EUROPE AND THE COVID-19 CRISIS:

THE CHALLENGES AHEAD

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The defining feature of the present situation is that the remaining demand and supply obstacles are highly sector specific. Aggregate demand management will thus be less effective. Income replacement measures, such as short-term work schemes, will be needed for some time, but should be applied flexibly to support rather than hinder structural adjustment. This also applies to the funds to be made available under the €750 bn Recovery and Resilience Facility. Money is fungible. This means that the key for success will not be the projects to be financed by the RRF, but whether member states undertake structural reforms that increase their growth potential.

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This paper is based on a contribution for the informal ECOFIN meeting, Berlin, 11 September 2020.

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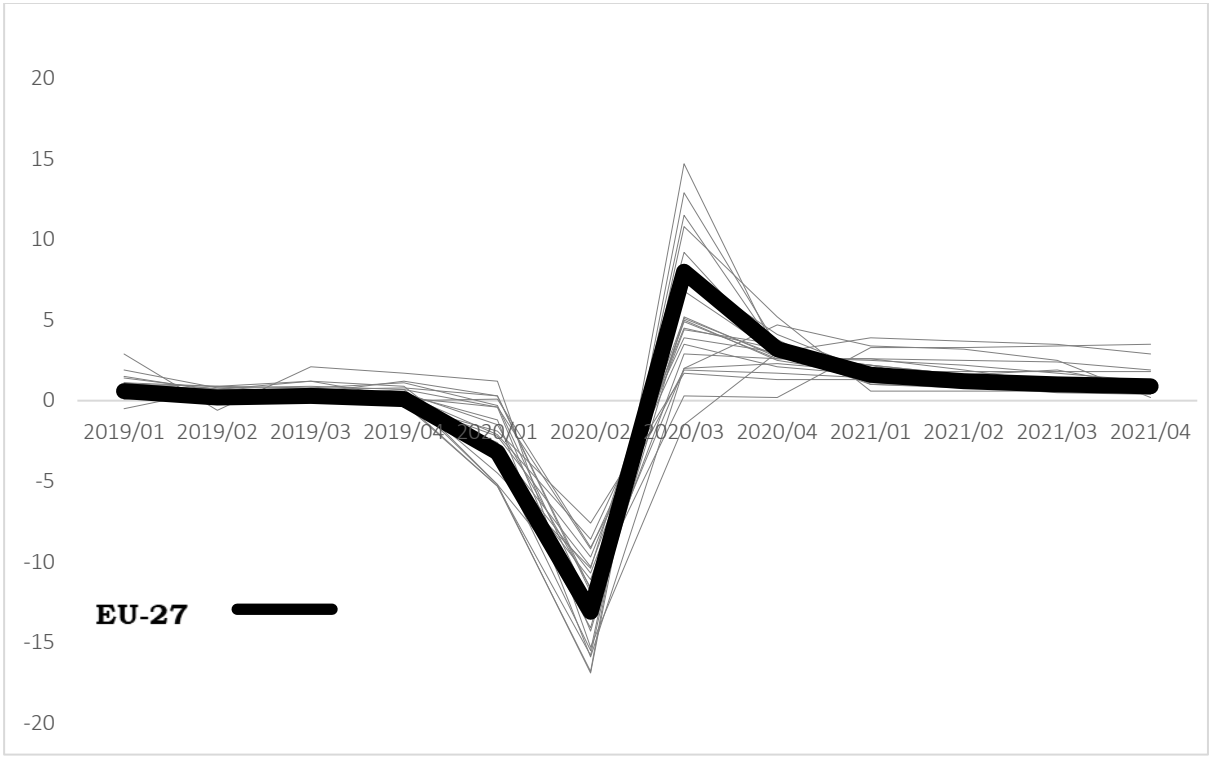
Introduction

The social distancing measures put in place by many governments to deal with the Covid-19 outbreak dealt a massive shock to the economy everywhere. The initial reaction to the lockdown decreed in many countries in Europe has been a generalised recession. Once the lockdowns were lifted, recovery could begin.

