The European Policy Response to the Covid-19 Pandemic

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Subcommittee Chairman Keating, ranking member Kinzinger, members of the Subcommittee, it is a pleasure to brief you today on the European policy response to the Covid-19 pandemic.[1] In my written comments, which will focus on policy actions taken in the European Union (EU) and euro area, I will address two issues: The macroeconomic policy response in the EU and euro area and the important political role played by climate change and digital transition considerations in the design of the European response.

I The Macroeconomic Policy Response in the EU and Euro Area

The EU27 in early March 2020 became the first major economic region outside of China impacted by the Covid-19 virus. Early and virulent outbreaks in Italy, Spain, and France quickly spread to the rest of the EU, after which European leaders—with the noticeable exception of the Swedish government—implemented national economy-wide lockdowns in the attempt to stem the spread of the virus. Following the early confusing health policy response to the sudden pandemic, including short-lived and counter-productive national and EU-level restrictions on trade in personal protective equipment and other relevant medical supplies,[2] comprehensive national economic lockdowns and rapid progress in testing capabilities resulted in the pandemic peaking in the EU27 excluding Sweden in early April 2020, in terms of new Covid-19 cases and deaths (Figures 1 and 2).

The pandemic in the EU27 excluding Sweden declined rapidly in intensity in the following weeks and by mid- to late May 2020 reached a level low enough for most EU governments to begin a gradual reopening of their economies. The pandemic trajectory in Sweden, which did not implement a nation-wide economic lockdown but instead relied on ultimately less coercive policies in the form of strong government encouragements to maintain social distancing and other measures to reduce the spread of Covid-19, has been different from the rest of the EU. Confirmed cases and deaths per capita reached higher levels and have not yet declined to levels seen in the rest of the EU.

Following the economic lockdowns implemented in early/mid-March 2020, the European Central Bank (ECB) on March 18th instituted an aggressive monetary policy easing centered on the expansion of asset purchases and especially the €750 billion Pandemic Emergency Purchasing Program (PEPP)[3], aimed at stabilizing euro area sovereign debt and other financial markets. The PEPP, which was on June 4th

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[1] 1 I am grateful to my colleagues at the Peterson Institute for ongoing and highly rewarding discussions of this and related issues, in particular Olivier Blanchard, Jean Pisani-Ferry, Patrick Honohan, Nicolas Véron and Adam Posen. Any errors are solely mine.

[2] See Chad Bown for a detailed discussion of this early and temporary European policy error at https://www.piie.com/blogs/trade-and-investment-policy-watch/eu-limits-medical-gear-exports-put-poor-countries-and

[3] See ECB press release at https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html

expanded with an additional €600 billion,[4] is characterized by a high degree of flexibility in the ECB's asset purchase choices, and as such enables the central bank to provide additional financial market support for particular highly indebted euro area member states, such as Italy, badly affected by the pandemic. The principal macroeconomic aim of the PEPP has been to enable all euro area member state national governments, the region's all-dominant fiscal actors, to implement any required pandemic policy response without immediate concerns regarding available financing and market reactions after mid-March 2020. With euro area sovereign bond yields now roughly back at pre-pandemic levels, the ECB has been successful in this endeavor.

In addition to its large-scale asset purchases, the ECB in response to the pandemic also launched new large-scale liquidity provision to the banking system,[5] the most important credit intermediator in the euro area (in contrast to the United States, where most credit is intermediated through financial markets). The ECB also began a policy of offering loans to euro area banks at rates up to 100 basis points below the ECB deposit rate.[6] This provides eligible euro area banks with an explicit financial incentive to access ECB loans and channel them on to the wider euro area economy, and enables the ECB to de facto replicate the stimulative effect of a further cut further into negative territory in short-term policy rates.

In total, the ECB's pandemic monetary policy responses represent a very rapidly deployed and significantly scaled up version of the asset purchases and liquidity provision strategies implemented only gradually following the Global Financial Crisis (GFC) after 2008. As such, the current ECB leadership appears to have learned important lessons from economic developments in Europe after the GFC and has today implemented a far more aggressive and to date broadly effective monetary policy response.

Following the onslaught of the pandemic and the imposition of economic lockdown measures, EU27 and euro area governments implemented a wide range of fiscal support measures for the European economy. Significant differences exist between individual EU countries' national fiscal responses, but the overall magnitude of the spending increase (new discretionary stimulus + automatic stabilizer spending) is very large and represents a marked difference from the austerity years following the GFC and during the Greek sovereign debt crisis. The main economic efforts are focused on three things:

1) providing income security to residents,
2) maintaining workers' existing employment relations during the lockdown, and
3) ensuring the financial viability of as many firms as possible.

