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Wilfried Martens Centre for European Studies

"Flexibility without Limits": The Political Economy Implications of the Coronavirus

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The Coronavirus (COVID-19) is continuing to spread quickly around the world. It is a highly transmissible virus which impacts disproportionally on older age cohorts. Large gaps in our understanding remain, particularly with regard to the possible extent of undiagnosed cases and whether the virus will naturally reduce in Europe as the spring develops. However, as of March 16th, over 170,000 global cases have been confirmed with over 6,500 deaths. All European countries are now preparing for large increases in the number of affected people requiring treatment and hospital care. On March 11th, COVID-19 was declared a global pandemic by the World Health Organisation.

Understandably, much of the current commentary on the virus still focusses on the fluid situation regarding the number of infections, the mortality rate and the differing containment measures enacted by varying states. The level of societal unease at the implications of the virus – restricted activities span all aspects of daily life from cinemas to cafes, from schools to universities and businesses – is currently dominating the media discourse. Such a focus reflects the overwhelming priority of all societies to protect human health where possible.

Immediate Impacts will be severe and wide ranging

However, from an economic perspective it is important to look past the short-term fluctuations (in societal behaviour, in the stock market or general business sentiment) if we really want to gain an understanding of the longer term economic and political implications for Europe.

Based on the experience of China (and to a lesser extent South Korea and Italy) it is clear that wide-spread and prolonged containment measures are re-quired to combat very high transmission levels.

However, such measures are accompanied by a rapid deterioration in economic fundamentals. For example, regarding China, the IMF estimates that while "*the drop in manufacturing is comparable to the start of the global financial crisis, the decline in ser-vices appears larger this time – reflecting the large impact of social distancing*".

The index of Chinese manufacturing and non-manufacturing economic activity declined by 14% and 25% respectively in February 2020 alone. More recent data highlights a much more significant impact on the Chinese economy than previously anticipated. In Italy, partial data relating to the second weekend of forced closing highlight a 96% decline in revenue for clothing/fashion enterprises and a 70-80% drop for bars and restaurants throughout Italy. Even before the implementation of restrictive measures in Belgium, hotel bookings in Brussels had declined by 70%.

It should be noted that in late 2019, before the COVID19 outbreak, major economies in Europe were already experiencing a softening of economic performance. Italy's economic forecasts, among other EU member states, was already downgraded by the European Commission in early 2020 to only 0.3% growth. During this initial phase of COVID19 the governmental response is focused on containment and trying to delay a surge in positive cases overwhelming social services.

This is turn implies significant and immediate additional public spending in areas such as healthcare and policing. Further expenditures will be required in providing social security and other supports to workers on sick leave, small business owners or those unable to work owing to the nature of their employment. In addition, the cancellation of flights, events, business and leisure travel, sports and even parliamentary business is simultaneously occurring.

This ensures that the negative economic impact is **both** from the supply and demand side. A **much more serious scenario** than occurred over the decade of economic and financial crisis beginning in 2008.

Longer Term Scenarios indicate significant economic disruption

Given the experience of the past few months (and of the past three weeks in Europe) it is possible to categorise two possible scenarios as likely to occur.

- ***Scenario 1****: Short term global impact followed by quick recovery.* Under this hopeful scenario the containment measures instituted in Italy and other countries are successful in largely containing the virus. This, added to the introduction of preventative measures in other states not so seriously affected, will bring the virus under control by the end of Q2 (June), 2020. However, even under this scenario the outlook for global growth has reduced significantly compared to pre-COVID19 forecasts. For example, January forecasts of global growth of 3.5% in 2020 have already been reduced to under 2.5% with further revisions downward (to well under 2.0%) likely in the coming days.

  Scenario 2: *Longer term economic impacts arising from a more generalised pandemic*. This scenario is predicated on a wider, less restricted spread of COVID19 to most major economies. Supply and demand side shocks will last until Q3/Q4, 2020 with severe stress (even partial collapse) evident in key social services in states with weaker social service provision. Under this scenario global growth will turn negative for the current year, possibly falling as low as -1.5% to -3%.

  To put this in context, annual global growth remained positive (in excess of 2.5%) during the Economic Crises of the 2008-15 period. Many analysts feel that a global recession, such as envisaged in this scenario, is now in-evitable.

Risk of Contagion poses the more significant long-term risk

Apart from the direct economic costs associated with higher government spending (and reduced revenues) it is the wider risk of contagion to other parts of the economy that poses the much more significant long-term risk. Although it is too early to model the secondary effects of COVID19 on wider global supply chains, the serious outbreak centred in Italy will likely pose longer term questions regarding the stability of the Italian banking system and, by extension, the wider Eurozone.

