase in programmes is to pursue long-standing EU objectives such as improving the competitiveness of the agriculture and forestry sector.

276. **New own resources**, which could be introduced during the next MFF, are to be made available for the Recovery Fund before 2028 **for early debt repayment**. However, this does not apply to EU revenue from the levy on non-recycled plastic waste, which is due to be introduced on 1 January 2021. Planned other new own resources include a CO_2 border adjustment levy and a digital levy by early 2023 at the latest. The long-discussed Financial Transaction Tax is to be targeted in the coming MFF. In addition, the European Emissions Trading Scheme (EU ETS) is to be expanded to include emissions from aviation and maritime transport, and these additional revenues, unlike the existing EU ETS revenues, are to serve the EU as own resources. ↘ ITEM 399 The European Commission is expected to make proposals on this in the first half of 2021. The EU Commissioner for the EU Budget expects to receive €5.7 billion per annum from the plastic levy (Börsen-Zeitung, 2020). Current plans also envisage €5 to €14 billion per annum from a CO_2 border adjustment scheme, €10 billion from the expansion of the EU ETS and €1.3 billion from the digital levy (European Commission, 2020e).

Limited contribution to mitigating the consequences of the coronavirus pandemic

277. With the agreement on the MFF and an additional temporary **Recovery Fund**, the European Council has sent a **political signal** on the cohesion of the EU and the ability of its institutions to act during the coronavirus crisis. The strength of the Recovery Fund lies in its EU-wide and relatively rapid response to the crisis. Non-repayable subsidies to the member states, financed by the other states, are not a novelty but have long been part of the European convergence effort. For example, the EU pays out grants through the regional and cohesion funds. EU borrowing is not a novelty either but was first used in 1976 to provide balance-of-payments assistance under the Community Loan Mechanism (Horn et al., 2020). The EU currently has €50.4 billion in bonds outstanding for the European Financial Stabilisation Mechanism (EFSM) and Macro-Financial Assistance (MFS) (European Commission, 2020f). However, the volume of borrowing in the Recovery Fund is much larger than before.

278. This extensive **borrowing** is **substantiated by the exceptionally severe economic downturn** in all EU countries. The plan does not provide for joint and several liability, as each country remains liable for its contributions to the EU budget only approximately according to its share of EU GDP from which the new EU debt is serviced. The EU's borrowing does not increase the debt-to-GDP ratios of the member states, as contributions to the EU budget are not counted against the debt.

279. The strong **link** between the Recovery Fund **and the MFF** could represent a challenge for its future design. While the MFF finances the EU's medium and long-term programmes over seven years, the unique, time-limited Recovery Fund

is designed as an instrument for overcoming the current coronavirus-induced economic downturn. Around 10 % of the Recovery Fund will be used to finance long-term EU programmes such as the Structural and Cohesion Funds or Horizon Europe. As a result, at the next MFF starting in 2028, either these (or other) programmes will be reduced, or member states will have to make higher contributions to the EU budget; otherwise the period of debt financing will have to be extended. The third option is possible in the EU's current institutional set-up for emergency situations. It is not intended for permanently financing EU tasks and requires amendments to the EU Treaties – in some member states also parliamentary majorities for amending the constitution, not least in Germany (Schorkopf, 2020).

280. The financing of **loans** to EU member states **by the Recovery Fund** amounting to €360 billion **competes with the ESM-PCSI**. ↘ ITEM 261 However, the ESM is only designed for euro-area member states that have access to loans of up to 2 % of their respective GDP under the ESM, which are also refinanced on the financial markets. Although this is a smaller volume than the 6.8 % of GNI from the Recovery Fund, it would be possible to extend the ESM. The ESM-PCSI requirements are deliberately set low to reduce political reservations and to facilitate drawdown. By contrast, the conditions for the loans from the Recovery Fund are linked to the reform and investment plans, which are to be assessed and approved by the other states. However, unlike the ESM, no additional resources were currently earmarked for loan monitoring and processing at the European Commission.

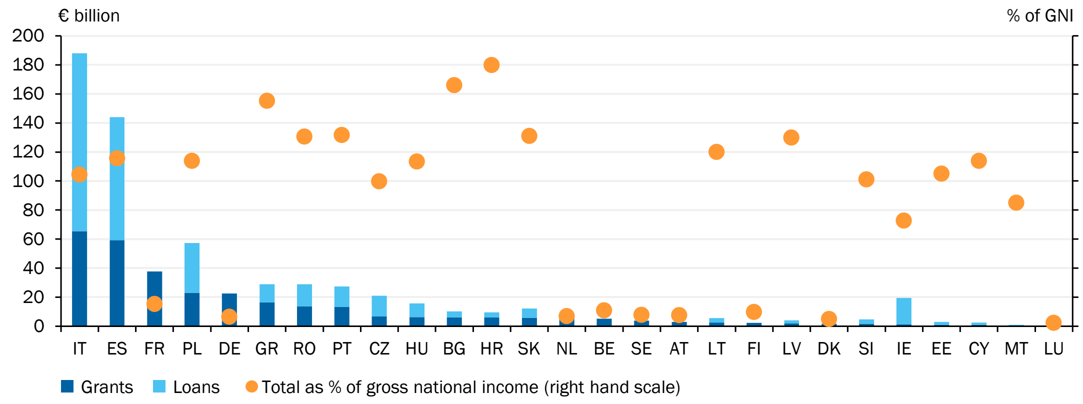
There are probably political reasons for not using the ESM programme while at the same time using the loans of the Recovery Plan, as is currently being considered by Portugal or Spain – for example fear of a stigmatisation of the ESM and its negative impact on the domestic policies of some member states. Italy has so far only planned for the transfer payments from the Recovery Fund. Utilization of the loans is still unclear (Deutsche Bank Research, 2020). From an economic point of view, using **one single lending instrument makes sense**. The experience of the **ESM** and its institutional implementation **could ensure fast and efficient lending**. An extension to all EU states would be possible in the context of the currently pending ESM reform (Aerts and Bizarro, 2020), but as an intergovernmental institution it would require ratification by all participating states.

281. At around 5.4 % of EU GDP spread over seven years, the **Recovery Fund** represents only a **relatively small part of the overall fiscal response** to the coronavirus pandemic in relation to the crisis packages of the individual member states. ↘ ITEM 258 However, Italy and Spain in absolute terms and in particular smaller countries such as Croatia with around 18 % or Bulgaria with around 17 % of their GNI can call on comparatively large amounts through the Recovery and Resilience Facility. Countries with more favourable financing conditions on the capital markets than the EU would probably not take up loans, which means that the overall fiscal stimulus is likely to be less than 2.5 % of GNI. ↘ CHART 50

282. By increasing productivity, the Recovery Fund could support growth and increase resilience to future crises. However, its design means that it is **not well suited for directly mitigating the consequences of the coronavirus pandemic**.

↘ CHART 50

Possible drawdown[1] from the Recovery and Resilience Facility highest in Italy and Spain[2]



1 – Assumptions: the allocation criteria and the GDP forecasts for 2020 and 2021 of the EU Commission in June; the drawdown of loans by member states which, according to the Deutsche Bundesbank (2020), have worse financing conditions than the EU Commission. 2 – IT-Italy, ES-Spain, FR-France, PL-Poland, DE-Germany, GR-Greece, RO-Romania, PT-Portugal, CZ-Czech Republic, HU-Hungary, BG-Bulgaria, HR-Croatia, SK-Slovakia, NL-Netherlands, BE-Belgium, SE-Sweden, AT-Austria, LT-Lithuania, FI-Finland, LV-Latvia, DK-Denmark, SI-Slovenia, IE-Ireland, EE-Estonia, CY-Cyprus, MT-Malta, LU-Luxembourg.

Sources: European Commission, Eurostat, own calculations

Disbursement of the direct grants and loans from the Recovery Fund will not start until 2021 and will be spread over several years. Moreover, EU programmes with additional funding are designed for seven years, which would allow the disbursement of this proportion of the funds to be spread over an even longer period. The contribution of the grants and loans from the Recovery Fund towards stabilising the economy is therefore likely to remain rather limited. Such an effect is likely to happen in particular for member states that were already highly indebted before the crisis, thanks to the stabilising impact on the financial markets.

Use the Recovery Fund in a targeted way

283. The EU member states' agreement on grants worth €390 billion opens up the **possibility** of using these funds to **facilitate investment** and **structural reforms** in the member states, thereby boosting productivity and long-term growth. This could make member states more resilient in future crises. The EU has an instrument for achieving this in the form of the country-specific recommendations within the framework of the European Semester, which offers each member state orientation for economic adjustments. However, **support can be given to a transformation process**, which is necessary because of climate change or digital and demographic transformation. Both can lead to positive economic externalities for other member states by making growth more sustainable and crisis-resistant. The EU should make sure that the funds are used for these purposes.

284. The EU has already used the European Structural and Investment Funds (ESI funds) to define various priority areas for which subsidies are paid. However, these funds cover a very wide range of possible uses. By contrast, the **one-off nature** of the Recovery Fund agreed by the member states provides an **opportunity to contribute to a transformation** without the need for longer-term,

recurring project financing. The aim should accordingly be to raise productivity and competitiveness in the long term, for example through one-off investment projects.

285. The investments financed by the Recovery Fund lead to direct **growth-enhancing effects** if these **investments** are implemented **in addition** to the expenditures already planned by the member states. Alternatively, there could be a growth effect if, for example, EU funds were to replace national funds, so that, for example, there are no expenditure cuts or tax increases. Even if the investments are not additional, growth could benefit from indirect effects, e.g., through better financing conditions for the future. However, the focus for the goals of the Recovery Fund is likely to be on direct effects. Emphasis could be placed on projects that are strongly oriented towards European added value. ↘ ITEM 253

286. In order for the grants from the Recovery Fund to have a growth-enhancing and sustainable effect, a **precise examination of the use of the funds** by the European Commission is necessary, which should, furthermore, begin relatively quickly. The connection with the projects, which the EU clearly defines, must be comprehensible and verifiable. The EU could improve micromanagement to this end. On the one hand, the time between application and approval should be reduced; on the other, care should be taken to ensure that projects are implemented promptly after approval. A final evaluation of the use of funds should take place after a fixed period of time in which the project should be completed. Any use of funds not related to projects should result in repayments, increased contributions or reduced funding from the EU budget.

2. Rebuilding fiscal leeway and preventing sovereign debt crises

287. The fiscal policy measures to cushion the **coronavirus pandemic** and the related recession are likely to involve a **considerable fiscal burden**. Worldwide, these measures are to be financed mainly through higher debt. According to the IMF (2020), the average public debt-to-GDP ratio in emerging economies and developing countries is likely to rise from around 53 % to around 62 %. In the developed economies, this figure will probably rise from over 105 % of GDP in 2019 to over 125 % of GDP in 2020. For the euro area, the IMF forecasts an increase in the debt ratio from just over 84 % to around 101 % of GDP.

