

# CER Bulletin

Issue 131 | April/May 2020



## The two economic stages of coronavirus

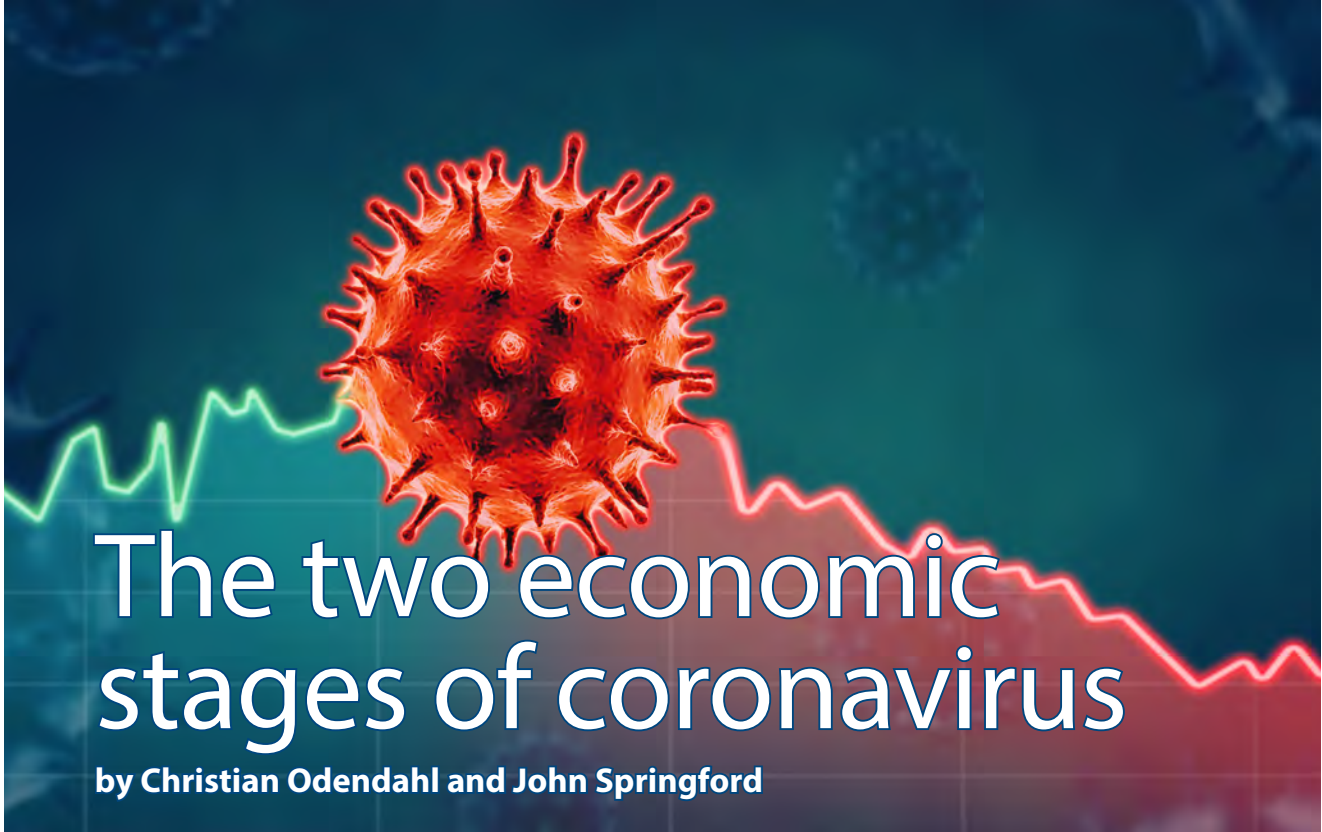
By Christian Odendahl and John Springford

## Turkey and the EU: Preserving transactional co-operation

By Luigi Scazzieri

## Can the EU's defence ambitions survive budget cuts?

By Sophia Besch



# The two economic stages of coronavirus

by Christian Odendahl and John Springford

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European policy-makers must offset the huge costs of containing the virus, while keeping debt sustainable in all eurozone member-states. But they also need a plan to stimulate a V-shaped recovery.

