COVID-19: Europe needs a catastrophe relief plan

voxeu.org/article/covid-19-europe-needs-catastrophe-relief-plan

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The unfolding coronavirus epidemic represents a severe economic stress test for Europe as well as a test of European unity. This column discusses how the crisis might unfold and the appropriate policy response. It advocates a comprehensive emergency package through which the EU would take responsibility for a meaningful share of the overall emergency effort.

Beyond its public health dimension, the unfolding coronavirus epidemic also represents a severe economic stress test for Europe that comes from a totally unexpected side. This time, it is primarily a shock to the real economy hitting all European countries more or less equally (time lags will soon become a footnote). The buffers and firewalls put in place after the global financial crisis and the euro crisis have been designed to fight a different sort of crisis, originating in the financial sector or in a particular sovereign. This time is different.

For this reason, and because its fallout for integration may be persistent, this crisis calls for a common Europe-wide response**. This is not only an economic crash test, but also a test of European unity.** How European leaders will deal with the fear and the suffering of their fellow citizens will be remembered. By the same token, the crisis is an opportunity for leaders to build trust and to show unity, strength, consequence and solidarity. They will need to demonstrate that Europe can help put in place an effective catastrophe relief plan. Just a few weeks after Brexit, it is time for the EU to demonstrate that it can deliver in the face of dramatic events.

There is no European roof

Twelve years ago, the global financial crisis triggered a major recession and marked for many countries the beginning of a 'lost decade'. **Europe is entering this new crisis with different strengths and weaknesses.** Among the strengths are that the banking sector is better capitalised and more liquid; the derivative markets are more transparent; the European Stability Mechanism can act as a backstop in case of bank resolution and, more importantly, it can deliver emergency assistance to a member state, conditional on an adjustment programme; and last but not least, the ECB can help counter an attack on a member state by purchasing potentially unlimited amounts of sovereign bonds, again conditional on an adjustment programme. Hence, banks are stronger than they used to be; and although sovereigns are weaker (due to accumulated debts), the potential for multiple equilibria on the bond market is reduced.

As for weaknesses, the ECB is running out of fire power, with a still negative deposit rate and little room for further quantitative easing. A long period of extremely low interest rates has encouraged borrowing and buoyant asset prices in the euro area, although through different channels and to different extents across member states; it has also weakened the banking, pension funds and life insurance sectors. Although macroprudential policies have been activated in most countries, various actors are entering the crisis with debts, overvalued assets and small interest margins.

On the fiscal side, the European roof is not only leaking, it is missing altogether for the kind of shock that is unfolding. Europe is equipped with a fair-weather budget that has not been designed to cope with emergencies. The pre-COVID negotiations on whether the EU budget should amount to 1.11% of national income (the European Commission's proposal), 1.02% (the 2014-20 level) or 1.07% (a compromise) will probably appear pathetic to future historians, who will compare the Chinese and European reactions to COVID-19. More importantly, the adequacy of a pre-allocated budget over a seven-year period is problematic: it leaves no room for frontloading (with common borrowing) and even little room for the rearrangement of spending priorities. Moreover, the long-lasting discussions on the need for a fiscal stabilisation capacity at euro area level have gone nowhere, except for the meaningless micro-BICC (Budgetary Instrument for Convergence and Competitiveness) agreed upon in October 2019.

A very serious economic crisis for Europe

The COVID-19 shock combines features of a demand and a supply shock. Assuming, as a working hypothesis, that the epidemic is over in the summer of 2020, the crisis in Europe could unfold through four partially overlapping phases:

- **Phase 1 – the China Shock** (January-March): mostly adverse supply-side effects of the Chinese health crisis through global manufacturing value chains. Supply-side shortages are specific to some producers and products; sectoral effects are significant but macro effects are small since the most affected sectors (transport equipment, electronics, pharmaceuticals, textiles) represent some 4% of GDP (though more for Germany), according to OECD data.
- **Phase 2 - sectoral disruptions** (starting in February): a sectoral and regional demand shock hitting mostly tourism, air transport, hospitality and entertainment. This is a more violent shock but again, the impacted sector is small overall – at most, 5% of GDP if restaurants are included, with some variation across countries (more in Spain, less in Germany).

