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**Article**

## The Coronavirus Pandemic and Next Generation EU in the Baltic States

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*Karsten Staehr and Katri Urke*

## The Coronavirus Pandemic and Next Generation EU in the Baltic States<sup>1</sup>

The coronavirus pandemic made economic and social conditions worse in most EU countries at a time when many were still recovering from the global financial crisis and the European debt crisis. The leaders of the EU countries decided at a summit in July 2020 to launch a program that would make resources available to all EU countries to aid their recovery and resilience after the pandemic.

The program has over time been given different labels, but the official term ended up being Next Generation EU (NGEU), which is not very informative in itself, but may signal a fundamental change in how the EU operates (Picek 2020). The final agreement on the program and the EU budget for the years 2021–2027 was reached on 10 December 2020, though various details remain subject to ongoing negotiations and future decisions.

The sums of the NGEU are substantial. Allocations to the EU countries total 750 billion euros at 2018 prices, of which 390 billion euros are grants and 360 billion euros are low-interest loans. The 750 billion euros account for approximately 5.5 percent of the EU's total 2018 GDP, excluding the UK.

The NGEU funds will be distributed over several years starting in 2021. There are intricate rules governing the allocation to each country, and they generally mean that the South European and the East European EU countries will receive proportionately more than other EU countries. The Baltic states stand to receive substantial sums from the NGEU because of their income levels and macroeconomic situations.

The Baltic states did not play a major role in the negotiations leading up to the decision regarding the NGEU program. When the “frugal four,” consisting of Denmark, the Netherlands, Austria and Sweden, sought to reduce the size of the NGEU, the Baltic states did not join the initiative, despite the Baltic states' preference for small government and their traditional alignment with other Nordic countries.<sup>2</sup>

Their lack of support for the

frugal four may in part reflect how attractive they found the idea of receiving substantial additional funding from the EU in years to come.

This paper discusses the possible impact of the NGEU on the Baltic economies and asks whether the program represents a new opportunity or a distraction. It contributes to the debates on the program and its economic effects on the EU as a whole and in various EU countries.<sup>3</sup> The paper may also be viewed as a contribution to the broader debates on the future of the EU and the prospects for further economic and fiscal integration (Dabrowski 2016; Picek 2020).

### NEXT GENERATION EU

The European Commission will borrow up to 750 billion euros on the capital markets on behalf of the European Union to finance the Next Generation EU recovery program. These funds will then be used to provide support to the EU countries in the form of loans totaling up to 360 billion euros and grants of up to 390 billion euros (European Council 2020a). The amounts are defined in 2018 prices, so the actual payments in current prices will be higher.

The funds available under the NGEU are linked to the regular Multiannual Financial Framework (MFF), and the MFF instruments and programs will be used to distribute the new additional NGEU funds as loans and grants. The aim is to achieve a coordinated European fiscal response that supports long-term EU policies such as the European Green Deal, the digital revolution and enhanced economic resilience.

In total, 80 percent of the grants and the entire loan portfolio will be allocated to the Recovery and Resilience Facility (RRF), which is the core of the NGEU. The RRF is designed to finance investment and reforms in EU countries so that their recovery can be resilient and in line with the EU's digital and green priorities (European Commission 2020a). The remaining 20 percent of the grants are divided between

the new React-EU facility, which supports investments to aid the recovery, and various top-ups of such existing financing facilities,



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<sup>1</sup> The views expressed are those of the authors and not necessarily those of the Bank of Estonia or other parts of the Eurosystem.

<sup>2</sup> The Baltic states have in other cases been aligned with other North European countries that oppose fiscal transfers within the EU (The Economist 2018).

<sup>3</sup> Staff members of Bruegel have written extensively on the facility (<https://www.bruegel.org/tag/next-generation-eu/>). The November/December 2020 issue of *Inter-economics* focuses on various aspects of the NGEU (<https://www.intereconomics.eu/archive/year/2020/number/6.html>).

including the Just Transition Fund, which compensates regions that are adversely affected by the EU's emissions policies.