General income security for EU residents is typically provided through the existing automatic stabilizers and social safety net via direct income support, general access to paid sick leave, and other targeted support measures already in place. As such, European social models were overall relatively well prepared for a sudden pandemic lockdown, when compared to advanced economies like the United States, where permanent public income support is less readily available.

[4] See ECB press release at
https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.mp200604~a307d3429c.en.html
+[5] See ECB press release at
https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200430_1~477f400e39.en.html
[6] See ECB press release at
https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200430~fa46f38486.en.html

Very large fiscal expenditures have been channeled towards different versions of direct government wage subsidization of 80-90 percent of firms' labor costs during the lockdown measures to avoid layoffs and increases in unemployment, to the greatest extent possible, during the lockdown. These subsidies were made available in the expectation that the frequently draconian and economy-wide lockdown measures implemented by mid-March 2020 would ultimately prove effective and hence relatively short in duration. Once the economy would be able to reopen, as large a share of the workforce as possible, would be able to return to their existing job, minimizing pandemic economic dislocation and labor market friction.

To date, this policy has been largely successful, as pandemic related increases in EU unemployment have been far lower than in the United States (figure 3). It is also noteworthy that Sweden, which did not implement a nationwide economic lockdown, does not appear to have gained any labor market benefit from this policy, as its level of unemployment remains higher and has risen more than its comparable Scandinavian neighbors (figure 3). This should be a cautionary tale for advocates of a direct employment trade-off between the severity of the economic lockdown and job losses.

However, it remains too early to say whether very expensive wage subsidies will be maintained for long enough for the EU economies to fully recover, implying that a significant future increase in European unemployment rates remain a distinct possibility, once generous government wage subsidies are eventually phased out. Should the pandemic lead to lasting shifts in consumer preferences, firms in negatively affected sectors in for instance cruise line related businesses, would not be viable after wage subsidies end, even if the overall economy fully recovered. It further remains an open question whether wage subsidies implemented in March could be maintained in the EU, if a 2nd pandemic wave were to affect the region.

Lastly, EU governments offered varying degrees of credit guarantees to national firms, temporarily protecting them against some forms of financial stress. Some EU government went further and directly offered to temporarily subsidize parts of their firms' fixed costs, in order to avoid that otherwise viable firms go bankrupt during the pandemic. As with European wage subsidies, to date this policy has generally been successful, but it remains too early to say if most European beneficiary firms ultimately survive the pandemic. Or even if, given the potential for pandemic related sectoral reallocations of consumer and investment demand, most firms should be kept afloat via this form of direct government subsidies.

Overall, due to the severity of the virus outbreak and the comprehensiveness of lockdown measures implemented to combat them, the euro area economies are projected to suffer a historic decline in economic output of more than 9 percent in 2020—about 2 percentage points more according to the latest OECD projections from June 2020 than the United States (figure 4). The euro area economy though, due to a combination of gaining control over the pandemic and the high and timely degree of policy support provided, is estimated to recover faster than the United States, growing 6.5 percent in 2021, against a projected only 4.1 percent in the United States. Sweden further appears to have gained no overall short-term economic benefit from its lack of pandemic economic lockdown, as its 2020 economic recession is expected to be as deep as in its comparable neighboring countries. Indeed, with the weakest OECD projected economic recovery in 2021 in the EU with only 1.7 percent growth, Sweden looks set to continue to pay an economic prize for its choice of a "no lockdown Covid-19 strategy." Lastly, it is clear that the latest dramatic rebound in the number of US Covid-19 cases can be assumed to amplify the divergent economic recovery paths in the United States and Europe.

The vast majority of the pandemic fiscal response has naturally to date come from EU member states' national governments, facilitated by ECB asset purchases. However, while all of Europe has been heavily affected by the pandemic though no fault of their own, some member states were affected earlier and more severely than others (figure 4). As the most affected group is concentrated among already heavily indebted member states like Italy, France and Spain, the European pandemic policy response has also had to include a dramatic increase in common European-level policy measures with potentially sizable fiscally redistributive effects.

This has been necessary both for economic reasons to ensure that all member state governments are fiscally able to take any pandemic related measure required, while avoiding a further deterioration in the economic and financial imbalances in the euro area and rest of EU by already highly indebted countries becoming even more so. It is a political necessity, as European citizens needs to feel, at a time of acute personal and economic pandemic stress, that EU membership entails a degree of common insurance against the worst outcomes. Without such an implicit insurance policy from EU membership , some EU populations might turn against the EU in the medium term.