The **fiscal leeway** that states can use to respond to crises **is made up of various components**. These are in particular budgetary margins that exist on the revenue or expenditure side. In addition, a state can create its own financial leeway using the possibilities of issuing debt on the financial markets. The amount of the room for manoeuvre varies with the interest payable, for which own creditworthiness plays an important role. At the European level, additional fiscal leeway is provided by joint financing in the form of grants or loans. In addition, national and European fiscal rules limit the possibilities for credit financing; in times of crisis, however, the temporary use of escape clauses creates room for manoeuvre. ↘ ITEM 264

288. The financial markets' assessment of the **long-term sustainability** of public finances is a decisive criterion governing the costs involved in the issuance of new government bonds. Among other, mainly structural factors, the debt-to-GDP ratio is an important criterion for this assessment, (GCEE Annual Report 2019 items 476 ff.; GCEE Special Report 2020 item 180). The sovereign debt crisis in the euro area in the early 2010s showed that high debt-to-GDP ratios can be accompanied by doubts about the solvency of individual member states. Although the interest rates of some member states have risen temporarily this year, the **interest level of government bonds of European member states** and thus the refinancing costs as a whole are **far below** those of **2011 and 2012** (GCEE Special Report 2020 item 180). ↘ ITEM 115

289. However, this is likely to have more than just fiscal policy reasons, and there is probably close connection with the ECB's purchase programmes. Since 2007, but especially with the ECB's purchase programmes starting in 2015, the average interest rate on government bonds has been falling with the exception of an interim increase during the sovereign debt crisis in the euro area. This is accompanied by **substantial savings** for member states in **interest expenditure** (GCEE Annual Report 2017 items 400 ff.). The more favourable refinancing costs are likely to have eased the consolidation and reform pressure on euro-area member states (GCEE Annual Report 2017 items 397 ff.). For example, the consolidation undertaken in the wake of the financial crisis came to a standstill in 2014 in Italy, in 2015 in Spain and France, and in 2016 in Germany. In these four countries, this can be seen on the one hand in the marked decline in **structural primary balances**, i.e., cyclically-adjusted revenue minus cyclically-adjusted expenditure excluding interest expenditure, or the change in these balances (GCEE Annual Report 2017 items 403 ff.). On the other hand, the end of the consolidation efforts can be seen from a review of the planned and implemented consolidation measures in the context of the European Semester (GCEE Annual Report 2017 Box 12). Moreover, according to the OECD, efforts in the euro area to ensure higher growth and thus improve the sustainability of government debt through structural reforms have also declined significantly since 2014 (OECD, 2017).

A differing opinion

290. One member of the GCEE, Achim Truger, does not share the interpretation expressed in ↘ ITEM 289 of fiscal policy developments in the euro area member states since 2014 as "the end of the consolidation efforts", because the ECB's purchases of government bonds had "eased the consolidation and reform pressure". Rather, his view is that the **acute euro crisis** in the countries on the European periphery in the period from 2010 to 2015 was essentially caused **by** the **extremely restrictive fiscal policy**, which was furthermore **accompanied** by a tightening of European fiscal rules ('six-pack', fiscal pact, 'two-pack'). The fact that the crisis could be overcome at all from 2015 onwards was due, on the one hand, to the ECB's intervention with bond purchases and, on the other hand, to the fact that the fiscal rules were interpreted and applied much less strictly by the European

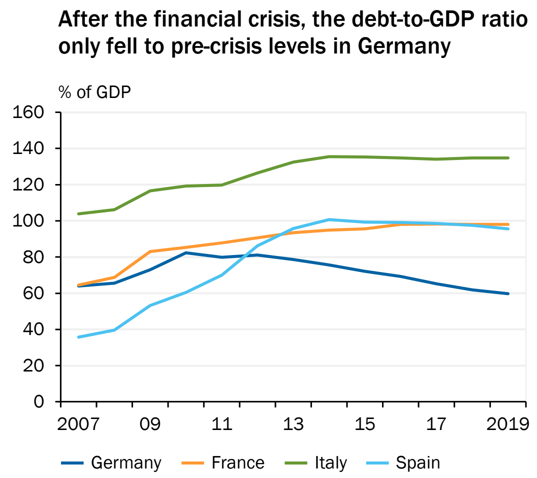
Commission under Jean-Claude Juncker (European Commission, 2015; European Council, 2015).

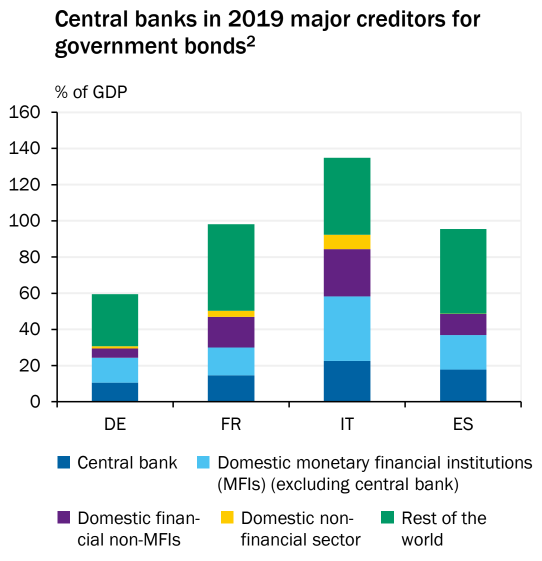
Only this enabled the crisis states to switch to a more or less **cyclically neutral fiscal policy**, which led to a gradual upswing supported by domestic demand, but which nevertheless **resulted** in **significant budget consolidation** and an end to the crisis-induced increase in government debt (Truger, 2020).

291. **The extent to which consolidation measures affect** a government's debt level **depends on the timing and nature of the consolidation**. For example, consolidation at an inappropriate time, e.g., during a recession, or using less appropriate measures, such as raising distortionary taxes, can lead to lower economic growth, which in turn can reverse the effect of consolidation on debt levels. This could be observed in some countries during the euro area sovereign debt crisis. The study by IMF economists Blanchard and Leigh (2013) conceded that the negative (short-term) effects that accompanied this may have been underestimated.

292. With the exception of Germany, in the period before the coronavirus crisis the debt-to-GDP ratios of large euro-area member states have remained relatively constant or have even risen since 2012. ↘ CHART 51 LEFT While fiscal policy measures are needed for an economic recovery from the coronavirus pandemic, they themselves will aggravate the strained budgetary situation of some member states in the medium term. Moreover, the ECB has become the largest **single creditor of the member states** in recent years. ↘ CHART 51 RIGHT At the end of 2019, for example, national central banks' share of their own government's debt in relation

↘ CHART 51
Public debt[1] of selected euro-area member states





1 – Government debt as defined by the Maastricht Treaty as a percentage of GDP. It is based on the consolidated general-government debt, including local government and social security funds. 2 – DE-Germany, FR-France, IT-Italy, ES-Spain.

Sources: ECB, Eurostat, own calculations to GDP was 10.63 % in Germany, 14.60 % in France, 22.56 % in Italy and 17.85 % in Spain.

293. **Sustainable public finances** can help ensure that the ECB is not required again, let alone permanently, to reduce risk premiums. If member states could rely on monetary policy (crisis) instruments being used to offset risk premiums, this could become a threat to monetary policy independence in the long term. Former ECB President Mario Draghi (2012) pointed this out with regard to the conditionality of an ESM programme as an essential element in preventing the **fiscal dominance of monetary policy**.

294. In the medium term, i.e., after the immediate resolution of the coronavirus crisis, the question thus arises as to how the increased **debt-to-GDP ratios** can be **reduced**. Long-term-sustainable public finances and their institutional anchoring are not only likely to reduce the risk of future sovereign debt crises; they also involve more favourable refinancing costs on financial markets (GCEE Annual Report 2019 item 489). These have recently been below the GDP growth rate for a prolonged period, which has been accompanied by additional **fiscal policy leeway** and calls for higher debt. The sharp shift from 2007 onwards in the maturity structure of government bonds towards the long term should also provide longer-term security for low interest expenditure. Debt with long maturities reduces the risk of being affected by interest rate fluctuations when refinancing. Since this risk is particularly important when debt levels are high, long-term government bonds can reduce fiscal uncertainties (Greenwood et al., 2015; Nöh, 2019). ↘ CHART 52 That this risk is not negligible is shown by the current recession and by historical studies that illustrate how quickly the ratio of interest rates to GDP growth can reverse (GCEE Annual Report 2019 Box 13). This can imply that refinancing on the market could become more expensive than in previous years.

295. Furthermore, the **interest rate is not independent of the financial markets' assessment** of the sustainability of public finances and may be subject to an abrupt increase when debt levels are higher. The theoretical approach of Bi (2012) and Bi and Leeper (2013) to the fiscal limit, i.e., the debt-to-GDP ratio at which the intertemporal budget condition of general government is just met, is a suitable way to explain the sudden increase in risk premiums on government bonds (GCEE Annual Report 2017 Box 16). For a threshold range within which the probability of payment defaults increases significantly, holders of government bonds adjust their expectations and risk premiums accordingly. Bi and Traum (2014) show that an estimated (non-linear) version of Bi's (2012) model is consistent with the rise in interest rates in Greece in 2011.

296. In principle, a reduction in debt-to-GDP ratios can be achieved using various means (Schaltegger and Feld, 2009; Reinhart and Sbrancia, 2015; Grier and Grier, 2020). ↘ BOX 12 On the one hand, these are measures directly affecting the primary balance, e.g., through less sharply rising or appropriate cuts in expenditure or increases in tax revenue, whose macroeconomic effects do not overcompensate the consolidation effect of the primary balance. On the other hand, higher growth, an inflation rate that is above the inflation target in the medium term, or

specific policy measures can help create a relatively favourable interest rate environment for governments. The ultima ratio is a restructuring of a country's **public debt**, which would, however, entail considerable political and economic costs (Cole and Kehoe, 2000; Borensztein and Panizza, 2009; Aguiar et al., 2016).

Such measures have been used in the past to reduce a considerable proportion of debt, for example after wars or major crises. ↘ BOX 12 In the past, the GCEE has primarily advocated **consolidation and structural reforms** (GCEE Annual Report 2016 items 426 ff.; GCEE Annual Report 2017 items 408 ff.) These are likely to have **lower economic costs** compared to other measures such as higher inflation rates in the long term or financial repression, because these measures greatly distort relative prices. Chari et al. (2019), for example, show that financial repression can only be a successful strategy for debt reduction in extreme crisis situations, particularly if a state is no longer able to service its debt. However, experience with the sovereign debt crisis in the euro area shows that consolidation can indeed **involve economic and social costs**. Under certain overall conditions, these costs can be reflected in frequent changes of government or a lack of political majorities (Alesina et al., 2011; Ciminelli et al., 2019).

↘ BOX 12

Instruments that have been successfully used in the past to reduce debt

Important factors relating to the long-term sustainability of government debt are the general government primary balance and the ratio of real interest rates, r, to the real GDP growth rate, g. The primary balance is the part of the general government balance (government revenue minus expenditure) excluding interest expenditure. Without fiscal countermeasures, interest rates that are permanently higher than the GDP growth rate can lead to an explosive debt path, since the costs of interest rise faster than the economy grows. The starting level of government debt plays a particularly important role here. For a given debt level, D'Erasmo et al. (2016) show that there can be multiple dynamic trajectories that are consistent with **intertemporal budget constraints**. In some of these equilibria the debt level converges, in other situations it diverges. In order to stabilise the debt-to-GDP ratio on a sustainable basis, the government would need to maintain permanent primary surpluses at a corresponding level. A permanent inverse ratio, however, would allow primary deficits of a given size without changing the debt-to-GDP ratio or, if the difference between r and g is negative, would even be associated with a decline in the debt-to-GDP ratio.

A successful debt reduction must begin with one of these levers or a combination of them: for example, a consolidation policy with (future) expenditure not growing as fast as GDP, or an increase in (future) taxes could be used to **reduce** the debt-to-GDP ratio to the desired level **via primary surpluses**. However, repercussions for GDP must be taken into account; the weighting and type of the measures on the expenditure or revenue side play a key role here.

Studies by the IMF suggest that fiscal consolidation initially leads to a decline in growth (IMF, 2010; Guajardo et al., 2014). Moreover, revenue-oriented consolidation measures tend to be associated with deeper recessions than expenditure-oriented consolidation. Alesina et al. (2015, 2019) confirm this correlation in their analyses of over **200 consolidation episodes in 16 OECD countries**. The authors document that tax increases typically coincide with deep and long recessions. For example, a revenue-side consolidation of 1 % of GDP is followed by a decline in GDP of 2 % on average over a period of three to four years. By contrast, expenditure-oriented consolidations of a similar magnitude lead to a GDP decline of only 0.25 % within less than two years. Wolters (2013) shows in a structural macroeconomic model that tax increases (especially income or capital gains taxes) have less favourable macroeconomic effects than cuts on the expenditure side.