To receive financial support under the RRF, each EU country needs to submit national recovery and resilience plans by the end of April 2021. These plans need to feature coherent packages of reforms and public investment projects that will reinforce the potential for growth of the country submitting them, its job creation, and its socio-economic resilience. A minimum of 37 percent of expenditures in the recovery plan need to be focused on green investments and reforms, and a minimum of 20 percent of the expenditure should foster digital transition (European Commission 2020b).

A total of 70% of the RRF grants needs to be committed in the years 2021 and 2022, and the remaining 30% by the end of 2023 (European Council 2020a, A15). The 2021-2022 commitments are allocated to each country using the inverse of 2019 GDP per capita, the 2019 population and the 2015-2019 average unemployment rate, all relative to the values for the EU excluding the UK (European Council 2020b, Annex I). However, the final size of the remaining 30% of the RRF grants for 2023 is uncertain, since it will only be calculated in June 2022 using the loss of real GDP in 2020 and the cumulative loss of real GDP in 2020-2021 (European Council 2020a, A16). This means that the recovery plans will be reviewed in 2022 to include the final allocation of the funds. Payments from the RRF and other NGEU funds will start in 2021 and need to be completed by the end of 2026.

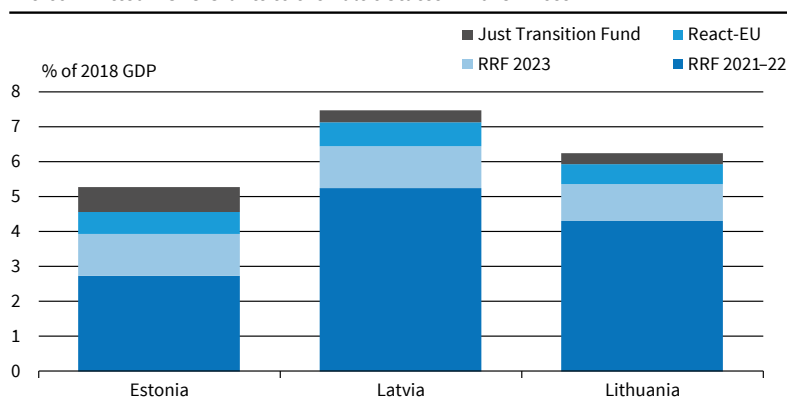
The EU countries can request RRF loans of up to a maximum of 6.8 percent of their GNI (European Council 2020a). How much of the RRF loans each country takes on remains to be seen. Since the EU is expected to borrow in the markets at more favorable interest rates than most EU countries can, the countries with the highest borrowing costs will benefit the most from using the RRF loan facility.

The funds that the European Commission raises on the capital markets will need to be repaid by the end of 2058 at the latest. At the time of this writing in early December 2020, the revenue side of the funding measures has not been decided. However, it is inevitable that new sources of own resources will have to be agreed upon to help repay the borrowing.<sup>4</sup> It may be supposed that if no specific new revenue sources are decided upon, then the loans will either be turned over or the debt servicing costs will be rolled into the EU's general seven-year budgets.

The Baltic states are set to receive substantial funding from the NGEU. The grants available from

Figure 1

#### Pre-committed NGEU Grants to the Baltic States in 2018 Prices



Note: European Commission's preliminary calculations for 2023 based on the summer 2020 economic forecast. Source: European Commission (2020a); Eurostat (2020); authors' calculation.

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the NGEU under the preliminary allocations plan are worth a little over 5% of GDP in Estonia, 6% of GDP in Lithuania, and 7% of GDP in Latvia (Figure 1). The RRF funds represent the bulk of the expected allocations.

The Baltic states may also request RRF loans, but the amounts each country will request are not known at this stage. A fairly similar loan facility offering temporary support to mitigate unemployment risks in an emergency is SURE, which was introduced in spring 2020, and which benefits countries with high borrowing costs. At the time of this writing, Latvia and Lithuania had requested loans from the SURE facility, but it is of course not clear whether this indicates that they will also take on RRF loans in the future.

