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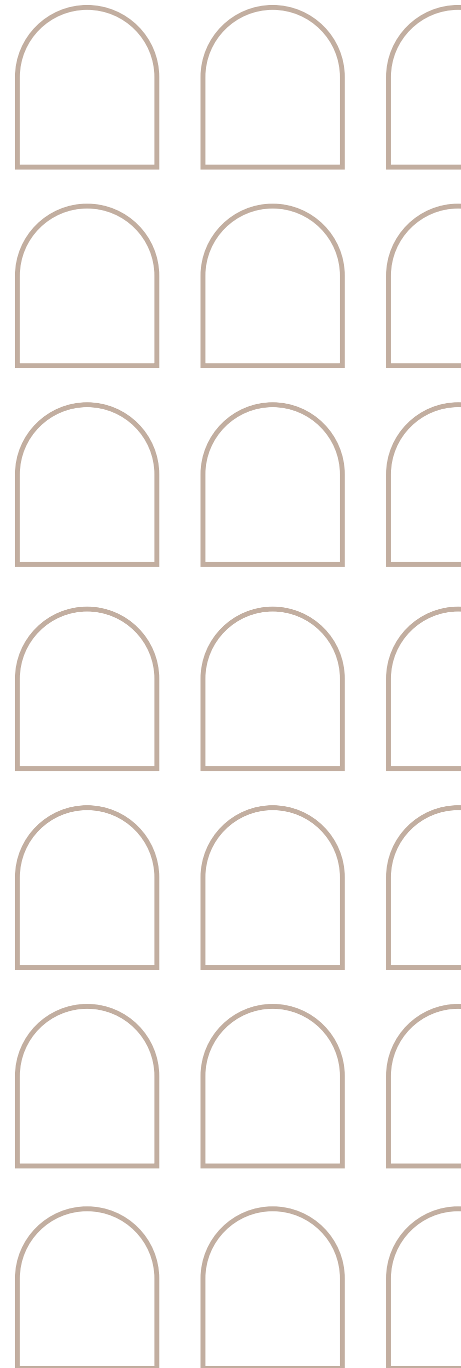

STG Policy Papers

POLICY BRIEF

DOES THE EU EVER LEARN? FROM THE FINANCIAL CRISIS TO THE COVID-19 CRISIS: LOOKING BACK TO MOVE FORWARD

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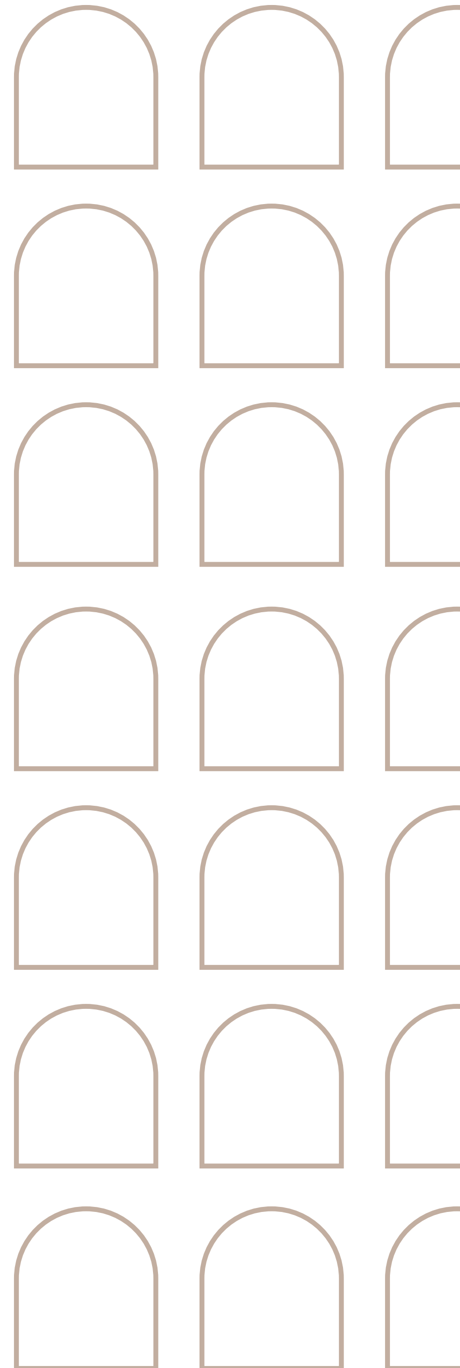

EXECUTIVE SUMMARY

The economic policy response to the Covid-19 pandemic broke new ground, in terms of ambition, tools used, and institutional characteristics. This policy brief argues that three sets of factors explain this: our evolving understanding of macroeconomics; the nature of the current crisis; and the policy learning from the financial crisis. It also reviews the emerging institutional landscape at EU level, with its rules-based and institutional features, and assesses critical factors for successful implementation of the Recovery and Resilience Plans at national level.

