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Europe’s New Reality: Covid Economics, Debt and the Future of Trade

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Covid-19 has triggered the largest economic recession since the Second World War. Governments injected billions into the economy and paid wages to protect the jobs of millions. EU countries took on shared debts for the first time. Many bold claims followed: austerity is dead, globalisation is a thing of the past, and the European Union has made a huge stride towards federalism. Are we living through an economic paradigm shift? We spoke with Guntram Wolff, director of the think tank Bruegel, about Europe’s economic prospects, the recovery fund, and Europe’s ecological and digital transformation.

Roderick Kefferpütz: Covid-19 is not only a health crisis but also a huge economic shock. What lies ahead in the coming years?

Guntram Wolff: This is the biggest crisis since World War II, and we are not out of the woods yet. The recovery is fragile – it is gradual and very cautious. It will remain so as long as there is no vaccine available. Without a vaccine, patterns of consumption and production will remain changed. We are in for another very difficult year. Economic performance will still be well below trend in 2022. Even when the vaccine arrives, it will take time until normality returns.

Is a major jobs crisis yet to come?

That is the key question. I fear the worst may still be ahead of us. The strong response by the European Union and successful furlough schemes stabilised labour markets across Europe. But they cannot protect jobs forever and we don’t know how many firms will declare bankruptcy next year, shifting people from furlough into unemployment. It’s a real risk.

Is the EU’s recovery package the right response?

The immediate focus for recovery needs to be on stimulating demand. But that is not the job of the EU recovery package – it is the job of the national fiscal authorities that borrow money on financial markets to support economies. The recovery package only facilitates this process. The Next Generation EU plan tries to help countries with weaker economies and greater debt, who may not have the necessary fiscal space to stimulate demand. It basically helps those countries to borrow and spend money by acting as a financial facilitator. But this programme is not a short-term, anti-cyclical instrument because payouts will not happen for a while.

How would you evaluate the package in terms of quantity and quality?

Looking at the numbers, this package is significant and appropriate. Some countries in Central and Eastern Europe will receive more than 10 per cent of their GDP, while EU member states in Southern Europe will receive 5 to 8 per cent, or more in the case of Greece and Cyprus. It is a major transfer of financial resources to help those countries stay solvent. The package also contributes to bringing down interest rates. Financial markets have welcomed the fiscal response as a strong signal of unity and European stability, and that has helped bring down spreads. That really benefits countries borrowing huge sums of money.

The quality of the recovery package is more difficult to evaluate and will depend on its implementation. There are big buzzwords attached to the plan – "green", "digital", and "social" – but there is no good governance structure in place to ensure the money is well spent. This is still being negotiated. The proposal agreed upon by the European Council is too imprecise and technocratic. Of course, there will need to be a technocratic process and policy coordination, but the EU recovery package particularly needs political accountability. The European Parliament will have to closely monitor how the money is being spent and it should have the right to stop payouts in extreme cases. EU money needs EU-level political accountability.

Will the EU countries be able to use all this money and pour it into shovel-ready projects?

That is a big concern. Some member states will struggle to spend the money. For instance, Italy, Spain, and Croatia take a long time to spend their allocated structural funds. Usually they don't even manage to do so within the EU's seven-year budget framework. In our work at Bruegel, we have shown that countries like Italy only manage to spend around 40 per cent of their allocated funding. Now, of course, the recovery package wants to spend this money very quickly but that may work to the detriment of its quality. It is a dilemma.

Some have argued that this recovery package is Europe's "Hamiltonian Moment", akin to the 1790 agreement between Alexander Hamilton and Thomas Jefferson, which turned the US from a loose confederation into a genuine political federation. Do you agree?

It's a big word. The package is certainly significant but it's not comparable to what Hamilton did in the US. It is significant because it changes the nature of the monetary union by introducing an explicit insurance mechanism and allowing borrowed money to be transferred to countries hit by the pandemic. This crisis mechanism will be a precedent whenever there is a comparable major recession in future.

Are we ever going to pay back these huge sums of money?

That is the wrong question. The real question is: should we ever pay back this money? The European Council wants it to be paid back. But my prediction is that in seven years, when it comes to discussing the repayment as part of the next EU budget (which will start in 2028), they will postpone repayment by seven years. And that is appropriate because this debt is cheap, long term, and helpful. It helps Europe in establishing a common debt and capital market and it strengthens the euro as an international currency. I don't see any reason why this debt should be repaid. Look at national debt – that is almost never repaid but simply rolled over. In the end, it's about growing out of debt.

But what about inflation?

What inflation? There isn't any. Quite to the contrary, all market indicators show that this pandemic has been highly deflationary.

So on the economic side, there is no reason to worry about debt or inflation linked to the EU recovery package. What about the politics? In Europe, debt and austerity politics divide North and South. Could this package – in the coming years – bring forth a new debt debate that threatens European unity?

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a comparable major recession in future.

Indeed. My worry is that the EU will not put in place strong governance mechanisms that ensure accountability. As a result, this new money could make less of a difference in terms of growth and sustainability than hoped for. It is easy to see how this would then turn the narrative in Europe, in Northern Europe especially, against these kinds of EU spending programmes. Germany is particularly relevant. It was a huge step for Germany and Angela Merkel to change their position. When reports on the misspending of EU money start appearing, the narrative could easily become "never again".