#### THE CORONAVIRUS CRISIS IN THE BALTIC STATES

The coronavirus pandemic came relatively late to the Baltic states and the numbers of new cases have, in proportional terms, been comparatively low. The total number of coronavirus cases as most 1 December 2020 was 0.98% of the population at the beginning of the year for Estonia, 0.96% for Latvia and 2.24% for Lithuania (John Hopkins 2020). The corresponding number was 1.33% for Germany, one of the least affected among the major countries in Western Europe.

The coronavirus pandemic has led to serious health emergencies and strained health care systems in the Baltic states. All three countries instituted comprehensive lockdowns in the spring of 2020. The restrictions were relaxed in the early summer months, but when the pandemic worsened in the autumn, new restrictions and partial lockdowns were put in place in November 2020.

The pandemic has had serious consequences for the Baltic economies, starting with the first quarter of 2020. The disruptions caused by outbreaks of the coronavirus and the lockdown of shops and various workplaces were negative supply shocks. Equally important, demand for exports, and consumption and investment declined substantially. The construction

<sup>4</sup> In November 2020, the European Parliament and the EU countries in the Council agreed on which sources the possible new future revenues will be linked to. The European Commission will propose new revenue sources based on a carbon border adjustment mechanism, a digital levy and the EU Emissions Trading System. Additional own resources could include a financial transaction tax, a financial contribution linked from the corporate sector and a new common corporate tax base (European Commission 2020a).

sector remained open in all three countries during the lockdown, which helped soften the downturn.

At the time of this writing in early December 2020 it is too early to assess the longer-term consequences for economic growth, unemployment and financial balances. In the short term, the GDP had already started to decline in the first quarter of 2020 (Figure 2). The decline in seasonally adjusted GDP from the first quarter of 2020 to the second was 5.5% in Estonia, 7.1% in Latvia, and 5.9% in Lithuania. These declines were comparable to those in many Western European countries. Economic growth resumed at a rapid pace in the third quarter and large parts of the income declines were reversed in the third quarter of 2020.

The unemployment rate is lagging behind developments in GDP. Figure 3 shows quarterly data for the unemployment rate from 2015 to the third quarter of 2020. The unemployment rate increased substantially from the second quarter to the third, particularly in Estonia, where the large tourist sector was hit severely by the crisis, and where regulations on employment protection are less strict than in the other two Baltic states. Unemployment rates continued to rise in the third quarter of 2020, though at a lower rate than in the second quarter.

Figure 2  
Gross Domestic Product

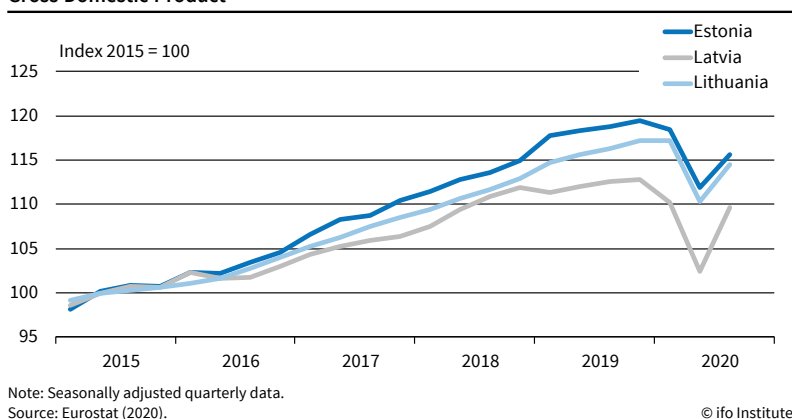
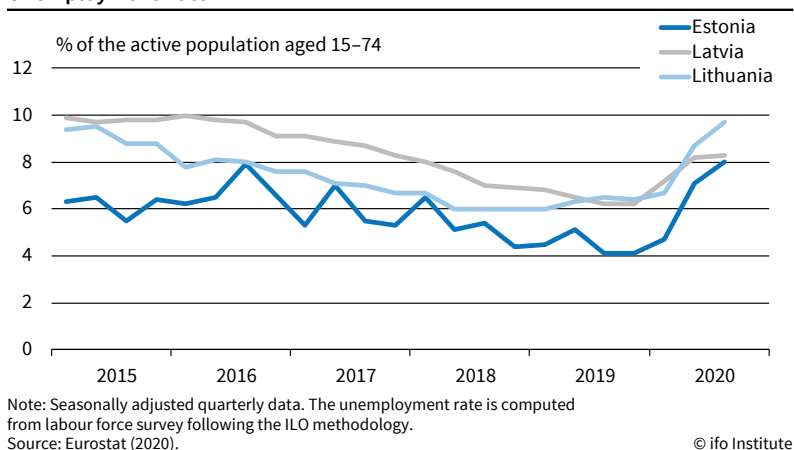


