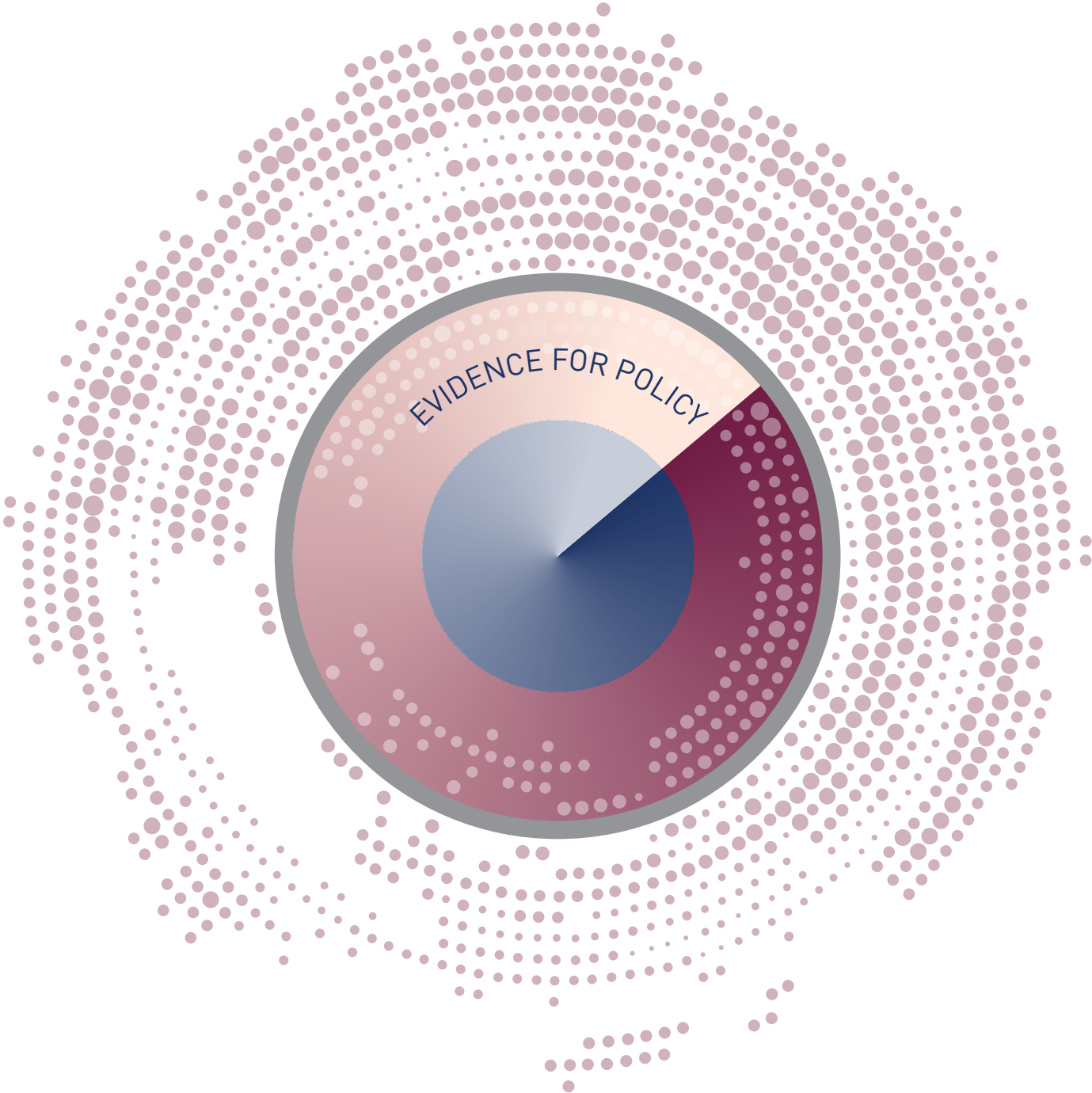


MACRO  
ECONOMIC  
FORECASTING  
MARCH 2020

# QUARTERLY ECONOMIC COMMENTARY

SPRING 2020

KIERAN MCQUINN, CONOR O'TOOLE, MATTHEW ALLEN-COGLAN AND  
CATHAL COFFEY



# QUARTERLY ECONOMIC COMMENTARY

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## Spring 2020

The forecasts in this *Commentary* are based on data available by 19 March 2020

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## SCENARIO RESULTS SUMMARY TABLE

