



# 1. Economic developments and policies: is this time different?

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“National responses to the crisis have seemingly led to the crumbling of a series of taboos and orthodoxies guiding economic policy over the last 40 years.”

**Sotiria Theodoropoulou**, ETUI

# Introduction

European economies are currently caught in the eye of a storm caused by a pandemic whose scale has been compared to that of the 1918 Spanish flu. Covid-19 hit the continent just as the economic and social scars left by the previous crisis were beginning to heal. However, it must be noted that at the beginning of 2020, there were clear signs that the pace of this recovery from the latest phase of the W-shaped recession was slowing down.

The European Union was, moreover, facing both old and new challenges, with the new European Commission having taken office just a few months earlier and set as one of its ambitions to make Europe the first climate-neutral continent in the world. The incoming Commission's new growth strategy, the European Green Deal, was launched in December 2019. In its own words, it aimed to transform the EU into a 'fair and prosperous society, with a modern, resource-efficient and competitive economy' where economic growth was decoupled from resource use (European Commission 2019: 2). This Green Deal was also an integral part of the European Commission's strategy to implement the United Nations' 2030 agenda and its sustainable development goals. A little later, in January 2020, the Commission also announced its Sustainable Europe Investment Plan, the investment pillar of the Green Deal (European Commission 2020a).

Meanwhile, other political projects in areas that will shape the future of Europe, such as the deepening of the European and Monetary Union (EMU) and the implementation of the European Pillar of Social Rights, remained incomplete at the moment Covid-19 arrived on the continent.

European policymakers and societies were completely unprepared for the magnitude and breadth of the shock Europe was about to suffer. Complacency seemed to reign even when the epidemic spread like wildfire in Lombardy, wreaking havoc on one of Europe's hitherto best-resourced healthcare systems. The European Commission's winter economic forecasts issued in January (European Commission 2020c) considered the downside risks from the coronavirus epidemic that was ravaging the Hubei province in China only in terms of its impact on international trade.

The EU Member States were thus caught off guard – but they were also affected to different degrees, and their policy responses were based on their individual capabilities to deal with such a shock. Firstly, the spread of the virus during the first wave was much faster in the west and south-west of Europe, whereas, partly due to the implementation of strict and early measures, it largely spared the east and south-east. The second wave has been fiercer, however, even in these latter regions. Secondly, different Member States had been facing different policy challenges prior to the pandemic, with some emerging more scarred from the previous crisis than others. And finally, EU countries all have different healthcare system capacities, different social safety nets to deploy to support incomes and companies, and also very different capacities to expand fiscal measures. Thus, although the pandemic has not spared any European country, its repercussions have depended largely on the particularities of each Member State, the economic and social state of affairs at that moment in time, and the way in which each national government responded.

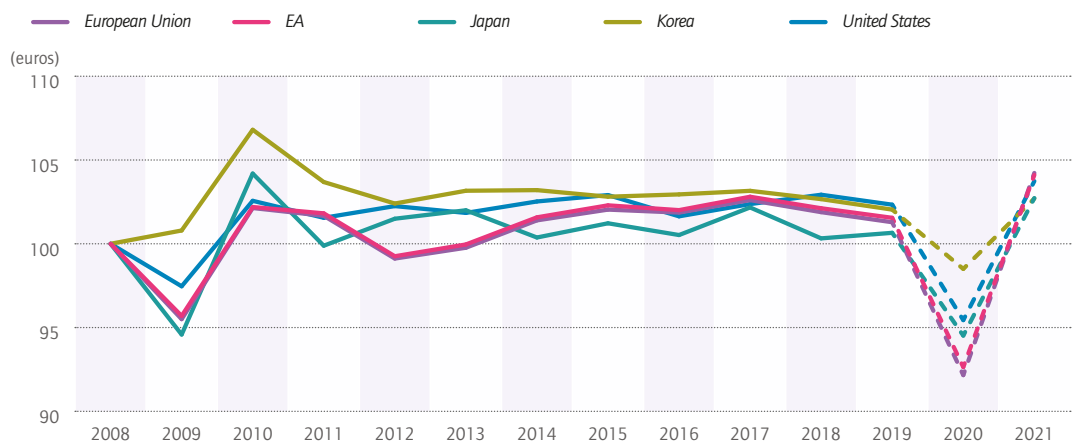
This chapter thus looks in more detail at economic developments in Europe since the beginning of the pandemic, but in the context of the economic and social challenges that Member States were already facing, to different degrees, before its onset. It shows the different ways in which the pandemic affected European economies and examines the policy responses that were deployed at the national and EU levels, as well as to what extent they indicated that lessons had been learnt from the previous crisis. It concludes by considering the questions that these developments leave open for the future.

# A global recession: GDP growth in Europe and the world



The EU and the euro area shrank by 13.9% and 14.8% respectively between the first and the second quarters of 2020.”

**Figure 1.1** Real GDP change, EU, Japan, South Korea and the US, 2008-2021 (forecast) (2008=100)



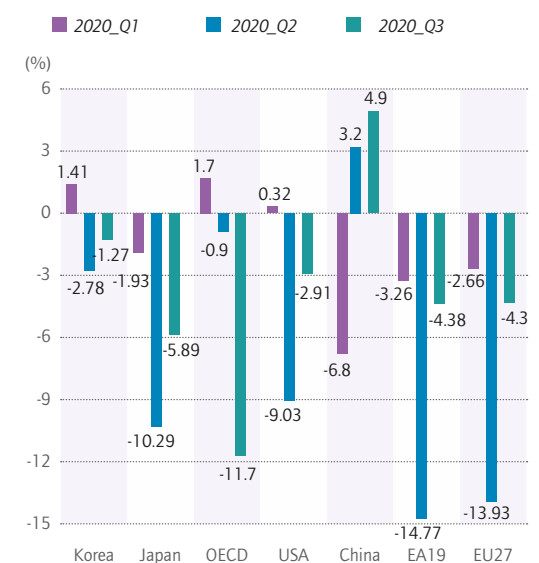
Source: Own calculations using AMECO data, OVGD series.

The EU economy went into a nosedive in March 2020 once the number of reported Covid-19 cases started picking up rapidly. Wary of avoiding the saturation and, eventually, the collapse of healthcare systems, European governments began taking measures to stem the speed at which the virus was spreading among the population. The measures taken in spring 2020 were sharp and sudden, consisting primarily of ordering the shutdown of all economic activity except for those sectors considered 'essential', such as food production and healthcare, or those in which teleworking or virtual provision was possible, such as electronic trading. Schools were also closed, as were borders between Member States and, eventually, EU borders themselves. While the range of measures taken and their degree of severity varied across countries, it was very clear from February/March onwards that the global economy was entering a period of crisis, with very high uncertainty about its depth, duration and consequences.

Figure 1.1 shows the evolution of real GDP growth in the EU and the US, including the (autumn) annual forecasts of the European Commission for 2020, while Figure 1.2 focuses on OECD quarterly real GDP data for the EU, the euro area, the US, China, South Korea and Japan. While the European Commission's annual autumn forecasts are still subject to great uncertainty and feature rather optimistic scenarios regarding subsequent waves of the pandemic and the measures that national governments will have to take to stem them, the data clearly shows (Figure 1.1) that the shock is going to be larger than that of the global financial crisis in 2008, which led to what has been dubbed the 'Great Recession', in comparison to the Great Depression of the late 1920s and 1930s. This recent large shock came during a period in which real GDP growth had been slowing down (since 2017) following a lacklustre recovery from the 'W-shaped' recession between 2008 and 2012. According to OECD data, real GDP in the EU and the euro area shrank by 2.6% and 3.3% respectively between the final quarter

of 2019 and the first quarter of 2020, by 13.9% and 14.8% respectively between the first and second quarters of 2020, and by 4.3% and 4.4% respectively between the second and third quarters of 2020. The US real GDP was flat in the first quarter of 2020 and shrank by 9% between the first and second and 2.9% between the second and third quarters of 2020. Remarkably, South Korea, whose approach to stemming the pandemic did not rely as heavily and exclusively on blanket measures restricting economic and social activity, experienced much smaller real GDP losses in the second and third quarters than the EU, the US and Japan did. Last but not least, the Chinese economy, the first to be affected by the virus, shrank only during the first quarter of 2020 (by 6.8%) and grew by 3.2% and 4.9% in the following two quarters.

**Figure 1.2** GDP growth in the EU27, EA, US, Japan, Korea, China and the OECD (growth rate compared to previous quarter), 2020\_Q1-2020\_Q3



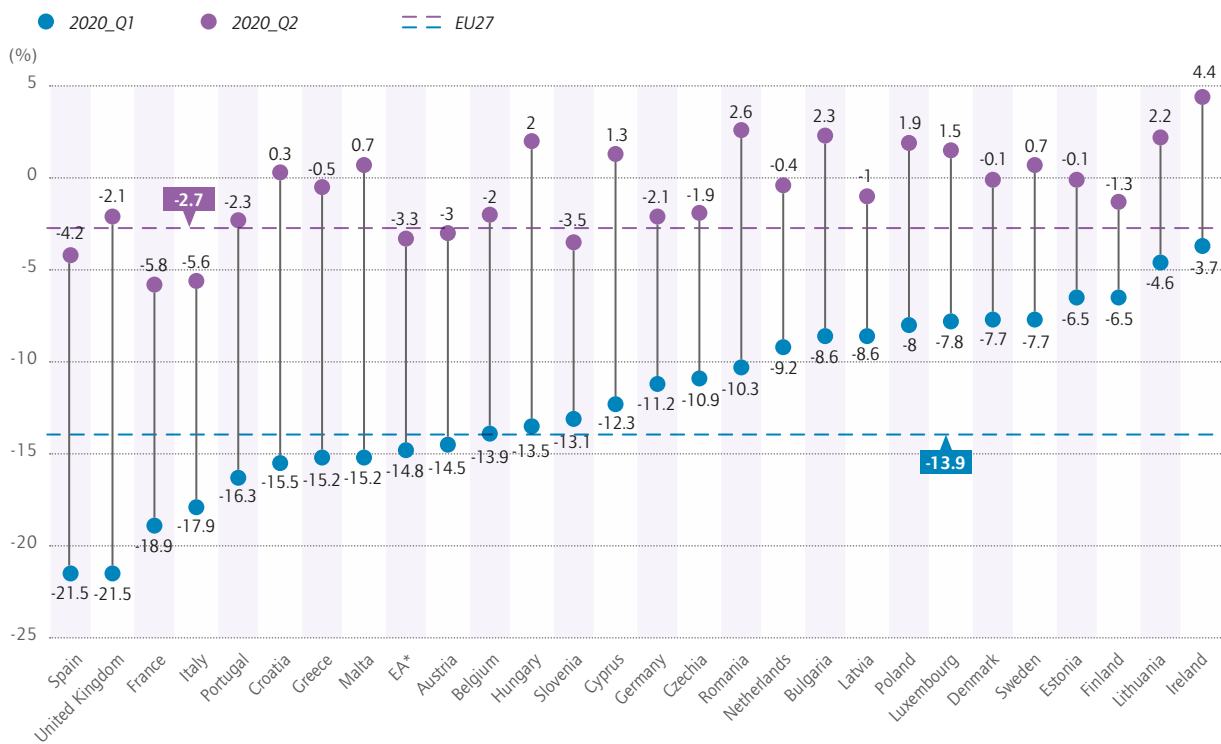
Source: OECD Quarterly GDP data.

# A common shock with diverse consequences

Figure 1.3 shows the change in real GDP in the first and second quarters of 2020 compared to the first and second quarters of 2019 (year-on-year) in the EU27, its Member States (bar Slovakia, for which there are no data yet available), and the UK. Figure 1.4 shows the European Commission's forecasted

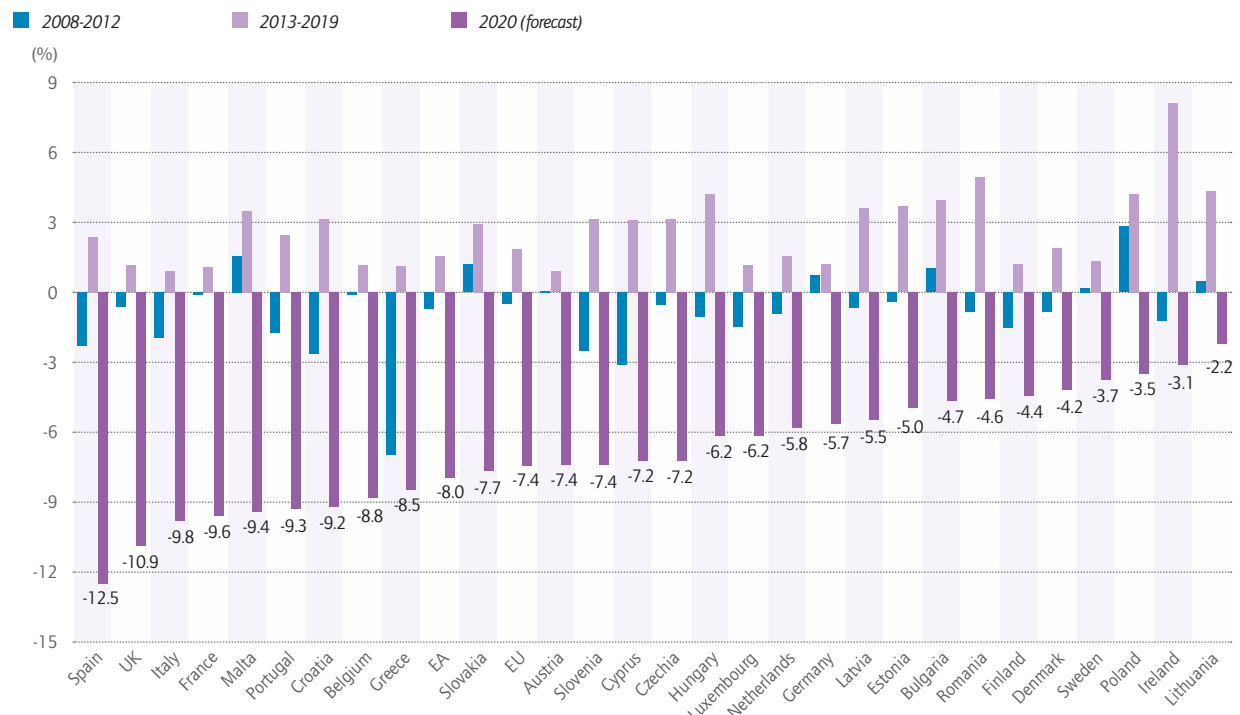
growth rate of real GDP per capita for 2020 for the EU Member States and the UK as well as the respective average annual growth rates for the periods of the previous recession (2008-2012) and the long-drawn-out recovery that followed (2013-2019).

