Covid-19 as a wake-up call: Three considerations going forward

Category: COVID-19
written by oecdecoscope | May 27, 2020
by Philippe Aghion, Collège de France, drafted by Shashwat Koirala, OECD Economics Department

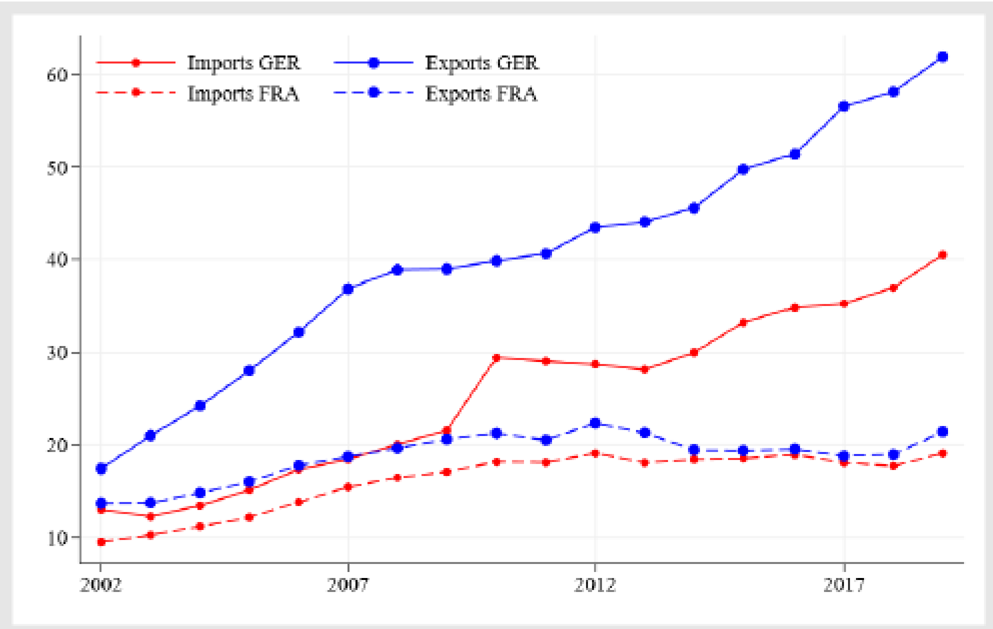
As a part of the Chief Economist Talks series, the OECD hosted Philippe Aghion, Collège de France on May 11, 2020. This blog presents the takeaways from his presentation. More information regarding the OECD's Chief Economist Talks, including previous speakers, can be found here.

COVID-19 has prompted many difficult questions, chief among which is how we should re-envision the world after the crisis. This pandemic has revealed the shortcomings of our current social, economic and political systems, and addressing these will be central to rebuilding the post-coronavirus society. Notably, there are three, albeit non-exhaustive, areas that merit reflection: trade and value chains, social and health insurance, and civil society and trust.

Trade and value chains

Although COVID-19 has incited criticisms against the international trading and production systems, there is evidence that trade has actually helped mitigate the crisis and may even help countries exit and recover quicker. For example, preliminary estimates suggest that, on average, countries that are net exporters have lower daily cumulative deaths. The cases of France and Germany are also revealing, as the differences in medical capacity between the two countries mirror their divergence in trade. Whereas Germany entered the crisis with high medical capacity (e.g. 25 000 hospital beds with respirators) and was able to test on a large scale (e.g. 500 000 tests per week), France had much smaller capacity (e.g. 5 000 hospital beds with respirators) and was unable to perform mass testing until recently. This was driven not by any form of protectionism in Germany, but rather a consistent growth in its trade of vital medical supplies, amounting to a trade surplus today of over EUR 20 billion. Meanwhile, French imports and exports of these goods have grown minimally since 2002 (see Figure 1).

Figure 1. Trade in pharmaceuticals over time (France vs. Germany)



However, there is some scope for domestic production in strategic sectors to improve resilience to acute shocks. Again, the differences in the value chains of French and German firms for medical supplies are telling. Since 2000, domestic production of pharmaceuticals in France has stagnated while that in Germany has increased substantially. Simultaneously, German asset holdings abroad (both in terms of number of foreign affiliates and direct investment assets abroad) in the pharmaceutical sector have remained flat over time while those of French firms have grown markedly. Given France’s lower medical capacity at the onset of the pandemic, this raises the question of whether French firms outsourced excessively, and whether policies are needed to maintain domestic reserves in strategic sectors. This does not, however, suggest that massive re-shoring of production is needed, but rather that policies concerning the storage of vital goods and investment in domestic industries could be warranted. These include policies to boost investment in automation/robotisation, which generate cost savings for firms and provide incentives to re-shore some production (Kilic & Marin, 2020).

