

EUROPE: FISCAL POLICY IN ACTION

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The Covid-19 shock has triggered a significant fiscal policy response by European Union member states. Even though it is likely to be short-lived, the 2020 recession will be historic. The fiscal response has therefore been essential in avoiding much more serious and longer-lasting economic consequences. Member states have not all been affected in the same way by the current crisis, and the scale of their fiscal responses varies. The European response has been one of the few positive aspects of the crisis. However, the challenges are not yet over. Levels of risk and uncertainty on both the public health and economic fronts will remain particularly high over the next few months. An agreement on a European recovery programme is therefore needed and there is little likelihood of any letting up in national efforts.

The Covid-19 crisis is an unprecedented shock for the global economy and the eurozone economy. The latter avoided recession in 2019 and there were some signs of a stabilisation of economic activity towards the end of the year. The Covid-19 pandemic has put an end to the expansionary phase in the eurozone, which is likely to suffer the deepest recession in its brief history during 2020.

Since mid-March 2020, the European Central Bank (ECB) has adopted a particularly proactive and flexible monetary policy in order to avoid a tightening of lending conditions and mitigate the risk of financial fragmentation within the eurozone. This very substantial monetary response has provided the breathing room needed for calm consideration of the fiscal stimulus package needed. After a bit of turbulence, sovereign spreads between member states (that is to say the interest rate differentials on the government debt issued by individual countries) seem to have come back under control despite the sharp expected rise in government debt this year.

The eurozone economies have made significant use of fiscal measures to support various economic agents (households, companies, the healthcare sector) during the crisis. A substantial (and long hoped for) response at the European level has backed up national fiscal measures. This range of support packages was necessary to protect production capacity and thus ensure the best possible conditions for an economic recovery from the crisis. What is the nature of the fiscal response in the different member states? Is the scale of national fiscal stimulus plans comparable and adequate in the light of the lessons of the past and the likely economic consequences of the pandemic? Is the coordinated European response, which seems to break established taboos, appropriate? This article will endeavour to go some way to answering these questions.

An unprecedented economic shock

The public health measures put in place to tackle the epidemic will have significant consequences for eurozone economies through both supply and demand channels and in increased uncertainty. According to certain estimates, lockdown measures will lead to an instantaneous contraction in economic activity of some 30% relative to a normal situation (i.e. without lockdown).

The most recent economic data give initial indications of the scale of the economic effects caused by the pandemic shock. The current crisis and public health measures have, however, made the production of statistics more problematic. One should therefore remain cautious in their interpretation. In the 1st quarter of 2020, eurozone GDP fell by 3.6% compared to the fourth quarter of 2019 (quarter-on-quarter, q/q). Although the comparison between the economic performances of eurozone member states remains difficult, Germany appears to be holding up better than its major European partners. German GDP fell by

2.2% in Q1 2020, compared to falls of 5.3%, for example, in both France and Italy. The economic situation in the eurozone is likely to worsen significantly further in the 2nd quarter, given the length of time spent in lockdown. Although some initial signs of recovery are emerging, leading economic indicators are still sending particularly negative messages. The shape of any eurozone recovery in the 2nd half remains highly uncertain. The degree to which lost economic activity will be restored could be lower than expected. The ECB recently stressed that in the worst case scenario, real GDP could fall by 12% in 2020 and remain below its pre-crisis level for several years.

The latest European Commission (EC) forecasts suggest that eurozone real GDP will contract by 7.5% in 2020, before recovering in 2021. This is greater than the eurozone's economic contraction during the economic and financial crisis of 2008-2009. The current recession could however prove to be shorter-lived, in the absence of any crisis in the banking and financial sectors or a collapse in international trade, two features of the 2009 crisis.

All eurozone member states will see a marked contraction in GDP in 2020 (Figure 1). The size of this will vary from one country to the next and will depend in particular on public health measures (length and severity of the lockdown) adopted to tackle the epidemic and the nature of fiscal support.