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1. THE COVID ECONOMIC POLICY RESPONSE AT NATIONAL AND EU LEVEL

During the Covid-19 crisis, EU member states were faced with what amounted to a "sudden stop" of economic activity because of the lockdowns and the simultaneous supply and demand shock in economic systems. The economic policy response was generally swift and decisive. It was aimed at maintaining liquidity through cash, debt and guarantees, ensuring households can delay payments, and workers receive pay-checks even in quarantine or if temporarily laid off; at the same time preventing mass insolvencies, ensuring firms have cash flows to pay workers and suppliers, especially small and young businesses. The logic was to focus on disaster relief first, followed by policies to facilitate the recovery.

EU member states differed both in generosity and in their mix of policy instruments, reflecting in part diverse underlying fiscal conditions. Such differences however were significantly less than in the Eurozone crisis, so that taken together, the overall fiscal effort as well as the liquidity provisions added in 2020 to a substantial 2,5 trillion euro (see Table 1), with a significant part of the effort carried over into 2021.

Table 1: National and EU responses to the Covid crisis

		Fiscal	Liquidity
NATIONAL, EA-19	2020 measures	420bn	2170bn
EU	SURE, ESM, EIB		540bn
	NG – EU	390+bn	360bn
ECB	PEPP		1850bn

Source: European Commission

While however the economic response first came at the national level, it was decisions by the EU institutions (ECB, Commission, Council) that set the stage for recovery and altered the discourse on economic policy and governance moving forwards. In a benign environment of low interest rates, the ECB played a key role from early on in ensuring the crisis did not spill over to financial markets and to stabilise markets for sovereign debt. It expanded its targeted and non-targeted refinancing operations, amended its collateral policy (expanding accepted collateral and eligibility, reducing haircuts) and crucially both renewed and expanded its asset purchases programme, while inaugurating the large mission-specific Pandemic Emergency Purchase Programme (PEPP), which included flexibility in the capital key and issuance share.

At the level of the European Commission, the early activation of the general escape clause in the Stability and Growth Pact (SGP) rules allowed member states to proceed with large scale fiscal relaxation. This was supplemented by measures for liquidity provision aimed at protecting firms (the relaxation of state aid rules allowing the activation of national guarantees, coupled with increased overall lending capacity by the EIB), safeguarding jobs (Commission borrowing and lending to governments to finance expenditures related to short time work - SURE) and assisting sovereigns (for the euro area, the decisions on European Stability Mechanism (ESM) pandemic crisis support).

In terms of EU decision-making however, the seminal moment was the July 2020 EU Council decision (European Council 2020) putting in place a new fiscal and governance framework. This

built on a Franco-German proposal that for the first time allowed for direct transfers to countries, in addition to loans, and on Commission proposals to finance these by borrowing in markets and temporarily lifting the own resources EU ceiling. The resulting EU Recovery Plan has two pillars (European Commission 2021c): a new recovery instrument of €750 billion which involves funding raised on financial markets for 2021-2024 (Next Generation EU); and a reinforced long-term EU budget for 2021-2027 (€ 1,100 billion). Together, these are aimed at assisting member states to recover and "build back better", by aligning public and private investment with broader EU goals, notably its green and digital agenda.

These decisions represent a clear break with precedent. This is true in terms of instruments (the use of grants, the push for new "own resources", the issuance of common debt on the part of the Commission); institutional mechanics (the return of the Community method); as well as in terms of the sheer magnitude of the underlying fiscal effort and liquidity provision.

What has underpinned this shift? Three broad factors have driven what we are observing. The first is the evolution in our understanding of macroeconomic policy beyond the EU - the new macro paradigm. The second is the different nature of the current crisis. And the third is policy learning from the eurozone financial crisis. Together, these explain why decisions taken to date differ in scope and nature from those in the financial crisis and potentially set the stage for closer European economic and political integration post-crisis.

