Chapter 3
The economic and social consequences of Covid-19

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Introduction

This chapter analyses the economic and social crisis caused by the Covid-19 pandemic and its implications for the European Union (EU) and its Member States. The first responses in EU countries have mostly been similar, with steps taken to block the spread of the virus and then to mitigate the effects of lockdown. The longer-term economic consequences are less clear and partially depend on decisions being taken at EU level. Indeed, the Covid-19 crisis can be seen as a test of whether the EU can prove its worth in enabling Member States to weather the crisis and to achieve economic recovery with political stability. This will mean that public debt problems, so damaging in the crisis after 2009, can be handled satisfactorily; that key economic sectors can survive and return to prosperity; and that divergences across the Union, both old and new, can be held in check and ultimately reduced.

To establish the context for assessing how far these difficulties can be satisfactorily overcome, the present chapter begins by setting out the policy responses within Member States, first to the health crisis (i.e. lockdown measures) and then to the economic consequences of those lockdown measures. The second section covers a discussion of the effects of the crisis on economies and two sectors that are particularly important for showing differences between countries. The third section deals with social consequences, pointing to an even greater differentiation between countries. The fourth section covers policy responses at EU level including from the European Central Bank (ECB). The concluding section points to open questions about how far thinking on EU economic policies may be altered by the Covid-19 crisis.

1. The first policy measures

As the severity of the threat to public health from Covid-19 became clear in early and mid-March 2020, European governments imposed lockdown measures to block the spread of the disease by reducing social and economic activities, unless essential for life and health. These restrictions, rather than the virus itself, were the cause of the deepest economic depression in decades.

The measures taken across Europe, and indeed across the world, were similar in timing and nature. An index for international comparison across 166 countries prepared by Oxford University's Blavatnik School of Government (2020) uses indicators of containment and closure policies to rate countries between zero (the least restrictive) and 100 (the most restrictive). The EU scored an average of 83 on 31 March 2020, against a world average of 79. The main outlier in Europe was Sweden, with a score of 46, while Italy scored 85, the second highest of any country in the world at that time. Common features in measures taken included partial border closures; restrictions on international travel; preventing all but the smallest of gatherings (meaning a suspension of sporting and cultural events); closing many retail, education and tourist activities; and encouraging public- and private-sector employers to enable home working where possible. Those activities judged to be essential, obviously including health and social care, were not restricted, while energy, food production and sale and at least parts of public transport were among the activities allowed to continue. Much of manufacturing was shut down, while construction stopped in some countries.

These lockdown measures, aimed at preventing a public health catastrophe, in turn threatened to cause an economic and social catastrophe. Member State governments took a series of previously unthinkable steps through March and early April 2020, following the advice from international agencies, notably the International Monetary Fund (IMF), as well as from many prominent economists, as expressed in the title of a collection of contributions called 'Mitigating the COVID economic crisis: act fast and do whatever it takes' (Baldwin and di Mauro 2020). This was an obvious adaptation of Mario Draghi's famous determination in 2012 not to let the sovereign debt crisis of that time lead to the end of the Eurozone. It meant 'doing everything possible', without regard to financial cost, to ensure the functioning of health care systems and as far as possible to keep firms from losing valuable employees or even collapsing into bankruptcy, all so that they could return to full activity once the health care crisis was resolved. The resulting budget deficits and rising debt levels would have to be dealt with later.

These first emergency measures were similar across the EU, as shown by a further index produced by the Blavatnik School of Government (2020) on policy responses. This index is only a rough guide, reporting what governments announce and not necessarily what they do or for how long measures are kept in place. Reported and regularly updated by the IMF, the Organisation for Economic Co-operation and Development (OECD) and the European Foundation for the Improvement of Living and Working Conditions (Eurofound 2020a), the specific measures show substantial variations in their details and hence in their likely impacts. Neither precise costing nor accurate comparison between countries is possible, as the nature of information differs between countries. Expenditure will ultimately depend on uptake, the length of the economic emergency and the extent to which announced measures are fully implemented.

Key measures typically included state support to businesses to keep people in employment and to the self-employed, loans and credit guarantees to businesses and relief from various tax and national insurance obligations, with a bias towards reducing those related to employment. Several countries suspended some tax obligations and social contributions and did not pursue tax arrears. Such measures obviously risked helping businesses with no prospects, as well as those with potentially good prospects, but the need was for speed rather than time-consuming precision in targeting. Help was sometimes given to specific sectors, such as airlines, as economic effects led to lobbying from those sectors. The population was helped by relief on payment obligations, such as mortgages, and in some cases with additional social benefits, protection for tenants against eviction and assurance of continued provision of essential services – such as electricity – for those unable to pay bills. In some cases, sick-pay entitlements were extended to help those asked to self-isolate (Eurofound 2020a).

