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, an overview of some policy recommendations made in the public domain to mitigate the negative economic effects of the pandemic.

Some recent economic estimates

Some takeaway from the latest ECB Economic Bulletin (14 May 2020)

The ECB's Economic Bulletin published on 14 May 2020 gives an update on economic and monetary developments in Europe and other major economies, one section thereof dedicated to the non-euro area, gripped by the sharp decline in economic activity, a sharp reduction in commodity prices, significant tightening of financial conditions, and substantial capital outflows.

A preliminary estimate for the **US economy** indicates a contraction in the first quarter by 4.8%, the largest decline in GDP since the global financial crisis. As that estimate is based on incomplete data, forthcoming releases could show an even larger decline. The cumulative number of workers seeking unemployment insurance from mid-March to end-April reached around 30 million (19% of the labour force), leading to consumer confidence and spending plunge. On the fiscal side, US Congress agreed on fiscal support amounting to almost 10% of GDP.

Incoming data for the **United Kingdom** suggest that the coronavirus outbreak has had a significant adverse impact on an already slowing economy. Economic policy responses have been swift and strong. Apart from interest rate cuts by the Bank of England, the government introduced a series of coronavirus contingency measures, including a variety of income support measures, additional budget for the National Health Service, as well as an expansive array of loan facilities, tax payment holidays and grants to small businesses.

In **Japan,** the government announced a sizeable economic package in response to the coronavirus crisis. Although the overall size of the announced package appears unprecedented (about 20% of GDP), a large part is related to private sector outlays.

Economic growth in **China** has fallen to its lowest level in decades as a result of the pandemic and weak external demand. In the first quarter of 2020, GDP decreased by 6.8%. Activity is expected to rebound only partly in the second quarter of 2020 as weak domestic demand is amplified by weak external demand. Policy measures have been implemented to support the economy and ensure liquidity in the banking system. Fiscal policy stimulus in the form of tax exemptions, purchase vouchers, income support and loan guarantees is expected to cushion the impact of the pandemic.

A deeper look at US: Recent estimates by the Conference Board

The US based think tank "Conference Board" is adopting a **U-shape scenario for US** as their base forecast, and expect second quarter GDP to decline by almost 45% (annualised). This large drop is driven by a fall in consumer spending of more than 50%, a drop in real capital spending of just over 20% and a fall in exports

Economic Governance Support Unit (EGOV)
Authors: K. Grigaite, S. Lenzi, A. Di Filippo
Directorate-General for Internal Policies
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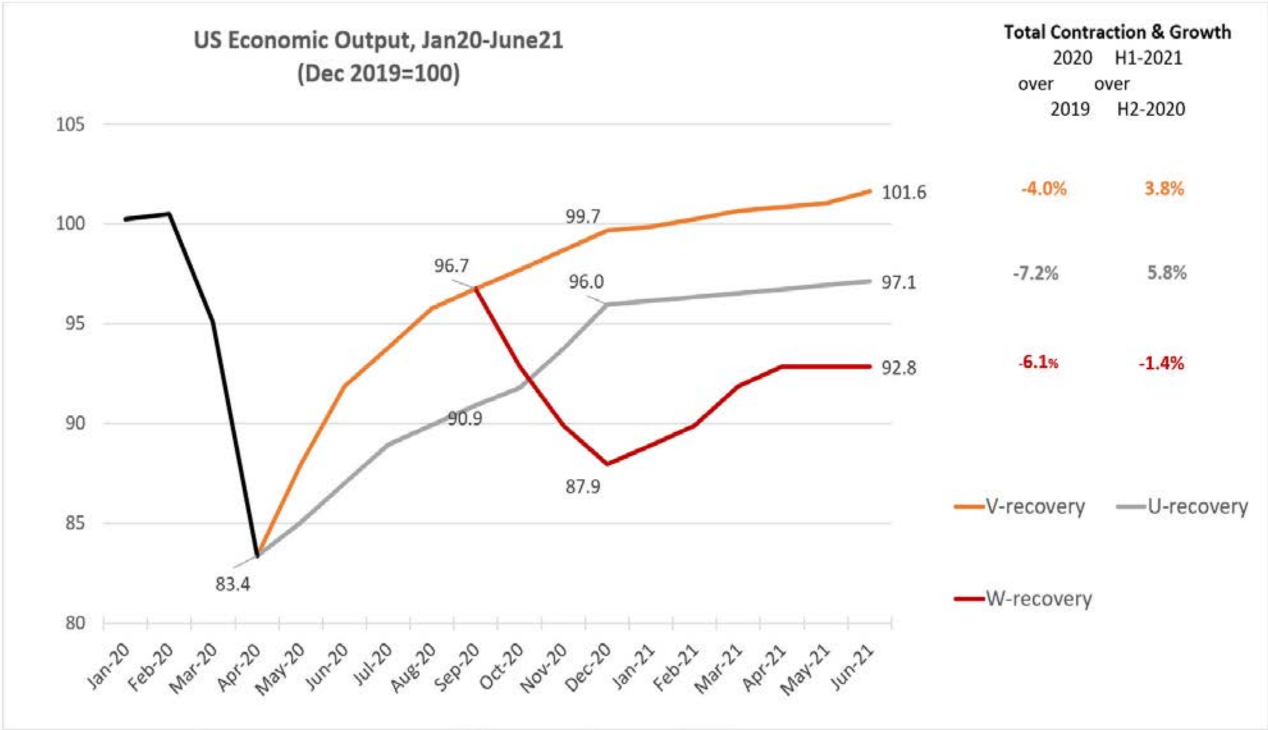
of more than 35%. Based on the abovementioned scenario, by the end of June, economic output is expected to have recovered to 87% level of what it was in December 2019.