Governments are deliberately curtailing economic activity for public health reasons. This is the first stage of the crisis, and in a CER analysis on March 10<sup>th</sup>, we explained how policy-makers must offset falling income for businesses and households. Most European governments have started to enact policies similar to our proposals: emergency lending to help firms with cashflow and banks with funding, short-time working policies and pay support to prevent unemployment. These policies will require enormous government deficits this year, and borrowing costs have risen in Italy, Spain, Portugal and Greece. But policy-makers must also plan for stage two of the crisis. They must prevent a weak recovery, by stimulating the economy as soon as the virus is sufficiently contained to allow people to return to work. What can governments do now to help the recovery? And what must the eurozone do now to ensure that all governments have the capacity to enact both stages of this plan?

Markets are unstable because investors do not know how long containment policies will last. And there is a risk that, once the crisis begins to ease, fiscal and monetary action is withdrawn too quickly, as happened after the financial crisis. Now, as then, governments are expanding deficits in order to keep businesses and households afloat. But from 2010, most governments embarked

on austerity – and only few did so because of pressure from bond markets. Then the European Central Bank (ECB) raised interest rates in 2011.

Governments and central banks must be clear that they will stimulate the economy once the strict containment phase is over. This will make containment policies more effective now. Knowing that stimulus is coming, banks will be more willing to lend, confident that future revenues will be higher than otherwise. Workers, especially the self-employed, will be more willing to stay at home to prevent transmission of the virus if they have increased confidence that there will be plenty of work once the emergency is over. And firms might even use the time they are temporarily closed to invest in their business.

Both monetary and fiscal policy are needed. The ECB should announce that it will tolerate a period of above-target inflation to compensate for the current undershoot: eurozone inflation has been hovering around 1 per cent for years. Last year, the ECB made clear that it wanted inflation to make a sustained recovery to 2 per cent before raising interest rates and stopping its bond purchase programme. It should now go further, and permit inflation to overshoot for two years to allow a boom to play out, without raising interest rates.

Fiscal policy should act on four fronts. Governments have provided loans to businesses to help them cope with falling revenues. But loans will raise debt burdens, which can curb investment. Governments should announce that part of these loans will be forgiven if the economy as a whole fails to make a strong recovery after the epidemic is contained. Companies should not be responsible for governments' failure to overcome the virus and create the conditions for recovery. Governments should also legislate for generous tax relief for investment after the crisis through temporary tax credits.

The second front should be aid to the most affected services sectors. Here, the recovery will be weaker than in manufacturing: a cancelled restaurant visit, concert or holiday trip will rarely be rescheduled. To help raise demand, governments should announce today that these sectors will pay a lower VAT rate for a year, to boost consumption and activity (if prices are lowered in response) or repair balance sheets (if firms choose to use the tax cut to raise profits, and not lower prices). In 2009, the UK temporarily cut VAT, and the evidence suggests that 75 per cent of the cut was passed on to consumers.

The third front is consumption. Boosting consumer spending would help the most badly affected services sectors too. A one-time payment could be made as the pandemic eases, along the lines of the US's 2008 'economic stimulus payments' of around \$300-600 per person. Research shows that consumers spent between 50 and 90 per cent of that money within three months of its disbursement. In countries like Germany that have a high tax burden on low incomes, permanent tax reductions on low incomes would be preferable, making work more attractive and expanding economic activity.

The final front is public investment. Many countries will have much higher public debt after the containment phase, and governments will be tempted to cut investment. Companies may anticipate that, and curb capacity now. If governments commit to a long-term programme of higher public investment after this crisis, firms dependent on public sector contracts will know that they can maintain – or even increase – capacity.

