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ThisGenEU

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Abstract

The recent geopolitical events in Eastern Europe represent an important challenge to the European project. As most European economies are still recovering from the pandemic economic shock, the escalation of the Russian invasion of Ukraine has increased both fuel and food prices. Proposals to raise tariffs or ban fuel imports from Russia have been met with resistance by the leaders of certain European economies, in particular those that are dependent on Russian energy products. Is there a new role for EU solidarity? In the last two years, the pandemic response increased integration and coordination within the EU and led to the NextGenerationEU program, a stimulus package with long-term goals that included an unprecedented amount of EU debt issuance to finance loans and grants to Member States. Faced with new military and energy supply threats, the EU could use the policy impetus associated with NextGenerationEU to address these issues at the European level for the current generation. This essay highlights how the EU could develop programs to tackle the geopolitical challenges that we are experiencing right now, a ThisGenerationEU programme.

Mots clés (keywords): ThisGenEU, NextGenEU, EU solidarity, budget, economic policy

Introduction

The escalation of the Russian invasion of Ukraine on February 24th 2022 poses a significant challenge for European economies and for the European Union (EU). Just as European economies were recovering from the Covid-19 pandemic economic shock, with inflationary pressures already building up worldwide, the military conflict further increased energy and food prices. It also destroyed a significant part of Ukraine's economy, and brought economic sanctions on Russia. Together, these factors are impacting European economies negatively. Crucially this impact is asymmetric. Some European economies are more exposed to trade with Russia and Ukraine, both in terms of exports and more importantly in terms of energy imports, and are therefore suffering relatively more from this economic shock.

The Russian invasion of Ukraine has produced a European-wide economic and political shock. Political decisions, such as a full embargo of Russian energy imports or punitive tariffs, are best left to democratic decision making. Meanwhile, we believe that the war shock requires a more systematic policy response at the European level. We therefore highlight some economic mechanisms that may limit the costs of the current shock and facilitate political decision making. One concern is that because the shock is so asymmetric, the distribution of costs associated with these political decisions fall more heavily on a few countries. Because European political decisions are taken unanimously, this asymmetry has hindered political decision-making and may even prolong the conflict as well as the economic shock for the EU as a whole. European solidarity, once again, is crucial.

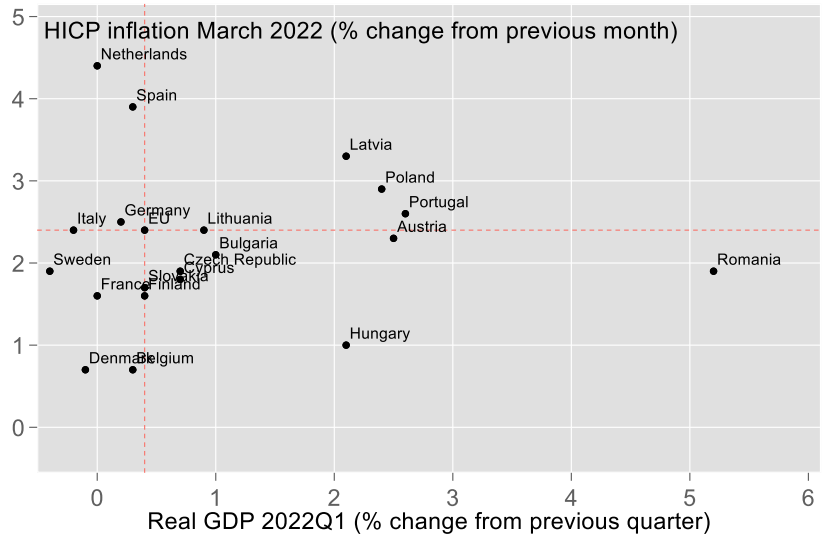
The paper is organized as follows. The first section highlights the economic costs of the war on European economies. The second section draws a parallel with the pandemic crisis and its European management via the creation of a new programme, NextGenerationEU (NextGenEU), and a new facility, the Recovery and Resilience Facility (RRF). The next section outlines how to spend European funds to tackle the asymmetric shocks associated with the Russian invasion of Ukraine and the sanctions levied as a result of the invasion, a ThisGenerationEU (ThisGenEU). The final section outlines how to pay for increased European level expenses, in particular, how to develop a mechanism that funds the European Commission in a way that Member States contribute to the European budget in a state-contingent manner, therefore minimizing negative consequences for their own debt sustainability.