**Figure 1.3** Real GDP change (compared to same period in previous year), EU27, Member States and the UK, 2020\_Q1 and 2020\_Q2



Source: Eurostat NAMQ\_10\_GDP\_CLV\_PCH\_SM.  
\* EA11-1999, EA12-2001, EA13-2007, EA15-2008, EA16-2009, EA17-2011, EA18-2014, EA19-2015

**Figure 1.4** Real GDP per capita (average % change per year), EU27, Member States and the UK, 2008-2012, 2013-2019 and 2020 (forecast)



Source: own calculations using AMECO RVGDP series.

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2. Labour market and social developments

3. The path to 'zero carbon' in a post-Covid world

4. Fair minimum wages and collective bargaining

5. Covid-19: a 'stress test' for workers' safety and health

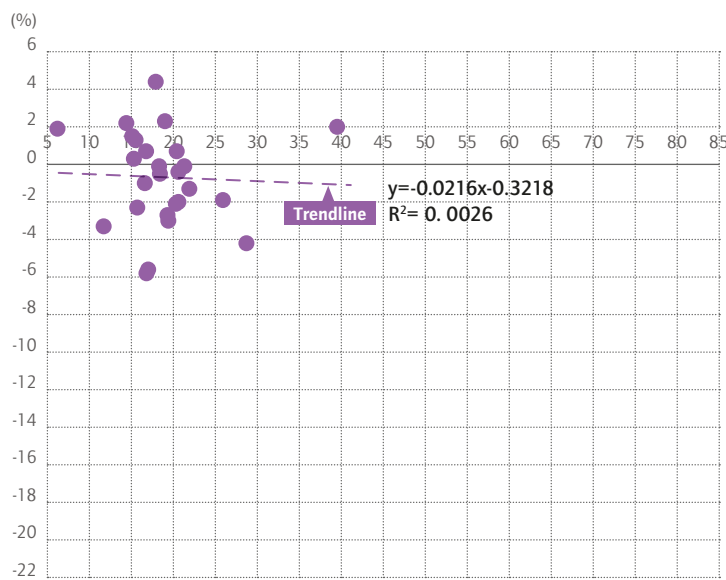
6. Democracy at work in a pandemic

7. Foresight: the many possible post-pandemic futures

The first signs of the recession appeared in many, but not all, countries in the first quarter of 2020, as the pandemic and the measures to stem it began in March. Real GDP fell in the first quarter of 2020 compared to the first quarter of 2019 by as much as 5.8% in France and 5.6% in Italy. European economies then experienced a free fall in the second quarter of 2020. This dip in real economic activity varied widely however, from 3.7% in Ireland to 21.5% in the UK and Spain. Estonia, Finland and Lithuania also experienced losses of only around 4.5-6.5 % in the second quarter, whereas France, Italy, Portugal, Croatia, Greece and Malta saw some of the largest losses, with quarterly year-on-year GDP drops ranging from around 15% to, in the case of France, 19%.

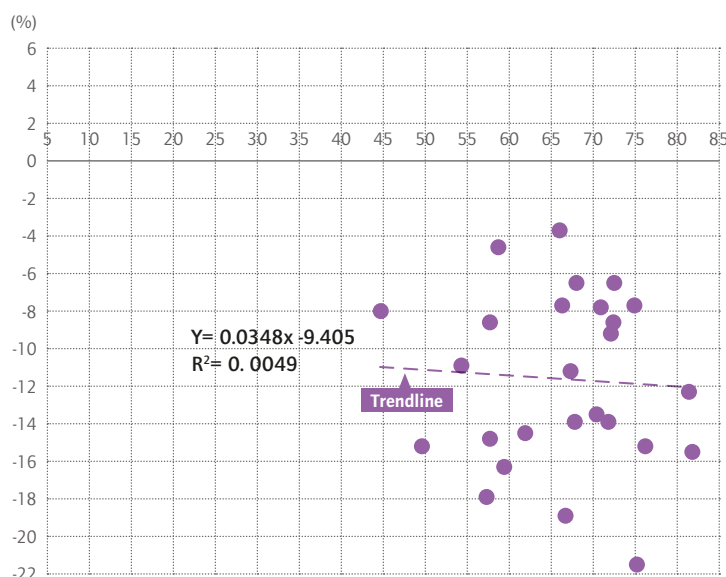
Turning to the annual GDP-per-capita forecasts, some of the Member States which are forecasted to suffer the most from the current recession are also those that were worst hit and/or have taken longer to recover from the previous recession; they are mostly concentrated in the south of Europe – namely Italy, Spain, Greece, Portugal, Croatia and Malta – but also include the UK, France and Belgium. The Spanish GDP per capita has been forecasted to shrink by 12.5% this year, followed by that of the UK (-10.8%), with Italy, France, Malta, Portugal and Croatia suffering expected losses of around 9-9.5%. The forecasts for the north and east of the EU were relatively less grave, although a lot will depend on the evolution of the pandemic. Lithuania, Ireland, Poland, Sweden, Denmark, Finland, Bulgaria and Estonia have all been forecasted to see their GDP per capita shrink by between 2.2% and 5%.

**Figure 1.5** Stringency of government measures and real GDP growth (change from same quarter in previous year), EU, 2020\_Q1



Source: own calculations using data from Eurostat NAMQ\_10\_GDP\_CLV\_PCH\_SM and Hale et al. 2020.

**Figure 1.6** Stringency of government measures and real GDP growth (change from same quarter in previous year), EU, 2020\_Q2



Source: own calculations using data from Eurostat NAMQ\_10\_GDP\_CLV\_PCH\_SM and Hale et al. 2020.

There are various possible explanations for the diversity in the current dip of economic activity across Member States, ranging from the stringency of the measures taken, the dominance of sectors in the economy that were relatively more affected, and the public policy responses to counter the economic shock.

Figures 1.5 and 1.6 illustrate the association between the losses in real GDP growth (year-on-year) in the first and second quarters of 2020 and the stringency of the measures taken by governments – that is, the lengths that governments went to in order to create and enforce social distancing among citizens (e.g. ordering the closing down of businesses in ‘non-essential’ sectors, or limitations on movements within or across countries), as measured by the Oxford Stringency Index (Hale et al. 2020). We see that more stringent measures have been associated with larger losses in output in each of the two quarters. However, the correlation is not particularly strong and there seem to be many Member States that have taken similarly stringent public health measures but that have experienced different degrees of output loss. This implies that there have been other factors influencing the depth of the recession.

### The Oxford Stringency Index (Hale et al. 2020)

The Oxford Stringency Index of national policy responses summarises information on a range of government containment and closure policies. The policies falling under this category concern the shutting down of schools, workplaces and public transport, cancellations of public events, restrictions on gatherings, stay-at-home requirements, restrictions on internal movement between cities/regions, international travel controls, and public information campaigns on the coronavirus. These policies illustrate to what extent governments have imposed measures to restrict economic and social activities to curb the speed at which the coronavirus is spreading: the higher the score, the more stringent the policies. Each of these policies has an equal weight in calculating the overall index.

# Service sectors suffering the biggest losses

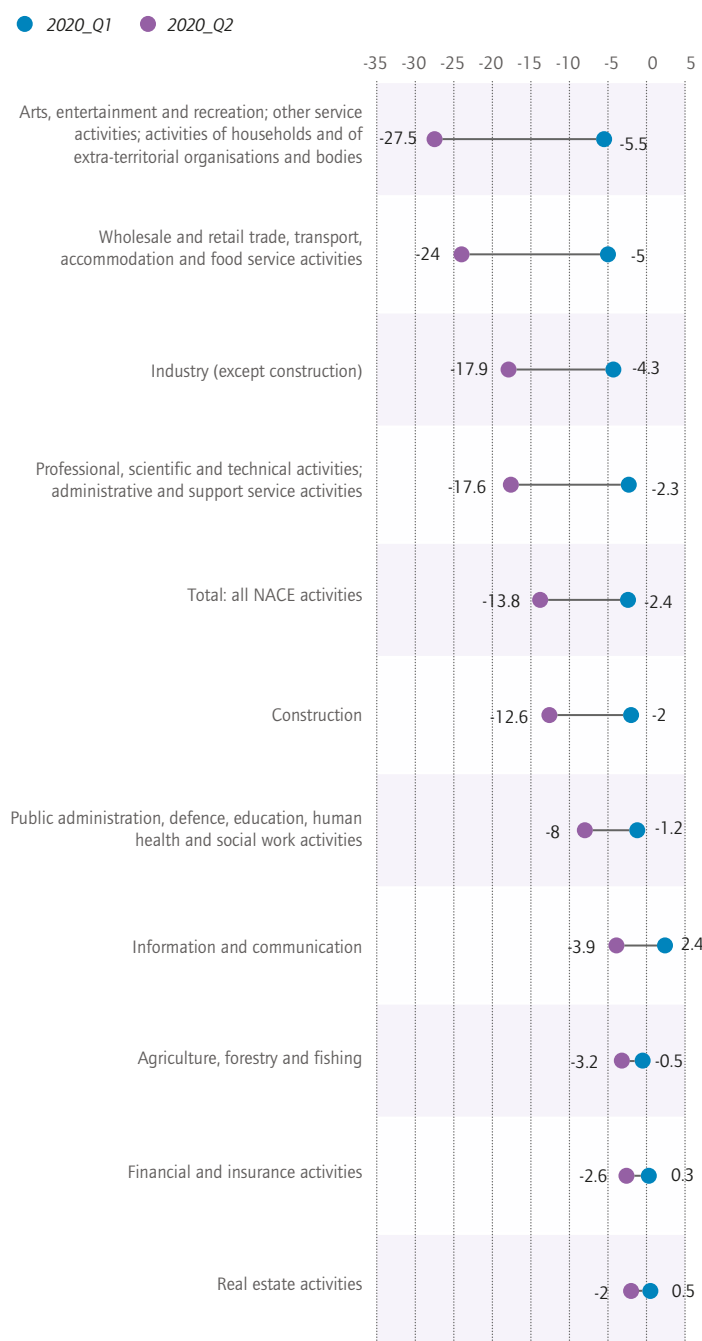
The forced stop in activity imposed by governments across Europe on large parts of their economies did not affect all sectors equally. Activities that revolve around social interaction and which require physical contact evidently suffered more constraints than others; at the same time, some sectors have been deemed as 'essential' and had to carry on despite the risks, while others could carry on their activities thanks to teleworking or virtual operation (e.g. e-commerce).

Figure 1.7 shows how the different economic sectors fared in the first two quarters of 2020 (percentage change in real value added compared to the same

quarter in 2019) in the EU27. 'Arts, entertainment and recreation' and 'wholesale and retail trade, transport, accommodation and food service activities' were the two sectors most heavily affected, with their real gross value added dropping by 28% and 24% respectively in the second quarter of 2020 (-5.5% and -5% in the first quarter of 2020). These are service sectors which are labour intensive and hence a drop in demand in them is linked to relatively high job losses (see Chapter 2). Other sectors whose gross value added shrank by more than average in the first two quarters of 2020 were the 'professional, scientific and technical activities; administrative and support service activities' (-15.5 and -3.1% in Q2 and Q1 respectively) and 'industry (except construction)' (-14.4 and -3.5% in Q2 and Q1 respectively). The shared characteristics of these sectors are that they include activities which are not amenable to social distancing or teleworking and are not considered 'essential'. The sector including 'professional, scientific and technical activities; administrative and support service activities' is evidently very heterogeneous; many of these activities can be performed by teleworking, but also several others, such as 'private security and services to buildings' (e.g. cleaning), whose demand suffered due to the fact that many other services started being performed via telework and also due to bans on travelling and limitations on social contact; examples include travel agencies, tour operators, and the organisation of conventions and trade shows. More information on the classification of activities under the various sectoral headings can be found [here](#).

While demand for the activities of some sectors, such as restaurants, arts and entertainment, and tourism, should be expected to bounce back once the pandemic is over (even though there will be inevitable permanent closures of individual firms in these sectors), there are others, such as business travel or professional and restaurant services around large office areas in big cities, which may not ever recover to their pre-crisis intensity. The use of virtual means for meetings, in combination with a drive to meet emission reduction targets (see Chapter 3 in this volume) may permanently reduce professional travelling. Moreover, the extent of teleworking is expected to increase, so it is not clear whether work from a professional office will resume to the same extent as what was the rule prior to the pandemic. This may be especially the case for large metropolitan areas in which congestion, high housing costs and long commuting times have an impact on the quality of life. The form in which other activities such as retail trade take place may also shift (e.g. from physical to virtual stores), although it is not clear whether demand and turnover for these activities will bounce back or not.