	2017	2018	2019	2020
<b>Output (Real Annual Growth %)</b>				
Private Consumer Expenditure	3.0	3.4	2.8	-3.8
Public Net Current Expenditure	3.9	4.4	5.6	6.5
Investment	-6.8	-21.1	94.1	-8.1
Exports	9.2	10.4	11.1	-5.0
Imports	1.1	-2.9	35.6	-3.6
Gross Domestic Product (GDP)	8.1	8.2	5.5	-7.1
Gross National Product (GNP)	5.2	6.5	3.3	-8.1
<b>Labour Market</b>				
Employment Levels (ILO basis ('000))	2,194	2,258	2,322	2,145
Unemployment Levels (ILO basis ('000))	158	137	121	307
Unemployment Rate (as % of Labour Force)	6.7	5.8	5.0	12.6
<b>Public Finance</b>				
General Government Balance (€bn)	-0.9	0.2	1.4	-12.7
General Government Balance (% of GDP)	-0.3	0.1	0.4	-4.3

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## The Irish Economy – Overview

COVID-19 poses the single largest challenge to the Irish economy since the financial crisis.

The response of authorities both domestically and internationally to the spread of the virus, while absolutely necessary from a general health perspective, will result in millions of jobs being lost globally in the coming weeks and months and a sharp contraction in global economic activity. The limitations on international travel and the effective sealing-off of entire countries will have profound implications for cross-country trade and commerce.

The swiftness of the economic deterioration is unprecedented in modern times and in many respects exceeds that of the financial crisis.

It is clear that both monetary and fiscal authorities across the globe must act with conviction and speed to smooth the economic and financial effects of the crisis. Fiscal authorities must support the income levels of those made unemployed and ensure that those commercial enterprises financially viable prior to the crisis are able to operate after it.

The European Central Bank (ECB) will have a key role to play in both stabilising debt markets in the short run in response to the increased fiscal pressures on member states, and in mitigating the effects of the crisis on economic growth in the months and years to come. This may require an extensive expansion of the ECB's balance sheet.

Given the unprecedented uncertainty concerning the virus, we conduct a scenario analysis as opposed to a traditional forecast. Mainly through demand-side channels, we examine the impact of the current restrictions on economic life on the assumption that the restrictions are in place over a period of 12 weeks. Under such a scenario, the domestic economy would register a recession in this year with output contracting by 7.1 per cent. This constitutes a significant reversal of the pre-COVID-19 related economic trends.

Crucially, this scenario assumes that economic activity both domestically and internationally begins to recover significantly in Q3 and Q4 of the present year. If this does not occur, then the results will be even more adverse for the domestic economy.

All sources of growth such as consumption, investment and exports are substantially impacted under the scenario.

Under the scenario, the unemployment rate is set to increase significantly with the rate increasing from 4.8 per cent in February to 18 per cent in Q2 2020 before falling back to just under 11 per cent by the end of the year. This speed of change in the fortunes of the domestic and international labour markets is unprecedented.

Consequently, there will be significant pressure on the Irish public finances. The combination of the extra expenditure on health and social welfare allied to the sharp decline in certain taxation revenues means a deficit of nearly 4.5 per cent is now likely to occur in 2020 and could be higher. Greater expenditure may still be required in order to meet this threat to public health.

The path to recovery for the Irish economy is complicated by its extremely open nature. While the domestic authorities may be successful in limiting the spread of the virus, the performance and recovery of the Irish economy will now also depend on the effectiveness with which other countries deal with COVID-19.

It is clear that a coordinated response across the European institutions is required to address the economic fall-out from dealing with the virus. In particular, lessons must be learned from the manner in which European institutions dealt with the aftermath of the financial crisis. Beyond a European context, the global economic shock is going to require extensive, coordinated fiscal and monetary expansion to mitigate the effects of the economic shock.



