BRIEFING

The economy and coronavirus: Weekly Picks

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

Latest economic estimates for the Euro Area

On 24 June, the IMF published a partial update to its April 2020 Word Economic Outlook (WEO). Data releases since April suggest even deeper downturns than previously projected for several economies. As a result, global growth projections have been revised down to –4.9% in 2020 (–10.2% for the euro area), 1.9 percentage points below (2.7 percentage points below for the euro area) the April 2020 WEO forecast.

Table: Estimates for real GDP growth for some EU Member States

			June 2020 Projections		Difference from April 2020 WEO Projections	
	2018	2019	2020	2021	2020	2021
France	1.8	1.5	−12.5	7.3	−5.3	2.8
Germany	1.5	0.6	−7.8	5.4	−0.8	0.2
Italy	0.8	0.3	−12.8	6.3	−3.7	1.5
Netherlands	2.6	1.8	−7.7	5.0	−0.2	2.0
Poland	5.3	4.1	−4.6	4.2	0.0	0.0
Spain	2.4	2.0	−12.8	6.3	−4.8	2.0

Source: IMF World Economic Outlook, June 2020 Update

Assumptions used by IMF for its baseline scenario:

Based on downside surprises in the first quarter and the weakness of high-frequency indicators in the second quarter, this updated forecast factors in a larger hit to activity in the first half of 2020 and a slower recovery path in the second half than envisaged in the April 2020 WEO. For economies where infections are declining, the slower recovery path in the updated forecast reflects three key assumptions: persistent social distancing into the second half of 2020, greater scarring from the larger-than-anticipated hit to activity during the lockdown in the first and second quarters, and a negative impact on productivity as surviving businesses enhance workplace safety and hygiene standards. For economies still struggling to control infection rates, the need to continue lockdowns and social distancing will take an additional toll on activity. An important assumption is that countries where infections have declined will not reinstate stringent lockdowns of the kind seen in the first half of the year, instead relying on alternative methods if needed to contain transmission (for instance, ramped-up testing, contact tracing, and isolation).

The updated IMF forecast presents also some estimates for two alternative scenarios: (1) a second COVID-19 outbreak in early 2021, and (2) a faster recovery from the lockdown measures implemented in the first half of 2020.

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When comparing the recent economic estimates for the Euro Area as whole, one may note that OECD and IMF are expecting a slightly deeper recession in 2020 in comparison to the Commission and the ECB (see Table below).

Table: A comparison of recent forecasts for selected Euro Area indicators

	COM May 2020 (November 2019)			IMF June 2020 (October 2019)			ECB June 2020 (December 2019)			OECD June 2020 (November 2019)		
	2019	**2020**	**2021**	**2019**	**2020**	**2021**	**2019**	**2020**	**2021**	**2019**	**2020**	**2021**
GDP Growth (%)												
Euro area	1.2	-7.7	6.3	1.3	-10.2	6.0	1.2	-8.7	5.2	1.3	-11.5	3.5
	(1.1)	(1.2)	(1.2)	(1.2)	(1.4)	(1.4)	(1.2)	(1.1)	(1.4)	(1.2)	(1.1)	(1.2)
General Government Budget Balance (% of GDP)												
Euro area	-0.6	-8.5	-3.5	-0.6	-11.7	-5.3	-0.6	-8.5	-4.9	-0.7	-10.9	-8.3
	(-0.8)	(-0.9)	(-1.0)	(0.9)	(-0.9)	(0.9)	(-0.7)	(-0.9)	(-1.1)	(-0.8)	(-0.9)	(-1.0)
General Government Gross Debt (% of GDP)												
Euro area	86.0	102.7	98.8	84.1	105.1	103.0	84.1	101.3	100.6	86.0	109.9	112.5
	(86.4)	(85.1)	(84.1)	(83.9)	(82.3)	(80.8)	(84.5)	(83.4)	(82.3)	(86.7)	(86.0)	(85.3)

Sources: European Commission (COM)'s Economic Forecast Autumn 2019 and Spring 2020; IMF World Economic Outlook, June 2020 update and October 2019; ECB Staff Macroeconomic projections June 2020 and December 2019; and OECD Economic Outlook, June 2020 and November 2019. Note: Forecasts by the four institutions have different "cut-off" dates and are made under different sets of assumptions about policies and underlying economic and financial assumptions and conditions.

Fiscal measures undertaken by EU Member States by May 2020

On 26 June 2020, the network of EU independent fiscal institutions released a Special Update Edition of the European Fiscal Monitor providing an overview of fiscal measures taken in response to Covid-19 in 25 EU member states and the UK, as of end of May 2020. It is based on a survey of Network's Members on fiscal measures adopted in response to Covid-19. The network concludes, *inter alia*, the following:

According to recent macroeconomic forecasts, fiscal councils estimate the budget deficit in 2020 to be on average 8% of GDP across EU member states. The Gross Public Debt is expected to rise by an average 14%-15% of GDP in 2020.