The eurozone's fiscal hawks will argue, wrongly, that stimulus measures of this type make debt unsustainable. The ECB and the European Stability Mechanism (ESM), the eurozone's bailout fund, have all the tools necessary to keep government borrowing costs down. On March 18<sup>th</sup>, the ECB announced €750 billion of new asset purchases, and, in a departure from usual practice, said they

would be willing to buy more Italian assets, rather than buying from all countries in proportion to their ECB capital. This powerful commitment has eased tensions in markets.

European fiscal policy-makers should complement the ECB with collective action of their own. The ESM should help by providing bailout funds, with conditions to ensure spending is well-targeted on liquidity support to companies and wage support for workers. Ideally, this would be agreed for all eurozone member-states at once, rather than singling out Italy. A memorandum of understanding could make clear that the credit lines will only last for one year before having to be renewed. Policy-makers should also make clear that ESM funding will be increased if need be, through more joint borrowing by the member-states.

Of course, even well-designed stimulus programmes would raise public debt. But since they also increase economic activity, the crucial debt-to-GDP ratio may not increase much, or even fall. Monetary policy is currently weak because interest rates are near (or below) zero. In these conditions, deficit spending by governments tends to raise GDP faster than it raises public debt. This is particularly true if a pre-announced stimulus has positive economic effects during the epidemic, in reassuring businesses that revenues will be higher in the future, allowing them to pay for the loans taken on during the containment phase.

If Europe does not stand together, the consequences of the virus could be severe. Countries that fail to use fiscal policy to offset the deep recession will suffer permanent (and unnecessary) economic damage. *In extremis*, a renewed financial crisis in the eurozone would need to be contained, most likely through the ECB printing money and financing government deficits directly. Such a move is not as radical as it appears, since the economic hit from coronavirus will be severe but temporary, but it would almost certainly face fierce opposition in northern member-states. This virus is a very difficult test for the EU, but there is a broad expert consensus about the economics of the pandemic. And there will be no excuse if governments fail to act.

Christian Odendahl  
Chief economist, CER @COdendahl

John Springford  
Deputy director, CER @JohnSpringford





Despite growing tensions with Turkey on many issues, it is in the EU's interest to renew co-operation on migration with Ankara. The Union should also try to shift the relationship in a less confrontational direction.

In late February, thousands of migrants and refugees tried to enter Greece after Turkish president Recep Tayyip Erdoğan said he would allow refugees living in Turkey to travel freely to Europe. The announcement led to violence at the border, and confronted the EU with the prospect of a renewal of the 2015-16 migration crisis. It was also a stark reminder of the very poor state of EU-Turkey ties. Relations have been increasingly fraught due to a series of disagreements over the implementation of the 2016 refugee deal, Turkey's military operation against Kurds in northern Syria, and its gas exploration activities off the coast of Cyprus, which have led the EU to impose sanctions. As tensions have increased, even transactional co-operation on migration has become more difficult.

Ankara's recent move was an attempt to apply pressure on the EU to provide more support for the almost 4 million refugees and migrants Turkey is hosting. Their presence in the country at a time of high unemployment has become a major political issue, with polls suggesting that most Turks want them to leave. As part of its 2016 migration deal with Turkey, the EU agreed to provide €6 billion to help Ankara support refugees, through the 'Facility for Refugees

in Turkey'. This funded a range of projects to support refugees in the country, helping to pay for their education, housing and healthcare. But Ankara has accused the EU of not living up to the agreement.

Turkey argues that EU funds should have been transferred directly to the Turkish treasury rather than being given to non-governmental organisations (NGOs) and others, and that in any case the funding was insufficient, given that Turkey itself spent around \$40 billion supporting refugees. Indeed, only half the money pledged in the deal has actually been disbursed. Moreover, some programmes will run out of funds soon, and the Union has not committed itself to continue funding them. Ankara is also frustrated that other EU promises have not materialised. As part of the 2016 deal, the EU promised to give Turkey visa free travel, to modernise the EU-Turkey customs union, and to revive Turkey's accession negotiations. Progress on all three has stalled in response to the restriction of civil liberties in Turkey following the 2016 coup attempt, and the broader deterioration in EU-Turkey relations.

