CHAPTER 3

The Greek Economy as a Eurozone Member

3.1 INTRODUCTION

Greece, as a Eurozone and European Union (EU) member, is subject to specific restrictions in regard to its economic policy. Institutions such as the European Stability Mechanism (ESM), European Central Bank (ECB), and European Commission play an important role. After 2010 and the entry of the economy into the so-called Memorandums (Adjustment Program), International Monetary Fund (IMF) entered the spotlight in May 2010 through the SBA (Stand-By Agreement). Gradually since 2012, however, the IMF’s role began to weaken, even though it still carries out post-memorandum monitoring on the economy. These were suspended for 2020 on the occasion of the Covid-19 crisis.

EU established in October 2012 the ESM, the successor to the European Financial Stability Facility (EFSF)—a temporary funding instrument that was introduced in June 2010. Since then, ESM has been actively contributing to financial and macroeconomic stability in the Greek economy. It was the main financing mechanism for the 2012, 2015, and 2017 adjustment programs, preparing and monitoring domestic economic policy.

In August 2018, Greece officially exited its final adjustment program. The Greek economy has entered to a post-memorandum monitoring program—European Regulation 472/2013 (Council of the EU, 2013a)—that is imposed on any high debt country once it has completed...
an adjustment program in order to ensure a smooth transition to normality and secure the return to sustainable economic growth.

Initially, Sect. 3.2 deals with the effects of monetary integration in Europe, Sect. 3.3 presents the mechanism for economic policy-making in Eurozone, and then (Sect. 3.4) the existing economic policy framework for EU countries is analyzed, regarding nations that do not follow any adjustment programs. In Sect. 3.5 there is a reference to the preset economic policy framework of EU countries that are committed to fiscal adjustment programs. Section 3.6 provides some information on EU’s changing position after the 2008 crisis, with a special reference to the Greek economy, and, finally, Sect. 3.7 introduces the effects of Covid-19 crisis on European economy.

### 3.2 A Common Currency Union

A monetary union of diversified economies improves trade and financial integration between members, having also redistributive effects. A common currency between strong and weak members has structural implications as, although wages and productivity adjust slowly, prices and flows—particularly capital flows—between economies adjust rapidly. The adjustment to the functioning and quality of institutions, however, is even slower. The key lies in bridging the gap between higher capital mobility and lower labor mobility, by collecting income based on the more mobile factor (income tax) and providing support to the less mobile factor (social security).

A discretionary program with broadened benefits aimed at reducing unemployment, funded mainly at a union level and supported by the borrowing capacity of each government, proves a powerful example of a timely and effective stabilization instrument (Nikolov & Pasimeni, 2019). The Eurozone creation provided economic and political incentives, favoring the strong economies (Perotti & Soons, 2020). The weaknesses of the regional economies were well known, while adjustment difficulties were underestimated. Core countries gained a comparative monetary advantage by benefiting from a depreciated currency that provided regional economies monetary and financing credibility. Cheaper lending to regional economies resulted in ballooning public and private debt—with most capital inflows being inefficiently used, leading to developments such as growth in non-marketable sectors—thereby further burdening their competitiveness.
Consequently, budgets worsened further at the outbreak of the crisis of 2008. Thus, large differences in the quality and functioning of national institutions and their inability to converge created deeper problems in the euro area, along with the lack of support for monetary integration through a common fiscal policy.

3.3 Mechanisms Forming Economic Policy in Eurozone

Since 2009, informally, and 2010, officially, the governments of Eurozone member states, ECB, and European Commission launched the beginning of a readjustment and redefinition period for objectives, ways to implement economic policy and Eurozone’s general operating framework, in an effort to respond in a coordinated manner to the 2008 crisis.

This policy was mainly aimed at adopting a cooperative approach to restoring financial stability, protecting savings, securing a smooth and easy credit flow toward businesses and households, and gradually establishing a solid system of economic and political governance in EU. In particular, in 2010, European Commission and European Council adopted a total of six economic governance measures for EU, the Six-Pack, which reformed the existing Stability and Growth Pact established by the Maastricht Treaty. This new framework came into force in December 2011 and was set out by four fiscal policy regulations and two regulations on macroeconomic imbalances.

On the one hand, this improved the monitoring of state budgets and public finance in Eurozone, the coordination, acceleration, and clarification of the excessive deficit procedures being adopted, and the framework conditions within which the member states budgets should operate in. On the other hand, the prevention of macroeconomic imbalances in all EU countries was consolidated, as was the immediate response and regulation, via specific actions, of macroeconomic imbalances among euro area member states.

Furthermore, European Commission, in its effort to further broaden budgetary discipline, proposed in 2011 two regulations, the Two-Pack, which were launched in 2013 and imposed further coordination and budgetary surveillance among euro area member states, complementing the Stability and Growth Pact.

The first regulation related to systematic reviews and provisions from state budget plans, thereby ensuring the regulation of potentially high
deficits of euro area member states, while the second focused on strengthening the broader financial monitoring of euro area member states faced with serious systemic threats due to their financial instability.

Finally, it is noted that all Eurozone member states must respect and stick to the first regulation, while the second regulation only comes into force when a member state is on an adjustment program, or is systematically monitored as part of the Excessive Imbalance Procedure (EIP).

