Getting Back to Basics

Four Centre Right Steps to Economic Recovery

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Summary

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Europe and the centre right simply can't afford to get this recovery wrong. The challenge is to develop a policy approach which balances the unprecedented economic circumstances arising from the pandemic with the societal demand for more inclusive growth. Only in blending these challenges into a "Middle Way' can the centre right hope to lead the economy recovery. This Policy Brief proposes four steps.

(1) The unlocking of consumer spending and business investment to drive an initial economic expansion aided by tapering pandemic supports. Growth must become the immediate tool for tackling (and capping) pandemic related debt. (2) A back to basics set of priorities facilitating employment creation, affordable housing and the provision of essential public services. A 'back to basics' approach is necessary as it is the only way to deliver the payoffs needed to maintain support across a broad swathe of the middle classes. (3) A renewed commitment to reducing public debt and controlling inflation. Prolonged high inflation erodes purchasing power, particularly for those on fixed incomes or with savings. The optimal strategy for debt reduction is to keep debt levels steady initially, but then focus on slowly reducing it over time. Repairing public finances remains a marathon, not a sprint. (4) The centre right must play the long-term game because institutional reform (at both EU and national level) is about generational change, not soundbites. The European Recovery Fund is a long-term investment tool for achieving structural change, not a short-term mechanism for fiscal expansion. Europe's fiscal rules also require a more easily understood framework. The ownership of these redesigned rules should rest with member states through a more decentralised Eurozone.

Keywords Recovery, Economics, European Recovery Fund, Fiscal Rules

The post-pandemic environment will be driven by an (almost) unprecedented set of economic conditions

In many ways the Coronavirus pandemic has had a war-like impact on European societies. Aside from the terrible health implications of the pandemic, strict restrictions on tourism, hospitality, retail, education and many other economic sectors have been combined with unprecedented restrictions on work and travel. In countries such as Italy and the Netherlands, curfews were introduced for the first time since the Second World War.

Economically, the impact of the pandemic also exhibits many of the characteristics of post-war societies. The fiscal supports required to combat the worst effects of the pandemic have significantly increased national debts. The Eurozone's debt-to-GDP ratio is forecast to exceed 100% in 2020/21 (up from 84% in 2019) with debt levels already exceeding 130% of GDP in Greece, Italy and Portugal.[1] US debt is projected to reach 107% of its GDP in 2021.[2] In Britain, the national debt climbed over 100% in late 2020 for the first time since 1960.[3]

This debt accumulation has increased at a rapid pace owing to the pace of the economic downturn. Germany, France and Italy experienced contractions of 5%, 8.3% and 8.8% respectively in 2020.[4] Nor is this debt accumulation limited to governments. In the first half of 2020, Eurozone companies added over 400 billion euros in corporate debt.[5]

Unemployment too has increased in all EU member states. Although such a measure underplays the extent of temporary support measures and the deep inequalities evident in European labour markets. Data indicates that those employed in the retail and tourism sectors have been disproportionally impacted with highly

1 Eurostat, Euro indictors Q3 2020, Brussels, 21 January 2021.

2 Congressional Budget Office, Long term budget outlook, Washington D.C. September 2020.

3 Carl Emmerson and Isabel Stockton, 'Outlook for the public finances', Institute for Fiscal Studies, 13 October 2020. Accessed at: https://www.ifs.org.uk/publications/15081 on 15 February 2021.

4 European Commission, *Winter 2021 Economic Forecast*, Brussels, 11 February 2021.

5 Michael P. Regan et al. 'Europe's corporate debt binge risks years of pandemic pain', Bloomberg, 20 November 2020. Accessed at https://www.bloomberg.com/news/articles/2020-11-23/europe-s-corporate-debt-binge-risks-years-of-post-pandemic-pain on 15 February 2021.

negative trends also evident among many part-time workers (who tend to be overwhelmingly female).[6]

However, workers in other sectors of the economy – those more suited and able to work remotely for extended time periods – have been characterised by excess saving rates relative to historic norms. Household savings rates in the EU exceeded 24% in Q2, 2020 up from 13% a year earlier.[7] A trend likely reinforced in the period since November 2020 when restrictions began to be reimposed across much of Europe. In Britain, excess household savings have been estimated at £125 billion during 2020 (approximately 20% of Britain's entire tax revenue in 2019).[8] Such savings are largely driven by reduced opportunities for consumption arising from pandemic restrictions.