However, the **short-term effects of fiscal consolidation do not necessarily** have to be **negative**. For example, a number of empirical studies show that a reduction in government spending can be correlated with an increase in economic output in the shorter term (Hellwig and Neumann, 1987; Giavazzi and Pagano, 1990, 1995; Alesina and Perotti, 1996; Alesina and Ardagna, 1998; Perotti, 1999, 2013; Ardagna, 2004; Braguinsky et al., 2011). Cogan et al. (2013) simulate an expenditure-side consolidation strategy within the framework of a structural macroeconomic model. Compared to a counterfactual scenario without consolidation, GDP rises in both the short and long term. In the model, the expansionary effects result from the forward-looking behaviour of households: lower expenditure today leads to lower taxes in the future, which can remove distortions, provide incentives and stimulate employment and production.

The **range** that fiscal **multipliers** of expenditure-side measures assume in their effect on GDP is quite wide, from 0.3 to 2.0 (Ramey, 2019). At the zero-lower-bound, however, the fiscal multipliers could exert a much stronger impact on macroeconomic activity than in a normal interest-rate environment (Christiano et al., 2011). This is because crowding-in effects via interest rates on private capital and investment demand are less pronounced (Krugman et al., 1998; Krugman, 2014; Summers, 2014a, 2014b; De Grauwe, 2015; GCEE Annual Report 2015 item 319). The same applies in situations where companies or households cannot self-insure against specific uncertainties (Challe and Ragot, 2011) or are limited by financial frictions (Woodford, 1990). In that case, the multiplier is likely to be even stronger. If the effects on GDP of a reduction in expenditure or an increase in taxation are greater than those on the deficit, the debt-to-GDP ratio could rise despite consolidation.

Chodorov-Reich (2019) estimates the **multiplier of the American Recovery and Reinvestment Act** (ARRA) – which was adopted during the recession of 2008 and 2009 and included measures amounting to 5 % of GDP – at 1.7 and higher. Survey-based analyses of fiscal transfers, however, show that private households largely saved the transfers they received or used them to repay their debt (Sahm et al., 2012). Cogan et al. (2010) do not find a strong increase in the multiplier at the zero lower bound in the case of the ARRA. An extensive comparative study by Coenen et al. (2012) confirms this. Instead, Cogan et al. (2010) find significantly smaller fiscal multipliers for Dynamic Stochastic General Equilibrium (DSGE) models than in the case of traditional Keynesian models.

Policies favouring sufficiently high GDP growth rates in the medium and long term are likely to facilitate a reduction in debt-to-GDP ratios. In addition, all instruments that reduce the state's refinancing costs are important. The **refinancing costs** reflect the general interest rate level, risk premiums or regulatory provisions that keep the refinancing costs artificially low.

Furthermore, **inflation rates** that are well **above the medium-term inflation target** can ensure that, in the case of non-inflation-indexed bonds, the real value of government debt has fallen at the time of repayment. Finally, **debt restructuring** would reduce the debt burden to be borne. In this context, the state's creditors lose some or all of their invested capital, tolerate lower interest rates or accept longer maturities.

Eichengreen et al. (2019) have examined the influence of various **debt-reduction measures** on the relationship between interest rates and growth rates for different countries. The authors show that in the period before the First World War, and whenever real interest rates were higher than the real GDP growth rate, primary surpluses more than compensated for the increase in interest expenditure and contributed to a marked reduction in the debt-to-GDP ratio. In the post-war period of both the First and Second World War, an inverse relationship between interest rates and GDP growth rates contributed to the reduction in debt levels to a similar extent as primary surpluses.

A study by Reinhart and Sbrancia (2015) furthermore points to the role of a combination of higher inflation rates and measures of financial repression in reducing the public debt that accumulated in the course of the Second World War. The authors show for a dataset of developed economies that real interest rates were negative for half of the period observed (1945-1980). This resulted in annual **interest savings** for the countries concerned of between 1 % and 5 % of GDP on average over the period. This allowed almost half of the accumulated debt to be reduced over time.

297. **Fiscal rules** have been part of the institutional framework of the euro area since the Maastricht Treaty. The best-known examples are the 3 % deficit rule and the 60 % debt rule. The rules aim to counteract the deficit bias of governments by setting explicit limits on different fiscal variables, thereby contributing to the sustainability of public finances in the member states and supporting the independence and effectiveness of monetary policy. The effect of fiscal rules on different fiscal variables, such as aggregates of public budgets or interest rates on government bonds, is empirically well documented (Feld and Kirchgässner, 2008; Nerlich and Reuter, 2013; Reuter, 2015, 2019; Burret and Feld, 2018a, 2018b; Christofzik and Kessing, 2018; Heinemann et al., 2018). The fiscal rules framework has been revised and supplemented in several reform steps over time. Furthermore, there are a large number of rules at the national and subnational levels which must be observed at the same time. **Complexity** and **opacity** have **greatly increased** as a result (Christofzik et al., 2018; GCEE Annual Report 2017 items 95 ff.; GCEE Annual Report 2018 items 64 ff.).

298. This year, the European Commission launched the **Governance Review**, an evaluation of the effectiveness of its economic and fiscal surveillance (European Commission, 2020g, 2020h, 2020i). It refers to the contribution made by fiscal rules to the reduction of excessive deficits in the member states. At the same time, however, it sees **room for improvement** in some member states due to the **still high level of public debt**. In addition, the European Commission points to the areas where there is need for improvement with regard to the **complexity of** the fiscal rules framework, a **possible procyclical effect** of the rules, and their potential impact on the quality of public finances, e.g., the composition of government expenditure with a special focus on **public investment**.

299. Some reform steps have led to greater **consideration of the economic cycle** and to a more flexible application of the fiscal rules framework. Second-generation fiscal rules (Eyraud et al., 2018), such as a structural budget balance rule, limit the fiscal aggregates, such as the budget balance, which are adjusted for the influence of cyclical fluctuations. This should allow the automatic stabilisers to operate freely in the form of cyclical additional expenditures and revenue shortfalls, if correctly calculated, and should, by definition, have a countercyclical effect. However, discretionary fiscal policy measures can weaken or reverse this countercyclical effect. Fatás (2019) documents such an opposite effect of the discretionary fiscal policy measures in the euro area to that of the automatic stabilisers between about 2010 and 2014. By contrast, discretionary measures led to procyclical fiscal expansion in the early 2000s (EFB, 2019).

300. However, it was probably not so much the fiscal rules as such that have led to **procyclical fiscal policy in the euro area** over the past twenty years. Large errors could be observed in the real time measurement of the cyclical position and hence of the structural deficit. In retrospect, the economic position proved to be different from what had been assumed in real time. For example, on average, the underutilisation of capacity relative to production potential was lower and overutilisation higher (Eyraud and Wu, 2015; Claeys et al., 2016; Reuter, 2020; GCEE Annual Report 2017 Box 3). The fiscal rules therefore allowed larger deficits in real time and thus a more countercyclical policy. The use of exceptions to the rules and non-compliance with the fiscal rules furthermore made a more procyclical policy possible, especially in good economic times, than before the financial crisis and before the coronavirus pandemic (Reuter, 2020). Larch et al. (2020) show that compliance with the fiscal rules would have been accompanied by a more countercyclical fiscal policy. Between 2010 and 2014, some countries implemented strong procyclical consolidation using discretionary measures. The European Fiscal Board (EFB, 2019) points out that this was primarily due to concerns about the sustainability of public finances and could be observed in states with higher debt-to-GDP ratios.

301. In particular, by **reforming the fiscal framework**, fiscal rules could help increase fiscal leeway in better times and counteract a procyclical policy. In addition, it would be advantageous to use as far as possible variables in the rules such as public expenditure, which are under the direct control of policy-makers and involve minor revisions of the estimate in real time. The latter can be achieved by minimising the use of variables that do not require the use of output gaps estimated in real time. As described by Fatás (2019), this would, for example, furthermore prevent self-fulfilling downturns from occurring during an economic downturn because of an excessive restriction of the fiscal leeway as the result of an incorrect assessment of the respective roles played by cyclical and structural components in a GDP decline. In addition, a reform could lead to greater public visibility of the rules, particularly through greater transparency and predictability, which is regarded, inter alia, in the European Commission's documents (2020g) on the Governance Review as an important element in promoting governments' ownership with the rules and their compliance with them.

302. One possible reform approach to address a large number of these needs for improvement would be to focus European fiscal rules on an **expenditure rule**. The GCEE and a whole series of other academic contributions have made proposals for reform in this regard (Andrle et al., 2015; Claeys et al., 2016; Bénassy-Quéré et al., 2018; Christofzik et al., 2018; Darvas et al., 2018; EFB, 2018; GCEE Annual Report 2018 Box 1). These proposals have in common a refocusing on a central expenditure rule (Reuter, 2020). In this context, public expenditure (excluding interest expenditure and expenditure on cyclical unemployment benefits) should be allowed to grow less than, or at the same rate as, the average growth of potential output. The minimum difference between the two growth rates here should be dependent on the debt-to-GDP ratio.

303. To improve the quality of public finances, the European Commission is also considering the introduction of a **golden rule**. This is intended to allow exceptions

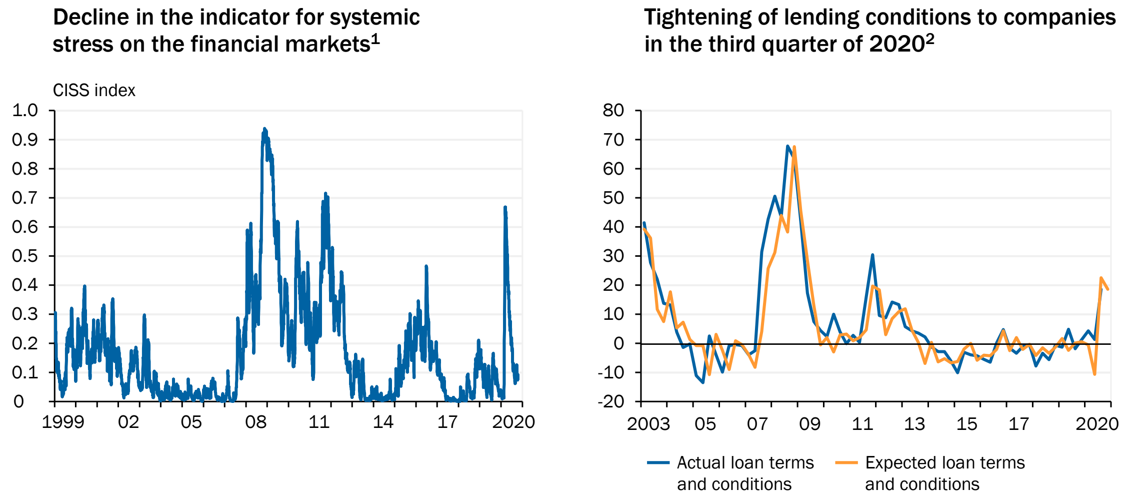
for certain categories of expenditure, e.g., public investment, in order to increase their share in public expenditure. While expenditure rules do not in principle prevent policy-makers from strengthening certain expenditure items, the key challenge of a golden rule lies in identifying expenditure categories that need strengthening. Furthermore, the question arises of precisely defining the respective categories in such a way as to exclude the possibility of these rules being improperly applied. The complexity of the former can be illustrated in particular by the example of public investment (Christofzik et al., 2019).

3. Safeguarding the stability of banks and financial markets

304. In addition to fiscal policy regulations, **banking supervisory regulations** were also **relaxed** at the European level in the wake of the coronavirus pandemic in order to stabilise lending. Compared to the situation before the global financial crisis, the financial system will probably be better prepared overall for an increase in non-performing loans resulting from any rise in corporate insolvencies in the coming months. This **resilience of the financial system should be strengthened after the coronavirus pandemic** by rebuilding reserves, tightening regulations and rapidly reducing holdings of non-performing loans.