At the same time, Turkey's border move aimed to pressure Europeans to be more supportive

of Ankara's actions in northern Syria. President Bashar al-Assad's forces, backed by Russia, have been making substantial advances against the last Turkish-supported rebel stronghold of Idlib, killing scores of Turkish soldiers and pushing about one million people towards Syria's border with Turkey. Ankara wants the EU and NATO to put pressure on Russia to de-escalate, and it also wants the Europeans to provide material support for displaced persons in Syria.

While European leaders have condemned what they say is Ankara's "use of migratory pressure for political purposes", they have also sought to reduce tensions and to save the migration deal. Initial talks have had some success, with Turkey resuming some border co-operation. However, this is only a lull, as the EU and Turkey have not yet agreed on a way ahead for the migration deal. European leaders do not want to be seen to give in to Erdoğan's demands for more money and assistance, and tensions could easily flare up again. While some member-states, such as Germany, favour pragmatic engagement with Turkey, others are taking a harder line. Greece and Cyprus, as well as France, are particularly angry about Turkey's ongoing gas exploration efforts in Cyprus' Exclusive Economic Zone in the Eastern Mediterranean, and by its maritime delimitation agreement with the Libyan Government of National Accord, which infringed on Greece's Exclusive Economic Zone.

It is in the EU's interest to renew migration co-operation with Turkey and put it on a more solid footing. The EU should make clear that it is willing to continue to help Turkey to shoulder the burden of providing support for the refugees it is hosting. Given that the EU still lacks an effective asylum policy and is unwilling to take in large numbers of migrants and refugees, it is left with a choice between helping Turkey or using brute force to try to keep migrants out at the Greek border. Helping Turkey to support the refugees it is hosting is preferable, as repelling people at the border is both contrary to the EU's international obligations to asylum seekers, and unlikely to be feasible if numbers rise significantly. The EU should continue to provide funds to organisations that support refugees, rather than to the Turkish government, to ensure that Turkey does not use money to resettle people to Syria against their will. Willing member-states should also offer to take in some of the most vulnerable refugees directly from Turkey.

At the same time, the EU cannot insulate itself from the crisis in Syria, which is the root cause of the surge in refugees. The latest ceasefire agreed between Russia and Turkey is unlikely

to last. Russia's aim remains to push Turkey out of Syria, allowing Assad to re-establish control over the whole country. But Moscow seems prepared to do so gradually in order to avoid a rupture in its relationship with Ankara, which it wants to nurture with a view to dividing NATO. This is a problem for the EU: if Idlib falls, then hundreds of thousands of refugees are likely to pour into Turkey and try to reach Europe. The Turkish idea that EU member-states should set up a no-fly zone to protect refugees in Syria and stop Assad's offensive would require military engagement, and appears detached from the reality of what Europeans are willing to do. There is also no consensus in Europe or the US for substantially increasing the pressure on Russia to de-escalate. But this should not prevent member-states from increasing humanitarian support for displaced people in northern Syria.

The recent spat over the migration deal shows the importance of maintaining some EU-Turkey co-operation. As the CER argued in 2018, even maintaining transactional co-operation in areas such as migration would be increasingly difficult without a broader positive agenda to structure EU-Turkey relations. It will be difficult to inject fresh impetus into talks over visa liberalisation or modernising the customs union as long as civil liberties in Turkey remain constrained and Ankara continues to fuel tensions in the Eastern Mediterranean. But the EU should still try to shift its relationship with Ankara in a less confrontational direction.

Europe should show that it is willing to be generous in helping Turkey take care of refugees, and ready to increase dialogue and consultation over regional security. It should underline that it takes Turkey's security concerns in Syria seriously and is willing to pressurise Russia to put a lasting ceasefire in place. Ultimately, however, whether EU-Turkey relations can significantly improve depends above all on what Ankara decides to do. This will be driven by how well the Turkish economy performs in the face of the coronavirus emergency, and how Turkey's relations with Russia evolve. If the economy suffers, or if relations with Russia deteriorate as a result of renewed fighting in Syria, Ankara may be tempted to decrease tensions with Europe and the US. Europe should be ready to seize that opportunity.