The economic upheaval caused by the pandemic has also reinforced the loose monetary policy of the European Central Bank (ECB). The ECB's commitment to maintaining an accommodative policy seeks to avoid repeating mistakes made in previous crisis when support was withdrawn too fast thus weakening the subsequent recovery.

However, the combination of monetary (and now fiscal) loosening has contributed to continued price appreciation across many asset classes. Some global stock markets – such as the S&P 500 in the United States – remain at, or close to, historic highs. Low interest rates over an extended period – combined with technological developments that foster wider market access – have further inflamed market valuations, many argue to the point of instability.[9] Traditional financial metrics are warning of overvalued markets and overleveraged investors even as low interest rates are expected to remain for the foreseeable future.

Within the EU, the continued availability of "cheap" money has driven residential property price appreciation across member states. This reduction in average financing costs across the Eurozone – from an average of 5% to 2% between 2007 and 2019 - is partly driving excess demand for property as an investment

[6] For example see McKinsey Global Institute, 'Covid-19 and gender equality: countering the regressive effects', 15 July 2020. Accessed at: https://www.mckinsey.com/featured-insights/future-of-work/covid-19-and-gender-equality-countering-the-regressive-effects# on 16 February 2021.

[7] Charles Wypolosz, *The Euro Area after Covid-19*, Econ Committee, European Parliament, November 2020, p. 12.

[8] Philip Aldrick, 'Record household spending spree to regenerate British economy after pandemic', The Times. Accessed at: https://www.thetimes.co.uk/article/economy-back-to-pre-covid-levels-within-12-months-says-bank-of-england-q8czckhq9 on 16 February 2021.

[9] Rana Foroohar, 'The biggest lesson of Gamestop', Financial Times, 7 February 2021. Accessed at https://www.ft.com/content/ca94c275-43aa-4d12-a0ff-868f2760c8b5 on 16 February 2021.

asset.[10] This, in turn, has fuelled further price rises and increased affordability issues throughout many EU members. This is a trend which has increased, not decreased, during the pandemic.

Therefore, Europe now finds itself confronting an almost unprecedented set of economic circumstances. Low interest rates (a remnant of Europe's sluggish recovery from the Great Recession) have now been paired with unprecedented fiscal supports, soaring consumer savings, increasingly unequal labour markets and rapidly rising public and corporate debt.

The combination of these economic trends are unsustainable in the long run. The challenge for the centre right is to foster a plan that puts growth, jobs and social inclusion at the heart of Europe's recovery. A plan which also ensures that budgetary balance and inflation are controlled over the longer term. Historically, prolonged periods of high inflation have resulted in economic instability (particularly for lower socio-economic groups) and societal disfunction.

Europe (and the Centre Right) simply can't afford to get this recovery wrong

European economies and societies are vulnerable. This is not just attributable to the impacts of the pandemic, as dislocating as many of its side effects are. The reality is that these vulnerabilities have been built up over the preceding decades, particularly in the period since 2008. The last decade has witnessed Europe attempting, not always successfully, to come to terms with a series of overlapping crises.

These immediate threats – economic, banking, migrant and public health – have played a significant role in creating a deeper level of societal unease. An unease magnified by the terrible personal cost – physical and emotional – arising from the pandemic. This is now reflected in a more fluid, disgruntled and vulnerable political landscape.

10 Roser Ferrer, What's happening in Europe's property markets, Caixa Bank Research, 2020. Accessed at https://www.caixabankresearch.com/en/node/8127/printable/print on 15 February 2021.

These vulnerabilities were reflected in a deeply scared pre-pandemic economic environment. Unemployment across the EU remained above 9% between 2009 and 2017 notwithstanding a benign economic environment post-2014. The burden of unemployment also fell disproportionally on the young. In December 2019, youth unemployment still averaged 15% across the EU with rates of more than 25% evident in Spain, Italy and Greece.[11]

The pandemic has significantly worsened these existing economic and societal weaknesses. In this context, Europe (and the centre right) simply can't afford to get this recovery wrong.