The macroeconomic impact of the Russian invasion of Ukraine

To investigate the impact of this economic shock on macroeconomic outcomes within the EU, we can look at the two most tracked macroeconomic outcomes: real GDP, a measure of economic activity, and inflation, a measure of the growth in prices. Figure 1 shows available Eurostat estimates published on May 17th for the percentage change in real GDP in the first quarter of 2022, relative to the last quarter of 2021 on the x-axis, together with estimates of inflation rates for March 2022 relative to February 2022 on the y-axis. These data are computed as percentage change from the previous period, instead of the traditional approach of percentage change from a year ago, to better capture the effect of the invasion in the presence of base effects related to the pandemic. Because the pandemic hit different countries at different times, variations in output and prices from a year ago may be contaminated by country-specific experiences.

Looking at Figure 1 it is possible to see that there is substantial heterogeneity in terms of macroeconomic outcomes. The dashed red lines represent the European Union (EU) values for real GDP growth and inflation rates. Some larger EU economies are experiencing lower GDP growth and higher or equal inflation relative to the EU average. These include the Netherlands, Spain, Germany and Italy. Others like Sweden, France, Denmark and Finland are experiencing lower inflation than the EU average but also lower real GDP growth while Latvia, Poland and Portugal saw higher inflation than the EU average, but also higher output growth. The remaining economies experienced lower inflation and higher output growth than EU averages.

Figure 1: ASYMMETRIC SHOCKS WITHIN THE EU IN 2022 Q1 (Source: Eurostat)



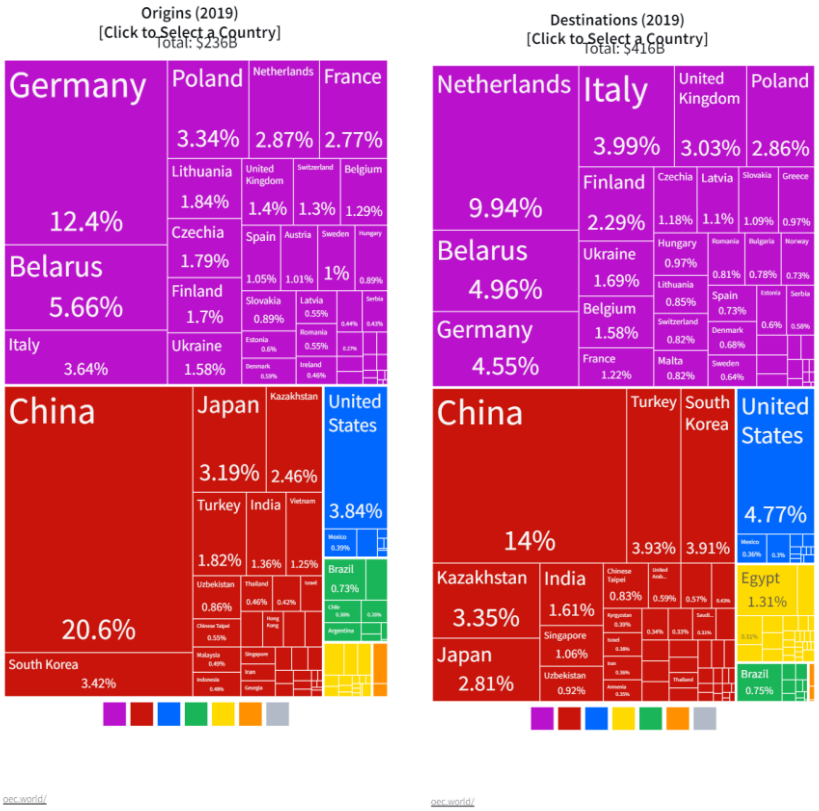
These data represent the first, crude, measured macroeconomic effects following the escalation of the Russian invasion of Ukraine. To estimate the full impact on macroeconomic outcomes one would need to compare realized macroeconomic outcomes with counterfactual outcomes without the conflict. A rough comparison can emerge from the differences between economic forecasts made in the autumn of 2021 and in the spring of 2022. While differences encompass other unexpected outcomes, such as the resurgence of the pandemic in China and subsequent supply chains disruptions, it gives a measure of the macroeconomic impact of the geopolitical tensions. According to the European Commission, inflation rate in the euro area measured by the increase in the harmonized index of consumer prices is expected to almost triple in 2022 and to double in 2023, with regards to the autumn of 2021 forecast at 2.2 percent and 1.4 percent respectively. Moreover, the euro area GDP growth rate in 2022 would be 1.6 percentage points lower, at 2.7 percent, than the autumn 2021 forecast.[1] Germany's economic forecast would decrease by 3 percentage points, Italy's by 2 percentage points and France's by only 0.6 percentage points.