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## The Domestic Economy

### OUTPUT

Our approach to assessing the impact of the COVID-19 virus on the Irish economy is to conduct a scenario analysis where we focus on the demand-side implications of the measures introduced by the Government to contain the spread of the virus. Before the onset of the virus, in early 2020 we had believed the economy could grow by up to 4 per cent in the current year.

Based on a framework in Keogh-Brown et al. (2010),<sup>1</sup> we conduct a detailed analysis of the impact of the virus on consumption levels. In particular, we examine the impacts of a 12-week pandemic period where the current restrictions and closures on economic and social life remain in place. Our key working assumption is that the majority of the economic impacts of the virus occur in Q2 of the present year. By Q3 and into Q4, economic activity both domestically and internationally is assumed to return to normal.

We also conduct a similar exercise for exports and imports. Separately, we evaluate the economic impacts of the virus pandemic on investment, the labour market and the public finances. Under the scenario, the domestic economy contracts by over 7 per cent in 2020. The unemployment rate, under the scenario, jumps to 18 per cent in Q2 before falling back for the rest of year, to just under 11 per cent by the end of the year. The resulting pressure on the public finances results in a deficit of nearly 4.5 per cent of GDP. While these economic impacts are severe, if the impacts of the virus persist on a significant basis into the second half of the year, the adverse effects will be even greater.

In the following sections we outline the effects of our scenario analysis on household demand, the traded sector, investment, the labour market and finally the public finances.

### DEMAND

#### *Household sector consumption*

Understanding the path of consumption in Ireland over the coming year has become increasingly challenging due to the outbreak of COVID-19. During periods of economic disruption caused by disease outbreaks, households often react by

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<sup>1</sup> Keogh-Brown, M.R., S. Wren-Lewis, W.J. Edmunds, P. Beutels and R.D. Smith (2010). 'The possible macroeconomic impact on the UK of an influenza pandemic', *Health Economics*, Vol. 19, Issue 11, p. 1345-1360.

cutting back on discretionary consumption and increasing precautionary savings. Given the suddenness of this shock, its global reach and scale, as well as the strict administrative restrictions on social and economic activity, parameterising the likely economic impact is exceptionally difficult. The dramatic and instantaneous rise in unemployment and cuts to income for households remaining in employment will reduce expenditure sharply. In such a scenario, any analysis based on historical experience may underestimate the initial economic impact on household spending.

During a pandemic, households pull back on spending for a number of reasons. First, households become unemployed and spending falls; second, other households reduce discretionary spending by avoiding situations that may increase the likelihood of infection. Precautionary savings (to buffer any future shock) are also likely to rise. Keogh-Brown et al. (2010) present some scenarios as to how consumption patterns may change during a pandemic. These are parameterised from population-based survey data which leverage information from Sadique et al. (2007).<sup>2</sup> The method goes through a range of household spending items and discusses the extent to which this spending is foregone during the pandemic. Keogh-Brown et al. (2010) note that 75 per cent of households would avoid making purchases in the area of leisure, transport, furnishings, clothes, cars and tourism. They assume the losses to transport and leisure will not be made up but spending on furnishings, clothes, cars and tourism are likely to be deferred rather than lost altogether.

However, these studies assume that the economy remains, to a large extent, fully functioning with the only new frictions due to school closures and adjustments to the labour force. Given the experience with the COVID-19 pandemic in other countries (notably China, Italy and France), and the measures around business and educational institutional closures announced in Ireland to date, these influenza studies are unlikely to sufficiently capture the shock to Irish spending. This is due to the extensive closure of businesses and services on public health grounds.

Therefore, to give some insight into the scale of the economic shock to household spending, we undertake a static exercise using the Household Budget Survey (HBS) data from 2015, to explore by how much Irish consumption may fall if (on average) households were to adjust their spending in line with a shock that we entitle the '12-week shutdown scenario'.

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<sup>2</sup> Sadique, M., W.J. Edmunds et al. (2007). 'Precautionary Behavior in Response to Perceived Threat of Pandemic Influenza'. *Emerging Infectious Diseases*, 13(9): 1307-1313.

The average expenditure by Irish households across broad categories from the HBS is presented below. A majority of spending is accounted for by housing costs and miscellaneous expenditure and food purchased at home.