Although the EU eventually managed to staunch the systemic breakdowns often threatened over the past decade, its approach has created distinct political cleavages which now threaten to colour its approach to the post-pandemic recovery.

The first relates to divisions which emerged during the financial crisis. In the Eurozone crisis a clear "*north v south*" debate crystallised around the issue of Greek membership of the Euro and member state bailouts. In the migrant crisis a dominant question remained the issue of migrant resettlement. An issue which emerged as a clear fault-line between member states in the west and those in the east.

The EU's response to the pandemic has already been heavily influenced by the preceding divisions. The European Recovery Fund has been explicitly developed as a vehicle for putting Europe's "*old prejudices to one side*".[12] A source of solidarity between all member states.

But as vaccination programmes expand and economic restrictions recede, Europe will face the challenge of balancing its desire for expansive collective action with the reality of economies (and public finances) significantly altered by the pandemic. This challenge is particularly acute for the centre right given our long-standing commitments to fiscal rectitude and economic stability.

The centre right must play a key role in ensuring that the Recovery Fund is utilised for its intended purpose. The risk of member states misusing these funds to strengthen their domestic position or to reduce the independence of financial

[11] Eurostat, *Unemployment rates EU28, January 2000 – December 2020*. Accessed at https://ec.europa.eu/eurostat/statistics-explained/index.php?title=File:Unemployment_rates_EU-28,_EA-19,_seasonally_adjusted,_January_2000_-_December_2020.png on 12 March 2021.

[12] Speech by Ursula von der Leyen to the European Parliament Plenary, 27 May 2020. Accessed at https://ec.europa.eu/commission/presscorner/detail/en/speech_20_941 on 22 February 2021.

or educational institutions should not be tolerated. Such abuses risk undermining the political and public support for the entire Recovery Fund concept.

In some ways, the current set of economic conditions are viewed with trepidation by many decision makers. Worries about rising public and private debts, asset bubbles underpinned by loose monetary policy and the looming threat of inflation are already evident in calls favouring more restrictive policies.[13]

Politically, the economic options facing the centre right are often viewed as a binary choice between continued monetary/fiscal stimulus or a return to more restrictive pre-pandemic norms. But this is incorrect.

The real challenge for the centre right is to develop a more nuanced, or mixed, policy approach which takes account of the vulnerabilities of Europe's economies and societies. Vulnerabilities which almost all existed in a pre-pandemic landscape.

But this approach does not preclude an adherence to the principles of sound financial management. Rather, this social market economy approach can be a model which also strengthens the EU's long-term stability by controlling debt levels, managing inflation and creating employment.

In reality, the real choice facing the centre right is whether we view the post-pandemic economic environment as a threat or an opportunity. A 'threat' infused approach will emphasise a return (as quickly as possible) to pre-pandemic norms. This will, correctly or incorrectly, be identified by many European citizens as including cuts in government spending, reimposition of fiscal rules and arguments about financial conditionality.

An 'opportunity' led plan, on the other hand, emphasises the unique economic consequences of the pandemic. Unlike other crises, Covid-19 has stimulated excess savings in many parts of the economy. It has left the physical and intellectual capital of economies intact.[14] Therefore, the depth of the post-pandemic, consumer driven boom will likely be larger and lengthier than expected. Before the early 2021 lockdown, data from Germany in Q3, 2020 indicated an 8.5% bounce back

[13] Martin Arnold, 'Bundesbank head says rising inflation likely to require policy tightening', Financial Times, 12 February 2021. Accessed at: https://www.ft.com/content/29517402-562e-4fb5-9d6a-6513085d45b9 on 23 February 2021.

[14] Martin Wolf, 'Joe Biden's $1.9tn package is a risky experiment', Financial Times, 23 February 2021. Accessed at: https://www.ft.com/content/441ca3df-77a3-4e89-a5cb-e32d570980fb on 25 February 2021.

in GDP driven by consumer spending.[15] A level likely to be significantly exceeded when vaccinations reach critical mass in late 2021 and 2022.

