Eurozone: Bridging the economic fallout

As the economic impact of the coronavirus has become greater among eurozone economies, the focus has turned to policy makers and their responses. What are the policy options and what has already been done?

ECB headquarters, Frankfurt

The economic consequences of Covid-19 manifest themselves as both supply and demand shocks, now aggravated through a negative feedback loop from the latest market turmoil. This makes it an unprecedented and very tough to respond to situation. Currently Covid-19 affects the economy through five broad channels:

- Direct economic impact of prevention measures
- Indirect effect through supply chains
- Economic impact of change in behavior of consumers and businesses
- Indirect effect through sick leave, remote working and downsizing of operations
- Financial market effects

Policy makers have to respond. There is not all that much that can be done to adequately counter the short-term effects of supply and demand loss. Incentivizing people and businesses to spend and invest more is very difficult when the main goal of policy, businesses and people is to curtail or avoid the virus. Even though there are no guarantees about the period of time over which the virus will negatively impact the economy expectations are that this will be limited, after which growth will resume. Policy measures taken will therefore mainly concern bridging the period of output loss so that an otherwise healthy economy will not experience more lasting effects.

What can be done?

Both fiscal and monetary policy can help bridge the economic fallout, but the menu of options for fiscal policy seems somewhat broader. First of all, governments can help by reducing labour costs for businesses when output is temporarily reduced. *Kurzarbeit* measures, which countries like Germany successfully employed in the aftermath of the 2008 crisis, reduce the amount of working hours with subsidized pay to make up for workers' lost income. Another way of helping businesses through a sudden period of economic fallout is through state guarantees for businesses to help combat liquidity problems that arise from sudden loss of revenue and could otherwise lead to bankruptcy. In the current crisis, the sectors to be hit first are tourism, leisure and (sport) event organisers.

Stimulating demand in times of an external shock is tough and will likely mainly help the recovery after the maineconomic fallout has ended. It can nevertheless be useful to help create a v-shaped return to growth. Also, think of employees working in service industries who will not be (fully) paid due to a sudden fall in their employer’s revenues. Here, any demand-side support would be more than welcome. These might include government investments or more targeted measures such as temporary VAT decreases. These measures are sometimes difficult to decide on politically and there is also a time lag for the stimulus to materialize. If indeed the idea is to counter a short-lived shock this will mainly help in the aftermath. This is not unimportant: it also serves as an important sign of confidence for financial markets.

From a monetary perspective, a conventional rate cut would help lower financing costs somewhat. The conventional stimulus expected from lower rates is unlikely to materialize as the problem lies outside the economic realm. Monetary policy can also help bridge the period of output loss, though, as it can stimulate banks to provide bridge loans to businesses. More QE on the corporate sector side would also make loans for large corporates cheaper and on the public sector side it would keep borrowing affordable for sovereigns. Lower rates for TLTROs would help the banking sector to continue to provide enough liquidity. In addition, and in order to avoid a market meltdown which eventually could turn into a credit crunch, clear communication, determination and commitment can confirm the central bank’s role as lender of last resort.

What has been done so far?

On the monetary side, the ECB has decided on a range of options as their initial crisis-fighting measures. The option of a deposit rate cut has been left out and measures have been more targeted and small - aiming at specific economic fallout. These measures include LTROs aimed at providing liquidity to SMEs, a dual-rate with TLTROs available at a lower rate than the deposit rate for banks that keep their lending portfolios stable and making another 120 billion euro available for asset purchases. It has also decided on temporarily lower capital requirements for banks. This is a package that is mainly aimed at supporting the banking sector to keep a credit crunch scenario at bay. However, market reaction during and after the ECB’s press conference shows how important good communication and demonstrated a willingness to act can be.

No coordinated fiscal measures for the eurozone have been announced just yet. On Monday the

Eurogroup will come together to further discuss the eurozone's fiscal approach to the economic fallout from the coronavirus, something that ECB president Lagarde considered to have upmost priority in the current situation: "it's fiscal first and foremost". Individual countries have already taken that to heart and have implemented a range of measures.

The largest package that has been announced so far has been – as is to be expected – by Italy. Italy will make up to 25 billion euro available as an emergency fund, with around 12 billion expected to be used for immediate healthcare spending, bridge loans for SMEs, postponement of tax duties and broader job protection. In Germany, investments will be increased by 3.1bn euro per year, something which has a negligible macroeconomic impact given that this is less than 0.1% of GDP. Most other countries haven't announced spending plans yet, although Ireland has a one-time package of 3.1bn euro announced, a more sizable economic injection per capita than in Germany and Italy.

In France, Spain, Netherlands and Belgium no spending plans have been announced so far. Measures taken mainly focus on tax relief in countries like France. The Netherlands and Germany have employed *Kurzarbeit* measures. Most countries are providing some form of liquidity support for companies that help bridge the period of output loss. As this is a fast-moving environment many governments have already suggested that more measures will come.

> This means that the measures taken so far in the eurozone have been mainly targeted at the specific issue at hand, both by the ECB and by governments. If indeed more blanket measures like a deposit rate cut and broader fiscal spending are to be employed likely depends on how the virus develops and how deep the economic fallout will be.

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