BRIEFING

The economy and coronavirus: Weekly Picks

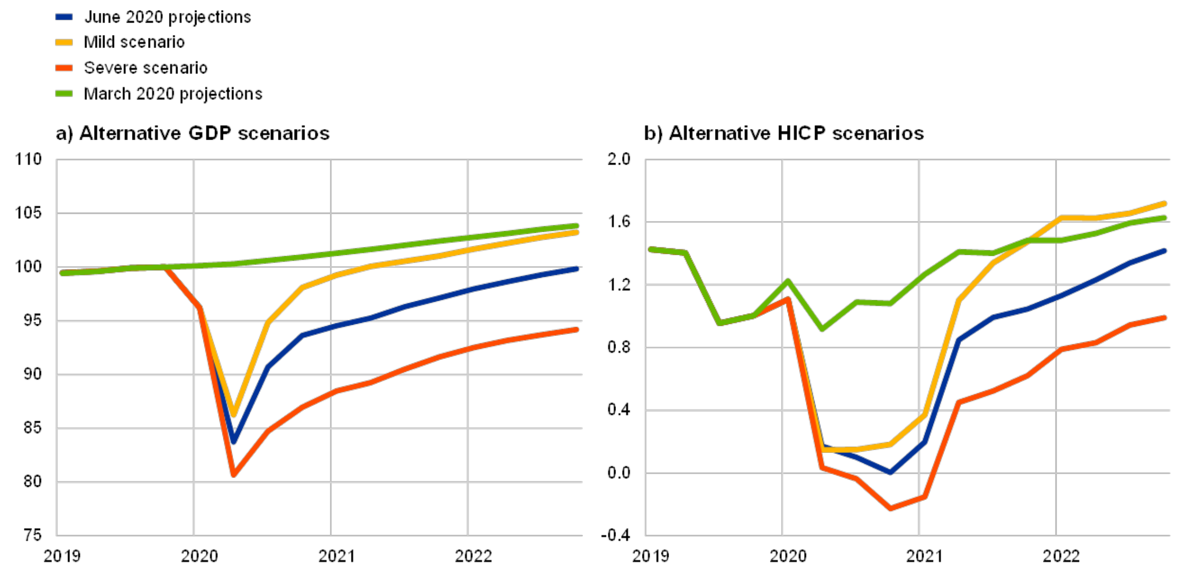
This paper provides a summary of some recent estimates and analyses of the economic and financial effects of the coronavirus, an overview of the grants component included it the Commission's proposal for a new EU recovery and resilience facility, and some policy recommendations made in the public domain to mitigate the negative economic effects of the pandemic.

ECB latest macroeconomic projections (4 June 2020)

Under the ECB **baseline scenario**, real GDP in the euro area is projected to fall by 8.7% in 2020 and to rebound by 5.2% in 2021 and by 3.3% in 2022. This implies that by the end of the projection horizon, the level of real GDP would be around 4% below its level expected in the March 2020 staff projections. Overall, the baseline foresees HICP inflation declining from 1.2% in 2019 to 0.3% in 2020 and rising to 0.8% and 1.3% in 2021 and 2022, respectively.

The ECB baseline scenario rests upon a set of key assumptions about the future evolution of the pandemic as well as the necessary containment measures and the behaviour of households and enterprises. Namely, the baseline assumes only partial success in containing the virus, with some resurgence in infections over the coming quarters, necessitating persistent containment measures until a medical solution becomes available, which is assumed to happen by mid-2021.

The **mild scenario** sees the shock as temporary, with a fast and successful containment of the virus allowing restrictions to be removed swiftly. In this scenario, real GDP would decline by 5.9% this year, followed by a strong rebound in 2021. By the end of the horizon, real GDP would almost reach the level of the March 2020 staff projections. Inflation in this scenario would reach 1.7% by 2022. In contrast, a **severe scenario**, with a strong resurgence of infections, implies more stringent containment measures that significantly weigh on economic activity. In this scenario, real GDP falls by 12.6% in 2020 and, by the end of the projection horizon, stands around 9½ % below its level in the March 2020 staff projections, with the inflation rate at only 0.9% in 2022.



Source: ECB, 4 June.