2. HOW MACROECONOMICS HAS CHANGED

Over the long-term, the consensus in macroeconomics has constantly evolved, chiefly in response to crises or to an apparent disconnect between theory and reality. In this vein, the global financial crisis led to a change of the thinking around a number of issues. Chief among these is the insufficient focus on the complex role of banks and of financial institutions in the economy, and the associated risks related to liquidity and solvency for economic stability. The nature of macro financial linkages have become more important in economic discourse.

A related set of issues centres on the possibility of secular stagnation in economies (Summers 2013, Teulings and Baldwin 2014), an old concept that has seen some resurgence, suggesting that a number of factors (ranging from demographics to globalisation and the debt overhang) are dragging down the equilibrium real interest rate as well as long-term growth, despite advances in technology and productivity. In an environment characterised by persistently deficient aggregate demand, economies would be operating at the "effective lower bound" (ELB) which is however higher than the equilibrium real interest rate.

The policy implications of this shift in macroeconomic thinking are stark and are already having an impact on policy-making consensus, including in Europe. They relate to the overall macro policy stance, our understanding of debt sustainability, the mix of fiscal and monetary policy, and the role of central banks.

In a situation of persistent excess savings, with economies operating at or close to the ELB and little or no inflation, there are strong arguments for a macroeconomic policy stance that attempts to counteract chronically deficient aggregate demand and reach full-employment output with a more expansionary stance of fiscal policy. This would seem to reverse the overarching emphasis on "prudent" fiscal policies that dominated over a long period.

A corollary relates to the size of fiscal deficits and debt sustainability. In an environment of persistently low interest rates, there is increasing support from academic writing for higher "upper bounds" of fiscal positions as well as a discussion on the quality of fiscal expenditures that enter into their measurement. Equally, with debt to GDP levels historically high, the emphasis on establishing debt sustainability has complemented the focus on headline debt to GDP ratios with a more complex analysis reflecting i.a. the capacity to service debt.

Central to this new policy discussion is the fiscal-monetary policy mix and the role of central banks. Operating at or near the ELB, central banks including the ECB have increasingly resorted to unconventional measures, with an emphasis on asset purchases. This has raised a number of issues. The first is the delimitation between fiscal and monetary policy: the expansion of their portfolio with government securities effectively blurs the lines between classic monetary policy and government finance. The second - and related - is their call to governments (repeatedly by the ECB) to step up fiscal policy so as to avoid central banks bearing the brunt of policy adjustment. And the third is their increasingly important role in acting as a safety valve in avoiding disruption emanating from the financial sector.

The need to ensure a "congruent" policy mix (Bartsch et al. 2021) underpins an evolution in the relations between monetary and fiscal authorities in Europe. The ongoing monetary strategy review undertaken by the ECB and the review of the macroeconomic surveillance framework launched by the Commission, whilst institutionally independent, will need to result ex post into a coherent framework in both the short run and in the medium to long run.

3. THE DIFFERENT FEATURES OF THE COVID-19 CRISIS

The second broad reason explaining the different policy response at EU level is the features of the Covid-19 crisis compared to the eurozone crisis. In Table 2, we attempt to capture this difference along several dimensions. As argued in Buti (2020b), a key difference relates to the exogenous nature of the pandemic shock. Whilst a number of policy circles viewed the eurozone crisis as self-inflicted because of reckless behaviour, such arguments did not gain traction in the case of the pandemic.

Table 2: Comparing crises

	Eurozone crisis	Covid crisis
Source	Fiscal shock and/or financial sector imbalances	Combined supply and demand shock
Nature	Endogenous and asymmetric in origin	Exogenous and common in origin
Impact	Severe; asymmetrical on countries	Severe; asymmetrical on countries (and sectors)
Timing	Full economic shock felt over 1-2 years	Immediate economic shock over 1-2 quarters
Recovery	Slow, but durable	Fast(er), but fragmented

These differences in the nature and incidence of the crisis allowed for a completely different political narrative to develop which eventually resulted into a very different policy response. In the eurozone crisis, the prevailing narrative was one of moral hazard; avoiding it implied the design of policies that could demonstrate policy mistakes had consequences. Creditors dictated the rescue conditions. The leading role of the European Council within an intergovernmental setting was the way to impose those conditions. At a second stage, the rationale for a collective response was the preservation of the euro.