A recovery had undoubtedly taken hold in the second quarter of 2020, but much uncertainty remains about its speed. The economy is a moving target, especially under the present, unprecedented circumstances. Hard data on the state of economy are sparse and come with some weeks' delay. Certain new data sources are available in real time, but their link to economic data that matters in the end (i.e. GDP, employment, inflation, etc.) is untested. Policymaking does not have the luxury of waiting for better data; in fast-moving times such as these they rely on forecasts and projections to assess what economic conditions they are likely to face in the near future.

The European Commission's latest forecast suggests a wave-like pattern for (quarterly) growth and an incomplete recovery (even by the end of 2021). Figure 1 below shows the sharp down and up movement of the quarterly growth rates of member states, alongside the EU average. Growth is likely to turn from about minus 15% to plus 10%. But subsequent quarters should see a sharp slowdown in growth.

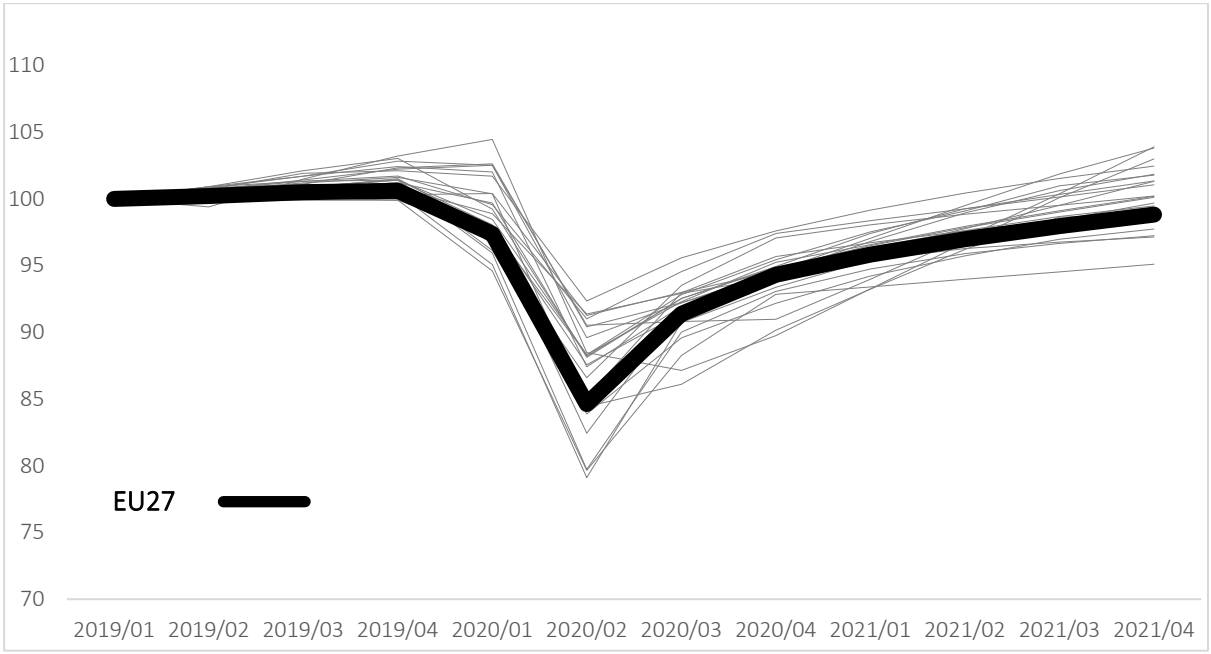
Figure 1. Quarterly growth rates of GDP



Source: AMECO.

As a result of this slowdown in recovery, the Commission expects that even by 2021, the pre-COVID level will not have been reached.

Figure 2. GDP Summer forecast GDP 2019Q1 = 100



Source: AMECO.