The core objectives of this effort for reconstruction and creation helped introduce new structural coordination, monitoring, transparency, and prevention of macroeconomic imbalances among member states.

Such cases were: the European Semester (ES), the introduction of new mechanisms to ensure the financial and fiscal stability of crisis-hit member states; the ESM, the institutionalization of existing authorities that aim at protecting monetary and currency stability and supervising the financial system; and the Single Supervisory Mechanism (SSM). It should also be noted that as of 2008 the role of the IMF in shaping the economic policy of a subgroup of EU countries has been important (ES).

The ES is a structure established and launched in 2010 under the auspices of European Commission and aims to coordinate annual economic policies of Eurozone members, while also identifying and reporting economic challenges that may threaten EU.

In particular, it aims at ensuring fiscal discipline and stability, as well as avoiding excessively high public debt, unsound public finance, promoting structural reforms, proposing and implementing economic growth and development policies, and, finally, boosting investment by creating the conditions needed for a favorable and attractive investment environment. The diversity of tools and instruments used by the ES to achieve set objectives, on different countries and in general, will be analyzed in more detail below, in terms of how to implement economic policy on member states that are (or not) committed to a program.

Finally, it is worth noting that only member states that are not committed to other obligations and have an independent economic policy can be part of the ES, meaning that these countries have not agreed to an adjustment program. Those that are committed can join the ES once they have completed their program. Greece is an example which, although it did not participate in the ES from 2010 to 2018, joined it in November 2018 after completing in August 2018 its third adjustment program signed in 2017.
ECB is the central bank of euro currency and the core of Eurosystem which includes the nineteen central banks belonging to Eurozone member states. As it is being referred in the second paragraph of its charter, its fundamental task is to ensure price stability in Eurozone, while based on the charter’s third paragraph, its basic duties are to implement monetary policy in Eurozone, conduct international exchange rate operations, hold and manage Eurosystem’s foreign currency reserves, and manage a variety of financial market transactions through the TARGET2 payment system.

ECB’s primary objective, in accordance with Article 127 of the Treaty for the functioning of EU (2012), is to maintain Eurozone price stability. This is in contrast with the United States, where Federal Reserve (Fed) has a dual role: to curb inflation and keep employment at desirable levels. In October 1998, ECB’s board of directors ruled that, from a quantitative perspective, Eurozone price stability is defined as the annual increase of the Harmonized Consumer Price Index (HCPI) at a rate below, but close to 2%. The board added that this rate should be maintained over the medium term (ECB, 1998).

In short, the ECB, having a set of specialized tools, implements the necessary monetary policy to ensure price stability in Eurozone, thereby shaping conditions for monetary equilibrium.

The decision to set up the SSM was made at a Eurozone summit in June 2012 as an additional step to unifying the European banking system (Council of the EU, 2012). In September of the same year, it was formally listed and proposed as an institutional concept. The ECB accepted the proposal to oversee, via this mechanism, the financial system in general, though focusing primarily on banks operation. Therefore, the SSM, which was set up by the Council of the EU Regulation 1024/2013 (Council of the EU, 2013b) and came into operation in November 2014, is the legislative and institutional framework that provides a supranational authority—the ECB—with exclusive licensing powers on all banks active in EU, and has the ability to conduct precautionary reviews and supervision, directly, on large systemic banks and, indirectly, on smaller ones.

However, the institutional extension of SSM indicates that ECB undertakes the direct prudential supervision of 123 of the largest credit institutions (and their 1104 subsidiaries) that are based in Eurozone member states.
Credit institutions are required to meet demands on prudential requirements, while direct precautionary supervision of the remaining (approximately 3500) credit institutions continues to be exercised by national supervisory authorities, that can be either a central bank (in Greece it’s the Bank of Greece) or an independent administrative authority (in some member states supervisory tasks have been delegated to both an independent administrative authority and a central bank), in accordance with ECB directions and guidelines. In the case of Greece, the four systemically significant credit institutions are directly supervised by ECB. Finally, only Eurozone member states are obliged to be part of SSM, while EU countries have the option to do so.

Since the crisis, the structure and function framework has gradually begun to adapt and evolve based on a new reality. This new reality was aimed at exercising economic policy in an EU that emerged fragmented, in terms of economic harmony and unity, mainly, between the north and south, that is, between mildly affected economies and those that had experienced a more severe crisis.

Specifically, the Greek economy in 2000–2019 had the lowest growth rate, the highest fiscal deficit, the highest debt-to-GDP ratio (2019) and an average inflation rate when compared to the other Eurozone countries (Table 3.1).

3.4 The Existing Economic Policy Framework of Countries Not Committed to an Adjustment Program

The economies that faced milder symptoms from the 2008 crisis, due to their high degree of resilience, were mainly the Northern European countries that certainly did not have to seek financial support to create safety mechanisms in their economies. Of course, Ireland was the exception as its economy was heavily exposed, forcing the country to resort to the IMF to avoid bankruptcy (bail-out) in 2010.