In this context, the real objective for the centre right should be to facilitate (in the short-run) a post-Covid economic expansion which increases employment and addresses key day to day concerns of middle class voters in areas such as housing affordability and the provision of key public services. Longer-term objectives can focus on reducing debt levels while simultaneously working to deliver a longer-term structural reform programme. A reform programme designed to boost investment, modernise economies and tackle socio-economic inequalities.

For Europe the post-pandemic environment is both a threat and an opportunity. And only in blending these challenges into a "Middle Way' can the centre right hope to lead the economy recovery. If it cannot, the reality will be felt through a significantly smaller parliamentary representation in Brussels post-2024; and an electorate increasingly alienated from the wider integration process.

Four Steps to Economic Recovery

1. Just get out of the way!

Let consumers and businesses drive the short-term recovery

As economic restrictions loosen in the future (and confidence increases) a consumer/investment led expansion should be facilitated. Buoyed by the enforced savings of 2020/21 discretionary spending will fuel the return of the in-person retail, hospitality, tourism and entertainment sectors among many others in the short-term. The potential for consumer spending to drive the immediate economic recovery should not be underestimated. The International Monetary Fund (IMF) estimates growth of 6.4% and 8.4% in the US and China respectively in 2021.[16] Although consumer spending comprises less of European economic growth, utilising pent up demand can stimulate short term growth and aid in returning normalcy to pre-pandemic norms. This step would comprise:

15 Reuters, 'Germany's economy grew by 8.5%'. Accessed at https://www.reuters.com/article/us-germany-economy-gdp-idUSKBN2840NK on 22 March 2021.

16 Gita Gopinath, *Managing divergent economies*, IMF blog, 6 April 2021, Accessed at https://blogs.imf.org/2021/04/06/managing-divergent-recoveries/ on 20 April 2020.

a) The gradual removal of pandemic employment and business supports in 2021. This tapered approach should be carried out on a sectoral basis and be reflective of industry specific trends. Financial supports should be phased out based on easily understood metrics and milestones;

b) No new national level taxes – on both personal and business incomes - should be imposed during this immediate post-pandemic rebound phase. This will ensure the recovery can take hold across the economy while increasing certainty for businesses;

c) The unlocking of excess savings to drive the post-pandemic recovery should be promoted. The concept of "National Recovery Bonds' should be explored as a way for ordinary citizens to invest in their countries future.[17] This idea is not about raising money for national governments (the financial markets can currently provide this more cheaply), but about helping direct excess savings to more productive uses. Such bonds would also act as a hedge against relying solely on consumer spending as an immediate driver of short-term growth;

d) In the short-term reducing government expenditure on pandemic era supports allied to a bounce back in economic growth (driven by businesses and consumers) will put a cap on rising public debt. **Growth must become the immediate tool for tackling (and capping) pandemic related debt.**

e) Private businesses, from sole traders to SMEs and large companies, will drive the economic recovery. The centre right should reinforce its long-standing commitment to easing the administrative burdens of businesses in this post-pandemic landscape. A particular focus should be on facilitating the emergence of new businesses and on supporting SMEs across all sectors.

2. It's time to get back to basics!

Focus on jobs, housing and essential public services

As noted, the centre-right simply can't afford to get this recovery wrong. A 'back to basics' approach is necessary as it is the only way to deliver the payoffs needed to maintain support across a broad swathe of the middle

[17] Interestingly, such an idea has been proposed on both the right and the left of the British political spectrum.

classes. And as the recovery begins in 2021, it is essential that the centre-right focuses on the key issues which are driving voters to political parties outside of the traditionally centrist, pro-European tent. In focusing on the long-term priority of combatting climate change, centrist political parties cannot lose sight of the day-to-day realities which are underpinning current voter behaviour. This step includes:

a) **An overarching goal of creating, developing and sustaining meaningful new jobs.** An integrated approach must be developed which actively promotes employment creation, especially for younger people. No new EU projects or funding streams are required. Simply the flexibility to allow member states to invest in technical/digital skills, hi-tech manufacturing, life-long learning and in facilitating new ventures and businesses. Small and medium sized enterprises should be actively supported at national level. Not every young person needs to learn to code, but every young person deserves an opportunity to work and to be covered by social security, regardless of their position. The centre right must make significant employment its top priority.