Figure 3  
Unemployment Rate



When looking at the dynamics of unemployment, it should be noted that the unemployment data do not cover workers who are furloughed. Moreover, the increasing unemployment risks do not have an equal effect on all the different parts of the populations. The coronavirus pandemic has disproportionately affected workers in the service sector and, to a lesser extent, the manufacturing sector, and these workers were often paid low wages before they were let go and may also lack the education and skills that could ease their return to employment (Eesti Pank 2020).

## A LONGER PERSPECTIVE

It is instructive to consider the fallout from the coronavirus crisis in the Baltic states from a longer perspective. The Baltic states have seen very strong business cycles since they regained independence in 1991. GDP dropped dramatically in all three countries after the global financial crisis and unemployment rates followed in the opposite direction after a short delay. The economic downturn in the Baltic states due to the coronavirus pandemic has been severe but nevertheless relatively well contained in comparison to the experience after the global financial crisis.

Figure 4 shows annual GDP growth in the Baltic states from 2000 to 2019 together with the forecasts from the European Commission for 2020 to 2022. The accumulated decline in output after the global financial crisis was around 20 percent of the GDP before the crisis, whereas the declines in output due to the coronavirus crisis are forecast to be between 2 and 6 percent of pre-crisis GDP and the downturn is forecast to last for only one year.<sup>5</sup>

The economic setbacks in the Baltic states following the coronavirus pandemic have been serious, but they are similar to, or milder than the setbacks that most other European countries experienced (European Commission 2020c). The impact on the Baltics has also been considerably less serious than the fallout they experienced after the global financial crisis. The global financial crisis affected almost all areas of private enterprise, whereas the coronavirus crisis has mainly affected tourism, the hospitality industry and culture. The construction industry faced serious difficulties after the global financial crisis, but it has held up well during the coronavirus crisis.

The losses in output in 2020 may be comparatively small partly because the macroeconomic stance was more balanced before the coronavirus crisis than it was before the global financial crisis. The Baltic states are members of the euro area, and the expansionary monetary policy of the European Central Bank has benefited them directly as credit

<sup>5</sup> The unemployment dynamics follow a similar pattern. While the unemployment rates in the Baltic states have been creeping up during 2020, the rates are still well below the peaks of around 20% of the labour force following the global financial crisis.

conditions were eased, and indirectly through trade and financial flows.

The economic downturns associated with the coronavirus pandemic may also have been softened by expansionary fiscal policy. The three countries allowed the automatic stabilizers to operate and furthermore took discretionary measures in support of businesses and the unemployed. The European Commission projects the cyclically adjusted deficits in the Baltic states to be between 4 and 8 percent of GDP in 2020 (Ameco 2020).