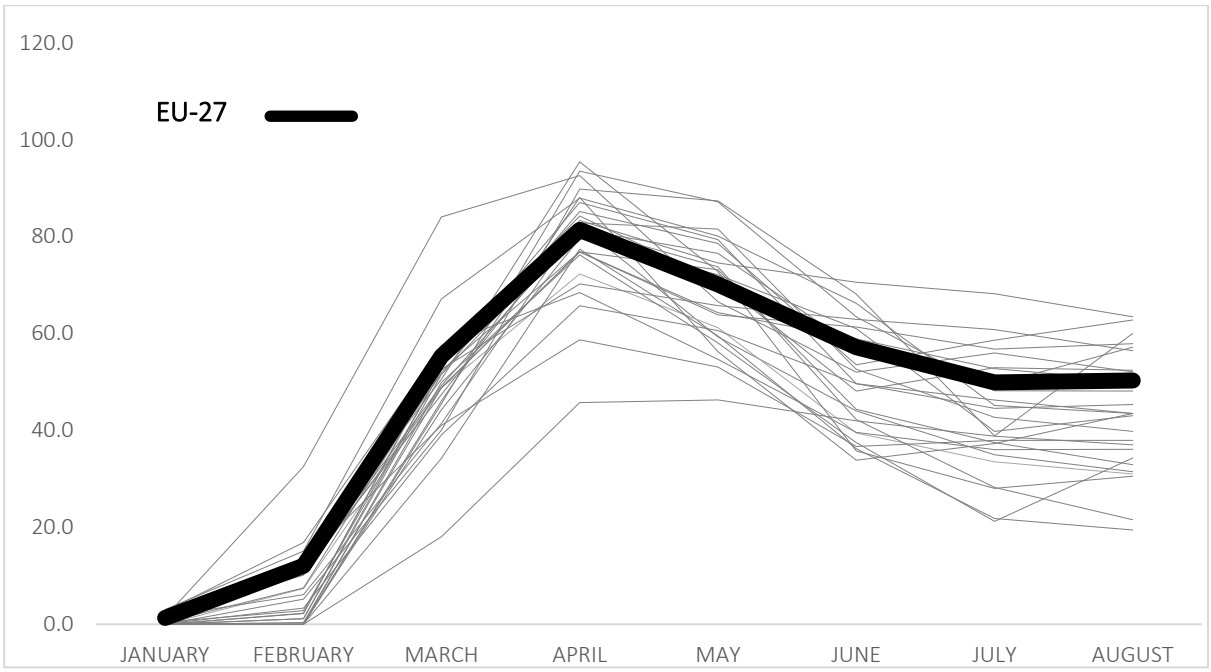
Figures 1 and 2 illustrate considerable variability across member states in terms of the depth of the recession and the extent of the recovery. In some member states economic activity contracted by close to 20%, but in others by 'only' 10%. What could be the reason for these enormous differences?

In part it could just be forecast errors, of course, as all the foregoing was based on projections. But this does not seem to be the decisive factor in this case. The little hard data available so far is only for Q2, 2020, but allows one to look at the factors that determined the depth of recession.

The appendix to this paper reports the results of an econometric exercise that links the drop in GDP in Q2, 2020 (relative to Q2 in 2019, to avoid issues related to seasonality) with the severity of the social distancing measures put in place by member states. Researchers at Oxford University have developed a numerical index which measures various aspects of the restrictions put in place in different countries. Figure 3 below shows the evolution of this Oxford stringency index.[1]

[1] The stringency index is rank-scaled and built on different components such as school and workplace closures, restrictions on gatherings and individual movement, contact tracing, international travel restrictions, and policies to test for corona infections (Hale et al, 2020). The composite measure is a simple additive score of nine individual indicators, rescaled to vary between 0 and 100. Increasing values of the index imply stricter regulations.

Figure 3. Oxford stringency indicator (monthly averages)



Source: Oxford University.

