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

THE ISSUE

To slow the spread of COVID-19, European governments have adopted stringent

1 THREE PHASES OF ECONOMIC RESPONSE TO COVID-19

COVID-19 lockdown measures have led to sharp contractions in economic output,

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

2 FOUR GUIDING PRINCIPLES FOR MANAGING PHASES 2 AND 3

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

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

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

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

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

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

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

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

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

ensures that the most innovative and productive firms thrive, rather than those

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

EIB guarantee fund, are insufficient[8].

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

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

will take time and investment.

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

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

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

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

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

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

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The EU has committed to lead the transition to a healthier planet and a new digital world (von der Leyen, 2019), and it is important that both demand and supply-support measures promoted under the recovery initiative/plan will be consistent with these broader societal goals. The planning work done so far on the European Green Deal, and on a new EU industrial policy, should represent the starting point for the design of the recovery. Trade-offs certainly exist between policies exclusively aimed at minimising the socioeconomic damage left by the crisis, and those also aimed at promoting broader societal goals. However, it is possible to design recovery policies that can deliver on both economic and societal goals and reduce the trade-offs[10].

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