You mentioned that the recovery package comes with big buzzwords linked to the ecological and digital transformation. Does it need to be flanked by an active industrial policy?

This is one of the most difficult questions and I wish I had a good answer. The discussion on industrial policy in Europe is very ambiguous. There is no defined industrial strategy, goal, or orientation – there is only a handful of individual documents, which do not make up a strategy. For some areas, there is a clear need for an active industrial policy. Take the ecological transformation. To stop runaway climate change, we need to obtain all the necessary green tech; carbon pricing will not suffice. Carbon pricing needs to be complemented with a green industrial policy that can develop the necessary technologies and business models faster than the market would do alone. Europe needs to make real progress here.

As regards the digital transformation, I am more sceptical. What would a digital industrial policy mean? Of course, there is a need for a regulatory policy, an investment policy, and setting the correct framework conditions. But what else could industrial policy bring to the table? There is some talk of setting up a European cloud, but who would implement and manage this? The state is not a good entrepreneur so I do not see this happening.

During the pandemic, the state has taken a massive stake in the economy. Will we ever see it retreat from this position and allow some Schumpeterian "creative destruction" to take place?[1]

The core function of a state is to provide stability in times of major stress, act as a lender of last resort, and support the private economy. What the state has done since the pandemic began is completely appropriate. Schumpeter did not say that the state should retreat at a time of a historic supply and demand shock, allowing for massive destruction of existing capital. What he advocated was a competitive environment in which new firms have a chance to emerge and unproductive firms can be driven out of the market through that competition.

Reshoring and localised production are not the answer because they make things more expensive, simple as that.

As we move into 2022, we must evaluate whether the state is so dominant that new firms cannot establish themselves. At the moment, they cannot emerge because of the pandemic and recession. But at what stage should state support and state ownership be reduced? This is a conversation that we need to have because it is not up to the state to run major companies. The state will have to retreat at some point, but I do not think that time is now. We should have this conversation in late 2021 and 2022.

This pandemic highlighted the fragility of international supply chains. Should the state promote the relocalisation of production?

No. Reshoring and localised production are not the answer because they make things more expensive, simple as that. Of course, we need to increase our resilience, but we need to find the most cost-efficient way to achieve that. I think we can do it by increasing our stocks and reserves in critical goods, such as medical supplies, or by promoting the diversification of global suppliers. But deciding to put up our borders and produce everything domestically would be a major, expensive shock that would be bad for our welfare and our economies.

So no paracetamol production in Europe, then, as French president Emmanuel Macron has advocated?

Let us take face masks as an example. Face masks were sorely lacking during the first two months of the crisis. Now it would seem appropriate to have greater stocks in Europe. But does it make sense to start up face mask production in Europe, where they could cost something like 3 euros each, instead of buying them from China, where each mask would cost around 3 cents? We must look at the costs of our policy choices, too. In this case, more stocks and perhaps a second supplier outside of China sound like better options. The EU is a net exporter of medical goods – do we really want to become protectionist and risk losing exports?

The global economy has entered a geopolitical phase and the spheres of security and economy are increasingly linked. In this context, focusing on cost efficiency can cost you geopolitically. If the only concern is cost, for example, then Huawei should be allowed to build the 5G network.

Security concerns need to be taken seriously. We did not do this sufficiently in the past. Especially when it comes to core infrastructure, it would be wrong to depend on one supplier. And if there are concerns about the security of existing infrastructures, then that is a problem that needs to be immediately addressed. I would also agree that dependency on countries for the imports of critical supplies, such as rare earths, needs to be scrutinised, and alternative suppliers established.

However, it is economically and politically dangerous to want to “decouple” Europe from other economies. Economically dangerous because it undermines our future economic prospects, and politically dangerous because economic decoupling tends to make military confrontation more likely. Instead of decoupling, the EU needs to work on having a stronger and unified position that allows them to retaliate and increase the cost to trading partners of playing geo-economic games. In other words, we need better EU instruments on investment screening, competition, and state aid control, as well as a stronger international role for the euro and foreign policy.

The year 2020 has underlined the critical importance of sectors such as healthcare. Hasn’t the pandemic also demonstrated the need to change our economic priorities more broadly?

I agree that it would be extremely useful to discuss what is important for society and give greater attention to welfare and wellbeing in general. Part of the issue is measuring, or the lack thereof. We do not even measure the development and broad impact of the pandemic at the European level. Eurostat, the organisation responsible for providing statistical data on the EU member states, has no numbers on this. It would be extremely useful, for example, to break out of the daily reporting of GDP and see the bigger picture, including inequality, CO2 emissions, and social welfare. Green, health, social, and inequality indicators should figure prominently in the policy debate and shape the political agenda.

Footnotes

1 “Creative destruction” is a term coined by the Austrian economist Joseph Schumpeter in the 1950s to refer to the process through which capitalism incessantly revolutionises the economic structure via spurts of innovation that see old enterprises replaced with new ones.

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