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Europe's Economic Winter: Putting Unity to the Test

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After the Covid crisis, the war in Ukraine and the unfolding energy crisis are puttingthe economy of the European Union (EU) in serious difficulty once again. With high inflation rates, gas supply disruptions and the expectation that the European Central Bank (ECB) is set to further increase interest rates, the risk of Europe falling into recession is real. Against this backdrop, the most immediate challenge is to tackle the energy crisis. There will, however, be other important items on the EU's winter economic agenda. Chief among these is the reform of the EU's fiscal rules. The fiscal consequences of the energy crisis are immense and will take their toll on Member States' finances. It is essential to reassure the markets with credible yet realistic engagement in the area of debt sustainability. At the same time, the Union is confronted with demands for extra EU spending stemming from the war and the energy crisis that cannot be neglected. All of these issues will put the EU's unity to the test. They will require Member States – and, above all, France and Germany – to overcome their divisions and work together to build political compromises.

A largely national-level response that is inadequate for addressing the crisis

So far, Europe's response to the energy crisis has mostly come from the national level. We have seen Member States unilaterally adopting massive subsidies and tax cuts to mitigate the impact of higher prices on households and firms, signing bilateral deals with gas producers, deciding to establish new liquefied natural gas (LNG) terminals or postponing the closure of coal-based and nuclear plants. This »go it alone« approach is very ineffective given the strong interconnection between national energy systems. Major differences in fiscal capacity may also give rise to imbalances in the level of support provided to energy consumers, creating distortions in the functioning of the single market.

The lack of a gas solidarity scheme at EU level may also fuel calls for protectionism. In the event of major gas disruption in the coming months, we risk seeing Member States pitting against each other and imposing export bans to keep »their« gas for national consumers. This would largely undermine trust among European countries, ultimately weakening their unity.

Finally, national governments are more inclined than the EU level to conduct short-sighted policies. Subject to electoral cycles, they tend to prioritise measures providing immediate relief (e.g. tax cuts and energy subsidies to mitigate the impact of higher prices) rather than decisions seen as unpopular (e.g. demand reduction measures) or providing long-term or more diffuse benefits (e.g. investments in renewables and energy efficiency). Through regulations or funding, the EU can influence national responses to ensure consistency with its long-term climate goals.

A badly needed EU compromise on the gas price cap

Despite various high-level meetings, EU Member States remain widely divided on the question of whether or not to set a cap on wholesale gas prices. A group of 15 countries –including France – is vehemently calling on the Union to set this cap. They are deeply dissatisfied with the Commission's gas price cap proposal, which they consider to be useless given the high bar for activating it. A smaller but significant group of countries – led by Germany – remains firmly opposed to the establishment of a cap. They fear this would distort the market and reroute LNG to other parts of the world.

This deep division on the price cap is weakening the EU's unity in the face of the crisis. It is also diverting attention from other more effective and less controversial measures to lower the EU's gas prices, such as joint gas purchasing or negotiating long-term agreements with Norway and Algeria to reduce the price of pipeline gas. France and Germany should help the Commission and the current Czech Presidency of the Council to build a workable compromise on this thorny issue. Germany should acknowledge that excessive prices are harmful and that temporary and well-designed cap mechanisms may be justified in exceptional circumstances. France should recognise the need to couple gas prices with more binding measures to reduce consumption. It should also renounce the extension of the Iberian model, which raises a number of problems and appears less necessary after the Council's decision to tax infra-marginal electricity producers. Both countries should also agree to fully back the European Commission on the other two less controversial initiatives to lower gas wholesale prices, i.e. joint purchasing and the signing of long-term agreements with the EU's major gas pipeline importers.

The imperative of curbing demand

While emergency measures to lower gas wholesale prices are welcomed, they should not be seen as a magic bullet. Given its strong import dependence, the Union has limited capacity to reduce gas prices through diplomacy, market force or regulation. It is thus necessary to prepare for a situation of scarce gas supply – if not this winter, then the following one – with demand reductions imposed through price or regulations.

The EU should establish mandatory gas reduction targets. It should also merge all the different bilateral agreements into a single EU-wide solidarity mechanism to share gas in the event of major supply disruptions. There should also be stronger incentives for Member States to reduce demand. Many have adopted energy saving plans, but these vary significantly in terms of ambition. For instance, whereas German gas consumption decreased by 15 percent during the first six months of 2022, in Italy the decrease was only two percent. The EU should find a way to reward those countries going to greater lengths and punish those that are doing less. Finally, one of the best measures for saving energy and reducing energy costs for households is investing in building renovation. The EU should scale up its efforts in this domain through greater funding and improved regulation to create a market for far-reaching renovations.

The need to guarantee a level playing field in the single market

To avoid a major economic disaster, public authorities should partially shield end consumers from extraordinarily high energy prices. The EU cannot provide this tailored support directly but should ensure that national governments' schemes maintain the price signal and do not fragment the single market. In this respect, the announcement of a German 200 billion euro package to support households and firms has raised alarms. Some of the criticism of Germany's plan is unjustified. Germany is one of the EU countries that has been hit hard by Russian gas disruptions, and a German recession is in nobody's interest. Besides, other countries have also adopted generous fiscal relief schemes – like France – and the German package seems to be well-designed in order to prevent an increase in energy consumption. Having said this, critics are right to point out the risk that generous German support to domestic companies could distort the level playing field in the single market.