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Eurostat inflation estimate for May 2020

In May 2020, a month still marked with COVID-19 containment measures, euro area annual inflation is expected to be 0.1%, down from 0.3% in April according to a flash estimate from Eurostat, the statistical office of the European Union.

Looking at the main components of euro area inflation, food, alcohol & tobacco is expected to have the highest annual rate in May (3.3%, compared with 3.6% in April), followed by services (1.3%, compared with 1.2% in April), non-energy industrial goods (0.2%, compared with 0.3% in April) and energy (-12.0%, compared with -9.7% in April).

Some take-always from the Commission staff paper: Identifying Europe's recovery needs (27 May 2020)

The Commission quantifies the economic impact of the crisis across Member States (MS), varying significantly because of MS's different economic structures and capacities to absorb and respond to the resulting economic shock through financial buffers in the public and private sector. As a result, GDP losses in 2020 are expected to be particularly large in Greece, Spain, Italy and Croatia, at around 9½% each, compared to recessions of between 6% and 7½% in most other MS. Furthermore, the economic impact of the crisis also differs substantially across regions within EU MS. The sharp drop in real GDP will cause large employment losses in countries suffering most under CoVid-19 and its economic fallout.

Overall, the primary government balance (i.e. the difference between current revenues and expenditures) is projected to worsen in 2020 by around 7½ percentage points of GDP on average. The crisis risks harming the least resilient MS most.

The crisis has opened up new investment gaps, estimated to amount to at least €1.5trn in 2020 and 2021, the majority of which falling onto the private sector. That estimate includes needs to deliver on the green transition and digital transformation. An increase in public investment of about €100bn per year would be needed to stop the trend decline in the public capital stock as a share of GDP. The needs related to investment gaps and strained EU health and social systems will partly fall on the public sector.

Additional government financing needs due to the impact of the CoVid-19 crisis are estimated at almost €1.7trn for EU Member States over 2020 and 2021. This estimate captures the impact of higher spending and lower tax revenues compared to a pre-crisis baseline scenario; that pre-crisis baseline scenario already foresaw gross financing needs of €3.7trn. Adding the additional financing needs resulting from the crisis brings total financing needs to close to €5.4trn. This estimate includes also financing needs to cover governments' current and public investment spending in 2020 and 2021, as forecast in the Spring Forecast. It also includes funding needed to roll over maturing sovereign debt.

The Commission argues that the revised Multiannual Financial Framework (MFF) for 2021-2027 is reinforced through a Recovery Instrument that can fill financing gaps which could add €750bn, equivalent to around 5¼% of annual EU GDP, to the EU's capacity to finance the recovery. On the basis of an econometric model (QUEST), the Commission estimates that the Recovery Instrument will have a permanent positive effect on EU27 real GDP, raising real EU GDP levels by around 1¾% in 2021 and 2022, and 2¼% by 2024, claiming prudent assumptions regarding the additionality of loan-based public and private investment. Up to two million additional jobs are estimated to be created through the operation over the medium term.

The Commission also assesses the equity repair needs of companies in 2020 and 2021 using (or better: mixing) balance sheet, income and cash flow data, incorporating the implicit solvency support provided by governments through short term work schemes. The results of that analysis suggest that in case the baseline economic scenario from the Spring Forecast materialises, companies' total losses could by the end of the year exceed €720bn, an amount that would increase to above €1.2trn in the stress scenario.

The Commission's analysis is, however, based on an "unorthodox" assumption (footnote 8, p. 10): "*The "liquidity buffer" simulations assume that all firms can deplete their cash reserves to (at least partially) cover the losses.*" Technically speaking, that assumption mixes two different things, i.e. buffers against liability obligations (liquidity) and buffers against losses (capital), meant to address two different problems on different sides of companies' balance sheets.