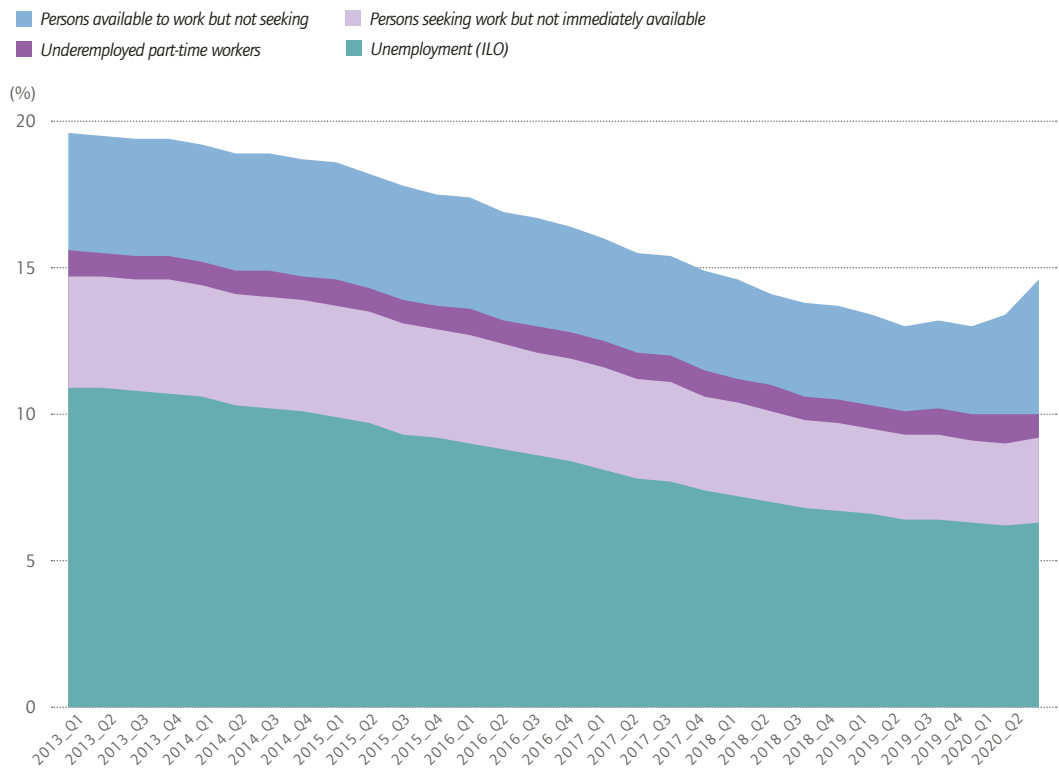
**Figure 1.7** Change in real gross value added (change from same period in previous year), by industry



Source: Eurostat NAMQ\_10\_A10 CLV\_PCH\_SM.

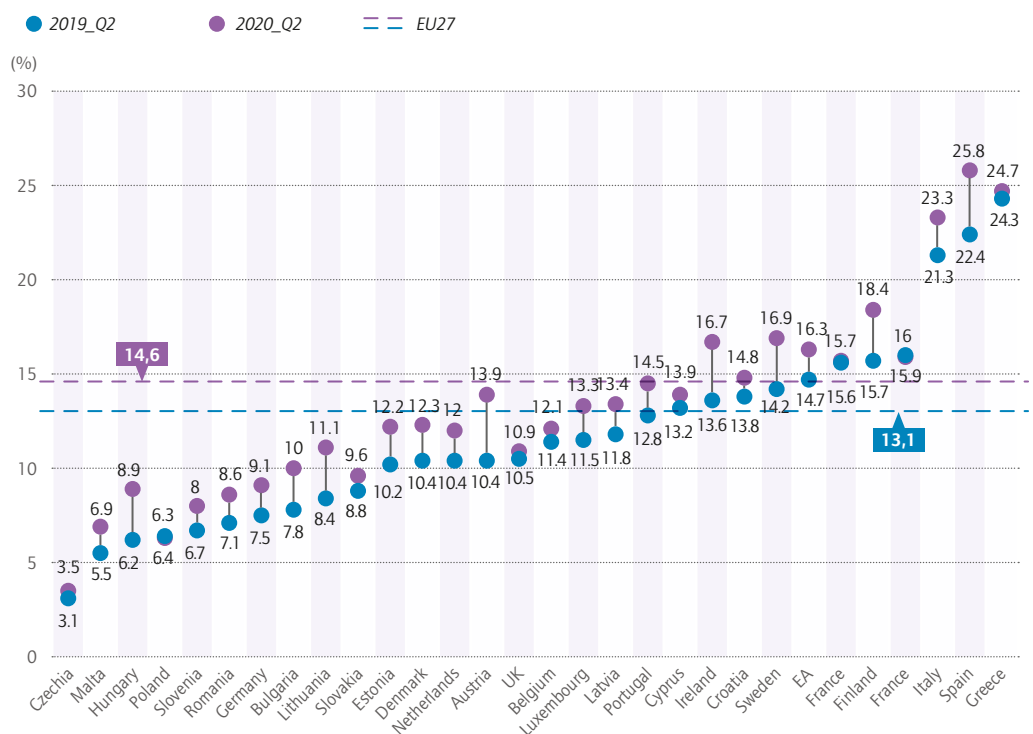
# An increasing underutilisation of the labour supply

**Figure 1.8** Labour market slack (% of extended labour force), EU27, 2013\_Q1-2020\_Q2



Source: Eurostat LFSI\_SLA\_Q\_PC\_ELF series, seasonally adjusted, not calendar-adjusted data.

**Figure 1.9** Labour market slack (% of extended labour force), EU Member States and the UK, 2019\_Q2 and 2020\_Q2



Source: Eurostat LFSI\_SLA\_Q\_PC\_ELF series, seasonally adjusted, not calendar-adjusted data.

As a result of the shock, the numbers of those unemployed, underemployed (that is, part-time workers who would like to work more hours but cannot find jobs offering this), and marginally attached to the labour market (unemployed workers who are either currently immediately available to start a job but have not been seeking one, or who have been seeking a job but would not be immediately available to start one) as a share of the extended labour force was 14.6% in the second quarter of 2020 in the EU, compared to 13.1% in the second quarter of 2019. This sum is also known as the labour market slack, and illustrates in a broader manner the underutilised labour resources in an economy. The unemployment rate in the EU27 in the second quarter of 2020 was 6.3%, and that underlines the importance of these additional categories included in calculating the labour market slack for more accurately illustrating the underutilisation of labour resources. The extended labour force includes the marginally attached workers in addition to those employed and unemployed. Labour force groups that are neither

employed nor unemployed, according to the ILO definition, but instead marginally attached to the labour market, have expanded – most notably those without a job who are available to work but have not been actively seeking one. By the second quarter of 2020, they represented 4.6% of the extended labour force, up from 2.9% in the second quarter of 2019 (see Figure 1.8). The share of those seeking work but not immediately available to start also increased as a share of the extended labour force.

Labour market slack was higher in all but a handful of EU Member States in the second quarter of 2020 compared to the second quarter of 2019. As Figure 1.9 shows, labour market slack in the second quarters of 2019 and 2020 was by far the highest in Europe in Italy, Spain and Greece, with Spain experiencing a substantial increase in the second quarter of 2020. Austria, Ireland, Finland, Lithuania, Hungary, Bulgaria and Sweden also saw substantially higher labour market slack in the second quarter of 2020 compared to the second quarter of 2019.

# Europe's pre-existing socioeconomic challenges



*The long-drawn-out recovery between 2013 and 2019 was associated with a clearly lower risk of poverty in only 10 EU Member States.*

Even though the pandemic has been causing unprecedented economic damage by peacetime standards, it is not the only challenge facing Europe and its policymakers. A sustained slowdown in labour productivity growth, the depletion of natural resources and critical environmental degradation (see Chapter 3 in this volume), and persistent economic and social inequalities (see also Chapter 2) are all issues which were at the centre of reflections and policy debates in the EU before the arrival of SARS-CoV-19 in Europe, and they have not gone away. We take a look at a few of them here.

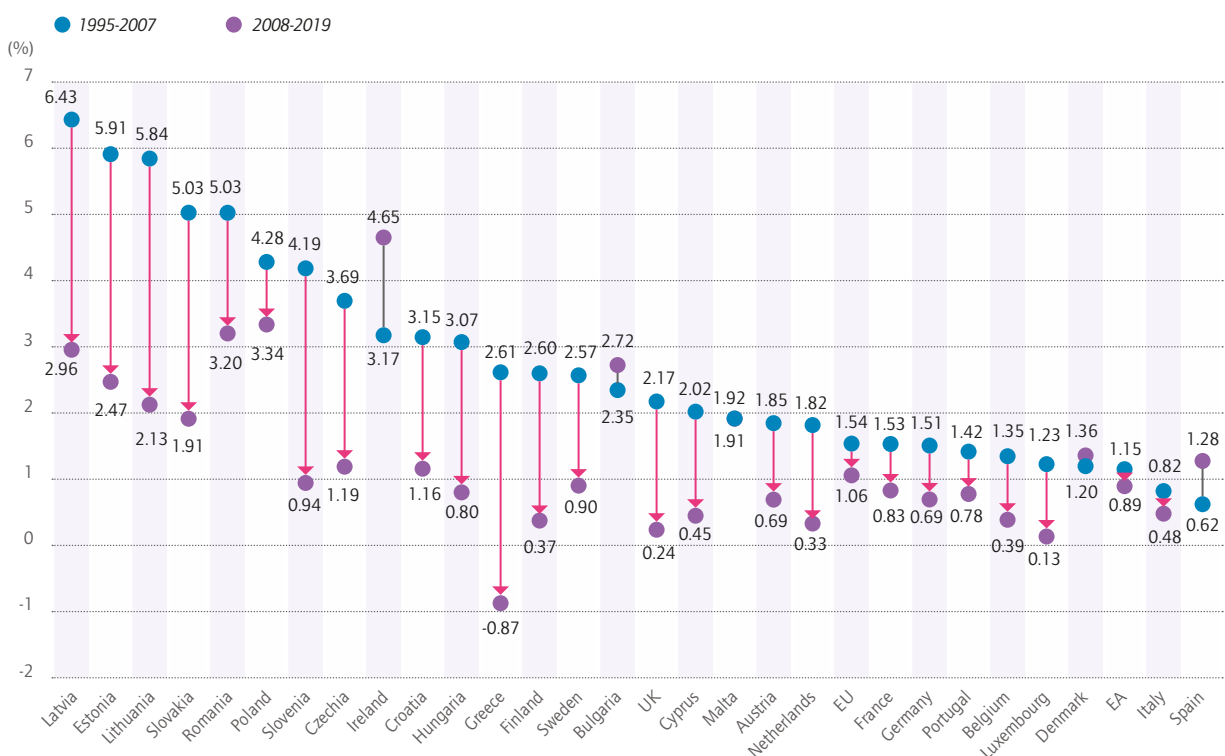
Figure 1.10 shows the evolution of the average annual labour productivity growth rates in 1995-2007 and 2008-2019 for the EU and its Member States (2000-2007 for the EU, euro area, Estonia and Malta). We see that, with the exception of Bulgaria, Malta, Denmark, Spain and Ireland, the average annual growth rates of productivity in 2008-2019 were lower than those in 1995-2007. In the case of Greece, arguably the country hardest hit by the previous economic crisis, the average annual growth rate of labour productivity was negative for the 2008-2019 period. In 15 Member States, it stood at below 1% per year and this was also the case during the recovery period of 2013-2019. This is a worrying development for several reasons: labour productivity growth provides the material base for sustainably raising real wages, even if it is not a sufficient condition thereof (see Theodoropoulou 2019b; see

also Chapter 4 in this volume). In principle, it makes the redistribution of resources within and across generations to counter inequality politically easier; it could also imply producing the same output with fewer resources.

The process of convergence in living standards (conventionally measured as output per capita and therefore closely related to the labour productivity mentioned above) across Member States had slowed down during the crisis and then started picking up again in 2017 (Theodoropoulou et al. 2019a). While it is still too early to conclude what the effect of the pandemic will be on the process of convergence, some of the worst-hit Member States, such as Italy and Spain, were also among those who had been driving the slowdown in convergence during the previous economic crisis. It is therefore likely that the pandemic will rekindle tendencies of divergence in income growth.