The explosion triggered by the crisis led to a shift in economic policy of the aforementioned economies and the entire EU. However, they focused on establishing both an a priori prevention and control line and a posteriori position completely guarding against any future disruptions that have now formed the process of implementing economic policy among EU member states, as we show immediately below.
### Table 3.1 Basic national economic data for eurozone countries (2000–2019)

| Country     | GDP growth rate (2000–2019 average) | Public deficit/surplus to GDP (2000–2019 average)* | Debt to GDP (2019)* | Inflation rate (2000-2019 average)** |
|-------------|--------------------------------------|----------------------------------------------------|---------------------|---------------------------------------|
| Eurozone    | 1.4                                  | -2.5                                               | 84.1                | 1.7                                   |
| Belgium     | 1.7                                  | -1.9                                               | 98.6                | 2.0                                   |
| Germany     | 1.4                                  | -1.1                                               | 59.8                | 1.5                                   |
| Estonia     | 4.1                                  | 0.3                                                | 8.4                 | 3.5                                   |
| Ireland     | 5.0                                  | -3.7                                               | 58.8                | 1.7                                   |
| Greece      | 0.4                                  | -6.3                                               | 176.6               | 2.0                                   |
| Spain       | 1.8                                  | -3.7                                               | 95.5                | 2.1                                   |
| France      | 1.4                                  | -3.6                                               | 98.1                | 1.6                                   |
| Italy       | 0.4                                  | -3.0                                               | 134.8               | 1.8                                   |
| Cyprus      | 2.5                                  | -2.7                                               | 95.5                | 1.8                                   |
| Latvia      | 3.8                                  | -2.3                                               | 36.9                | 3.6                                   |
| Lithuania   | 4.1                                  | -2.3                                               | 36.3                | 2.4                                   |
| Luxembourg  | 3.1                                  | 1.7                                                | 22.1                | 2.3                                   |
| Malta       | 3.8                                  | -2.6                                               | 43.1                | 2.1                                   |
| Netherlands | 1.6                                  | -1.4                                               | 48.6                | 1.9                                   |
| Austria     | 1.6                                  | -2.0                                               | 70.4                | 1.9                                   |
| Portugal    | 0.9                                  | -4.9                                               | 117.7               | 1.9                                   |
| Slovenia    | 2.4                                  | -3.2                                               | 66.1                | 3.1                                   |
| Slovakia    | 3.8                                  | -4.2                                               | 48.0                | 3.4                                   |
| Finland     | 1.6                                  | 0.8                                                | 59.4                | 1.7                                   |

*Source* Statistical Office of the European Communities (2020a, 2020b*, 2020c**) and author’s own calculations and creation

National governments that do not follow an economic adjustment program are coordinated and guided by the ES, as of 2010. ES ensures that these member states discuss economic and fiscal policy plans and targets with EU partners at specific times—in the first part of the year—so that in the second part of the year national governments have the ability to achieve set goals.

Interaction between European Commission and members that make up the ES, allows for more effective targeting and, as a result, achievement of common EU objectives.

These institutions analyze and examine the ability of governments to achieve set goals and secure the viability and compatibility of national policies (along with broader macroeconomic objectives targeting stabilization and structural reform) by intervening when necessary or by
proposing alternative parameters and ways of implementing economic policy for the next twelve to eighteen months. If and when goals and incentives are successfully aligned, European Council comes forward to institutionalize proposals and mutually support them in order for them to be formally adopted.

However, it is national governments that make final decisions, adjusted to the given framework, on the way and means in which suitable policies for their economies are being formed.

It must also be stressed that European Commission monitors efforts by member states to establish and adhere to the ten-year Europe 2020 strategy, that it proposed in March 2010, in a bid to strengthen and stimulate employment, education, innovation, defend and protect the climate, and generally promote economic growth and development through the following five objectives (European Commission, 2010):

- Increase the employment rate from 69% of the population, aged between 20 to 64 in 2010, to at least 75% in 2020.
- Boost investment in Research & Development (R&D) to 3% of GDP by creating a favorable climate for private sector R&D investment and launching the European innovation cooperation program between EU and its member states.
- Converge with the “20/20/20” energy and climate goals calling for at least a 20% cut in greenhouse gas (GHG) emissions (from 1990 levels), a 20% increase in the share of renewable energy of final energy consumption, and a 20% increase in energy sufficiency.
- Limit the number of early school leavers from 15% in 2010 to 10% in 2020, and increase the proportion of the population, in the 30 to 34 years old age group, completing tertiary education from 31% to at least 40%.
- Reduce the number of Europeans living below the national poverty line by 25%, therefore removing 20 million people from poverty.

The aforementioned framework for the economic policy of EU member states, i.e., the ES, follows an exact and specific annual time schedule. ES’s cycle begins in November of each year with the publication of the Annual Growth Survey (AGS), the Alert Mechanism Report (AMR) and the Joint Employment Report (JER) by European Commission, along with economic policy proposals for Eurozone member states.
In regard to public finance and national budgets, Eurozone member states are invited to submit draft state budgets for the following year to European Commission by the second week in October every year. Then, Commission examines the plans, based on the Stability and Growth Pact and each country’s economic policy proposals, and expresses and publishes views and comments on each member state in November so that the proposed guidance can be included in the final version of budget.