Chart: Estimated US economic output in Jan2020 - June2021



Source: Conference Board. The Conference Board is the member-driven think tank. A not-for-profit entity holding 501 (c) (3) tax-exempt status in the United States. Founded in 1916.

Their U-shaped growth scenario assumes a slow recovery in the second half of the year that will bring December 2020 economic output to about 96% of what it was a year earlier. This recovery will be primarily driven by consumer spending in Q3 and Q4. The Conference Board doesn't expect a recovery in investment to start until Q4. Despite some isolated supply-side price spikes, overall inflation is likely to remain weak at -0.4% for the first half of 2020 and 0.5% for the second half. This is due to soft demand, muted oil prices, and ongoing monetary support.

On the basis of their U-shaped scenario, GDP will contract by -7.2% for 2020 on the whole. This compares unfavorably to the -4% contraction associated with their V-shaped recovery scenario. However, steeper recovery under the V-shaped scenario is predicated based on the assumption of a rapid reopening of the US economy that may trigger a COVID-19 resurgence that would require implementation of containment measures. This would result in a W-shaped scenario that would hurt fourth quarter growth and extend this economic crisis into 2021.

Box: Industrial production in US in April 2020

Total industrial production fell 11.2% in April for its largest monthly drop in the 101-year history of the index, as the COVID-19 (coronavirus disease 2019) pandemic led many factories to slow or suspend operations throughout the month. Manufacturing output dropped 13.7%, its largest decline on record, as all major industries posted decreases. The output of motor vehicles and parts fell more than 70%; production elsewhere in manufacturing dropped 10.3%. The indexes for utilities and mining decreased 0.9% and 6.1% respectively. At 92.6% of its 2012 average, the level of total industrial production was 15.0% lower in April than it was a year earlier. Capacity utilization for the industrial sector decreased 8.3 percentage points to 64.9% in April, a rate that is 14.9 percentage points below its long-run (1972–2019) average and 1.8 percentage points below its all-time (since 1967) low set in 2009.