Initially, a support common fiscal package was negotiated among finance ministers in early April 2020[7], focusing on the access to unconditional loans from them European Stability Mechanism (ESM) to member states for pandemic related expenditures, additional capital for the European Investment Bank (EIB) to provide more financial support to EU SMEs, and a new initiative enabling the European Commission to first borrow up to €100 billion in joint funds and then lend it on to member states to support efforts to protect workers and jobs and health-related measures. This initial package did represent a significant break with EU and euro area precedent, as ESM loans were made available without country-specific reform conditionality and the European Commission would be able to borrow up to €100 billion in common funds to be channeled towards a commonly agreed purpose in combating the pandemic.

On May 18th 2020, however, German Chancellor Merkel and French President Macron made a significant additional proposal for a €500 billion joint EU pandemic recovery fund (RF)[8], linked to the regular 7y EU budget, conveniently scheduled to be negotiated by the EU member states in the early summer of 2020 anyway. Crucially, the Franco-German proposal stipulated a common debt-funded RF able to make investment grants to member states in relation to how badly their economies have been affected by the pandemic, as well as within the sectors already identified as long-term EU policy priorities, noticeably climate change and digital transition (5G).

The RF and the regular 7y EU budget from 2021-27 are currently being negotiated among the 27 EU member states based upon a new proposal from the European Commission foreseeing a total common EU pandemic fiscal response of €750 billion, split between €500 billion in grants and €250 billion in loans to member states. The outcome remains uncertain, though a final political agreement is expected on the upcoming EU Council Summit under the leadership of the EU Council's new incoming rotating chair, German chancellor Angela Merkel on July 17-18th 2020.

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[7] See EuroGroup press release at https://www.consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-the-comprehensive-economic-policy-response-to-the-covid-19-pandemic/

[8] See May 18th 2020 joint virtual press conference at https://www.france24.com/en/20200518-live-macron-and-merkel-present-joint-covid-19-recovery-plan-for-eu

This probable outcome is brought about partly by Brexit, as the United Kingdom was traditionally among the strongest opponents of any expansion of the EU budget. Its departure from the EU has therefore made reaching an agreement to do so easier. Secondly, Chancellor Merkel's German center-right CDU/CSU party has shifted away from its traditional opposition to further fiscal integration. Partly, this is due to a broader and gradual realization among the German business community that their long-standing export orientation will not this time be supported either by the US consumer or like after the GFC by Chinese investment-led economic stimulus. As a result, Germany will have to spend more itself to boost its own and Europe's economic recovery. And partly, it is due to an apparent personal change of heart by Chancellor Merkel, who is currently enjoying record high approval ratings for 85 percent for her handling of the Covid-19 pandemic after 15 years in office. Hitherto a reluctant European integrator, she now appears intent on securing a political legacy also at the EU level.

Brexit and the shift among Germany's conservatives have left traditionally fiscally conservative smaller member states like the Netherlands, Austria and the Scandinavians without large member state political allies in the EU. This suggests that these countries will ultimately be unable to block the Franco-German RF proposal, but may secure some concessions in terms of its ultimate design and on other unrelated policy areas of their interest.

II The Political Role Played by Climate Change and Digital Transition (5G) in the European Policy Response

In the probable event that EU leaders will agree a compromise along the lines currently being proposed by EU Council president Charles Michel[9] including as proposed by Chancellor Merkel and President Macron a €500 billion grant-based pandemic recovery fund, it would represent a very significant additional fiscal integration measure in the EU.

It would be the first time the EU will issue debt common debt of this magnitude (€750 billion equals 5.4 percent of EU27 2019 GDP); it will be the first time the EU would launch a common fiscal policy initiative with an explicit counter-cyclical stimulus purpose (post-pandemic economic recovery); and it will be the first time that the EU will engage in a supplementary common fiscal policy measure (outside the regular EU budget, which has always had a limited fiscally redistributive character) with the explicit intent to facilitate limited fiscal transfers between member states.

Politically, an investment grant-making RF would similarly represent a significant integrative step for the EU. It would be the first time EU leaders has together identified a commonly shared problem of such severity (post-pandemic economic recovery) to justify the issuance of joint debt to help solve it. A historical parallel exists here with the political argument offered by Alexander Hamilton ahead of the Compromise of 1790, that saw the federal government take over the debts of the US states. These state debts were overwhelmingly incurred in the joint struggle against the British Empire during the War of Independence, presenting an important political argument for Hamilton for their absorption by the federal government.