305. The ECB's Composite Indicator of Systemic Stress (CISS) for the euro area has signalled **a calming of the situation** since April **2020** after a sharp increase in

↘ CHART 52
Systemic stress and lending conditions in the euro area



1 – The CISS index summarises the development of 15 mainly financial-market-based stress indicators, taking into account the correlation between the underlying time series. 2 – The actual lending terms and conditions refer to the lending terms and conditions in the previous three months (according to the ECB's Bank Lending Survey). For the expected lending terms and conditions, the institutions are asked about the conditions in the coming quarter. In each case, the net percentage is shown, i.e. the difference between the sum of the percentages for 'deteriorated considerably' and 'deteriorated somewhat' and the sum of the percentages for 'eased somewhat' and 'eased considerably'. The banks' responses are weighted by the respective countries' share of the total lending volume in the euro area and by the banks' share of the total lending volume of the surveyed banks. A representative sample of banks in the euro area is surveyed.

Source: ECB

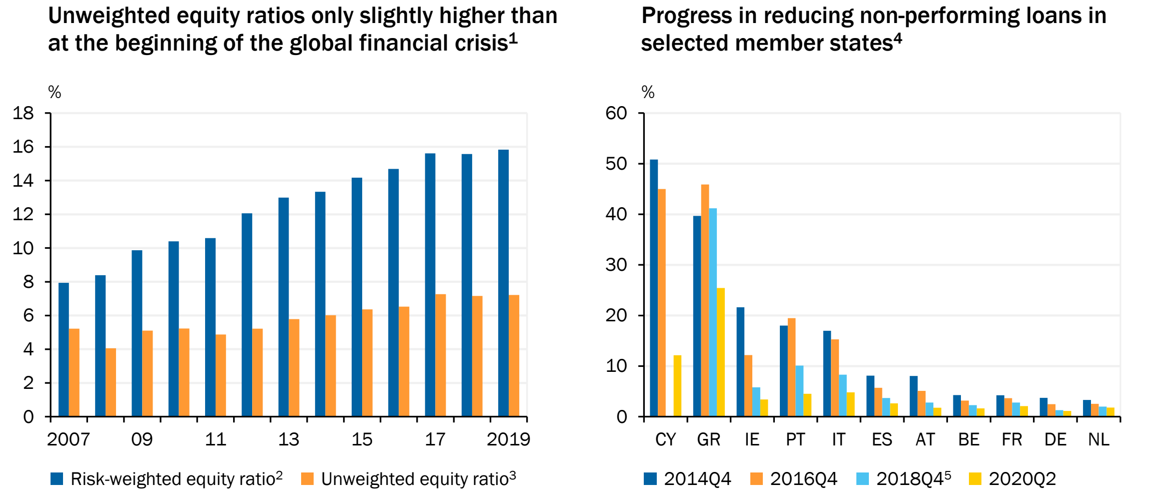
March. ↘ CHART 52 LEFT This development is probably partly due to the announcement and implementation of comprehensive monetary and fiscal policy measures in the member states. ↘ ITEMS 99 FF.

A **vulnerability analysis by the ECB's banking supervision** (2020a) suggests that the **European banking system is currently sufficiently capitalised** to cope with the simulated consequences of the pandemic. Nevertheless, the coronavirus pandemic is likely to have a negative impact on banks' equity base by increasing credit risks. In the main scenario with a GDP reduction in the euro area of 8.7 % for 2020 and a rebound of 5.2 % for 2021, the decline in the risk-weighted equity ratio (CET1 ratio) is estimated to be 1.9 % on aggregate average. This would mean that the CET1 ratio would fall to 12.6 %. The main contribution to this decline comes from the increase in credit risk in the loan portfolio. While universal banks will be able to offset this increase with a continued positive development of net interest, fee and commission income, smaller banks will be less able to do so. The ECB's banking supervision therefore estimates that the decline in their CET1 ratio could be higher. Studies by the EBA (2020) and BaFin (2020) come to similar conclusions. However, the results do not represent a forecast in the conventional sense and depend heavily on the model assumptions. Furthermore, **the collapse of a single bank** can have **serious consequences for the financial system**, even if it is well capitalised on average.

306. On 28 July, the ECB's banking supervision extended its call on banks to refrain from dividend payments and share buybacks until 1 January 2021 to prevent capital from flowing out of the institutions through these channels (ECB, 2020b). It also recommended keeping variable remuneration elements as low as possible at least until that date. Overall, although the risk-weighted equity adequacy of banks

↘ CHART 53

Risk indicators for banks in the euro area



1 – Average value for banks and banking groups in the euro area. 2 – A bank's Tier 1 capital in relation to its risk-weighted assets. 3 – A bank's total equity in relation to its total assets. 4 – Non-performing loans and credit facilities in relation to gross loans and credit facilities. Loans are classified as non-performing if they are more than 90 days overdue or if full repayment without the realisation of collateral is considered unlikely. Weighted averages at the country level. Data at the end of each quarter. CY-Cyprus, GR-Greece, IE-Ireland, PT-Portugal, IT-Italy, ES-Spain, AT-Austria, BE-Belgium, FR-France, DE-Germany, NL-Netherlands. 5 – No figure available for Cyprus.

Sources: EBA, ECB

in the euro area was significantly higher at the end of 2019, the **non-risk-weighted equity adequacy** was **only slightly up on the beginning of the global financial crisis.** ↘ CHART 53 LEFT

307. An **increase in credit risks** in the wake of the coronavirus pandemic **could lead to tighter lending conditions** in the euro area via an increase in risk provisions. To counteract a procyclical effect of the prudential rules, the ECB's banking supervision already announced temporary relief in the spring with regard to capital and liquidity requirements for the credit institutions it supervises (GCEE Special Report 2020 item 162). An ECB survey (2020c) on the lending business indicates that their lending conditions to companies did not significantly tighten in the first and second quarters of 2020. ↘ CHART 52 RIGHT This development can mainly be attributed to special fiscal and monetary policy measures, as banks' risk tolerance declined in both quarters and their risk perception increased sharply. After some special measures ended, lending conditions tightened significantly in the third quarter (ECB, 2020d).

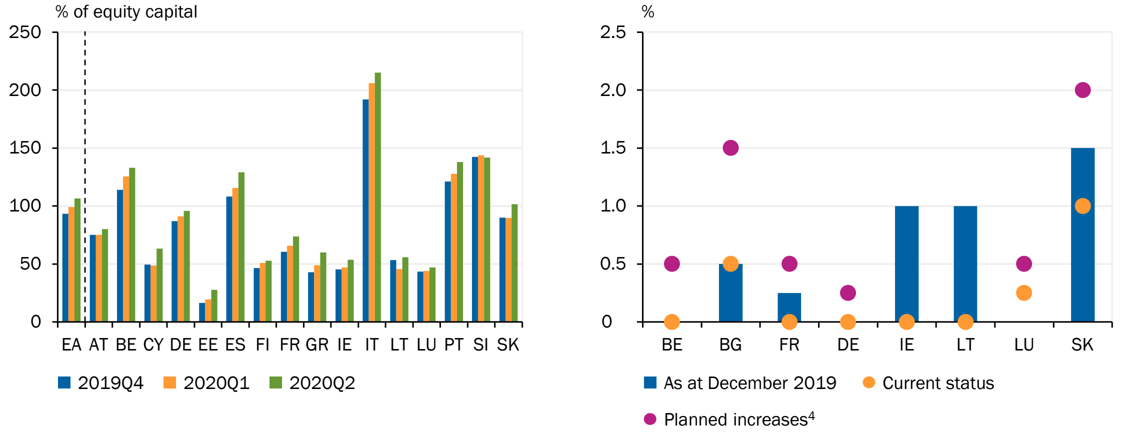
308. If there is an **increase in non-performing loans** after the expiry of government support measures and the reinstatement of the obligation to file for bankruptcy, this **could** also **cause** a **decline in lending activity** during the economic recovery phase (ECB, 2020e). The slow decline in non-performing loan volumes observed in the past may provide an indication of the speed of reduction after the current crisis (Gropp et al., 2020; Ratnovski et al., 2020) and indicate that an end to the pandemic is not the same as an end to risks in the banking sector. ↘ BOX 1 The economic consequences of the pandemic could reverse the progress already made in reduction. ↘ CHART 53 RIGHT

↘ CHART 54

Recent developments within the scope of the Single Supervisiory Mechanism (SSM)[1]

Large differences in euro-area banks' claims on their domestic government[2]

Reduction in countercyclical capital buffers since the beginning of the coronavirus pandemic[3]



1 – EA-Euro area, AT-Austria, BE-Belgium, BG-Bulgaria, CY-Cyprus, DE-Germany, EE-Estonia, ES- Spain, FI-Finland, FR-France, GR-Greece, IE-Ireland, IT-Italy, LT-Lithuania, LU-Luxembourg, PT-Portugal, SI-Slovenia, SK-Slovakia. 2 – No data available for Latvia, Malta or the Netherlands. 3 – The figure shows countries within the scope of the SSM that have had positive buffers since 2015 or had announced their introduction. 4 – Planned increases before the outbreak of the coronavirus pandemic. Increase for Luxembourg still planned for January 2021. No increases planned for Ireland and Lithuania.

Sources: ECB, European Systemic Risk Board, own calculations

309. **The sovereign-bank nexus in the euro area** has expanded in the course of the pandemic. For example, the share of claims on the domestic government rose from (a weighted average of) 99 % of equity at the end of the first quarter of 2020 to 107 % at the end of the second quarter. In this context, there are big differences between the EMU member states. ↘ CHART 54 LEFT

310. The expansion of the sovereign-bank nexus can have an impact on the stability of the domestic banking sector if negative developments in one sector spread to the other (Angelini and Grande, 2014; Dell'Ariccia et al., 2018). The GCEE has therefore proposed a reduction in the privileged treatment of claims on governments by the banking supervision in order to reduce the incentive for banks to hold domestic government bonds. For example, **risk-based large-exposure limits** could be introduced in combination with capital adequacy requirements that are also commensurate with the risk (GCEE Annual Report 2015 items 57 ff.). The large-exposure limits would prevent the insolvency of a government from triggering the insolvency of a bank by reducing the cluster risk. Capital adequacy would increase banks' ability to absorb losses and reduce price distortions in the financial markets. Alternatively, **creditworthiness-linked equity backing of concentration risks** above a certain threshold allows greater flexibility in the adjustment process compared to (hard) large-exposure limits (GCEE Annual Report 2018 items 488 ff.).

311. In both proposals, **procyclicality**, triggered by reduced equity of banks and reduced creditworthiness of debtors during an economic downturn, could be avoided by using multi-annual averages in the calculation of capital requirements and thresholds. By contrast, **generous transition periods** could mitigate distortions in the financial markets and negative effects on public finances. For example, the GCEE has proposed a ten-year period for large-exposure limits (GCEE Annual Report 2015 item 62). In terms of capital adequacy, claims on governments that are already in the bank portfolio on a certain reporting date could be exempted from capital adequacy regulation by means of portfolio protection (grandfathering).

A differing opinion

312. One member of the GCEE, Achim Truger, does not share the call made in ↘ ITEMS 310 F. for a "reduction in the privileged treatment of claims on governments by the banking supervision" and "risk-based large-exposure limits". The envisaged **removal of privilege for government bonds** and loans from the balance sheets of **European banks** would put the latter at a **disadvantage** in competition with institutions outside the EU for which no such arrangements exist. Moreover, capital adequacy requirements for government bonds and loans would make **public financing more expensive** and thus also make it more difficult to reduce government debt (GCEE Annual Report 2018 item 499, MV Bofinger). **The same applies**, moreover, **to Collective Action Clauses (CACs)** in the member states' sovereign debt instruments (de Grauwe and Ji, 2013; Theobald and Tober,

2020) and, in particular, to the introduction of single-limb CACs, as envisaged in the context of the ESM reform and endorsed by the GCEE majority. ↘ BOX 11

Furthermore, depending on how it is designed, the **removal of privileges** could force German institutions to exchange what they consider to be absolutely safe bonds, especially German bonds, for bonds from other member states that they regard as less safe. There is nothing to indicate that German government bonds could default over the next few decades which could justify corresponding capital adequacy requirements or credit restrictions (GCEE Annual Report 2018 item 500, MV Bofinger).