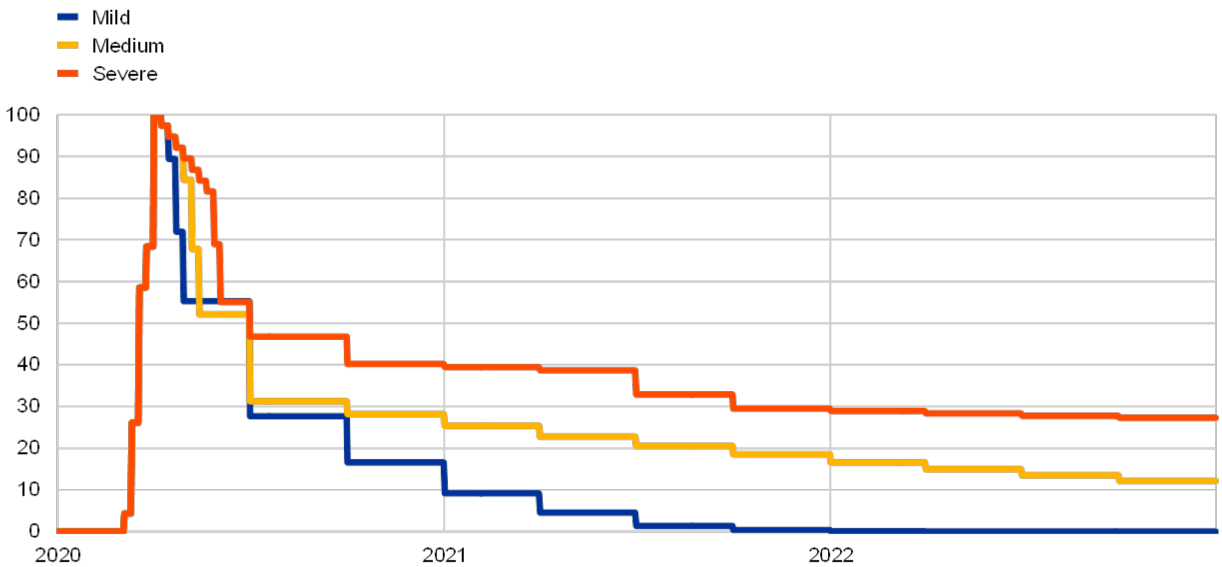
Source: Federal Reserve System

A deeper look at Euro Area: ECB Bulleting (14 May 2020)

Niccolò Battistini and Grigor Stoevsky look in their article on alternative scenarios for the impact of the COVID-19 pandemic on economic activity in the euro area:

The different assumptions underlying the three illustrative alternative scenarios imply a range spanning from mild to severe expected economic impact. In the first (mild) scenario, strict lockdown and further containment measures, as well as rapid advances in medical treatments, entail relatively short-lived strict lockdown periods (ending in the course of May 2020), a gradual return to normal activity thereafter and only temporary economic losses. In the second (medium) scenario, a short-lived strict lockdown period (also ending in the course of May 2020) is followed by relatively stringent and protracted containment measures, implying a delayed return to normal activity, as well as persistent output losses. In the third (severe) scenario, a longer-term strict lockdown period (ending in the course of June 2020) has only limited success in containing the spread of the virus, thus requiring ongoing tough containment measures to remain in place even after some loosening of the very strict lockdowns. The sustained efforts to prevent the spread of the virus would continue to significantly dampen activity across sectors of the economy until a vaccine (or another effective medical solution) were to become available. This is not expected to occur until around mid-2021. Therefore, this scenario envisages significant and permanent output losses.

Chart: Time profile of indicative losses in gross value added implied by containment measures in the euro area under the mild, medium and severe scenarios (percentage of maximum euro area sectoral loss)



Source: ECB calculations.
Note: Losses are measured relative to the maximum sectoral losses for the euro area, computed as a weighted average of the losses for the largest five euro area countries.

According to the authors, strict containment measures are expected to severely affect economic activity in the euro area well beyond the short-term horizon. While containment measures – coupled with the longer-lasting costs inflicted on activity stemming from the pandemic – are expected to exhaust their negative impact by end-2021 under the mild scenario, they would continue to weigh on economic activity in 2022 under the medium and severe scenarios.

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

G. Corsetti, A. Erce, A. Garcia Pascual - *Perpetual bonds are not the best way to finance the European Recovery Fund* (14 May 2020):

A number of prominent voices have put forward the idea of funding a large investment package (€1.5-2 trillion) to support the EU recovery from Covid-19 by issuing EU perpetual bonds (consols). Such a joint recovery plan is seen as vital for the stability of the EU. We share the objectives motivating these proposals: lending long-maturity to states will be crucial to create space for effective recovery policies. However, we want to call attention to one fact. By borrowing through consols, the EU would stand in sharp contrast with the recent practice of countries like the US or Germany that, when facing unexpectedly large financing needs, have relied heavily on the shorter part of the curve. The EU is best placed to take advantage of its status as a borrower with strong market access. The cheapest way to finance the European Recovery Fund would be to issue joint EU debt at shorter maturities, then pass those low interest rates onto member states through loans at low margins over funding costs and with very long maturities. Supporting member states through low rates and maturity transformation would further reinforce debt sustainability across all member states (Erce et al. 2020). It is important to think of EU debt issuance and the provision of EU financing to member states as two separate policy instruments. As we are facing large and complex shocks challenging our capacity to stabilize the economy, we cannot afford the luxury of overlooking stabilization tools that can help us designing efficient and equitable solutions to the current European problems.