b) Second, there is more than one type of inflation to worry about. Housing affordability – be it rents or real estate prices – are a key concern for many young people today all across the EU. If young families continue to be priced out of the housing market, the drift of voters to the fringes will continue. **To hold the centre ground, the centre-right has to win the battle for housing.** Affordable, good quality, and accessible housing is a key ingredient of the European middle-class lifestyle. This issue cannot be seriously addressed without tackling inter-generational wealth issues and the concentration of such capital in older generations. It also involves the realisation that an economy based on rising property prices, but stagnant real wages will become increasingly unaffordable for younger generations. On this, the centre-right must be brave.

c) Thirdly, **the under-provision of basic public services generates a large element of societal unease.** For families, issues like childcare, schools, and leisure facilities represent a fundamental part of their ability to enjoy a sustainable work-life balance. These are common issues across most member states, increasingly also in Central and Eastern Europe. The centre-right must double down on giving the middle classes a stake in a society that they feel is working for them. National governments must be able and free to invest in linking local communities, both physically and digitally, with the realities of the post-pandemic world.

3. Yes! Deficits still matter

Remain committed to reducing public debt and controlling inflation

An understandable concern among many in the centre right is that loose monetary and fiscal policies (combined with high levels of consumer spending) will lead to an upsurge in inflation and ever higher levels of debt. This is because deficits still matter, as do the risks posed by a resurgence in inflation. As noted, inflation erodes purchasing power, particularly for those on fixed incomes or with cash savings. The historic experience shows that surging public debts bring higher inflationary risk when accompanied by monetary expansion.[18] It is also clear that the cumulative impact of constant stimulus are negative. Constant stimulus "*encourage more borrowing and rising debt, which drags productivity lower and slows growth*" in the long run.[19]

But these worries must be balanced against the exceptional nature of the Covid-19 crisis. They must also take account of the anaemic growth evident throughout much of Europe in the last decade. A situation which has fed into an increasingly fragile political environment. In this context, it is important to balance the opportunities for growth afforded by a post-pandemic economic expansion with policies designed to maintain credible budgetary and inflation commitments in the long run. This "opportunity" led approach includes:

a) Over the course of 2021, a retargeting of existing fiscal stimulus programmes to concentrate on those citizens and businesses most in need of support;

b) The phasing out of pandemic specific fiscal stimulus as vaccinations programmes are rolled out and economies re-open;

c) Consistent with Step 1, **the optimal strategy for debt reduction is to keep debt levels steady initially, but then focus on slowly reducing it over time.**[20] Repairing public finances remains a marathon, not a sprint;

d) An understanding that conditions currently exist which may signal the beginning of a period of significant inflationary pressures. In this environment, rising interest

[18] Oxford Economics, *Surging public debt and inflation – lessons from history*, Global Briefing Note, 15 Dec 2020.

[19] Ruchir Sharma, 'Dear Joe Biden, deficits still matter', Financial Times, 20 January 2021, Accessed at: https://www.ft.com/content/d49b537a-95f8-4e1a-b4b1-19f0c44d751e on 25 February 2021.

[20] Presentation by Professor Christopher Simms, *How to worry about government debt*, Princeton Bendheim Centre for Finance, 15 October 2020. Accessed at: https://bcf.princeton.edu/events/christopher-sims-how-to-worry-about-government-debt/ on 15 March 2021.

rates and a contractionary fiscal policy may be required in the future. However, it remains important that future inflation expectations do not crowd out returning economies to higher post-pandemic growth paths. There is no certainty that the spike in inflation witnessed up to early 2021 presages a rapid return of higher prices.[21] **Higher economic growth and moderate inflation have been the key historical drivers of debt reduction;**[22]

e) The pandemic has shown that the principle of creating fiscal buffers during periods of economic growth to facilitate additional spending in times of crisis is sound. It must become a vital underpinning of any future fiscal framework at European level (see below). It allows greater fiscal space to counter unforeseen shocks without causing immediate debt pressures from the financial markets.