**TABLE 1 IRISH HOUSEHOLD EXPENDITURE**

	Average Spend per Week (€)	% of Total
<b>Total food consumed at home</b>	97.01	12
<b>Meals away from home (incl. takeout tea/coffee)</b>	26.27	3
<b>Drink consumed at home</b>	10.56	1
<b>Drink consumed out</b>	10.06	1
<b>Tobacco</b>	7.39	1
<b>Clothing and footwear</b>	33.65	4
<b>Fuel and light</b>	38.56	5
<b>Housing costs</b>	164.36	20
<b>Household non-durable goods</b>	16.51	2
<b>Household durable goods</b>	27.50	3
<b>Vehicles (net of trade-in)</b>	46.89	6
<b>Motor Fuel</b>	34.88	4
<b>Insurance, tax and fines</b>	22.14	3
<b>Vehicle maintenance and other costs</b>	12.22	1
<b>Bus, Luas, rail and taxi</b>	6.68	1
<b>Delivery charges (takeaways) and other transport services</b>	0.14	0
<b>Air travel within ROI</b>	0.00	0
<b>International air travel</b>	1.30	0
<b>Other purchased transport services</b>	0.14	0
<b>Total miscellaneous goods, services and other expenditure</b>	281.21	34
<b>Total</b>	837.47	100

Source: Household Budget Survey, CSO.

In the economic scenario, we go through the spending items for the average household and adjust the spending downward in line with a judgement-based assessment of how spending might react in a shutdown. While we use Keogh-Brown et al. (2010) and Sadique et al. (2007) to provide guidance, the realities of the current scenario have led us to adjust these assessments accordingly. The mechanics of our scenario are as follows:<sup>3</sup>

#### *Pandemic period*

For a 12-week pandemic period, we apply the following changes to spending:

<sup>3</sup> For brevity, we do not show the full mappings. However, these are available on request from the authors.

- Expenditure on food and drink at home and medical care is doubled;
- Spending on housing costs, fuel and light, insurance, telecommunications, internet, other utilities, education expenditure (given fees etc. are already paid), home help, charitable donations, maintenance payments, elderly care costs and baby equipment are all kept constant;
- All other spending is set to zero.

Given the stringent administrative controls on activity, we do not see this as extreme. The doubling of food and drink and medical expenses reflects a number of factors including the administrative closure of services providing non-home based food and drink, precautionary expenditure and excess goods hoarding (panic buying) as well as treatment for illness.

#### *Recovery period*

For the 12-week period following the end of the public health emergency, we assume the following:

- Food and drink at home and medical expenses return to normal spending patterns;
- Items for which the purchase was not time-specific – related to a journey or leisure, sporting or social activity – we assume that spending for this item recovers by 50 per cent; thus we project spending at 1.5 times higher than normal for 12 weeks. The items included in this are: spending on clothing and footwear; durable and non-durable goods (broadly defined by HBS categories); spending on vehicles and their maintenance; repair of personal items; catering for weddings etc. Selection of these categories was based on judgement; attempting to understand what spending households would forego as opposed to postpone;
- All other items return to normal.

The weekly spending profiles under these three scenarios are presented below:

**TABLE 2** WEEKLY SPENDING PROFILE

	Normal Week	Pandemic Week	Recovery Week
<b>Total food consumed at home</b>	97.01	194.02	97.01
<b>Meals away from home (incl. takeout tea/coffee)</b>	26.27	0.00	26.27
<b>Drink consumed at home</b>	10.56	21.12	10.56
<b>Drink consumed out</b>	10.06	0.00	10.06
<b>Tobacco</b>	7.39	7.39	7.39
<b>Clothing and footwear</b>	33.65	0.00	50.48
<b>Fuel and light</b>	38.56	38.56	38.56
<b>Housing costs</b>	164.36	164.36	164.36
<b>Household non-durable goods</b>	16.51	0.00	24.77
<b>Household durable goods</b>	27.50	0.00	41.25
<b>Vehicles (net of trade-in)</b>	46.89	0.00	70.34
<b>Motor Fuel</b>	34.88	0.00	34.88
<b>Insurance, tax and fines</b>	22.14	22.14	22.14
<b>Vehicle maintenance and other costs</b>	12.22	0.00	18.33
<b>Bus, Luas, rail and taxi</b>	6.68	0.00	6.68
<b>Delivery charges (takeaways) and other transport services</b>	0.14	0.00	0.14
<b>Air travel within ROI</b>	0.00	0.00	0.00
<b>International air travel</b>	1.30	0.00	1.30
<b>Other purchased transport services</b>	0.14	0.00	0.14
<b>Total miscellaneous goods, services and other expenditure<sup>4</sup></b>	281.17	183.96	289.56
<b>Total</b>	837.43	631.55	914.20

Source: Authors' calculations.