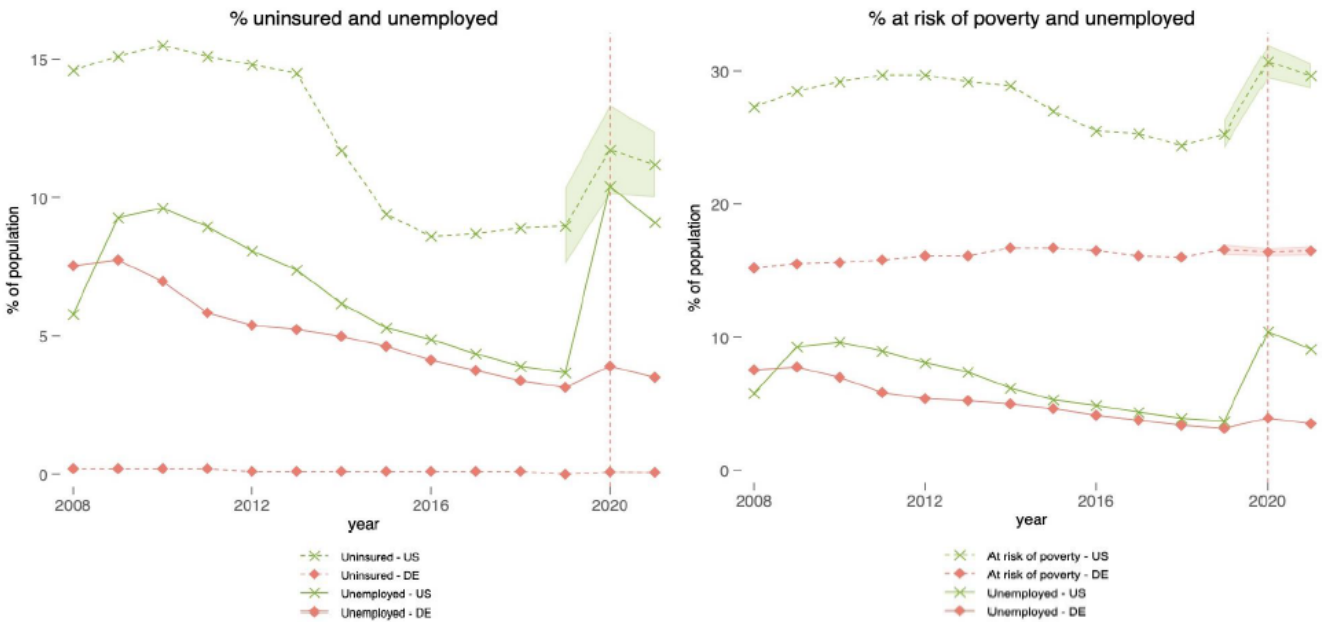
Social and health insurance

COVID-19 has also elucidated the importance of social safety nets to protect against unexpected shocks and their adverse impacts on employment, health, and poverty. Social protection mechanisms tend to vary by country. A clear dichotomy is apparent between the United States and Germany, even prior to the crisis, as the former is much less protective than the latter. This is reflected in outcome indicators such as the Gini index for inequality (0.39 in the U.S. vs. 0.289 in Germany) and the poverty rate (0.178 in the U.S. vs. 0.104 in Germany).[1]

These differences in social protection systems have been made abundantly clear by the crisis. Forecasts show that the unemployment rate in the United States is set to jump sharply in 2020, compared to a much smaller increase in Germany (Figure 2). Furthermore, empirical estimates extrapolating from past relationships between unemployment and poverty risk and healthcare coverage indicate a substantial increase in 2020 in the share of uninsured population in the United States, owing to the bundling of health insurance with employment, as well as in the percentage of population at risk of poverty. In Germany, no such increase is evident. These differences hold even when comparing the United States with other European countries, such as France, Italy, Spain, and the U.K.

What this data reveals is that the American system has less social protection relative to Europe. This lack of protection increases the vulnerability of its citizens, especially in times of crises. There is, thus, a need to reform the American social insurance system to incorporate more safeguards. Doing so is not only key for social wellbeing, but also can foster the innovation that is often considered the hallmark of American capitalism, for example by boosting education and quality of work.

Figure 2. Relationship between unemployment, poverty risk, and healthcare coverage (U.S. vs. Germany)



Trust and civil society

COVID-19 has revealed the extent to which society rests on a bedrock of trust and social norms, for which civil society is indispensable. Practices used to limit the spread of the virus include many voluntary actions that are dependant on mutual trust and respect. Countries that were most successful in limiting the spread of the virus, such as Germany and South Korea, have civil society systems that played an important role in instilling self-discipline and civic spirit needed for the implementation of measures like large-scale social distancing. While market incentives and government actions are important elements of addressing the pandemic, they alone cannot prevail without a fundament role for civil society and the values of community, fairness, and reciprocity that it promotes (Bowles & Carlin, 2020).

The importance of civil society should be well-reflected in how we address future problems and make policy decisions. Existing research already shows that too much government coercion engenders distrust. For example, on average, countries with higher levels of regulation for firm entry, rigidity of employment, and court formalism show higher levels of distrust (Aghion, Algan, Cahuc, & Shleifer, 2009). This suggests an important role for social dialogue in decision-making. Moreover, decentralised decision-making and effective coordination between local and central governments may also help promote civil society and trust, especially as trust tends to be higher at lower levels of government.

As countries begin to emerge from stringent containment measures and chart a path to recovery, it is important to address some of the underlying lessons that COVID-19 has highlighted. First, turning inward towards protectionism is not the answer; on the contrary, this may have worsened the crisis and slowed the recovery. However, domestic reserves in strategic sectors may be justified. Second, social safety nets are indispensable in protecting and safeguarding against downturns and hence, should be bolstered. Finally, while governments and markets are important elements of society, civil society should not be overlooked, as strong civil society systems are needed to foster cohesion and trust, which can help navigate shocks like this pandemic.

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[1] Data for 2017.

The OECD COVID-19 Policy Tracker: What are governments doing to deal with the COVID-19 pandemic?

Category: COVID-19
written by oecdecoscope | May 27, 2020
by Tim Bulman and Shashwat Koirala

Governments have implemented an extraordinary range of new policy measures to tackle the health and economic consequences of the COVID-19 pandemic, including actions to stop the virus's spread, to bolster health systems, to support economic activity and livelihoods, and to protect the vulnerable. To identify effective policies to fight the pandemic, policymakers and researchers need to share experiences and learn from each other.

The OECD COVID-19 Policy Tracker is a centralised database of government responses to the different dimensions of the COVID-19 crisis, compiled and verified by OECD country experts. Covering over 90 countries, across all continents and income levels, the Tracker summarises each country's containment and health measures, fiscal responses, monetary and macro-prudential mechanisms, and structural policies. It also links to highly granular information on countries' responses pertaining to tax policy, social, employment and income policies, policies in support of small and medium-sized enterprises, and health technology policy. The Tracker is updated daily to capture the evolving nature of the crisis. To facilitate empirical analysis of the impact of the pandemic, users will soon be able to access a time-series of countries' responses, and assess the policies in place on different dates.

This blog post presents some of the Tracker's insights into how OECD and G20 countries are responding to the COVID-19 crisis.

Support for the health sector

Governments have taken substantial steps to strengthen the capacity of the health sector. Many countries have boosted health funding to cover the costs of increased staffing needs, vital medical infrastructure (e.g. hospitals, ventilators, beds, etc.) and safety equipment (e.g. personal protective equipment). For example, Italy has devoted EUR 845 million to recruit 20 000 health care workers and allocated additional funding to produce and procure necessary equipment.

