BRIEFING

European Parliament

The economy and coronavirus: Weekly Picks

This paper provides a summary of some recent analyses of the economic and financial effects of the coronavirus and some policy recommendations made in the public domain to mitigate these negative effects.

Focus: What role of the banks to mitigate the crises?

A number of publications in the public domain have addressed what banks can (will) do to mitigate the effects of the coronavirus crisis. Policymakers have been particularly attentive of the financial sector specific characteristics and measures have been addressed to ensure that it maintains credit flowing to the economy and citizens (see EGOV publication on EU/EA measures addressing the Banking Union, Section 4) without undermining its overall soundness. Measures have been "*unprecedented*" as Andrea Enria put it and address three complementary areas: the prudential side, the fiscal area and the monetary policy. That may come at a price for the banks, namely, preventing banks from distributing dividends, bonuses and so on (see ECB recommendation and recent Andrea Enria interventions, here, here and here) to ensure the conservation of capital. Despite the flexibility already given, some banks have pushed for additional leeway in implementing the post financial crisis rules (see deferral of Basel III decision by BIS) or amend existing requirements (see also IMF blog).

Banks play a crucial role in making funds available and function as a "transmission mechanism" to support the near-frozen European economy. Acting as such requires banks to ensure their critical functions remain in place, and procedures to channel funds are as flexible as possible, without losing sight of their obligation to monitor debtors.

Whether banks behave, indeed, as "the doctors of the economy", remains to be seen. It also remains to be seen whether they can do more, particularly if the coronavirus crisis turns out to be an opportunity to build trust, confidence and (contrary to expectations) improve their balance sheets. Thishis time there seems to be no reason as such for policy makers to introduce any so-called financial stability taxes, as it was done in the 2007-2008 financial crisis.

by EGOV banking team (Marcel Magnus, Cristina Dias, and Kristina Grigaite)

Some recent economic estimates

Portugal: Banco de Portugal (26/03/2020) has chosen to present two scenarios – a baseline scenario and an adverse scenario – with different assumptions on the economic effects of the pandemic in Portugal and worldwide. The projections seek to take into account the potential impact on Portugal's economy of the policies adopted by national and European authorities in response to this shock and estimate the peak of the crisis to take place in the second quarter of 2020. Banco de Portugal points to specific vulnerabilities of the portuguese economy linked, namely, to the high exposure to the tourism sector, particularly hit by the crisis.

In the baseline scenario, real GDP is estimated to decrease by 3.7% in 2020. It is assumed that the economic impact of the pandemic is relatively limited on account of the measures taken by economic authorities. The economic growth is expected to still be weak in 2021 (0.7%), but recover more considerably in 2022 (3.1%).

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PE 645.717 - 6 April 2020

The unemplyment rate is projected to deteriorate (from 6.5% in 2019) to 10.1% in 2020 and to slightly recover to 9.5% in 2021.

In the adverse scenario, Portuguese economy is expected to experience a deeper recession, with GDP dropping by 5.7% in 2020. In the subsequent years, economic activity should recover, with foreseen growth of 1.4% in 2021 and 3.4% in 2022. The unemplyment rate is projected to deteriorate (from 6.5% in 2019) to 11.7% in 2020 and to reach 10.7% in 2021.

Netherlands: The Netherlands Bureau for Economic Policy Analysis (26 March 2020) uses four scenarios to outline the possible economic impact on the Dutch economy of COVID-19 in 2020 and 2021. All scenarios result in a recession in the Netherlands, with GDP declining by between 1.2% and 7.7% in 2020.