B. Badré, M. Lemoine - ***Europe's COVID Crossroads*** (18 May 2020):

Beyond the immediate threat to public health, the coronavirus has also pushed most European economies onto a slower growth track, all but ensuring a more difficult recovery over the long term. To prevent the worst, EU policymakers must address the looming shortfall in public and private investment. Beyond quantity, the quality of investment will determine Europe's long-term economic prospects. To succeed, any recovery plan must transform billions into trillions. It needs to direct investment toward real social needs, while minimizing windfall effects that reinforce existing inequalities. The goal is to build a new future, not merely to restore the past. That will require tough decisions. Success will depend, above all, on avoiding doubt and maintaining trust between and within countries. The structures put in place during and after the crisis must not raise suspicions or seem obviously unfair. They should come with mechanisms for independent review and oversight, lest we once again set the stage for another crisis ten years from now. In confronting a virus that threatens everyone, European leaders must remember that their duty is to the many, not the few.

T. Assenza, et al. - ***The hammer and the dance: Health and economic objectives are not mutually exclusive after all!*** (15 May 2020):

How should governments balance controlling the COVID-19 pandemic with limiting its economic costs? This column argues that health policy and economic policy objectives in pandemic control are not that far apart, and that the epidemiological strategies adopted by many countries – aptly described as a 'hammer and dance' – are also based on sound economic principles. By paying close attention to behavioural responses and externalities, the authors offer concrete prescriptions for lockdown and recovery policies. Policy must be able to control new infections at all times. The hammer: early, decisive action is warranted if it helps to save lives in the long run. If it merely delays infections in the short run, it just lengthens the recovery and inflicts higher economic costs.The dance: optimal deconfinement eases economic restrictions as much as possible while keeping the pandemic's transmission rate below 1. Policy must control the epidemic, not the other way around. Beware of dynamic infection spillovers: be patient during deconfinement and do not pay for faster recovery with higher mortality. Do not count on private agents to fully understand the risks they pose to others. The value of herd immunity really depends on whether there exist better long-term alternatives (a cure or a vaccine), and at what horizon.

M. Greene - ***Get ready for a two-speed recovery*** (15 May 2020):

With so many unanswered questions about the epidemic, the only certainty is that its economic impact has already been devastating.Then there's the fact that not all countries are equally equipped to bounce back. And worryingly, giving the pre-existing imbalances in the eurozone, those slower to recover are likely to be in southern Europe. The structure of a country's economy is another factor that will impact how fast it can recover. To begin with, countries with a large proportion of small- and medium-sized enterprises (SMEs), are likely to be less resilient as these businesses usually have less collateral to offer banks for loans. The lack of a common European response to the crisis means that the epidemic and its aftermath is likely to widen the eurozone's divides. So far, stimulus efforts have mainly been left to national governments, with the European Central Bank buying up assets to ensure borrowing costs stay low. The trouble is that it's not clear how long the ECB can keep this up — especially now that it is facing pressure from the German Constitutional Court over its intervention during the euro crisis. The eurozone will not be alone in facing collapsing economic activity and mounting debt, but it is unique in having a common currency shared among very different economies. As the pandemic exacerbates the pre-existing north-south divide in the eurozone, there is a significant risk that the currency union will tumble into another sovereign debt crisis. Once again, European leaders might find themselves having to choose between debt mutualization and richer countries assuming risk for the less resilient ones or another round of bailouts and painful austerity for the south.

M. Demertzis - ***Save markets to save the single market*** (15 May 2020):

It's time for the EU to make quick and indispensable progress in forming a capital markets union. And it can do it, as it did with Banking Union during the previous financial crisis. This could take the shape of a "28th regime": a separate legal jurisdiction, created from scratch and separate from any national jurisdiction. By design, it should encourage more private capital involvement, domestically but also across member states. Markets are the only ones capable of sifting through the risks the EU currently faces and identify who is the fittest to survive. The best the EU can do is provide the legal certainty necessary for this to happen.

