"Viral divergence": Heterogenous effects of the COVID-19 crisis in the euro area[11]

Die COVID-19-Krise hat asymmetrische Auswirkungen auf die Volkswirtschaften der Länder des Euroraums. Dies ist auf mehrere Faktoren zurückzuführen: (1) Unterschiede in Tempo und Intensität der Ausbreitung der Viruserkrankung, (2) Unterschiede in Stringenz und Zeitprofil der nationalen Sperrmaßnahmen und (3) Unterschiede in der Bedeutung von Sektoren, die stark von den Einschränkungen betroffen sind (insbes. Dienstleistungen). Während der anfängliche Schock daher asymmetrische Auswirkungen hatte, könnte sich die Erholung als noch asymmetrischer erweisen, da sich einige Sektoren wahrscheinlich erst langsam erholen werden (Tourismus, Gastgewerbe, Kunst und Kultur) und jedes Land unterschiedliche Ausgangsbedingungen in Bezug auf Produktivität, Wettbewerbsfähigkeit, fiskalpolitischen Spielraum, Unternehmensstruktur und Finanzierungsbedingungen hatte. Letztendlich hängen langfristige Erholung und die Entwicklung des Potenzialwachstums von der finanziellen Fragmentierung, der Stärke der Arbeitsmarktinstitutionen, dem Vertrauen der Anleger und der Entwicklung der Ungleichheit ab.

Insgesamt ist zu erwarten, dass die COVID-19-Krise heterogene Entwicklungen in den Ländern des Euroraums auslöst und die Nord-Süd-Kluft verschärft. Solche Abweichungen können die Rezession im Euroraum durch Nichtlinearitäten und Hysterese verstärken, was (in einigen Ländern) zu einer Bilanzrezession führen kann. Während sich die Geldpolitik im Allgemeinen auf die Stabilisierung des gesamten Währungsraums konzentriert, kann eine übermäßige regionale Fragmentierung dieses Bestreben untergraben. Entsprechend ihrem Mandat geht die EZB auch mit ihrem Pandemic Emergency Purchase Programme (PEPP) auf die mögliche Beeinträchtigung des geldpolitischen Übertragungsmechanismus ein. Darüber hinaus können die von der EU geplanten bzw. erwogenen Maßnahmen, einschließlich ihres Aufbauplans für Europa, einer Divergenz entgegenwirken, die das Funktionieren des europäischen Binnenmarkts untergraben könnte.

Monetary policy and asymmetric shocks

Within a currency union, monetary policy has limited scope in dealing with asymmetric shocks. As Otmar Issing expressed it in 1999, "The Eurosystem will focus exclusively on the outlook for euro area price developments and respond accordingly. This implies that the single monetary policy cannot play any role in countering economic shocks in individual countries. In the new environment, country-specific or regional economic problems will need to be addressed by implementing appropriate national fiscal policies and improving cost competitiveness. This could also alleviate possible asymmetric impacts of monetary policy actions on individual member countries."[12]

According to this view, it is up to national policies to deal with asymmetric shocks within a monetary union, i.e. national budget expenditure, structural policies that enhance factor mobility (labor mobility and integrated capital markets) and price and wage flexibility. Given varying degrees of fiscal space, (temporary) income transfers among Member States may help reduce divergence. However, when compared to fiscal federations like the U.S.A. or Canada, such a cyclical fiscal capacity is still underdeveloped at the European level.

[11] Autoren: Andreas Breitenfellner und Maria Silgoner (Abteilung für die Analyse wirtschaftlicher Entwicklungen im Ausland).

[12] https://www.imf.org/external/pubs/ft/fandd/1999/03/issing.htm

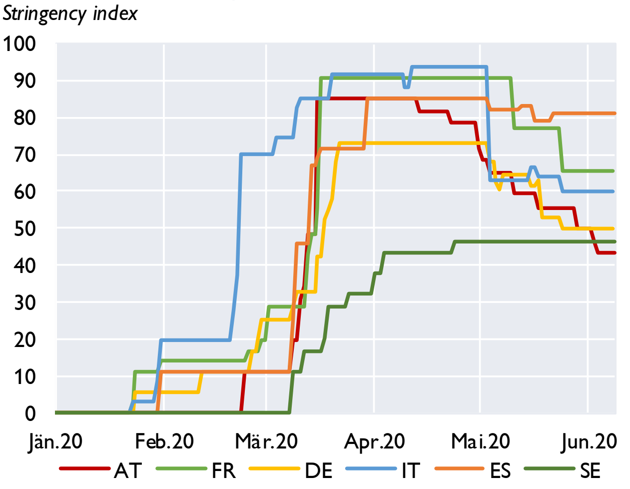
Since the start of EMU, business cycles within the euro area have converged to some extent (notwithstanding diverging peak-to-trough amplitudes). This development was foreseen by the European Commission, since trade integration within the area should lead to more similar economic structures, so that demand shocks hit all countries at once.[13] Nevertheless, situations may emerge where there is a case for monetary policy action to counter divergence. One recent example is the year 2012, when financial market fragmentation prevented interest rate cuts from reaching euro area countries in the southern rim. With the announcement of the Outright Monetary Transactions (OMT) programme, the Eurosystem demonstrated its determination to fight against dynamics that impair monetary policy transmission, promising to do "whatever it takes." The Treaty gives the Eurosystem the right to do so, first and foremost because a functioning transmission mechanism is essential for the Eurosystem to achieve its price stability objective. Apart from that, the Treaty explicitly calls for monetary policy support of the general economic policies in the Union as long as the primary objective of price stability is assured. The Treaty (Article 3, TEU) lists these secondary goals: balanced economic growth, full employment, economic, social and territorial cohesion and solidarity among the Member States. Finally, the fact that the spreads between sovereign bonds of different euro area countries partially reflected redenomination risks implies that the Eurosystem may act in defense of the common currency.