- **Phase 3 – acute overall disruption** (starting early March in Italy, 1-3 weeks later in other European countries): aggregate supply shock resulting from contagion containment measures with restrained demand and mobility. The nature of these may not be the same in all countries, but all will need to tackle the acceleration of contagion with measures such as travel bans, shutdowns of public transportation systems and school closures**. Such broad-based measures are bound to be very damaging** economically because of labour supply reductions (around 15% for school closures, based on simulations for the UK; Sadique et al. 2008), obstacles to business activities, financial disturbances (stock markets, credit standards) and a drop in social consumption. **Aggregate quarterly output is likely to fall severely during this phase, but hopefully still by single-digit numbers**. Reduced oil prices will act as a very partial stabiliser, with other international spillovers being clearly negative.
- **Phase 4 – recovery** (starting in May or June): **a sharp rebound is likely but may be muted by hysteresis** due to confidence effects, lost corporate income in the service sectors, bankruptcies among SMEs and credit constraints resulting from the accumulation of non-performing loans on banks' balance sheets and the rebuilding of dented savings at the household level. The danger is that such hysteresis effects prevent a return to the pre-crisis path once the health emergency is over. Again, major international spillovers will be at work, compounding national and regional difficulties. If the lesson from the global financial crisis is of any relevance, it is because it underlines the extent to which major shocks can have strong spillovers and persistent consequences.

The adequate policy response depends on the phase

The right policy response depends on which phase the economy is in. During the first phase, there was limited scope for policy intervention at the aggregate level. Some targeted sectoral measures, such as subsidised short working hours ('*Kurzarbeit*'), were already being discussed in Germany for firms hit by disruptions to their trade with China.

In the second phase, liquidity lifelines – starting with automatic delays to tax and social contribution payments and partial unemployment schemes – have been or are being deployed at the national level. **This is on the whole an adequate response**, on top of additional funding for healthcare.

Phase 3 requires more generalised emergency support measures for various reasons. First, spending on healthcare (temporary facilities, equipment, hires, overtime for medical personal) and on related items (security, control of lockdown measures, etc.) must be stepped up significantly. The corresponding one-off cost is hard to assess, but may amount to several tenths of a percent of annual GDP. Second, some service sectors will suffer permanent income losses instead of just liquidity shortages. SMEs in particular need substantial financial support in this phase, in the form of tax relief and concessional credit lines and grants on top of the previous measures in order to forestall bankruptcies. Temporary partial unemployment support (*Kurtzarbeit* in Germany, *Cassa Integrazione Guadagni* in Italy and *chômage partiel* in France) needs to be activated as it helps cushion the shock and avoid lay-offs, which is exactly what is needed when facing an exogenous drop in activity. Direct support to households, through relief of cash payments (such as tax holidays or relief from paying electricity bills, as announced in Italy) or cash handouts (as already announced in Hong Kong and Singapore) may also be necessary, as well as direct transfers to independent workers.

In the event of a one-month lockdown leading to a temporary 50% drop in private-sector activity, we estimate that the cost of exceptional support measures would amount to 0.5% to 1% of annual GDP.[1] The direct cost of *discretionary* measures (emergency health and lockdown measures plus economic relief) would therefore be of the order of magnitude of 1% to 1.5% of annual GDP. This may seem a large number, but Italy has already announced an emergency support programme amounting to €10 billion, or 0.6% of GDP. Together with the fiscal stabilisers, such an action plan would imply accepting a short-term deterioration of the fiscal balance by about 2% of GDP.