As of 31 May 2020, 19 out of the 25 member states have triggered national escape clauses to suspend national budgetary restrictions. Although in most countries escape clauses were triggered only for the fiscal year of 2020, some member states have suspended their fiscal rules for more than one year.

Fiscal councils estimate a reduction of 9% in the budget deficit from an average surplus of 1.2% before the lockdown measures to a budget deficit of 8.3% in 2020 in the projections at the end of May. The UK is expecting the highest budget deficit – at more than 16%. To finance the Covid-19 measures EU countries plan to increase their borrowing by 14% on average. The largest increase in debt to-GDP ratio is projected in Cyprus (+25.7%). Austria, Croatia, Portugal, Spain and the UK all project an increase in their debt ratio of more than 15%. Romania has the smallest projected increase of 3.8% as their fiscal response is constrained by the Excessive Deficit Procedure launched in March 2020.

On average, EU member states and the UK each adopted around 14 Covid-related fiscal measures, including those with retroactive effect. Funds involved amount to around 13% of GDP per country, including contingent liabilities and fiscal measures stretched out for several years. Czech Republic, Germany and Italy expect to have *the largest fiscal response. Italy introduced a total of 13 measures with a size of almost 50% of GDP, of which 44% are public guarantees that typically would not have a direct fiscal impact unless the guarantees are called. Similarly, in Germany, expected Covid-related measures amount to 37% of GDP, of which 25% are public guarantees. In Czech Republic state guarantees take up around 19% of GDP while the total fiscal response is expected to cost around 29%. Romania, Slovakia and Sweden have adopted the smallest packages. Sweden implemented measures that amount to only 1% of GDP, which could be explained by the fact that Sweden did not impose a lockdown, unlike other EU countries. Romania and Slovakia committed around 3% of GDP to Covid-related fiscal measures.*

All countries have postponed some tax deadlines. These measures in part delay the receipt of tax revenues, but at the same time it is expected that the large majority of the amounts due will ultimately be paid. The magnitude of the immediate fiscal response is unparalleled. Most countries will increase their spending by around 3.1% of GDP and give tax relief for another 1.1% of GDP. Nearly all countries have budgeted these measures for a short term only (up to one year).

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

Y. Kasperskaya, R. Xifré - Fiscal discipline and budgetary analytical capacity: The case of the euro area (1 July 2020):

In the aftermath of crises, the state of public finances typically regains prominence in policy agendas. This column advances the hypothesis that three properties of the budgetary setup - reliability of projections, openness to scrutiny, and transparency – facilitate the exercise of the 'budgetary analytical capacities (BAC)' of the government, legislature, and the wider public. It constructs an index of such capacities from the OECD Survey on Budget Practices. For the period 2012-2016, a simple measure of fiscal discipline is correlated with the index and is not correlated with other standard political-economy variables that are generally used to explain fiscal discipline. The authors conclude that, controlling for the economic cycle, the BAC index is positively associated with fiscal discipline. The association is stronger for the composite index than for the three separate pillars, which is suggestive of complementarity effects among them. Budgetary policymakers could therefore improve fiscal discipline by enhancing the three pillars – reliability of projections, openness to scrutiny, and transparency – that support the BAC.

A. Kleinnijenhuis, L. Kodres, T. Wetzer - Usable bank capital (30 June 2020):

The COVID-19 induced 'Great Lockdown' has cast doubt on the efficacy of bank buffers in supporting the real economy in times of crisis. Despite accommodative regulatory and supervisory action, banks remain hesitant to draw on their buffers to maintain credit provision. Recognising the difficulty in judging the demand for credit in the midst of the COVID-19 crisis, this column focuses on the potential supply of credit and explores the obstacles to 'usability' of bank capital. It concludes that the current capital framework falls short: there is not enough 'usable capital', and the disincentives to actually draw it down are too strong. Finally, it recommends improvements in current capital framework to overcome these issues. The authors propose three guiding principles: non-optional build-up of sufficient, usable capital in non-crisis times, give regulatory discretion to release buffers during a downturn, while providing stronger incentives to actually use usable buffers, set clear expectations about the pathway banks should follow to rebuild their buffers**.**

E. Carletti, S. Claessens, A. Fatás, X. Vives - The bank business model in the post-Covid-19 world (18 June 2020):

The Covid-19 pandemic has induced a deep global economic crisis. While so far banks have shown their resilience, partly thanks to major reforms after the crisis of 2007-2009, the crisis will put them under stress. Moreover, the traditional banking model was already being challenged pre-Covid by three trends: persistently low interest rates, enhanced regulation, and increased competition from shadow banks and digital entrants. Covid-19 will likely accelerate the digitalisation and the shift over the medium term of activities away from the sector. Medium-sized banks will likely be suffering the most since reaping cost efficiencies with large IT investments, crucial in a persistently low interest environment, will be out of reach. As a result, the banking sector will need deep restructuring; winding up banks and consolidating the remaining ones will be preferred. Whether in the post-Covid-19 world, political obstacles to cross-border mergers will prevent, as states become more protective of their national banking champions, is a major policy question.