313. Developments in the course of the coronavirus pandemic so far suggest that **stricter regulation**, accompanied by higher capital and liquidity requirements, has **proved** its worth. Larger buffers and flexibility when regulatory requirements are temporarily eased in crisis situations have prevented a procyclical effect and thus maintained banks' ability to lend. In its announcement of 28 July 2020, the ECB banking supervision underscored the temporary character of the special measures and indicated an exit (ECB, 2020b). However, the aspect of the medium- to long-term stability of banks should not be neglected: the **buffers should be rebuilt and** the low **profitability** of European banks by international comparison **should be strengthened** (Deutsche Bundesbank, 2020b). Furthermore, efforts to reduce the share of non-performing loans should continue to be pursued intensively despite the difficult economic situation.

314. There is, therefore, **still a need for action**. For example, although the anticyclical capital buffer was lowered by many countries in the course of the coronavirus pandemic, ↘ CHART 54 RIGHT even before the pandemic the question arose – at least in Germany – as to whether the buffer was built up in time and on an appropriate scale (GCEE Annual Report 2019 items 408 f.). In addition, the imminent withdrawal of the UK from the EU (Brexit) ↘ ITEMS 333 F. could exacerbate an already existing fragmentation of European capital markets and slow down economic recovery processes (High Level Forum on the Capital Markets Union, 2020). In order to avoid this, an expansion of efforts to **complete the Capital Markets Union** could prove to be **useful** (GCEE Annual Report 2018 471 ff.). ↘ ITEM 329

IV. IMPROVING CONDITIONS FOR GROWTH IN THE REAL ECONOMY

1. Strengthening economic convergence

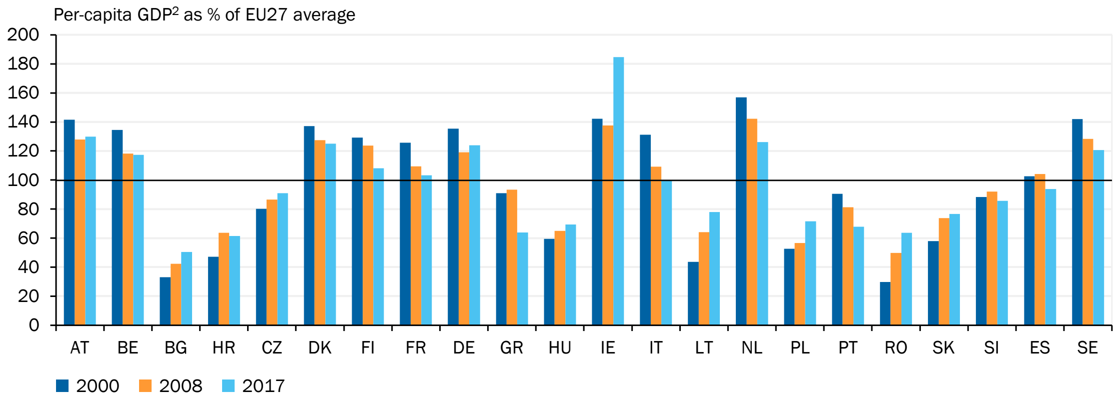
315. Precisely because of the economic crisis triggered by the pandemic, the **longer-term conditions for growth** in the EU should be **strengthened**. A closer look at the development of per capita incomes in the EU member states reveals a continuing high level of heterogeneity. In principle, countries with a lower per capita

income would be expected to have higher growth rates than countries with a higher per capita income, so that income differentials would narrow over time (GCEE Annual Report 2017 item 253). Such a convergence can be observed for most EU member states between 2000 and 2008. ↘ CHART 55 TOP Since 2008, however, a number of southern European countries as well as Croatia and Slovenia have been moving away from the EU average.

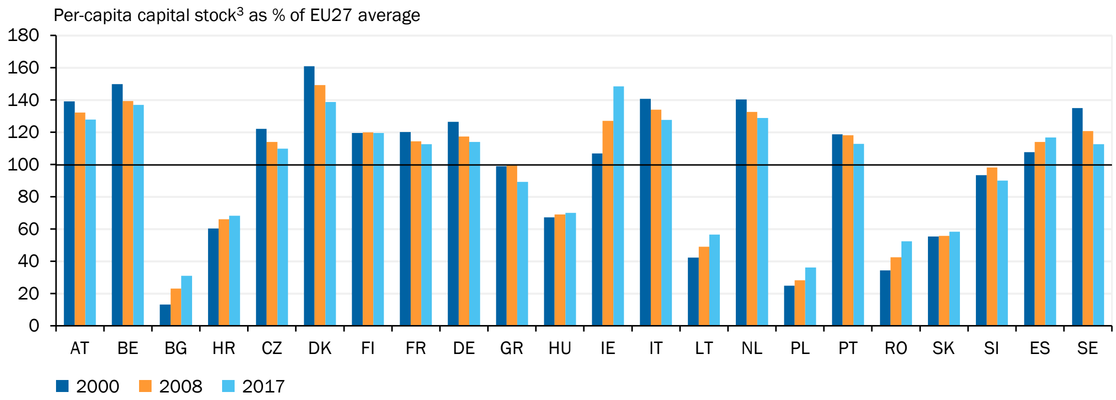
316. Several of the member states have (far) **below average capital adequacy** levels, even though it has converged towards the EU average over time. Below average capitalisation does not necessarily lead to lower per capita income, provided that **the productivity of capital and labour** are above average. In the EU, however, the countries with below average capitalisation tend to have a below average per capita income at the same time. ↘ CHART 55 BOTTOM Particularly in the case of the southern European countries that were particularly hard hit by the debt crisis in the euro area, lower labour productivity is not accompanied by higher **productivity growth** (Ridao-Cano and Bodewig, 2018; Schivardi and Schmitz, 2020; GCEE Annual Report 2019 item 163).

↘ CHART 55
Convergence and divergence in the EU[1]

Since 2000, Eastern European countries in particular have been catching up...



... while capital adequacy continues to vary greatly



1 – The chart refers to the EU27 member states with more than two million inhabitants in 2017. Latest available data: 2017. AT-Austria, BE-Belgium, BG-Bulgaria, HR-Croatia, CZ-Czech Republic, DK-Denmark, FI-Finland, FR-France, DE-Germany, GR-Greece, HU-Hungary, IE-Ireland, IT-Italy, LT-Lithuania, NL-Netherlands, PL-Poland, PT-Portugal, RO-Romania, SK-Slovakia, SI-Slovenia, ES-Spain, SE-Sweden. 2 – Based on data adjusted for purchasing power. 3 – Based on data in US dollars.

Sources: Penn World Tables, own calculations

Total factor productivity (TFP) plays a **central role** in long-term potential growth. Here, investment can make an important contribution to increasing productivity (GCEE Annual Report 2019 item 209). Nevertheless, the **productivity impact of investment** depends greatly on **the type of investment made** (GCEE Annual Report 2019 items 208 ff.). Investment in digitalisation or research and development is likely to yield higher overall economic productivity gains than, for example, investment in housing; misallocations of capital could even lead to a fall in productivity.

317. The Treaty on the Functioning of the European Union (TFEU) (2012) stipulates that the **Structural and Investment Funds** should contribute to **economic, social and territorial cohesion.** Programmes include, for example, investment in research, digitalisation and infrastructure projects and support for smaller and medium-sized enterprises.

The **Structural and Investment Funds** play a **prominent role** in **public investment in some member states**. While resources from the EU Cohesion Fund accounted for 8.5 % of total public investment in the EU between 2015 and 2017, the percentage was over 50 % in Slovakia, Hungary, Latvia and Poland. In Lithuania and Croatia, the Fund's share of total public investment was over 70 %, in Portugal even over 80 % (European Commission, 2017a). Overall, the budget for regional and cohesion policy has risen from 5 % of the EU budget when it was introduced in 1975 (Manzella and Mendez, 2009) to around 30 % in the MFF 2021-2027 (BMF, 2020).

318. Whether the **Structural Funds** really **boost convergence within the EU** has no **unambiguous empirical support** (Becker et al., 2010; Breidenbach et al., 2016; Merler, 2016; Bachtler et al., 2019). One reason for the different **empirical results** could lie in the history of the **Structural and Development Funds**. The EU's regional and cohesion policy only developed slowly from a policy focusing on transfers that was almost entirely oriented towards the preferences of the member states to a policy based on EU-wide objectives and cooperation between supranational, national and regional administrations. In the 1980s, uniform criteria were introduced for the principles of resource allocation. Before that, the allocation of funds was almost entirely in the hands of the member states. Furthermore, local interest groups have been officially involved in project design since 1988 (Manzella and Mendez, 2009).

319. There is a **need for improvement** in the efficiency of the use of structural funds (Bachtler et al., 2013). In a study covering the period from 1989 to 2012, the authors note that, especially at the beginning of the period under review, the strategic component of the projects examined had a low profile: over the entire period, only about 50 % of them were relevant to regional policy. While the situation has generally improved over time in the regions observed, in some cases there was a deterioration in programme planning and implementation, particularly towards the end of the study period. The authors therefore stress the **need for good project management**. The European Commission sees the **quality of local institutions** as an **important prerequisite for** the **effectiveness of regional**

policy measures (European Commission, 2017a). The 2014-2020 budget introduced extensive ex-ante conditionality – rules that the proposed projects must comply with to be eligible for funding from the EU budget. Other initiatives have been launched to further improve the efficiency of the resources used (OECD and European Commission, 2020).

320. Convergence in the real economy could also be promoted via **labour mobility**, for example by aligning capitalisation per employee to result in higher per capita incomes in poorer countries and lower per capita incomes in richer countries. Even taking into account the brain-drain phenomenon, positive effects in the country of origin can be generated by remittances, higher education incentives or more productive and better trained returnees (Wolszczak-Derlacz, 2009). Increased labour mobility could also contribute to allocation efficiency (Ridao-Cano and Bodewig, 2018) and should thus make productivity gains possible. In the monetary union, the impact of asymmetric shocks could be mitigated by labour mobility. Overall, however, the **evidence** on the effect of labour mobility on growth rates and convergence is **ambiguous** (Rappaport, 2000; Wolszczak-Derlacz, 2009; Fratesi and Percoco, 2014).

Labour mobility has increased within the EU over the past few years; even so, the existing level of mobility was **still too low** to **compensate for** the **consequences of** the global financial crisis and the European sovereign debt crisis (Ehmer and Schwegmann, 2017). Only around 25 % of an asymmetric labour demand shock is offset by labour mobility between countries within one year, 60 % after 10 years (Arpaia et al., 2014). Beyer and Smets (2015) calculate a level of regional mobility for Europe comparable to that of the United States. According to their study, around 40 % of an asymmetric labour demand shock will be absorbed within one year. However, mobility across national borders in Europe is much lower than regional mobility within a member state. Reasons for the low level of labour mobility could lie in language barriers or differences in training systems (Ridao-Cano and Bodewig, 2018). The EU Erasmus+ initiative could help alleviate these problems.

2. Developing the European single market further

321. In 2019, the **European single market** was one of the largest economic areas in the world with a GDP of €13.95 trillion, even excluding the United Kingdom (Eurostat, 2020a; World Bank, 2020). The EU Single Market is founded on four fundamental freedoms: the free movement of goods, persons, services, as well as capital and payments. Over the past decades, the four basic freedoms have led to a pronounced **economic interdependence** between the member states and to a significant **increase in welfare** for the countries involved (Badinger, 2005; Feld, 2006; Crespo Cuaresma et al., 2008; Rueda-Cantuche et al., 2013; Ravikumar et al., 2019).

