Public Hearing on the COVID-19 outbreak, its expected impact on the EU economy and possible policy responses including monetary and fiscal measures.
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Honorable members, ladies and gentlemen, I am very pleased and honored to be here today to discuss the expected impact of the COVID-19 pandemic on the EU-economy.

I would like to start by outlining the severity of the economic crisis that the EU and the world are facing. It is without precedent since at least the Great Depression.

Starting in March of this year, most European countries aimed to `flatten the pandemic curve' with a combination of government-imposed lockdowns and strict advice to maintain social distances.

These policies, as well as sharp adjustments in individual behavior, caused a sudden collapse in both demand and supply, resulting in a large economic downturn. According to the OECD, activity contracted by as much as 20 to 30% during the shutdowns, and the Euro area is expected to shrink by 9.1% this year.

EU policymakers quickly recognized that the immediate objective was not to stimulate the economy –an impossible task when people are confined and businesses are shutdown- but instead to 'flatten the recession curve', by putting in place the necessary safety nets to protect workers, businesses and banks (Gourinchas, 2020).

This required large-scale interventions by fiscal authorities, with a combination of job retention schemes for workers, tax-deferrals and loan guarantees for businesses, as well as aggressive and timely liquidity provision for the financial sector.

These policies have been largely successful in limiting the surge in permanent layoffs and business failures, and in preventing the initial shutdown from morphing into a full-blown financial crisis.

These policies also have large fiscal costs. For the Eurozone, the OECD expects that the ratio of public debt to GDP will increase from 104% to 121% in 2020. With historically low interest rates, this needs not be a major concern. It can nonetheless put serious pressure on the more fiscally fragile economies, increasing the risk of a fiscal and financial downwards spiral.

The ECB responded early and decisively to this potential threat, setting up a temporary and targeted Pandemic Emergency Purchase Program (PEPP) with a capacity of €1350bn (11.3% of 2019 EZ GDP). This was a critical action that greatly helped to stabilize markets and expectations.

Ultimately, however, what is needed is a strong show of fiscal solidarity, so that all countries in the European Union can safeguard both their people and their economy in the face of a common threat. The latest announcements from the European Commission, with a new recovery instrument, Next Generation EU, that budgets €750bn (5.4% of 2019 EU GDP) for a temporary recovery plan, constitutes a major advance in the European toolkit, that will allow the EU to deal with extreme shocks such as the pandemic.

Now that the sanitary situation has improved markedly, economies are restarting, and we should be reaping the benefits of the policies that were put in place. Yet, a number of important challenges lie ahead. I will make six observations:

1- Many small businesses (SMEs) have seen their balance sheet and liquidity position deteriorate significantly. In recent work (Gourinchas et al, 2020) I used firm-level data for a sample of 17 countries (14 of which in the EU) and estimate that up to 12% of SMEs could fail by the end of 2020, compared with 4.5% in a normal year. The workers employed in these 'at risk' businesses --primarily in the Food, Accommodation, Arts and Entertainment and Retail sectors-- represent 5% of total employment. In the context of already elevated unemployment rates, the danger of a 'second wave of business failures' is real.

2- This wave of business failures would have a significant impact on the EU's financial sector. EU banks were well capitalized before the crisis, but its severity could exceed that of typical stress-test scenario. With about €3000 bn in loans to SMEs in the Eurozone, the projected increase in business failures could represent an additional €250 bn, possibly more, in Non-Performing Loans (2.1% of EZ GDP). Again, this second wave lies ahead of us.

3- Uncertainty about the economic and health trajectories remains extremely elevated. Consider aggregate demand. It could become abnormally high -if households decide to catch up on depressed spending during confinement- or remain abnormally low -if households decide instead to remain prudent. At the same time, the aggregate productive capacity of the economy will remain low for some time. Health trajectories are equally uncertain. This suggests that it may be too early to engage in large-scale fiscal stimulus. Protecting jobs and businesses, at a gradually decreasing rate as the economy strengthens, should remain the priority.

4- Some voices are pointing out -correctly- that excessively generous support policies could hinder 'efficient' reallocation from 'zombie' firms to productive ones. I consider that, in the short run, the bigger risk is that we will not do enough, not that we will do too much. Beyond the obvious suspects (online retail, restaurants…), there is still much uncertainty about which sectors may contract permanently, and which may benefit. It is too early to decide which is which, and sectoral policies run the risk of being unduly shaped by special interests.

5- Be that as it may, not all businesses can or should be saved. It is therefore also important to streamline business restructuring and liquidation proceedings in the EU, especially for SMEs.

6- We can expect an asymmetric impact of COVID on EU members. Countries more reliant on tourism, for instance, are likely to experience more severe downturns than others. Ensuring the economic and financial cohesion of the European Union must remain a paramount objective. It will require the continued support of the ECB for the Eurozone and may necessitate a fast deployment of the Next Generation EU resources.

Thank you.

References:

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