The scenario implies that household spending is 25 per cent lower during the pandemic than normal, but recovers to 9 per cent above normal following the pandemic to account for the return of postponed spending.

Using these data we apply the following calculation. For a full calendar year (52 weeks), we apply pandemic spending levels for a 12-week period; recovery spending for a 12-week period; and for the remaining 28 weeks expenditure is normal.

The overall annual impact on consumption is therefore -4 per cent with the recovery in spending in the 12 weeks following the pandemic. Without the recovery, spending falls by a further 2 percentage points to -6 per cent.

<sup>4</sup> Mappings for this category are available on request.

**TABLE 3 PANDEMIC IMPACT ON CONSUMPTION**

	Spending (€)	Change %
Base Case	43,548	
12 Week (No Recovery)	41,077	-6%
12 Week (Recovery)	41,998	-4%

Source: Authors' calculations.

## TRADED SECTOR

As a result of the rapid global spread of the COVID-19 virus, all of Ireland's major trading partners have been/will be impacted in a major way by the pandemic. Given the variation in which the speed of the virus has spread through each country and the disparity in policy responses that governments have made, the pandemic is likely to peak at different points in time in each country throughout the year. This means the impact of COVID-19 on Irish trade may be spread out over a longer time period than its impact on other components of Irish GDP. However, in light of the current uncertainty regarding when the virus is expected to peak, we follow our baseline assumption for the other components of GDP and assume that the virus has a one quarter impact on Irish exports and imports, and that trade returns to normal in the following quarter.

The disruption the virus causes to the economies of all of Ireland's major trading partners will significantly reduce consumption and business investment in these economies which in turn will result in a large fall in Irish exports. However, some components of Irish exports are likely to be more impacted than others with machinery and equipment and business services likely to be particularly hard hit as a result of the fall in global investment. The fall in consumption and restrictions on international air travel also mean that tourism is likely to collapse over the quarter. Other less cyclical exports such as medicinal and pharmaceutical products are likely to be more resilient and, in some cases, may benefit from increased demand for medical supplies. Overall, under the scenario Irish exports fall by 5.0 per cent in 2020. As per the impact of COVID-19 on domestic consumption and investment, imports are also likely to decline significantly this year. Again, 'machinery and equipment' is likely to take a significant hit as are business services. Imports for the year, therefore, decline by 3.6 per cent under the scenario.

## INVESTMENT

Investment expenditure by enterprises has two distinct features that make it more likely to adjust rapidly to the current COVID-19 outbreak. First, expenditure on

fixed capital is irreversible (other than re-sale of the assets) and second, it is highly dependent on companies' expectations for future revenue streams. In the current environment, with an immediate and sharp adjustment in aggregate demand from households and firms, and an exceptionally high degree of uncertainty about the future trading landscape, it is likely that companies will pare back investment significantly. Furthermore, given the administrative controls introduced for public health reasons, physical barriers to undertaking investment will also be present for the duration of the outbreak.

However, the degree to which investment will recover will be highly dependent on the duration and scale of the public health crisis. In previous simulations of pandemic scenarios, Keogh-Brown et al. (2010) simulate that while investment drops during the pandemic, it fully recovers in the quarter afterwards. The scale of the current crisis may lead this to be too benign a scenario. We therefore make the following adjustments to investment spending, taking into account that the rebound in the following quarter is unlikely to entirely make up for the loss in the impacted quarter:

- Dwellings – investment falls to zero for the period but an 80 per cent rebound occurs;<sup>5</sup>
- Improvements – households cut spending to zero in the quarter and an 80 per cent rebound occurs;
- Other building and construction – investment to fall by 50 per cent, and half of the lost investment is recovered;
- Transfer costs are unchanged;
- Machinery and equipment and R&D – all investment stops for the quarter with 50 per cent of the lost investment being made up in the following quarter (net loss of 50 per cent of one quarter).