Scenarios	GDP-growth (%)		Unemployment (% labour force)		Budget balence (% of GDP)	
	2020	2021	2020	2021	2020	2021
I: 3 months of restrictions	-1.2	3.5	4.0	4.5	-1.3	-0.5
I: 6 months of restrictions	-5.0	3.8	4.2	5.3	-4.6	-2.9
III: 6 months of restrictions, more negative impact	-7.7	2.0	6.3	8.4	-6.8	-5.7
IV: 12 months of restrictions + additional problems	-7.3	-2.7	6.1	9.4	-7.3	-9.9

Source: The Netherlands Bureau for Economic Policy Analysis, 26 March 2020

Estonia: Bank of Estonia (27/03/2020) indicated four main channels through which the virus will affect the economy, namely, (i) the direct impact of restrictions guarding against the virus, as they will prevent businesses from working; (ii) tourism and travel services; (iii) exports, imports and production (including hold-ups in international supply chains); and (iv) private consumption and investment. There are two projection scenarios: first, if the situation eases before the beginning of May, it is estimated that the Estonian economy would contract in 2020 by around 6% (every week that the state of emergency is extended in Estonia and the recovery in export markets is delayed will see the 2020 recession deepened by around 0.5%); and, second, if the situation eases before the beginning of August, it is estimated that the Estonian economy would contract in 2020 by around 14%.

Lithuania: the Bank of Lithuania (26/03/2020) expects that the Lithuanian economy will be hit the hardest in the second and third quarters of 2020. The Bank of Lithuania has prepared three economic development scenarios which entail:

1) a sudden recession followed by a longer recovery period, i.e. a U-shaped recession (baseline scenario);

2) a protracted recession and recovery, i.e. a prolonged U-shaped recession; and

3) an abrupt recession followed by a rapid recovery, i.e. a V-shaped recession.

Scenarios	Real GDP-growth (%)		Unemployment (% labour force)		Wages (%)	
	2020	2021	2020	2021	2020	2021
I: U-shaped recession	-11.4	9.7	12.5	9.1	-2.6	2.0
II: prolonged U-shaped recession	-20.8	-	16.0	19.8	-12.2	-2.5
III: V-shaped recession	-3.4	-	8.7	6.9	2.4	3.6

Source: Bank of Lithuania, 26 March 2020.

Latvia: Bank of Latvia (26/03/2020) revised downwards its forecast of Latvia's GDP growth for 2020 to -6.5% and that of inflation to 0.5% (compared to 2.6% and 2.4% respectively in December 2019 projections). The projections are based on the assumption that the spread of the coronavirus will have its effect on the economy in the first half of the year and the economy will start to recover in the second half of the year. The Bank of Latvia assesses that the most severely affected sectors will be accommodation, catering, recreation and entertainment (estimated drop in value added is around 70% in the Q2 2020 and about 30% in 2020 overall); transport services (around 20% drop in 2020 overall); manufacturing; trade (both wholesale and retail, estimated drop in private consumption is around 5.9% for 2020).

Latest OECD estimates of COVID containment measures on economic activity (26 March 2020)

In n a rapidly changing environment, it is extremely difficult to quantify the exact magnitude of the impact of these measures on GDP growth, but is clear that they imply sharp contractions in the level of output, household spending, corporate investment and international trade. This note by OECD provides illustrative estimates of the initial direct impact of shutdowns, based on an analysis of sectoral output and consumption patterns across countries and an assumption of common effects within each sector and spending category in all countries. This approach suggests that the initial direct impact of the shutdowns could be a decline in the level of output of between one-fifth to one-quarter in many economies, with consumers' expenditure potentially dropping by around one-third. Changes of this magnitude would far outweigh anything experienced during the global financial crisis in 2008-09. This broad estimate only covers the initial direct impact in the sectors involved and does not take into account any additional indirect impacts that may arise.

The implications for annual GDP growth will depend on many factors, including the magnitude and duration of national shutdowns, the extent of reduced demand for goods and services in other parts of the economy, and the speed at which significant fiscal and monetary policy support takes effect. Nonetheless, it is clear that the impact of the shutdowns will weaken short-term growth prospects substantially. The scale of the estimated decline in the level of output is such that it is equivalent to a decline in annual GDP growth of up to 2 percentage points for each month that strict containment measures continue. If the shutdown continued for three months, with no offsetting factors, annual GDP growth could be between 4-6 percentage points lower than it otherwise might have been.

Variations in the impact effect across economies reflect differences in the composition of output. Many countries in which tourism is relatively important could potentially be affected more severely by shutdowns and limitations on travel. At the other extreme, countries with relatively sizeable agricultural and mining sectors, including oil production, may experience smaller initial effects from containment measures, although output will be subsequently hit by reduced global commodity demand.