2. The first economic consequences

A common hope was that Covid-19 would lead to a V-shaped economic depression – i.e. a sharp and rapid fall in economic activity followed by a rapid recovery as the virus was brought under control. Even if that could be the case in some countries and sectors, a full recovery was always threatened by the possibility of new Covid-19 outbreaks and by the unpredictability of developments in other countries. The longer the crisis lasts, the harder recovery could become, as it could lead to bankruptcies of businesses, non-repayment of debts to banks (threatening a crisis in the finance sector), and rising unemployment (reducing incomes and demand). There could also be more lasting changes in consumer behaviour – for example, if people become accustomed to not travelling so much and to purchasing more online. The issue of public debt and how governments respond could also be expected to become more pressing. Estimating the consequences of the first Covid-19 measures on the European economy is difficult, albeit essential for making informed policy responses.

The European Commission's Spring Forecast for 2020 (European Commission 2020c), using data available on 23 April 2020, took as its base the most optimistic plausible assumptions about the effects of Covid-19: that containment measures could be lifted after the second quarter of 2020, that there would be no major 'second wave' and that the policies adopted would prevent significant damage to economies. In this optimistic scenario, strong recovery in the third quarter of 2020, albeit leaving some permanent reductions in consumer spending and investment rates, would take GDP in 2021 almost back to its 2019 level. Overall, there would be a 7.4% fall in GDP (7.7% for the Eurozone) in 2020, followed by 6.1% growth in 2021.

It was acknowledged that 'risks to the forecast are extraordinarily large and concentrated on the downside' (ibid: 6), such that a V-shaped recovery, which was roughly what the forecast seemed to assume, 'would be extraordinary' (ibid: 17). The figures presented, which were fairly similar to those published by the IMF (2020b) and ECB (2020) at the same time, can best be seen as an optimistic baseline. The OECD (2020) was less optimistic, predicting a 9% decline in Eurozone GDP and seeing a deeper depression, following a second Covid-19 wave, as equally likely.

The first results for 2020, and the continuing presence of the pandemic at the time of writing (September 2020), are consistent with these estimates being overoptimistic. Preliminary Eurostat data, not covering all countries, shows GDP in the second quarter 14.1% down on the previous year (15.0% for the Eurozone). In all cases there was some degree of relaxation of lockdown rules before the end of the second quarter of 2020. The lowest monthly level of economic activity will therefore be somewhat below the quarterly figure. Table 2 (which includes further data discussed below) shows results for all the countries, with the biggest declines in economic activity in Spain, France and Italy. The smallest downturns were in some Northern European countries and in Central and Eastern European countries (CEECs).

The differences between countries were substantial and would contribute to political differentiation across the EU. They were partly the result of differences in the spread of the virus, of the promptness and effectiveness of lockdown measures and of success with testing, tracking and tracing. Thus, the relatively strict lockdown in France was associated with a 64.8% fall in construction activity (April 2020 compared with April 2019), while there was little change in Germany and even growth of 2.2%, 12.0% and 8.9% in Finland, Denmark and Romania respectively (Eurostat sts_copr_m). Results were less varied as lockdowns eased, with France only 12.0% below the 2019 level in June 2020. Indeed, the immediate response to the health emergency may prove less important in causing differences between countries than the underlying economic structures and subsequent policy choices. This is illustrated in two very different kinds of activities, tourism and motor-vehicle production, both hit hard by lockdowns.

The expectation that tourism would suffer immensely through the peak summer months of 2020, in other words well beyond the second quarter, was reflected in the Spring Forecast's prediction that the biggest GDP reductions would take place in Greece (-9.7%), where the direct Covid-19 impact was small, followed by Italy (-9.5%), Spain (-9.4%) and Croatia (-9.1%). Eurostat data defines tourism rather broadly to include hospitality, accommodation, travel agencies, vehicle rental and also inter-city and international transport (Eurostat 2020), activities not serving only tourists. Using a narrower definition of accommodation, plus food and beverage services, Table 1, which includes countries with the highest and lowest levels of these activities, shows the wide differences in their importance. The latter group includes both some countries with high incomes but few visitors and some, notably Slovakia and Poland, with much lower incomes, leading to lower demand for these kinds of activities from the domestic population.

The activities covered in Table 1 faced compulsory closure in some countries and then continuing restrictions due to social distancing rules. A V-shaped recovery was further threatened by the possible closure of the many smaller businesses in these activities. Some bigger firms related to tourism have also been hit, notably airlines, but have greater financial resources and lobbying power. The demise of tourism would practically eliminate economic activity from some regions within countries, while having much less impact in others (European Commission 2020d: 8).