Luigi Scazzieri  
Research fellow, CER @LScazzieri



# Can the EU's defence ambitions survive budget cuts?

by Sophia Besch

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The proposed cuts to the EU's defence budget will not put an end to the EU's ambitions. But they show that, on defence, the Union is only as effective as member-states allow it to be.

European Commission President Ursula von der Leyen promised that hers would be a “geopolitical Commission” that would take bold steps towards a “genuine European Defence Union”. The Commission's 2019 proposal for the EU's next multiannual financial framework (MFF) reflected this ambition. Years of high-profile announcements about the Union's aspirations as a defence actor culminated in a proposal to spend money on defence for the first time – almost €20 billion over seven years. This was to be divided between defence research and development and ‘military mobility’ – measures to facilitate the movement of military equipment across the EU by upgrading existing infrastructure (for instance by strengthening bridges) and simplifying customs formalities for military operations and the transport of dangerous goods.

The EU member-states have not yet agreed on a final MFF, and the unprecedented emergency measures to tackle the coronavirus may still lead to significant adjustments. But in the negotiations so far, defence has emerged as a loser. The Commission had originally planned, through the ‘European defence fund’, to spend €8.9 billion to co-finance collaborative capability development projects and €4.1 billion to fund collaborative defence research. This money would have catapulted the EU into the top four

defence research and technology funders in Europe. As things stand, that will not happen: in the most recent proposals, the defence fund was halved, to €6 billion over seven years. The Commission's €6.5 billion military mobility plan was scrapped altogether.

Even with a larger budget, it was never guaranteed that the Commission's initiatives would deliver. Critics raised a number of concerns about the EU's efforts in general and the defence fund in particular. Central and Eastern member-states and the US argued that the Commission's ambitions would undermine NATO. The US and Nordic countries with close defence industrial links to the US charged that the money was more about helping Western European defence industries win market share from American firms than about turning the EU into a more capable defence actor. And defence industry experts across Europe claimed that the Commission did not have the in-house capacity to select the most promising projects to fund. The reduced budget would make it much harder to prove these critics wrong.

In the end the EU's defence initiatives did not fall prey to strong opposition, but rather got lost in the traditional horse-trading of EU budget negotiations. Member-states found themselves under pressure to reduce the overall size of the



budget, while at the same time maintaining existing priorities, such as agricultural funds or support for poorer regions. Newer programmes, such as those pertaining to defence, fell by the wayside regardless of their merits. The loss of funding for military mobility is especially hard to justify - popular with Central and Eastern member-states, who saw it as a measure to strengthen Europe's defences against Russia, it was also a flagship initiative of EU-NATO co-operation and thus made the defence fund easier for ardent transatlanticists to swallow.

The lesson here is that while there may be a general consensus that the EU should do 'more' on defence, it is not yet strong enough to loosen member-states' purse strings. The next step therefore should be to get greater agreement from member-states on the purpose of von der Leyen's Defence Union. The new so-called 'strategic compass' process could help. Planned as a follow up to the EU Global Strategy, the compass aims to involve member-states in a joint threat analysis and build a consensus on what the EU should be able to do. That should help lay the foundations for greater investment in defence. But the compass process is designed to take two years - frustrating for anyone who believes that the Union needs to act to shore up European defence sooner rather than later.

The EU's defence ambitions will not be completely stalled by the budget cuts. Too many initiatives have been set in motion over the last

few years. Within the Permanent Structured Co-operation (PESCO) framework for increased defence co-operation member-states have made commitments to invest in the readiness of their national armed forces. The new Co-ordinated Annual Review (CARD) mechanism is designed to co-ordinate the defence planning of member-states. The first ever Commission Directorate-General (DG) for defence industry and space also remains. Its creation in the autumn of 2019 broke a taboo: for decades, member-states had resisted the Commission's attempts to become more involved in the development, production and procurement of military goods and services - defence industries were traditionally considered areas of vital national interest and therefore beyond the Union's sphere of influence. However, while the new DG has established the EU's right to get involved in European defence industrial co-operation, a lack of funding would mean member-states risk setting it up to fail.