For a regularly updated database on measures taken by OECD countries to contain the spread of the coronavirus, please see **OECD Country Policy Tracker.**

Policy recommendations in the public domain: Some picks from last week

D. Gros **- EU solidarity in exceptional times: Corona transfers instead of Coronabonds (5 April 2020):**

The countries hit hardest by the COVID-19 crisis already have too much debt. Lending from the European Stability Mechanism or via Coronabonds would add to that debt, potentially making it unsustainable. This column suggests that European solidarity should take the form of transfers, not credit. A substantial transfer could be organised via the EU budget simply by exempting the weakest countries from their contributions to the EU budget for the duration of the programming period 2012-2027. Of course, the transfers envisaged here would not come all at once. This means that in the short run the debt of the Southern countries would increase. Nonetheless, given that this is transitory (and that, on average, even Italy only pays less than 1% on its public debt), this should not be a problem. Moreover, financial markets are very likely to react to the announcement of such a scheme with more confidence within the country.

F. Dorn, C. Fuest et al **- The Economic Costs of the Coronavirus Shutdown for Selected European Countries: A Scenario Calculation (April 2020):**

This paper presents scenarios of the shutdown costs in terms of lost value added for Austria, France, Italy, Germany, Spain, Switzerland and UK. The shutdown phase will lead to considerable production losses and large declines in GDP this year.

Lasting longer than a month, the losses within the EU quickly reach dimensions well beyond the growth slump of previous recessions or natural disasters. Shutdown costs justify almost every conceivable investment in health policy measures which allow to combine a resumption of production with further fight against the epidemic.

W. H. Buiter - **The Helicopters are coming (26 March 2020):**

Because the eurozone lacks a serious central facility with independent budgetary powers, the European Stability Mechanism (ESM) is the obvious institution through which financially strong member states could provide politically transparent support for weaker members should the need arise. And yet, there does not appear to be any consensus within the eurozone on whether the ESM could be used in this way.

The remaining option, then, is for member states to increase their national fiscal-stimulus programs to, say, 7.3% of GDP, while the ECB acts as the monetary helicopter. This, however, would engage the ECB in quasi-fiscal actions involving cross-country redistributions of fiscal risk, requiring either a change in existing treaties or a collective willingness to ignore the obvious legitimacy issues raised by such operations.

But even if that is the case, it would be criminally negligent to allow a design flaw in existing treaties to inhibit the appropriate use of helicopter money at a time of existential crisis. Italy must implement a fiscal stimulus worth at least 5% of GDP – most likely more – and some combination of the ECB and the ESM must enable it to do so.

O. Blanchard - **"Whatever it takes." Getting into the specifics of fiscal policy to fight COVID-19 (30 March 2020):**

I see three roles for fiscal policy in the COVID-19 crisis.

The first is infection fighting, spending as much as needed both to deal with the infection now and to give incentives to firms to produce tests, drugs, and vaccines, so that the pandemic can be both brought down and kept under control.

The second is disaster relief, providing funds to liquidity-constrained households and firms. Many households do not have the cash to survive the next few months without financial help. Many firms do not have the cash to avoid bankruptcy without help. Providing financial relief is essential to avoid extreme suffering and permanent damage to the economy.

The third is support of aggregate demand, making sure that the economy operates as close to potential as it can, but recognizing that potential is, for the moment, profoundly impaired by the health measures needed to decrease the infection rate.

G. Dell'Ariccia, P. Mauro, A. Spilimbergo, J. Zettelmeyer - **Economic Policies for the COVID-19 War (1 April 2020):**

Interest rates and inflation were projected to be low-for-long prior to the pandemic in most advanced economies. Preventing major disruptions in supply chains should avoid inflation during the emergency and recovery phases. If the measures to contain the spread of the virus are successful, the necessary increase in the public debt ratio will have been sizable, but interest rates and aggregate demand are likely to remain low in the recovery phase. Under those circumstances, fiscal stimulus will be appropriate and highly effective in most advanced economies. And this will facilitate exit from the exceptional measures introduced during the crisis.