Table 1 **Percentage share of accommodation and food and beverage service activities in employment and value added, 2017**

	Employment	Value added
Greece	11.3	7.5
Cyprus	11.0	13.7
Spain	6.5	6.5
Italy	5.9	4.6
Croatia	5.8	8.0
EU-27	4.9	3.6
Denmark	4.6	2.3
Hungary	3.1	2.1
Finland	2.8	2.4
Slovakia	2.4	1.4
Poland	1.6	1.5

Source: Calculated from Eurostat (sbs_na_sca_r2), (sbs_na_1a_se_r2).

Parts of manufacturing were also hit hard by lockdown measures, especially the automotive sector, a sector most important in countries which, by chance, have smaller tourist sectors. The sector accounted for 1.7% of EU value added in 2017 (Eurostat sbs_na_sca_r2), with the highest shares in Czechia (4.9%), Hungary (4.3%), Slovakia (4.1%), Germany (3.6%) and Romania (2.5%). The lowest figure was 0.02%, in Greece. All of these countries had low incidences of Covid-19, and the fall in production was similar across all the significant producers. The fall across the EU as a whole from April 2019 to April 2020 was 83.4% (Eurostat sts_inpr_m). A V-shaped recovery still appeared possible – as the big and powerful vehicle manufacturers have every chance of surviving intact – but that would depend on a full recovery of demand, which remains very uncertain. Output was still substantially below 2019 levels in June 2020.

The longer the economic depression lasts, the greater the costs to state budgets. The final cost of the measures adopted during lockdown cannot be calculated precisely because it depends on how long they are kept in place and on their effective take-up. Automatic stabilisers, taking estimates quoted by the IMF (2020), could amount to the equivalent of 2.5% of GDP for Denmark or even 4 to 5% of GDP for Finland. The cost of not pressing for payment of tax and social security arrears also varied greatly, estimated at over 3% of GDP for Portugal and over 5% for the Netherlands. The estimated total cost of discretionary payments was almost always equivalent to over 2% of GDP and 3.25% for the Eurozone as a whole (European Commission 2020c: 57). A variable item was the extent of credit guarantees, averaging 24% of GDP across the Eurozone (European Commission 2020c: 57), but with take-up likely to be much lower.

The 2020 European Commission's Spring Economic Forecast foresaw net borrowing at 7.5% of GDP in 2020 and 3.6% in 2021, implying a significantly bigger increase in debt than in 2009, with several countries expected to reach net debt levels equivalent to over 100% of GDP. That point was already surpassed in 2019 by Greece, Italy and Portugal. The point at which a level of public debt becomes a serious danger for an economy is not clear, but the levels in prospect – far above the 60% of GDP permitted under the EU's Stability and Growth Pact – could put the worst-affected countries in danger of a sovereign debt crisis, repeating the experience of 2012. There were ominous signs of this in mid-March 2020, as the interest rate on Italian government ten-year bonds rose to three percentage points above that on German bonds. The gap came down to 1.6 percentage points on 26 March 2020, following action taken by the ECB (discussed in Section 4.3). Nevertheless, public debt could limit countries' ability to cope with the Covid-19 crisis by restricting the scope for spending on essential health measures, measures to maintain key sectors and on any programme for subsequent recovery.

Table 2 shows the debt burdens for EU Member States alongside the falls in second quarter 2020 GDP and per capita GDP levels. The data shows both high-income and low-income countries suffering severe declines. This first phase of the Covid-19 crisis therefore did not increase existing divergences in GDP. However, the GDP declines were greater in several countries with strong representation for vulnerable activities, notably those related to tourism and those with high levels of public debt. Moreover, debt levels in Greece, Spain and Italy have all increased since 2012. A few countries with lower debt levels seemed much safer in other respects, too, notably higher-income Scandinavian and several lower-income CEECs. This sets the context for different views on an appropriate EU-level policy to handle the crisis. The potential for that differentiation becomes even clearer from a discussion of the first social consequences of the crisis.

