Eurozone fiscal response gaining steam

Europe in (partial) lockdown

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Summary

- Over the past week, Eurozone member states have announced drastic virus containment measures and, in its wake, large fiscal support measures are gradually coming on stream
- Containment measures include the closure of schools, restaurants and borders
- Fiscal measures are mostly aimed at keeping viable firms afloat and to prevent people lose their jobs and fall into severe financial distress
- We have lowered our growth outlook for the Eurozone economy in 2020 to -0.7%
- This is arguably still a conservative estimate in a situation that is extremely fluid
- We think that support measures cannot prevent a significant and (hopefully) temporary economic contraction, but targeted measures may prevent an even deeper and more protracted recession, which could be aggravated by a financial crisis
- Moreover, government support measures may support a swifter recovery in output and consumption once virus containment measures are lifted

Governments are stepping in

If there were still people that thought the COVID-19 outbreak was exaggerated and that it was just a disease like the flu, these people have probably changed their stance after last week. The number of confirmed cases as well as the number of fatal cases has been rising exponentially. In order to limit the spread of the disease, governments across the Eurozone have implemented a host of drastic measures that curb social interaction, depressing economic activity.

Notwithstanding differences in details between national measures and the fact that factories have not yet been closed as was the case in China, it is clear that a large part of the Eurozone finds itself in some form of a lockdown. In an attempt to prevent a severe downturn and ensuing financial crisis, monetary and fiscal policy makers are now working around the clock to alleviate the pressure on the economy.

Table 1: Eurozone faces recession

GDP growth (% yoy)	*2018*	*2019*	*2020*
World	3.6	2.9	0.7
Eurozone	2.9	1.2	-0.8
Germany	1.9	0.6	-1.2
France	1.5	1.3	-0.8
Italy	1.7	0.2	-1.9
Spain	0.7	2.0	-0.3
Netherlands	2.4	1.7	-0.2

Source: Macrobond, RaboResearch

As explained [here](), we think that measures cannot prevent an economic contraction, but targeted measures may prevent an even deeper and more protracted recession and ensuing financial crisis. Moreover, government support measures may support a swifter recovery in output and consumption once virus containment measures are lifted.

All in all, we have downwardly adjusted our growth outlook for the Eurozone economy to -0.7% (table 1). Given the seriousness of the situation, risks to these projections is still tilted to the downside. If lockdowns will be substantially lengthened beyond the dates currently announced (which is certainly not inconceivable), this would negatively impact this growth projection. But it is also important to stress that these projections for annual GDP growth in 2020 do not preclude much bigger swings in output growth over the quarters, with the second quarter now likely to show a very sharp contraction.

*Un*coordinated similarity in measures

All major Eurozone economies have announced far-reaching containment measures (table 2) to combat the spread of the virus, and fiscal measures (table 3) to support the economy. This is obviously a fluid situation, so things can change rapidly. Although there are national differences, in essence the measures all follow the approach of mitigating and slowing down the spread of the virus, with countries being hit hardest by the virus taking the most stringent measures.

As of this week, in many Eurozone member states schools, bars, restaurants and other recreational entities are closed. Several countries have closed non-essential shops as well. Other companies and factories are still open, but where possible people should work from home and factories should deploy work shifts to ensure sufficient distance between workers. There is an increasing number of companies (notably in the retail sector, but also in manufacturing) that are voluntarily closing their doors temporarily for health reasons or due to insufficient demand.

On top of that, multiple countries have reinstalled border controls and only allow citizens, cross-border workers and freight to cross their border by land. And whereas governments in Germany and the Netherlands urge people to stay home if they have a cold – or even only suspect to have one -, the French, Spanish and Italian government are actually employing the police, civil guard and/or the army to force people to stay at home. Unless they are out for work, groceries or care/health reasons, people can get a fine or jail sentence if they leave their homes.

Finally, just as some of the individual member states are doing within the Schengen area, the EU has closed its external borders to the outside world for a minimum of 30 days. Non-EU residents will not be allowed to enter the Schengen area.

