



COVID-19

How policy can buffer the virus shock

February 28, 2020

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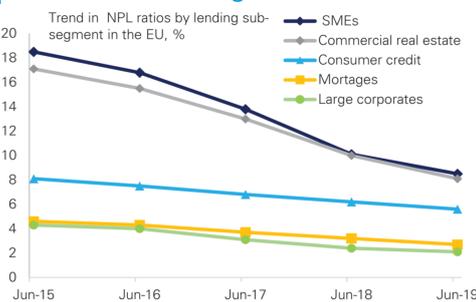
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In addition to absorbing a virus shock through the China export demand and supply chain channels, Europe now has to absorb a domestic outbreak. Voluntary steps to prevent the spread of the coronavirus (“social distancing”) as well as official containment measures are likely to disrupt economic activity. We expect disruption beyond northern Italy, an area which accounts for about 5% of euro area GDP. A temporary economic shock similar in scale to Hong Kong’s when SARS struck in 2003 would only need to occur in 10% of the euro area for area-wide GDP to stagnate in H1 and take the zone to the verge of technical recession. It is a highly fluid situation, but this might be a best case outcome.

We do two things in this note. First, we look at how quickly economic activity can fall with a virus shock, the channels through which a shock can transmit and the sectors that might be most vulnerable. Second, we think about the best design for a policy response to a situation like this. Minimising the duration of the virus might require maximum containment. This could sharply curtail income flows in affected regions and sectors for a few weeks to a few months. In its initial response, policy needs to target the affected regions and sectors to ensure that the virus shock is not amplified, for example, through job shedding and business failures.

Stress on SME sector more likely to translate into rising NPLs



Source: Deutsche Bank, European Commission

ECB Chief Economist Lane has left the door open to a further deposit rate cut, but ECB President Lagarde’s comments imply patience for now. Through the lens of net interest income, a rate cut would benefit Italian corporates but hurt households. A debt moratorium would be more effective. Unless there is a spike in sovereign yields, buffering the virus shock will be more about backstopping the flow of financing in the real economy than reducing the already low cost of financing. A short-term (6 month) LTRO to support SME lending in regions affected by the virus would be a targeted response. This could be combined with temporary adjustments to loan loss provision rules to defuse the risk of tighter bank credit supply in the affected regions.

Fiscal policy can be more easily targeted. To minimise the threat of second-order shocks, targeted fiscal policies need to be implemented rapidly. The focus should be less on slow-moving public investment spending and more on short-term and fine-tuned policies to bolster cash flows in affected sectors and regions. Examples of effective policies are social contribution cuts – member states could replicate Germany’s Kurzarbeit “short-shift” labour



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policy to encourage labour hoarding – specific tax relief and income support. The latter could include state financing of debt payments, utility bills, etc.

This is an excerpt of our [Focus Europe on policy responses to buffer the Covid-19 shock](#), published on February 28, 2020.

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