These are large enough numbers to test the fiscal capacity of the most vulnerable member states. As there are now large externalities of containment measures, the economic response should also involve the European level.

Phase 4 will call for significant fiscal demand support to help avoid hysteresis effects. The magnitude of the effort will depend on the length and severity of the Phase 3 recession, but it is best to plan for action that is meaningful, comprehensive and long-lasting enough to ensure the elimination of the scars inherited from the crisis. The priority in this phase will be on aggregate demand rather than supply-side or sectoral measures. The most appropriate vehicle is likely to be direct transfers to households. There is a need to plan the boost beforehand so that it can be activated at the right moment. Again, the European dimension will be key to internalising externalities.

During phases 2 and 3, the ECB should stand ready to provide liquidity to banks that are likely to be affected by the deterioration of credit quality, while facing urgent demands for short-term credit. The ECB also has a long experience with (targeted) long-term refinancing operations and should consider launching such a programme (conditional on bank lending to SMEs). As for monetary policy, the best course of action would be a monetary easing in coordination with a fiscal stimulus. The decline in oil prices will affect headline inflation and, as happened in the past, could affect household and corporate inflation expectations. It is therefore key that the ECB provides firm communication on its inflation target to avoid a deflationary scenario.

Since non-performing loans (NPLs) will be on the rise, the ECB and national supervisors could **provide temporary relief (for example, for the remainder of the year) of the agreed framework to reduce NPLs in the EU.** A temporary waiver on the implementation of the Basel standards for loans categorisation might also be useful. Finally, some specific buffers could be relaxed. However, supervisors should not allow a massive deterioration of banks' balance sheets, since the banks will be needed to finance the restart of the economy in phase 4. Guarantees extended by the European Investment Bank would help protect banks' balance sheets, while at the same time allowing for an extension of credit lines to SMEs.

The bottom line, though, is that phase 3 will create not just a liquidity problem but also a solvency problem in the various economies, although to a varying extent depending on specific sectors and firm sizes. These solvency problems cannot be addressed by monetary policy and even less so by micro- and macroprudential policies; fiscal intervention will be key.

A European fiscal response

Under current circumstances, t**he Economic and Financial Affairs Council should formally rule that all temporary additional public expenditure caused by the outbreak of the health crisis will be deducted from 2020 public expenditures** and the corresponding public deficit for the assessment of the member states' compliance with the Stability and Growth Pact (SGP). The Commission has already given indications of this, but a formal EU decision covering the period of the health emergency is needed. This would require triggering the general escape clause introduced in the SGP 2011 to cope with "an unusual event outside the control of the Member State concerned and with a major impact on the financial position of general government, or when resulting from a severe economic downturn" (Council Regulation No 1177/2011, Art. 2).

However, as after the global financial crisis, **the hard constraint may not be the SGP but rather the ability of national governments to borrow several additional percentage points of GDP.** Here, member states are not equal. Between 22 February and 10 March 2020, interest rates on 10-year sovereign bonds fell by 0.3 percentage points in Germany and stayed stable at a negative level in France; but they rose by 0.4 and 0.15 percentage points in Italy and Spain, respectively. It could be argued that such divergence is the logical outcome of different situations in terms of debt sustainability. However, it is not in the interest of Germany or France to see Italy or Spain restricting spending related to the epidemic, since this might impact on them in the form of further contagion and economic weakness. Conversely, costly containment measures will produce positive spillovers on other countries, and thus should be co-financed.

A European catastrophe relief plan aiming at supporting the combined efforts of the member states in combating the pandemics should be urgently conceived and decided upon.