COVID-19: a shock with asymmetric effects and even more asymmetric recovery paths

While COVID-19 affected all countries in the euro area, which is why some may call it a symmetric shock, it certainly did not affect all countries to the same degree. Numerous factors contribute to this initial asymmetry:

- Both the intensity and pace at which COVID-19 affected countries differed – so that lagging countries could benefit from the experiences of countries hit earlier. In several countries, local health care systems became overburdened – partly because of decades-long fiscal consolidation.
- As a result, but also reflecting different cultures, lockdown measures differed in stringency and sequencing.
- The service sector was affected more strongly by the lockdown measures than manufacturing. Among the most

COVID-19 Stringency index



Source: Blavatnik School of Government, University of Oxford.

[13] There were, however, also opposing views ahead of the establishment of EMU, claiming that economic integration would lead to a local concentration of production to exploit economies of scale. This view, advanced for example by Paul Krugman, was based on the U.S. experience with local clusters such as the IT industry in Silicon Valley or the automobile industry in Detroit. It turned out, however, that in Europe trade intensification took place mostly intra-industry. Clusters exist, but they are often cross-border ones to exploit the comparative advantages of different jurisdictions. And finally, services, that do not benefit so much from economies of scale, account for about two-thirds of GDP today. Nonetheless, the sovereign debt crisis revealed that some peripheral regions had indeed become disconnected from industrial production centers in core countries of the euro area.

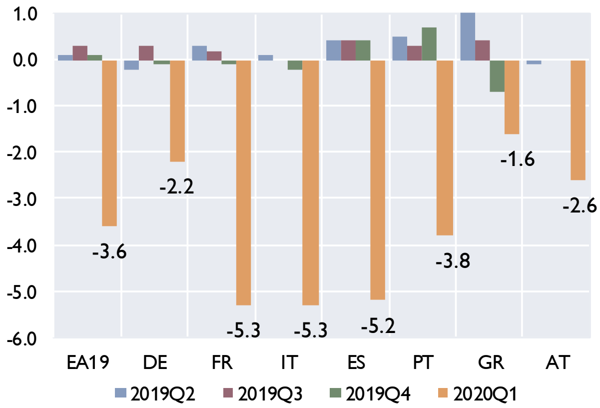
affected services were retail trade, hospitality and arts. Therefore, how hard the economy was hit by lockdown measures also depends on the given country's economic structure.

The flash figures for real GDP growth in the first quarter of 2020, covering only the initial phase of the lockdown, confirm the asymmetric effects of the COVID-19 shock. The economies of countries that were hit by the crisis early (Italy) or that opted for particularly stringent lockdown measures (France, Spain) were hit much more strongly than countries with a lagging COVID-19 cycle (Germany) or looser lockdown policies.

While the initial shock had asymmetric effects, the recovery may turn out to be even more asymmetric. A number of factors contribute to this assumption:

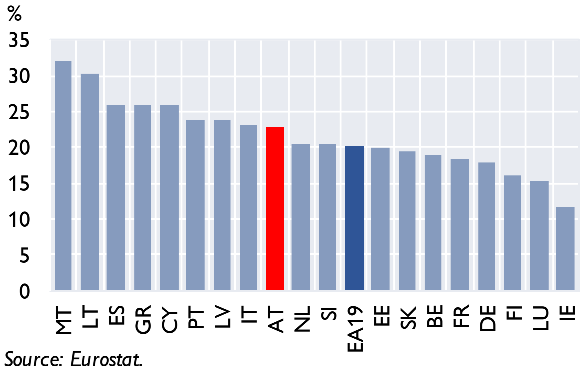
Euro area: Real GDP growth

Quarter on quarter in % (seasonally and working day-adjusted)



Source: Eurostat.