To give their health workforce more flexibility, governments have also relaxed or eliminated certain rules, regulations and administrative procedures. In Denmark and France, working time rules and overtime caps for healthcare employees have been relaxed while in the United States and Brazil, regulatory barriers to telemedicine have been removed to facilitate remote consultations. Meanwhile, Argentina and New Zealand have eased import procedures by temporarily reducing import duties and tariffs on medical supplies.

In addition to these instruments, countries have deferred non-essential medical services, promoted research and development of innovative medical equipment (e.g. affordable ventilators), vaccines, treatments and testing-kits, and compenseted medical workers through bonuses or salary increases. Though generally not considered to be good practice, some governments have also imposed restrictions, such as export bans, to preserve access to vital medical supplies.

Containment measures

Containment measures aim to limit human interaction through confinement or stay-at-home orders, school closures, and restrictions on international and/or within-country travel. These measures vary in intensity across countries (Figure 1). One-fourth of OECD and G20 countries, covering about 558 million people[1], have instituted nation-wide lockdowns, affecting many but not all groups or regions. Forty-one percent have implemented more moderate confinement measures; many areas or population groups in these countries are restricted, but there are broad exceptions. These countries account for about 2.6 billion people.[2] Meanwhile, only a few countries (11%), with roughly 73 million people, have refrained from or no longer have confinement measures.

Countries' travel restrictions and school closures policies also vary. In 21% of countries, totalling almost 1.9 billion people[3], both international travel and movement within the country are severely restricted. A larger share (53%) have only imposed restrictions on all international arrivals, while allowing internal movement to continue. These countries cover a comparatively smaller number of people (approximately 1 billion). Likewise, whereas schools are completely closed in 25% of countries, some (16%) have kept physical sites open for targeted groups, such as children of essential workers. Nevertheless, these two groups of countries encompass a similar number of people (about 1.7 billion and 1.8 billion respectively[4]).

Certain countries have also started lifting their containment measures (e.g. Austria, Spain, and Germany) and have indicated timelines for further easing in the future. As the stringency of containment measures changes across countries, the Tracker is updated accordingly.

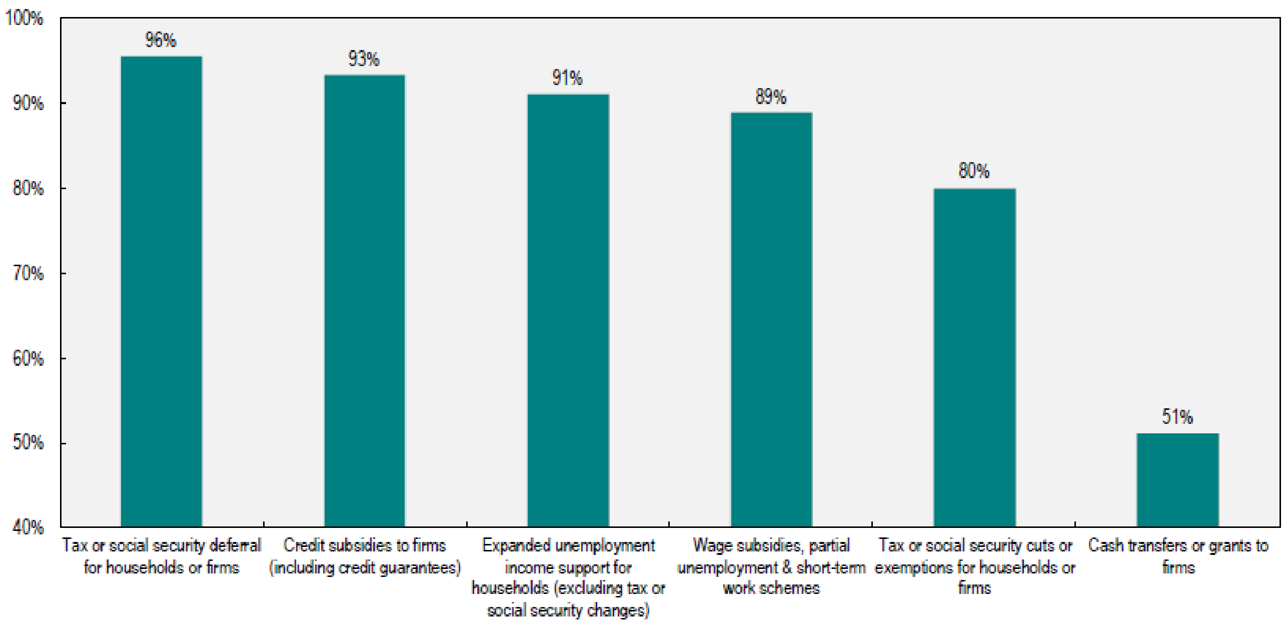
Figure 1. Selected containment measures

Note: **a)** Data as of 13 May, 2020, 11h30 CET. **b)** Total number of OECD & G20 countries is 45, but data is missing for Switzerland for all three indicators and data is missing for China for travel restrictions; so, n=44 for confinement/lockdowns, n=43 for travel banks/restrictions, n=44 for school closures.

Fiscal and monetary policy responses

The containment measures, in conjunction with people's anxieties about the virus, have brought economic activity to a standstill, inducing estimated output and consumption decreases in many countries of 20-25% and 33% respectively (OECD, 2020[1]), as well as severe income losses for firms and households. To address this, governments have implemented expansionary fiscal policies (Figure 2). The most common schemes are deferral mechanisms for tax or social security contribution payments (96%), credit subsidies (including credit guarantees) for firms (93%), and expanded unemployment income support programs for households (91%). Nearly half of the countries have also introduced targetted support – financial and otherwise – for vulnerable segments of their population (e.g. elderly, low-income, migrant workers, informal workers, etc.). For example, Spain has put in place a special program to provide housing to victims of gender violence.

Figure 2. Selected fiscal measures to support firms and households



Note: **a)** Data as of 13 May, 2020, 11h30 CET. **b)** N=45. **c)** Expanded unemployment income support for households includes income support mechanisms for the self-employed.

Countries have also eased their monetary policies and macro-prudential regulations to ensure that there is sufficient liquidity in the economy. Common monetary instruments include the reduction of policy rates and large-scale asset purchases by central banks. For example, the United States Federal Reserve has lowered its interest rates by 100 basis points to 0-0.25% and resumed large-scale asset purchases of treasury securities, agency mortgage-backed securities, as well as assets backed by student, car, credit card and small business loans. Similarly, the Bank of England has reduced its policy rate to 0.15% and increased its holding of UK government and corporate bonds by GBP 200 billion.