REAL GDP GROWTH FORECASTS FOR 2020

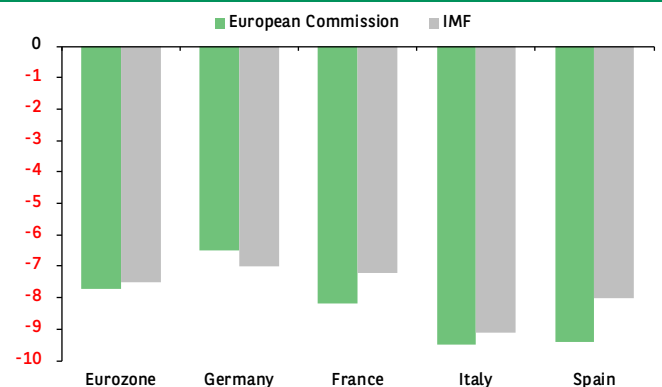


CHART 1

SOURCE: WEO IMF, EUROPEAN COMMISSION, BNP PARIBAS



Significant support at a national level

Swift fiscal response from member states

Faced with the shocks caused by the pandemic, eurozone member states reacted fairly quickly, and at a substantial scale, using fiscal measures. By acting as a macroeconomic stabiliser, the fiscal response of member states aims to maintain production capacity (reducing the risk of business failures and layoffs) in order to ensure a vigorous recovery from the crisis.

Governments have used three main fiscal instruments. First an immediate fiscal stimulus, which has taken the form of widespread use of short-time working schemes¹, payments of subsidies or the cancellation of tax or social security payments. Then, cash flow support for companies and households through deferrals of tax or social security payments. Lastly, provision of liquidity support, most notably in guarantees for loans to companies.

All of these measures, of whatever type, provide support to economic activity in the eurozone. That said, not all measures have the same effect on the public finances.

In this article, we will draw the distinction between 'direct' measures, that have an immediate fiscal impact, and 'indirect' measures, such as those used to underpin liquidity. This distinction has been used by most international organisations in their recent work on the effects of the crisis on GDP and public finances in the eurozone. Financing of short-time working measures represents an immediate government outlay. Meanwhile, in the case of a government guaranteed loan, for example, government debt will only be affected if the guarantee is triggered, that is to say if the borrowing company cannot meet its obligations.

Of the direct measures, one of the flagship policies adopted by nearly all member states, has been the use of short-time working ('chômage partiel' in France or 'Kurzarbeit' in Germany). These programmes are relevant in the current context² and their introduction draws on recent historical precedent. In the major recession of 2008-2009, Germany, in particular, made substantial use of this job protection approach. Although German GDP fell by 5.6% in 2009, employment proved resilient, and the German unemployment rate remained under control. France, which made less use of short-time working schemes, suffered a lasting increase in unemployment, despite a shallower recession. It should be noted that although a number of eurozone countries – including Germany, France, Italy, Spain and Belgium – have introduced short-time working measures, the details of the scheme vary from one to the next.

The use of fiscal tools varies in scale between eurozone members, and the types of tools used also vary (direct and indirect measures)³.

Overall, direct measures have made up the smaller part of the fiscal support provided by the major member states to their economies (Figure 2). Over and above short-time working, eurozone economies have most notably provided support to small and mid-sized companies, through direct transfers, and to the self-employed. There have also been increases in public healthcare spending, including the purchase of medical equipment. In contrast, the US and Japan appear to have focused more on direct measures. In Japan, the steps taken included most notably the direct distribution of cash to the households hit hardest by the health crisis. Germany and Italy, meanwhile,

FISCAL RESPONSES (% OF NATIONAL GDP)

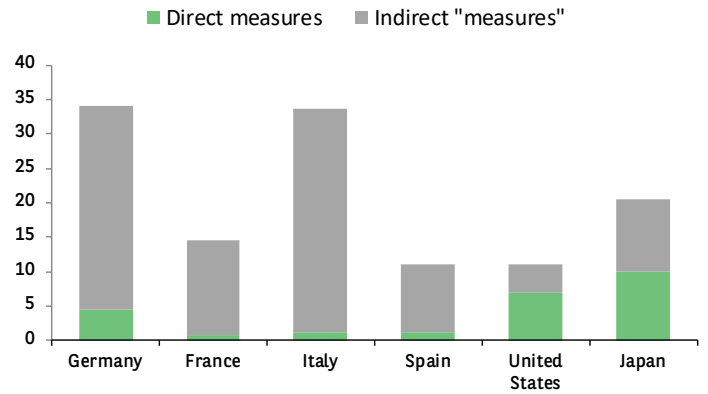


CHART 2

SOURCE: IMF FISCAL MONITOR APRIL 2020

Note: The measures identified here were taken from the latest edition of the IMF Fiscal Monitor. Only measures introduced prior to 6 April are included.

