EU ECON Hearing 15th June

Thank you

As you know, the OECD has just published its Spring 2020 Economic Outlook.

There are three striking features in this outlook: (i) exceptional and pervasive uncertainty; (ii) an exceptional shock and exceptional policy response; (iii) an exceptional European response. I will focus the bulk of my remarks as to **how the European response answers the widening divergence that is resulting from the crisis.**

1. Exceptional uncertainty: it is important to keep in mind because that suggests more may be needed or differently implemented.

The highest uncertainty is the epidemic outlook which has huge implications for the economic outlook. We do not have a vaccine or treatment and will not for at least 12 to 18 months. This means:

- Physical distancing, sanitary and hygiene regulations will be with us for a while, raising costs in some sectors and affecting the structural operation of the economy, including not all borders open in the same way as before;
- Some sectors will be harmed for long period of time or will even have to change. Others may thrive, implying structural changes for economies with consequences for labour and capital reallocation
- The virus may raise in intensity again, if not globally, potentially regionally, so that certain sectors or categories of population may have to go into shelter again – and therefore more policy support may be needed

Thus, my **first remark is that economic policy could, and should, do more to reduce policy uncertainty**

2. Exceptional shock and exceptional public intervention

Economic activity has collapsed across the OECD during shutdowns, by as much as 20 to 30% in some countries. We project the world economy to contract between 6.0 and 7.5% this year, and the euro area between 9 and 11.5%. Moreover, the recovery will be subdued, resulting in income losses per capita around 10%, and varying across countries.

EU countries have responded rapidly and boldly to the economic shock, first at the national and then at the European level. Most of the economic policy response is national however, levelling up healthcare systems, supporting workers, generally through the adoption of short-time working schemes, and through loan guarantees, tax and charges deferrals for firms. Special support to some sectors are also taking place.

At the European level, like at the national level, the response has been faster and larger than in the previous crisis.

The Commission has been prompt to lift rules, both fiscal and state aid, that would have impeded national responses. In addition, further direct fiscal support is also taking place through a number of programs, timely and targeted, a big difference compared to the financial crisis; SURE to support the funding of temporary work schemes (€100bn or 0.7% of GDP); EIB facilities (1.7% of GDP); ESM pandemic program (2% of GDP) and the forthcoming Recovery and resilience fund (RRF).

The ECB's response has been large and timely, including the PSPP programme, which has been at the forefront to address financial market tensions. This programme will remain central for the months to come**.** The ECB response is in sharp contrast to what happened at the beginning of the 2011/12 crisis.

We should not underestimate the confidence signals that these diverse programs are sending. These programs and especially the Recovery and resilience fund announcement have resulted in lower interest rates. **This is important because national fiscal support, coupled with the depth of the recession, will push public debt to GDP ratio by about 20ppt across the EU, with consequences for debt servicing costs.** The debt increase could be even larger, because recovery support will be needed for the 2nd half of 2020 and for 2021, and because much will depend on the speed of the recovery, as well as the nature and extent of off balance sheet support.

Now the question is whether these are enough and where we see points of vigilance, which brings me to my third point.

3. Is it enough? Let me make three points here.

First, the size of the overall packages, including national and European may need to increase. Our recently released Economic

Outlook projects euro GDP will be up to 7% below 2019 level by the end of 2021, taking into account current plans, suggesting there is scope for a more forceful combined policy support.

In part, this owes to national countries: for that reason, it is important that the suspension of fiscal rules remain unchanged in 2021, when the recovery Budget will be needed most (on top of this year).

In addition, however, at the European level, the timeline for the RRF implies there will be little funds available over the period 2020-2021 and, rather, projects for peak stimulus will take place in 2023/2024. This will be too late for many firms and families. This suggests that delivering an agreement fast is especially important. But it also begs the question of whether it would be possible to bring forward some of the funds; to avoid corporate solvency issues rising and bringing European economies into a deeper crisis, public support will be most needed over the second half of this year and 2021 when the existing national support programs end.