The expansionary fiscal policies introduced during the coronavirus crisis have led stocks of government debt in the Baltic states to increase rapidly. Figure 5 shows gross government debt in percent of GDP where the data for 2020–2022 are once more projections by the European Commission. Estonia stands out for having a very low government debt stock before the coronavirus crisis, while the debt levels in Latvia and Lithuania were higher in consequence of their expansionary fiscal policies during the global financial crisis.

The ratio of government debt to GDP is projected to increase rapidly from its 2019 level. It is noticeable, however, that the stock of government debt in the Baltic states will remain among the lowest in the EU and it is projected to remain well below the debt ceiling of 60% of GDP as defined in the Stability and Growth Pact and the Macroeconomic Imbalance Procedure.

In conclusion, the coronavirus pandemic has dragged the economies in the Baltic states down, but the declines in output are much smaller than what was seen during the global financial crisis and also smaller than those in many other EU countries (European Commission 2020c). Monetary easing by the European Central Bank has helped them to avoid credit crunches, and expansionary fiscal policies have provided support to businesses and workers without jeopardizing fiscal sustainability. Meanwhile, the longer-term economic ramifications of changes in markets and business practices, the disruption of education and job training, and reduced business and public investment remain unclear.

## NGEU AND THE BALTIC STATES

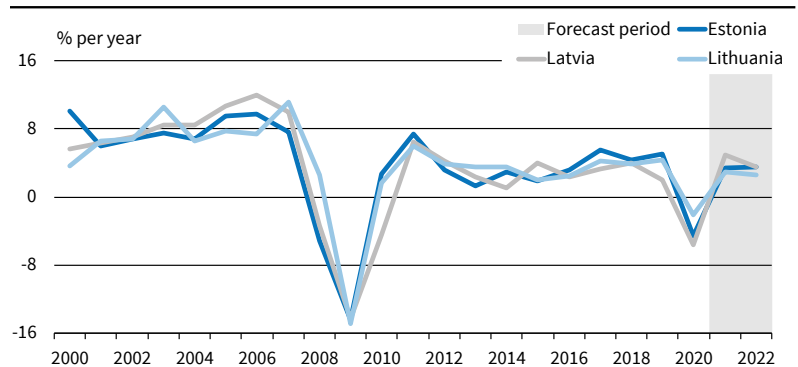
### Public Finances

The NGEU was devised a few months after the coronavirus had reached Europe. Early proposals emphasized the need to ease fiscal pressures immediately in order to avoid a crash akin to the European debt crisis of 2009–2012, but the final version emphasized objectives like supporting recovery and resilience in the medium-term rather than the immediate financing requirements provoked by the pandemic (Heinemann 2020).

The absence of short-term support in the NGEU program has not had serious consequences. European governments have generally retained access

Figure 4

### GDP Growth



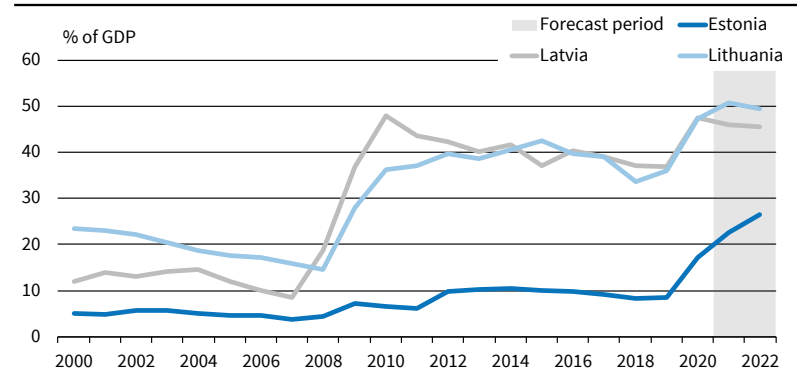
Note: Projections for 2020–22 from the Autumn Forecast 2020 of the European Commission (2020).

Source: Ameco (2020).

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Figure 5

### General Government Debt



Note: Projections for 2020–22 from the Autumn Forecast 2020 of the European Commission (2020).