A snap-shot of the allocation of grants in the EU recovery and resilience instrument

On 27 May, the European Commission proposed a Recovery Plan for Europe along three axis: (a) supporting recovery from the current COVID-19 crisis; (b) kick-starting the economy and helping private investment; and (c) learning the lessons from the crisis. As part of the first axis, the Commission put forward a proposal for a new EU instrument to support EU Member States in their recovery measures, the Recovery and Resilience Facility (RRF)[1]. The RRF would aim at enhancing cohesion in the EU by providing financial assistance to Member States to address the economic and social challenges of the COVID-19 crisis in areas such as social, employment, skills, education, research and innovation, health, business environment, public administration and the financial sector. At the same time, the challenges and investment needs related to the green and digital transitions would be addressed. Such EU financial assistance would be financed through issuance of EU debt on capital markets[2], backed by a temporary increase in the so-called EU own resources ceiling[3]. The outstanding debt would be reimbursed in the future (not before 2028) by one or more of the following ways: cuts in EU expenditure, higher national contributions and revenues streams for new own resouces. The Commission proposes, in its Communication "Europe's moment: Repair and Prepare for the Next Generation" to put forward concrete proposals for additional sources of own resorces.

The RRF would be allowed to provide grants and loans to Member States. According to the Commission proposal, this facility would provide support:

- at request from a Member State, which has to present a recovery and resilience plan. Such plan must be consistent with the relevant country specific challenges and priorities identified in the context of the European Semester, in particular those relevant for or resulting from the green and digital transition[4];

- in the form of non-repayable support (grants) of a total amount of EUR 335 billion and in the form of loans up to an amount of EUR 268 billion (current prices);

- the disbursement of the financial contribution will follow the completion of the milestones and targets agreed with the Member State concerned; instances of significant non-compliance may lead to the suspension of payments;

- Member States can request grants until 31 December 2022[5] and loans until 31 December 2024; and

- the maximum amounts of grants per Member States over the whole period is capped by a predefined limit calculated on the basis of the size of the population; the inverse of GDP per capita; and the average unemployment rate over the past 5 years (compared to the EU average from 2015 to 2019)[6];

- in loans, a Member State can only obtain up to 4.7% of its Gross National Income;

The table below shows the maximum amount of grants for each Member State, proposed by the Commission. Furthermore, it presents the maximum amount that grants would represent in terms of annual

[1] Legal base 175(3) of the TFEU and to be adopted by the European Parliament and the Council under ordinary legislative procedure
[2] As set out in the Commission proposal for a Council Regulation establishing a European Union Recovery Instrument (EURI), also put forward on 27 May, under Article 122 of the TFEU: requiring an unanimous decision by EU Member States to be adopted.
[3] As set out in the Commission proposal for an amendment to the Coucil Decision on the system of EU Own Resources, under Article 311 of TFEU: requiring an unanimous decision by EU Member States and ratification of all EU national parliaments to be adopted. The Commission proposal is an amendment to the proposal made by the Commission 2 May 2018, which included also proposals for new EU own resources.
[4] The recovery and resilience plans shall also be consistent with the information included by the Member States in the national reform programmes under the European Semester, in their national energy and climate plans and updates thereof under the Regulation (EU)2018/1999 21, in the territorial just transition plans under the Just Transition Fund, and in the partnership agreements and operational programmes under the Union funds.
[5] For a period starting after 31 December 2022 until 31 December 2024, where financial resources are available, the Commission may organise calls in line with the calendar of the European Semester.
[6] Annex 1 to the Regulation provides a formula for calculating the relevant amounts.

GDP, accounting for two scenario: a quick absorption (during the first two years) and a slow one (over the five years of the facility). The stimulus effect varies between the two scenarios and among the Member State.

