EUROFI VIEWS MAGAZINE - ZAGREB APRIL 2020

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Post-crisis recovery agenda: we need it now

None of us have ever experienced anything remotely similar to the ongoing situation, not even previous post-war generations. We are not in the midst of a «simple» financial market crash, but rather a real economic and humanitarian crisis. Many governments globally face a unique health crisis which has seen no borders. Combatting it has meant taking a deliberate, difficult and delicate trade-off versus economic growth. The global fiscal stimulus put to work to cushion the shock from Covid-19 on the economy is already double that seen during the global financial crisis (GFC). Massive amounts of guarantees are not even reflected in this number.

The insurance industry is at the core of the current situation: we provide financial coverage to households, corporates and governments on the underwriting side. In addition, we also deploy long-term capital on the asset side. As such, the industry has an inherent self-interest in the sustainability and prosperity of public policy actions. Future crises will arise and as such it is key for economies, society and the insurance industry to takeaway lessons learnt to make ourselves more resilient and more fit-for-future.

This time is different: paradigm shifts are in the making

A lot of factors remain uncertain, but one thing is for sure: the Covid-19-induced recession is unique as the virus affecting the global economy will result in one of the deepest downturns on record. The good news is that it may also be one of shortest on record and the pandemic has an associated expiry date – latest when a vaccine is released. This being said, there will be long lasting ramifications beyond the containment of Covid-19 which will take societies, policy making and the economic framework into a new era. Such paradigm shifts are as follows:

- **Further innovation from the ECB** – The central bank has pledged to use all its policy instruments as necessary - the 2008 playbook has already been largely rolled out. Should the situation not see a turn for the better we expect to see more innovation and an even larger role for central banks in private capital markets. While this could create some political tension due to the heterogeneity of member states, such obstacles are ultimately political in nature and can, and will in our view, be overcome should the situation warrant it.
- **Policy coordination and implicit debt monetisation** – Well coordinated and structured fiscal and monetary policy can go a long way to revive an economy. Compared to other countries and regions, outright monetization of government debt is legally prohibited in the Eurozone. But that is in name only: the ECB's quantitative easing programmes de facto already implicitly monetise government debt. It seems clear that this will be the way forward for Europe for quite some time, as the ECB provides governments with fiscal space they otherwise would not have had.
- **Bigger role of governments** – Governments have emerged as lenders and spenders of last resort by providing emergency loans and guarantees to businesses, and paying salaries and transfers to many individuals. They are unlikely to retreat hastily when the crisis is over. There have already been public injections of capital into private firms, and we expect more as loans turn into equity stakes and guarantees into bailouts.
- **Peak of globalisation and emergence of parallel supply chains** – Globalisation peaked pre-GFC, with the euro area having retained a much higher participation in global value chains than the US and China. The Eurozone's participation, however, has been supported by trade between member states since the European sovereign debt crisis.[1] The Covid-19 shock will likely translate into companies prioritising diversified and robust supply chains over efficiency and affordability. This will give rise to parallel supply chains that will result in a more resilient network, but also associated with increased costs.
- **Is low inflation coming to an end?** – After more than two decades of low inflation, the pandemic shock could trigger a turnaround. The collapse in demand from the strict lockdowns is dominating the short-term inflationary pressures. Peaked globalization, longer-lasting supply chain disruptions and massive fiscal stimulus could result in higher inflation once containment restrictions are lifted. De facto monetary financing of fiscal expenditures could further amplify this inflation risk.
- **Accelerated digital transformation** – Some of the strictest national lockdowns in response to the virus are seen across a number of EU countries. A clear majority of desk-job employees are now accessing their company's network remotely. The Covid-19 experience will only perpetuate such trends to the extent that they become «new norms».

[1] Euro area participation in the global value chain has declined by less than 1% since the European sovereign debt crisis of 2011, while when excluding intra-area trade this drop increases to roughly 2%. Source: European Central Bank Eurosystem, "The impact of global value chains on the euro area economy", Apr 2019

These paradigm shifts are difficult to appreciate in the first instance. But in our opinion, they will sustainably shape the business environment of the Eurozone and elsewhere.

A union of individualistic nations

The aforementioned paradigm shifts offer a glimpse of where the world might go from here. If the Eurozone wants to maintain its place as one of the major global economies, it must adapt and evolve.

The important disparities in the fiscal responses from euro area countries risk further exacerbating tensions between member states. The challenges arising as a result of Covid-19 will mean the union either «makes it or breaks it», with the eurozone at greater risk of falling apart now than during the Greek debt crisis. As such, it is vital for the euro area to experience an upsurge of solidarity if it is to survive. Instead, what we have is a union made up of countries that do not share a common approach when it comes to the handling of the shock - whether in terms of health response, exit strategies or the absorption of economic costs. This striking lack of political leadership, along with the behavioural and structural challenges, will result in a hesitant and sluggish recovery. We expect a global cumulative output loss of roughly USD 8 trillion by end-2021, more than 15% of which will be lost from the eurozone's economy.