It is clear that one crucial element determining the economic impact of the war is the exposure to Russia. Figure 2 shows the main import and export markets for Russia for 2019, the last available data before the pandemic. Unsurprisingly, countries like the Netherlands, Italy and Germany, are very exposed to Russia through international trade, both in imports and exports, and have been experiencing relatively high inflation and

[1] The economic forecast for 2023 is only barely impacted.

lower real GDP growth during the first quarter of 2022. However, there is substantial uncertainty about the final economic outcomes of the war, in particular whether imports of energy products from Russia will be subject to an embargo or punitive tariffs, and when. Additionally, the economic effects of the war are not limited within country borders. Countries in the EU trade substantially with each other, leading to second round, external effects, even for countries that are not directly exposed to Russia, which may materialize over the next quarters.

Figure 2: Imports (Origins) and Exports (Destinations) for Russia 2019 (source: Observatory for Economic Complexity)



European solidarity: the experience of NextGenerationEU

One straightforward solution for overcoming these difficulties is to employ European solidarity. There are different options and levels of solidarity though, which can tackle specific issues. For example, Germany was reluctant to stop imports of Russian oil, which arrive through a pipeline to Germany, as its ports could not accommodate enough oil brought by sea from elsewhere. This lack of alternatives was pointed out by German officials as an example of the extreme dependence on Russian energy that would make an embargo impossible.[2] However, this lack of substitutability holds only when looking at

[2] See Wolfgang Schmidt, Germany's Federal Minister for Special Affairs and Head of the Chancellery, making the case against substitutability here https://youtu.be/7S-V1EcsY28?t=1559, [Minute 26:23].

Germany. On April, 26th, Robert Habeck, Vice Chancellor of Germany and Federal Minister for Economic Affairs and Climate Action, announced a solution to substitute Russian oil where non-Russian oil is shipped to Germany by pipeline from a port in Gdansk, Poland. These intra-European logistical solutions represent one option for dealing with asymmetric dependency on Russian energy. However they will nevertheless impose asymmetric economic costs, as existing infrastructure which imports energy from Russia still provides the cheapest source of energy.

Another option would be to build on NextGenEU and RRF and transform them into a permanent fiscal capacity. The economic and social costs stemming from the pandemic have urged the EU Member States and institutions to devote €750bn (at 2018 prices) to fostering recovery and resilience with a country-specific funds allocation and temporary European-debt financing. The question of the reimbursement of EU debt by new EU resources has been left to future political decisions. NextGenEU adds to the EU budget and has therefore a multi-annual (7-year) perspective. The pandemic has shown that it is possible to develop an integrated and coordinated EU response to a deep crisis, including unprecedented moves like the issuance of substantial European debt to finance a stimulus package with long-term goals. NextGenEU represents a significant leap in European wide policy in response to a crisis; in this case, targeting the pandemic recovery and transforming European economies and societies, making them healthier, greener, and more digital. Nonetheless, the unrolling of the RRF is still ongoing. By the end of 2021, hence more than one year after the pandemic started, only €100bn had been tapped. As a consequence, the impact of RRF on EU economies remains unknown to date. For this reason, it is difficult to argue for an immediate shift to a permanent facility.

Moreover, part of the RRF is made of loans, not grants. Although the entire amount for grants has been requested by Member States during the European Semester of 2021 (with the exception of the Netherlands), as of May 2022, €200bn of loans had not been yet requested. EU Member States still have until August 2023 to request these loans and therefore tap RRF funds entirely.

It is likely however that the funds available in NextGenEU will not be sufficient to achieve its dedicated policy goals. According to the European Commission (2020)[3], additional *annual* investment would need to increase to €1,040 bn on average (at 2015 prices) to achieve the goal of net-zero greenhouse gas emissions in the EU by 2050. While not all that amount would have to be funded collectively (at the EU level), it makes a sharp difference with the 7-year amount of NextGenEU which is dedicated to climate change for at least 37 percent of the total amount.