The impacts are presented (for a full year) in Table 4.

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<sup>5</sup> For investment in dwellings and improvements, our net loss is calibrated to be proportionate to the labour market shock facing households. Given that we predict an unemployment rate of close to 20 per cent in the quarter, we parameterise the scenario net loss as 20 per cent for investment in dwellings and improvements.

**TABLE 4 PANDEMIC IMPACT ON INVESTMENT**

	Base Case (€million)	With One Quarter Pandemic (€ million)	Change %
<b>Modified Gross Domestic Fixed Capital Formation</b>	39,528	36,290	-8.2
<b>Gross Domestic Fixed Capital Formation – Dwellings</b>	4,511	4,285	-5.0
<b>Gross Domestic Fixed Capital Formation – Improvements</b>	2,687	2,553	-5.0
<b>Gross Domestic Fixed Capital Formation – Other Building and Construction</b>	15,965	14,967	-6.3
<b>Gross Domestic Fixed Capital Formation – Transfer Costs</b>	1,324	1,324	0.0
<b>Machinery and equipment and R&amp;D</b>	15,041	13,161	-12.5

Source: Authors' calculations.

Investment in other buildings and construction, which primarily relates to commercial building, falls in the impacted quarter by about half of what it would be in the base case. However, in the following quarter about half of this loss is recovered leading to an annualised loss of 6.3 per cent. Under the scenario, investment in dwellings and improvements comes to a complete halt in the quarter of the pandemic but much of this investment is then deferred to the following quarter offsetting a significant amount of the original loss. The annual loss of investment in dwellings and improvements is estimated to be 5.0 per cent. A similar scenario is estimated for other machinery and equipment and R&D with a complete fall in investment during the pandemic quarter, though less of the investment is made up in the next quarter. Investment in these items is forecast to fall by 12.5 per cent on an annual basis. Investment related to transfer costs is not forecast to be impacted by the pandemic. Overall, under our scenario, investment is down 8.1 per cent for 2020 compared to the previous year.

## LABOUR MARKET AND PUBLIC FINANCES

### *Labour market results*

An inevitable consequence of the decision taken by the authorities to restrict the spread of the virus has been an almost total decline in certain types of economic activity from mid-March onwards. Many outlets particularly in the retail, food and hospitality sectors have simply stopped trading. Under our scenario we assume a 12-week period during which the restrictions and controls on public life continue. This will inevitably result in a dramatic increase in the numbers of workers in these sectors being made unemployed. In particular, the wholesale and retail trade and the accommodation and food service activities, which together employed over 480,000 people in Q1 2020, look set to lose a substantial number of workers over a very short period of time. While the domestic labour market experienced a rapid



increase in unemployment in the period between early 2008 and 2009 (from 5.3 per cent to 14 per cent), such an increase in the present context could take place in a matter of weeks.

Under our scenario, we assume that normal economic activity both domestically and internationally will have commenced by Q3 of the present year. Overall, the unemployment rate increases from 4.8 per cent in Q1 to 18 per cent in Q2 before falling back to 16.5 per cent in Q3 and 10.7 per cent in Q4. The increase in the unemployment rate through Q2 and Q3 is equivalent to approximately 300,000 workers losing their jobs during this period. Under our scenario we also assume that net migration into Ireland declines significantly during the course of 2020.

Clearly, policy interventions that ensure inherently viable businesses survive the crisis, and that secure income levels for those households most affected, will lower the impact of the crisis on the labour market. However, the increase in unemployment could be greater if economic activity does not return to normal in the latter half of the year.

#### *Public finance results*

Given the impacts of COVID-19 on consumption, trade and the labour market in our scenario, it is evident that certain tax headings such as income tax, VAT, corporation taxes and PRSI receipts are all likely to experience significant declines in 2020. The substantial increase in unemployment in Q2 inevitably results in a dramatic fall-off in revenues across a number of tax headings for that quarter. Under the scenario, for example, total receipts for income tax fall by 5 per cent in the present year, with VAT receipts also declining by 8 per cent. The decline in income taxation receipts is consistent with our scenario results for the labour market, while the decline in VAT receipts reflects the sharp decline in consumption detailed above. Overall, under the scenario, taxation receipts are reduced by almost 7 per cent. This is in sharp contrast to recent trends in taxation receipts.