Table 2 **Indicators of the first effects of the Covid-19 crisis on EU Member States**

	Gross government debt, 2019, % of GDP	Decline in GDP, 2nd quarter 2020 over 2nd quarter 2019	Per capita GDP, % of EU-27 average
Luxembourg	22.1	-7.8	328.6
Ireland	58.8	-3.7	232.3
Denmark	33.2	-8.1	171.3
Netherlands	48.6	-9.2	150.2
Sweden	35.1	-7.8	148.3
Austria	70.4	-12.9	144.4
Finland	59.4	-6.3	140.1
Germany	59.8	-11.2	133.4
Belgium	98.6	-14.4	132.4
France	98.1	-19.0	115.6
EU-27	77.8	-13.9	100
Italy	134.8	-17.7	95.2
Malta	43.1	-15.2	85.2
Spain	95.5	-22.1	85.0
Cyprus	95.5	-11.9	80.1
Slovenia	66.1	-12.9	73.9
Estonia	8.4	-6.4	68.0
Czechia	30.8	-10.9	67.5
Portugal	117.7	-16.3	66.4
Greece	176.6	-15.3	56.3
Lithuania	36.3	-4.1	55.8
Slovakia	48	-12.1	55.5
Latvia	36.9	-8.6	51.2
Hungary	66.3	-13.5	47.3
Poland	46.0	-8.0	44.3
Croatia	73.2	-15.1	42.9
Romania	35.2	-10.5	37.0
Bulgaria	20.4	-8.5	27.9

Source: Eurostat (namq_10_gdp, sbs_na_sca2, tipsgo10, nama_10_pc).

3. The first social costs of the Covid-19 measures

Initial data on social consequences, more limited than those on economic effects, points to greater pain in lower-income CEECs. These have created social protection systems with low spending relative to GDP – in the cases of Romania, Bulgaria and the Baltic Republics, little over half the EU average level – and with particularly low spending on labour market protection, despite often high unemployment rates (Myant and Drahokoupil 2015: 290-293). Social effects also differ within countries. Despite the measures to maintain employment outlined above, those on non-standard contracts – self-employed, temporary and part-time workers – had less protection than those on regular contracts, for example with no support under short-time working schemes in any CEEC (OECD 2020: 109). Less secure employment was often high in the sectors most affected by lockdown, reaching more than 60% in Italy (OECD 2020: 104). Employees in tourism activities were particularly vulnerable, with 45% of employees in Greece in 2017 on fixed-term contracts, for example, often working for only part of the year (Eurostat 2020).

Short-time work compensation schemes went a long way towards delaying a rise in the unemployment rate, recorded as 6.6% across the EU-27 in April 2020 (slightly below the 6.8% recorded a year earlier) and still only 7.0% at the end of June, with some countries even recording a decline. Labour Force Survey (LFS) data for the second quarter of 2020 shows falls in total employment of 2.7% for the EU as a whole, still well below the falls in economic activity.[1] By the end of April 2020, 42 million employees were covered by applications for support under short-time work schemes – a quarter of all employees, ranging from just under 50% in France and Italy to 3.6% in Bulgaria and 3.1% in Poland. The figures reflect a general tendency for worse provision in lower-income countries (Müller and Schulten 2020). Only in the Netherlands, Denmark and Ireland did allowances cover 100% of original pay and then only for limited periods. The lowest level was 40% of the national average wage in Poland. In all countries the scheme was time-limited, albeit with scope for renewal and extension in some cases. Schemes for partial employment therefore diminish and defer social costs rather than avoiding them altogether. They do not prevent redundancies or closures of firms for which employment is only one expense. Employees are therefore in a weaker bargaining position than before, and in some cases have been visibly pressured into accepting pay reductions.

Comparing April 2020 with April 2019 (but not covering all countries and excluding motor vehicles, on which spending could remain depressed in view of lower incomes), incomplete data on retail trade shows an average decline for the EU of 18.0%, ranging from growth of 0.3% for Finland and a small decline of 3.0% for Denmark to falls of 30.8% for France and 31.4% for Italy (Eurostat sts_trtu_m). The differences largely reflected the strictness of lockdowns, with spending mostly recovering in the following months in most countries. Bulgaria appeared the worst affected, with the April 2020 figure 18.5% below and the June 2020 figure still 17.3% below that of the previous year.

1. https://bit.ly/35LkBjC

This apparent range of social effects is consistent with preliminary results of a Eurofound (2020b) survey, using 85,000 responses received by 30 April 2020 from across Europe. By that point, 5% of respondents had lost their jobs permanently and 23% were temporarily idle – in line with the proportion covered by short-time working schemes – while 50% had seen some reduction in working time, though by how much was unclear. This translated into severe financial consequences, especially in lower-income countries. In Bulgaria, 60% of respondents reported being worse off than three months previously, while more than 60% expected to be even worse off in another three months' time, against an EU average of 38%. By way of contrast, effects were quite small in several higher-income countries, including Denmark, Finland and Sweden.