In contrast with the former option of turning NextGenEU and the RRF into permanent policy instruments, another option may be to create a new temporary programme. In the face of current challenges, including a tendency towards deglobalization, political disintegration in the EU and within EU countries, as well as new military and energy supply threats, the EU could use the impetus associated with NextGenEU to address such issues at the European level, building upon a new dedicated programme. Let us call it ThisGenEU programme as it would be mostly dedicated to the EU's immediate challenges.[4]

[3] See also Creel et al. (2020) for a more ambitious EU recovery programme.

[4] For an opposing view, see Sapir (2022).

ThisGenEU: for what purposes, or how to spend it?

The pandemic crisis has prompted a budgetary reaction by the EU Member States that surprised many observers. The issuance of European public debt instruments delegated to the European Commission to fund a kind of European fiscal capacity was judged impossible a few years or quarters before. With monetary policy stuck in the liquidity trap and at the zero-lower bound, active fiscal policy is back in policy and political agendas. Furthermore, the discrepancies in available fiscal space between Member States to manage the economic and social consequences of Covid urged a common fiscal reaction.

Collective and coordinated spending reactions by the Member States have also stemmed from the exogenous nature of the health shock. In contrast with the former European debt crisis, this time was extremely different: it could not be argued that Member States and their governments were directly responsible for the shock. This certainly accelerated the involvement of Germany and the frugal countries, e.g. the Netherlands, to endorse NextGenEU and RRF.

The two above-mentioned arguments that are at the origin of NextGenEU and RRF have not lost their relevance. First, two years after the pandemic erupted, European public finances are still not in order and public deficits are very different from one country to another: Greece, Italy, Latvia, Malta and Romania had deficits above 7 percent of GDP in 2021, whereas Denmark, Luxembourg and Sweden achieved public balance or a surplus. Moreover, Belgium, Cyprus, France, Greece, Italy, Portugal, and Spain had a public debt to GDP ratio above 100 percent in 2021, whereas Germany was 10 percentage points above the 60 percent threshold and the Netherlands 10 percentage points below. Member States maintain uneven fiscal spaces. Second, the geopolitical and energy shocks are exogenous to the EU. Circumstances for a collective reaction at the European level are thus met (see also Pisani-Ferry, 2022).

There are at least two other conditions to fulfil before expanding collective spending. First and foremost, the multiannual budget of the EU must be balanced every year, unless some exceptional circumstances occur. The Russian invasion of Ukraine can easily be thought of as such an exceptional circumstance requiring exceptional reactions. Second, the EU rests on the subsidiarity principle: a policy decision must be taken at the political level (local, national or European) where it is the most efficient at fixing the problem it is meant to solve. According to the subsidiarity principle, one can argue that policy decisions with negative or positive spillovers are better handled at the European level. This is certainly true for the transition towards an EU carbon-free economy that requires common regulations and a shared impetus to be achieved. The target of the RRF towards green investments is adequate in this respect.

The current energy and geopolitical crisis will prompt a common budgetary reaction along the same arguments, if and only if the targeted investments are prone to generating positive spillovers (or to limiting negative spillovers) in an emergency. In contrast with NextGenEU, the common fiscal impetus may be targeted towards those currently living in the EU and who face new risks for their security, for their purchasing power and for their ability to offer solidarity to new migrants.

Accordingly, the ThisGenEU programme may involve the acceleration of the means allocated to the European defense agency (EDA). The priority of the EDA is to support the development of defence capabilities and military cooperation among the Member States. With war at the EU borders, and in connection with the disruption of supply chains, securing the EU territory and goods' supply may be a necessity.

The uncertainty of oil and gas supplies and the substantial rise in energy prices require an acceleration of energy input substitution via renewables. This situation modifies the forecast about the transition towards a net-zero greenhouse gas emissions in the EU in that it *accelerates* the requirement to achieve this goal and substantially reduce the EU's dependence on Russian energy. Moreover, it has had uneven effects on inflation between EU Member States. In some states, the issue of purchasing power loss will be more acute as domestic fiscal space is limited. Reliance on European funding would alleviate the social tensions posed by surging inflation and contribute to European and social cohesion.