Table 2: Containment measures in selected Eurozone countries

Country	*Schools*	*Hospitality*	*Non-essential shops*	*Factories*	*Borders*
France	Closed	Closed	Closed	Open	Closed*
Germany	Closed	Closed	Closed	Open	Closed* (excl. Dutch border)
Italy	Closed	Closed	Closed	Open	Open, but only allowed to be in the streets with Italian permit
Spain	Closed	Closed	Closed	Open	Closed*
Netherlands	Closed	Closed	Open	Open	Open

Note: Most Eurozone countries ban flights from China, Iran, South-Korea and Italy. Some also from Spain.
* Closed except for citizens, cross-border workers and freight.
Source: National government statements and websites, interpretation RaboResearch

Fiscal policy to the rescue?

Countries are announcing new fiscal support measures every day. While things are developing fast, so far (18 March) countries seem to be taking pretty similar routes when it comes to supporting the economy. We have summarized some of the key measures for the 'big five' member states in Table 3. Three major areas of interest are:

- Liquidity support for companies and support for employees with reduced work hours
- Deferral of (tax and social security) payments
- Allowing companies to temporarily lay-off workers or reduce working hours – and (partly) compensating employees for lost income

Liquidity is mostly being offered through (implicit) state-guaranteed loans issued by banks or special entities. In Germany, government guaranteed loans are offered through the KfW, the state investment bank, with a potential capacity of EUR 560bn. These guarantee schemes are complemented with deferrals of tax and social security payments. In some cases, such as in Spain, mortgage and utility bills can also be paid later. Compensation for reduced hours is often offered through revitalized schemes adopted during the Global Financial Crisis of '08. These should prevent a significant second-round hit in domestic demand. Seen from the perspective of the receivers (businesses in particular), the difference with the first two types of measures is that these hand-outs mostly have a permanent character, whereas liquidity support and deferred payments have to be paid back at some point in the future.

For the countries below, the known measures amount to around 1.2-2.4% of GDP, but for many countries details are still lacking. Liquidity measures known thus far are ranging from 8-16% of GDP, but it should be borne in mind that these are contingent liabilities and it would require a much smaller amount of capital to be held on the part of the loan distributors.

Table 3: Fiscal measures Eurozone countries

Country	*Liquidity*	*Payment deferrals*	*Reduced hours*	*Other*
France EUR 45bn (1.8% GDP)	EUR 300bn guaranteed loans	Taxes and payroll charges	Work reduction scheme - compensation	Bail-out state shareholdings
Germany Unspecified	EUR 560bn guaranteed loans	Taxes	Easing conditions to reduce working hours – no compensation	EUR 12bn investment housing and infrastructure
Italy EUR 25bn (1.4% GDP)	Unspecified amount for guaranteed loans	Mortgage, tax and social security A tax credit of 60% of rent for businesses	Work reduction scheme - compensation (Partly) paid parental leave	EUR 3.5bn for health care and civil protection Income subsidies Intervention Alitalia
Spain EUR 17bn (1.4% GDP)	EUR 100bn guaranteed loans Cheap credit for the travel sector	Tax, some social security, mortgage and utility bill	Easing conditions temporary layoffs (ERTE) – compensation	EUR 3.8bn for health care Income subsidies EUR83bn (6.7% GDP) of unspecified 'private investment'
Netherlands EUR 10 – 20bn initial estimate (1.2-2.4% GDP)	Unspecified amount for guaranteed loans	Taxes	Work reduction scheme - compensation	Income subsidies

Source: National government statements and websites, interpretation RaboResearch

What does the ECB bring to the table?

In its last meeting (March 12) the ECB left the deposit rate unchanged at -0.50%, while keeping the refinancing rate at 0.00%. However, it expanded the existing asset purchase program. An additional EUR 120bn in purchases will be conducted through the end of the year and will mainly be aimed at the private sector. This amount can be used at will. Additionally, the ECB announced very cheap LTRO loans through June, as well as an easing of the TLTRO-III conditions and costs for the period June 2020 to June 2021.