Lastly, Eurozone finance ministers, those in charge of state budgets and the European Commissioner overseeing fiscal planning, hold special sessions to analyze European Commission’s findings and to draw up EU’s annual budget at the Economic and Financial Affairs Council (ECOFIN Council), thus winding up the yearly timetable cycle for the ES.

3.5 The Predetermined Economic Policy Framework of Countries Committed to an EU Adjustment Program

The 2008 global financial crisis unevenly shook balances within EU’s broader economy. However, despite the fact that the northern EU economies managed to spot, and absorb, in time the large shock due to their structural integrity, a group of countries—economies on Europe’s south—were caught off guard by the crisis.

This resulted in them failing to combat autonomously large-scale volatility affecting their economies, which was spread by the bursting of inflated financial market bubbles created within their financial systems.

As a result, these economies were forced to seek financial support and technical guidance from external bodies, such as EU and northern countries, as well as IMF. This safety feature provided by partners was not generously offered to southern EU countries, as it was accompanied by strict terms and conditions. However, it should be stressed that there was not much time for EU to process and study requests for support from hard hit economies. The shock to EU posed an existential threat, while a further delay in responding raised the risk of a total collapse.

The countries that faced the most critical economic issues are in descending order, based on budgetary needs and degree of uncertainty: Greece, Ireland, Cyprus, Portugal, Spain, Romania, Latvia, and Hungary. All eight of these countries are linked by the fact that they resorted to financial aid programs. The first four, in fact, signed macroeconomic
adjustment lending agreements, while Spain signed a lending agreement indirectly recapitalizing its banks.

More analytically, the above countries signed an appropriately adjusted Memorandum of Understanding (MoU) that set out the terms and conditions on a broader set of economic policy mechanisms to be adopted by the country in order to receive the requested aid tranches during the agreed period. For the most part, the economic policy tools proposed were based on three pillars and aimed at eliminating structural imbalances.

The first pillar focused on fiscal consolidation policies, that is, measures to cut public spending, reduce public administration operating expenses, improve efficiency, stimulate public revenue through privatizations, or reform the tax system with a primary goal of increasing tax revenue. The second pillar included structural reform policies aimed at boosting productivity and improving markets technological efficiency and institutional structures, while removing obstacles to ensure efficient resource allocation and combating any deficiencies and structural rigidities in goods and services, labor, money, and capital markets. The third pillar included financial sector reforms, which mainly aimed at strengthening the banking system supervision, as well as recapitalizing banks.

In order to secure the right conditions that must be met by the borrowing countries, a monitoring process is conducted by Troika, that is by the technical representatives of European Commission, ECB, and IMF. In 2012, ESM also actively took part in this monitoring procedure.

These representatives hold extensive meetings with national officials responsible for the related issues to determine whether agreement terms are actually being respected, as only then are the program’s payments disbursed. A MoU can only be successfully completed if all of the agreement’s proposed criteria have been sufficiently met in the agreed time period and positively assessed by the technical experts.

Although terminating an adjustment program formally signals a return to normality and flexibility, regarding the economic policy framework, countries then enter a new period of enhanced post-memorandum supervision (Enhanced Surveillance of European Regulation 472/2013). This requires them to stick to new specific commitments and timetables, as there are also penalties in the event that agreed conditions are not met (Council of the EU, 2013a). In short, it is a process that seeks to ensure budgetary discipline and a continuation of the economy’s institutional direction as outlined by the specific economic policy framework
in the originally signed agreement, but focusing now on effective implementation of structural reforms after the successful completion of the MoU.

The “commitment” of an economic policy can be considered as being dependent on a country’s level of public debt, that is, its debt-to-GDP ratio. Consequently, countries with high debt levels, both in absolute terms and, mainly, in relative terms (debt-to-GDP ratio), even after a MoU ends, may face future structural constraints on economic policy, given the debt repayment issue. Greece is a typical example of this.

3.6 EU ADJUSTMENT TO THE FACTS AFTER THE 2008 CRISIS

Greece’s entry into Eurozone was a political decision, both on the part of European partners and Greece’s political leaders, as well as Greek society, since it was a topic at the center of national elections in 2000. In economic terms, euro was adopted to contribute to economic integration, increase credibility and confidence in the Greek economy to investors, and allow for Greece’s participation in European economic policy-making. As a result, Greece’s accession to Economic and Monetary Union (EMU) was aimed at reducing the risk premium, which intended to reduce nominal and real interest rates and get rid of foreign exchange risk, while boosting domestic investment and stimulating faster long-term economic growth. In general, monetary integration costs, arising from the loss of independent monetary policy and the use of the exchange rate, were expected to be low for most new member states, as speculation on currency depreciation was seen as being eliminated.

The adoption of the single currency required certain economic and legal requirements (Maastricht criteria) to be met which were set out in the treaty (Maastricht Treaty) regarding the founding of EU. The goal of these criteria is to ensure that an economy that adopts euro is ready to operate within an EMU framework, which guarantees the broader smooth monetary union functioning.