Important differences obviously exist between the 1790 ex post mutualization of US states' existing debts by the federal government and an ex ante EU agreement to issue new common debts towards a commonly agreed purpose. And the creation of a grant-giving RF would not, given that the EU continues

[9] See EU Council press release at https://www.consilium.europa.eu/en/press/press-releases/2020/07/10/president-charles-michel-presents-his-proposal-for-the-mff-and-the-recovery-package/

to lack federal political institutions, represent a dramatic shift towards a politically more integrated federal Europe. Yet, at the same time, an RF of the envisioned nature would have important precedent setting effects in the EU, establishing the principle that EU leaders can identify particular problems so grave that they can be addressed with joint debt issuance.

While it has taken the worst pandemic in 100y hitting Europe to unleash this initiative, and the one-off nature of the RF is emphasized by many EU leaders, including Chancellor Merkel, it nonetheless is likely that future elected EU leaders will in times of future crises affecting the EU look to the pandemic related events of the spring of 2020 for a possible solution. The precedent setting effect hence is likely to "politically lower the threshold" for when joint EU debt can be issued to help address future crises. The RF hence is an important building block in a very gradual piece-by-piece (or crisis-by-crisis) establishment of a common EU fiscal capacity to complement the euro area's common monetary policy. This is particularly the case, as the financial market advantages in the form of a liquid debt benchmark of having a sizable amount of common EU debt outstanding is likely to in time delay or even prevent the repayment the €750 billion in RF debt.

That further fiscal integration now is to take place among all the 27 EU members, rather than just the 19 in the euro area, opens important longer-term institutional challenges for the EU. How can a fiscally integrative step among 27 countries complement an existing monetary union of only 19 of them? This tension seems likely to grow over time.

In addition to the joint experience of Covid-19 and lack of moral hazard issues related to the pandemic's economic effects, the most important enabling political factor for the creation of the RF is its intended ability to issue investment grants to promote the Europe's decarbonization goal and digital transition to 5G. Increasing jointly funded public investment levels in this manner has the economic advantage of (probably) increasing the EU's long-term potential growth rate in a manner similar to that of well-designed structural reforms. In principle therefore, a share of the incurred RF debts should be repaid by the additional tax revenues coming from the increased economic activity generated by the increase in public investments.

Focusing on climate change and the EU's existing ambitious decarbonization goals (carbon neutrality by 2050) and 5G investments, both existing long-term EU policy priorities, defuses a lot of the risk of a row among EU leaders over what to spend the newly created pot of common money on. Moreover, especially climate change related measures enjoy such strong political support among most EU populations (noticeably among the largest net contributors to the RF, such as Germany) that it greatly expands the political space for national leaders to agree to make commonly funded investments in this area. It is not by coincident that EU Council President Charles Michel are currently proposing that 30 percent of the total RF (and regular EU budget) is devoted to investments to reach the EU decarbonization goals. Without the political imperative of addressing climate change in the process, the willingness to raise large amounts of common EU debt to nominally help the post-pandemic recovery would be greatly reduced. Without the fight against climate change the post-pandemic RF would simply be a lot smaller than currently envisioned.

The importance of climate change in EU pandemic policymaking is also visible in the role it plays in the current attempt to utilize the virus emergency to give the EU greater ability to raise more direct revenue for its budget, reducing correspondingly the EU budgetary reliance on financial contributions from member states (hereby reducing their ultimate say over the design of future EU budgets). This is a very important political struggle in the EU, as the European Commission currently does not have the power to directly or indirectly tax EU residents, though the Commission does accrue all external EU trade tariffs directly to budget. In some ways therefore, today's EU budget bears some resemblance with the US federal budget before the passage of the 16th Amendment in 1913 granting the federal government the right to levy income taxes on Americans.

Current proposals envision that the European Commission create a new pan-European levy on nonrecycled plastic packaging waste, that the Commission derive the financial proceeds from any future EU carbon border adjustment mechanism, as well as benefit from some or all of the additional revenue generated by expanding the existing European Emissions Trading System (ETS) to also fully include the aviation and maritime sectors. Viewing revenue from an EU carbon border adjustment mechanism as essentially climate related trade tariffs and ETS revenue from the sales of emissions credits as carbon related "sin taxes", it becomes clear that the European Commission are today during the pandemic aiming rely on 21st century versions of precisely the types of revenues that made up the bulk of pre-1913 US federal government revenues[10].

Unless current US federal climate change policies are changed in the relatively near future, the creation of an EU carbon border adjustment mechanism would likely result in US exports being affected by it. This would add a further climate related trade conflict between the United States and the EU. The same is the case if the ETS is expanded to also include international flights, including by US carriers to Europe, or US flagged ships sailing in EU territorial waters or docking in European ports. Several potential climate related transatlantic disputes potentially lie ahead, given the details of Europe's pandemic response.