Source: Ameco (2020).

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to borrowing and interest rates have remained low, or even negative in many cases. The expansionary monetary policies pursued by the European Central Bank after the pandemic have helped allow European governments to retain access to private sector borrowing at low interest rates. Moreover, the coronavirus pandemic did not cause disruptions in financial markets in the same way that the global financial crisis did (Giese and Haldane 2020).

The payments from the NGEU will not start until 2021, but the facility may nevertheless have helped drive down risk premiums on government debt in anticipation of future grants and loans. It is difficult to be certain how this anticipation has affected the costs of government funding in the Baltic states, but the effect may be small.<sup>6</sup>

The Baltic states are projected to receive grants worth between 5 and 7 percent of GDP over the years 2021 to 2026, and the countries can borrow comparable amounts from the RRF facility. At first sight such large transfers over a relatively short period should ease fiscal pressures.

<sup>6</sup> It is noticeable that Estonia, which did not issue government bonds until 2020, entered the market in 2020 and borrowed at very low interest rates.



How the *grants* affect the fiscal balances in the Baltic states will depend on how much of the required spending would have taken place anyway. The NGEU presumes that the spending is additional, in which case the net effect on the fiscal balance would be small. Given that energy transition, digitalization and modernization of the economy are high on the political agenda in all three Baltic states, parts of the spending might have happened anyway.

The *lending* facility of the RRF will affect the fiscal balance to the extent that it lowers the borrowing costs to the governments (Darvas 2020a). Since the interest rates on government borrowing are relatively low in the Baltic states, the possible savings from this source are likely to be small. This may change, however, if the risk premiums were to increase on government debt issued by the Baltic states, in which case, access to RRF borrowing might be highly beneficial.

### Recovery and Growth

The NGEU is intended to support economic recovery and resilience in the EU countries. The focus is on medium-term objectives and the facility does not provide short-term crisis measures (Heinemann 2020). Some funding may be available in 2021, but the rules for obtaining funding mean that the NGEU funds will not start to be paid out in substantial amounts until 2022 (Darvas 2020c).

Projections of economic growth in the Baltic states suggest that the downturns will prove to be relatively short-lived and concentrated in 2020.<sup>7</sup> This suggests that support from the NGEU is unlikely to play a role in the policy measures taken to contain the short-term fallout from the coronavirus crisis in the Baltic states.

The NGEU seeks to facilitate recovery over the medium-term by providing funding for investment in green technology, digitalization and other forms of modernization. Fornaro and Wolf (2020) show in a theoretical model how the pandemic can lead to a “stagnation trap” where the initial supply disruptions caused by the pandemic reduce demand, and this then leads to lower investments and a lasting depression of supply. Government spending to address the supply constraints would be very effective in such a case.

The NGEU program provides resources to the EU countries to expand investment and reduce the risks of supply constraints in energy, digitalization and other areas that can hold back economic growth. It may thus reduce the likelihood of the Baltic states entering a prolonged period of low growth after the coronavirus pandemic. The risk of such a scenario unfolding is difficult to assess. It is noticeable, however, that economic growth in the Baltic states was

unimpressive for several years after the global financial crisis, and this led to concerns that the crisis had altered the dynamics of growth in these countries (Staehr 2015). The debates on the risks of the Baltic states following a path of low growth receded as economic growth picked up starting in 2017.

Besides the immediate or direct effect on investment from larger domestic spending, the NGEU may also give rise to indirect or spillover effects, given that the program compels all EU countries to increase spending on a green economy, digitalization, and innovation (Picek 2020). Given the size and openness of the Baltic economies, the possible spillovers from introducing NGEU measures in other EU countries might be as important as the measures taken in the Baltic states themselves.

The possible positive effects of the NGEU in the medium-term rest in large part on the additional resources being spent effectively. As discussed previously, funding from the NGEU must be spent within specific areas and only after various administrative procedures have been observed. These rules are meant to ensure that the funding is well spent, but they may also represent roadblocks in some cases.