In terms of macro-prudential regulations, many central banks and financial regulators have reduced reserve and/or capital requirements for banks. The European Central Bank has allowed banks that it supervises to temporarily operate at lower capital levels. Many Eurozone countries have supplemented the ECB’s responses through additional actions at the national level. The French High Council for Financial Stability, for example, has released all banks’ from its countercyclical capital buffer.

Given the extraordinary burden of the COVID-19 pandemic on socio-economic systems, many countries are also reaching to tools beyond fiscal and monetary measures, towards sharing the burden across the private sector. This includes payment holidays affecting private transactions between firms and/or households, such as rent freezes or reductions, mortgage deferrals, and exemptions from utility payments.

Tracking policies to launch the recovery

As governments relax restrictions, the goal of policy responses will shift from bridging the crisis to the recovery. To launch sustained and inclusive recoveries, governments will need to transition from broad economic support mechanisms to targeted initiatives that buttress demand while helping people to find new jobs, viable firms to restructure, and new businesses to emerge and grow. The Tracker will continue to report structural policies implemented by countries in response to the COVID-19 crisis, such as strengthening safety nets, upgrading skills, raising the effectiveness of public administration, leveraging the benefits of digitalisation, and supporting investment for green growth.

Forthcoming OECD Ecoscope blog posts will present further policy insights from the Tracker that can help countries tackle the COVID 19 crisis and prepare the recovery.

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OECD (2020), Tackling coronavirus (COVID 19): Contributing to a global effort, http://www.oecd.org/coronavirus/en/. [2]

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[1] All population figures are based on country populations for 2019. The sample includes China (about 1.40 billion people) and India (about 1.33 billion people), which helps explain the large number of people covered by the level of containment measures to which these countries correspond. Total population for all OECD and G20 countries is about 4.86 billion.

[2] These countries include India.

[3] These countries include India.

[4] Former includes India and the latter includes China.

The COVID-19 crisis creates an opportunity to step up digitalisation among subnational governments

Category: COVID-19,Digitalisation
written by oecdecoscope | May 27, 2020
By Luiz de Mello, OECD, and Teresa Ter-Minassian, OECD Fiscal Network

Recent decades have seen rapid growth of advanced digital technologies, including high-speed computing, big data, artificial intelligence, the internet-of-things and blockchain. This “digital revolution” creates significant opportunities for all levels of government to improve the delivery of public goods and services, and to raise more and better revenue.

This is particularly important in the context of the COVID-19 crisis. Fighting a pandemic while minimising the associated economic costs calls for appropriate digital infrastructure for the design and enforcement of containment measures, as well as to ensure access by the population and enterprises to critical government services. After all, subnational governments (SNGs) account for about 40% of government spending on average in OECD countries; they also play an important role in the delivery of key services that are at the heart of the policy actions being taken to slow the spread of the pandemic, including on health care and social protection.

Much of the literature has focused so far on the scope for advanced digitalisation at the central/federal level of government. In a recent OECD paper, de Mello and Ter-Minassian (2020) focus on the opportunities and challenges that digitalisation creates for SNGs.

Advanced digital technologies can help improve the quality and efficiency of subnational programmes. Geographic information systems (GIS) are being used to identify potential environmental and health risks, which is important when it comes to controlling the spread of a pandemic and avoiding its recurrence. Of particular interest is the use of sensors, to control road and railway traffic, maintain regional or local infrastructure, and monitor water and sanitation usage, just to cite a few. Digital portals facilitate SNGs’ communication with their populations and the delivery of certain public services, and well-designed information systems can strengthen all aspects of subnational public financial management, and facilitate subnational transparency and accountability.

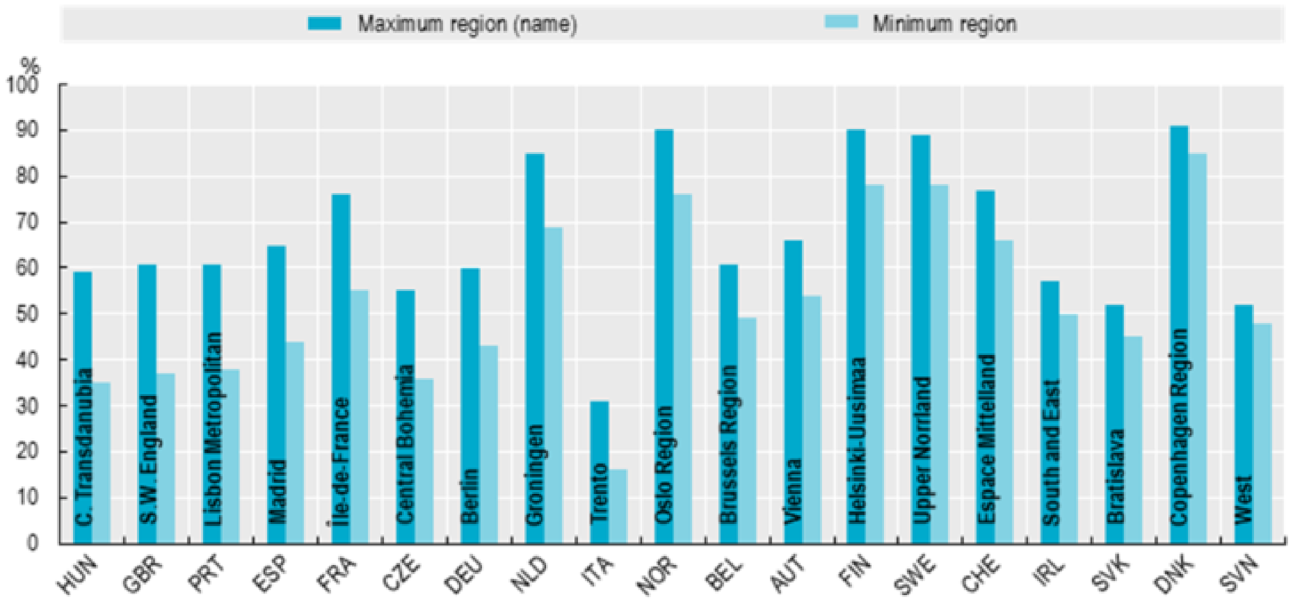
At the same time, regional and local governments are having to operate digitally in periods of confinement and to broaden the range of services provided on-line to the population, including in some cases in the area of e-health. The case of testing, tracing and tracking through digital devices to contain the spread of COVID-19 is a case in point, where the local governments are in many cases actively involved in these efforts, and privacy/confidentiality concerns are prompting important debates among policymakers.