Although Europe’s political and economic integration was very ambitious and promising, the 2008 crisis showed that the single currency adoption was not a strong and effective shield against crises, given that many necessary conditions for an optimal currency area (OCA) (Mundell, 1961) were missing. The recent debt crisis and the divergence of performances among peripheral countries, as in the case of the Greek economy,
versus Eurozone core countries have sharply raised concerns among citizens and governments.

The following figure is indicative of the drop in estimated confidence Greeks had in the institution of EU (Fig. 3.1) after crisis broke out, which prior to 2010 was higher than the average among EU countries. It is noteworthy, that after 2016 there is an upward trend on the relevant views held in Greek society. Covid-19 crisis may have created new conditions, as it was essentially the first time European institutions operated—probably in a timely manner—by agreeing on an initial intervention package (550 billion euros from the Eurogroup decision on April 9, 2020, about 750 billion euros via the ECB, and 750 billion euros from the Next Generation EU), even if this was considered incomplete. Objectively this affected the degree of public confidence in EU institutions and Eurozone.

The deep debt crisis that erupted in Greece in 2009 forced EU to change rules governing the institutionalization of the euro area, mainly regarding the non-activation of rescuing debt-ridden countries. As a result, however, the individual member states operation within the common monetary zone has been affected. At the same time, the currency’s inability to be depreciated due to the EMU, in cases where a boost to competitiveness is needed, poses a serious lack of flexibility which lies at the root of the structure.

Participation in EMU and the fact that member states use the same currency (the euro), while not being its creators, create structural

![Fig. 3.1 Trust in the European Union (Source European Commission [2019] and author’s own creation)]
constraints. The countries that make up the union should have the ability to acquire, but not print, the euro they use. Failure to achieve this condition raises a serious bankruptcy risk. Instead, a state that creates its currency can calculate the taxes it wants to collect, print the money needed to accomplish its goal, and has an infinite ability to issue payment orders without fear of going bankrupt.

States that create their own currency keep control of it through fiscal and monetary policy. In a framework where the central bank does not add in any way fresh capital to the system, it has the ability through either system to impose an exchange of financial data, to intervene on individuals’ preferences, without adding new financial elements. The entry and exit of financial elements into the system is fiscal policy’s responsibility. Finally, tax payment removes capital, while deficits increase creates new capital.

Thus, despite monetary policy in Eurozone being of a central nature (one discount rate for all), fiscal policy is much more complex.

One of the system’s major consequences is that, usually, euro countries tend to operate pro-cyclically—following the business cycle’s flow. By contrast, in the United States there is a driving force, Fed, which adds new funding capital, and has the ability to operate counter-cyclically—go against business cycle’s flow. So, in times of recession, the required budgetary discipline required for Eurozone countries often involves spending cuts at the worst point of the economic cycle. This pro-cyclicality (Harrison, 2011) in managing financial crises can be devastating for economies.

But the 2008 crisis forced Eurozone and EU to take certain important initiatives. ECB, like Fed in the US, had to significantly raise funds available in the European economy through Quantitative Easing (QE) and the financing policies of national credit systems, causing even a limited risk transfer.

At the same time, the banking system monitoring has been restructured. ESM’s capabilities have also been expanded, allowing it to be present in any new private or public debt crisis. But this tendency to return (at least part of the) power to national parliaments and the rise of Euroscepticism, that emerged as a result of crisis of 2008 and the refugee problem, is weighing on the European integration process.
3.7 The European Union and Covid-19 Crisis

This part aims to introduce the effects of Covid-19 crisis on European economy. To this end, the evolution of the economic crisis in European economy, economic policy requirements, and the specific policies developed by April 2020 are being examined.

Covid-19 pandemic pushed global economy and major economies into a deep recession in the first half of 2020. Initial estimates on economies’ course have given way to worse estimates over time due to pandemic’s spreading. Initially, forecasts for the whole of 2020 spoke of zero economic growth, amounting to the second weakest growth rate in fifty years.

However, forecasts then agreed on a large recession as multiple Covid-19 outbreaks caused shock, both in terms of supply and demand in global economy.

The lockdowns imposed by the economies helped to reduce the pandemic and protect human health, but at the cost of losing production. The mechanism for spreading the crisis in European economies, but also in global economy, in general, included the sharp tightening of financial conditions as well as liquidity restrictions for businesses.

However, before the pandemic being appeared in Europe, Eurozone had been showing some signs of concern since the beginning of 2020. Manufacturing activity has been in recession since the second half of 2018 with some signs of improvement, while services were resilient. The recovery of Eurozone, albeit at a slow pace, has been altered by Covid-19 pandemic, at a time when it could have benefitted from the trade agreement between China and United States.

China, where the pandemic began, was the first economy to return to normality, helping partially to resolve global supply chains and support global demand. Despite this, Eurozone was found recording large losses in the first half of 2020 and recovering in the second one.

Contributing to this was the gradual easing of social distancing measures, the resuming of discretionary spending as well as the fiscal and monetary economies’ stimulation. The recovery was combined with how many small to medium-sized enterprises managed to survive the shock of the pandemic.

