Box 1.2

THE EU RESPONSE TO THE COVID-19 ECONOMIC CRISIS AND ITS NEW GOVERNANCE CHALLENGES

The European Union (EU) has forged consensus around a common response to the economic crisis caused by the COVID-19 pandemic (see Figure 1).[1] This response has significantly complemented the likewise resolute reaction of monetary policy. Particularly notable among the various initiatives approved is the creation of the *Next Generation EU* (NGEU) recovery tool, set out in greater detail in Chapter 2 of this Report. Though temporary, this programme is an unquestionable milestone in the Union's integration project, as it contains unprecedented elements of pooled solidarity and accountability.[2]

This ambitious response – reflecting partly the lessons learned in previous crises – has evidenced the EU's capacity for resolve and joint action. But it has also highlighted the need to continue strengthening its economic governance. This box sets out some of the main courses of future action needed to reinforce the European economic and financial architecture.

One such area for action of particular significance is the reform of European fiscal rules. In February 2020, the European Commission (EC) launched a review of fiscal governance, which was interrupted by the COVID-19 crisis and by the activation of the General Escape Clause (GEC).[3] Adding to the reasons then identified for this review[4] – among which were the excessive complexity of fiscal rules, which has led to a lack of transparency and predictability, and their inability to prevent fiscal policy procyclicality – is the strong worsening of national public finances as a result of the pandemic and the need to safeguard public investment.[5] According to the EC's proposal, and in order to preserve the fiscal impulse needed to entrench the recovery from the current crisis, the GEC will not be deactivated until the EU attains its pre-pandemic level of economic activity.[6] However, the review of the fiscal rules should be resumed as soon as possible.

Another key component of the reform agenda is the creation of a common and permanent fiscal capacity in the euro area to address serious adverse shocks. That would prevent the European economic policy response in these episodes from having to depend essentially on ad hoc political agreements.[7] This macroeconomic stabilisation mechanism would allow a common response to both systemic and idiosyncratic shocks, ensuring fiscal policy countercyclicality.[8] This fiscal capacity might consist of an investment support instrument (which would contribute to raising the region's potential growth), the funding of common European projects (e.g. in the environmental and digital realm) or European unemployment insurance.[9] Undoubtedly, with a view to establishing a permanent instrument of this type, at least for the euro area, it will be crucial to take in and draw inspiration from the lessons that may be learned from the design and implementation of the temporary programmes NGEU and SURE (Support to mitigate Unemployment Risks in an Emergency).

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1 For a more detailed description of the various elements of the EU response to the pandemic, see, for example, Banco de España (2020), Chapter 3, *Annual Report 2019* and L. Guirola, I. Kataryniuk and C. Moreno (2020), "Fiscal policy response to the crisis in the euro area and the United States", Box 2, *Economic Bulletin,* 4/2020, Banco de España.

2 Chapter 2 of this Report analyses in depth the characteristics and implications of this programme. In addition, see Banco de España (2020), "Next Generation EU: main characteristics and impact of its announcement on financial conditions", and J. J. Pérez (2020), Thoughts on the design of a European Recovery Fund*,* Occasional Paper, no. 2014, Banco de España.

3 See European Commission (2020), "Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions. Economic governance review", COM(2020) 55 final and "Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact", COM(2020) 123 final.

4 See Box 4 "The reform of the fiscal surveillance framework in Europe", *Economic Bulletin,* 1/2020, Banco de España.

5 See Box 3.4 "The importance of an internationally coordinated fiscal policy response and its interaction with monetary policy", *Annual Report 2019,* Banco de España, and M. Delgado-Téllez, E. Gordo, I. Kataryniuk and J.J. Pérez (2020), *The decline in public investment: «social dominance»' or too-rigid fiscal rules?,* Working Paper no. 2025, Banco de España.

6 On current forecasts, this criterion would entail the deactivation of the GEC in 2023. However, once the GEC is deactivated, it may be necessary to resort to flexibility in the application of the Stability and Growth Pact (SGP) in those Member States that have not yet recovered the pre-crisis level of economic activity. See European Commission (2021), "Communication from the Commission to the Council. One year since the outbreak of COVID-19: fiscal policy response", COM(2021)105 final.

7 See European Fiscal Board (2020), *Annual Report 2020.*

8 For an analysis of the stabilisation capacity of a centralised fiscal capacity, see P. Burriel, P. Chronis, M. Freier, S. Hauptmeier, L. Reiss, D. Stegarescu and S. Van Parys (2020) *A fiscal capacity for the euro area, lessons from existing fiscal-federal systems*, Occasional Paper no. 2009, Banco de España

9 For an analysis of the macroeconomic consequences of these instruments, see Chapter 4, "Fiscal policy in the euro area", *Annual Report 2016,* Banco de España.

Box 1.2

THE EU RESPONSE TO THE COVID-19 ECONOMIC CRISIS AND ITS NEW GOVERNANCE CHALLENGES (cont'd)

Figure 1

THE EUROPEAN RESPONSE TO THE COVID-19 CRISIS. REGULATORY AND FISCAL MEASURES APPROVED BY THE EU

Rapid or SHORT-TERM measures

Temporary added flexibility to common regulatory frameworks in different areas

Easing of fiscal rules via activation of SGP escape clause (March 2020)	Temporary framework of State aid (March 2020 and successive updates)	Anti-crisis banking package (April 2020) and quick fix (CRR amendment) in June 2020

Triple safety net: support to employment and workers, firms and EU Governments €540 billion