Contribution of highly exposed sectors to GDP

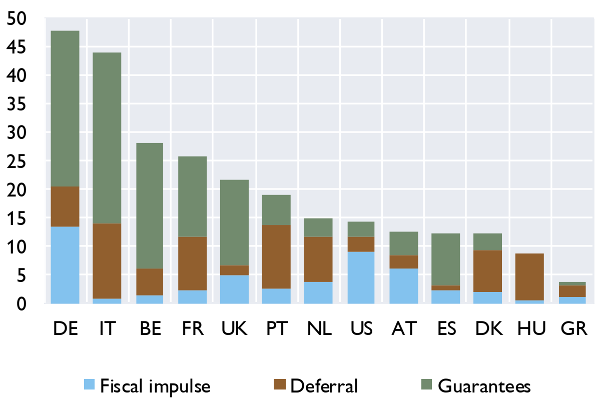


Source: Eurostat.
Note: Highly exposed sectors are wholesale and retail trade; transport; accommodation and food services; arts, entertainment and recreation.

- Some sectors will take longer to recover even after lockdown measures are relaxed. This is especially true for tourism, the hospitality industry and cultural events. The exposure of economies to these sectors also determines the speed of recovery. Current forecasts assume unanimously that by end-2021, GDP and employment will not have reached pre-pandemic levels. The gap is generally bigger for countries that depend more heavily on sectors disproportionately affected by lockdown measures.
- Fiscal policy may support sectors and companies that are hit hardest by the COVID-19 crisis. A comparison of the size of national automatic stabilizers already shows a North-South divide, reflecting a lower tax (and contribution) to GDP ratio in Mediterranean Member States. In addition to these standard fiscal equalizers, national governments adopted sizeable discretionary COVID-19 packages varying considerably in size and focus[14]. The total size of these packages may crucially depend on the available fiscal space. Generally, a direct fiscal impulse, such as additional spending to keep people employed, subsidizing SMEs or

COVID-19 support packages

% of 2019 GDP



Source: Bruegel, for AT: OeNB.

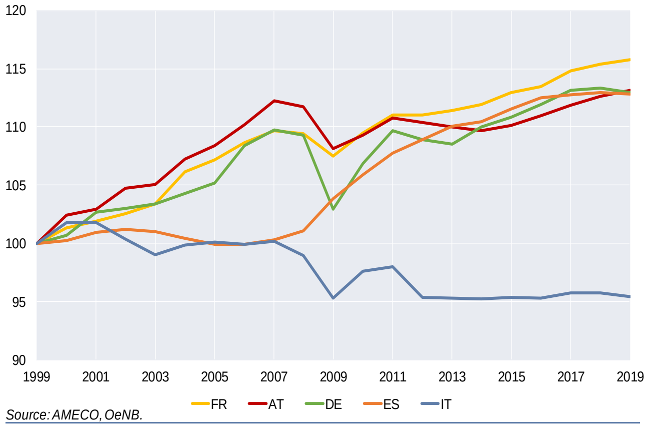
[14] The Bruegel data set relies only on discretionary measures already adopted. Bruegel distinguishes between fiscal impulse (additional spending and foregone revenues, such as cancelation of taxes and social security contributions),

public investment, represents only a minor part of total COVID-19 packages, except for Austria and the U.S.A. The latest extension of the COVID-19 package in Germany focuses explicitly on stimulating private consumption. Guarantees and liquidity support dominate in countries with large-scale packages, while deferrals of taxes, social security contributions, loan or utility payments are more important in countries with smaller packages. Again, we see a pattern of a North-South divide across the euro area – with few exceptions – regarding direct fiscal impulse measures. Strangely enough, this divide tends to be inversely proportional to the size of the COVID-19 shock.

- Countries' economic conditions at the start of a crisis also determine the pace of recovery. A country like Italy with virtually zero productivity growth over the last decades is certainly in a disadvantaged position. Also, the distribution of companies by size may matter, as smaller firms tend to have a smaller financial buffer and are more likely to feel tightening financing conditions.

Labor productivity in selected euro area countries

Labor productivity, 1998 = 100



Source: AMECO, OeNB.

The longer-term effects of the COVID-19 crisis on potential growth will crucially depend on financing conditions and whether it will be possible to prevent a surge in financial fragmentation, as this influences the willingness and capacity of firms to invest. The structure and strength of labor market institutions will determine how many workers and jobs will be lost irreversibly. With a view to limiting mass unemployment and deskilling, an extended period of short-time work would allow for easier and smoother re-employment. The performance of the labor market is closely linked to the evolution of inequality: in past pandemics, the gap between rich and poor widened progressively, as pandemic-related job losses disproportionately harmed workers with the lowest levels of education.