This figure shows that there were (and remain) significant differences in the severity of the measures imposed in some countries (often resulting in a lockdown).

The main finding of the empirical exercise is that the key drivers of cross-country differences in the loss of output in Q2, 2020 were the differences in the severity of the social distancing restrictions and the importance of tourism for the economy (share of this sector in GDP).[2] Neither result is surprising. Economic activity necessarily suffers when mobility is reduced and tourism is the economic sector that suffers the most. This is one reason why the recession has been particularly severe in some southern member states, where tourism accounts for more than 10% of GDP. Somewhat more surprising is the 'non result' that trade intensity (exports relative to GDP) seems to have no influence on the magnitude of the actual fall in GDP, despite the importance of trade in most member countries (and especially Germany). However, the steep fall in exports was accompanied by a parallel decline in imports, thereby cushioning the impact on GDP.[3]

Figure 3 shows not only the differences in national social distancing measures as measured by the Oxford index, but also that the EU average (weighted by GDP), indicated by the bold line, has not fallen much over the last few months. Given that this indicator could explain the fall in GDP experienced so far, one must conclude from its relative stability at a high level that the recovery will not continue at its present rate. In other words, the key reason it might take some

[2] More technically: the strength of restrictions explains 60% of the variation of national GDP growth rates in the second quarter. In a weighted regression this increases to 95%. Other variables, like the share in exports or the size of discretionary fiscal packages to combat the crisis, are not significant at usual statistical levels.

3 As an example: compared to the baseline, German exports dropped by 13% in 2020, Q2, and imports by 11%.

time to reach a full recovery is that social distancing measures will remain in place for the time being. This is the most direct way in which the evolution of the pandemic weighs on the economy. [4]

Policy needs to foster adjustment

The shock of the pandemic, and its accompanying social distancing restrictions, has affected different sectors in very different ways (e.g. air travel remains far below pre-crisis levels, whereas durable goods sales have almost fully recovered). At present, it is not known how long some of these shocks will take to play out. Moreover, the pandemic is also strongly accelerating pre-existing trends, such as digitalisation. What these shocks have in common is that they are sectoral in nature, with some being transitory (e.g. travel); and some permanent (e.g. digitalisation of economy).

The challenge for policymaking is to reconcile adjustment with targeted income support. Most member states have either introduced or vastly expanded existing short-time work schemes. The basic idea behind these schemes is sound. In a sharp recession, cash-strapped enterprises would be tempted to fire workers with specialised skills. Mass redundancies risk destroying valuable relationship capital that results from continuing employment. At the same time, structural change is also necessary.

For the time being most member states have already decided to extend their short-time work schemes into 2021. This would risk freezing the labour market. However, there is a way that short-time work schemes could be used to foster adjustment. At present, most schemes provide a subsidy only if the worker stays in the firm. This creates a de factor tax of 100% on adjustment and should be changed. Workers should be able to keep their replacement income even if they take a second, part- time or temporary job, or better change to another a sector. This might be politically difficult to sell, but it makes sense from an economic point of view. Governments can only gain if people produce something instead of being idle. The workers themselves would also gain by working somewhere else because an extended period of inactivity leads to a loss of general working skills.

The sectoral dimension of disturbance to the economy is key for macroeconomic policy

As illustrated above, some restrictions on mobility and some services requiring close contact remain. This implies that some sectors of the economy will remain weak for some time, while others have already bounced back.

[4] Kozlovski et al. (2020) provide additional rationale on why the economy might recover more slowly. They argue that the occurrence of the pandemic causes investors to increase their belief in the likelihood of a further large shock, thereby reducing investment.

In this situation governments need to look forward to a longer period during which they need to provide replacement income for those rendered idle by the direct and indirect impact of the pandemic. Moreover, some 'GDP gap' will persist since there remain important sectors that will operate below normal capacity for some time. This is already incorporated in the forecasts shown above. The question for macroeconomic policy is thus whether government should go beyond providing replacement income and try to lift aggregate demand.