Avoid zombification and focus on improving Europe's service sector – the future remains green

The economic shock is largely single-handedly being cushioned by the massive global fiscal stimulus which will exceed 3% of world GDP (compares to 1.6% in the GFC)[2]. This alone, however, will not absolve countries of all the challenges resulting in governments not being able to take away the massive fiscal measures any more than they were able to after the GFC. Given a similar demographic profile to Japan, it is critical that Eurozone governments provide support to companies and sectors with strong potential for future growth to avoid replicating Japan's growth trap. The survival of «Zombie» companies has been weighing on Japan's economic growth trajectory and its stock market: the Nikkei still stands at roughly half of its 1990 valuation.

In our view, the future of the Eurozone lies in the services sector and is green. Europe has increasingly grown into a service economy, with the sector amounting to nearly three-quarters of EU GDP. This challenges the notion of a single market, which was originally devised for goods, as lifting barriers to trade in services is much harder. The part of the economy covered by the single market is shrinking, putting in question its purpose considering the rising protectionism. European companies focussed on the sale of goods can make use of the single market, reaching scale and so profitability quickly. But service companies tend to be more productive than goods producing firms, resulting in higher salaries. Given the slowing productivity of the eurozone in recent years, the services sector must be a focus point on policy makers' agendas. Furthermore, with global efforts towards transitioning to a carbon neutral economy, the services sector in Europe comes with a lower carbon footprint at around 7%[3,4] of direct carbon emissions. The Eurozone could really kill two birds with one stone.

Call for action to improve resilience and build a common European recovery agenda

The euro area is demonstrating a surprising lack of cross-country solidarity in the face of one of the deepest recessions on record, and the global nature of the downturn will translate into global reaching paradigm shifts. The key question on policymakers' minds should therefore be: Where do we go from here?

Measures taken by governments around the world up until now have primarily been focused on cushioning the recession. Although this is necessary, European leadership also needs to approach the disruptions from Covid-19 as a window of opportunity to ensure sustainable economic growth in the longer-term. Thanks to the medical advances seen in the last century, Covid-19 will end up being a temporary, albeit painful, disruption. However, other themes such as climate change will remain at the forefront of global dialogues and won't be resolved any time soon. The Eurozone could position itself to spearhead the climate change dialogue and ensure the well-being of citizens and the environment.

Increasingly, the success of nations will be defined by a wider spectrum of factors than economic growth alone. Sustainability and resilience will be key competitive advantages, especially in a world where the risk landscape is growing more complex. The Eurozone can achieve this competitive edge by means of an over-arching resilience framework. We propose the following to kick-start the European economy, which will also improve trend growth, economic resilience and the political stability of the euro area:

1. **Common green innovation fund** – establishment of a euro area-wide fund to support innovative technology. The focus should be particularly put on low-carbon technologies in order to meet global climate change objectives all the while increasing productivity.
2. **Common resilience fund** – establishment of a common resilience funding pool that members can draw from in times of shock without the debt mutualisation aspect. The fund would have to be well structured with pre-defined trigger levels for fund access and the proceeds would need to be earmarked for targeted investments that are in line with Europe's economic and political ambition and vision.
3. **Digital alignment** – all European countries have improved their digital performance in the last few years. However, there are still large disparities across member states which need to be levelled. Europe would benefit greatly from a digital single market, in which the knowhow would be made available to SMEs. To some extent, Europe is in a luxurious position in this regard, as the Union can start from scratch without a pre-existing, institutional legacy on this front. The continent needs to seize this opportunity to the fullest.
4. **Infrastructure spending** – emphasis should be put on sustainable infrastructure, with the spending done at a national level but also at a eurozone level. Improving the transport infrastructure will be key to help the euro area transition to a low-carbon economy, while supporting the shift to parallel supply chains.
5. **Financial integration** – the capacity of the euro area financial system to channel surplus funds to parties in need of financing for consumption or productive investment purposes has remained largely unchanged in recent years[5,6]. Furthermore, better integrated asset markets should help smooth income and consumption growth, and hedge against country-specific sources of risk.

Ultimately, the European integration is a peace project which builds on solidarity and a joint future. The Eurozone therefore needs to act now while it still can and before what were once shared values drift further apart from each other. ●

[2] This number only reflects stimulus that flows into the fiscal deficit this year, and excludes all loan guarantees.

[3] Transport, construction, and real estate services are accounted for separately.

[4] Eurostat on "Greenhouse gas emission statistics – carbon footprints", Feb 2020.

[5] Total financial system size provides an indication of the capacity of the system to transfer funds.

[6] European Central Bank Eurosystem, "Financial Integration and Structure in the Euro Area", Mar 2020.