Digitalisation can also help to improve both shared and own subnational revenues. This is particularly important to prepare governments to restore the sustainability of the public finances, once the post-COVID-19 recovery has been firmly established. Especially promising are possibilities to introduce, or strengthen, the enforcement of consumption taxes, regional personal income taxes (PITs), or regional surcharges on national PITs; make more efficient and equitable the administration of local property taxes; and better utilise user fees for local services.

Digitalisation, however, also poses significant challenges for SNGs, whose capacities to deal with such challenges vary widely both across and within countries (see Figure). The most important constraint in many SNGs is likely to be the scarcity of requisite skills, not only in government leadership and bureaucracy, but also across the population at large. Lack of skills breeds, in turn, distrust and resistance to digitalisation.

Figure. Regional variation in population using the Internet for public services

Percent of total population, 2017



Source: OECD (2018), *Regions at a Glance*.

Other significant constraints can be posed by inadequate physical infrastructure and financial resources to improve it. Less recognized, but also important, can be legal or regulatory constraints. Tackling cyber security risks, and adequately addressing citizen’s privacy concerns constitute further significant challenges.

These challenges in SNG digitalisation highlight the need for a well-structured overall strategy beginning with a stocktaking of the initial state of, and main obstacles to, digitalisation. Within these constraints, SNGs need to define priorities (e.g. which public services should be digitalised first); identify needs for legal and organisational supporting changes; define responsibilities for different tasks; set up realistic timetables for implementation; appropriate the necessary budgetary resources, and procure any needed skills and materials; and closely monitor the implementation of the strategy.

Early involvement of main stakeholders and clear communication to the public at large of expected results, are essential for securing citizens’ support for the digitalisation effort.

Moreover, co-operation among and within different levels of government can play a significant role in supporting effective and efficient digitalisation of SNGs. The case for support by national government is made more compelling by the fact that different SNGs are differently equipped to meet the challenges of digitalisation. Smaller and poorer urban, and especially remote, rural communities are more likely to suffer from skill shortages, limited connectivity and scarcity of budgetary resources.

Policy innovation is another important area for inter-governmental co-operation in the digital sphere, with considerable potential for SNGs to launch pilot programmes that can be tested and subsequently taken up by other same-level jurisdictions and/or up-scaled to other levels of administration through gradual experimentation. The pandemic is actually triggering a lot of promising innovation by SNGs that can do much to improve their preparedness to deal with future crises.

National governments can support subnational digitalisation efforts. This can be achieved in particular through appropriate reforms to intergovernmental fiscal relation systems, including the assignment of own tax bases to SNGs; greater clarity in the assignment of expenditure responsibilities, and the implementation of equalization transfers; by giving adequate weight to regional digital inclusion in public investment choices; by defining appropriate nation-wide standards to facilitate seamless interfaces among the national and subnational digital systems; and through technical assistance and training of subnational officials.

There is also significant scope for horizontal co-operation among SNGs. Peer support can include demonstration effects, technical assistance and joint training of officials, as well as effective interfaces among subnational digital systems in areas of common interest. Dedicated forums for inter-regional and inter-municipal dialogue on digitalisation issues, possibly under the umbrella of broader horizontal co-operation forums, can be instrumental in facilitating both the exchange of experiences and consensus building on common digitalisation issues.

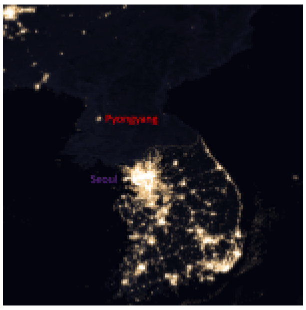
The COVID-19 crisis provides an opportunity to step up the digital transformation of SNGs given the need to act steadfastly during the ongoing containment phase but also in preparation for the post-crisis recovery. The lessons that are emerging from the current experience, if put to good use, can do much to make SNGs better equipped to cope with future crises.

Reference

de Mello, L. and T. Ter-Minassian (2020), "Digitalisation Challenges and Opportunities for Subnational Governments", OECD Working Papers on Fiscal Federalism, No. 31, OECD, Paris.

North Korea and the coronavirus pandemic

Category: COVID-19,North Korea
written by oecdecoscope | May 27, 2020



by Vincent Koen and Jinwoan Beom, Country Studies Branch, OECD Economics Department

The COVID-19 epidemic started in Wuhan, China, but soon spread across borders and became a pandemic on a scale not witnessed since the 1918 flu pandemic. One of the countries most directly exposed to the outbreak was North Korea, whose economy is not as closed as the “Hermit State” moniker might suggest, but highly dependent on China, as documented in the OECD’s first study on North Korea.