Partial or complete lockdowns in most European economies have caused major interventions in tourism, travel, and discretionary spending,
leading to a reduction in household spending and exports in the short-term. The prevalence of high levels of uncertainty has led to reduction in business investments, reduction in demand and tightening of financial conditions.

States’ intervention to avoid permanent damage to productive structures had to be immediate and decisive on the part of national governments, as EU announced on March 13, 2020. Given the limited size of the EU budget, the main fiscal response to the Coronavirus would come from Member States’ national budgets. “Fresh” money could actually come from national governments with inevitable consequences for public finances’ viability, especially when combined with GDP reduction. For this reason, European Commission proposed that the Council had to apply the full flexibility existing within EU fiscal framework to cater “unusual events outside the control of government,” thus accommodating temporary deviations from the required fiscal adjustments.

In order to tackle the economic crisis caused by Covid-19, those in charge of implementing fiscal and monetary policy in Europe could not forget the lessons learned from the 2008 crisis. There could be no excuse for repeating mistakes made ten years before Covid-19 pandemic.

In March 2010, as investors abandoned Greek debt and Greek economy’s ability to borrow again, European institutions were reluctant to use the mechanisms and resources at their disposal to the necessary extent or with a clear end goal (Honohan, 2020). Instead of maintaining an expansionary stance, fiscal policy was restrained prematurely, while monetary policy provided some sort of signal, and sometimes, even in the wrong direction.

The weakness of European institutions to act in a direct and effective way to reduce the debt crisis in Greece was apparent. This contributed to crisis’ spread in other Eurozone countries with persistently negative effects on prosperity and political environment. It took more than two years for the situation to get under control and for economic activity to return to pre-crisis levels. The damage was greater in countries with macroeconomic imbalances as during growth periods they did not implement appropriate policies, however, the effects spread throughout the whole of Eurozone.

However, the nature of Covid-19 pandemic is different from the 2008 crisis in both its source and its geographical distribution. European economies were faced with a major external shock that raised hopes that there could be an effective collective response. Perhaps for Europe the
time has come for a rapid and powerful policy implementation that would reduce the effects and secure the equal regionalization of the pandemic among all member states.

The implementation of direct economic policies was necessary as:

- They needed to limit the negative expectations of businesses and households before converting to self-fulfilling expectations. The increased expansion of the pandemic and the adoption of social distancing measures have led investors to take measures to mitigate their exposure. The fall in stock markets that followed and the increase in government borrowing costs could lead firms to overreaction.

- The impact of the recession on employees and small enterprises needed to be reduced. Major government interventions were needed to boost household incomes to ensure that employees and firms were not “punished” for their involvement in the collective action against the spread of the virus. In this regard, among other things, a safety net has been set up among various groups of the population who have been affected either by illness or losing their jobs. For small enterprises, moratoriums have been imposed on debt seizures with special guarantee programs and government collateral. At the same time, work was subsidized to ensure the non-bankruptcy of private companies and social collapse.

The need to implement the above measures was accompanied by an increase in public debt in many countries, while also being accompanied by an increase in borrowing costs. A typical example was Italy, where the market feared that the pressure on its public finances should weigh on the country without the intervention of its European partners. Under these circumstances, the activation of European mechanisms and especially ECB was a necessary condition. The activation of ECB to provide additional flexibility through QE helped stifle any unwarranted market pressures that threatened to disrupt financial markets.

The political answer, whether it is trying to cover problems from the supply or the demand side, focused on ensuring liquidity in the economy. Both monetary and fiscal policies were largely incapable of tackling the virus-induced disruption to supply, while preventing the desired results
from lockdowns against the spreading of the virus. The boosting of businesses affected by the crisis and the provision of bank liquidity has been a key policy response to reduce possible future adverse effects. In this regard, it was necessary to provide as much liquidity as possible from central banks in order to limit contagion risks from money markets to real economy through the banking system (e.g., long-term refinancing operations [LTROs], QE).

EU was initially slow to come up with an organized and targeted response to Covid-19 crisis. But then the situation began to change, especially after Eurogroup decisions on April 9, 2020. As a result, Covid-19 crisis led to the need to develop mechanisms that would initially address liquidity issues in the economy by activating fiscal policy that increased fiscal deficits and debts, while also mobilized monetary policy to control states and firms cost of borrowing.

In essence, however, due to the required size approaching 1–2 trillion euros, there were inevitable consequences on the way the European structure has been organized through the cooperation of its two main branches: national governments and supranational institutions, namely ECB, ESM and European Bank for Reconstruction and Development (EBRD). Here we are interested in the supranational level of developments in which the main actions were the following:

### 3.7.1 Fiscal Measures

As March 23, 2020: Fiscal measures amounting to approximately 37 billion euros (0.3% of EU-27 GDP) include:

- The creation of the Corona Response Investment Initiative (CRII) in the EU budget to strengthen actions for investments in hospitals, small and medium-sized enterprises (SMEs), labor market, and affected areas.
- Enlargement of the EU Solidarity Fund to include the health crisis in its scope and resources mobilization up to 800 million euros in 2020 for EU’s hardest-hit members.
- Redirecting 1 billion euros from EU budget as a guarantee to European Investment Fund (EIF) to motivate banks to provide liquidity to SMEs.
- Extension and freezing of borrowers’ debt repayments that were negatively affected by the crisis.
European Commission has also activated the general escape clause in EU fiscal rules, which suspends the obligation of member states to make fiscal adjustments, allowing budget deficits to exceed 3% of GDP.