322. Economic integration in the Single Market is still **in need of further development**. This applies in particular to **trade in services**, to the **digital sector**, the

energy sector and **financial-market integration**. Before the United Kingdom's withdrawal from the EU, the European Parliament estimated that the completion of the European single market could generate a wealth gain of €713 billion for the EU-28 over the next ten years (EPRS, 2019). This would correspond to additional annual growth in EU-27 GDP of about 0.5 percentage points. However, such estimates are subject to uncertainty. Ziltener (2004) and Andersen et al. (2019) show, for example, that the economic integration effects of a single European market have often been overestimated in the past in terms of depth, breadth and dynamics. The potential efficiency losses of a lack of, let alone a decline in European integration are high (Felbermayr et al., 2018; Mayer et al., 2019).

323. The **free movement of goods** specifies that there are no border controls, customs duties or other trade restrictions on goods within the EU. The **digital single market** aims to ensure the free movement of digital goods and services. ↘ ITEM 584 International efforts are being made to address the challenges posed by the growing importance of the digital economy for income taxation. While some European countries prefer the introduction of a **digital tax**, the United States and Germany are primarily in favour of minimum taxation, which ensures that profits from digital business models are taxed in the country where the holding is located. Originally, an internationally coordinated negotiated solution was to be worked out by the end of this year (OECD, 2018). Now, negotiations are progressing more slowly than planned due to the coronavirus pandemic and political disagreements, and a deal is unlikely to be reached before the middle of next year (OECD, 2020).

The European Commission has announced its intention of proposing a digital tax at the EU level if the international talks do not succeed by the end of 2020 (European Parliament, 2019). However, such negotiations at the EU level have already failed in the past due to resistance from individual member states. In principle, it seems to make sense to wait for an internationally coordinated approach. A European agreement would make national digital taxes superfluous, such as those that already exist in France and Austria and those planned in Italy and Spain. Such **unilateral solutions at the level of individual member states** contribute to the unequal treatment of digital business models in the EU and thus to the **fragmentation of the European digital single market** (GCEE Annual Report 2018 items 615 ff.). However, a special tax on the major digital companies would probably be seen as a discriminatory trade policy measure, particularly by the United States, and could fuel further trade conflicts.

324. The completion of the **internal energy market** is a key challenge for the coming years against the background of the **European Green Deal**, which defines climate neutrality by 2050 as a central goal of the EU (European Commission, 2019). The efficient use of the common market to achieve European climate policy targets is essential for achieving these objectives. The key instrument of European climate policy should continue to be a uniform CO2 price. The endeavour to extend the EU ETS to all sectors in all member states should be the primary goal of EU climate policy efforts.

Europe faces a challenging **transformation process** if it is to become climate neutral by 2050. ↘ ITEMS 358 FF. Defossilisation is only likely to succeed if electricity from renewable energy sources plays a central role in the energy supply in all sectors (acatech et al., 2017; Runkel, 2018; Agora Energiewende and Wuppertal Institute, 2019; IRENA, 2020). In July 2020, the European Commission paved the way to a more efficient and more interconnected energy sector with the **EU Strategy for Energy System Integration** (European Commission, 2020j). Cross-sectoral CO2 prices in combination with suitable framework conditions can trigger a comprehensive process of sector-coupling at the European level. A common European energy policy and the development of the **Energy Union**, which aims at a sustainable and competitive energy supply in the member states, should therefore have significant positive external effects.

325. The **free movement** of goods and **persons** is an essential foundation of the European Single Market. At the beginning of the **coronavirus pandemic**, 17 European member states **temporarily closed internal borders**, which restricted trade in services and goods as well as the mobility of workers (European Commission, 2020k). While border crossings for professional reasons and the cross border movement of goods were not prohibited in principle, even the short-term reintroduction of border controls is likely to entail economic costs (van Ballegooij, 2016; WHO, 2020). Most restrictions have been lifted in the meantime. The current renewed sharp rise in the number of infections in Europe could lead to a threat of new border closures in the Single Market. However, at the recent EU summit member states called for closer cooperation and rejected a return to unilateral national action in the second wave of the pandemic. What remains is the realisation that the role of the European Commission for ensuring well-functioning intra-European goods flows and the free movement of persons is limited in the acute crisis, since temporary border closures within the Schengen area are initiated at national level and can only be ended there. In order to minimise restrictions, the Commission issued several guidelines on European border management about two weeks after the first border closure (European Commission, 2020l). These regulated, for example, the **Green Corridor**, which aimed to guarantee the completion of all health and entry checks for freight vehicles at the borders within a maximum of 15 minutes.

326. As the virus spread heterogeneously and at different speeds, the ability to react in a faster and more focused way favoured action at the national level at the beginning of the coronavirus crisis. The European Commission reacted to the acute crisis situation within the scope of its legal possibilities. A **communitarisation of decisions on temporary border closures** by the EU **does not** seem **expedient on principle**. Since the refugee crisis in 2015, and on the basis of a reform of the Schengen Agreement in 2013, controls of internal borders with individual member states have nevertheless become the new normality for individual European states, including Germany. Even though the EU has for several years been stressing the urgent necessity for the member states to return to the Schengen system (European Commission, 2017b), the temporary border controls have since been repeatedly extended by individual countries. The legally formalised time limits on such temporary border controls have been pushed to the limits (Deutscher Bundestag, 2018) or already significantly exceeded (European Parliament, 2020), depending on one's point of view. However, freedom of movement in the common Single Market should not be permanently burdened in this way, and temporary

border closures in the Schengen area should, in the long run, be the ultima ratio again. A departure from the Schengen Agreement could have negative economic effects, not least for Germany (Böhmer et al., 2016; Felbermayr et al., 2018).

327. The **free movement of services** allows providers of industrial, commercial, craft and freelance activities free access to the services markets of all EU member states. The barriers to cross-border trade in services are still much higher than those that apply to goods. According to the European Parliament's Research Service (EPRS, 2019), many of the prosperity gains that can be derived from free market access to services markets have not yet been realised. In the future, digitalisation will enable more and more service industries to participate in the international division of labour. This opens up a wide range of opportunities, such as the creation of electronic procedures for completing administrative formalities, which could be used to **strengthen trade in services in the single market**.

The purpose of the Posting of Workers Directive is to ensure that workers who provide services in another member state for a limited period of time are guaranteed the minimum protection provisions of the state to which they are posted. The aim is to ensure a level playing field for the cross-border provision of services. The **amended Posting of Workers Directive**, which was adopted in 2017, came into force on 30 July. In the future, companies sending their employees abroad will have to pay them not only the statutory minimum wage applicable in other EU countries, but also the applicable collectively agreed or customary wage. The GCEE has already pointed out in the past that this decision goes against the free movement of services in the European Single Market, as it is likely to serve primarily to drive Eastern European competitors out of the market (GCEE Annual Report 2017 item 138; GCEE Annual Report 2018 item 77). It serves the same purpose on other borders of the Single Market, for example between Germany and France.

A differing opinion

328. One member of the GCEE, Achim Truger, does not share the criticism of the new regulation of the Posting of Workers Directive expressed in item 327 The EU **Posting of Workers Directive,** which is the basis of the German law on the posting of workers, aims at **a social component** in the posting of workers. Before the Directive, it was only possible to lay down minimum conditions. Now, the entire collective-bargaining structure, too, can be extended to posted workers. The Directive is not expected to lead to major changes in Germany since only representative or generally binding collective agreements can be extended to posted workers. However, there are no representative collective agreements with above-average collective bargaining coverage in the German low-wage sectors, and it is precisely the declaration of general applicability that is currently largely being blocked. In a completely unregulated labour market, postings would threaten to **destroy** the **collective-bargaining structure** in the **destination countries** of the postings. Expensive domestic workers would be replaced by cheap contract workers. Given the huge wage differentials across the EU, the incentives to do so

are huge. The Posting of Workers Directive is particularly relevant for Germany as the main destination of EU postings. In the meat industry, for example, there are now no longer any regular employees in the core processes of slaughtering and meat processing (Bosch, 2019).

Ultimately, the Posting of Workers Directive is about protecting the entire social fabric. The **Single Market risks considerably losing support** if national standards no longer apply to all workers. This is what Mario Monti said in his report on the common market back in 2010: "The revival of this divide has the potential to alienate from the Single Market and the EU a segment of public opinion, workers' movements and trade unions, which has been over time a key supporter of economic integration." (Monti, 2010, p. 68).

329. Barriers to the **free movement of capital and payments** are to be removed within the framework of the **European Capital Markets Union**. This has the potential to improve cross-border risk sharing by strengthening the Single Market for capital. By diversifying the sources of financing more widely, capital-market financing can **increase the resilience of the financial system, especially in times of crisis** (High Level Forum on the Capital Markets Union, 2020; GCEE Annual Report 2017 items 477 ff.) The measures taken so far have not yet led to a noticeable increase in capital-market integration in the euro area. This is probably due, among other things, to the fact that the adopted measures will only take full effect after some time (European Commission, 2020m). Less fragmented stock and bond markets could, however, facilitate the acquisition of funding once government aid expires, thereby **promoting economic recovery in the medium term**. An expansion of efforts to complete the Capital Markets Union, as proposed by the European Commission in July (European Commission, 2020m), may therefore prove to be **meaningful** (GCEE Annual Report 2018 items 471 ff.).

3. Trade relations between resilience and efficiency

Allowing increases in welfare, counter protectionism

330. The intensification of international trade has led to major **increases in efficiency and welfare** both globally and in Germany and to a perceptible reduction in global poverty (GCEE Annual Report 2017 items 629 ff.). **On an aggregated level, the effects of globalisation have been almost exclusively positive** and these positive effects would be at stake if globalisation were to be reduced and national markets sealed off from global competition.

The structural changes associated with globalisation have led to **differentiated effects at the regional, sectoral and individual level**. For example, some economic sectors (and thus regions where companies from the respective sectors are located) benefit above all from export opportunities, while others are primarily exposed to additional competition from imports. At the same time, the relative demand for higher- and lower-skilled workers is changing in individual countries, leading to corresponding adjustments in real wages. In principle, this structural change is no different in economic terms from that triggered by technological transformation or by fundamental changes in consumer preferences. Politically, however, structural changes brought about by globalisation tend to be seen by the state as a reason to play an active role in cushioning the negative consequences for the population (Di Tella and Rodrik, 2020). Ignoring the social consequences for sections of society can be detrimental to societal acceptance and encourage populism (Rodrik, 2020). Social security and transfer systems make an essential contribution to compensating those negatively affected by the above-mentioned changes. In addition, economic policy can make employees, enterprises and regions more adaptable to structural change (GCEE Annual Report 2017 item 698; GCEE Annual Report 2019 item 245 ff.). On the other hand, attempts to prevent partially negative effects at a disaggregated level through more protectionism and less international division of labour is unlikely to succeed in the long term.

331. The global financial crisis brought to a standstill a long phase of the globalisation of goods markets, as shown by the growth of global imports relative to industrial production (Felbermayr and Görg, 2020). A relapse into protectionism was successfully prevented to a large extent during the financial crisis, and world trade subsequently recovered rapidly to pre-crisis levels (McDonald and Henn, 2010; IBRD, 2017). However, a **return of protectionist tendencies** has been observed since then; these were subtle to begin with but they have accelerated in recent years (Georgiadis and Gräb, 2013; Blackwill and Harris, 2016; Evenett, 2019). Non-tariff trade barriers in particular have gained in importance in the years since 2009 (Kinzius et al., 2019; WHO, 2019). The weaker dynamics of world trade over the past decade have also been accompanied by a **shortening of value chains**, especially in China but also in Germany and the United States (Felbermayr and Görg, 2020; Flach et al., 2020).