There were also differences within countries. The self-employed and unemployed in particular complained of financial distress, often with inadequate savings to last for three months at the same standard of living. Explanations include levels of job security and of household savings and the strength of state safety nets. Another factor is that teleworking, then being undertaken by 37% of employees across the EU, was much more prevalent in higher-income countries with their greater proportions of non-manual work that could be performed from home. A further factor that could push more pain towards lower-income countries is the dependence of many people there on working abroad, often in insecure jobs that are likely to be the first to disappear. Thus, for example, 15.5% of Romanian citizens were living in another EU Member State in 2019 (Eurostat migr_pop9ctz).

4. The policy response at EU level

For its own credibility, the EU had to play its part, or at least appear to play its part, in resolving the Covid-19 crisis. The Eurofound survey referred to above (Eurofound 2020b: 4) showed a rapid deterioration in public trust in the EU – the lowest level was in Greece and the highest in Finland – at just the time when the EU needed to prove its usefulness. The EU is not well structured for rapidly responding to a crisis. Decision-making can be painfully slow, needing lengthy consultations and unanimity on issues affecting the budget. The EU budget is largely set for a seven-year period, and it is equivalent to around only 1% of EU GDP. A small additional spending capacity – the Budgetary Instrument for Convergence and Competitiveness (BICC) – was agreed in October 2019, but not at a level that could satisfy those countries that wanted a meaningful 'fiscal pillar' to flank the ECB's ability to use monetary policy. The Eurozone budgetary instrument was explicitly not to be a tool for economic stabilisation. Rules ensured that a Member State would receive back at least 70% of its contribution to a pot which was likely to be the equivalent of only 0.02% of total EU GDP over the 2021–2027 period.[2] Much more than this was needed, and the measures taken by the EU can roughly be divided into those involving a relaxation of some of its own rules which could hamper actions at Member State level and those involving new initiatives and spending.

2. https://www.consilium.europa.eu/en/policies/emu-deepening/bicc-faq/

4.1 Relaxing some EU rules

Rapid steps in March 2020 included changes to the rules on state aid originally established to prevent governments from giving their firms a competitive advantage over those in other EU Member States by direct financial support. The European Commission had already granted exemptions for support that could be justified as contributing to regional development and support for small- and medium-sized enterprises (SMEs). These had been supplemented at various times, with help given to ailing banks during the financial crisis, for example. On 19 March 2020, the European Commission published new rules on what was not prohibited, greatly increasing the scope for state aid to companies in difficulty: this included liquidity support, state guarantees and low-interest loans. Shortly afterwards, research relating to Covid-19, wage subsidies and recapitalisation of ailing companies were added, albeit in this case with conditions attached, such as a suspension of dividend payments.

The extent of state aid is likely to be greater in higher-income countries with lower debt burdens. It is also likely to be biased towards helping bigger companies that are better equipped to lobby governments and towards high-profile industries, such as the automotive sector. The biggest early beneficiaries appeared to be in Germany, set to receive 52% of the €1.9 trillion committed in early May 2020 (Hornkohl and van't Klooster 2020). One German scheme offered help to individual companies with up to €1 billion per company, while €6 billion was approved to support Lufthansa, on top of approval for a state guarantee on a €3 billion credit, totalling 29 times the total approved for Cyprus by the end of June 2020.[3] Relaxing state aid rules, unless accompanied by other means to redress geographical imbalances, could therefore favour continued geographical concentration of new technologies, for example in the automotive sector. One German government proposal supports development of electric vehicles to take place in companies' German bases rather than in lower-income countries. A French government proposal for supporting the automotive sector adds a condition that production should be repatriated from outside the EU. A general retrenchment towards companies' home bases would be a severe blow to EU countries hosting Western European multinational companies. This relaxation of state aid rules could thus end up widening divergences across the EU.

A second important step was a relaxation of budget rules, announced on 23 March 2020 after EU Finance Ministers agreed to use the 'general escape clause' of 'a severe economic downturn in the euro area or the Union as a whole', to suspend the obligations of the Stability and Growth Pact (SGP). Member States were allowed to take 'all necessary measures' to protect health care and also their economies, with the caveat that measures, and any relaxation of the SGP, were to be 'temporary and targeted'.[4] It was therefore unclear whether, and how quickly, countries would be expected to eliminate any extra debts they had accrued and whether a further bout of austerity might not be

3. https://ec.europa.eu/competition/state_aid/what_is_new/Covid-19.html
4. https://bit.ly/2G9ohmt

imposed. Relaxing this rule still left an uneven playing field and fell short of proposals for a 'golden rule' to allow borrowing to finance productive investment to be excluded from SGP calculations.