Common sense suggests that no amount of support to aggregate demand can bring the Covid-affected sectors back to their previous level. Those previously employed in travel would remain unemployed, even if spending on durable goods were to increase greatly.

Moreover, economic modelling suggests that consumers might be more careful in spending today when there are some goods that, temporarily, they cannot or do not want to buy. Most economic models supposed that many households are cash constrained and will spend a good portion of any transfer they receive from the government. However, this mechanism works less well when households today cannot afford their normal consumption basket.

Policy implications of a sectoral recession

Two recent papers analyse in a formal model the sectoral nature of the Covid-19 recession One, Guerrieri et al. (2020) considers the pandemic crisis to be a supply shock. The authors' main insight is that "a 50% shock that hits all sectors is not the same as a 100% shock that hits half the economy."

The conclusion associated with the sectoral nature of the shock has several implications for policy. One is that standard fiscal stimulus becomes less effective than usual because the sectoral shutdown mutes the Keynesian multiplier feedback.

Another recent contribution argues that Covid-19 should not be considered only as a sectoral supply shock (because of government-ordered social distancing measures), but also as a sectoral demand shock as households and firms voluntarily reduce demand for travel, tourism and other contact-intensive services. Farhi and Baqaee (2020) study supply and demand shocks in a general disaggregated model across multiple sectors. A major element in their approach is the input-output linkages across sectors that propagate these sectoral shocks (both demand and supply) to the entire economy.

Their major finding is that "aggregate demand stimulus is only about a third as effective as in a typical recession". This finding applies to both fiscal and monetary policy. The authors also argue that "More targeted forms of demand stimulus deliver better bang for the buck."

An example can illustrate this proposition.[5] Consider a person who wants to buy new sports equipment or clothes to use in a gym or on holiday abroad. Normally, a higher income would

[5] The extreme example made by Keynes is that of shoes: if today only right-foot shoes are available consumers will not buy them; they would rather wait until both right and left shoes are available again as pairs. For this reason, interest rates will not have a big impact on consumption decisions.

make it more likely that the entire consumption basket (vacation and sports equipment) is bought today. But if today, due to the pandemic, foreign travel is impossible and gyms are closed, the sports equipment and clothes will not be bought. Higher cash transfers would probably just lead to more savings. The counterpart to higher government deficits (over and above those needed to provide substitute incomes) would thus lead mainly to higher savings – as one could observe this summer.

The observation that aggregate demand stimulus becomes less efficient in a sectoral recession implies that one should not judge deficits by the metrics used during normal recessions; namely by relating the deficit to the output gap or the unemployment rate. Both metrics are misleading in the current circumstances. Any remaining fiscal space should be used to support adjustment and new jobs, rather than to try to fill the bank accounts of households with transfers they are likely to save. Authors Coibon et al. (2020) find that US consumers saved most of the transfers distributed under the US CARES Act.[6]

The Recovery and Resilience Fund

The RRF represents a key step towards European solidarity and provides a new source of European safe assets. Although it has not yet been implemented, it has already had an impact on financial markets, including lower risk premia for some countries and a stronger demand for euro assets from the rest of the world.

An economic evaluation of the direct impact of the RRF must start from a simple, but fundamental proposition: money is fungible. This applies in several dimensions.

Money is fungible over time

Most of the funds from the RRF will be disbursed only after 2021, i.e. after the crisis, has (hopefully) been overcome. However, it would be a mistake to conclude from this delayed disbursement that the RRF has been irrelevant during this year's crisis.

First of all, the announcement of the agreement reached at the marathon European Council in July already further stabilised markets and ensured continuing market access, even for high-debt countries. Earlier forceful action by the ECB in March and April prevented the emergence of a liquidity and financial crisis. But some risk spreads remained relatively elevated. After the agreement on the RRF, market access further improved and borrowing costs for the peripheral countries fell. Borrowing costs are now very favourable with, for example, Italian 10-year rates at around 1%; which does not constitute an all-time low but is lower than in January of 2020. Similarly, Spanish 10-year yields are now below 0.4 %, lower than they were at the start of the year.