332. The **World Trade Organisation** (WTO) has repeatedly been **hampered in its ability to act** by several of its member states in recent years. Most WTO members probably benefit from membership in the organisation; this is particularly true of the United States (Felbermayr et al., 2019). Nevertheless, the United States has increasingly turned away from international cooperation. The climax of this development was the United States government's blockade against the appointment of new judges for the WTO Appellate Body. For this reason, the organisation's dispute settlement mechanism has been unable to function since mid-December 2019. In response, the EU and 15 other WTO members have signed an agreement to continue arbitration under the old WTO rules. In October, after years of dispute over subsidies for aircraft manufacturers, the WTO ruled that the EU may impose punitive tariffs on imports from the United States amounting to almost four billion US dollars (European Commission, 2020n). This decision could give the trade dispute between the United States and the EU renewed momentum.

↘ BOX 13

Dependencies in European supply relationships

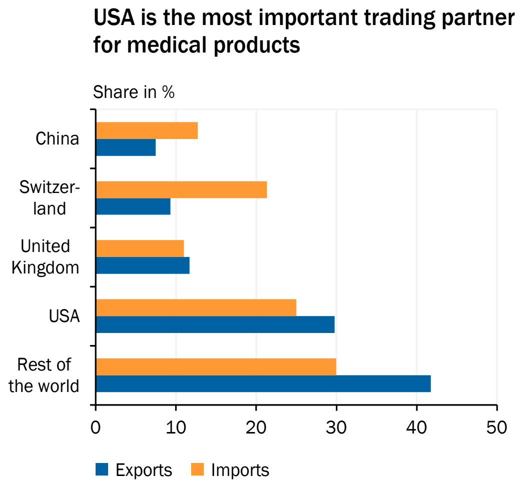
About 12 % of global value added and 17 % of German value added is generated via global value chains. Unlike China and the United States, **Germany and the EU** are **integrated into international supply chains to an above average extent** (Flach et al., 2020). The EU-28's most important foreign trade partners in 2019 were China and the United States (Eurostat, 2020a). Since its withdrawal, the United Kingdom has also become one of the EU's key foreign trade partners. German and European value chains are primarily organised on a regional basis: the largest share of trade in goods takes place between and with member states. The share of intra-European trade links has increased in most sectors in recent years (Flach and Steininger, 2020).

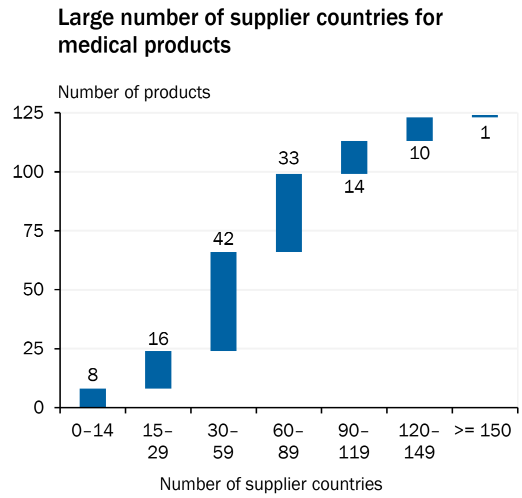
The various sectors of the economy are integrated to varying degrees in global value chains. In the **manufacturing sector** especially, a **large share of the production value is attributable to intermediate inputs** (Fries et al., 2020b). International integration in the fields of commerce and other services, on the other hand, is considerably less pronounced. About two thirds of imported intermediate goods in manufacturing originate from an EU member state. A similar structure of interdependence in manufacturing can be observed in most other EU member states. In 20 of the 27 member states, more than half of imported inputs come from other member states (Fries et al., 2020b). This illustrates the strong dependencies within the EU and the correspondingly great importance of functioning supply chains for value creation in manufacturing.

Manufacturing is intensely integrated into international value chains through purchases of intermediate inputs and sales of intermediate and final goods. The **volume of trade with EU member states and with countries outside the EU** is roughly **balanced** in terms of sales. Germany's manufacturing sector is much more dependent on export demand than the other large member states. Nevertheless, on the demand side overall interdependence within the EU is close-knit. In view of the strong interdependence via exports of intermediate and final goods, economic development in Germany's most important sales markets plays a prominent role for the economic situation of German industry.

↘ CHART 56

European Union's foreign trade in medical products in the context of COVID-19 in 2019[1]





1 – The analysis covers 124 different products and product groups. The list is based on an assessment by the European Commission, World Customs Organisation (WCO) and World Health Organisation (WHO) of the classification of medical devices in relation to COVID-19.

Sources: Eurostat, own calculations

In the world markets for **pharmaceutical products and medical equipment**, increased demand from almost all countries **at the beginning of the coronavirus pandemic** was met by a **supply-side shortage** of precisely these goods, triggered by an interruption in supply chains and newly imposed export restrictions. At the beginning of the crisis, supply was not guaranteed in all member states, at times. This led to an intensive debate on existing dependencies in trade relations with medical goods.

The WCO (2020) and the European Commission (2020o) have published a list of necessary **medical supplies** in connection with the coronavirus pandemic. The **EU-27's most important foreign trade partner** for these goods in 2019 was the **United States**. China, Switzerland and the United Kingdom also account for a significant share of the trade volume ↘ CHART 56 LEFT Overall, Germany shows a considerable degree of diversification in the procurement of medical products (Braml et al., 2020): Germany obtains 72 % of the total volume of pharmaceutical imports from EU member states. China and India together account for only 0.8 %.

The **regional dependence of imports** on one source of supply **decreases** and the stability of supply increases **with** the **diversification** of supplier countries per product. In 2019, the EU-27 received about 81 % of the necessary medical products related to the coronavirus pandemic from at least 30 different countries. ↘ CHART 56 RIGHT The assertion that the EU is very dependent on individual countries for drug imports (Deutsches Ärzteblatt, 2020) is not borne out by this analysis, although the number of suppliers does not fully define the existing international dependencies. The same applies to dependence on China: China is involved in imports into the EU of 95 % of the medical products related to COVID-19 examined here; there are at least 13 alternative sources in other countries for each of these products (Eurostat, 2020b). A very similar picture emerges for German trade relations (Braml et al., 2020). **Germany and the EU** are therefore likely to be **only slightly dependent on trade relations with individual countries in their** aggregate **supply of medical products**. Nevertheless, critical supply bottlenecks may occur for individual supply-critical drugs or vaccines for which there are few alternatives (BfArM, 2020).

333. New barriers to trade could be created by the **United Kingdom's withdrawal from the EU**. Brexit represents a major watershed in the European unification process. After the British government let the possibility of extending the current transitional phase pass on 1 July 2020, the United Kingdom is expected to finally leave the European Customs Union and the European Single Market at the beginning of 2021. By the end of October, no further agreement had been reached on the shape of future trade relations, so that, as things stand at present, the United Kingdom is likely to have the status of a WTO third country for the EU as from 2021. The current level of integration between the UK and the EU member states, not least Germany, is so great – given the specialisation in the common Single Market and the internationalised value chains – that **this departure** will **primarily leave losers** in its wake.

334. In order to **limit** the **significant negative economic effects** (GCEE Annual Report 2016 items 292 ff.), the GCEE continues to argue in favour of a **comprehensive trade agreement** between the EU and the United Kingdom (GCEE Annual Report 2017 item 150). Negotiating such an agreement would first require an extension of the transition period. Up to the end of the latest round of negotiations, however, formulating an agreement or extending the transition period

proved to be difficult, and there are evidently continuing differences of substance on crucial points (European Commission, 2020p).

Consequences of the coronavirus pandemic for global trade

335. The coronavirus pandemic is subjecting global supply chains to a special test. The virus is spreading across national borders through travel by tourists and business people. Cross-border supplies of intermediate products affect the industrial production in particular. The global spread of the virus is affecting regions that are strongly interlinked via international value chains, such as Europe, North America and Asia. The pandemic and the health policy measures adopted to contain it are having an impact on **both the supply and demand sides of national and international relations among suppliers and final customers** (Fries et al., 2020a). Because of the strong international interdependencies, Europe can only engage in the meaningful crisis management of supply chains by working together. ↘ BOX 13 In a crisis like the present one, the European Commission has an important coordinating role to play. Within its range of possibilities, it should ensure that production bottlenecks are avoided through cooperation between the countries concerned, by keeping trade routes open and allowing goods, capital and knowledge to flow without major obstacles.

336. Against the background of recent experience in crises, the question arises as to how dependencies in foreign trade relations can be reduced and globalisation made more resilient. An evaluation of supply relationships by companies in the aftermath of the current crisis can reveal dependencies; hopefully, this can help identify **precautions that can be taken against future crisis-related production disruptions** (Kilic and Marin, 2020). This does not necessarily have to lead to greater nationalisation of supply chains. It could equally tempt companies to keep more stocks than before, to diversify their supply chains more and to reduce the specificity of inputs. Such measures are likely to increase overall resilience to shocks (Felbermayr and Görg, 2020).

337. However, shortening **global supply chains** would **involve considerable welfare losses for the economy as a whole** (IBRD, 2017). These decisions should be taken by companies with the necessary information advantage over policy-makers. On the one hand, domestic production could lead to improved supply security; on the other, higher trade barriers reduce the average efficiency of economies. Overall, the **effects of greater trade liberalisation** on the resilience of value chains are likely to depend largely on the **nature of the shock** (Baldwin and Evenett, 2020; Felbermayr and Görg, 2020). Caselli et al. (2020) show that macroeconomic volatility increases with trade liberalisation in response to sectoral shocks. However, if the shocks are regionally uncorrelated, then international trade has an insurance function. Such country-specific shocks are quantitatively much more important than sectoral shocks (Caselli et al., 2020).

338. The coronavirus pandemic is a shock that affects all countries and all economic sectors. Although this does not mean that the crisis affects the world's regions in an uncorrelated way, the **epicentres** have **shifted globally over time**. Diversification of supply chains is unlikely to generate much more value added if many

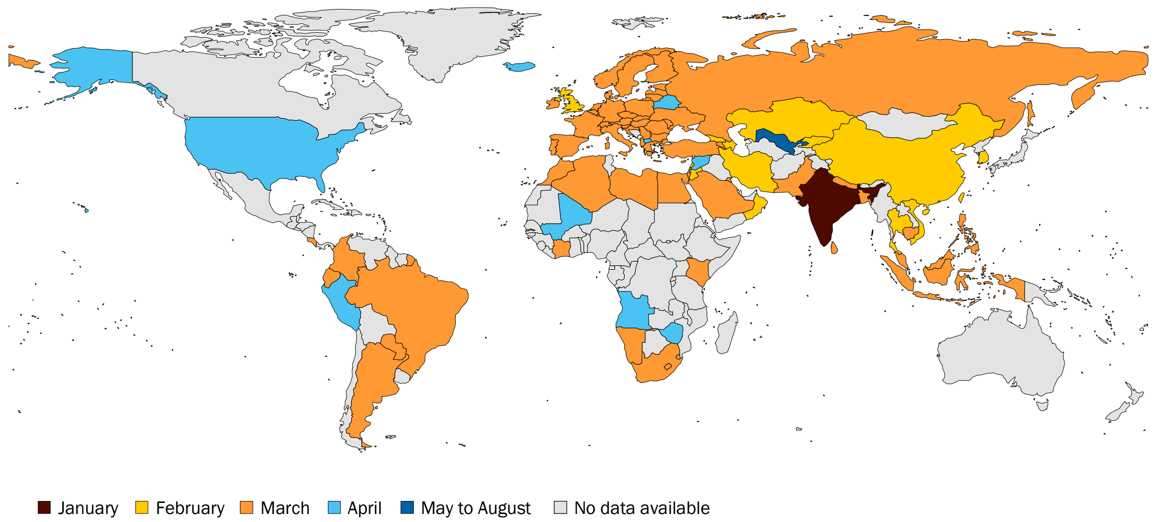
countries are in shutdown. Diversification could be helpful if shocks occur locally, or if only a few economies are affected at the same time (Costinot et al., 2013; Baldwin and Evenett, 2020; Egger, 2020). While Europe and, shortly afterwards, North America were experiencing major outbreaks early in the year, China and other parts of Asia were already boosting their production capacities again.