As of April 9, 2020: The latest additional package of measures amounting to 540 billion euros (4% of EU-27 GDP) includes:

- The possibility of ESM to provide Pandemic Crisis Support up to 2% of 2019 GDP for each Eurozone member state (up to 240 billion euros in total) to finance health spending.
- The provision of 25 billion euros in government guarantees to European Investment Bank to finance firms, mainly SMEs, with up to 200 billion euros.
- The creation of a temporary loan-based instrument (support to mitigate unemployment risks in an emergency [SURE]) of up to 100 billion euros to protect employees and jobs, backed by state guarantees from 27 EU member states.

### 3.7.2 Currency and Macro-Financial Measures

ECB has decided to provide monetary policy support through: (a) additional asset purchases of 120 billion euros until the end of 2020 under the existing asset purchase program (APP), and (b) the provision of temporary additional auctions for the liquidity facilitation of fixed interest rates and more favorable terms for existing targeted longer-term refinancing operations (TLTRO-III) between June 2020 and June 2021. Other measures include the 750-billion-euro pandemic emergency purchase program (PEPP), by the end of 2020, an expanded range of acceptable assets under the corporate sector purchase program (CSPP) and collateral easing for Eurosystem’s refinancing operations (main refinancing operations [MROs], LTROs, TLTROs). Collateral standards were further eased in early April. These facilities include a permanent 20% reduction for non-tradable assets and temporary measures for the duration of PEPP (in order to reassess its effectiveness before the end of 2020), such as reduction to cuts by 20% in the expansion of Greek government bond eligibility as well as expanding the application of the so-called additional framework of credit receivables, so that they also include guaranteed public sector loans to SMEs, self-employed and households.
Bank Supervisory Board of ECB allowed major institutions to operate under the guidance of Pillar 2 Requirement (P2R), the regulatory framework to maintain capital and liquidity coverage ratio (LCR). Additionally, the new rules for capital composition on meeting the requirements of P2R were front loaded in regards to releasing additional capital. ECB considers that the appropriate release of the anti-cyclical capital stock by the national macro-prudential authorities will strengthen measures to alleviate capital. ECB’s Banking Supervisory Board also decided to exercise—on a temporary basis—flexibility in categorizing claims and expectations to cover losses from non-performing loans covered by public guarantees and state moratoriums related to Covid-19. ECB also advised banks to avoid pro-cyclical assumptions in determining loss forecasts and to choose International Financial Reporting Standard (IFRS) 9 transition rules. More recently, ECB’s Banking Supervisory Board asked banks not to pay dividends for the financial years 2019 and 2020, nor to repurchase shares during Covid-19 pandemic, but to use available capital to support households, small enterprises and corporate borrowers and/or to absorb losses from existing positions against these borrowers.

EU’s proposal (end of April 2020) is to incorporate a 300-billion-euro recovery fund into its 2021–2027 budget and to borrow 320 billion euros from capital markets. In total, the fund will include 2 trillion euros for the economic recovery.

According to Commission’s proposal, half of the funds to be raised will be given to countries in the form of loans, while the rest will remain in EU budget to cover annual interest payment of about 500 million euros. Apart from the temporary 300-billion-euro recovery fund in its new multi-year budget, European Commission’s proposal provides for a 200-billion-euro recovery and sustainability fund, which will be reorganized by an old convergence tool.

It also predicts that 50 billion euros of cohesion funds will be used for another purpose and will be given up front in 2021 and 2022, as well as two 200-billion-euro funds to protect EU’s internal markets.

National governments and ECB were at the forefront of the action. SURE mechanism and ESM’s contribution, as mentioned above, are powerful tools to strengthen EU action. However, stronger involvement from the EU-27 is needed to ensure that they are able to fulfill their mission, to ensure necessary solidarity, and establish mechanisms for the post-crisis reconstruction of the entire European economy.
After several months of severe restrictions and lockdowns, corporate sector across Europe has been hit hard. Many companies faced the inability to service their debt, new operating regulations created new costs and investment needs to comply with new reality, while catering and tourism industry faced the biggest problems. The blow to airlines was similar.

However, individual state interventions raise concerns on two areas: firstly, there may be conditions for unfair competition in subsidized industries and businesses, and secondly, the amounts required will further weaken fiscally weak economies by threatening their fiscal sustainability.

As a result, it was suggested that it would be more productive to create a Recovery Fund (Bénassy-Quéré et al., 2020) to repair and rebuild European economy. The goal of such a recovery initiative is to consolidate corporate balance sheets, repair value chains and rebuild economy in a sustainable way by investing in public goods. Such an effort could be a mechanism for dealing with future pandemics and similar crises.

By examining these actions, it is clear that the course of European unification seems to be succeeding and is reminiscent of the process of United States unification, starting with A. Hamilton in 1790 and going through two world wars.