4. Play the long-term game

Institutional reform is about generational change, not soundbites

European businesses and citizens need certainty to invest in the future. The pandemic has highlighted gaps in investment in areas such as digitalisation, education, transport infrastructure and combatting climate change. Yet, it is important that large-scale investments – such as those proposed by the European Recovery Fund (ERF) – complement existing national reform efforts. Likewise, the pandemic has illustrated the requirement to revise Europe's fiscal rules to better reflect the priorities (and realities) of post-pandemic economies. These types of institutional reforms are vital to enabling the EU to compete globally in the future. These institutional reforms should always be about facilitating generational change. This step should include:

a) **An explicit recognition that the ERF is a long-term investment tool for achieving structural change**, not just a short-term mechanism for fiscal expansion. It is better to get these investments right, rather than succumbing to shorter term pressures for action which can result in sub-optimal outcomes;

b) Given that the ERF is financed by EU debt, it is essential that the European Parliament plays a key role in ensuring the credibility of the entire process is maintained. This includes the enforcement of meaningful anti-corruption and

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21 Oxford Economics, *Why today's inflation spike isn't likely to last*, Research Briefing, 26 February 2021.

22 For example, see Sofia Bernardini et. al. Reducing public debt: the experience of advanced economies over the last 70 years, Policy Brief, LUISS University. July 2019. Accessed at https://sep.luiss.it/sites/sep.luiss.it/files/Policy%20Brief%20-%20Bernardini,%20Cottarelli,%20Galli,%20Valdes.pdf on 24 April 2021.

rule of law provisions; and the development of further 'own resources' to meet future repayment obligations;

c) The ongoing suspension of the EU's existing fiscal rules highlight the need for a more thorough reassessment of Europe's economic governance. A simplified and more easily understood approach is required which recognises the reality of higher debt levels in post-pandemic economies. **The ownership of these redesigned rules should rest with the individual member states through independent and transparent institutions** (such as fiscal boards) with the Commission in a monitoring role.[23] The development of a more decentralised Eurozone should be supported.[24]

d) The revision of the EU's fiscal rules should also consider a revised quantitative approach towards public debt. While a numerical anchor is important in a revised framework, it is clear that the current 60% debt to GDP level is no longer achievable for many member states in the medium term. Consideration should be given to implementing a revised framework which places the cost of servicing public debt (as a % of GDP) as a key debt sustainability indicator. Such an approach would take account of potential interest rate increases in the future and could form part of a wider commitment to reduce public debt (as a % of GDP) over the longer term.[25]

e) A key lesson from the experience of the Japanese economy since the 1990s has been the requirement to ensure financial stability. In this context, the EU should – as a priority – further proceed with the completion of Banking Union while simultaneously seeking to work towards a real Capital Markets Union. Such initiatives will reduce risk concentrations in national markets while enabling stability for European businesses in attempting to compete in an increasingly competitive global economy.

[23] See Adriaan Schout and Jens Kuitert, *Economic* governance from rules to management: how to strengthen member states, Clingendael Policy Brief, December 2020. Accessed at https://www.clingendael.org/publication/economic-governance-rules-management on 27 April 2021. Also, Olivier Blanchard, Alvaro Leandro and Jeromin Zettelmeyer, *Redesigning EU fiscal rules: from rules to standards*, Peterson Institute for International Economics, Working Paper, February 2021. Accessed at https://www.piie.com/publications/working-papers/redesigning-eu-fiscal-rules-rules-standards on 24 April 2021.

[24] As previously set out by Charles Wyplosz, *Towards a decentralised Eurozone*, Martens Centre, November 2019. Accessed at https://www.martenscentre.eu/publication/creating-a-decentralised-eurozone/ on 22 March 2021.

[25] See presentation by Jason Furman, *When, if ever, should we worry about the debt*?, Bendheim Centre for Finance, Princeton University, 19 November 2020. Accessed at https://bcf.princeton.edu/events/jason-furman-on-when-if-ever-should-we-worry-about-the-debt/ on December 12 2020.

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Credits

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