R. Gürkaynak, D. Lucas - ***Funding pandemic relief: Monetise now*** (14 May 2020):

The current macroeconomic policy scene in advanced economies is dominated by three interrelated challenges: rapidly meeting the unprecedented spending needs to respond to the COVID-19 crisis, while holding government debt to a sustainable level and avoiding deflation. Most advanced economies have resorted to leaning on central banks one way or another to accommodate their emergency spending needs, leading to a fear of monetization (Blanchard and Pisani-Ferry 2020). We argue that what has been done so far is not monetisation, but that to address the current emergency some strictly controlled monetisation is in fact desirable. In general, monetisation occurs when a government funds its expenditures by issuing intrinsically worthless claims that the public is compelled to accept, effectively printing paper money. In our proposal, the special issue zero coupon perpetuities issued by Treasury and purchased by the Federal Reserve are doing exactly that. By contrast, issuing government debt in the open market creates an obligation for future repayments of value equal to that of the money raised; it is clearly not monetisation. Hence, current central bank debt purchases, similar to those made in the aftermath of the global financial crisis, are not monetising debt. That fact helps explain the low levels of inflation that have accompanied the enormous expansion of central bank balance sheets. Only with an increase in reserves, unaccompanied by a corresponding increase in the value of future claims on government revenues, can a government obtain fiscal resources without adding to its liabilities. This is monetisation, and this is what we are proposing should be done in a limited way during these extraordinary times.

M. Bordignon, G. Tabellini - ***The EU response to the coronavirus crisis: How to get more bang for the buck*** (13 May 2020):

In designing the EU responses to the coronavirus crisis, the European Commission and European policymakers should be guided by the subsidiarity principle. Action should be taken at the EU level "if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States … but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level". The problem of how to enable the Recovery Fund to borrow at long maturities could be reduced if the funding of the EU budget was based on genuinely own EU tax revenue, as proposed by the Spinelli Group (2020). A similar proposal has been made by Garicano (2020). Currently, the EU's own resources largely consist of transfers from member states. Replacing these transfers with revenue from own EU tax bases would reduce the uncertainty surrounding the seven-year cycle of bargaining on the EU budget. In normal circumstances, these EU taxes would be used to finance the EU budget; but in exceptional cases, such as the present crisis, they could be used to back the issue of long-term EU debt. A step in this direction would also be a step towards remedying the incompleteness of the euro area. It is well understood that a key fragility of the common monetary policy is that it lacks a solid common fiscal capacity. The recent decision by the German Constitutional Court, although questionable under many respects (e.g. Poiares Maduro 2020), makes it clear that member states cannot keep delegating all macroeconomic policy management to the ECB.

J. Anderson, S. Tagliapietra, G. B. Wolff - ***Rebooting Europe: A Framework For A Post Covid-19 Economic Recovery*** (13 May 2020):

To slow the spread of COVID-19, European governments have adopted stringent containment measures. These have led to a severe recession and policymakers in European Union countries are providing generous support to help companies cope with the immediate consequences. The basic approach has been to provide generous and indiscriminate emergency support to help cash-strapped firms meet their immediate liquidity needs. But as lockdown measures continue and the recession gets deeper, a more comprehensive strategy for the future needs to be designed. In the fiscal economic policy response to the pandemic, three phases can be broadly distinguished. Phase 1 measures are meant to temporarily freeze economies as they were before the crisis, to shield healthy businesses from bankruptcy and to protect European firms from hostile takeovers by foreign state-backed enterprises. Phase 2 will be about solvency support. Phase 3 will then be about recovering from the severe contraction phase that the likely on-and-off switching of lockdown measures will leave in its wake. Moving from phase 1 onto the next phases is not simply a matter of providing equity instead of debt. While phase 1 injections have been emergency measures, phase 2 requires a long-term plan. It also requires recognition of difficult trade-offs ahead: speedy economic recovery versus environmental goals; health of the private sector versus public indebtedness; solvency versus social cohesion. In phase 3, the EU must play a major role – through the MFF and the recovery initiative/fund – alongside national recovery programmes. As phases 2 and 3 are intrinsically linked, measures should be based on the same objectives.

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- The economy and coronavirus - Weekly Picks - 15/04/2020
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