Similarly, on the expenditure side, the Government has committed significant additional resources to addressing the outbreak of the virus. We assume that the funds which had been set aside to deal with a hard Brexit (approximately €1.2 billion) are now fully spent on virus-related measures as well as additional revenues publicly pledged. Also, the sharp increase in unemployment will result in a sizeable increase in transfer payments. Based on our results for the labour market, upwards of €2 billion in such payments are now required in 2020.<sup>6</sup>

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<sup>6</sup> We are particularly grateful to our colleagues Karina Doorley and Barra Roantree for providing us with this estimate based on the SWITCH model.

We also include the cost of an income protection scheme similar to that proposed in the United Kingdom. Under such a scheme 80 per cent of the salary of workers made redundant during the virus crisis would be paid by the national Exchequer. On top of the regular transfer payment, we estimate this would result in an additional €2.8 billion expenditure over the period in question. When we combine this with the lower revenues on the taxation side, it results in a deficit for 2020 of over 4 per cent for the year.

It may be necessary to increase the deficit beyond this amount if additional health expenditure and/or social welfare payments are required. Additional expenditure may also be required to fund a broadly-based stimulus when economic activity recommences in Q3 and Q4. Obviously, if there is a significant delay in the economic recovery both globally and domestically, then the size of this deficit would also increase as the year progresses.

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## General Assessment

### ECONOMIC IMPACT OF COVID-19:

Ultimately, in order to contain the spread of the COVID-19 virus, the public authorities have had to implement measures which will have a drastic impact on certain aspects of economic activity. In that regard it is important also to note that, for once, Government policy is actively seeking to limit certain aspects of economic activity. Part of the necessary action taken by the authorities involves closing schools, pubs, restaurants, hotels and limiting the use of airports. All of this significantly curtails what Wren-Lewis<sup>7</sup> calls ‘social consumption’.

This will inevitably result in a significant decline in output in key sectors of the economy with a significant increase in unemployment. The likely increase in Irish unemployment will be substantial in size and rapid in nature. To provide some perspective, at the height of the financial crisis Irish unemployment went from 5.3 per cent in February 2008 to almost 14 per cent in September 2009. This time around, the unemployment rate could increase to 18 per cent in Q2 of this year from its rate in February of 4.8 per cent. If economic activity does begin to return to normal in Q3 and Q4, the unemployment rate declines through the rest of the year from 16.5 per cent in Q3 to 10.7 per cent in Q4.

Given the uncertainty around the duration of the virus it is not possible to produce accurate forecasts at a time like this. In estimating the economic effect of the virus, our approach is to conduct scenario analysis as opposed to a traditional forecast. Also, given the rapidly changing nature of the pandemic, it is likely that even well thought out scenarios can quickly become out of date. Therefore, we will produce a range of scenarios and economic updates over the coming months as more information becomes available concerning the scale and impact of the pandemic.

We begin by providing a specific scenario which considers the impact on the Irish economy of a continuation of the current restrictions and controls on economic and social life for a 12-week period. On an annualised basis, we believe consumption could decline by almost 4 per cent relative to 2019 levels under such a 12-week pandemic period. We combine these impacts on consumption along with impacts on trade and on investment. These results indicate that the Irish economy is almost certainly heading for a significant contraction in 2020.

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<sup>7</sup> Wren-Lewis defines consumption as social if it helps bring people into contact with other people. See <https://mainlymacro.blogspot.com/2020/03/the-economic-effects-of-pandemic.html> for more on this.

It is important to acknowledge the assumptions made in this exercise. These include the expectation that most major economies will have managed to contain the virus by July, and that normal economic activity will recommence during the latter two quarters of the year. If this does not happen then the impact on the Irish economy will be even more severe.

Under our scenario, key fiscal metrics for the economy will be adversely impacted. While a surplus had looked likely at the onset of the year, the knock-on impact of lower taxation revenues coupled with greater than expected public expenditure on health and social welfare means that a deficit of at least 4.3 per cent is now likely in the public finances.