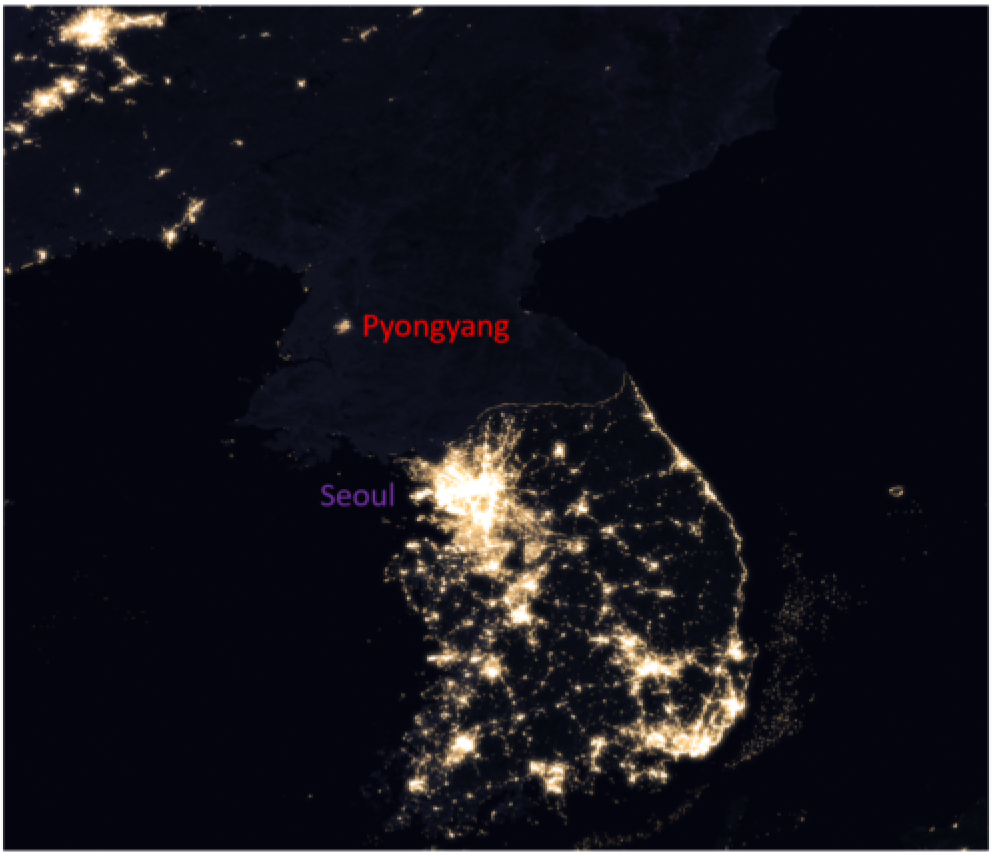
The North Korean authorities acted swiftly: Air China flights between Beijing and Pyongyang were suspended on 20 January and so were national carrier Air Koryo flights soon thereafter and Chinese tourism more generally – a major forex lifeline. On 21 January, North Korea was reportedly already working with the World Health Organisation to try and prevent the spread of the virus in the country. Quarantine measures followed, including school and university closures.

The North Korean economy has been a statistical black hole for decades but is undergoing substantial transformations. Rapid post-war industrialisation had put the country ahead of South Korea by the time Prof Joan Robinson visited in the mid-1960s, prompting her to wax lyrical: “Eleven years ago in Pyongyang there was not one stone standing upon another (…) Now a modern city of a million inhabitants stands on two sides of the wide river (…) A city without slums (…) Even more remarkable are the neat villages, scattered over the countryside (…) A nation without poverty (…) everyone is adequately provided with food, clothing, shelter, medical care, and educational opportunities” “All the economic miracles of the postwar world are put in the shade by these achievements (…) Every industry and every service is building up capacity so as to be able to rush aid to the South as soon as communications are opened up.”

The “miracle” was not sustained, however, and South Korea’s economy far outpaced North Korea's during the next three decades, during which trend growth declined and turned negative as Soviet support ended and the terms of trade with China became less friendly.

Today, GDP in North Korea is reportedly lower than in 1990, notwithstanding a larger population, and gross national income per capita is down to only a tiny fraction of South Korea's. A large share of the workforce remains in agriculture but domestic food production is insufficient to avoid widespread chronic undernourishment. Infrastructure shortcomings are glaring, not least with respect to electricity supply and transportation.

The Korean Peninsula by night

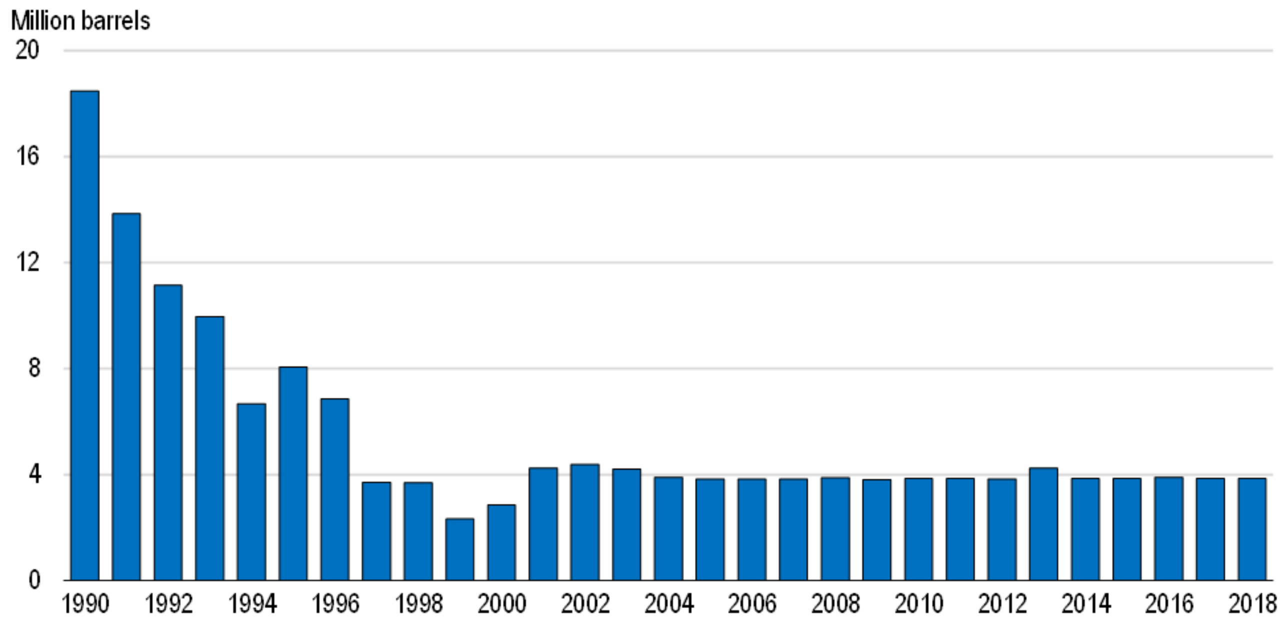


Source: NASA Earth Observatory, 2016.

At the same time, the scale and breadth of market activities has visibly expanded since the turn of the millennium, as part of a transition to a hybrid system mixing State, Party and army control with decentralised initiative, against the backdrop of a military build-up met by tightening international sanctions.