FISCAL RESPONSE AND 2020 GROWTH

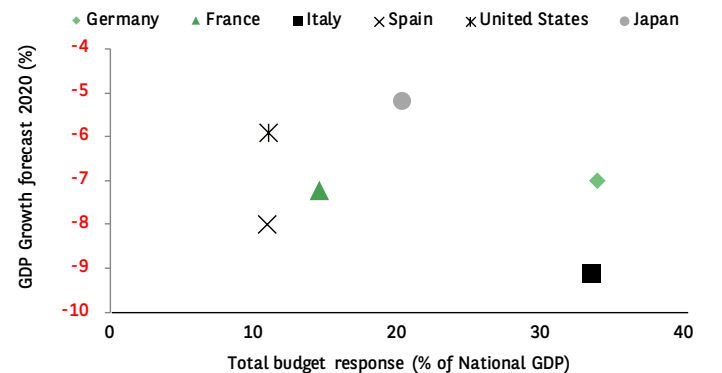


CHART 3

SOURCE: IMF, WEO AND FISCAL MONITOR

have introduced massive government guarantees to limit the risk to refinancing of private non-financial companies.

In order to offset the loss of activity resulting from public health measures (it is worth remembering that this loss is estimated at around 30% relative to normal circumstances), fiscal support should in theory be proportional to the loss. This might lead one to the conclusion that the countries hit hardest economically would see a higher level of government support than those less affected. However, when looking at all the fiscal measures brought forward (both direct and indirect), this is not necessarily what we find. Both Germany and Japan, for example, have adopted more substantial fiscal measures than Spain, even though the latter will suffer a greater economic shock.

¹ Short-time working schemes enable companies facing economic difficulties to reduce the number of hours worked by their employees. Employees receive payments that may be fully funded by the government.
² C. Berson et al., L'activité partielle, un outil précieux en temps de crise. (Short-time working, a valuable tool in a crisis) Bloc-notes Eco, Banque de France, April 2020
³ The classification of a measure by type depends on methodological choices and can therefore vary between analyses. For example, some analyses might treat a proportion of deferred tax payments as a cancellation, and therefore a direct expense, whilst others may treat it as a deferral. Moreover, since this article was written additional fiscal measures have been announced by euro zone governments.

Rapid fiscal expansion in 2020

According to the latest forecasts from the European Commission⁴, the aggregate government deficit in the eurozone is likely to increase significantly, from 0.6% of GDP in 2019 to 8.5% of GDP in 2020. The budget balance in the eurozone has been improving steadily since the sovereign debt crisis of 2010-2011; indeed the primary budget balance (that is to say before interest payments) has been in surplus since 2014.

The trend in government deficits in the eurozone in 2020 reflects the interplay of the automatic stabilisers and the direct fiscal measures taken by governments, as discussed in the preceding section. The deficit is essentially affected by changes in public spending. The ratio of public spending to GDP will go up significantly, rising by 8 points of GDP (to 55.2% of GDP) under the effect of the discretionary measures introduced and the contraction of nominal GDP. Social security benefits (in cash) will rise sharply (particularly as a result of short-time working schemes), as will public sector consumption and subsidies. Public sector investment will increase only slightly. The revenue ratio (taxes and social contributions over GDP) will be more or less stable.

Given the steeper decline in economic activity than during the 2008-2009 crisis, the increase in the ratio of public spending to GDP is likely to be greater. This observation holds true in the eurozone (8.1pp increase in the ratio in 2020, compared to 4.1pp in 2009), but also in individual member states including Italy (10.4pp compared to 3.3pp), Germany (8.8pp compared to 4.0pp) and to a lesser extent France (7.2pp compared to 3.9pp).