Should Scenario 2 come to fruition in the coming months and the Italian government is forced to respond with more prolonged financial support, the possibility of greater financial market instability increases significantly. As noted, even before COVID19 was identified in China, the Italian economy was characterised by a high proportion of non-performing loans on its banks balance sheets, high public debt, low growth and very limited recent reform of its economic structures. Italy and the Eurozone remain highly vulnerable to further financial market speculation.

The longer the virus continues to spread the greater the impact of secondary economic contagion. The financial markets will soon – if not already – be largely driven by the "*economics of fear*" as noted recently be economist Mohamed A. El-Erian.

Economic Responses

Five key points are relevant here:

1. **More Financial Support will be Required**

   The financial alleviation measures already announced in many countries (including Italy, Ireland, Britain and the United States) and by international organisations (European Commission, IMF, World Bank) **will not be sufficient** to counter the slowdown in economic activity arising from COVID-19.

Further, significantly greater, financial support will be required. Italy's financial support package has risen from 4 billion euros to 25 billion euros in just over a week. That equates to a rise from 0.2% of GDP to ap-proximately 1.3% of GDP. This figure will in-crease dramatically in coming days.

These expanded national financial packages should be supported and, where possible, coordinated with the EU level policies al-ready announced. Further economic policy coordination should be undertaken at global level between the EU, IMF, World Bank and all major global economies.

2. **Fiscal Policy must shoulder the burden and be coordinated with Monetary Actions**

There is little more that monetary policy and central banks can do to support growth apart from ensuring ample liquidity in the markets and ensuring demand in the sovereign bond market. The monetary arsenal is practically empty. Within Europe, the primary sources of support will need to be fiscal coming primarily from member state, but also from, EU resources.

The nervous market reaction to the ECB's package of measures announced on March 12th highlights the fragility of the global financial landscape. Christine Lagarde's call for a close system of monetary and fiscal policy coordination should be embraced.

The ECB must also coordinate policy actions with other global central banks. A continuation of the ECB's accommodative stance in the coming weeks will be vital in maintaining banking stability and in ensuring the liquidity of the banking sector and the workings of the broader financial markets. The ECB's actions should be supported clearly at a political level.

3. **Rapid and Significant Fiscal Loosening is Required at National Level**

The financial proposal by *Bruegel* for social security contributions to be reduced by 50% for three months equates to about 2.5% of Europe's GDP (to be funded by larger budget deficits). In this context, and assuming the generalised pandemic scenario, total direct financial support costs (including increased expenditure on health and other economic areas) in Europe will likely exceed 6% to 8% of GDP in six months or less. Potentially, this financial cost could be increased significantly if support measures are required for the wider economy to prevent a rapid rise in un-employment.

The general thrust of these types of measures should be supported but need not be overly prescriptive at a European level. State level supports – be they tax holidays, cash payments to small businesses or social security reductions – are best formulated at national level to take account of specific local conditions and priorities.

4. **"Flexibility without Limits" at European Level is required**

The "*whatever it takes*" mantra of the ECB evident during financial crisis should now be applied to Europe's fiscal response to the COVID-19 regardless of short-term budgetary implications. This approach (as sup-ported by Bruegel) should form part of the more generalised, rapid and coordinated fiscal response highlighted in points 1 and 2 above.

Both points 3 and 4 should be explicitly sup-ported at EU level by acknowledging that the additional spending required to combat COVID-19 are permitted under existing Eurozone budget rules to counter *"unusual events outside of the control of government"* This fact should be widely communicated to the financial markets and form the basis of national level fiscal policy over the coming weeks.

Based on experience of other global eco-nomic crises, **the COVID-19 shock to the economy will be longer and deeper than is currently anticipated.**

5. Eurozone Reform: Doing nothing is no longer an option

Although it is very easy to become embroiled in the technical details of the short-term eco-nomic impacts, it is important to remember that COVID-19 represents a short-term eco-nomic shock. But when the market and investor volatility work its way out of the financial system in the coming months serious questions will be asked of the future of the Eurozone given the scale of the additional spending undertaken.

In this context, it is very important that discussions begin immediately on reforming the economic governance of the Eurozone. While issues such as completing Banking Union must be included as part of this work, much more fundamental issues relating to how the Eurozone is constructed and governed must also be discussed.

Eurozone reform ground to a halt in 2014. The impetus and sense of urgency arising from the Greek crises was quickly lost. The COVID-19 crisis provides the EU with an-other opportunity (possibly the last) to claim leadership of the Eurozone reform debate. Given the seriousness of the economic situation, doing nothing is no longer an option.

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