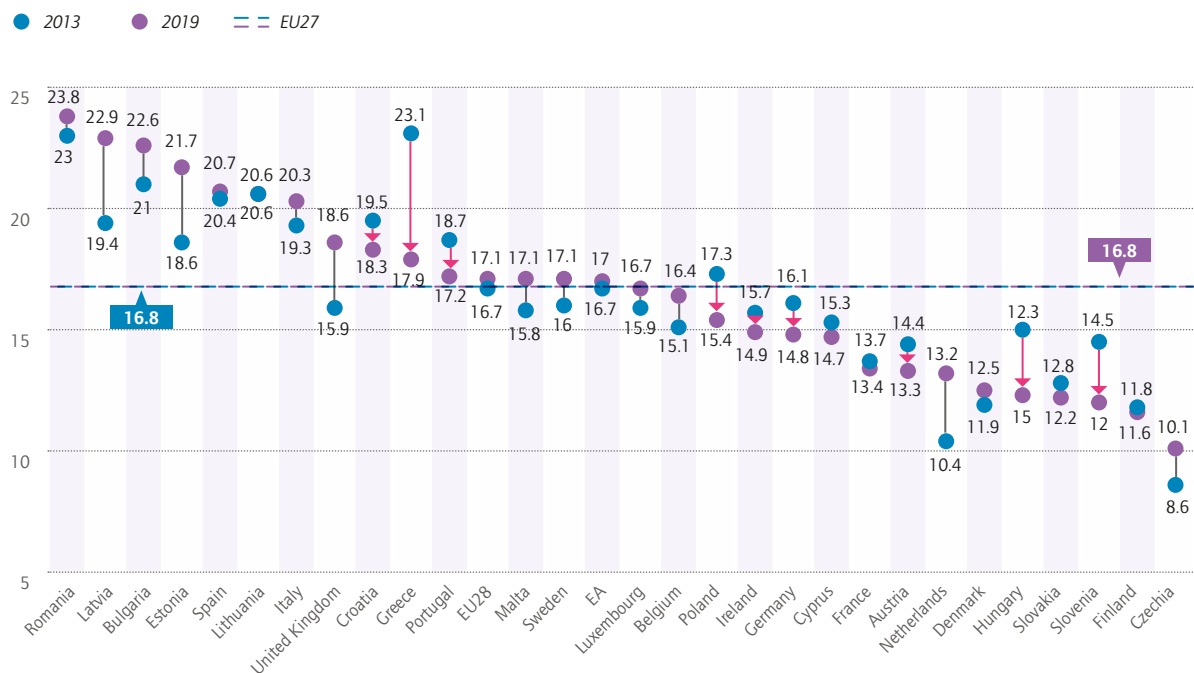
Figure 1.11a shows the evolution of the at-risk-of-poverty rate, a measure reflecting income inequality, in the EU, its Member States and the UK in 2013, when the recovery period began in Europe, and in 2019 (2018 for the EU, the euro area, Luxembourg, Belgium, Ireland, France and Slovakia). In 2019, a little over one in six people lived in a household with disposable equivalised income at or below 60% of the median income (the definition for measuring the at-risk-of-poverty rate) in the EU and the euro area,

**Figure 1.10** Average annual real hourly labour productivity growth rate, EU, Member States and the UK, 1995-2007 and 2008-2019



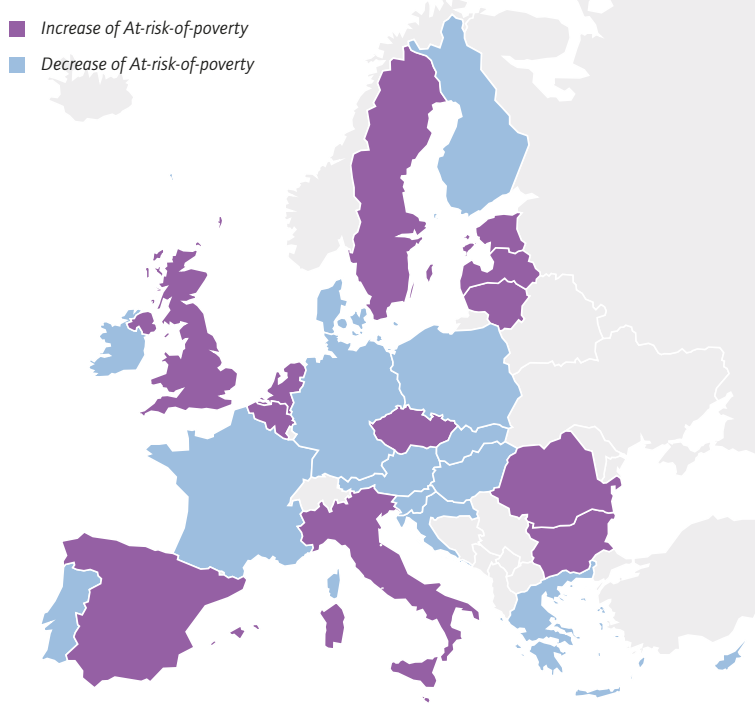
Source: Own calculations using AMECO data, RVGDE and NLHA series.

**Figure 1.11a** At-risk-of-poverty rate (% of population), EU Member States and the UK, 2013 and 2019\*



Source: Eurostat, TESP010 series.  
\* 2018 data for Italy, UK, EU28, EA, EU27-2020, Luxembourg, Belgium, Ireland, France, Slovakia.

**Figure 1.11b** At-risk-of-poverty rate (% of population), EU Member States and the UK, 2013 and 2019\* Countries with increase and decrease of AROP (map)



Source: Eurostat, TESP010 series.  
\* 2018 data for Italy, UK, EU28, EA, EU27-2020, Luxembourg, Belgium, Ireland, France, Slovakia.

not too different than in 2013. Looking at individual Member States, there was a wide range of values: in 2019, almost one in four people in Romania were at risk of poverty, while only one in ten people faced that risk in Czechia. There was a clear reduction in the share of people at risk of poverty in Croatia, Greece, Portugal, Poland, Ireland, Germany, Cyprus, Austria, Hungary and Slovenia. In Spain, Lithuania, the EU, the euro area, France, and Finland, the rate remained practically unchanged, whereas in Romania, Latvia, Bulgaria, Estonia, Italy, the UK, Malta, Sweden, Luxembourg, Belgium, the Netherlands and Czechia, the share of people at risk of poverty increased (Figure 1.11b). In other words, the long-drawn-out recovery between 2013 and 2019 was associated with a clearly lower risk of poverty in only 10 EU Member States.

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# Varying economic and social resilience

**Figure 1.12** Expenditure on social protection benefits, by function, as % of GDP, 2018



Source: Eurostat SPR\_EXP\_GDP series).

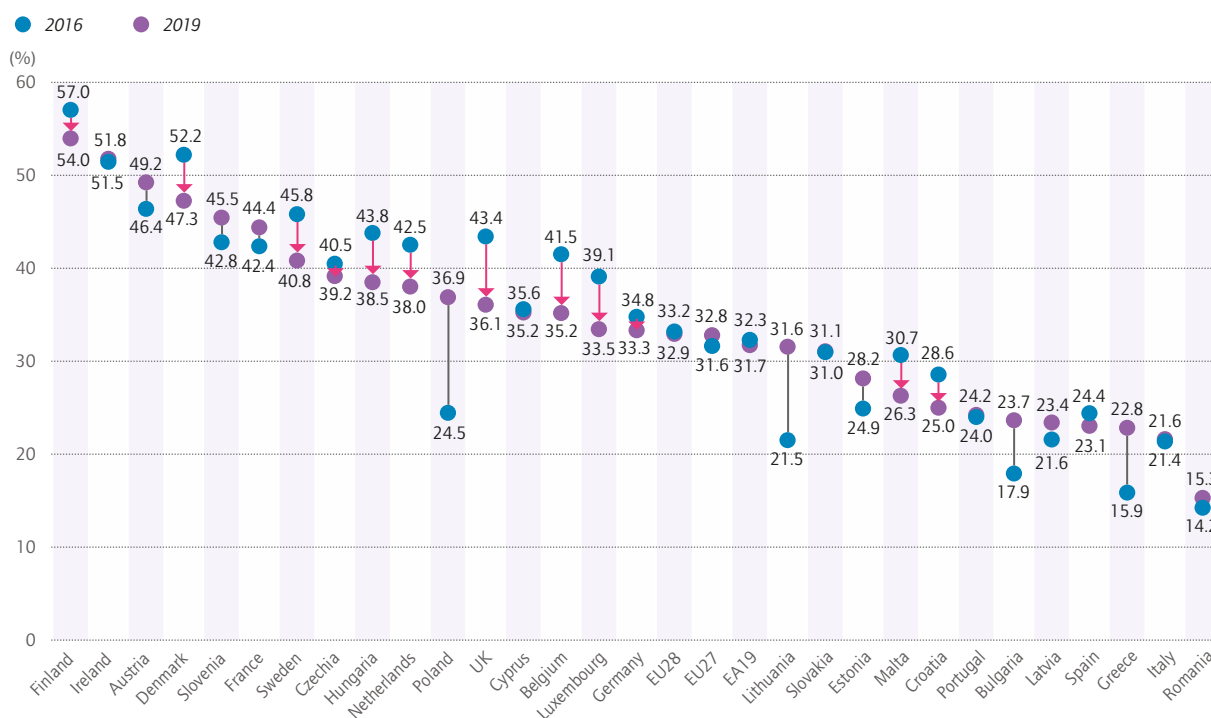
One of the means of targeting the risk of poverty is through social protection benefits. Figure 1.12 shows social protection expenditure by function (e.g. health/sickness, unemployment, old age) as a share of GDP for the EU Member States for which data by Eurostat was available for 2018. Two observations stand out. First, as a total, the slice of GDP that goes into the various forms of social protection varies, from 31.5% in France to 13.7% in Ireland. In principle, and insofar as social protection provides tools for supporting households in the face of various life and market risks, this variation shows the different degrees to which Member States dedicate resources to tackling not only income inequality but also a crisis such as the current pandemic. Secondly, it illustrates the different relative weight that expenses dedicated to healthcare and unemployment (among other things) have in different countries and thereby the different ways in which they create resilience. In 2018, France dedicated 9.1% of its GDP to sickness/healthcare public expenditure, while Cyprus only 3.4%. On the other hand, France and Belgium spent 1.9% and 1.8% of their GDP respectively on unemployment benefits, whereas Poland, Hungary and Malta only spent 0.2-0.3%.

Nevertheless, public spending on social transfers is alone not a good predictor of how efficiently social transfers mitigate social risks and income inequality. Figure 1.13 shows the effectiveness of social transfers (excluding pensions) in reducing the share of households at risk of poverty in EU Member States and the UK in 2016 and in 2019. This

effectiveness is measured here by the difference in percentage points in the at-risk-of-poverty rate when considering market incomes (i.e. before the receipt of any benefits) and the at-risk-of-poverty rate when taking into account disposable income (i.e. after the receipt of benefits and payment of taxes). There is a wide variety in that effectiveness, ranging from almost 60pp in Finland to 15pp in Romania. Other countries with above average at-risk-of poverty rates also have relatively ineffective social transfers, such as Greece, Italy and Spain.

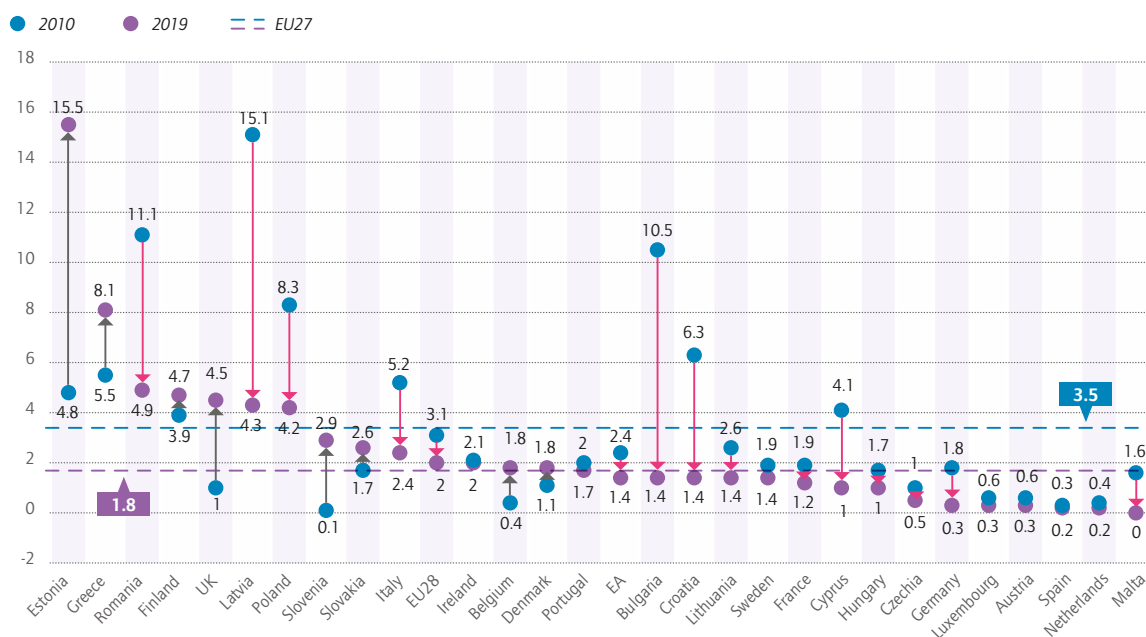
One of the dimensions of social protection which came under scrutiny during the crisis is the capacity of healthcare systems to deal with medical care needs. The pandemic has put an enormous strain on them, and metrics related to their capacity have been largely guiding the tightening and loosening of measures to stem the spread of the virus almost everywhere in Europe. National healthcare systems, however, have not been equally well resourced and accessible to citizens across Europe, meaning there is an unevenness to the capacity of different Member States to deal with the pandemic. Figure 1.14 shows the share of respondents in the EU and Member States reporting unmet needs for medical care due to financial reasons, too long waiting lists, or due to the fact that health facilities were too far to travel to a healthcare indicator from the Social Scoreboard of the European Pillar of Social Rights. In 2019, the share of respondents with unmet needs for medical care due to the above reasons was 2% in the EU28 and 1.4% in the euro area, while it

**Figure 1.13** Impact of social transfers (excluding pensions) on poverty reduction EU Member States, 2016 and 2019\*



Source: Eurostat, TESP050 series.  
\* Data from 2018: Ireland, France, the UK, Belgium, Luxembourg, Germany, EU28, EU28=7-2020, Euro area, Slovakia, Italy.

**Figure 1.14** Self-reported unmet need for medical care (% of respondents), 16 years and over, EU Member States, 2010 and 2019\*



Source: Eurostat, series TESP110 series.  
\*Data are from 2018: UK, Slovakia, Italy, EU28, Ireland, EU27-2020, Belgium, Euro area, France, Germany.  
Note: Reasons for unmet needs : too expensive or too far to travel or waiting list.

ranged from 15.5% in Estonia and 8.1% in Greece to 0% in Malta. In quite a few Member States, that share was higher in 2019 than in 2010, suggesting increasing constraints on access to medical care. These countries included Estonia, Greece, Finland, the UK, Slovenia, Slovakia and Belgium. While in the majority of these countries, the share of the population which reported unmet medical care needs was still fairly low, it is worth noting that these are all rich countries by global standards, where one

would expect that adequate medical care would be universal. More recent data on this indicator are not yet available, but there have been concerns in several Member States that the overflow of Covid-19 patients has led to a high rate of unmet needs for medical care among people with other conditions, because hospitals have had to postpone non-urgent consultations and treatment to dedicate resources to the treatment of Covid-19.