In contrast, the narrative during the current crisis is almost completely devoid of moral hazard elements. The focus is on a common threat that requires a common response. Countries who were hit hardest could benefit from EU solidarity. This allowed also to avoid operating under the so-called 'ultima ratio' doctrine where the EU help would come only at the very end after all domestic actions by the vulnerable countries had been taken and was actually conditional on such actions been undertaken.

4. POLICY LEARNING FROM THE FINANCIAL CRISIS

The eurozone financial crisis put EU governance rules and institutions in a stress test, as the very existence of the common currency area was called into question. As a result old rules had to be reinterpreted, new policy tools were devised, new institutions were created, and an overhaul of the EU economic governance started in earnest. However, also to justify rescue plans in creditor countries, there was an urge to go back to normality, withdraw the fiscal support and start implementing the rules again as quickly as possible. Whilst the institutional and political conditions at the time make ex post rationalisation a treacherous exercise, it is fair to conclude that the response to the Eurozone crisis was sub-optimal.

In our view, the main lessons from the eurozone crisis which are relevant for devising the response to the Covid crisis are the following (see also Buti 2020b):

- First, monetary policy has to be very forceful to stop self-fulfilling dynamics or the realization of negative equilibria. Whilst the ECB reacted very fast in the summer of 2007 with liquidity provisions at the first signs of market dislocations, it was more hesitant compared to other central banks in relaxing the monetary stance and embarking in asset purchases. It was only in the aftermath of the "whatever it takes" statement by Mario Draghi that the ECB came to be perceived by the markets as standing fully behind the integrity of the eurozone. As a certain amount of risk sharing is needed in EMU, either openly via national budgets or indirectly via the ECB balance sheet, for a time this was in short supply.

- Second, after a very severe shock, early withdrawal of fiscal stimulus is very costly. Analyses pioneered by Olivier Blanchard (see Blanchard and Leigh, 2014) showed that fiscal multipliers are much higher under large negative output gaps, especially if monetary policy approaches the effective lower bound. Again, in retrospect, after a strong fiscal expansion in 2009 which helped stem the negative shock, EU countries were too quick to "declare victory" and embark in sharp fiscal retrenchment.

- Third, achieving an appropriate euro area fiscal stance only via horizontal coordination of national policies is exceedingly difficult. During the Eurozone crisis, countries with fiscal space focused on their domestic situation and refused to use it, whilst countries with fragile fiscal conditions frantically searched for a fiscal space they did not have. So when the appropriate fiscal stance at the aggregate level was attained, this was usually via the wrong country distribution which meant also lower effectiveness due to lower multipliers. The intergovernmental *forma mentis* led to ruling out a central fiscal response either at EU or Eurozone level which meant a failure of subsidiarity.

The response to the pandemic benefitted from learning the lessons of the eurozone crisis. In addition to both the ECB and national fiscal policies reacting swiftly and massively, the commitment to keep a supportive fiscal stance in 2021 and 2022, helped by extending the General Escape Clause of the SGP to 2022 (European Commission 2021b), showed an awareness of the need to keep support as long as it takes. This was clearly communicated by monetary and policy authorities who stressed that the risk of doing too little largely outweighed that of doing too much. Finally, the Next Generation EU (NG-EU) initiative ensured a degree of vertical policy coordination, complementing national fiscal expansions.

5. GETTING THE EU GOVERNANCE RIGHT

Over the past several years, a growing debate has emphasised the importance of institution building relative to a purely rules-based system. Mario Draghi has made this point forcefully in comparing the effectiveness of monetary policy to fiscal policy responses (Draghi 2019).

To be sure, during the financial crisis there was a strengthening of rules-based coordination and institution building. However, as sketched out in Table 3, this took a specific complexion: both the main new institution (the ESM) and the most important strengthening of fiscal rules (the Fiscal Compact) were not only intergovernmental in nature, but the adoption of the latter was a condition for the adoption of the former. The first Banking Union pillar (the Single Supervisory Mechanism (SSM)) was supranational, but the second pillar (the Single Resolution Board) was mixed; while the necessary third pillar (the single deposit guarantee system or European Deposit Insurance Scheme (EDIS)) is still under discussion.