Table 1: Estimation of the stimulus effect of the grant component of RRF

Member State	Share as % of total*	Amount (Billions, 2018 prices)	Share of GDP ** (%)	Scenario 1: absorption: over 2 years (2021-2022)*** (% GDP)	Scenario 2: absorption over 5 years (2021-2025)*** (% GDP)	GDP 2019 (Billions, 2018 prices)
BE	1.55	4.82	1.04	0.52	0.21	465.55
BG	1.98	6.13	10.57	5.29	2.11	57.98
CZ	1.51	4.68	2.20	1.10	0.44	212.71
DK	0.56	1.72	0.56	0.28	0.11	307.94
DE	6.95	21.55	0.64	0.32	0.13	3362.70
EE	0.32	1.00	3.70	1.85	0.74	27.16
IE	0.39	1.21	0.35	0.18	0.07	342.02
EL	5.77	17.87	9.50	4.75	1.90	188.17
ES	19.88	61.62	5.03	2.51	1.01	1225.99
FR	10.38	32.17	1.35	0.67	0.27	2384.04
HR	1.98	6.13	11.87	5.93	2.37	51.60
IT	20.45	63.38	3.58	1.79	0.72	1771.49
CY	0.35	1.08	4.96	2.48	0.99	21.82
LV	0.7	2.17	7.31	3.65	1.46	29.69
LT	0.89	2.77	5.87	2.93	1.17	47.13
LU	0.03	0.10	0.16	0.08	0.03	61.43
HU	1.98	6.14	4.46	2.23	0.89	137.61
MT	0.07	0.23	1.74	0.87	0.35	12.98
NL	1.68	5.20	0.66	0.33	0.13	788.05
AT	0.95	2.95	0.75	0.38	0.15	391.98
PL	8.65	26.81	5.22	2.61	1.04	513.87
PT	4.16	12.91	6.18	3.09	1.24	208.71
RO	4.36	13.51	6.47	3.23	1.29	208.89
SI	0.55	1.69	3.61	1.81	0.72	46.87
SK	1.98	6.14	6.69	3.35	1.34	91.76
FI	0.71	2.20	0.93	0.47	0.19	235.91
SE	1.24	3.85	0.83	0.42	0.17	461.59
Total	100	310	2.27	1.13	0.45	13656.75

* Figures taken from the COM proposal for a RRF (Annex 1)
** Compared to GDP 2019 at prices 2018 (Eurostat and EGOV's computations)
*** Assuming an equal distribution over the year

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

N. Roubini, B. Rosa - Europe's Non-Hamiltonian Muddle (01 June 2020):

Although any joint EU action should be welcomed, the current COVID-19 response plan hardly amounts to a radical break with business as usual. Far from a long-awaited embrace of debt mutualization, the newly proposed European recovery fund risks being both politically unpalatable and economically inadequate. Overall, although any common European approach to the COVID-19 crisis is a step in the right direction (and certainly better than no action), there is little reason to expect the EU to break from its long tradition of merely muddling through. If European leaders can prevent an immediate breakdown of the EU and euro projects, they at least will have averted the enormous economic, social, and political costs that would come from further rapid disintegration. But a net response that reflects the old inertia will leave Europe unequipped for the post-COVID world, where other major continental economies – the United States, China, and India – will make the most important geo-strategic and economic decisions.

J. Portes - [The lasting scars of the Covid-19 crisis: Channels and impacts] (01 June 2020):

Both economists and policymakers have highlighted the danger that the short-term measures taken to limit the spread of Covid-19 could lead to lasting economic damage. This column identifies and discusses five conceptually separate channels that could lead to such 'scarring' and attempts a very rough quantification of the potential impacts in both the short to medium term and longer term. Policy will eventually need to 'pivot' from helping firms survive and preserving jobs to helping workers into new jobs. Economists' concern about scarring is entirely justified. The magnitude of these potential impacts is huge – and dwarfs the short-term costs of the restrictions. "Doing whatever it takes" is an excellent starting point, but we will need to do it across multiple policy dimensions. In the short to medium term, the negative impacts of job separations and business failures dominate, so action – like furlough schemes – to keep firms in business and keep workers employed in their current jobs is justified. But over the longer term, the main channels are individual-specific human capital.

A. Ari, S. Chen, L. Ratnovski - [COVID-19 and non-performing loans: Lessons from past crises] (30 May 2020):

Non-performing loans are a crucial policy consideration, especially in times of wider economic crisis. This article uses a new database covering 88 banking crises since 1990 to draw lessons for post-COVID-19 resolution of non-performing loans. Compared to the 2008 crisis, the pandemic poses some different challenges. Despite some respite from the credit-crash of 2008, policymakers today are faced with substantially higher public debt, less profitable banks, and often weaker corporate sector conditions, making resolution of non-performing loans even more challenging. Given the importance of NPL reduction for economic recovery, and many countries' historical difficulties in implementing effective NPL-related interventions, designing effective NPL resolution policies for the post-COVID-19 world is a key forward-looking financial policy issue for Europe today