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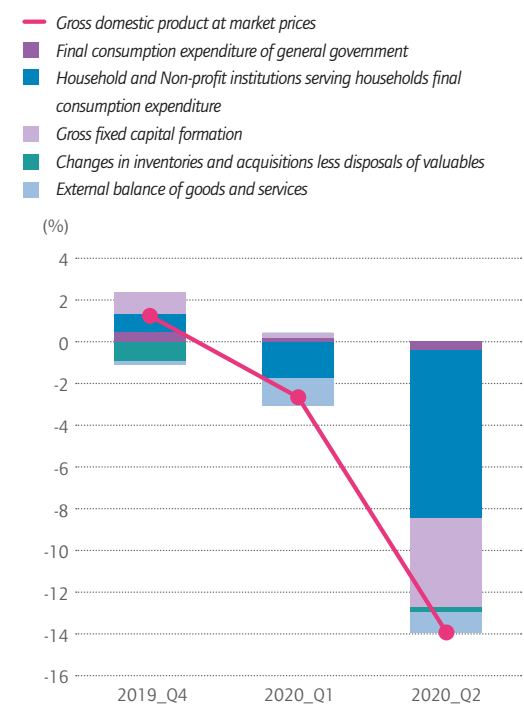
# Anatomy of a recession: developments in aggregate demand and its components

Figure 1.15 shows how the contribution of different components of aggregate demand to GDP growth changed year-on-year from the fourth quarter of 2019 to the second quarter of 2020 (for which the latest data are available). The evolution of GDP is shaped by the sum of the evolution of its components, which here are measured as different types of expenditure (on final consumption, investment, net exports and so on). This breakdown is important for understanding what drives the evolution of GDP and provides indications to policymakers as to where they should be focusing their policy interventions to mitigate a shock.

In the final quarter of 2019, nominal year-on-year GDP growth stood at 1.24%, driven by growth in investment (1.06pp year-on-year) and final consumption of households (0.83pp). In the first quarter of 2020, year-on-year nominal GDP shrank by 2.66%, with households' final consumption and the trade balance (that is, the difference between exports and imports) driving that development with year-on-year reductions of 1.73pp and 1.34pp respectively. In the second quarter of 2020, when year-on-year nominal GDP dropped by 14%, it was both the final consumption of households and investment that caused this drop, by falling by 8pp and 4pp respectively. The negative contribution of households' final consumption and of the trade balance reflect the reduced consumption spending of households domestically and abroad, as economies across Europe and the main trading partners were put into artificial comas. As economic activity in all but the essential sectors was put on hold, unemployment increased, as did uncertainty about near-future income and economic prospects. Although income losses due to unemployment can to an extent be cushioned by unemployment benefits, neither the income replacement itself nor the coverage of those out of employment, especially of those in non-standard forms of employment, was complete. Moreover, the closing down of sectors considered 'non-essential' meant that consumption opportunities were no longer available. This delay in consumption, together with uncertainty about incomes and the future economic situation, can trigger precautionary saving and stall investment decisions, which in turn serves to reduce GDP and affects countries' ability to provide unemployment benefits and financial aid for companies in crisis.

It is worth noting that in the second quarter of 2020, the general government final consumption expenditure, which measures the benefits *in kind* that a government pays out to society and

**Figure 1.15** Contribution to nominal GDP growth of final consumption, gross fixed capital investment, inventories and external balance (p.p. change compared to same period in previous year)



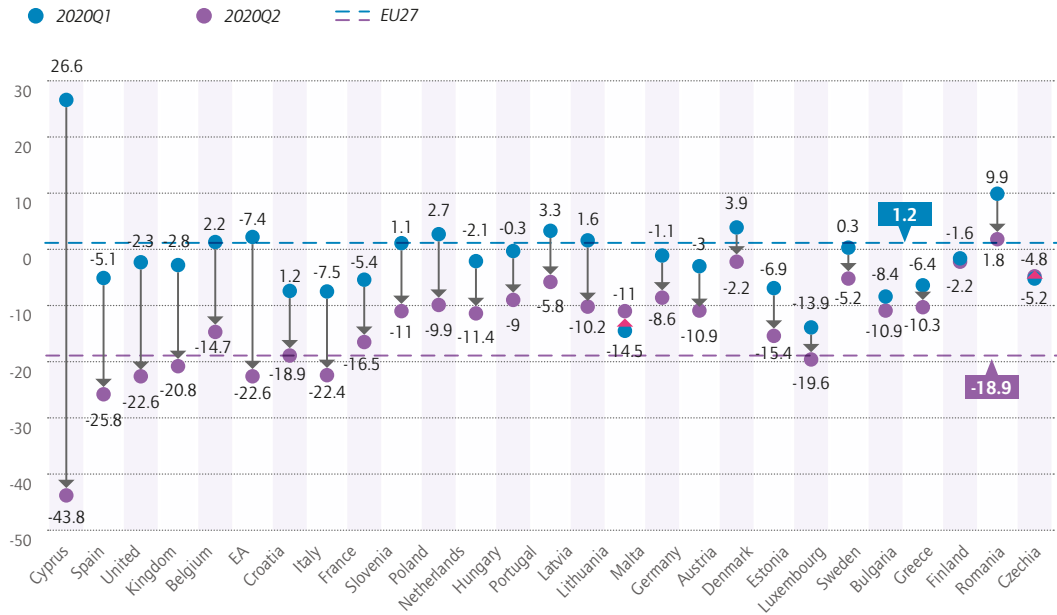
Source: Eurostat NAMQ\_10\_GDP\_CON\_PPCH\_SM.

households, excluding benefits *in cash*, contributed to the reduction of GDP only marginally. The extent to which governments reduced the provision of benefits in kind was far lesser than the reduction in final consumption of households, as many were essential (e.g. healthcare, defence, policing), inelastic or amenable to telework (education, public administration).

## Collapsing investment in an uncertain environment

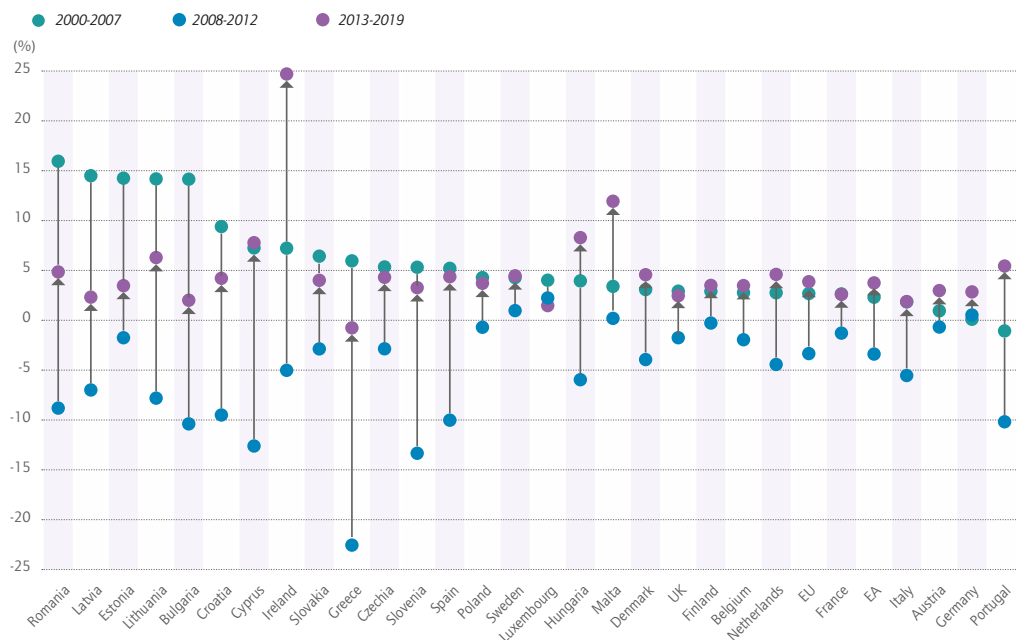
Figure 1.16 shows how investment (gross fixed capital formation) changed year-on-year in the first two quarters of 2020 in the EU27, Member States and the UK. Figure 1.15, meanwhile, shows how the average annual growth rate in real gross fixed capital formation evolved in 2000-2007 (prior to the Great Recession), 2008-2012 (the Great Recession), and 2013-2019 (the recovery period up to the pandemic) in the same countries. Investment indicates the rate at which capital accumulates. Capital accumulation allows labour productivity to grow. In the second

**Figure 1.16** Quarterly real gross fixed capital formation (change compared to same period in previous year), EU Member States and the UK, 2020\_Q1 and Q2



Source: Eurostat NAMQ\_10\_GDP\_CLV\_PCH\_SM series  
Note: Ireland has been excluded due to large fluctuations between data points.

**Figure 1.17** Average annual growth rate of real gross fixed capital formation, EU27 member states and the UK, 2000-2007, 2008-2012, 2013-2019



Source: Own calculations using the AMECO OIGT series.

quarter of 2020, investment dropped on average by 15.4% in the EU and 17.1% in the euro area. The variation at the Member State level was very wide, ranging from -44% in Cyprus to a meagre but still positive 0.6-0.7 % in Romania and Czechia. These were also the only Member States that registered positive quarterly growth in real investment.

This dramatic drop in investment in most EU Member States follows over a decade of weak or even negative investment growth. As Figure 1.15 shows, the average annual growth rate of real investment was lower in 2008-2012 than in 2000-2007 in all Member States except for Luxembourg and Germany, where it was 0.5%. During the recovery period of 2013-2019, the average annual growth rate of real

investment was lower than in 2000-2007 in many Member States and about the same but still low in many others. Weak real investment growth can at least partly explain the persistently weakening real labour productivity growth presented in Figure 1.8. In turn, the current situation of great uncertainty over economic prospects is bound to have a detrimental effect on investment until the pandemic is under control.

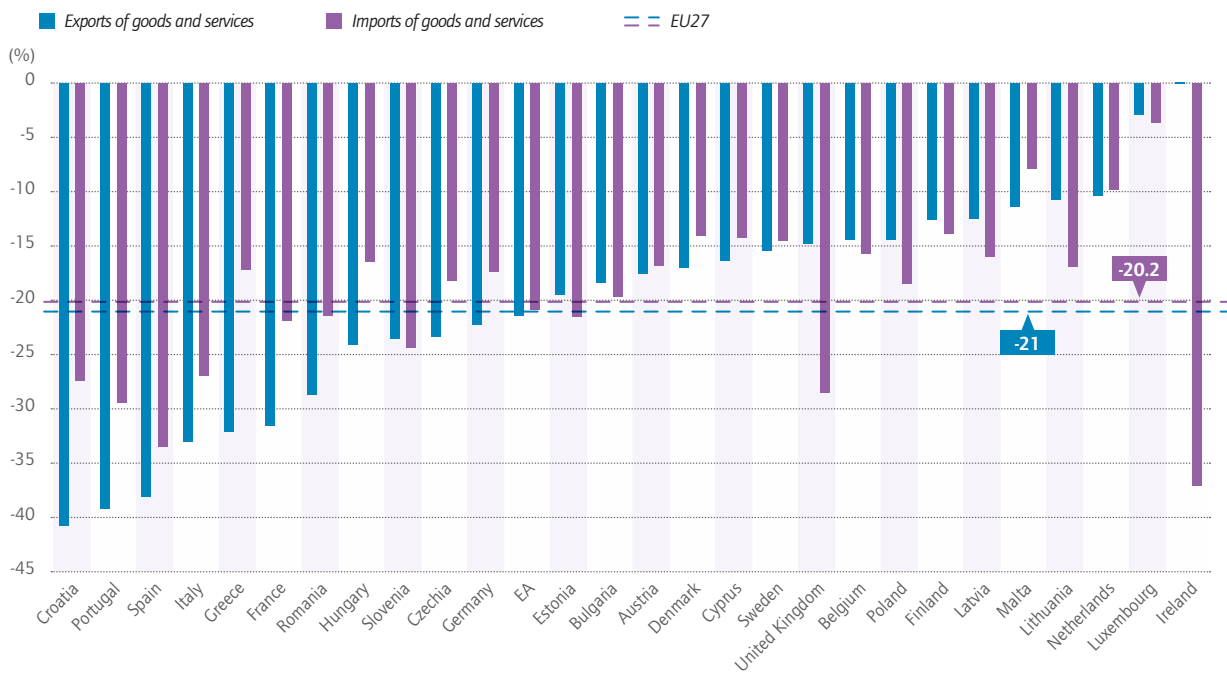
This is even more worrying when we consider that fostering a transition to a climate-neutral socioeconomic model is currently at the top of the EU's economic agenda, a venture which will require a significant investment effort. According to the European Commission (European Commission

2020), reaching the EU 2030 climate and energy targets of reducing carbon emissions by 40% of what they were in 1990, which were still in place in January, would require *additional* annual investment to the tune of €260 billion (see also Chapter 3 in this volume). Currently, however, both the European Commission and the European Parliament have been pushing for more ambitious targets of a reduction of 55-60% – proposals which still need to be validated by the Council. To this end, last January the Commission proposed the Sustainable Europe Investment Plan, with the particular aim of financing a just transition. The Plan not only includes proposals on financing (for more on which see Chapter 3) but also on creating an enabling framework for investors, notably via a renewed sustainable finance strategy

and taxonomy, the use of coordination mechanisms to identify investment needs, and the provision of technical support to public administrators and sustainable project promoters.

Figure 1.18 shows the year-on-year growth of exports and imports in the EU, its Member States and the UK for the second quarter of 2020. We see that both exports and imports fell, as demand plunged around the world. The pandemic resulted in serious disruptions of global supply chains as borders were closed around the world without any harmonisation among the EU Member States. In most Member States the drop in exports was greater than the drop in imports, suggesting that the trade balance contributed negatively to GDP growth.