The OECD's new working paper documents a number of the changes that have taken place North of the 38th parallel. It draws on a wide array of published sources, which rest on limited and often indirect hard evidence and numerous bits of more anecdotal evidence. The study describes the evolution of economic planning, currency reform, "yuanisation", the proliferation of markets, the emergence of a new mercantile class dubbed the "masters of money" (donju), the development of special economic zones and their failure to attract much foreign investment, the dispatch of North Korean workers abroad and the promotion of tourism as means to secure forex, and how digitalisation is changing lives. It also discusses the impact of the economic sanctions, which can be seen for example when looking at mirror statistics of official crude oil imports. The study lists some of the myriad ways the sanctions are circumvented, including via a bewildering variety of smuggling channels.

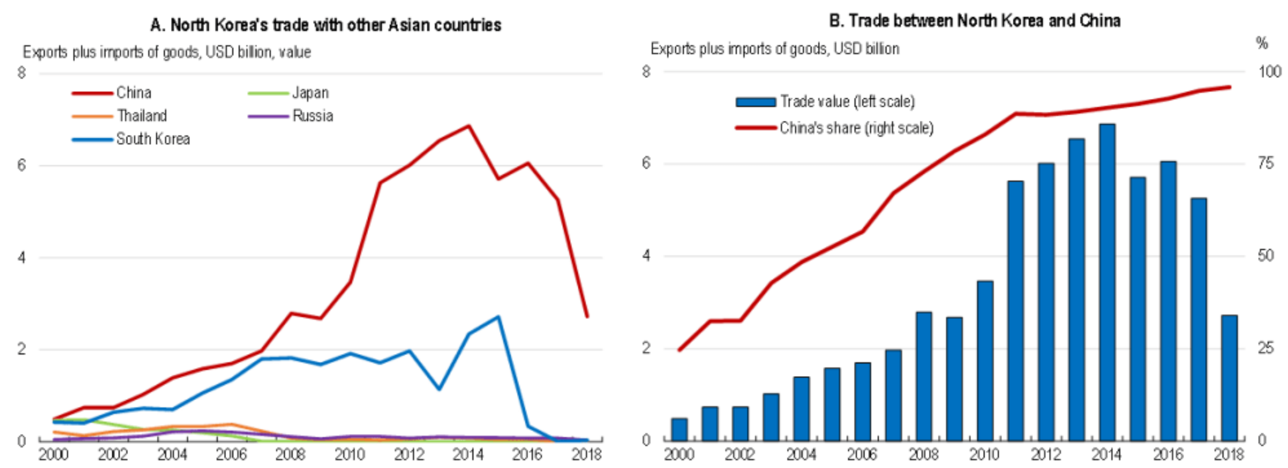
Estimated official crude oil imports



Source: Bank of Korea.

In many of the aforementioned areas, the country's very high dependence on China is striking. This has been particularly evident since the outbreak of the COVID-19 pandemic, which cut off some of North Korea’s major sources of supply and the main market for its products – a situation that is hard to sustain for an economy with limited reserves. Indeed, while North Korea closed its border with China in January 2020, some traffic has reportedly resumed, with exemptions provided by the Chinese authorities to North Korean traders in late March and container trucks seen to again cross the Sino-North Korean Friendship Bridge in early April.

Trade with other Asian countries



Source: Korea Trade-Investment Promotion Agency (KOTRA).

Read the full paper: Vincent Koen and Jinwoan Beom, “North Korea: the last transition economy?”, *OECD Economics Department Working Papers*, No. 1607, April 2020.

Information on COVID-19 in North Korea: https://www.nknews.org/pro/coronavirus-in-north-korea-tracker/

Europe must act now to

prepare the aftermath of the pandemic crisis

Category: COVID-19,Euro Area,European Union,Uncategorized
written by oecdecoscope | May 27, 2020

by Laurence Boone, OECD Chief Economist and Alvaro S. Pereira, Director, Economics Department Country Studies Branch, OECD

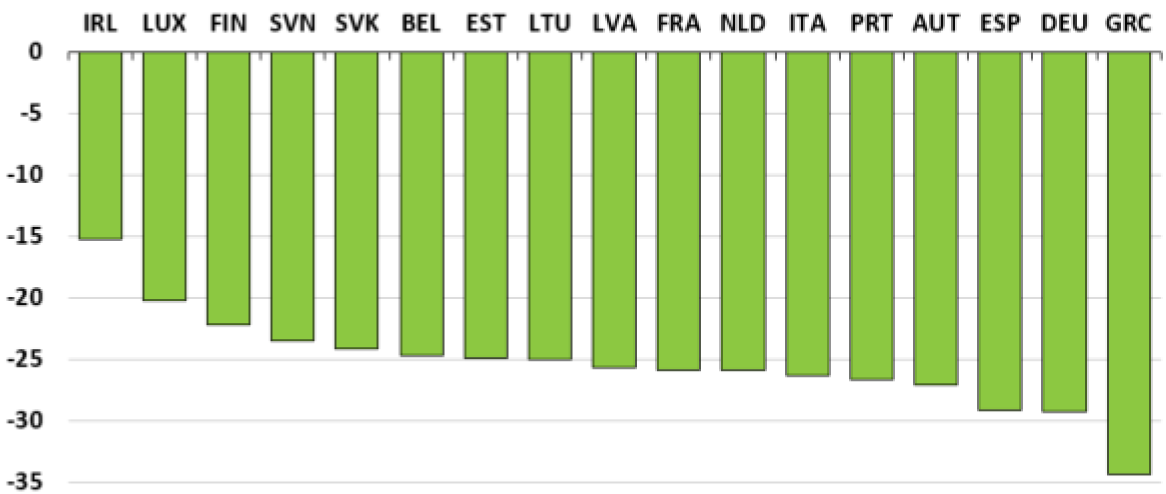
We are currently facing extraordinary challenges posed by the Covid-19 pandemic, due to which necessary health measures are shutting down part of our economies and precipitating a recession of unprecedented nature and magnitude.

In the immediate response to the crisis, governments increased health spending, but also introduced large fiscal support (e.g. short-time working weeks, extended unemployment schemes, tax and social security deferments, new credit lines, among others, see **OECD Policy tracker**) in an attempt to mitigate the social and economic impact of the pandemic. In addition, in Europe, the ECB launched a large program of asset purchases and a set of other unprecedented measures, and the European Commission temporarily shut down budget rules and exceptionally lifted state aid rules.