The RF's focus on the EU's digital transition and 5G investments on the other hand offer a potential for new transatlantic cooperation on 5G issues. Since potentially large new EU public investments in 5G are likely to overwhelmingly benefit European 5G producers Nokia and Ericsson, the role of Huawei and other Chinese manufacturers in the EU 5G market is likely to be potentially significantly smaller than otherwise would have been the case. Given the strong position of the US government on 5G investment issues, a pandemic recovery boost to public EU investment in mostly locally made 5G equipment should make a US-EU agreement on this set of issues easier to achieve.

[10] See Jacob F. Kirkegaard for a comparison of the currently suggested levels of new EU revenue with the historical US precedent from before 1913 at

Figures:

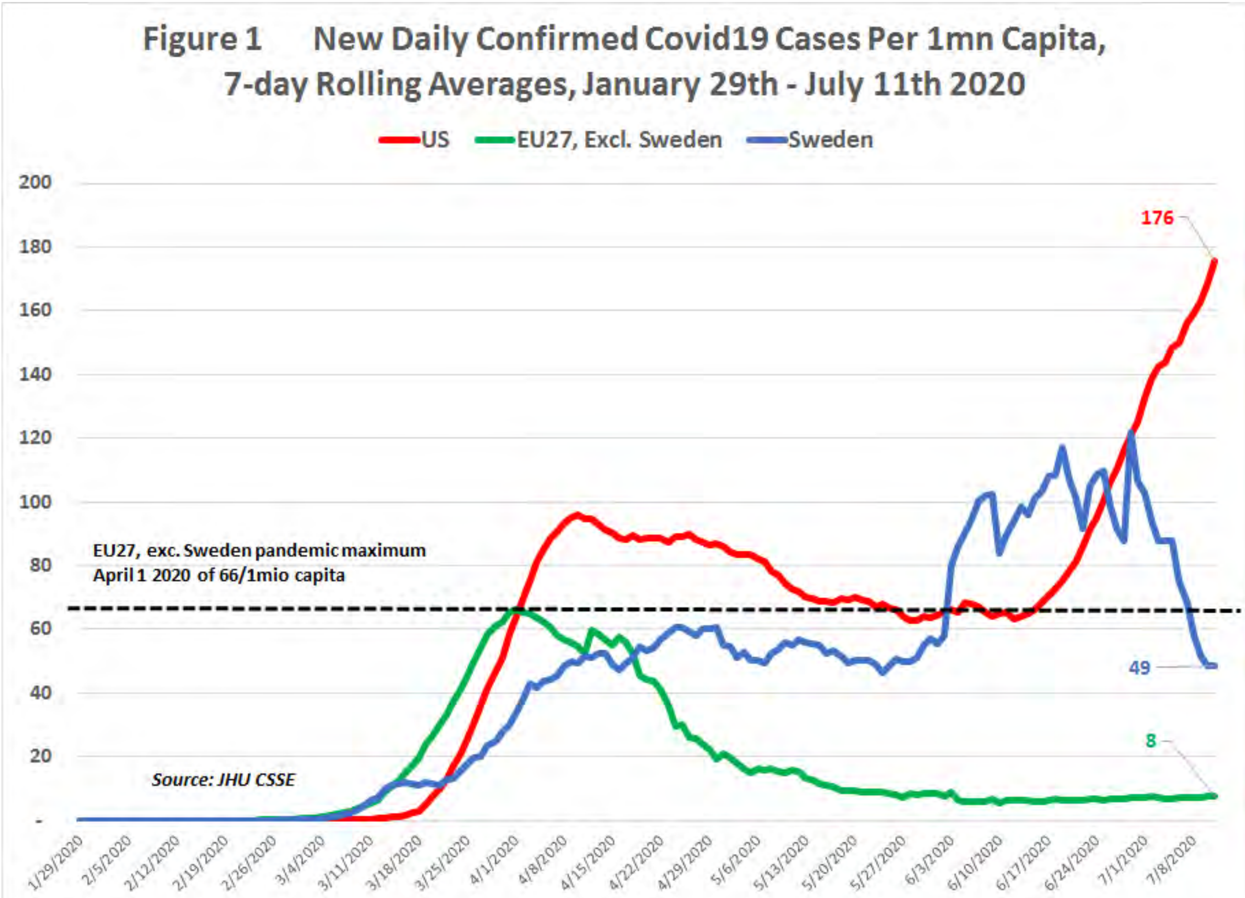

Figure 1 New Daily Confirmed Covid19 Cases Per 1mn Capita,
7-day Rolling Averages, January 29th - July 11th 2020
US
EU27, Excl. Sweden
Sweden
200
180
160
140
120
100
80
60
40
20
-
176
49
8
EU27, exc. Sweden pandemic maximum
April 1 2020 of 66/1mio capita
Source: JHU CSSE
1/29/2020
2/5/2020
2/12/2020
2/19/2020
2/26/2020
3/4/2020
3/11/2020
3/18/2020
3/25/2020
4/1/2020
4/8/2020
4/15/2020
4/22/2020
4/29/2020
5/6/2020
5/13/2020
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7/1/2020
7/8/2020