Z. Darvas - [An uncompromising budget] (29 May 2020):

Apart from decisive European Central Bank measures, the EU-wide response to the COVID crisis had been rather weak until the Commission put on the table a drastically new proposal: the creation of a new recovery facility, 'Next Generation EU', that would borrow money in the name of the EU to finance EU-wide expenditures. This new facility is, like the Franco-German proposal, a bold, macroeconomically relevant, positive step forward. However, considering the severity of the current crisis, on its own it remains below the levels needed for a stimulus to be efficient. The changes to the proposed standard seven-year budget that primarily focuses on long-term structural issues are however generally small, and funding reductions are compensated by new funds from the recovery instrument, suggesting that an opportunity is missed to reform the EU budget. In the author's view, the largest net contributors might judge that a big share of the EU budget is redistributed to countries for spending that do not constitute European public goods, or that there are risks for their proper use. In this case their attempt to reduce net contributions is understandable.

H. Davies - [Regulating in a Pandemic] (27 May 2020):

Many regulatory changes have been introduced around the world in the last two months, understandably in haste, as national policymakers responded to the COVID-19 crisis with measures to keep credit flowing to affected economic sectors. Sadly, unlike after the 2007-09 global financial crisis, signs of international cooperation are few .The changes to capital requirements have mainly affected the buffers imposed on banks since the last crisis under the general heading of macroprudential regulation. Many bankers had come to think that macroprudential supplements would only work in one direction: buffers imposed in credit upturns would be retained in the downturn. Faced with a sharp decline, economic regulators have shown welcome flexibility. These changes are typically described as temporary. So, banks that may avail themselves of the current flexibility are keen to know when the buffers might be re-imposed and how long they would then be given to meet them. The Basel Committee will have a lot to discuss when it is next allowed to assemble. The priority should be to assess the changes that members have made during the crisis and to address those that have skewed the playing field. That will be a delicate exercise, but it is essential if the global financial architecture painfully rebuilt after the last crisis is to be sustained.

J. Anderson, S. Tagliapietra, G. B. Wolff - [An equity fund for a zombie-free and EU-wide recovery] (26 May 2020):

As Europe recovers from the peaks of the Coronavirus pandemic, policymakers who shut down heaven and earth to contain the virus must now move mountains to save the economy. Governments initially rushed to keep firms afloat, mostly by providing loans. But, with spiraling debts abound, government loans may not be enough to keep companies solvent and equity (part-ownership) is now on the table. For one thing, equity can be more distortionary than other types of aid–the value being hard to assess, especially in uncertain times. At the extreme, we could emerge from the crisis with a wrecked single market, with only the most-subsidised companies left standing–a nightmarish world in which inefficient zombie firms feed on beleaguered taxpayers. Here are four principles to consider how and under what conditions support should be given. First, only financially viable firms should receive solvency support, with viability assessed considering both the past and the future. Second, state support should not undermine competition between firms in the EU's single market. Third, state interventions should support broader societal goals, from climate neutrality to social cohesion. Fourth, taxpayers should receive their share in the rewards of the recovery. Interventions must be framed as worthy public investments, not expensive bailouts.

R. Moghadam - Putting the Pep in PEPP (26 May 2020):

The European Central Bank's €750 billion ($818 billion) Pandemic Emergency Purchase Program (PEPP) was hailed at its inception in March as the "big bazooka," bringing welcome relief to bond markets in so-called peripheral eurozone countries such as Italy, Spain, Portugal, and Greece. But the ECB must strengthen the program to make it truly effective. PEPP's ability to target asset purchases, and without imposing policy conditions on the beneficiaries, makes it a more potent weapon than the outright monetary transactions scheme introduced by then-ECB President Mario Draghi at the height of the 2012 euro crisis. But, by itself, PEPP does not allay the debt-sustainability concerns created by COVID-19, because of two program restrictions. PEPP is not a monetary measure, but rather aims to overcome an obstacle to the transmission of monetary policy to all eurozone member states – namely, the high spreads induced by the pandemic's varying effect on their public-debt levels. If COVID-19's impact on eurozone bond markets is asymmetric and long-lasting, then the response must be as well. Any wider and unintended monetary effects from PEPP can be sterilized, or undone, through higher interest rates or sales of non-periphery bonds.