The eurozone's fiscal policy will be highly expansionary in 2020. Changes in the structural primary balance (corrected for interest payments), or primary structural adjustment (see box), is a measure that is often used to determine the direction of fiscal policy. The primary structural adjustment in the eurozone in 2020 will be -3.25 percentage points of potential GDP according to the European Commission.

This fiscal expansion is very noticeable in comparison to past patterns, and is shared across most eurozone member states. The easing of fiscal policy in Germany and Italy will be particularly sizeable in 2020. These two countries generally run a structural primary surplus, which is therefore likely to narrow significantly, at least temporarily.

Budget balance, structural balance and structural adjustment

The budget balance of governments corresponds to the difference between government revenues and spending. The budget balance consists of a cyclical element (cyclical balance) and an underlying or structural element (structural balance).

Changes in the cyclical balance are affected by cyclical factors, and are generally calculated with reference to the economy's position in the economic cycle (output gap). The structural balance can thus be obtained by removing the cyclical balance from the total balance.

In the context of this article, it is the structural component of the government budget balance that interests us the most. More precisely, the issue is the change in the structural balance, or structural adjustment, which is crucial as it defines the direction of fiscal policy (expansionary or not).

The change in the structural balance consists of a discretionary component (structural effort) and a non-discretionary component:

1. The structural effort (or discretionary component) in turn consists of a revenue effort and a spending effort. The revenue effort is estimated on the basis of new revenue-raising measures (taxes and social security contributions) introduced by governments. The spending effort compares the effective change in public spending relative to a 'counterfactual' baseline. Frequently, the potential growth line is used to provide the baseline. The spending effort thus depends on the growth differential between government spending and potential growth. If government spending grows faster than potential GDP, the public finances will deteriorate.

2. The non-discretionary component includes other government, i.e. excluding taxes and social contributions (dividends for example), together with the effects of the elasticity of the tax take to GDP.

EUROZONE: BUDGET BALANCE AND PRIMARY BUDGET BALANCE (% OF GDP)

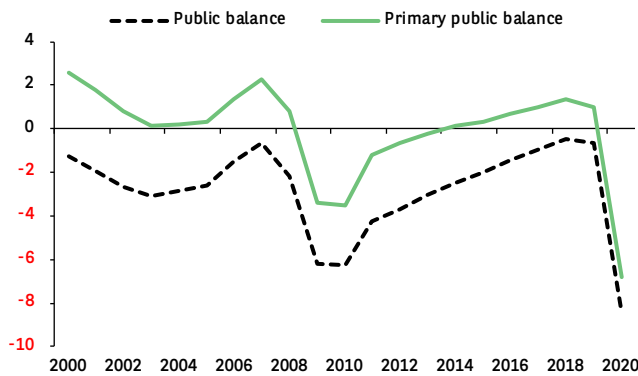


CHART 4

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

⁴ European Economic Forecast, Spring 2020, European Commission, May 2020

EUROZONE: PUBLIC SPENDING TO GDP RATIO AND CONTRIBUTIONS

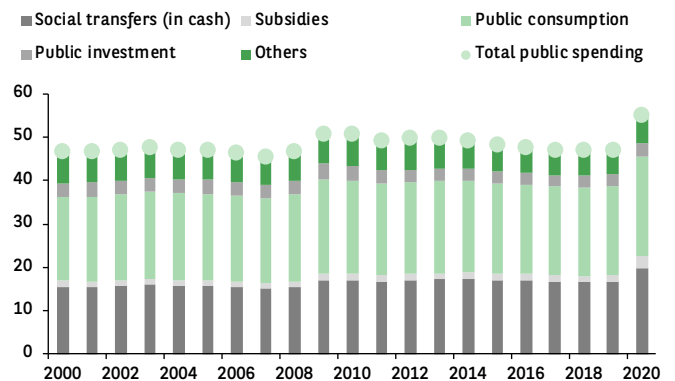


CHART 5

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS



CHANGE IN STRUCTURAL PRIMARY BALANCE (IN POINTS OF POTENTIAL GDP)