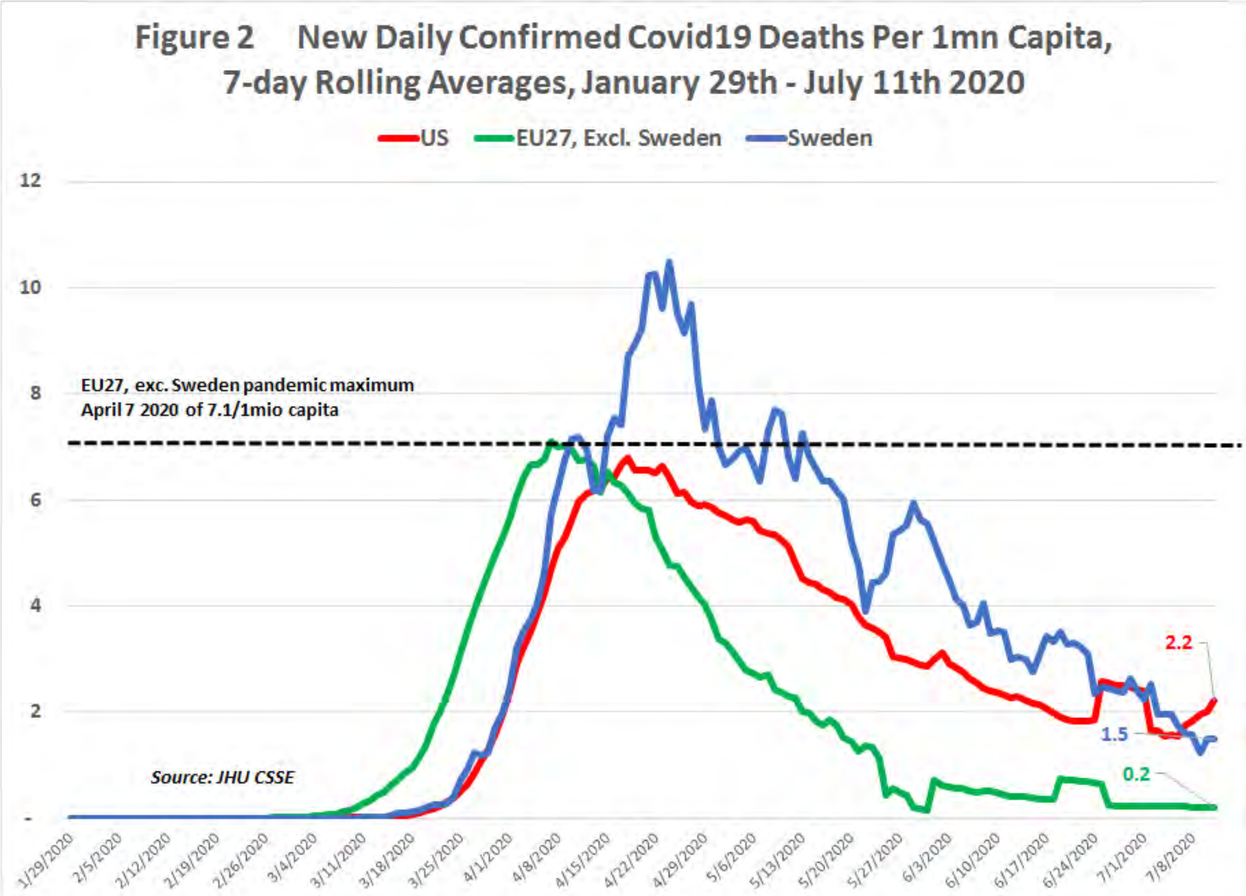

Figure 2 New Daily Confirmed Covid19 Deaths Per 1mn Capita, 7-day Rolling Averages, January 29th - July 11th 2020
US
EU27, Excl. Sweden
Sweden
EU27, exc. Sweden pandemic maximum
April 7 2020 of 7.1/1mio capita
Source: JHU CSSE
2.2
1.5
0.2
12
10
8
6
4
2
-
1/29/2020
2/5/2020
2/12/2020
2/19/2020
2/26/2020
3/4/2020
3/11/2020
3/18/2020
3/25/2020
4/1/2020
4/8/2020
4/15/2020
4/22/2020
4/29/2020
5/6/2020
5/13/2020
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7/1/2020
7/8/2020