A further step implemented in April 2020 was a change in the rules for Structural Funds. Under the Corona Response Investment Initiative (European Commission 2020a), an initial total of €8 billion of unspent funds already allocated to individual countries for long-term investment could be used for emergency spending related to the Covid-19 crisis. Rapid approval was possible as no additional spending was involved. Spending allocations announced over the following months largely focused on medical needs, although the guidelines gave scope also for spending to maintain jobs and keep SMEs in business.

4.2 Positive EU initiatives

The European Commission has recognised the need for an active role to help those in greatest difficulty, noting that 'the crisis risks harming the least resilient and still-converging Member States most' (European Commission 2020b: 6). However, any additional spending has faced major political obstacles in view of past opposition from some Member States to further financial transfers between countries or to sharing of risks. In the discussions of active responses to the Covid-19 crisis, the vocal lead in scepticism was taken by the so-called Frugal Four, an informal grouping of the Netherlands, Austria, Sweden and Denmark, with Finland often appearing as an ally. These were countries with low impacts from the Covid-19 crisis and low or moderate levels of debt. Neither Sweden nor Denmark were Eurozone members and therefore had less reason to feel responsible for the fate of the common currency.

Nevertheless, the urgency of this crisis meant that there was also strong pressure for a more active approach. Partial agreement was reached at the 26 March 2020 European Council meeting, which approved a package billed as providing €540 billion, 4% of EU GDP. As indicated below, the actual additional public funding was much less than this, and parts appeared as primarily another EU attempt to appear to be doing something without spending money. Any redistribution between Member States would be small. The package contained three elements, all focused on immediate economic survival rather than long-term plans.

The first, the Pandemic Crisis Support, allows Eurozone members to use loans from the European Stability Mechanism (ESM) for 'direct and indirect health care-, cure- and prevention-related costs due to the Covid-19 crisis'.[5] It therefore did not cover spending on an economic recovery programme. Each country could access the equivalent of 2% of its 2019 GDP, meaning a potential maximum across the Eurozone of €240 billion. New money was not on offer, as the ESM already had adequate resources. There were to be no further conditions attached, and rapid approval was promised with a repayment period of up to ten years. No country made a formal application within the first four

5. https://www.esm.europa.eu/content/europe-response-corona-crisis

months of the scheme's operation, apparently either seeing no benefit as they could already borrow at very low interest rates, or fearing that it could later become a pretext for imposing austerity.

Second, Member States would have access to the newly-created Support to Mitigate Unemployment Risk in an Emergency (SURE) mechanism, a fund backed by €25 billion in guarantees paid in by Member States, providing loans up to a total of €100 billion (0.7% of GDP) for short-time work schemes. This was a new area for the EU, following lengthy debates over the possibility of a common unemployment insurance scheme. It did a little to address problems of limited fiscal space by offering loans at somewhat lower interest rates than would be available on commercial markets for a number of Member States. By 24 August 2020, the European Commission was proposing the allocation of €81.4 billion to 15 countries with two more likely also to receive backing. Those not interested included Germany, France, the Netherlands, Austria and Scandinavian countries, which were able to borrow at low interest rates without difficulty. There will at most be a very small redistributive element in this policy.

Third, a €25 billion Covid-19 guarantee fund established by the European Investment Bank (EIB) was billed as enabling lending of up to €200 billion, with a focus on smaller firms. This figure is based on the optimistic assumption that an initial EIB credit will lead to co-financing from private banks to achieve investment eight times higher than the initial EIB contribution. A similar reasoning was used to claim an increase in investment of €335 billion[6] from the so-called Juncker Plan launched in 2015 with a €21 billion guarantee for higher-risk EIB credits. An investigation by the European Court of Auditors (2019) raised doubts over the claimed leverage, and the actual total volume of EIB credits was less after the plan's launch than in preceding years (calculated from EIB 2018). This project could prove even more problematic, since credits to SMEs are likely to be riskier than ever in the uncertain economic environment. The EIB would do well to contribute to recovery by keeping its level of credits at around 0.4% of EU GDP with, as before, no significant bias towards lower-income countries.