The composition of this stimulus package was different from what the market was expecting. The expectation was that the ECB would cut the deposit rate. And even though there were additional measures (such as the expansion of the APP and cheap long-term loans or LTROs) there was a clear risk-off reaction in markets. But in all honesty, a cut in the deposit rate would unlikely have urged people to spend more or that such a cut, particularly as a standalone measure, would have addressed this special situation. The current package of measures in that sense seems well targeted at providing liquidity to banks to serve their clients. Unfortunately the wording that ECB President Lagarde used in her speech ('we are not here to close spreads'), undid the positive effect that the package could have had pre-emptively. A follow-up statement nuancing her point regarding spreads did not fully undo the damage.

However, what has also happened since that press conference is that, alongside a sharp risk-off tone and rising stress in markets, an increasing number of governments are now heeding the ECB's call for taking the lead in 'stimulus' (or rather damage control). **This could make it easier for the ECB to stick with its narrative ('its first and foremost up to governments') and follow-up with additional easing measures to ensure that financial conditions do not tighten in 'unwarranted' fashion**, for example because of expected bond issuance in a market that is lacking liquidity at the moment. And to that we may indeed add rising sovereign stress which may also require additional action by the ECB. Recent developments in markets clearly show that fragmentation risk in the Euro area is back on the agenda is having EU leaders attention. A new publication on this topic is forthcoming.

What does Brussels bring to the table?

In the Eurogroup meeting on Monday EZ finance ministers pledged fiscal support measures worth 1% of GDP this year and liquidity measures of "at least" 10% of GDP – these including public guarantee schemes and deferred tax payments. The measures announced thus far by member states thus seem even to outstrip this guidance.

But what initiatives do we have on the Eurozone level? So far a number of EU-wide and funded support measures have been tabled. These include the redirection of EUR 37bn from the EU budget for a wide range of measures such as research, health care, liquidity to ailed businesses and possibly some kind of unemployment benefit scheme. The European Commission will try to subtract another EUR 28bn from structural funds for these purposes. And EUR 8bn working capital will be mobilized, backed by the EU budget, to provide EIB guarantees on loans to cash-strapped SMEs. The EU will also be keen to ensure that member states have ample access to medical supplies.

Additionally, the European Commission has confirmed the flexibility present within the EU's strict state-aid rules to support companies and banks affected by the virus. It has sent a proposal to national governments on **how to deal with state-aid rules** in the current exceptional situation. Flexibility present in European budget rules to deal with exceptional circumstances and crises will also be fully used. That means that automatic stabilizers will be allowed to run and temporary fiscal support measures will be excluded when assessing compliance with the budget targets under the rules.

Finally, the Eurogroup and other EU bodies have reiterated their commitment to do whatever is necessary to tackle the current health crisis and cushion related economic shocks. In this respect, it is still being debated, for example, if and how the ESM could play a role. Furthermore, the idea of joint bond issuance has been reinvigorated, with Germany indicating it is willing to consider the possibility. We will address this in an upcoming piece.

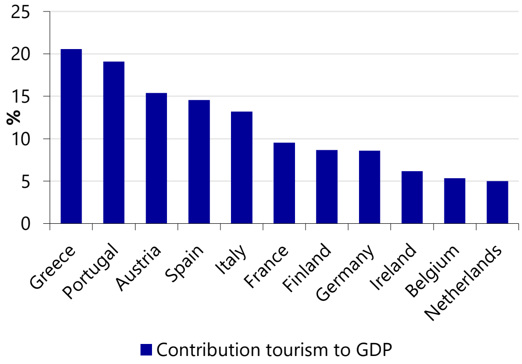
Economic vulnerability member states

In a previous publication we already ranked Eurozone member states on economic vulnerability to the spread of the virus. We looked at exposure to China and world trade, shock absorbing capacity of companies and the government and the importance of tourism.

With the outbreak and containment measures intensifying all over the continent, **the tourism and travel sector has become a key point of attention**. Although the broad economy will be hit by knock-on effects in the coming weeks, the tourism sector, both leisure and business, has already experienced a major decline in activity over the past weeks. In addition, it will likely take more time for tourism activity to rebound than certain retail sales. Indeed, full recovery is unlikely. For example, people can catch-up postponed purchases of consumer goods, e.g. a car or a washing machine, ones stores open again, but they are unlikely to go on a holiday twice within a short period of time. Restaurants and café's as well as high-street retail sectors are confronted with similar issues. These sectors are good for a combined 7.2% of gross value added (2017) in the Eurozone as a whole.