SURE (a) **€100 billion** Offers temporary support to mitigate unemployment risks in an emergency Financial aid of €90.3 billion approved for 19 MSs. €62.5 billion disbursed to 16 MSs as at 16 March 2021	**EIB Group** **€200 billion** Creation of pan-European guarantee fund for loans to firms Loans of up to €200 billion for firms, especially SMEs, throughout the EU Initial set of projects approved for €40.3 billion as at 28 February 2021	**ESM** **€240 billion** Creation of specific credit line of aid for MSs Aid of 2% of GDP of each MS in 2019 Not yet used

EU Budget Amendments for 2020
Added funds to finance medical equipment and vaccine purchases worth €9.3 billion, and reorientation of cohesion funds to help MSs finance pandemic spending of €65.8 billion

MEDIUM-TERM measures

NEXT Generation EU *€750 billion*

Recovery and Resilience Facility (RRF) **€672.5 billion** Regulation adopted by the Council on 11 February 2021 Support instrument for reforms and investment undertaken by EU countries in the form of → Grants: €312.5 billion; → Loans: €360 billion	**Other Programmes** **€77.5 billion** Grants REACT EU: €47.5 billion; Horizon Europe: €5 billion; InvestEU: €5.6 billion; Rural Development: €7.5 billion; Just Transition Fund: €10 billion, and RescEU: €1.9 billion

Multiannual Financial Framework (MFF) for 2021-2027
The MFF, worth €1.07 trillion and agreed by the European Council along with the NGEU Recovery Fund, will support invetment in the digital and ecological transitions, and economic resilience, via various programmes under the following headings:

Single market, innovation and digital sector **€132.8 billion**	Cohesion, resilience and values **€377.8 billion**	Natural resources and environment **€356.4 billion**

SOURCE: Banco de España, based on EU.

a SURE stands for *Support to mitigate Unemployment Risks in an Emergency,* and MSs for "Member States".

Fiscal matters aside, the financing of the NGEU and SURE programmes will involve the issuance of a very significant volume of euro-denominated pan-European bonds.[10] These issues mark a major step on the road towards a European safe asset, although additional measures will be required in the coming years for its full development and consolidation. In this respect, a European safe asset would play a decisive role in weakening the link between bank and sovereign risk, promoting the international role of the euro[11] and fomenting the Capital Markets Union.[12][13] Indeed, the latter is a fundamental project – all the more so following the United Kingdom's withdrawal from the EU – for increasing the integration of European capital markets and promoting private risk-sharing channels.

Along with the need to further financial integration in the EU is that of preserving its most valuable economic integration mechanism, namely the single market. During the COVID-19 crisis, the flexibility of its regulatory framework was used to ensure the support of the Member States to their economies, e.g. through State aid. However, any such national measures must be prevented from potentially fragmenting the internal market or undermining the level playing field.[13] Looking ahead, the internal market must adapt to the changing circumstances of international competition, so as to preserve its external openness, but also to eliminate vulnerabilities. The design of an open strategic autonomy strategy seeks to strike this balance between the commitment to multilateralism and openness, and the goal of making European value chains more sustainable and resilient. To prevent certain aspects of this strategy from hampering convergence among the Member States and distorting the workings of the single market, these measures should be accompanied by mutual insurance mechanisms guaranteeing the necessary internal cohesion.[14]

The euro area's financial architecture and crisis-management framework must also be strengthened. To complete the Banking Union requires setting in place a European Deposit Insurance Scheme (EDIS) with a risk-pooling component that is as extensive as possible. A credible political commitment here would represent a decisive contribution to ensuring financial stability in the euro area in the short and medium term.[15]

As regards the crisis-management and bank resolution framework, the approved amendment to the Treaty establishing the European Stability Mechanism (ESM) is a positive achievement in itself as it will be conducive, inter alia, to this mechanism becoming the financial backstop to the Single Resolution Fund in the resolution of significant institutions. However, outstanding issues remain, such as the provision of liquidity to institutions in resolution, a common regulatory framework for resolution in the face of systemic crises and a common European procedure for the administrative winding up of credit institutions.

Finally, in the current circumstances, inter-governmental responses (as in the case of the ESM), which require unanimity for their approval, have been relegated in favour of responses firmly anchored in the EU framework.[16] It might be appropriate here to move forward with the EC proposal, backed by the ECB in 2018, to integrate the ESM as an EU body, so as to strengthen and cement its role in the management of future crises.[17]

10 See M. Delgado-Téllez, I. Kataryniuk, F. López-Vicente, and J.J. Pérez (2020), *Supranational debt and financing needs in the European Union,* Occasional Paper no. 2021, Banco de España.

11 See P. Hernández de Cos (2019), "The EMU at 20: from divergence to resilience", opening remarks at the Banco de España *Third Annual Research Conference.*

12 See Box 4, "The Capital Markets Union: New developments", *Economic Bulletin,* 3/2020, Banco de España.

13 To achieve a sound and resilient recovery in the EU economy calls for a fully operational and more integrated single market that can redress the weaknesses identified during the crisis. See the Conclusions of the Council of the European Union (2020), "A deepened Single Market for a strong recovery and a competitive, sustainable Europe", 11 September.

14 See P. L'Hotellerie, M. Manrique and A. Millaruelo (2021), "Open strategic autonomy in the EU", Box 5, *Economic Bulletin,* 1/2021, Banco de España.

15 See P. Hernández de Cos (2020), *The European response to the COVID-19 crisis,* opening address at the Fundación Internacional Olof Palme Conference.

16 See A. Westerhof (2021), *Reform of the European Stability Mechanism signed: a landmark achievement fully respectful of EU constitutional and institutional limits,* EULawLive, Weekend Edition no 50.

17 See European Central Bank (2018), *Opinion CON/2018/20,* general observations.