C. Bredemeier, F. Juessen, R. Winkler - Cutting labour taxes brings back the jobs lost to COVID-19 (28 June 2020):

This paper investigates how a fiscal recovery plan should be designed to promote job creation for those hit hardest by the Covid-19 crisis. Their two main findings are: 1. A fiscal stimulus, independent of its specific design, promotes job growth in pink-collar occupations and the social sector. In this sense, fiscal policy is successful in helping create jobs where they were lost during the Covid-19 crisis. 2. Stimulating blue-collar job creation is more challenging. Only a cut in labour income taxes would quicken the recovery for blue-collar workers considerably. To stimulate job creation for blue-collar workers, the government needs to incentivise firms to enlarge their payroll by more than they raise their use of machines. This will happen, for example, if the government reduces the tax on labour income. With this stimulus, the government would not only boost the recovery, but it would also create jobs for all those workers whom the Covid-19 crisis hurt the most.

P. Aghion, H. Maghin, A. Sapir - Covid and the nature of capitalism (25 June 2020):

Both 'cutthroat' and 'cuddly' capitalisms are implementing changes to deal with their structural weaknesses during the Covid crisis. The US has implemented some short-term income support measures to reduce the risk of poverty, but it has not adopted structural measures to reform its system and move towards a cuddlier capitalism. In Europe, on the other hand, the Covid crisis may be an opportunity to move towards a new model of capitalism in which both innovation and the protection of citizens are promoted. This is not a naive ideal: states can have it all. The Scandinavian model of flexi-security has shown that countries can have both generous social protection and vibrant innovation. Germany has also achieved an impressive balance in this regard. Other European countries need to move in the same direction by incentivising innovation while continuing to protect citizens from social and health risks. The Next Generation EU package currently discussed by European leaders has the potential to stimulate a transformative recovery, making Europe a caring and innovative place.

S. Zahidi - What Today's Bailouts Can Do for Tomorrow's Economies (24 June 2020):

The crisis offers an opportunity for what the World Economic Forum has deemed the "Great Reset," starting not at some point in the distant future but right now. Building on the lessons learned during the 2008 financial crisis and its aftermath, many governments are attaching a range of meaningful conditions to bailouts and other rescue measures. The short-term assistance being provided today can and should be leveraged to encourage more responsible business practices, save jobs, address inequality and climate change, and build long-term resilience against future shocks. Even in deeply distressed sectors, rescue measures are being designed to emphasize social and environmental responsibility and encourage more long-term thinking. These instances of embedding long-term thinking into short-term measures are clearly steps in the right direction. Here, the European Commission's Next Generation EU crisis fund should be taken as a model for others to follow. With €750 billion ($845 billion) in grants and loans, it promises to usher in a fair and inclusive recovery by accelerating the transition to a green digital economy. Its basic conditions would help European countries shift away from declining heavy industries while supporting vulnerable workers. But while governments must assume a leadership role, shaping the recovery and charting a new course for growth will require greater collaboration between businesses, public and government institutions, and workers. By now, it should be obvious that we cannot go back to a system that benefited the few at the expense of the many. Governments' new clout gives them the means to start building fairer, more sustainable, and more resilient economies.

J.F. Kirkegaard - How Europe is taking another page from US financial history (18 June 2020):

Europe, ironically, can once again turn to US history, this time from the 19th and early 20th centuries, when the federal government had not yet acquired the right to levy direct income taxes on Americans. By proposing to issue the new common EU debt almost immediately, but only start repayments in 2028, the Commission further creates a "default position" in 2028: unless member states have agreed to new sources of direct EU revenues by then, they will face either higher national financial contributions to the EU budget plus debt repayments or will have to stomach politically painful cuts in other parts of the EU budget to repay the debt. Considering, too, how new sources of direct EU budget revenues, even if earmarked for debt repayment over 30 years, are likely to prove permanent in nature, it is clear that the long-term strength and very nature of the EU governance is at stake in the current EU budget process. The European Commission has proposed a new set of own resources similar to the revenue sources the US federal government had prior to 1913. Tariffs and carbon border adjustment would thus comprise 60 percent of the EU's new proposed traditional own resources, in line with how trade tariffs were the largest source of income for the US federal government pre-1913. Europe is thus following the example of the early US federal government prior to the 16th Amendment in raising its direct revenue from limited tax sources. Until that changes, member states will remain fiscally dominant in Europe, and the EU will not take over any additional redistributive tasks.

For an overview of some previous EGOV Regular Picks:

- The economy and coronavirus - Weekly Picks - 15/06/2020
- The economy and coronavirus - Weekly Picks - 04/06/2020
- 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 24- June 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

For an overview of the latest EU/EA level measures proposed or taken to mitigate the economic and financial effects of the pandemic, please see this regularly updated document.

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