**Figure 1.18** Change in exports and imports of goods and services (change compared to same period in previous year), EU27, Member States and the UK, 2020\_Q2



Source: Eurostat, NAMQ\_10\_GDP\_CLV\_PCH\_SM.

# EU and national fiscal and regulatory policy responses

As soon as governments across Europe started imposing measures to stem the spread of the virus, they also began announcing parallel actions to protect people, firms and the productive capacity of their national economies from the short-term impact of suspending large parts of economic activity. Governments stepped in to subsidise wage replacement for short-time work and job retention (furlough) schemes. They extended unemployment and sickness benefits, and expanded the eligibility criteria, to support the income of workers who had to go into quarantine (including support for categories of workers that would not have been previously covered).

Households and companies were granted the possibility to defer their tax and social security contributions and rent payments to the public sector. Public guarantees were granted to firms against their bank loans, and regulations were established to protect firms against creditors' claims. Governments also extended funding to expand the capacity of their national healthcare sector to cope with the demands from the pandemic. The objective has not just been to alleviate hardship but also to protect the production capacity of economies (in terms of both physical and human capital) in the face of what is being considered a temporary (albeit lasting longer than originally thought) shock, and thus to allow for a speedier recovery.

Policymakers at the EU level initially unsuccessfully tried to coordinate early national policy responses, while Member States instead attempted to secure sufficient stocks of health protection equipment for themselves and unilaterally close borders (see also Chapter 7 in this volume). They thus swiftly proceeded to temporarily suspend or ease regulatory restrictions – notably concerning state aid rules, fiscal rules and bank lending rules – that would have otherwise constrained national policy and financial initiatives to support workers, businesses and the economy. They also provided, among other funds, a total of €540 billion to finance three safety nets: the 'Support to mitigate unemployment risks in an emergency' (SURE) programme (up to €100 billion), a pan-European guarantee fund for loans to companies (up to €200 billion through the European Investment Bank), and the Pandemic Crisis Support credit line for Member States (a precautionary credit line of up to €240 billion provided via the European Stability Mechanism for the euro area Member States).

In May, following a European Commission proposal, the Council approved a regulation for the launch of the SURE programme, which would provide up to €100 billion in loans to Member States to support them, as a second line of defence, in meeting any suddenly and severely increased financing needs for short-time work and job retention schemes. This scheme aims at supporting firms in rescuing jobs

and at protecting employees and the self-employed against the risk of unemployment and income loss (European Commission 2020b) (see also Chapter 2). It will also help Member States by ensuring that they face more advantageous interest rates when borrowing to finance their short-time work or job retention schemes. It is therefore more relevant for those Member States which, due to their fiscal positions, might face higher borrowing costs than the EU.

The SURE loans have been backed by €25 billion of guarantees provided on a voluntary basis by the Member States to the EU budget, with national contributions depending on a Member State's share of total EU gross national income. By mid-November 2020, €90.3 billion worth of support had been approved for and/or requested by a total of 18 Member States after three rounds of bond issuance. The response of investors was very encouraging, with demand in each round of issuance being 10-13 times higher than the amount that the EU set out to borrow.

While the SURE scheme provides loans and not grants, is activated on an ad hoc basis rather than automatically, and focuses specifically on short-time work/job retention schemes, it could nevertheless be a first step in establishing a more permanent unemployment reinsurance scheme at the EU level, which could help Member States, especially those of the euro area, stabilise their economies in the face of shocks, which are hitting some countries harder than others. Moreover, SURE could entice even Member States without pre-existing short-time work schemes to set them up systematically (Claeys 2020). The benefits of these schemes have been well established during situations of temporary negative shocks in an economy (see for example Hijzen and Martin 2013). Still, given the relatively limited size of the funds available under SURE compared to the support need, its impact in lightening the fiscal burden for Member States of paying interest rates when borrowing to support short-time work/job retention is likely to be rather small (Claeys op.cit.). This is also because even Member States with higher public debt/GDP ratios, which, other things being equal, might face higher interest rates for borrowing, have not in fact been facing this problem, thanks to the interventions of the ECB in the financial markets (see next section).

The European Investment Bank group, following the endorsement of the European Council in late April, set up a Pan-European Guarantee Fund with €25 billion of capital to leverage support for SMEs and middle-capitalisation companies (also known as mid-caps) of up to €200 billion.

As a further measure to support governments, an agreement was reached at the Eurogroup in May to mobilise funds via the European Stability Mechanism (ESM) for a precautionary credit line, named

1. Economic developments and policies: is this time different?

2. Labour market and social developments

3. The path to 'zero carbon' in a post-Covid world

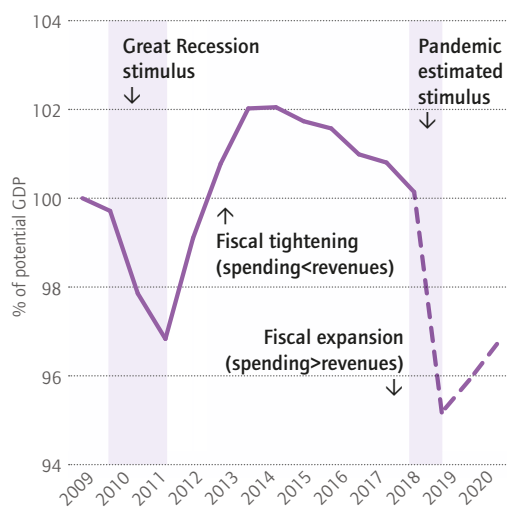
4. Fair minimum wages and collective bargaining

5. Covid-19: a 'stress test' for workers' safety and health

6. Democracy at work in a pandemic

7. Foresight: the many possible post-pandemic futures

**Figure 1.19** EU fiscal effort 2007-2022 (forecast) (2007=100)



Source: Own calculations using AMECO UBLGDP series (November 2020).

Pandemic Crisis Support, to the euro area Member States (those that fund the ESM) which would need funds to face the crisis. The credit line is based on the Enhanced Conditions Credit Line instrument. A euro area country can thus borrow funds of up to 2% of its 2019 GDP at the rate at which the ESM borrows in the markets, plus some small administration fees, with the condition that it uses the funds to support domestic financing of direct and indirect healthcare costs and cure- and prevention-related costs due to the Covid-19 crisis. To date, no Member State has drawn on this facility, as, following the previous public debt and banking crisis, recourse to the ESM has been associated with stigma for governments and their capacity to keep on servicing their public debt.

In addition to these safety nets, additional funds to the tune of €9.3 billion were mobilised in amendments of the EU's 2020 budget – to be spent on, among other things, healthcare and testing supplies, transfers of payments and pre-ordering vaccine doses. Moreover, decisions were taken to redirect cohesion policy funds from the EU budget to help members tackle the pandemic, most notably, €37 billion under the Coronavirus Response Investment Initiative to support healthcare systems, SMEs and labour markets, and €800 million from the EU Solidarity Fund, whose scope was extended to public health crises so as to support those hit the hardest. Measures were also taken to provide for additional flexibility in using structural funds, also known as the Coronavirus Response Investment Initiative Plus.

## Economic support costs weigh heavy on government budget balances and public debt

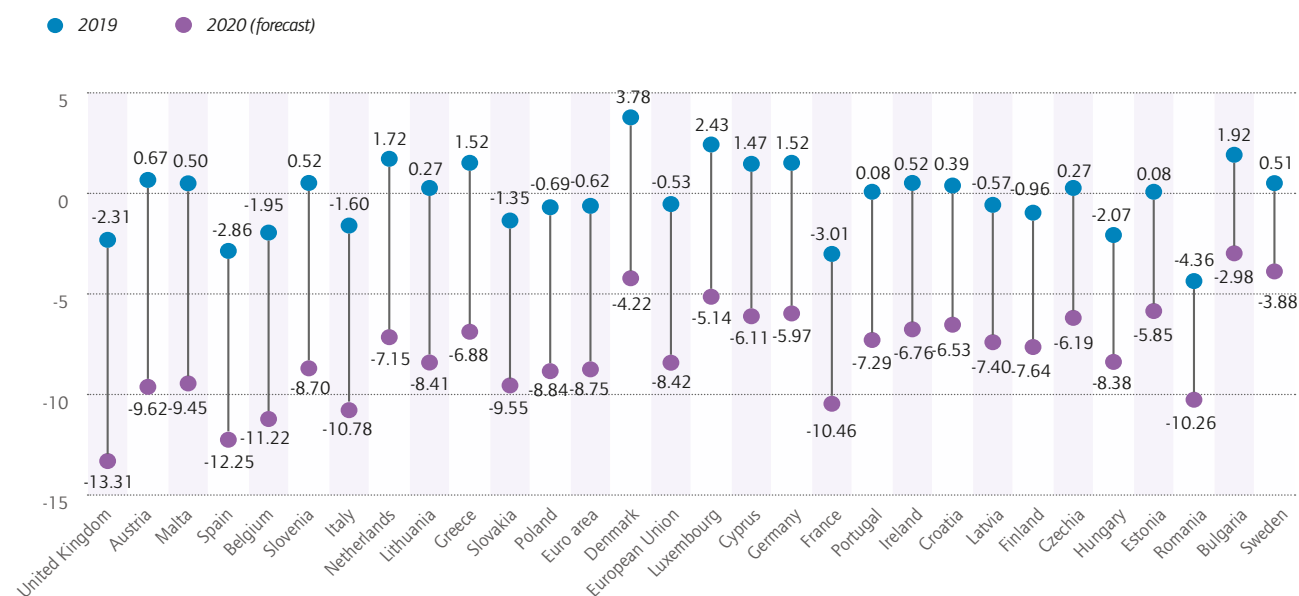
The EU safety nets notwithstanding, additional national spending and guarantee measures, along with the operation of automatic stabilisers, have pushed government budget deficits deeply into the red, while, inevitably, public debt as a share of GDP has been forecasted to expand everywhere. Governments have not faced difficulties in borrowing (i.e. too high interest rates or insufficient demand for their bonds) in the financial markets, as the ECB has intervened to buy securities, including sovereign bonds (see next section).

Figure 1.18 shows the evolution of fiscal effort in the EU since 2007. The fiscal effort shows how the balance between expenditure and revenues that are at the discretion of a government changes. It is measured by the government budget balance (i.e. revenues minus expenditures) adjusted for the business cycle, that is, taking out changes in expenditures and revenues due to higher/lower GDP (for example, higher expenditure in unemployment benefits thanks to the existing rules of the benefits system when unemployment increases) and excluding interest payments on existing public debt. An increase in the cyclically adjusted balance implies that expenditures are smaller than revenues and therefore the fiscal effort is tightening. When this happens while GDP growth is slowing or negative, then we have fiscal austerity. A fiscal expansion happens when the expenditure is greater than revenues.

We see that, according to the latest (autumn) European Commission forecasts (European Commission 2020d), in the EU, fiscal effort is forecast to expand in 2020 but then expected to tighten again in 2021 and 2022. The forecasts for 2021 and 2022 are still subject to much uncertainty though, regarding the evolution of output growth. What is interesting is that the fiscal stimulus of this recession seems to be sharper for this first year of the crisis than it was for the respective first year (2008-9) of the Great Recession.

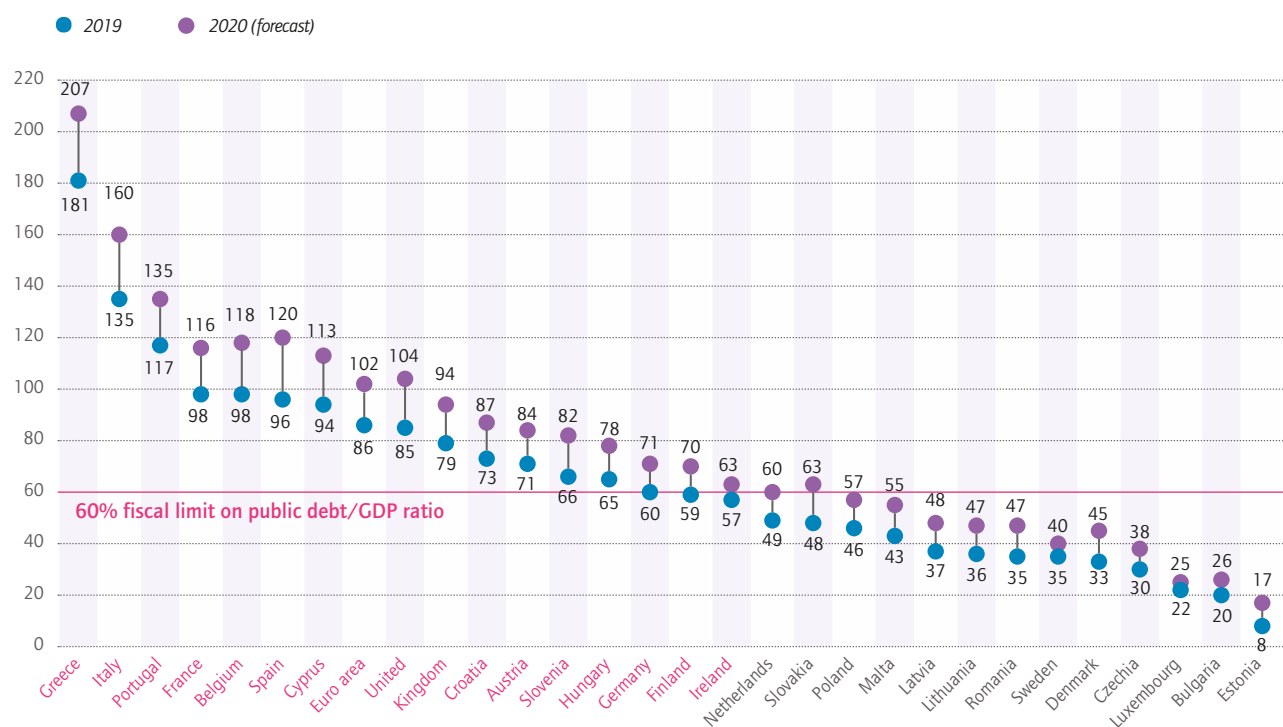
Figure 1.19 shows the general government budget balance for 2019 and the forecast for 2020. This budget balance is not adjusted for the effects of the business cycle, nor does it exclude interest payments as in the previous figure. What it does show is how government budget deficits which determine how much governments must borrow over a year is evolving. For 2020, the EU budget deficit is forecast to be 8.4% of GDP (8.7% for the euro area), down from 0.5% in 2019 (0.6% in the euro area). Bulgaria and Sweden are forecast to have the smallest budget deficits in 2020 at 3% and 3.9% of GDP respectively and also the smallest increases in budget deficits since 2019, by 4.9% and 4.3% percentage points respectively. The UK, Spain, Belgium, Italy, France, Romania, Austria, Slovakia, Malta, Poland and Slovenia are all forecast to have budget deficits larger than the EU average for 2020, between 13.3% of GDP in the UK, 12.2% in Spain, 10.8% in Italy, 10.4% in France and 8.7% in Slovenia.