Table 3: Coordination processes in the EU: institution-building vs. rules-based coordination

Coordination mode	Financial crisis	Covid-19 crisis
Institution building	• European Financial Stability Facility (EFSF)/ European Stability Mechanism (ESM) • Single Supervisory Mechanism (SSM) • Single Resolution Board (SRB) • European Fiscal Board (EFB)/National Fiscal Councils (NFCs)	• Recovery and Resilience Facility (RRF) • Support to mitigate unemployment risks in an emergency (SURE) • ESM Pandemic Crisis Support (PCS)
Rules-based	• Fiscal Compact • Strengthened SGP • Macroeconomic Imbalances Procedure	• SGP General Escape Clause • [Review of the Six-Pack and Two-Pack]

Intergovernmental
Supranational
Mixed

On the contrary, the main innovations during the response to the pandemic had a very clear supranational status: this is the case for the Recovery and Resilience Facility, within NG-EU. The support for short time work, SURE, has an intergovernmental component since borrowing by the Commission takes place on the back of guarantees provided by national budgets. However, it is clearly identified in the markets and the public as a Community instrument and indeed this is one of the reasons for the market success and large access by member states compared to the ESM pandemic facility.

In sum, the response to the Covid-19 crisis had in several instances the opposite sign of that prevailing during the Eurozone crisis. What is emerging is a more balanced institutional landscape

with a more robust combination between rules-based and institutional features and having the potential to lead to a more effective vertical coordination. This evolving institutional landscape should be reflected also in the outcome of the ongoing review of the EU macroeconomic policy framework.

6. MAKING SURE THE COVID-19 RESPONSE WORKS - LOOKING AT MEMBER STATES

For the politics to be conducive to more EU integration, there is one essential precondition: that the novel mechanisms and tools currently put into place to address the economic fallout of the Covid-19 pandemic are indeed successful in helping European economies "build back better" and are widely seen as doing so. This implies that the degree of success of national efforts based on EU funding go beyond the positive impact on member state economies; they will provide a narrative for the evolution of overall EU governance as well.

The timeline for the Recovery Plan process is now fully set out, but the effective use of the large sums involved in the time horizon prescribed represents a huge challenge, as "Next Generation EU" funds require committing the resources by the end of 2023 and completing the payments by the end of 2026 (European Council 2020). To this end, Member States are currently finalising with the Commission their national Recovery and Resilience Plans (RRPs), setting out a detailed reform and investment agenda based on specific guidelines (European Commission 2021a) and offering a narrative consistent with overall EU objectives (Table 4).

Table 4: Recovery and Resilience Plans content and processes

Narration	Internal consistency of NRRPs		
General objectives	*From objectives to projects*	*Cost estimation*	*Monitoring*
•Addressing the challenges and priorities of the European Semester •Strengthening growth, resilience and job creation •Contributing to economic and social cohesion •Contributing to the green/digital transition	•Final and intermediate objectives •Individual projects and investment timeframes •Implementation and achievement indicators	•Total costs •Correspondence between costs and impacts on employment and the •Possible other EU funding	•Accompanying measures (reforms, investments) •Monitoring procedures

Source: adapted from Buti and Messori (2020)

As member states complete their RRPs and move to the implementation phase, a number of issues will be critical for success:

- **Governance structures.** The new funding tools embody new conditionality rules, as well as milestones and targets for funds disbursement. As a response, EU member states have been putting in place new governance arrangements for the design and implementation of what will be in many cases a defining national effort. While one size does not fit all and arrangements will vary, they will need to embody a "whole of government" approach under a strong central direction, with the required flexibility of different administrative structures. Interestingly, this transition seems to be proving easier for countries with experience from support programmes during the Eurozone crisis.
- **Investments plus reforms.** A crucial element of the new Recovery Plan is the "twinning" of investments with reforms in national interventions. It will be important for this complementarity of reform elements and investments to be present in substance in both the design of RRPs as well as in their implementation, going beyond simple "box-ticking" and a formal adherence to rules, and to ground these on an overarching growth strategy in each country based on green/digital transitions.
- **Conditionality and ownership.** During the Eurozone crisis, the heavy conditionality imposed on programme countries meant that in many cases lack of "ownership" in individual countries undermined the reform effort. A new balance needs to be found under the Recovery Plan, where conditionality is lighter and linked to adequately addressing all or a significant subset of country-specific recommendations made in the context of the European Semester that are relevant for recovery and resilience. While respecting this new setup, the review process will need to reflect this conditionality in a substantive and rigorous way, as it relates to both the efficiency of the use of funds in individual cases as well as more broadly the future of EU governance.
- **Digital and climate.** In order to "recover and transform", the twin digital and green transitions have been put at the heart of RRPs. Ensuring the national plans (and their methodology/metrics) attain the digital and climate targets and guaranteeing the "do-no-significant-harm" principle will be important in this respect, as will be to ensure the additionality of EU funding in these areas, leveraging and not simply displacing private investment projects. In addition, as a number of green and digital projects will be similar across countries, a process of peer-exchange and learning from best practices in implementation should prove useful.
- **Transnational spillovers.** By design, the Recovery Plan prioritises national investments, and their "ownership" will be national, not EU-wide. In the digital and climate areas however (and even beyond those), there are strong externalities and network spillovers. Neglecting these in the appraisal of projects at national level will be to lose an important opportunity to push forward European value-added and European public goods aspects.
- **Fiscal sustainability.** Once the pandemic is over and support is gradually and carefully withdrawn, member states will be left with higher levels of national debt and will have to reverse current fiscal positions. This is why it is important for RRPs to include measures that improve the quality of taxes and of public expenditure and thereby support fiscal sustainability over the medium-term, and clearly distinguishing one-off from recurrent expenditures.
- **Granularity.** For many EU countries, the funding linked to their RRPs will represent a one-off opportunity to reset their national economies. Experience shows that implementing such large investment efforts rests on a host of factors: having clear milestones, setting well-defined