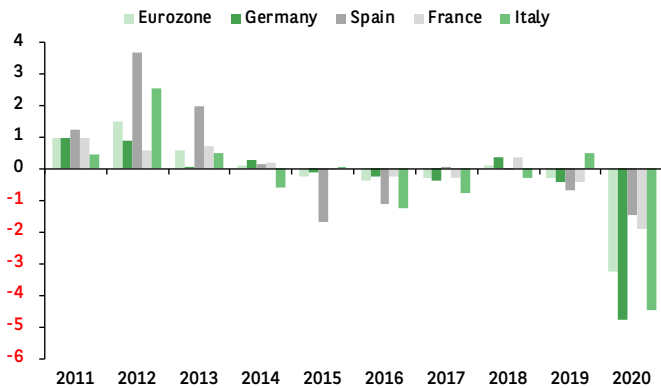


CHART 6

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

Government measures backed by a long-awaited European response

An encouraging initial response

Europe seems to have taken a more proactive and countercyclical stance than it has in the past. Constrained too tightly by European fiscal rules during previous crises, member states' public finances were not able to play their full role in macroeconomic stabilisation. Following the sovereign debt crisis, for example, the fiscal policies of several countries, in particular those limited by the Stability and Growth Pact (SGP), were restrictive with regard to their still negative economic positions⁵. Excessively swift fiscal tightening had a lasting negative effect on growth trends and limited the regaining of lost ground. This situation is likely to be avoided following the Covid-19 crisis.

The European response to the current crisis thus marks a degree of progress. First, fiscal rules have been relaxed. Finance Ministers and the European Commission (EC) have agreed that the conditions of the General Escape Clause have been met. This clause allows the waiver of certain limits set by the preventative and corrective arms⁶ of the SGP in the event, most notably, of a severe economic downturn in the EU or the eurozone. This more flexible approach to European fiscal rules was a necessity given the economic shock caused by the pandemic. Public debt is expected to increase significantly (it is likely to hit 102.7% of GDP in the eurozone in 2020, from 86% in 2019), but the short-term risks of an increase in long-term yields and a widening of spreads against the German Bund have been mitigated by the massive response provided by the European Central Bank (ECB). Following hard on the heels of the triggering of the General Escape Clause, a proposal for EUR32 billion in investment (under the EU budget) to help tackle the economic consequences of the pandemic was approved by the

5 A. Bénassy-Quéré et al., Which fiscal union for the euro areas?, Conseil d'Analyse Economique, February 2016

6 The preventative section of the SGP relates to the path of the structural budget deficit (Medium-Term Objective or MTO), whilst the corrective arm provides for the measures to be taken if target levels for government debt and deficit are exceeded (60% of GDP and 3% of GDP respectively).

7 These measures have since been approved by the European Council.

8 J. Creel et al., It seems like it's raining billions, OFCE Le Blog, April 2020

9 Council Regulation on the establishment of a European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) following the COVID-19 outbreak, European Commission, April 2020

10 F. Vandenbroucke et al., The European Commission's SURE initiative and euro area unemployment reinsurance, April 2020

European Parliament and introduced at the very beginning of April. This relatively small amount (0.2% of EU GDP in 2019) made the initial European response look somewhat timid. The Eurogroup meeting of eurozone finance ministers on 9 April provided some additional encouragement, suggesting several measures in response to the crisis.

Additional measures proposed by the Eurogroup⁷ to tackle the crisis amount to a package worth EUR540 billion (or around 4.5% of eurozone GDP). They include a range of approaches, but overall seek to focus on the consequences of the current crisis, in such a way as to avoid issues of moral hazard and thus the risk of a veto by certain member states. First, a budget line (Pandemic Crisis Support) has been activated under the European Stability Mechanism (ESM) framework, specifically allocated to the management of the Covid-19 crisis. This line, without strict conditionality – this is a key point – will total EUR240 billion (which for each country corresponds to 2% of GDP).

The effectiveness of this measure remains unclear and will depend on the take-up rates by member states for this credit line. Take-up will presumably increase as the interest rate differential between the market rate and the MES rate increases⁸. Using the MES facility becomes attractive for a government if this differential is positive. Loans made under this facility will have a maximum average maturity of 10 years, which might be explained by the fact that this credit line is explicitly linked to Covid-19.