Eurosystem and EU policies combat financial fragmentation and divergence

Even as companies and workers gradually re-emerge from the lockdown, cuts in investment budgets by firms and public authorities may prolong and deepen the impact of the crisis. Again there is divergence among the euro area countries. Forecasts and recent data reveal that investment plummeted most in the southern economies of the euro area, from already lower levels. Given the importance of infrastructure and intangible investment for future productivity, it is reasonable to assume a propagation of heterogeneous growth trends.

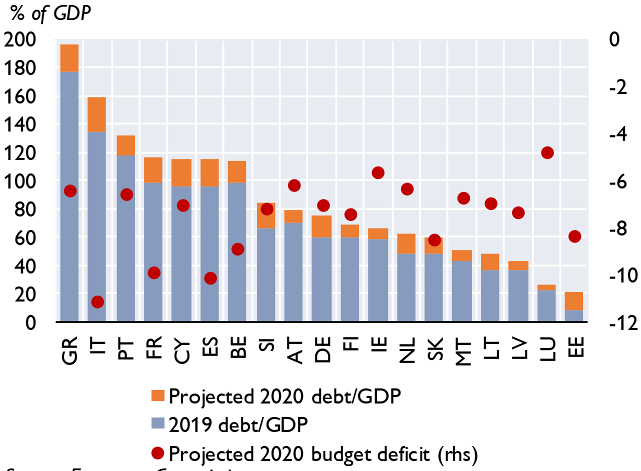
Widening divergence and rising sovereign debt levels in the euro area increase the risk that investors may revise downward their assessment of debt sustainability of the most indebted governments in the medium run.[15]

deferrals (of taxes, social security contributions, loan servicing or utility bills) and guarantees or liquidity support (export or bank guarantees, liquidity assistance, or credit lines through national development banks).

[15] https://www.ecb.europa.eu/pub/financial-stability/fsr/html/ecb.fsr202005~1b75555f66.en.html#toc10

Initially more indebted countries are going to see larger increases in their debt-to-GDP ratios – partly resulting from a larger drop in GDP. The larger, more indebted countries (France, Italy, Spain and Belgium) expect higher budget deficits this year. These four countries also have a higher share of debt maturing over the next two years. Additionally, some of these countries (e.g. Italy and Spain) expect very low or even negative inflation rates, which will result in higher real interest rates. All this may contribute to a negative dynamic, worsened by "positive" feedback loops where rating downgrades induce higher yield spreads and vice versa.

Government debt and budget deficit across euro area countries



Source: European Commission.

The fragmentation in sovereign debt markets translates into rising spreads also in private debt markets. Firms are shifting their borrowing from investment to revenue substitution, which increases their leverage. All the above-mentioned factors interact dynamically, producing non-linearities, extended via hysteresis effects, in product and labor markets. Ultimately, they may entail a balance sheet recession as firms and households seek to increase their savings to repay their debt. Northern euro area countries with a stronger export performance would also suffer from second-round effects via trade and financial contagion.

While maintaining price stability is the primary objective of the Eurosystem and its single monetary policy, the Eurosystem shall – without prejudice to the objective of price stability – support the general economic policies in the Union, which includes cohesion among Member States. So, even though monetary policy strives to achieve price stability defined as "below, but close to, 2%" for the entire euro area economy and not for individual subregions, responding to the asymmetric effects of the COVID-19 shock implicitly supports the Eurosystem's price stability objective. Such a response prevents the asymmetric nature of the pandemic-induced shock from being amplified by financial markets and from impairing the transmission mechanism of monetary policy. At the beginning of the crisis, perceptions of differences in fiscal policy space have widened the wedge between the financing costs of euro area sovereigns, and hence of firms, banks and households in the euro area.

The ECB has taken various measures in response to the COVID-19 crisis – most importantly, the EUR 1,350 billion Pandemic Emergency Purchase Programme (PEPP). With its inherent flexibility, the PEPP counters both, the deteriorating inflation outlook and the tightening of financial conditions. Tackling the latter helps safeguard the smooth transmission of monetary policy across asset classes and among jurisdictions. ECB staff estimates show that the impact of the PEPP announcement in March 2020 was much larger for peripheral than for core countries.[16] Additional measures already taken and further envisaged by the EU – including the European Commission's recovery plan for Europe – may have also contributed to easing market strain. They

[16] Isabel Schnabel: The ECB's policy in the COVID-19 crisis – a medium-term perspective. Remarks by Isabel Schnabel, Member of the Executive Board of the ECB, at an online seminar hosted by the Florence School of Banking & Finance. 10 June 2020.

are, however, mainly intended to keep a level playing field in the single market. The reason is that Member States with enough fiscal space can rather afford counter the severe crisis impact, but this would create an undue competitive advantage vis-à-vis highly indebted EU countries. As the resilience of the currency union and of the single market are at stake, it makes perfect sense to use synergies between monetary and fiscal policies in tackling both symmetric and asymmetric crisis impacts.