Still, given the magnitude of the crisis that we are facing, these measures and packages, albeit important and unprecedented, will not be enough for most European countries to address a post-pandemic world where debt levels will be much higher and the job losses tremendous. According to **OECD estimates**, the widespread shutdowns needed to contain the spread of the coronavirus and save lives will cause an estimated initial direct output decline of around 25% in many economies (Figure 1).This is equivalent to a contraction of about 2 percentage points of annual GDP per month of confinement. Thus, the 2020 output fall will far exceed that of 2009.

Figure 1 The potential initial impact of partial or complete shutdowns on activity in euro area countries[1]

In percent of GDP at constant prices[2]



1. Euro area countries that are also members of the OECD (17 countries).
2. The sectoral data are on an ISIC rev. 4 basis in all countries. The sectors included are manufacturing of transport equipment (ISIC V29-30), construction (VF), wholesale and retail trade (VG), air transport (V51), accommodation and food services (VI), real estate services excluding imputed rent (VL-V68A), professional service activities (VM), arts, entertainment and recreation (VR), and other service activities (VS). The latter two are grouped together as other personal services in the figure. Full shutdowns are assumed in transport manufacturing and other personal services; declines of one-half are assumed for output in construction and professional service activities; and declines of three-quarters are assumed in all the other output categories directly affected by shutdowns. Real estate services excluding imputed rent are assumed to be 40 per cent of total real estate services in countries in which separate data are not available.

Sources: OECD Annual National Accounts; OECD Trade in Value-Added database; and OECD calculations.

When the confinement is gradually withdrawn, European policymakers will have to do more to speed up the recovery and avoid massive unemployment and firm bankruptcies. The challenge will be significant: many euro area countries will have debt ratios above – and sometimes much above – 100% of GDP, and economic fundamentals will have been hurt. History shows that countries that invest in the recovery, rather than tighten too much too fast, not only accelerate the recovery, but are also able to bring debt down faster. Too rapid fiscal tightening in some countries in 2010/2011 weakened the euro area and left it with long-term scars, including an incomplete restructuring of the banking and corporate sectors, higher structural unemployment, low investment and low inflation, and a failure to revive structural reforms agendas.

There is an important positive element in the current crisis: by committing to “do everything necessary within its mandate”, the ECB has responded forcefully and much faster than in the previous crisis, contributing to and buying precious time for policymakers to work out a sustainable response to this symmetric shock.

Europe is building up a multi-pronged response to the crisis and the ensuing recovery, but some debate remains regarding the financial instruments that must be used for this purpose. The EIB is proposing substantial support to firms, and the Commission is proposing to support the unemployed, which seems to have met consensus. But the bulk of Europe’s fiscal response to address the “war effort”-like recovery remains largely individual or national. Unlike in the recent financial crisis, this exogenous shock is shared across countries. The debate is made more complex by some perceptions that the uneven situation across countries is due to different levels of responsibility at the national level, especially regarding fiscal policy. It may be fair to say that much of the debt legacy prior to the crisis is indeed individual countries’ responsibility. But this is not the case for the health and economic efforts resulting from the Covid-19 pandemic. Both **the widespread pandemic and the close integration of EU countries argue for a financial response that should be large and shared** . Such a response should be clearly differentiated from the stock of debt prior to the Covid-19 crisis.

It is imperative to bridge the gap between the existing options in the debate for a forceful response. Two options could provide the EU with the necessary fire power to address this crisis: a new financial instrument featuring joint issuance, and the European Stability Mechanism (ESM). We start with the latter.

The ESM was created by euro area members to mobilise funding and provide financial assistance to countries threatened by or experiencing severe financing problems. Its use involves a rigorous analysis of public debt sustainability and strict policy conditionality, because these difficulties were perceived as resulting from past policies having led to poor economic performance. Obviously, these criteria do not apply in the current crisis. In particular, the strong conditionality attached to financial assistance seems totally inadequate when the crisis arises from a pandemic or a natural disaster. Some are suggesting light conditionality. However, this approach may not be acceptable to those countries that believe that strict conditionality is an explicit requirement for accessing its resources. In addition, the 410 billion euros in unused lending capacity (3.4% of 2019 euro area GDP) seems modest when compared to the needs of the euro area as a whole. In addition, the ESM currently relies on short-term credit facilities having an initial maturity of one year, and renewable twice, each time for six months. Therefore, ESM credit lines provide only limited relief against medium-term rollover risks, which makes it more of a bridge facility to overcome temporary fiscal distress pending a medium to long-term solution.

For all these reasons, as it currently stands, the ESM is ill suited to provide widespread fiscal support to euro area countries to counteract the economic fallout of the pandemic. **If the ESM is to play a significant role in the challenges posed by the current crisis, its firepower will have to be substantially upgraded, the conditionality requirements will have to be significantly watered down and replaced by an allocation usage condition** (namely, fund all pandemic-related spending).

An alternative is the creation of European financial instruments that mutualise a large part of the fiscal costs and financing of the crisis. More specifically, **the launch of**

one-off, ad-hoc European debt instruments should help finance fiscal needs at a relatively low cost for all euro area members and for the euro area as a whole. This would have the advantage of not adding directly to the national debt numbers, provided such a feature is part of the original design. This approach demands that several conditions are met:

- Ensuring the one-off, temporary nature of the fund: the credibility of the one-off nature of the instrument would be enhanced by dedicating a targeted tax flow to its payment over a very long period, such as, for example, the model of the German solidarity tax after reunification. Long maturities should help ensure that repayments will be spread over generations and not hamper the recovery efforts.
- The spending would cover only Covid-related expenditures, to address health risks and the associated recovery from the exceptional shutdown. The instrument would be governed by the European Commission, and overseen by the European Parliamentt.
- The supra-national nature of the bonds would allow the ECB to purchase up to 50% of the issuance, while anchoring the fiscal commitment of euro area countries to the recovery .
- Such instrument would increase the fiscal space in countries more sensitive to borrowing costs and accelerate the recovery for all.

The crisis faced by Europe is extraordinary and requires extraordinary responses. It is also a unique opportunity for Europe, and in particular the EMU, to consolidate its economic and financial architecture, and to promote Europe as the engine of “shared prosperity”. A significantly reinforced and revamped ESM or a new financial instrument based on joint issuance, as described above, would be possible vehicles to translate words into action. The ECB has bought European policymakers some precious time that they now have to use to devise a common approach.