Second, Covid-19 has resulted in an asymmetric shock across the globe, but especially across the EU. Its economic consequences vary a lot across countries depending upon:

- Health factors; when the virus hit, the preparedness of the health care system, the containment measures and their level of stringency,
- Local features such as the density of the population and concentration of economic activity; where the population is dense and economic activity concentrated, such as Milan or Paris, diffusion is higher than for more decentralised population and economic activity,
- Economic characteristics such as sector specialisation and industrial structure. For example, a large tourism sector will be a drag - OECD illustrative estimates suggest that international tourism could drop up to 70% in 2020 due to COVID-19; role of manufacturing (more than a quarter of value added in Germany, only 10% in Italy and France). In addition, the share of SMEs versus large firm may also play a role, as the latter will more easily take up government support and absorb the additional regulation.

This potentially accentuates the existing divergences across EU countries. By the end of 2021, GDP pc in Spain will be more than 35%

below Germany, Italy 30%, the Netherlands more than 12% above. As you know, these gaps were much smaller before the financial crisis.

These gaps result both from the magnitude of the economic shock and the capacity to provide fiscal support by each nation. This, in turn, depends on its fiscal space for supporting households and firms. This holds for direct spending, but also for state aid rules.

According to the European Commission's proposed distribution key, there is a significant element of redistribution from the RRF. However, the extent to which the redistribution element is targeted to the sectors and countries more severely affected is not clear. One question is whether this element, especially in grant form, could be better linked to the magnitude of the economic shock.

There is another element which is very important and could require EU intervention. State aid rules have been lifted and this is welcome. However, state aid intervention matters not only in quantity but also in quality. There is a large discrepancy across countries in the use of state aid support. Some countries are supporting their firms mostly through loan guarantees, other deploy a lot of equity support.

Why does this matter? We are entering a phase where corporate solvency may be shaken, as national governments potentially begin to reduce the policy support put in place in the first phase of the crisis. Where state aid has taken the form of equity injection, corporates will be more resilient. Where state aid has taken mostly the form of loan guarantees, corporate solvency may deteriorate and result in bankruptcies first, and then increase the public debt burden.
Countries with more fiscal space tend to have much more equity injections, strengthening firms' resilience. Countries with less fiscal space make more use of guarantees on loans, which in turn may weaken their public finances, precisely at the time where a push on investment will be needed.

The European response is not addressing this issue to the extent that it would offset these divergences, which may have long lasting effect on countries competitiveness.

Third, there is one question still unanswered by the current package, but which has been lingering since the financial crisis: the euro fiscal instrument for stabilisation.

Among the three functions of fiscal policy, the RRF answers two, allocation and to some extent redistribution, but it does little for stabilisation. Implicitly, the strategy remains that fiscal cyclical stabilisation is with member states, while the ECB keeps rate low as is normal at this stage of the cycle. This raises a few issues:

First, the funds' instruments to implement the EU vision on digital and climate, and contribute to national policies, follow the spirit of some cohesion and regional funds. They are not cyclical. The fact that the discussion on these funds will take place through the European Semester makes the point; the process will be for the national level, with no attention devoted to the aggregate macro-economic situation and the aggregate fiscal stance. The euro are still lacks a real cyclical fiscal capacity.

Second, the discussion on the resources is open but could be addressed more directly. There might be scope for enhancing the cyclical element if some of the funding was realised through a corporate taxation, in addition to the mentioned proposal of a carbon tax or the receipts of ETS, or a digital tax. One element to highlight here is that giving certainty on carbon pricing could also be an element that could support corporate investment.

Third, an important element is that the debt issued for the RRF is a safe asset the ECB could purchase as part of its asset purchases programs, and would help ease some tensions. Given the depth of the shock on all economic variables, a European safe asset and the ECB support will continue to be instrumental both for the economic recovery and for financial stability. Issuing the common debt faster may therefore be helpful for the ECB in strengthening monetary policy transmission.

Thank you