All the measures discussed above are characterised by minimising the need for extra spending and by keeping new redistributive elements at a very low level. The depth of the crisis and its serious effects on a number of countries meant that there was strong pressure for more radical measures. The biggest dispute at the 26 to 27 March 2020 European Council meeting was over a proposal from nine countries, including Spain, Italy and France, for so-called 'Corona bonds', i.e. common debt instruments enabling the EU to raise funds on financial markets to help countries in difficulty. This partially revived the 2012 idea of 'eurobonds' intended to help countries facing sovereign debt crises – an idea opposed and blocked primarily by Germany and the Netherlands. Backing for this new proposal was particularly passionate from Spain and Italy, two countries badly affected by the pandemic, with warnings that failure to reach a satisfactory agreement would put the entire European project at risk. Without replaying arguments over how the earlier Eurozone crisis had been handled, they argued that the Covid-19 crisis was not caused by any past economic policy decisions and was affecting all EU Member

6. https://bit.ly/3e4DzFE

States. Solidarity in finding solutions was therefore in everybody's interests. Evidence presented above on the economic effects indeed confirms that all were affected, but the impact was, as indicated, uneven.

The March 2020 European Council meeting ended with an agreement to return to the issue (see Vanhercke *et al.*, this volume). New momentum came in the following weeks with a proposal from France and Germany – now on the side of a new debt instrument – and then from the European Commission for the July 2020 European Council meeting. The outcome of one of the longest-lasting summits in European Council history was a compromise. The EU would borrow €750 billion. Roughly half was for providing loans to Member States. This was of little immediate significance at a time when all could borrow for themselves. The important element was €390 billion in grants, including a €47 billion increase in Structural Funds (otherwise facing reduction in the new EU budget for the 2021–2027 period, agreed at the same time) and the so-called recovery and resilience facility of €312.5 billion in grants (equivalent to 2.3% of EU-27 GDP in 2018, or 0.7% annually), to be allocated over three years for projects in line with EU aims of strengthening growth potential and addressing the green and digital transitions. The agreement was not quite as good as it seemed, as there were severe cuts for some of the bloc's key priorities, including climate change transition (downgraded from €40 billion to just €10 billion; see Laurent, this volume), research and health (see Brooks *et al.*, this volume) and some other areas, alongside increased budget rebates for the leading sceptics. Such was the cost of reaching agreement.

The total proposed annual spending is still very substantial, roughly double the €351.8 billion allocated to regional and cohesion policy for the 2014–2020 period. The formula for deciding on country allocations takes account of how hard a country has been hit by the effects of the pandemic and, crucially for lower-income countries, of indicators of economic levels. Spending will thereby help especially those with potential debt difficulties while also targeting those with lower debt levels but the strongest concern for promoting long-term convergence. While it is possible to estimate how much each Member State is likely to receive, as shown in Table 3, it is impossible to calculate what this would mean in terms of net transfers, as it is yet to be decided how the EU will raise the revenue to pay for its borrowing.

Open questions remain over whether these sums are adequate for preventing a recurrence of sovereign debt crises and for enabling future economic recovery, and over whether they can be used effectively, or even at all, when many lower-income countries have had difficulties making productive use of Structural Fund allocations. It is also unclear whether this will remain a one-off measure or whether it presages the creation of a more permanent EU approach that could finance investment and development, with a permanent focus on helping those in greatest need and fostering convergence, across the Union.

Table 3 **Cross-country grant allocations from the EU recovery instrument as % of 2018 GDP**

Country	% of 2018 GDP	Country	% of 2018 GDP
EU-27	2.8	Estonia	4.3
Bulgaria	10.5	Slovenia	3.8
Croatia	10.1	Czechia	2.7
Greece	9.0	Malta	2.4
Latvia	6.7	France	2.1
Romania	6.7	Germany	1.4
Slovakia	6.2	Belgium	1.1
Spain	5.9	Finland	1.0
Lithuania	5.8	Netherlands	0.8
Portugal	5.6	Austria	0.8
Poland	5.4	Sweden	0.8
Italy	4.8	Denmark	0.6
Cyprus	4.7	Ireland	0.5
Hungary	4.6	Luxembourg	0.4

Source: author's own calculation from Darvas (2020).

4.3 Rescue by the European Central Bank?

The rigidity of EU structures has in the past been partly compensated for by flexibility on the part of the European Central Bank (ECB). The ECB has the advantage of independence from Member State governments and does not need unanimity for decision-making. In fact, limited transparency means that it does not even make public how many decisions are taken (Claeys and Linta 2019).

However, monetary policy is not an adequate substitute for fiscal policy. The ECB can vary interest rates and the quantity of money in the economy, with an impact on the global level of economic activity. Unlike government spending, it cannot target this onto specific objectives, such as health, poverty reduction or support for research. The ECB could directly finance government spending, but this is considered undesirable over a significant period, as spending not balanced by government revenues would create inflationary pressures and potentially a serious loss of confidence in the currency. The ECB is not authorised to undertake monetary financing of public spending by its statutes, which limit its primary aim to maintaining price stability.