The effectiveness of the funding from the NGEU is framed by the same factors as the regular cohesion policy funding, including the spending strategy, the absorption capacity and institutional competence (Medve-Bálint 2018). One particular concern is the relatively short time frame for preparing and submitting projects to be funded by the NGEU. This may hamper the ability to identify projects promising high social returns and may lead national authorities to prioritize projects that are already available or easy to prepare (Darvas 2020b).

The thematic focus implies that whereas funding will be available for energy conversion and digitalization, funding for other projects with potentially higher social returns may not be available. This concern is probably not too worrying given the flexibility in public budgeting and the fact that many projects within the greening of the energy supply and digital transformation have been identified in the Baltic states. The operation of the NGEU hinges on identifying projects that promise high social returns.

### Political Economy

Not only will the NGEU have economic effects in the Baltic states, but it may also change expectations about the role of the EU and could possibly change domestic policymaking in the three countries.

A key issue is whether support from the NGEU may lead to *moral hazard*, meaning that policymakers might start assuming that they will be able to get support from the EU whenever their countries encounter adverse economic conditions. This may make them less prudent in the future so that governments might not prepare sufficiently for economic difficulties. The

<sup>7</sup> There were fewer imbalances in the Baltic economies at the outbreak of the coronavirus pandemic than at the outbreak of the global financial crisis.

risk of moral hazard may also be real in the Baltic states. The Baltic states are small open economies and they have experienced strong business cycles since they regained independence. It is important that governments be prepared for sudden downturns, so expecting that the EU will provide support in a crisis may be deleterious.

The NGEU program comes at a time when income levels in the Baltic states are approaching or exceeding those in many South European EU countries. This means that the regular support from cohesion policy is set to be reduced in the budget period 2021–2027, especially for Estonia and Lithuania. The NGEU is set to provide substantial additional support at a point when the countries were set to gradually ease away from receiving support from the EU.

The NGEU implies that the total support from the EU to each of the Baltic states will remain substantial for an extended period of time. The risk is that support from the EU will be seen as an entitlement or an entrenched right. Such entitlement risks creating aid dependence, where policymaking and public administration become oriented toward extracting and utilizing external funding (Brazys 2018).

Persistent external funding may lead the public to expect that they will receive public services and generous social transfers without having to pay the corresponding tax. Such expectations may complicate policymaking when the funding is eventually phased out. Varblane (2016) discusses these issues in the context of EU support to the Baltic states and argues that the countries should take steps to reduce their dependence on funding from the EU.

## DISCUSSION

The coronavirus pandemic meant that 2020 was a year of health, social and economic crises in all the EU countries. The Next Generation EU program is meant to aid the EU countries in recovering from the crises and to improve their resilience to future ones. This paper discusses the coronavirus pandemic and the role of the NGEU for the Baltic states.

The NGEU program impacts the Baltic economies directly in various ways. The effects on the fiscal stance may be limited if funding from the NGEU is spent on new investments in green energy, digitalization and other recovery measures. It is difficult to assess how economic growth will be affected, since this will in large part depend on how the additional funding is spent. Finally, the NGEU may accentuate the existing reliance on external funding for policymaking in the Baltic states.

The NGEU may have limited direct effects for the Baltic states, while the indirect effects could be of greater importance. This is particularly the case if the NGEU contributes to economic development and improved resilience in the rest of the EU. The Baltic economies are, given their size and openness, highly

dependent on developments in their neighboring countries. Higher and more stable growth in the rest of the EU will therefore have immediate and positive effects in the Baltic states.

Next Generation EU represents a departure from previous policies and has potentially sizeable consequences for the role and operation of the EU. What consequences it will have for the Baltic states is difficult to pinpoint precisely, as may also be the case for the rest of the EU. The NGEU undoubtedly affords new opportunities as well as new challenges for all the EU countries, including the Baltic states.

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