The most pressing priority is to help finance the additional cost of improving hospital infrastructure (especially the number of intensive care beds) and paying for the extra workload of medical staff. The second priority is to open a window to finance indirect expenditures related to public health measures, such as containment and school closures. This mutualisation of healthcare costs should be subject to screening by an expert committee. Eligible expenditures could include security, partial unemployment schemes and support targeted at specific sectors such as hospitality, airlines and entertainment (after alleviating existing constraints on state aid, which should be easier to do if all countries are concerned simultaneously than if only one asks for it). The Commission could extend the funds on a weekly basis and carry out the audits once the crisis is over, hopefully in the second half of the year. Transparency (not bureaucracy) over how support is being spent will be a key element in the success of the fiscal intervention. Within each country, it is well understood that the shock is truly exogenous, hence moral hazard should not be a core concern and temporary support – for example, through *Kurzarbeit* – is legitimate. The same line of reasoning should apply at the EU level.

We are advocating a **comprehensive emergency package through which the EU would take responsibility for a meaningful share of the overall emergency effort.** This would require finding the means to release tens of billions of euros from EU resources, despite existing limitations on the use of the EU budget.

European Council President Charles Michel and European Commission President Ursula von der Leyen declared on 10 March that the EU should both take part in the fight against the disease and act on the macroeconomic front, and they announced initiatives that remain to be specified. We welcome such initiatives but underline that a mere renaming of existing budgetary credits and the announcement of large headline figures based on virtual multipliers would not do any good. The situation calls for the allocation at EU level of new funds dedicated to addressing the consequences of the disease wherever they occur within the Union. This is not a moment when the EU members should be afraid of 'mutualisation'. Rather, they should be afraid of the consequences of ring-fencing.

Possible sources of funding include the following:

- **Existing EU funds**, including the European Solidarity Fund and the European Globalisation Adjustment Fund, which would need to be leverage as they currently totalize less than €1 billion.
- **Reallocations within the EU budget**. Budgetary credits earmarked for the structural funds in the 2020 budget should be mobilised for the emergency health initiative. Article 317 of the TFEU Treaty makes it possible to reallocate funds within the budget. It will be important to provide relief to all member states, irrespective of their share in the structural funds or the distribution by country of as yet unspent money. A straightforward solution would be to reallocate within the EU budget specific budgetary items to the European catastrophe relief plan, and to negotiate a political agreement that would compensate the would-be beneficiaries of the reallocated funds through an exceptional allocation in the 2021 budget.
- **Cooperation among member states** outside the framework of the EU budget. Article 122(2) could provide a basis for organising such voluntary cooperation in the same way as was done for the creation of the European Financial Stability Facility (EFSF).

What could be plan B?

We know that our proposal is unlikely to receive warm backing from policymakers in several part of the EU and the euro area. Before discarding it, however, it is useful to understand the risks involved in an attitude of denial.

The starting point is that although the crisis today is believed to be mostly temporary, financial markets are short-sighted: they do not weigh future profits or tax receipts as they should based on the low level of interest rates. Hence there is room for multiple equilibria, and we should not rely on the assumption of well-behaved financial markets.

What would happen in the case of a sudden rise in interest rates in some member states, which would in turn make their debts unsustainable? This is not a theoretical threat, given that some governments are already on the razor edge. In such circumstance, there would be no solution other than an ESM financial assistance programme or, rather, the activation of the ECB's Outright Market Transactions (OMT) scheme. The fiscal adjustment programme would need to be postponed to the post-crisis period, with all the governance problems involved.

In the end, it is not guaranteed that plan A would be less costly. Policymakers in all countries will likely be better-off if they can be granted for solidarity in the face of a common health drama than if they muddle through and ultimately have to cope with new emergency assistance, new conditionalities, and the involvement of the ECB in solving another sovereign debt crisis. It is time for the Europeans to think more deeply about opportunity costs, which are at the same time economic, social and political.

References

Sadique, M Z, E J Adams and W J Edmunds (2008), "Estimating the costs of school closure for mitigating an influenza pandemic", *BMC Public Health*, 8 April.

Endnotes

1 Assuming that the government would cover one-third of income fallout of the reduced economic activity and that the other two-third would be borne by companies and, to a lesser extent, households.