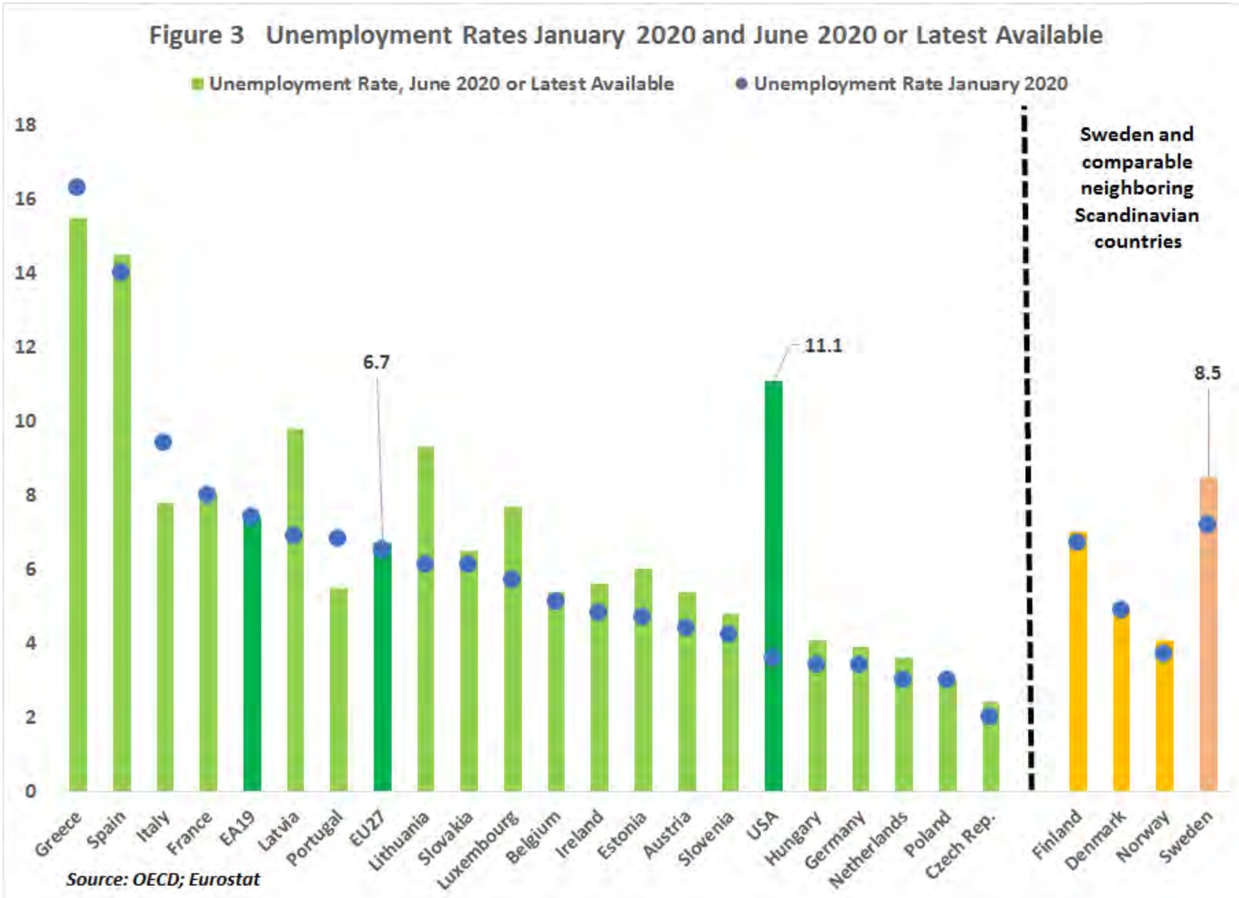
Figure 3 Unemployment Rates January 2020 and June 2020 or Latest Available
Unemployment Rate, June 2020 or Latest Available
Unemployment Rate January 2020
Sweden and comparable neighboring Scandinavian countries
6.7
11.1
8.5
18
16
14
12
10
8
6
4
2
0
Greece
Spain
Italy
France
EA19
Latvia
Portugal
EU27
Lithuania
Slovakia
Luxembourg
Belgium
Ireland
Estonia
Austria
Slovenia
USA
Hungary
Germany
Netherlands
Poland
Czech Rep.
Finland
Denmark
Norway
Sweden
Source: OECD; Eurostat