The push to prioritise defence has to come from the member-states themselves. It is likely that national leaders will continue to call for the EU to do more in this area. But so far, the budget negotiations imply that member-states do not take defence as seriously as the rhetoric of a 'geopolitical' Union suggests.

Sophia Besch

Senior research fellow, CER @SophiaBesch

## CER in the press

### CNN

14<sup>th</sup> March

"Now that future [UK-EU] relationship talks are being interrupted [due to the coronavirus], it is inevitable that both sides will have to start considering possible extensions," says Agata Gostyńska-Jakubowska of the CER in Brussels.

### Financial Times

4<sup>th</sup> March

Ian Bond of the CER offers six pointers to western leaders on how to deal with Vladimir "master of gaslighting" Putin: "Western leaders should not forget history, ancient or recent, or ignore the reality of Putin's Russia, but nor should they be its prisoners."

### Politico

4<sup>th</sup> March

As Sam Lowe of the CER has pointed out, the UK accepts that leaving the EU's single market and customs union means more autonomy but also more barriers to trade. There is none of the cognitive dissonance of the early May era, when the UK wanted to "have its cake and eat it."

### The Guardian

2<sup>nd</sup> March

"You have had a lot of out-migration from places that were less economically successful and a clustering of younger people ... in more successful regions of Europe. And so that is going to exacerbate social divides

and it's going to show up politically," said CER's John Springford, who co-authored the 'The Big European Sort?', a 2019 CER report.

### Euronews

28<sup>th</sup> February

Research fellow Luigi Scazzieri, from the CER, told Euronews this [Turkey's decision to allow refugees to travel to Europe] could lead to "hundreds of thousands of refugees" arriving in the EU, and could see "a break down of its relationship with Turkey and greatly straining the EU's cohesion".

### The New York Times

11<sup>th</sup> February

Nor has Germany been prepared "to suffer economic

pain for political and foreign-policy gains," said Christian Odendahl with the CER in Berlin. "And this is now a Germany feeling economically insecure about its future."

### The Scotsman

23<sup>rd</sup> January

Charles Grant of the CER said: "The reason the EU has not taken Catalonia's side in recent years is because the Catalans are pursuing a course of action the EU perceives as illegal. So long as Scotland moves towards independence according to the constitution and in co-operation with Westminster, I think the EU would look benignly on Scottish independence."

## Recent events



Philip Lane

### 27 February

Dinner on 'Monetary policy in a zero interest world', London  
With Philip Lane

### 4 February

22<sup>nd</sup> birthday party, Brussels  
With a keynote speech by Phil Hogan



Phil Hogan



(L to R) Thijs van der Plas and Nathalie Tocci

### 4 February

Conference on 'Europe and the rest of the world', Brussels  
Speakers included: Rosa Balfour, Sławomir Dębski, Maria Demertzis, Shada Islam, Pascal Lamy, Michael Landesmann, Thijs van der Plas and Nathalie Tocci

### 28 January

CER/AIG breakfast on 'What role for Europe in the Middle East?', Berlin  
With Dina Fakoussa and Michael Ohnmacht



Dina Fakoussa

## Forthcoming publications

Europe, the US and China:  
A love/hate triangle?  
*Sophia Besch, Ian Bond and Leonard Schuette*

What would an effective UK trade policy look like?  
*Sam Lowe*

The future of EU development policy  
*Khrystyna Parandii*

EU 2030: Globalisation, technological change and the future of the European economy  
*John Springford*

The UK-EU foreign policy relationship after Brexit  
*Ian Bond*

European autonomy and transatlantic divergence  
*Sophia Besch and Luigi Scazzieri*

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