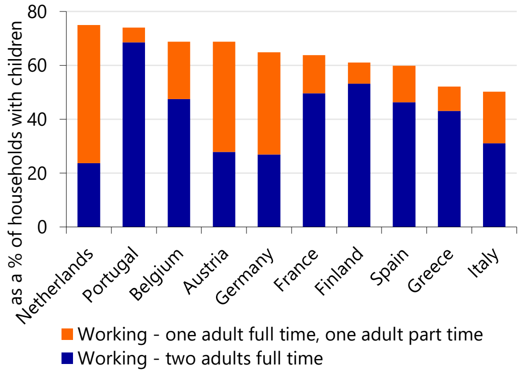
Figure 1 shows the total contribution of tourism to GDP. It includes a broad range of consumption spending, such as direct spending by tourists and business travellers, by airlines on food, and travel sector workers in general. Furthermore it includes investment within the sector, such as the construction of hotels or the purchase of an aircraft. In short, it includes both first and second order spending in the entire tourism industry. According to this data, the Greek and Portuguese economy are most vulnerable to the slump in the tourism and travel sector. But in fact all Southern Eurozone economies plus Austria are much more exposed than Northern peers. Although for Austria we could argue that the winter season is as important as the summer season, while that does not hold for the other countries.

Figure 1: Tourism a key attention point for Southern Eurozone member states



Source: World Trade and Travel Council (WTTC) and Oxford Economics

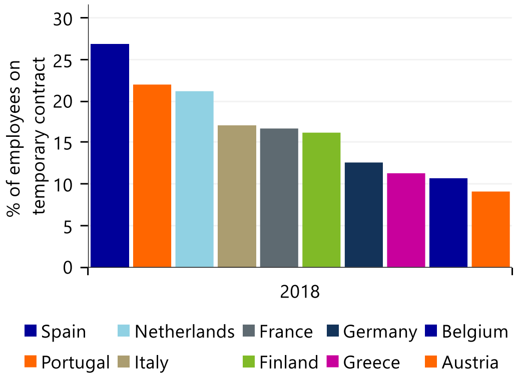
Figure 2: Who works in household?



Note: The definition two adults part time does not exist
Source: OECD, RaboResearch

Another important feature seems to be **the vulnerability of activity to the closure of schools**. To get an idea of this vulnerability we can look at the number of households with children in which both parents are working. The higher the percentage of households with children in which both parents work, the more economic activity is likely to drop because one parent has to stay at home to take care of the children. With a share of about 75%, the **Netherlands** has the highest share of households with children in which both parents work. That said, in the Netherlands in most cases at least one of the parents works part time, which should alleviate the burden. In that respect, Portuguese and Belgian families are likely to struggle more with the closure of schools.

Figure 3: Spanish employees most vulnerable to drop in economic activity



Source: Macrobond, Eurostat

Finally we look at the share of workers on a temporary contract[1] to grasp the potential impact of the current slump of economic activity on unemployment. All else equal, the larger the share of workers on temporary contracts, the larger the expected increase in unemployment and the larger the second-round effects on economic activity from the coronavirus outbreak if governments would not intervene. In this respect, a larger share of workers in Spain is at risk of losing its job. But also in Portugal and the Netherlands a relatively high share of employment contracts are on fixed terms.

We acknowledge these indicators do not paint the entire picture, but they do provide us with some insights on where vulnerabilities may lie in the member states now that containment measures have been enacted in full force.

To sum up

European Member States have initiated increasingly harsh containment measures to counter the spread of Covid-19. The first contours of the fiscal support packages are now becoming visible. Several member states have already announced (direct) measures worth between 1.2 to 2.4% of GDP, more than 'advised' recently by Eurozone finance ministers. Guarantees for liquidity support are also coming on stream.

However, this is unlikely to be the last of it as the situation is extremely fluid and changing by the day. The economic impact of Covid-19 likely to be very significant, notably during the lockdown/containment period and the duration of this period will of course determine whether the fiscal support measures announced thus far are sufficient.

The focus may now swiftly shift back to the question of how these measures are going to be financed.

[1] Another category impacted strongly are employees with flexible hours.

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