There is some flexibility in this, as shown by the ECB's programme of buying government debt introduced in March 2015 under the Public Sector Purchase Programme (PSPP). To comply at least formally with the block on monetary financing, the ECB bought only existing bonds. A formula was also created to ensure that it did not give greater help to countries in greater difficulty. This programme provided a model for the ECB's

Pandemic Emergency Purchase Programme (PEPP), decided on 24 March 2020,[7] with scope to lend up to €750 billion (6.25% of Eurozone 2019 GDP) through the end of 2020. No conditions were to be attached in terms of future austerity policies, and Greece was to be allowed to participate, which had not been the case for the PSPP. However, the stated aim was again to help banks' balance sheets so that they could lend more – an aim dependent on there being creditworthy clients or on effective government guarantees for bank credits.

A further danger for the PEPP was signalled on 5 May 2020 when the German constitutional court ruled that the 2015 PSPP programme conflicted with the German constitution. To be acceptable, there would have to be a clear end date to confirm that this was not a masked form of monetary financing and an explanation for how this was a sensible way to achieve price stability. The legal issue is complex, involving a dispute between a German court and the Court of Justice of the EU, which had judged PSPP acceptable. However, the PEPP could be open to the same objections that had been upheld by the German constitutional court. It is difficult to see a convincing exit strategy when total holdings of government debt of both PSPP and PEPP approach 24% of Eurozone GDP.

Conclusion

The Covid-19 pandemic has been associated with an enormous fall in economic activity. It remains unclear how long-lasting or how deep the depression will prove to be. Initial evidence casts doubt on early hopes of a short, V-shaped depression. Early evidence also points to substantial differences in how countries, sectors and individual social groups are being affected, with greater divergences in social than economic effects. The differences reflect the differing impacts of the pandemic, differences in economic structures and differences in policy responses. Although the measures taken have been similar in form, they have differed in coverage and application, with lower-income countries generally providing less protection against negative social effects. Thus, apart from an economic crisis of unclear length, the pandemic threatens to exacerbate divergences within the EU, while the extent of public spending to prevent economic and social catastrophe also again raises issues of the sustainability of public debt.

A key question posed in the introduction was whether the EU will prove its worth and increase its credibility by helping to find means to overcome the crisis and set Europe back on a road to increasing prosperity and convergence. For the most part, public spending measures remain the responsibility of Member States, but the EU, with potential resources and borrowing power derived from the collective economic strength of its members, could help ensure protection of health, survival of economic activities through the crisis and subsequent economic recovery for all Member States. The measures so far decided by the EU and ECB provide some protection for countries most hampered by public debt: there is no immediate threat of a sovereign debt crisis. The exemptions from state aid rules plus the finance offered from the EU should also

7. https://bit.ly/3oxaBmF

help ensure the survival of many threatened enterprises and jobs. There will still be pain in parts of economies and possible longer-term shifts in spending, pointing to the need for state involvement in fostering restructuring and recovery.

There is also a strong emphasis in EU policy statements on countering divergences, reflected in the targeting of funding under the recovery instrument agreed in July 2020. However, higher-income countries, especially those with lower public debt burdens, can take greater advantage of the decisions relaxing state aid rules, simply because they have more spending power. This therefore threatens to accentuate the concentration of higher-level activities (such as research and development) and the most modern products and processes in higher-income countries, accentuating the dependence of Central and Eastern European Member States on innovation and technology developed elsewhere. The dependent status that this represents is a barrier to economic and social convergence (Myant 2018). The loans and grants on offer under the resilience instrument will not reverse this process and may even exacerbate divergences if the sums are spent on fostering new technologies primarily in higher-income countries. Indeed, it remains an open question how far the larger sums available to lower-income countries can usefully be spent on economic recovery within the envisaged timescale when there have frequently been difficulties in making full use of past Structural Fund allocations. As argued by Czech trade unions, for example, convergence across the EU will require policy and institutional changes within Member States, enabling them to develop their own potential for innovation, alongside EU-level support, over a long period of time (Fassmann *et al.* 2019).

An optimistic view would be that the EU and its Member States are being pushed by the Covid-19 crisis towards a new recognition of the benefits of a larger budget, providing a fiscal capacity to accompany the common currency that could contribute to ensuring sustainable growth and convergence across the Union. A pessimistic view would be that steps taken will never be more than a temporary aberration, which will be followed by a renewed emphasis on austerity to repay the accumulated debts. A perceived failure of spending to bring satisfactory results could even contribute to more scepticism about the benefits of solidarity between Member States and financial transfers towards those in greater difficulty. The outcome in practice will be a result of political conflicts and compromises, themselves influenced by the further uncertain progress of the Covid-19 pandemic.

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