C. Midões - Millions of Europeans could not endure a two-month income shock without generous, targeted, government policies (25 May 2020):

The COVID-19 lockdown and ensuing crisis have forced many individuals to stop working or to substantially reduce their working hours. This column examines how many Europeans can afford basic necessities for two months without a privately earned income. The findings indicate that nearly 100 million people in 21 EU countries do not have enough savings for two months of food, utilities, and rent or mortgage. Those born outside of the EU are especially vulnerable. Targeted government support is essential; rent and mortgage suspension can be effective tools. Employment protection schemes around the EU are essential since even in a two-month horizon, savings and pre-existing public transfers do not provide enough cover for 57.5 million individuals. By taking home 50% of gross privately earned income, 11.3 million individuals would still not be able to cover two months of food and utilities and housing expenses. Schemes must provide the minimum to keep households afloat. Ensuring the quick channelling of support to families is fundamental since financial difficulties are apparent already in the first month.

L. Demmou, G. Franco, S. Calligaris, D. Dlugosch - Corporate sector vulnerabilities during the COVID-19 outbreak: Assessment and policy responses (23 May 2020):

There is widespread concern that the COVID-19 induced liquidity shortages may cause firm bankruptcies on a large scale. This column examines the financial vulnerability of firms associated with confinement measures, and discusses the immediate steps that governments can take to reduce the risks of such crisis. Without policy actions, around 30% of European firms would face liquidity shortages after two months of confinement measures. A decisive public intervention, and especially the support to wage payments, is found to be crucial in order to avoid the temporary shock implied by the COVID-19 crisis permanently scarring the corporate landscape. This column shows that the standstill in activity implied by confinement generates a high risk of large amounts of liquidity shortfalls and potentially of defaults of otherwise viable firms. Among the wide and complementary range of measures introduced by different countries, support to wage payments seems to be the most critical policy to curb the liquidity crisis.

S. Cecchetti, K. Schoenholtz - The euro area in the age of COVID-19 (22 May 2020):

While it has risen over the two decades of monetary union, risk sharing among the member states of the euro area remains well below that in the US. The progress reflects the hopes of the Kohl- Mitterand generation, but the gaps still make Europe's monetary union vulnerable. Recent research highlights the changing gap between the two monetary unions in the extent of risk sharing. Over the period 1999-2016, 60% to 80% of a US state-specific shock was 'smoothed' by efforts to insure consumption across state lines. In contrast, in the period 2001-2017, risk sharing in the euro area started at about 33%, and rose following the euro area crisis of 2010-2012 to about 56%. If most cross-border risk sharing in a monetary union occurs through private means, then the resilience of the financial system is critical for sustainability. This brings us to the financial trilemma: financial integration in a monetary union—where credit and capital flow freely across borders—depends on cross-border regulatory coordination. Otherwise, country-specific shocks can cause runs as investors come to doubt that a unit of currency will have the same value in every jurisdiction.

Ultimately, sustained popular support for the euro (still widely evident in 2019 surveys, see European Commission 2019) probably depends in part on the perception of 'solidarity'—the willingness to share risks—when a common, euro area-wide shock like COVID hits. So, while such solidarity has always been grudging, it seems reasonable in this crisis to expect another upward ratchet in euro area risk sharing.

For an overview of some previous EGOV Regular Picks:

- The economy and coronavirus - Weekly Picks - 19/05/2020
- The economy and coronavirus - Weekly Picks - 12/05/2020
- The economy and coronavirus - Weekly Picks - 04/05/2020
- The economy and coronavirus - Weekly Picks - 27/04/2020
- The economy and coronavirus - Weekly Picks - 15/04/2020
- The economy and coronavirus - Weekly Picks - 06/04/2020
- The economy and coronavirus - Weekly Picks - 30/03/2020

- Banking Union: Corona crisis effects - Calendar week 22- June 2020
- Banking Union: Corona crisis effects - Calendar week 20 - May 2020
- Banking Union: Corona crisis effects - Calendar week 17 - April 2020
- Banking Union: Corona crisis effects - Calendar week 15 - April 2020

An overview of the latest EU/EA level measures to mitigate the economic effects of the pandemic

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