L. Bini Smaghi - **Corona bonds – great idea but complicated in reality (28 March 2020):**

The debate on the Eurobonds poses two important political choices. The first is to promote a broad transfer of economic and social competences from the national to the European level, which is necessary to give the Union the ability to finance European bonds. The second is to adopt the ESM reform, perhaps by further strengthening its potential with conditionality better calibrated to systemic crises, and to ensure that a sufficient number of countries apply so as to avoid stigma. The two choices are not necessarily alternative. On the contrary, they can be complementary and carried out with a different time frame. However, they must be made explicitly. Otherwise it is useless, and illusory, to talk about Eurobonds.

G. Giupponi, C. Landais - **Building effective short-time work schemes for the COVID-19 crisis (1 April 2020):**

Short-time work is a subsidy for temporary reductions in the number of hours worked in firms affected by temporary shocks. Evidence suggests that it can have large positive effects on employment and can be more effective than unemployment insurance or universal transfers. This column discusses how the COVID-19 crisis – with its mandated reduction in hours of work and massive liquidity crunch for firms – is a textbook case for the use of short-time work.

S. Fujita, G. Moscarini, F. Postel-Vinay - The labour market policy response to COVID-19 must save aggregate matching capital (30 March 2020):

The COVID-19 pandemic represents an unprecedented shock to labour markets. This column argues that the policy response should balance two objectives: (1) facilitating prompt reallocation of employment to essential activities during the emergency, and (2) maintaining workers' attachment to their previous employers, preserving the aggregate stock of firm-specific human capital, and avoiding persistent mismatch, which would propagate the temporary shock into a prolonged stagnation.

A petition to the governments of all Member States and to EU institutions: European Solidarity Now! ***A joint German-Italian appeal to the governments of all Member States and to EU institutions*** (1/04/2020):

As we have entered this crisis together, we will only exit it well together. We need burden-sharing because some countries might otherwise run the risk of not being able to spend enough on health projects and a swift restart of economic activities. This would not only hurt the concerned country, but put the entire internal market at risk. We therefore call for the issuing of European Health Bonds with a clear and defined common objective and subject to jointly agreed guidelines. This would allow shouldering the burden together, in a democratic way.

The urgency is presently on fighting the Coronavirus pandemic and its immediate consequences. We should however start to prepare the measures necessary to get back to a good functioning of our societies and move to sustainable economic development, integrating inter alia the green transition and the digital transformation, and drawing all lessons from the crisis. This will require a coordinated exit strategy, a comprehensive recovery plan and unprecedented investment. We invite the President of the Commission and the President of the European Council, in cooperation with the European Parliament and in consultation with other institutions, especially the ECB and the EIB, to start work on an Action Plan to this end.

The time for solidarity in Europe is now – a concerted European financial response to the corona-crisis **Klaus Regling** (2/04/2020):

There are proposals to create new institutions or new instruments, but this takes time that we do not have right now. At the start of the euro crisis, it took the first temporary euro rescue fund, the European Financial Stability Facility, seven months to issue its first bond. This was a record speed compared to similar institutions that needed up to three years. Creating new European debt requires either capital, guarantees or assigned revenue and a functioning legal and governance system. Therefore, it is best to make ready use of all existing institutions and instruments that have been raising large amounts successfully for years already
In addition, the EIB could raise its capital, which would allow it to lend more over the coming years. And the ESM has available lending capacity.
The time for solidarity in Europe is now. If we want to protect the EU's Single Market, it is not enough to rescue your own economy. Every EU Member has an interest that all other EU countries can also overcome this crisis.

For an overview of the current role and tools of the European Stability Mechanism and the European Financial Stability Mechansim, please see EGOV documents: The European Stability Mechanism: Main Features, Instruments and Accountability and The European Financial Stabilisation Mechanism: Main Features.

For a regular update of measures undertaken at the European Union or Euro Area level to mitigate the economic, financial and social effects of the coronavirus crisis, please see EGOV document: EU/EA measures to mitigate the economic, financial and social effects of coronavirus.

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