The EU should ensure a minimum level playing field in the state aid provided to firms. One option would be to repurpose Resilience and Recovery Facility (RRF) funds. However, RRF funds are designed to finance investments, not measures to shield businesses from high energy prices. A more promising idea is to set up a new EU loan instrument similar to the SURE instrument (Support to Mitigate Unemployment Risks in an Emergency), which was established in 2020 to support national Covid-related employment measures. As for SURE, EU countries would only contribute by providing guarantees (not real cash), and thus the solidarity effect for beneficiary countries would be limited to the benefits reaped from borrowing at lower interest rates (thanks to the EU's good credit rating). Finally, a third option is the creation of an EU fiscal instrument providing support to energy-intensive companies.

An unavoidable reform of the EU's fiscal rules

In parallel to the response to the crisis, a key issue for this winter is the reform of the EU fiscal rules established in the Stability and Growth Pact (SGP). Reforming these rules in the middle of the crisis will not be easy, with all the political capital being spent on managing the crisis. And yet the issue of debt sustainability is more relevant than ever. The energy crisis is taking a massive toll on public finances. According to some estimates, Member States' fiscal relief plans amount to three percent of GDP on average, and the expectation is that governments will keep on increasing spending as long as the crisis persists. In the context of the economic slowdown and tightening of monetary policy, this may create tensions in government debt markets.

Given the need to respond to the crisis and the entrenched and polarised positions on this issue, there is a real risk that EU countries will opt for a very minimal compromise aimed at improving the existing rules from a technical point of view, or – even worse – decide to postpone the debate by a further year by extending the suspension of the current rules. This would be a mistake. The EU needs a new fiscal framework inspired by new principles. The focus should be on guaranteeing debt sustainability rather than controlling annual deficits. EU rules should be based on a more intelligent assessment of debt dynamics, taking into account the impact of inflation and long-term reforms and investments. There should be more scope for differentiation, as different debt levels require different debt reduction paths. Finally, the rules should be implemented in a consistent and transparent way and EU and national independent fiscal institutions must play a greater role in the preparation of fiscal forecasts and the assessment of debt sustainability.

A Franco-German deal is a precondition for any meaningful reform of the fiscal rules. France and Germany should work to find common ground on this crucial issue and help build a political compromise around the Commission's proposal, which constitutes a good basis for discussion. France should get serious about debt consolidation. It should acknowledge the importance of having common fiscal rules and accept that rules cannot be credible if their implementation is subject to too much discretion or politisation. Germany should accept that fiscal consolidation strategies have to be realistic in order to be credible. It must also recognise that curbing public debts not only depends on budgetary consolidation, but also on the adoption of growth-enhancing reforms and investments.

More EU debt will be needed in the coming years

While stabilising debt levels is essential at the national level, the opposite may be true at the EU level. Over the last year, the Commission has exhausted most of its budgetary room for manoeuvre in responding to the immediate repercussions of Russia's invasion of Ukraine – from the influx of refugees to the need to avoid a global food crisis or the provision of macro-economic financial support to the Ukrainian government – but the war is fuelling further demands for extra EU spending. First, the Ukrainian government will continue to require liquidity support. The EU has only provided three billion of the nine billion euro of EU loans promised so far to the Ukrainian government, and the Commission has already pledged to provide a further 18 billion euro next year. Second, Ukraine's post-war reconstruction will be very costly. A joint assessment by the World Bank, the Government of Ukraine and the European Commission estimates the total cost at 349 billion euro, but this figure is expected to grow as the war continues. While the EU will not bear the cost alone, part of this burden will be carried, or at least guaranteed, by the Union.

Apart from these two items, there are justified calls to set up new EU fiscal tools to share the costs of the energy crisis or support green investment. With national budgets under strain, all these demands will have to be addressed by issuing new EU debt. This should not necessarily mean replicating NextGenerationEU-like grant-based programmes, which imply an important dose of inter-state solidarity; for many of these demands, the creation of new back-to-back EU loans may suffice. This, however, requires willingness on the part of Germany and other low indebted countries to share the benefits of the EU's good credit rating with more highly indebted ones.

Conclusion

Europe is in the midst of an unprecedented energy crisis that may have potentially catastrophic consequences for the Union and its Member States. Against this backdrop, providing a bolder and more coherent European response to the crisis is an urgent priority. France and Germany should overcome their differences and work on a possible compromise at EU level to intervene in the wholesale gas market. In addition to this, Germany – as well as other frugal countries – should be open to the idea of setting up new and targeted debt instruments at EU level to share the costs of the energy crisis, support green investment or provide support to Ukraine. France, on the other hand, should recognise the need for more EU binding actions to reduce energy consumption. Finally, both Germany and France should work together on a possible political compromise to reform the EU's fiscal rules, taking the Commission's proposal as the basis for negotiations.

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Genshagen Forum 2022
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