### **THE POLICY RESPONSE TO COVID-19:**

While the most pressing policy concern at present is to introduce whatever measures are required to stem the spread of the virus, policies to stabilise the economic fallout are also critical from an economic and human perspective. The overarching policy concern should be twofold: protecting household incomes and ensuring businesses can survive the pandemic period and remain viable in the aftermath.

While the financial crisis and the current situation are very different, one lesson from the previous period should guide policy choices now. It is clear that households and firms with high debt levels cut back on consumption, investment and employment. If businesses, in particular, are to maintain employment and return to growth when the acute medical phase of the current crisis has abated, policies should be focused on helping these enterprises to manage their payments and cash flow without running up significant debt levels. Supports to protect workers' incomes can have a double boost of ensuring households have sufficient resources while lowering cash flow issues for employers. Policies by the financial sector to provide loan repayment holidays are welcome and should give households and firms breathing space, but more is required across a range of fixed payment items (such as rent, utilities, taxes and other charges).

On the fiscal front, the Government is already taking stimulatory action. While a further stimulus will be required at some stage, in the immediate future fiscal policy support should be specifically targeted towards income supports and measures to help firms remain viable. At present, with Government policy actively seeking to discourage people from engaging in unnecessary human contact, households are effectively being constrained only to consume bare essentials such as basic groceries. This would lower the impact of a broad stimulus now as households would have few avenues to spend. However, when the public health

phase of the crisis is over, more traditional fiscal policy levers should be engaged in an extensive and globally coordinated manner.

During this phase, huge responsibility lies with the European Central Bank (and European Banking Authority) as both lender of last resort and financial regulator. The ECB has outlined a series of measures which aims to support the supply of credit provided by banks to firms and households within the Euro Area. However, much more will be needed from the ECB in the weeks and months ahead and it will have to act in a ‘whatever it takes’ fashion.

It is clear that sovereign governments across the Euro Area are set to substantially increase their levels of debt over the coming months and years in response to this crisis. In the domestic context for example, it may be necessary to increase the deficit beyond the 4.3 per cent estimated under the present scenario; governments must do all that is required to meet the healthcare demands of this crisis. It is imperative, therefore, that the ECB does all that it can to prevent this development from becoming a full-blown sovereign debt crisis. It must also ensure that subsequent debt levels do not impede economic activity across the Euro Area in the years to come.

While the ECB is explicitly forbidden from engaging in monetary financing of government debt, there are more imaginative ways it can alleviate the fiscal burden on member states. For example, Whelan (2020)<sup>8</sup> has suggested that the ECB could issue very long dated Eurobonds. An announcement could be made where it would state that the ECB would purchase substantial quantities of these in the secondary market. This would enable governments to fund large deficits. These ECB purchases could then be calibrated to keep the yields on newly issued Eurobonds low for long periods of time. Alternatively, the ECB could loan money to the European Investment Bank which would provide funding to firms in distress. Honohan (2020) called for a ‘massive’ expansion of this type of funding.<sup>9</sup>

From a regulatory perspective, reductions in capital requirements for banks will be needed as the Central Bank of Ireland recently announced with its Countercyclical Capital Buffer. Creative ways to ensure loan modifications can occur without being classed as non-performing in the long run are going to be needed to ensure bank lending continues in the recovery phase and a credit crunch does not ensue.

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<sup>8</sup> <https://twitter.com/WhelanKarl/>

<sup>9</sup> <https://www.pii.ie/commentary/op-eds/coronavirus-no-excuse-repeating-errors-financial-crisis>

Overall, it is evident that European institutions must learn from some of the significant policy mistakes<sup>10</sup> which were made in dealing with the financial crisis of 2007/2008. Coordination and coherence are required across institutions such as the European Council (EC), the European Central Bank (ECB), the European Stability Mechanism (ESM) and the European Banking Authority (EBA).

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<sup>10</sup> See McQuinn, K. (2015) for more on this. 'European fiscal policy during the crisis: An Irish perspective', Research Note, *Quarterly Economic Commentary*, Autumn: The Economic and Social Research Institute, Dublin.

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