THE EU RESPONSE TO THE ECONOMIC CONSEQUENCES OF THE PANDEMIC: CLEAR PROGRESS

Clear progress has been made at the European Council meeting this week. The proposals of the recent Eurogroup meeting on the creation of three safety nets have been endorsed. There is agreement to work on a recovery fund intended for the most affected sectors and geographical areas in Europe. Its financing would be linked with the multiannual financial framework. Importantly, Chancellor Merkel has declared that, in the spirit of solidarity, one should be prepared to temporarily pay a higher contribution to the European budget.

Back in September 2007, former Treasury Secretary Lawrence Summers wrote an op-ed in the Financial Times about how concern about moral hazard –which refers to the risk that providing insurance may distort behaviour- may make it difficult to take measures to support the economy or certain sectors in times of severe stress[1]. Moral hazard is at the heart of discussions in the eurozone about cross-border public sector risk sharing. For this reason, loans such as those provided by the European Stability Mechanism, come with conditions. This makes sense, because one wants to make sure that the money provided is well spent. Rather than the principle of conditionality, it is the appropriateness of the conditions which have caused debate[2] . Given the specific nature of the current crisis, the very light conditions attached to the emergency loans of the ESM –they should be used to finance expenditures directly or indirectly related to healthcare, cure and prevention- have been welcomed. Moral hazard concern also explains, to some degree, why in certain countries, there is strong opposition to the joint issuance of so-called coronabonds. German Chancellor Merkel has argued that these debates are untimely: it is better to focus on areas where agreement can be reached quickly rather than embarking on a very time-consuming process whilst the economy is suffering.

Against this background, clear progress has been made this week. The European Council endorsed the agreement reached by the Eurogroup on three safety nets, amounting to a package worth 540 billion euros[3] which should be operational by 1 June 2020. Moreover, there is agreement to work towards establishing a recovery fund. It is considered as needed and urgent and "*shall be of a sufficient magnitude, targeted towards the sectors and geographical parts of Europe most affected, and be dedicated to dealing with this unprecedented crisis.*"[4] Targeting specific sectors and regions should be strongly welcomed. Providing financing where it is needed most should imply a bigger multiplier effect.

1. *Beware the moral hazard fundamentalists*, Lawrence Summers, Financial Times, 24 September 2007.
2. One can think of the austerity imposed during the sovereign debt crisis.
3. The package corresponds to about 4.2% of eurozone GDP. It consists of 1/ the SURE programme -a temporary European instrument to support national safety nets- worth EUR 100 billion in terms of loans to countries facing the greatest pressures in terms of unemployment 2/ the European Investment Bank will create a pan-European shield to guarantee EUR 200 bn of lending, in particular to SMEs 3/ a Pandemic Crisis Support has been established for an equivalent of 2% of members states' GDP, i.e. close to EUR 240 bn. It consists of loans provided by the ESM to finance expenditures directly or indirectly related to healthcare, cure and prevention.
4. Source: *Conclusions of the President of the European Council following the video conference of the members of the European Council*, 23 April 2020, European Council

The European Commission is tasked to quantify the exact needs and urgently come up with a proposal whereby a link should be made with the multiannual financial framework (MFF). On this last point, German Chancellor Merkel's declaration in a speech to the Bundestag that "*we should be prepared, in the spirit of solidarity, over a limited period, to pay quite different, that is much higher, contributions to the EU budget because we want the economies of all member states in the EU to be able to recover*"[5] has an importance going far beyond Germany. It will entice other countries to do the same, paving the way, hopefully, for a swift agreement on an enlarged MFF. The European Council members were reminded of this urgency by the plunge of the services PMIs to record lows as well as by ECB President Christine Lagarde's warning that eurozone GDP could shrink as much as 15% this year.

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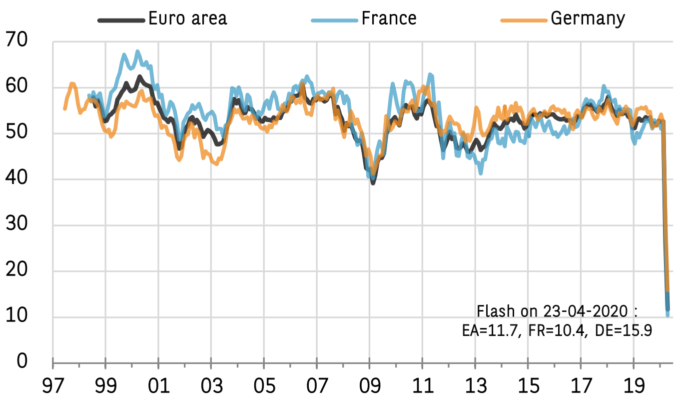
SERVICES PMI



SOURCE: MARKIT ECONOMICS, BNP PARIBAS

5. *Financial Times*, 23 April 2020

Chancellor Merkel's statement that Germany should be prepared, in the spirit of solidarity, to temporarily contribute more to the European budget will entice other countries to do the same, paving the way for the creation of the urgently needed recovery fund.