Finally, the EU has been facing a new refugee crisis. According to the UNHCR and as of 29 May 2022, more than 4.5 million Ukrainians had fled their country, with most arriving in Poland, Slovakia, Hungary and Romania. This puts a heavier weight on these countries that are still substantially below the EU average EU GDP per inhabitant.[5] Again, fulfilling social cohesion requires some mutualisation of the economic and social costs arising from the refugee crisis at the level of the entire EU.

ThisGenEU: how to pay for it?

To make the allocation of ThisGenEU possible, it will be necessary to increase the funding of the European Commission. The European Commission has access to different revenue sources. Although it is possible that new European-wide taxes will be developed, we argue in this paper that, as the residual element among the receipts of the EU budget, the Gross National Income (GNI) contribution is both the most natural and the best way to finance ThisGenEU. The GNI contribution already represents around 70% of EU funding. This contribution has tripled since the late 90s, so it increased substantially without significant political opposition. How should this financing be structured?

One option would be to ask member-states for an immediate GNI contribution and to implement the program through grants. This strategy would remove the fears of larger EU debt, but would be more demanding of member-states in the short run at an economically challenging time. Because the costs associated with the Russian invasion of Ukraine are asymmetric, the benefits from grants may be concentrated, which may make it politically challenging to finance with immediate contributions.

An alternative would be to reproduce the large debt issuance with postponed member-state payments, as in the RFF framework. In this case, the GNI contribution would only occur in the future. Crucially, it would have some desirable properties for member-states. This is because grants financed by EU debt with future GNI contributions by member states to service debt are equivalent to projects financed with state-contingent debt at the member-state level, even if as a whole the EU debt is non-contingent. This EU debt would likely be cheaper for member-states with costly domestic debt (although more expensive for member-states with cheaper domestic debt). Furthermore, judging from current EU borrowing under this mechanism, and examples of member-state state-contingent debt like the BTP Futura in Italy, the EU state-contingent borrowing would likely be substantially cheaper.

To make the role of state-contingent debt clearer, note that most government debt issued is non-contingent; that is, the payment on debt does not depend on economic

[5] According to Eurostat, in 2021, the real GDP per inhabitant of these 4 countries ranged between 33 and 56 percent of the EU average.

conditions. That means that when the economy is doing poorly, payments are unchanged, which can make debt unsustainable. State-contingent debt has been proposed as mechanism to avoid these situations (Pina, 2020). However, state-contingent debt is still relatively rare (Pina, 2022). Crucially, a ThisGenEU programme made up of grants financed by EU debt to be paid by future GNI contributions shares some features of state-contingent debt for member-states and it would therefore limit the negative impact on debt sustainability coming from this new debt (Gros, 2020). Given that member state contributions to the EU budget depend on their future GNI level, economies that are doing better than expected pay more than expected, and the contrary happens for countries doing worse than expected. For example, between 2008 and 2016 the GNI of Greece fell by 44%. This reduced Greece's contributions to the European budget compared to countries that saw smaller decreases in GNI. Other economies that would experience substantial economic growth would see their GNI increase, and with it, their contributions to the EU budget to pay for EU debt. Therefore, the postponed GNI contribution somewhat stabilizes member-state debt ratios following economic shocks by making payments to the EU budget a function of economic conditions for each member-state, a property that is shared with state-contingent debt.

Conclusion

The current geopolitical crisis has renewed interest in a European policy impetus to develop a European defense force, collective actions to shield European economies from the rise in energy prices as well as mutualising the social and economic costs of the Ukrainian refugee crisis. Rather than a permanent NextGenEU programme, we argue for a new temporary programme, ThisGenEU, dedicated to the three afore-mentioned objectives. This enlarged EU budget would allow the EU to deal with asymmetric shocks that require EU-level responses.

As for funding, we propose two options. One would contrast with EU debt issued for NextGenEU and would give rise to immediate GNI contributions by the EU Member State. Another would be an extension of the debt financing used for NextGenEU, and would be financed by postponed member-states contributions based on GNI. Both the immediate or postponed financing of ThisGenEU would represent a move towards more quasi-fiscal transfers within the EU through the EU budget. Better-performing economies would contribute a bit more than the under-performing countries, ensuring that European solidarity is used to tackle the issues affecting this generation of Europeans.

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