**Figure 1.20** General Government budget deficit (% of GDP) in EU, member states and the UK, 2019 and 2020 (forecast)



Source: AMECO UBLGE series.

**Figure 1.21** General government gross debt (% of GDP)



Source: AMECO database, UDGG series.

Figure 1.20 shows the public debt/GDP ratio in 2019 and the European Commission's spring forecasts for 2020. We see that in 14 out of 27 Member States this ratio is forecast to be above the stipulated 60% of the fiscal rules, while the EU and euro area average public debt-to-GDP ratios are forecast to reach 94% and 102% of GDP. Greece, Italy, Portugal, Spain, France, Cyprus and Belgium are all forecast to have higher public debt-to-GDP ratios than the euro area average, with Greece reaching 207% in 2020, while even the frugal Germany, Austria and Finland, as well as the high-growth Ireland, are forecast to exceed the 60% limit. It is mostly central and eastern European and Baltic states who have had relatively low public debt-to-GDP ratios that are forecast to remain below the limit, as well as Luxembourg, Denmark and Sweden. Although the gross public debt/GDP ratio cannot alone illustrate the sustainability of public

finances of Member States, it is one of the commonly used indicators thereof. The data on its forecasted levels for 2020 suggest that different Member States have very different degrees of fiscal space for rolling out support measures.

The suspension of the fiscal rules until the end of 2021 has meant that expenditures of Member States to deal with the impact of the pandemic will not be considered when budget deficits and public debts are assessed in 2020 and 2021 to evaluate whether Member States' public finances remain on sustainable paths. In recent public statements, Paolo Gentiloni, the EU Economics Commissioner, mentioned that the question of whether this suspension should be carried over to 2022 will be discussed in the coming months (Financial Times 2020b). While budget deficits should in principle start shrinking again once the pandemic and the extraordinary support

measures start being rolled back and economic activity resumes, there would be further concerns about how soon and how fast Member States would be required to start reducing their public debt at the rates stipulated by the rules.

Under the current rules, it is quite plausible that European economies with public debt/GDP ratios over 60% will be stuck with weak output growth but will nevertheless be required to tighten their fiscal policies to achieve the rate of reduction of public debt stipulated by the rules (one 20th of the difference between the actual public debt/GDP ratio and the 60% limit per year). Following losses in productive capacity and therefore a lower potential GDP, it is also very plausible under the current rules that structural budget balances will be ill-estimated for a while, resulting in recommendations for too tight fiscal policies. Under strong pressure to reduce deficits/expand surpluses too fast, public investment expenditure becomes more vulnerable to cuts, as the politically 'easier' option.

Prior to the current crisis, the European Commission had launched a process of assessing the EU economic governance framework, of which fiscal surveillance has been the most important pillar. Criticisms of the fiscal rules have been abundant, including opacity, over-reliance on metrics (most notably the potential output and the structural budget balance), which are

neither observable in real time nor under the control of governments, outdated and arbitrary limits on the public debt/GDP ratio, too restrictive policy stances for safeguarding public investment, and an inability to steer national fiscal policies towards a suitable aggregate fiscal stance. The discussion about these reforms has apparently ground to a halt for the moment. However, its eventual conclusion will be a crucial factor for determining whether in the aftermath of the pandemic Europe will face another period of fiscal austerity and long-drawn-out recovery, as in the 2010s, or whether sufficient public investment will lead the way for the green and digital transitions.

Up until now, the advice of international organisations and prominent policymakers, such as the OECD, the IMF and Mario Draghi, has been unequivocal: governments should do whatever it takes to cushion the economic and social impact of the pandemic, by borrowing and spending and providing guarantees to households and firms until the shock is over. However, it is not clear whether the diversity in the states of different countries' public finances, as often made clear by the public debt/GDP ratio, is likely to restrain Member States (and some more than others) from being able to borrow enough to deal with the short- to medium-term economic and social impacts of the crisis.



*The national budgets will be doing the heavy lifting in supporting the economy."*

# A recovery plan for Europe

These questions, along with the bruising memories of the previous crisis, prompted Member States, especially from the south of the EU, to advocate early on in the current crisis for stabilisation and recovery funding to be financed through common European debt. Following proposals in May, first from France and Germany and then from the European Commission, a political agreement on the broad outlines of a recovery plan involving both the next Multi-Annual Financial Framework (MFF, i.e. the EU budget) for the period 2021-2027, and a recovery pillar, the 'Next Generation EU' instrument, was reached at the European Council in July 2020.

The agreed commitments for the 2021-2027 MFF are at €1.074 trillion whereas the Next Generation EU (NGEU) pillar is to receive a total of €750 billion, €390 billion of which are to be provided as grants and €360 billion as loans to Member States, a total of about 4.5% of the EU's GDP, spread over several years. The NGEU funds would be channelled to Member States through existing programmes of the EU budget, mostly under the heading of 'Cohesion, Resilience and Values', but with some under the headings 'Single Market, Innovation and Digital' and 'Natural Resources and Environment'. The NGEU instruments would be organised under three pillars: supporting Member States to recover (which includes the Recovery and Resilience Facility as well as the REACT-EU initiative and some funds for the Just Transition Fund); kickstarting the economy and helping private investment; and learning the lessons from the crisis.

The European Commission would be authorised to borrow from the financial markets on behalf of the EU to provide the funds for NGEU. This would generate a large quantity of safe assets (EU bonds) which the ECB could also buy in the context of its asset purchase programmes, making its task politically easier, as it would be buying EU rather than country-specific debt. The biggest instrument under NGEU is the Recovery and Resilience Facility (RRF), the financial commitments for which were agreed at €672.5 billion (of which €360 billion is in loans and €312.5 billion in grants). The largest part of these RRF funds (70%) should be committed in 2021 and 2022 and the rest by the end of 2023; 30% will have to be dedicated to greening projects. The funds that will be borrowed over six years to finance these programmes will be repaid by 2058. The European Commission proposed some new 'own resources' which have yet to be agreed by the Council, to ease the burden of repayment of the loans on future MFFs.

To receive funding from the RRF, Member States would have to submit for approval their recovery and resilience plans, which should propose reform and investment programmes to be financed. In its first instalment of the autumn package 2020, the European Commission proposed guidelines to Member States for writing up their recovery and resilience plans, the positive evaluation of which will give them access to the RRF's funds. Although some

criteria for positive assessment were already stated in the July agreement, it is not yet clear how economic conditionality will be applied in practice to Member States for drawing on grants and loans, beyond the general conditions to which Member States already have to comply when receiving grants from the EU budget. Member States should take into account the last Country-Specific Recommendations when spelling out the challenges they will try to address in their plans while meeting specified objectives and contributing to flagship EU initiatives. Up to 37% of received funds should contribute to promoting a green transition and up to 20% should contribute to promoting the digital transition.

Disbursement will be agreed so long as Member States proceed to implement the agreed plan. The European Commission will be asking the opinion of the Economic and Financial Committee for its assessments, which will be adopted (or not) by the Council by qualified majority voting. One or more Member States may ask the President of the European Council to refer a Member State to the European Council if they think that it deviates from its plans. This process cannot take longer than three months.

This process will alter the European Semester at least until 2023, when the last funds of the RRF will be disbursed, and make it far more 'politicised' than it has been so far. These changes are welcome. On the downside, however, it is also clear that it will still be the national budgets that will be doing the heavy lifting in supporting Member States. NGEU will account for 4.5% of EU GDP, spread over several years. It remains to be seen whether the economic objectives set out by the European Commission in its guidelines to Member States for writing their Recovery and Resilience Plans will all be met to the same extent and whether, for example, actions to promote recovery will be successful in promoting the green transition as well. If the plan succeeds in instigating reforms and mobilising investment, it is likely to become a stepping stone towards developing a fiscal capacity at the E(M)U level.

The agreement over NGEU is a breakthrough in crisis management in Europe: the EU will borrow amounts of money at an unprecedented scale on behalf of all Member States, issuing common (albeit not joint) bonds to finance the recovery efforts of Member States, in line with progressive income and unemployment criteria and criteria related to the impact of the crisis on them. Member States will pay back this debt in line with their share of contributions to the EU budgets. Moreover, unlike the ESM in the previous crisis, NGEU has been established within the EU legal order using the Community method.

Before the plan is put into action, however, a legislative package specifying in more concrete terms what was agreed in broad terms in July would have to be adopted by the Council, approved by the European Parliament and ratified by Member States. Most notably, the Council would have to unanimously

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approve the MFF package of regulations, with the consent (that is, an approval or disapproval of the entirety of the package but without the possibility of making amendments) of the European Parliament. The Council would also need to unanimously decide on the 'own resources' that will finance the package, after having received an opinion by the European Parliament; this must be ratified by every Member State, in accordance with their constitutional requirements.

As part of the MFF package of regulations, in May 2018 the European Commission proposed a new regulation on the general regime of conditionality for protecting the EU's budget in case of 'generalised deficiencies as regards the rule of law' in the Member States. The European Council agreement in July 2020 included a broad statement on the importance of respecting the rule of law in order to protect the EU's financial interests. The content of this regulation was the subject of fairly intense negotiations between the negotiators of the German Presidency of the European Council and those of the European Parliament, with the latter preferring to take a hard stance on the matter. An agreement was reached on the new conditionality regime in early November, and on 10 November on the overall MFF package, including a roadmap for reforming the EU's own resources, to be eventually approved by the European Council.

However, at the time of writing, the leaders of Poland and Hungary, with some support from their Slovenian equivalents, have signalled that they intend to veto the package on the next MFF as they are unhappy with the conditionality regime related to the rule of law, thus throwing a spanner into the works of the ratification process. The risk is that reaching a new compromise would delay the launch of the new MFF and NGEU beyond 1 January 2021, forcing

the use of emergency budgets and blocking the disbursement of funds for new spending priorities, such as the green transition. Such a delay might also have repercussions for the awaited Council decision on increasing the EU's targeted cuts in carbon emissions to 55% of 1990 levels by 2030, as the financial means to start implementing it would not yet be available. The option of further watering down the condition of compliance with the rule of law for accessing EU budget funds is likely to meet with resistance from the European Parliament. Another alternative would be to establish the Recovery Fund outside of the EU legal order, instead opting for an intergovernmental treaty in the style of the ESM; but this would only draw into sharper focus the inability of all Member States to reach an agreement.

However, the economic and political risks for the two countries are high: should the deal be delayed they would both stand to lose large sources of financing at a time when the second coronavirus wave has been affecting them quite badly. Poland would also be the biggest beneficiary of the Just Transition Fund, which would help cushion the economic and social impact of phasing out coal in the country. More importantly, a persistent veto is likely to turn the vast majority of Member States (including large ones) against them and generate political losses in the longer term, as building broad alliances is important for influencing decisions in the EU. These factors all give the EU good reason to sit back and wait for the two countries to 'blink first' (Guttenberg and Buras 2020).

The history of the EU suggests that a compromise will be found. The situation, however, also calls into question the capacity of the EU to move forward with further integration initiatives when certain processes, such as the deepening of the EMU and the implementation of the European Pillar of Social Rights, are still ongoing.

# EU and national monetary and financial policy responses

In sharp contrast to the beginning of the previous decade, this time, when faced with the imminent prospect of recession and a disruption in the financial markets, the European Central Bank reacted speedily and decisively to support economic activity and government fiscal responses, giving individuals, firms and governments across Europe the capacity to borrow, thus maintaining cash flows in the system and keeping it from collapsing. It did so by using both conventional and unconventional tools of monetary policy, as well as its leverage as banking supervisor of banks of systemic importance in the euro area. The ECB had already been adopting the use of unconventional monetary policy tools since 2014 in its struggle to fight persistently lower-than-target inflation (see Figure 1.21). In fact, while it moved swiftly in spring 2020, it did so in the shadow of a ruling of the German Constitutional Court, according to which the ECB's earlier unconventional policies of purchasing public sector bonds had not considered the potential repercussions for other economic policy objectives.

As far as monetary policy tools are concerned, it was the unconventional ones that did the heavy lifting: the ECB expanded and extended its asset-purchasing programmes, and increased the amounts that banks could borrow from it to lend and the collateral conditions under which they can do it.