Other noticeable proposals from the Eurogroup included the temporary introduction of the Support to mitigate Unemployment Risks in an Emergency (SURE) programme. This consists of financial support for the length of the crisis in the form of loans from the European Union to member states on favourable terms. These loans are intended to respond to the increase in unemployment and the use of short-time working measures and the related social transfers. The maximum total amount is around EUR100 billion, drawn from the EU budget. As indicated by the European Commission, this temporary measure can be considered as an emergency unemployment insurance mechanism in response to the current crisis⁹. It therefore represents an interesting move towards greater European solidarity. However, such progress does not excuse European leaders from considering a true supranational mechanism for automatic stabilisation¹⁰. The total of EUR100 billion allocated to the SURE programme is crucial. Although such a sum might appear sufficient to address the massive and brutal collapse of the labour market during the lockdown period, it might need to be increased once lockdown is over to ensure a strong recovery. An increase in unemployment over the coming months is inevitable.

Lastly, April's meeting of the Eurogroup strengthened the role of the European Investment Bank (EIB), through the creation of a pan-European facility to guarantee EUR200 billion of loans, particularly targeting SMEs. The collapse in demand addressed to certain companies, without necessarily creating solvency risks, has resulted in increased demand for liquidity, which cannot be met by banks, which are themselves under pressure. Supporting these businesses, and thus productive capacity, is essential for the economic recovery and potential output over the medium term.



European debt issuance: a remarkable step forward

After the agreement in principle reached by heads of state at the European Council meeting on 23 April 2020, the European Commission brought forward proposals concerning the Recovery Fund. This fund will receive EUR750 billion, a figure higher than that proposed by German Chancellor Angela Merkel and French President Emmanuel Macron. This represents a remarkable shift, going beyond the European budget, which does not take account of the economic situation. The launch of the fund is based on the issue of debt on the financial markets in the name of the European Union rather than any additional contribution from member states. This collective debt will have long maturities. The overall plan includes a substantial element of direct grants (EUR500 billion), equivalent to 3.5% of GDP in the EU27. These grants will be paid during the early years of the next EU budget cycle, from 2021 to 2024, and will not be repaid individually. The remaining EUR250 billion will be distributed in the form of loans to member states. The money will be invested across three pillars: 1/ support to Member States with investments and reforms 2/ providing solvency support to companies and incentivising private investments to kickstart the economy 3/ health-related initiatives. The proposal is ambitious because of its focus on preparing for the future, i.e. the move towards climate neutrality and the digital transition: the right investments today not only support growth in the short run but also make the EU better equipped to cope with future challenges. The access to financing is taking place on the initiative of the member states, i.e. on a voluntary basis. Member States will have to submit national 'Recovery and Resilience plans' which are coherent with the long-term strategies of the EU and set milestones. They will be discussed with the Commission in the context of the annual cycle of policy coordination, the so-called European Semester, following which access to financing will be made available.

This proposed Recovery Fund, if it is passed by all member states, will not turn Europe into a fiscal union. However, it does send a positive signal to investors: Europe is capable of providing a joint response to a severe economic crisis¹¹. The negotiations are likely to be difficult, as some countries have already expressed reservations about this instrument. Austria, Denmark, the Netherlands and Sweden have indicated that they will not accept measures that imply a mutualisation of debt and a substantial increase in the European budget. It is hard to envisage failure, but as unanimous agreement is required, the negotiations threaten to be lengthy and it is to be hoped that they do not result in a significant watering down of the economic impact of the plan.

The epidemic seems to have been brought under better control in many European countries. Its economic consequences remain uncertain, and most analysts are now predicting a more timid recovery than initially thought. So far, the response of the EU and national governments has matched the scale of the crisis. But the story is far from over. There is a considerable risk that there will be a sharp rise in unemployment and business failures; ambitious national recovery plans are thus expected soon. At the European level, the proposed Recovery Fund also needs to be approved and implemented without delay.

Completed on 15 June 2020

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¹¹ C. Odendahl et al., The recovery fund faces a tricky passage, Centre for European Reform, June 2020