Far from the expected independence, domestic production thus does not inevitably offer greater resilience. Rather, it counteracts the specialisation gains of the global division of labour and makes production more vulnerable to regional risks. This is demonstrated not least by the experience of recent months: **new export restrictions** were imposed during the coronavirus crisis **in parallel with the respective course of the pandemic**. ↘ CHART 57 After the acute increase in demand passed, these restrictions were mostly lifted again (GTA, 2020). When Europe experienced supply shortages of medical products in March, they were not yet acute in the United States and no longer acute in China. In this respect, **global trade** was able to take on **the function of a production-loss insurance.** Even so, supply bottlenecks may affect individual supply-critical products for which there are few, if any, alternatives.

339. This result is underscored by past experience with **supply-chain interruptions caused by disasters**. They show that companies with a well-diversified global supplier structure are more resilient (Todo et al., 2015; Kashiwagi et al., 2018). As climate change progresses, natural disasters and associated production disruptions could become more frequent in the future (Bolton et al., 2020). Thoughts on how to organise supply chains more resiliently are therefore highly relevant, also after the acute crisis situation. Reducing future susceptibility to disruption means ensuring high diversification in supply chains in the long term (Baldwin and Evenett, 2020).

↘ CHART 57

Many new export restrictions on the trade in medical products since the beginning of the Coronavirus pandemic[1]



1 – As of 21.08.2020. Countries that have introduced new export restrictions on medical products since the beginning of 2020 are coloured. The chart shows the month in which such a restriction was first introduced.

Sources: Global Trade Alert, European University Institute, World Bank, own calcualtions

Safeguarding the supply of medical products at the European level

340. As a reaction to temporary supply shortages of medical products, nations all over the world imposed export restrictions during the coronavirus pandemic to ensure the supply of medical products to their own populations. By August 2020, 234 new **non-tariff trade restrictions on medical products** and food were introduced in the context of the coronavirus pandemic (GTA, 2020). ↘ CHART 57 Even within the EU, at the beginning of the coronavirus pandemic member states imposed various national trade restrictions on protective medical equipment contrary to the spirit of the common Single Market (BMWi, 2020a). It was not until the European Commission announced that all exports from the Single Market to third countries would be subject to approval (European Commission, 2020q) that almost all countries, including Germany, lifted their national export restrictions (BMWi, 2020b).

341. For a short period early this year, adequate supplies of protective medical equipment were not ensured in all countries. In line with the solidarity principle, a scenario should be avoided in which member states compete directly with each other in the procurement of scarce equipment in the event of a crisis. Introducing export restrictions does not solve the problem of an international lack of production capacity for certain medical products that are temporarily in high demand. Rather, such measures prevent a division of labour in production (Felbermayr and Görg, 2020). Germany and the EU should work to **reduce existing trade barriers**, particularly in connection with critical medical products, and to **avoid new export restrictions** (González, 2020). Not least, European trade restrictions on medical products are likely to have significant negative impacts on emerging economies and developing countries (Bown, 2020).

342. The Treaty of Amsterdam states that **member states are responsible for the organisation of healthcare services** and the provision of medical care (European Union, 1997). In accordance with the **subsidiarity principle**, therefore, responsibility in this area should be transferred to the EU level only where independent action at the member-state level is insufficient. Nevertheless, a **permanent crisis mechanism** could be established **in the European healthcare system.** Cross-border concepts for dealing with pandemics are likely to lead to greater European crisis resilience in the long term. Reliable joint European coordination could counteract national action in the second wave of the pandemic and in future health crises.

343. At the beginning of the coronavirus pandemic, there were supply bottlenecks, for example for respiratory masks and various medicines, in Germany and many other countries. Particularly in Italy, there was a dramatic shortage of intensive-care beds and ventilation equipment in spring. Such bottlenecks within Europe could threaten again in the second wave of the coronavirus pandemic. To avoid possible supply bottlenecks in acute health crises in the future, **stockpiling medicines and general medical equipment** could contribute to resilience. Inventory management could be organised along similar lines to strategic oil reserves, which are intended to bridge short-term supply bottlenecks (Braml et al.,

2020). The stockpiling of medical goods can be organised on a national or European basis; in the case of perishable medicines, a sensible system would have to be found in which stocks are used according to their shelf lives. Stocks could be managed in such a way that a certain **period can be bridged until unavailable imports can be substituted by a switch in domestic production**.

A reorganisation of medical inventory management could generate significant **added value at the European level** with supply chains becoming more robust vis-à-vis crisis-related supply bottlenecks **without giving up the advantages of the international division of labour**. ↘ BOX 13 With financial support from the European Commission, several member states are currently building up joint European stocks of vital protective and other medical equipment that can be distributed throughout Europe in the event of a medical emergency (European Commission, 2020r). Under the new MFF, the EU will for the first time receive a budget for the independent procurement of spare capacity for medical products. In parallel, some member states are planning the creation of strategic inventory management of medical goods at the national level (Koalitionsausschuss, 2020). If a common European system of medical inventory management is set up, there could be a relatively high degree of dependence between member states in the event of an acute crisis. It is unclear whether an efficient allocation of goods can still be achieved in times of crisis. Even so, in the interests of efficiency, duplicate structures should be avoided as far as possible.

344. **Joint European procurement measures** can provide access to a larger number of suppliers and contribute to **an even distribution of access for the member states**, particularly when there are sharp price rises for individual products as a result of a crisis-related supply shortage (Aghion and Tirole, 1997; Dimitri et al., 2006; Dessein et al., 2010). If, as in the coronavirus crisis, an acute threat to a single national critical infrastructure has cross-border effects, European measures could therefore be more effective than purely national approaches (European Union, 2008).

The **Joint Procurement Agreement (JPA)** is an instrument that already exists at the European level to guarantee equal access to certain medicines and critical medical equipment and to improve security of supply with balanced pricing in the event of serious cross-border threats to health. However, the use of this instrument during the coronavirus crisis has revealed the **weaknesses of the largely voluntary system** without distinct EU competences. The JPA is designed to offer the advantages of joint procurement without the disadvantages of relinquishing sovereignty. As a result, the instrument hardly exudes reliability. The JPA can in principle be used in parallel with the procurement of the same product at the national level. Since the beginning of the coronavirus, this option has been used by several member states including Germany (BMG, 2020a). In such cases, the EU ends up competing with its own member states, which is presumably contrary to the objective of the joint procurement measures.

345. The **procurement of a vaccine to combat COVID-19** will be of particular importance. A common European strategy can put the EU in a stronger position on the world market and probably ensure more cost-effective and reliable access

to the vaccine for the member states. On 17 June 2020, the European Commission presented a European strategy for accelerating the development, production and supply of vaccines against COVID-19 (European Commission, 2020s). For the right to purchase a certain number of doses of vaccine within a given period, the Commission will finance part of the upfront costs for several vaccine manufacturers by giving purchase guarantees. This approach reduces the investment risks for vaccine manufacturers as long as there is no guarantee that the vaccines will pass the clinical trials successfully. At the same time, significant business risks are being shifted from vaccine manufacturers to the EU level. However, in order to benefit from economies of scale, a **common and coordinated approach at the EU level** is **desirable** overall.

346. At the German and European level, various voices have been raised in favour of an – at least partial – **relocation of drug production to Germany or Europe** (Koalitionsausschuss, 2020). In their decisions of 16 July, the health ministers of the member states announced their intention to transfer the production of important drugs back to the EU in future (BMG, 2020b). While a reliable joint procurement strategy and a reorganisation of medical inventory management can strengthen the EU's resilience to future health crises, the discussion about relocating production facilities back to the EU to overcome dependencies is **not expedient**. A restructuring of European value chains towards greater nationalisation is likely to entail **considerable efficiency losses** (Flach and Steininger, 2020; Sforza and Steininger, 2020). A European self-sufficiency policy in the pharmaceutical sector cannot adequately guarantee security of supply in times of crisis (Braml et al., 2020). It would be expedient to spread the sources of supply further across countries, regions and continents ↘ ITEM 338, although, taken together, Germany and the EU are in any case not very dependent on trade relations with individual countries in their supplies of medical goods. ↘ BOX 13

V. CONCLUSIONS

347. The coronavirus pandemic is a **severe test for the EU** and its member states. To cushion the economic impact of the pandemic, many governments have adopted economic policy measures on an unprecedented scale. The **faster response time** and the possibility of **targeting** measures **precisely** in the event of a heterogeneous and time-staggered spread **seemed to call for action at the member-state level** at the time. The European Commission's flexible interpretation of the aid and budget regulations opened up the necessary leeway for such national responses by the states. No faster or stronger fiscal response capacity via the EU budget existed at the EU level, and this has not changed. National risks differed according to the severity of the crisis in the individual countries and their preparedness for national economic policy responses. These risks were diversified in the short term at the European level by the instrument of the European short-time-working allowance (SURE), which was temporarily used during the crisis, and by extended loans from the European Investment Bank. The possibilities of the ESM, which were expanded during the crisis, have not been used to date.

348. In the **short term**, all levels, both national and European, must prevent a longer-lasting economic downturn and **overcome** the economic **consequences of the coronavirus pandemic** as quickly as possible. The smooth functioning of supply chains, some of which were interrupted in the first phase of the pandemic, is an important prerequisite for this. The return to a sustainable growth path in all EU member states is of great importance because of the strong trade relations. However, this requires fiscal leeway; at the same time, sovereign debt crises must be avoided. Alongside the ECB's monetary policy, the ESM contributes to these objectives on the fiscal policy side. Moreover, the agreement on the Recovery and Resilience Facility is a sign that fiscal policy is responding. This offers an opportunity to increase member states' **resilience** to future crises by investing in productivity and growth and thereby facilitating structural reforms.

349. The EU's task in the **medium term** should be to **ensure competition**, for example by providing the national support for small and medium-sized enterprises that is needed in the acute crisis. In addition, the relaxation of state-aid and banking regulations should be reversed so as not to distort competition and to **prevent risks to financial stability**. The sharp increase in public debt as a result of the national aid measures jeopardises resilience to future crises. The debt-to-GDP ratios should therefore be reduced again in the medium term. Past experience suggests that sustainable reforms aimed at increasing competitiveness and consolidating public finances will be successful above all if they emerge from the insight of the member states themselves and are implemented domestically with sufficient political acceptance (ownership).

350. A **permanent continuation of measures introduced** in the short term **during the crisis**, such as SURE, as a permanent reinsurance system, or the debt-financed Recovery Fund, **should be avoided**. Instead, a reform of the EU's fiscal framework geared towards countercyclical incentives could reduce public debt to sustainable levels. A permanent European fiscal response instrument would have to avoid permanent financial transfers that create undesirable incentives for national economic policies. For example, EU unemployment insurance should not be introduced without harmonising national labour-market policies. A debate detached from the acute crisis could be more expedient for such far-reaching measures. More generally, such a marked expansion of fiscal policy competences at the EU level would have to be accompanied by a corresponding renunciation of sovereignty by the member states in economic and financial policy. This will not be possible without amendments to treaties and constitutions.

351. In the long term, the EU should focus on the policy areas where it can generate European value added. This can be achieved above all by strengthening the common Single Market. In this context, new momentum should be generated to **promote growth and increase productivity** in the member states. In particular, investments in digital change and the transformation towards a climate-neutral economy are crucial for this. The resources of the European Recovery and Resilience Facility can initiate this transformation. Close coordination at the European level is required for other challenges, such as Brexit and securing the supply of

medical goods in the future. In accordance with the principle of subsidiarity, however, powers should only be transferred to the EU level to the extent that a problem cannot be efficiently resolved at the national level.

Tasks with unequivocal **European value added** can be found not least in traditional areas of government action, especially in **foreign, defence and security policy**. The EU institutions which already exist in these policy areas should be permanently strengthened if the EU is to succeed in representing its interests more effectively in the international arena.

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