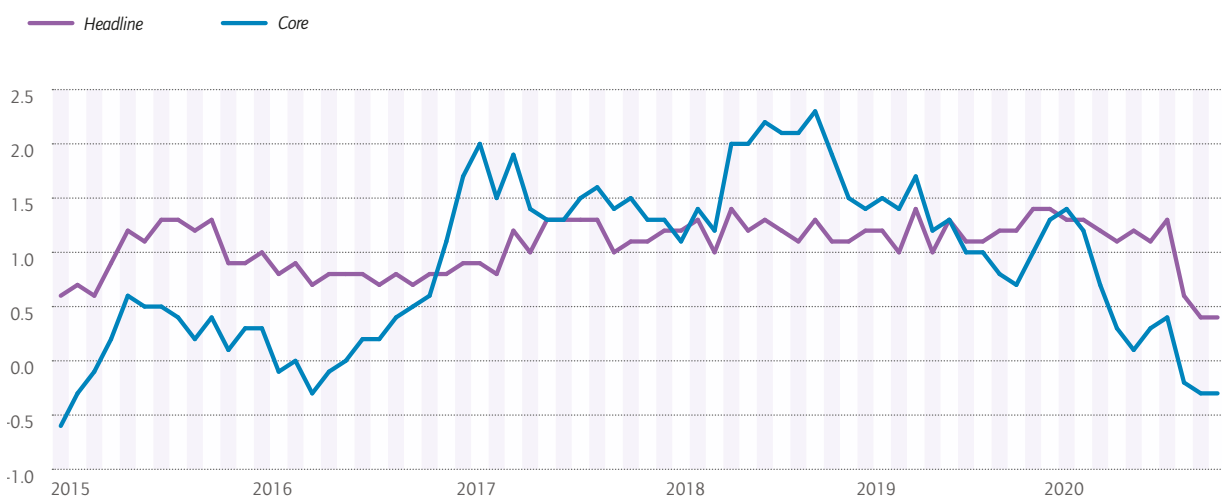
As early as mid-March, when EU Member States began imposing strict public health measures, the European Central Bank launched its Pandemic Emergency Purchase Programme (PEPP). Under this programme, it pledged to buy private and public securities (e.g. bonds), initially to the tune of €750 billion and until

the end of 2020. However, in June, following the worsening outlook regarding inflation, it expanded the 'financial envelope' to €1,350 trillion and the duration of the programme to *at least* the end of June 2021, leaving the possibility of a further extension open until the Governing Council of the ECB is reassured that inflation is on track for meeting its target. The aim of this programme is to ensure that households, firms and governments continue to have access to the funds they need in order to weather the crisis.

To further facilitate the access of households and companies to credit, the ECB increased the amount of money that banks can borrow through its targeted longer-term refinancing operations (TLTROs). Under these operations, the ECB has been lending money to banks at preferential rates with the condition that they extend credit to the real economy, for example to SMEs and households – hence the term 'targeted'. The ECB also eased the standards on the quality of collateral assets that banks could use as insurance to borrow money from the ECB, also issuing a waiver for the first time since 2015 on the use of Greek government bonds by Greek banks.

The ECB maintained its key interest rates, most notably its deposit facility, main refinancing operations and marginal lending facility rates, at -0.50%, 0% and 0.25% respectively, the rates at which they had been since 2019. The bank also made it clear that it was not planning to increase these rates until it had seen forecasts of headline but also core inflation approach its target of 'close to, but below 2%'. As Figure 1.22 shows, inflation dynamics in the euro area have been undershooting the target since 2015. While the headline inflation (HICP) measure did reach the

**Figure 1.22** Headline and core inflation rates in the EA, (monthly annualised % rates), January 2015 August 2020



Source: Eurostat prc\_HICP\_manr.  
Note: Headline: Harmonised Index of Consumer Prices (HICP). Core: HICP excluding energy and unprocessed food.



*The attempts to mitigate the risk that Covid-19 poses for public health have seemingly led to the crumbling of a series of taboos and orthodoxies guiding economic policy over the last 40 years."*

2% target for relatively brief periods in 2017 and 2018 due to energy price surges, the core inflation measure presented here (which excludes commodities with highly volatile prices, such as energy) has trailed below 1.5% since 2015.

Core inflation is a proxy for the inflation expectations of economic agents in an economy, including those who bargain over wages. When, for example, wage bargainers expect that inflation will be below the target rate of a central bank, it is an indication to them that an economy is producing below capacity. Below-target inflation expectations are thus a trigger for the central bank to keep an expansionary stance in its policy, in order to stimulate activity.

The ECB also used its banking supervision competence to temporarily loosen up the application of prudential provisions on, for example, capital and liquidity buffers and composition of capital to allow banks more space for continuing to lend money to protect economies from the shock. It also requested banks to not pay dividends or buy back shares during the pandemic.

Going forward, the role of the European Central Bank is likely to remain important for powering the response to and recovery from the pandemic, given the uncertainties over whether – and if so, how far and how fast – an EU fiscal capacity could be established, and over whether EU fiscal governance will be reformed to allow for national fiscal policies with a stronger stabilisation capacity.

In January 2020, the ECB launched a review of its monetary policy strategy, the first of its kind since 2003. This review has been deemed necessary as inflation expectations have persistently remained below target and as, due to a number of structural changes in the euro area economy, there has been a persistent decline in interest rates to levels that require a greater use of unconventional tools.

Several questions are on the agenda of the review. The first is how to define and re-operationalise the mandate of price stability, including over what time horizon it should be pursued and which measure of inflation should be used as a target for the bank's monetary policy decisions. Answers to these questions can have important repercussions for the way in which the ECB can balance the pursuit of its primary goal of price stability with that of other economic goals, such as jobs, growth and a just transition to a carbon-neutral socioeconomic model.

The second question is how to better understand the relationship between inflation and the real economy (output and employment growth), which seems to have changed in recent decades due to structural factors. One of the ways that this change manifested itself was in the fact that, despite accelerating output and employment growth, wage growth was for a while more sluggish than would have been expected in the recent recovery.

Finally, the mix of instruments the ECB should be using in the environment of low interest rates and low inflation expectations that it will most likely have to operate in for the foreseeable future needs to be better defined; so the third question is how effective they are and how this effectiveness can be enhanced. Like many other major central banks in the world, the

ECB has had to resort to the use of unconventional tools (e.g. asset purchases) since the previous crisis (see Bibow 2020 for a review), as the effective use of its conventional tool of lowering interest rates has become more contingent on such unconventional tools since they reached zero (see for example Loneragan 2019). These policy responses were carved out in an ad hoc manner, and while there seems to be a consensus that they have been helpful in sustaining the recovery, they do not come without unintended distributional consequences (e.g. on wealth inequality) or risks (e.g. financial instability). There is therefore a need for a more systematic approach and understanding regarding what they should include, how they work and how their use interacts with fiscal policies.

The policy goal of engineering a transition to a carbon-neutral socioeconomic model has ramifications for all of the above questions (see also Chapter 3 in this volume). For example, the ECB currently defines its mandate in terms of the harmonised index of consumer prices (HICP), which includes energy prices. If, in order to reduce carbon emissions, the price of fossil fuels has to increase (through taxes), then the HICP would also rise. If the ECB were to tighten its policy in response, it would be penalising other parts of the real economy. Decisions on how to adapt monetary policy strategy in response to the structural changes that will come about from this transition will also determine in part how the costs will be shared between labour and capital.

A debate which has been creating controversy among not only monetary policymakers but also environmental campaigners is whether the ECB should abandon the principle of 'market neutrality' when buying corporate bonds from the financial markets. According to this principle, the ECB buys corporate bonds in proportions that would not alter their relative prices in the financial markets (therefore having a 'neutral' impact on the structure of the market).

Proponents of abandoning the principle, whose pleas the governor of the ECB Christine Lagarde seems to be considering, advocate that the ECB should instead actively seek to reduce or even eliminate its purchases of bonds issued by companies that contribute heavily to carbon emissions (from airlines to oil and gas and utility companies) as, in this way, it could help to support one of the EU's chief policy objectives. Such a move would put downward pressure on the price of these bonds, effectively reducing the capacity of carbon-emitting companies to draw funds from the financial markets.

Opponents, however, have retorted that such a move would mean that an electorally unaccountable policymaker, such as the ECB is, would be taking policy actions with distributional consequences, decisions which are the prerogative of elected governments and which would ultimately call into question the ECB's political independence. The fact that, in the context of its ongoing strategy review, the ECB leadership has stated that it intends to take into account new challenges that 'people care about', such as climate change or inequality, and has even organised public consultations and 'ECB Listens' events in recent times, suggests that such a threat is not entirely unfounded.

# Conclusions

Europe is undergoing its second recession in the span of 12 years, and one that is even bigger than the previous 'Great Recession'. The attempts to mitigate the risk that Covid-19 poses for public health have seemingly led to the crumbling of a series of taboos and orthodoxies that have been guiding economic policy over the last 40 years. National governments have had to take far-reaching measures limiting highly valued individual liberties and forcing large parts of national economies to grind to a halt. A massive expansion of public support schemes and, ultimately, of the size of the state has taken place and hailed as a welcome development, even a highly recommended one, by the likes of the former governor of the ECB, Mario Draghi (Financial Times 2020a). For the first time in its history, the EU has established a temporary yet sizeable fiscal capacity to help those Member States most harmed by the pandemic, irrespective of their contribution. Central banks have embarked on massive purchases of government bonds to support these efforts, raising questions over whether a monetary financing of public debt should take place in the future to deal with the accumulated debt – and if so, how (see for example, Demertzis et al. 2010, Diessner 2020, DeGrauwe and Diessner 2020). At a more microeconomic level, the principles of healthcare system management have also come under scrutiny, as allocated resources have often not proved sufficient this year to effectively deal with such a rare yet catastrophic event as the current pandemic.

These developments could offer hope that the crisis will indeed result in different ways of managing the economy in general and prevent us from going through what would be another lost decade for parts of the EU by avoiding a repeat of the damaging policies of the 2010s. On the other hand, it is also possible that, as prominent new classical economist Robert Lucas Jr. stated, 'we are all Keynesians in a foxhole'. While the Great Recession was described as the failure of globalised capitalism, raising hopes that a shift in orthodox economic policy would happen as states stepped in to recapitalise financial institutions 'too big to fail', the aftermath of the initial Keynesian stimulus response was the imposition of harsh and counterproductive fiscal austerity policies. Is this time going to be different? And can it be?

The pandemic hit Europe at a time when momentum was building around the policy challenges of engineering a just transition to a carbon-neutral socioeconomic model and of addressing both the opportunities and the threats posed by digitalisation. It was clear that public investment would be necessary for such challenges. Moreover, the experience of the previous crisis had set in motion some policy initiatives, such as the programme for deepening the EMU, including items like the reform of the ESM and the completion of a banking union, and the implementation of the European Pillar of Social Rights (see Theodoropoulou et al. 2019a and Mueller et al. 2019). Both these programmes, which were born at moments of crisis (of public debt and of trust

in the EU, respectively), illustrated that while there was a consensus on where Europe needed to reach, there was no consensus on how to get there. The pandemic crisis has thrown into sharp relief the gaps that these policy initiatives aimed to fill, from the need for a better fiscal governance framework and a deeper EMU to the need for a more robust social safety net which could reduce the great divergence of outcomes within and across Member States. Last but not least, both the European Commission and the ECB had initiated review processes for the EU economic governance framework and monetary policy strategy, respectively, with a view to making them fitter for purpose.

The current crisis context provides several windows of opportunity for capitalising on recent policy decisions to bring about changes in the EU which, as well as supporting a faster and more robust recovery, could outlast the current pandemic and form the base for powering green, digital and 'just' transitions.

The current suspension of EU fiscal rules, as well as the ECB's declaration of intent to keep on purchasing assets in the financial markets, mean that national governments should not face difficulties in maintaining their support programmes for workers and firms, even if it means recalibrating them over time to prepare the recipients for making the most of the recovery once economic activity can resume. Taking advantage of the longer than originally expected recession and the spirit of solidarity that has seemingly prevailed across large parts of Europe, the SURE scheme should, if possible, be turned into a permanent automatic mechanism of reinsurance and extended to also cover unemployment benefits. At the labour market level, this would ensure that not only jobs but also valuable job-specific skills are not lost. At the macroeconomic level, this could be a more permanent fiscal capacity for stabilising EU and especially euro area economies in the face of idiosyncratic economic shocks, as well as for lightening the burden of national fiscal policies.

The suspension of the EU fiscal rules, possibly to be extended until 2022, is an opportunity for pushing through a reform of the EU fiscal surveillance framework to address at least some of its shortcomings. Rethinking the operationalisation of the debt fiscal rule to allow Member States whose public debt will be much higher than the reference value of 60% of GDP after the crisis to consolidate their public finances at a more gentle pace, and provided that the recovery is robust, would be sensible, especially given the low interest rates that are likely to prevail for several years (cf. European Fiscal Board 2020). Meanwhile, establishing a golden rule for public investment (which will exempt it from budget deficit calculations) will be necessary in view of the investment needed to engineer a just green transition and the likely economic scars that the current recession is likely to leave (see for example Alvarez et al. 2019).

1. Economic developments and policies: is this time different?

2. Labour market and social developments

3. The path to 'zero carbon' in a post-Covid world

4. Fair minimum wages and collective bargaining

5. Covid-19: a 'stress test' for workers' safety and health

6. Democracy at work in a pandemic

7. Foresight: the many possible post-pandemic futures



*The pandemic hit Europe at a time when momentum was building around the policy challenges of engineering a just transition to a carbon-neutral socioeconomic model and of addressing both the opportunities and the threats posed by digitalisation.”*

Getting the next EU budget and the Next Generation EU instrument across the finish line of ratification will be imperative for creating the foundations for these reforms, for providing real support to national fiscal policies, and for navigating the aftermath of the pandemic. It will also provide the financial means for a transition to a fairer, more sustainable socioeconomic model. The current stalemate with Poland and Hungary raises questions over how to ensure that future windows of opportunity for advancing and consolidating forms of economic

solidarity across Member States are not jeopardised, while respecting the political preferences of individual countries.

Finally, the monetary policy strategy of the ECB should be adapted to help meet EU economic policy objectives and to the context of chronically low inflation and interest rates. The issuance of EU social and green bonds in large quantities should ease such shifts.

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