[6] Coibion et al. (2020), "How US consumers use their stimulus payments", vox.eu, 8 September.

The combination of market access at favourable rates and the knowledge that the RRF financing will arrive in a few years allows member countries to shift some spending towards today because the future reductions in national spending can be offset by EU funds.

With market access ensured for all, there is also little need to accelerate payments. From a political point of view, it might be desirable to show that EU funds can arrive quickly. From an economic point of view, however, it matters little whether the EU funds are disbursed one year earlier or later. This 'economic' view is based on the understanding that national spending will be reduced when the Next Generation EU (NGEU) funds are being disbursed. If this is not the case, there is a risk that the NGEU package might become de facto pro-cyclical.

Money is fungible across sectors

The financing provided by the RRF will be provided for projects that will be screened by the Commission and that should fit the overall aim of the RRF: to foster a sustainable and digital recovery.

Here again one finds a contrast between the political and the economic logic. Member states are likely to present their best projects for financing under the RRF for the simple reason that this will ensure that they can qualify for the funds, and more quickly than if they were to present low-quality projects. Once the financing of these high-value projects has been ensured by the RRF, member states can use the fiscal space that has been liberated according to their own priorities.

This fungibility of international financial support is not specific to the RRF, or EU funds in general. A generally accepted maxim in the context of development aid is that

'Aid does not pay for the item it is accounted for but for the marginal expenditure it makes possible.'

This maxim applies to the RRF as well. Fungibility does not imply that the RRF is worthless, but that its overall macroeconomic benefits cannot be measured by the quality of the projects on which the funds are spent; rather the additional fiscal space it creates for highly indebted member states and the reforms that are implemented because of the overall conditionality of the RFF. It is this latter element that will be decisive for the ultimate success of the RRF.

Again, this insight is not specific to the RFF or EU programmes. As Dollar and Prichett (1998) put it:

*"*Aid is financing the entire public sector, and the overall quality of policies and institutions is the key to securing a large return from this finance*."*

In its Q&A on the RRF the Commission emphasises both investment projects and reform plans:

> To access the facility, Member States should prepare recovery and resilience plans setting out their reform and investment agendas for the subsequent four years, until

2024. These plans should comprise both reforms and public investment projects through a coherent package.

The arguments presented here underpin the view that the reforms are the key elements; effective structural reforms constitute a condition *sine qua non* for the success of the RRF.

How to green the RRF

Member states will have proposed their own projects and plans for how to spend the grants and loans from the RRF. In principle, at least 30% should be devoted to 'climate'. But how can one ensure value added, hopefully European value added, from the RFF financing? Here again, one needs to distinguish between appearances and economic logic.

The EU's current climate goals are largely based on numerical targets. The most prominent example is the Emissions Trading Scheme (ETS) with its cap on emissions, enforced via a carbon price, based on EU-wide demand for the limited allowed emissions. With the existing cap on emissions, EU spending on sectors covered by ETS (renewables, industry) just lowers the price of ETS emission certificates.

In other sectors (e.g. cars, energy-efficient building, etc.) there are already a variety of national and EU targets. In these sectors spending the RRF package will only relieve governments and/or the private sector of their obligations. The same logic applies to other parts of the green agenda, such as the circular economy.

The overall conclusion is that hundreds of billions of euro of green spending under the RFF risks leading to a result (in terms of emissions or recycling) no better than already planned before Covid, unless green targets (emissions, standards for automobiles, recycling, etc.) are tightened at the same time.