In these three cases, the federal composition of USA needed to be more active while developing a complex system of guarantees based on the redistribution of gold ownership by individual states in return for debt consolidation. This is how the common American structure was completed to a significant degree.

In essence, wars (and the threats to their existence) were the catalysts for the unification of the American structure. In Europe, it was not the enemy that led nation states to a common destination but it was the virus that would endanger Europe’s administrative capabilities. Of course, in EU, the impact is a slow and evolving process, and it is clear that the mass production of bonds that easily and quickly consolidate national risks will still have to wait for some time yet. But in the past (in 2012) similar bonds had been issued by EFSF (54.2 billion euros for Greece, Ireland, and Portugal) to meet the needs of the debt crisis. These are loans granted under conditionality.

Adversely, ECB’s PEPP provides about 820 billion euros that are symmetrically relevant to all European countries (even Greece that was not entitled to it) and consequently the most vulnerable, such as Italy, pulling the brake on Eurosceptics’ analyses.
However, the similarities between the pressures on European structure are greater than those of United States in 1970 (Kirkegaard & Posen, 2018) and fewer than the 2008 crisis in the sense that virus effects have an almost symmetrical impact on all European economies, that is, they increase the overall systemic risk, without the policies of national governments being symmetrical, whether epidemiologically or economically. Of course, Covid-19 cannot be described as an endogenous problem of economic imbalance. Consequently, the arguments for moral hazard are much less powerful than those related to the heavily indebted economies of 2008. Of course, the economic impact is not exactly symmetrical, as for different reasons, different economies were affected by varying degrees. In general, however, European society has come to terms with a common enemy after 75 years.

Of course, Europe, unlike United States, does not have budgetary transfers mechanisms to support the less favored by the wealthier in the north. However, the holding bonds issued by ECB for the crisis for a very long time means that a supranational organization, or mechanism, will be created that could free ECB from possessing them.

However, it should be noted that the reaction of European states, mainly in the area of fiscal and health policies, was in the first place mainly characterized by a lack of coordination. Policies such as cross-border mobility and local lockdowns were also adopted in an uncoordinated manner, revealing a lack of predictability for the forthcoming phenomenon, despite there being sufficient information coming from China. This resulted in an extended period of social pain and its greater dispersion, and ultimately an increase in the cost of dealing with it. The lack of coordination even took on an aggressive dimension when large European countries seized medical supplies.

Perhaps the biggest risk facing the European structure is the debt problem that will be created in countries with high debt, with an emphasis, of course, on Italy, Spain, and Greece where debt can exceed 200% of GDP but without high risk of non-repayment. Here there is a risk of creating self-powered negative expectations on the cost of debt that will trigger spreads.

The European Commission on May 27, 2020 submitted its proposal for a recovery plan for EU member states. In particular, to ensure that recovery is sustainable, fair and without exclusions for all member states, it proposed the creation of a recovery tool, the “Next Generation EU”
which is included in the EU’s multiannual financial framework (MFF) 2021–2027.

Essentially, this is a temporary emergency tool created to dynamically start Europe’s recovery and support sectors of the economy that need it most. Next Generation EU will have 750 billion euros in capital and, in combination with targeted EU budget support actions (MFF 2021–2027), offer an amount to the order of 1.85 trillion euros for the recovery of member states (European Commission 2020). Out of the 750 billion euros, 500 billion euros will be provided in the form of grants, while the remaining 250 billion euros will be in the form of loans for the recovery and promotion of strategic priorities. To raise funds, the Commission will issue 30-year bonds using its creditworthiness. Their repayment will begin in 2028.

The Next Generation EU program includes three pillars (Fig. 3.2).

The first pillar will finance national recovery plans by promoting investments and reforms:

Fig. 3.2 The three pillars of Next Generation EU (Source European Commission [2020] and author’s own creation)
The 560-billion-euro Recovery and Resilience Facility to support investments and reforms.

- Strengthen existing cohesion policy programs with 55 billion euros from today through to 2022 under the new recovery assistance for cohesion and the territories of Europe (REACT-EU) initiative.
- Reinforcement of the Just Transition Fund up to 40 billion euros.
- Strengthening the European Agricultural Fund for Rural Development with 15 billion euros to support rural areas and promote Green Deal structural changes.

The second pillar refers to supporting healthy businesses through capital boosts, mobilizing private investment and strengthening the strategic autonomy of the European economy:

- 31 billion euros for the creation of the Solvency Support Instrument that will mobilize private resources aimed at urgently supporting sustainable European companies in the areas, regions, and countries most affected. It may be launched in 2020.
- Upgrading of InvestEU with 15.3 billion euros to mobilize private resources toward investment projects.
- Creation of the Strategic Investment Facility with funds of 15 billion euros integrated in InvestEU to create investments up to 150 billion euros.

The third pillar focuses on EU preventative and preparatory actions against future health crises:

- 9.4 billion euros for the new EU4Health program aimed at enhancing health security.
- 2 billion euros for the Union’s Civil Protection Mechanism providing the EU with the ability to prepare for future crises.
- 13.5 billion euros for the Horizon Europe program, which will be boosted to fund vital research in health, resilience and the green and digital transition.
- 15.5 billion euros to finance partner countries, including humanitarian aid.
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