European economic prospects in 2021

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Alongside its direct health-related impact, the coronavirus pandemic threw a spanner in the economic works. Output fell by an unprecedented amount in 2020. Public debt ratios increased by around 20 percentage points, in some countries substantially more, as governments tried to keep their economies afloat. Still, companies were forced into debt or out of the market altogether, workers into short-time work or open unemployment. If that were not enough, Brexit finally materialised as the New Year bells rang out, adding to economic uncertainty.

Can the European economy recover in 2021? The answer is yes, provided policymakers hold their nerve and build on last year's substantial policy achievements.

Output losses and their knock-on effects have resulted primarily from the restrictive measures imposed to curb infection. With vaccine roll-out now under way, prioritising the most vulnerable, there is a realistic prospect of a gradual easing of these restrictions. A resumption of suspended economic activities will be reflected in high economic growth rates, which will gradually unwind the negative impact on government, corporate and household balance sheets. Those households whose incomes were maintained during the crisis but were deprived of consumption opportunities have the means to catch up on missed spending. This is why forecasts for economic growth not far short of last year's losses – by the EU Commission and other forecasters, including my institute, the IMK – are credible. Importantly, this is not the same as a return to the previous growth path.

It makes more sense to ask what could prevent a decent, albeit incomplete, rebound. Most obviously, a vaccination failure and consequent inability to ease restrictions. Aside from that, the danger is that the crisis has 'scarred' the economy, preventing a strong recovery: high government debt ratios, corporate debt and insolvencies, banks facing higher non-performing loans, unemployed workers losing skills. Is there a risk that such developments abort the recovery? Yes there is, and every day that lockdowns persist, the risks increase. But they are amenable to economic policy responses. And the signs from last year are encouraging.

The fiscal (and also the state aid) rules were suspended, opening up policy space for member states. They will not be reimposed in 2021. The reform process of the economic governance rules, launched by the Commission at the start of last year, will resurface this year. The higher debt ratios (and low interest rates) will focus minds. At least a modest reform package – de-emphasising debt ratios, making allowance for public investment, focusing on medium-run spending trajectories rather than dubious 'structurally adjusted' deficits – seems likely this year or next.

The European Central Bank launched its Pandemic Emergency Purchase Programme (PEPP), which has been decisive in preventing interest-rate spreads from opening up, in marked contrast to the euro crisis. While some legal challenges are likely in preparation, in the wake of the controversial ruling by the German Constitutional Court, these will not have an effect this year and possibly not at all. For as long as inflation remains below target, no change in monetary policy stance is expected.

Moreover, the EU has broken new ground in terms of developing a common fiscal response based on solidarity. Under the programme for temporary Support to mitigate Unemployment Risks in an Emergency (SURE), member states have been entitled to cheap loans providing important short-run support for vital work-sharing schemes, with a total volume of €100 billion. More importantly, the end-of-year agreement on the EU budget and the NextGenerationEU (NGEU) package of measures will provide hundreds of billions of euros, not only in loans but also grants, providing medium-run economic support and easing the burden on national budgets. Our analysis of just the grants component of the Recovery and Resilience Facility (the cornerstone of NGEU) points to a significant boost to output overall (just under 0.4 percentage points of GDP each year) with a distribution highly skewed towards poorer member states and those hardest hit by the Covid crisis.

The mistakes of the euro crisis have not been repeated – so far. It is vital that, unlike in 2011 when predictions of a recovery were used to justify a marked tightening of monetary and fiscal policy, the economic policy course is at least maintained. A pick-up in inflation is likely in 2021 as pent-up demand meets still impaired capacity. It is important to remember that (somewhat) higher inflation is a policy goal, and not a cause for a policy change.

Much more is needed than merely holding course to underpin recovery and increase longer-term resilience, however. As noted already, the fiscal rules need reform. NGEU needs to be backed by new own resources. Last year's limited progress in the area of banking union must be built on to provide an effective Europeanised deposit insurance. The work on preventing harmful tax competition needs to be completed to underpin member state government finances. What has changed, compared to the post-2009 years, is that these issues are high up the political agenda, have been the focus of detailed preparatory work already and, in most cases, do not currently seem to be characterised by the sort of fundamental political opposition that scuppered the recovery from the global financial crisis.

Overall then, a strong recovery can be expected in the course of 2021 – subject to the vaccination and policy caveats above – but one that will still leave the European economy lagging substantially behind its pre-crisis trajectory. The Brexit agreement will limit the economic fallout for the EU27 of this unfortunate step but will nonetheless crimp output in countries with close trading links to the UK. Ongoing negotiations are to be expected in areas not covered by the agreement, notably financial services. In the UK, meanwhile, the economic fallout will be more severe, and the political fallout – in particular the likely strong showing of the Scottish National Party in Scottish parliamentary elections, followed by formal calls for a second independence referendum – could be very substantial indeed.

The climate-change challenge has not receded due to the crisis, but it has fallen out of the news. It is vital that the steps to improve economic resilience are backed by serious decarbonisation efforts. A substantial boost to public investment is needed, all the more so as regulatory steps (such as tightening the Emissions Trading System or the limits on vehicle fleet emissions, which will start to bite in 2021) will cause economic dislocation in some member states. There is some provision for this in the new EU budget and NGEU, but an ambitious programme of investment in European public goods – as opposed to support for national efforts – is still largely absent. I fear it will still be on my Christmas wish list for 2021.