The principle that funds are fungible applies only if markets work, of course. This means that there are areas where the RRF can yield European value added. One important area where markets work only imperfectly is networks, for example power transmission or telecommunication.[7] Targeted investment in stronger networks, especially measures that strengthen the connection between the national networks, could yield a high European value added. What is needed in the area of networks is not only funding, but different structures. The power (and telecommunication) networks are still supervised by national authorities, which have a tendency to protect their domestic operators. The dispersion of renewable energy sources across Europe would in principle yield large benefits in ensuring against the intermittency of both sun and wind. But this would require a much larger degree of integration

[7] Another classic case where European value added is possible concerns areas (like low carbon steel, cement) where totally new production methods are needed. In this case, EU financing for development, pilot testing, and industry scale demonstration might be useful to prepare for large-scale deployment to bring costs down (as happened for renewables and EVs).

of the power networks, which are still operated and supervised on the basis of national energy policy goals.

The most important drawback of the RRF is that it is not focused on those areas where European value added could be the greatest.

Conclusions

It is often said that generals fight the last war. Today, European policymakers are trying to avoid the mistakes of the last crisis period. This has been the right approach so far. Action by the ECB has been instrumental in preventing another 'euro crisis'. The large package of EU-funded grants for member states in difficulty approved under the NGEU package in July of this year represents an important step towards European solidarity and a mobilisation of common fiscal resources.

But there remains one 'lesson learnt' that might not be applicable today. This is that the government must step in when private demand is too weak. This general rule seems appropriate in a 'normal' recession when demand weakens because of a tightening of financial condition or some other macroeconomic shock. But, 'this time is different'.

The Covid-19 recession (and the recovery) is different because it is the result of very sector-specific demand and supply disturbances. The key differentiating point is the sectoral specificity, not the demand or supply nature of the disturbance. Aggregate supply shocks are known to be 'stagflationary', i.e. they should depress output while inflation increases. This is not the case today. Aggregate demand shocks are deflationary, i.e. both output and inflation fall. An easing of fiscal policy is entirely appropriate in this case. However, attempts to stimulate aggregate demand cannot return the economy to full employment if several sectors are subject to both negative demand and supply shocks.

Aggregate demand management is thus likely to be less effective today in speeding up the recovery. Faced with this situation, those overseeing fiscal policy have two options: one reaction would be, given the lower effectiveness of these instruments, to increase the dose (even higher deficits until the output gap is closed). Another reaction would be to rein in deficits until more normal times return. The choice between these two reactions must depend on the cost of public debt. If one considers debt as free because interest rates are zero, a strategy of 'doubling the dose' would seem appropriate. This might be feasible for countries with low starting debt levels. But experience shows that after a certain level debt is no longer free because risk premia increase. This would suggest that high debt countries should be more prudent.

The RRF represents a fundamental advance in European integration. Its great political value should, however, not lead one to neglect some fundamental economic relations. Ultimately, the value of the RRF will not be the specific projects it finances, but the extent to which it fosters structural reforms.

A similar observation applies to the concept of a 'green recovery'. The benefit for the climate should not be measured by the emissions avoided through the projects financed by the RRF, but by the reduction in overall EU-wide emissions that can be achieved over the next decade. The latter requires more ambitious climate targets, not just the generous financing of green projects for a few years.

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Appendix: Econometric results, Oxford University Index

Dependent Variable: Fall in GDP Q22020/Q22019

Method: Least Squares Sample: 1 27,

Included observations: 19

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.0005	0.0006	0.746	0.4665
TOURISM	-0.989	0.48	-2.073	0.0547
STRINGENCY	-0.233	0.0466	-4.997	0.0001

R-squared	0.96	Mean dependent var	-0.007
Adjusted R-squared	0.95	S.D. dependent var	0.01
S.E. of regression	0.0022	Akaike info criterion	-9.2
Sum squared resid	7.84E-05	Schwarz criterion	-9.1
Log likelihood	90.8	Hannan-Quinn criter.	-9.2
F-statistic	190.9	Durbin-Watson stat	3.24
Prob(F-statistic)	0.000000		

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