targets, adopting proper audits and controls, a robust economic impact assessment and cost estimates, and complementarity with other EU funds. It is this type of granularity that links the design of RRPs to a successful implementation phase.

- **Stakeholders.** Despite their technical elements, and especially as the RRPs will combine reforms and investments towards transformation, their success will hinge on being embedded in societal acceptance. The timing and quality of the involvement of national stakeholders will therefore be important, accompanying the process, and operating at different levels (from central to local) of national administrations and government.

The policy response to the current crisis has broken new ground. At the same time, the difficulties on vaccines delivery and uncertainties on the follow up at national level on Next Generation EU have shown that the latest advances will need to be consolidated. Whether the response to the pandemic marks a fundamental shift in the paradigm of European integration or it remains an "exceptional one-off" under extreme duress will also largely depend on the success of member states in implementing their RRPs.

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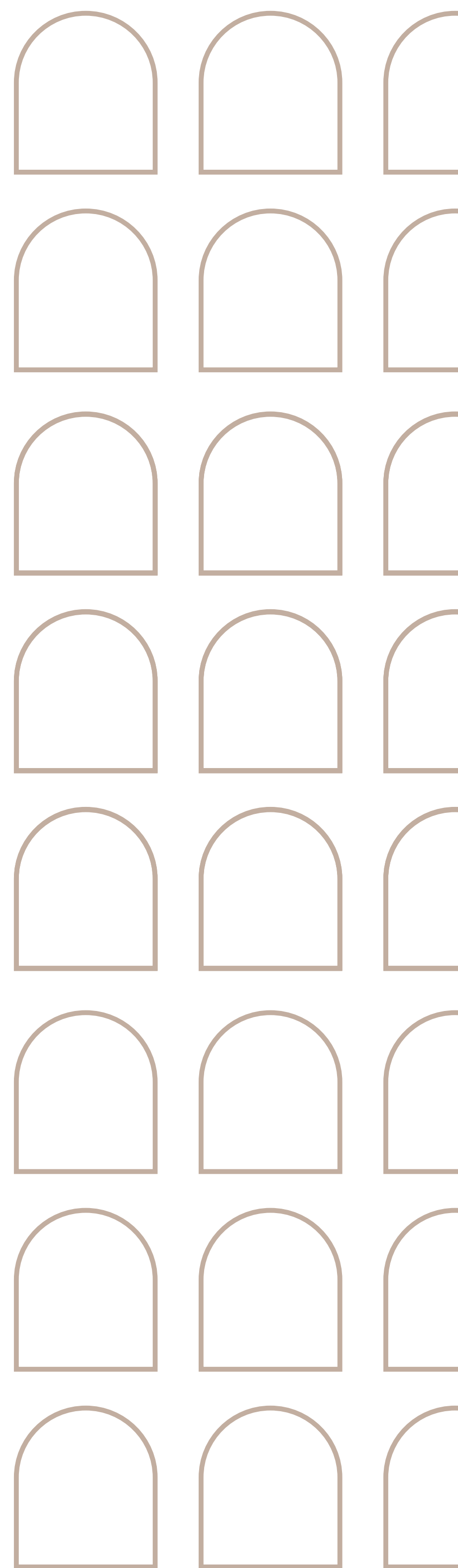

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