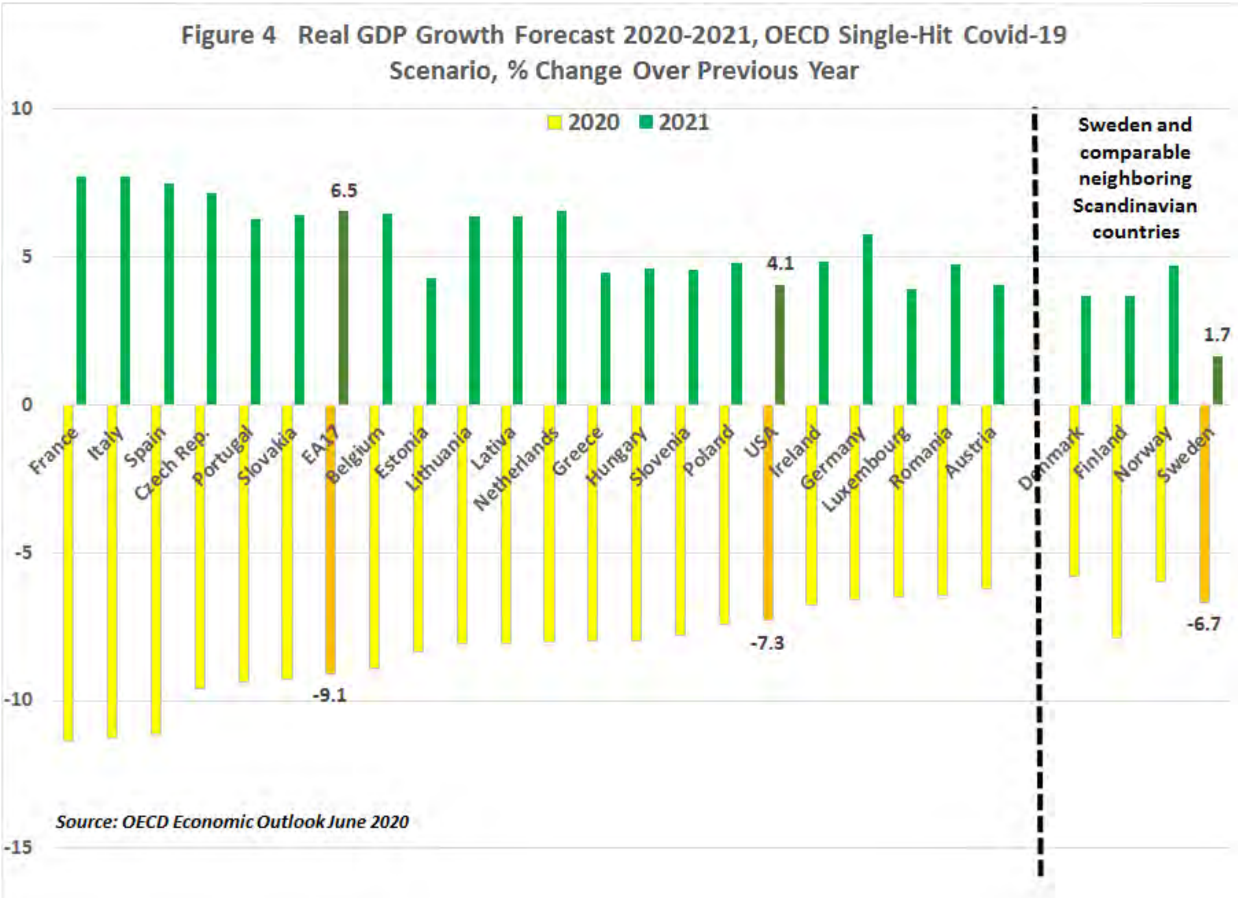

Figure 4 Real GDP Growth Forecast 2020-2021, OECD Single-Hit Covid-19 Scenario, % Change Over Previous Year
2020
2021
Sweden and comparable neighboring Scandinavian countries
10
5
0
-5
-10
-15
6.5
4.1
1.7
-9.1
-7.3
-6.7
France
Italy
Spain
Czech Rep.
Portugal
Slovakia
EA17
Belgium
Estonia
Lithuania
Latvia
Netherlands
Greece
Hungary
Slovenia
Poland
USA
Ireland
Germany
Luxembourg
Romania
Austria
Denmark
Finland
Norway
Sweden
Source: OECD Economic Outlook June 2020