

Bank fragility: What consequences for economic growth and its relationship with bank loans?

[Jérôme Creel](#) and [Fabien Labondance](#)

The collapse of Silicon Valley Bank (SVB) has rekindled concern about the solidity of the US banking system and, via the danger of contagion, the European banking system. It offers a kind of case study of the complex relationship between banks and the economy.

SVB's collapse came a few months after the [Committee for the Alfred Nobel Memorial Prize in Economics](#), funded by the Royal Swedish Bank, awarded the 2022 prize to Ben Bernanke, Douglas Diamond and Philip Dybvig for their contributions to banking economics. In particular, Diamond and Dybvig explained the mechanisms by which a banking panic can occur (word of mouth is enough – economists speak of self-fulfilling prophecies), the difficulty of separating a solvency crisis from a liquidity crisis, and the measures to be implemented to stop it, i.e. by insuring deposits^[1]. Bernanke showed the way that a banking panic can be transmitted to the real economy, thereby justifying the central bank's implementation of a bank bailout. Their work undoubtedly helps to better understand the recent decisions of the US monetary authorities to contain the crisis triggered by SVB, such as the [extension of deposit insurance](#).

In addition to this work, an empirical consensus had emerged that economic growth, as measured by the change in GDP per

capita, could be explained by the development of bank credit and the financial markets. The international financial crisis of 2007-2009 reshuffled the deck. The work of [Gourinchas and Obstfeld \(2012\)](#) and [Schularick and Taylor \(2012\)](#) (and much subsequent work) showed that the expansion of bank credit was a leading indicator of banking crises. However, the link between bank credit, bank fragility and prosperity remained to be established.

This is the link that we explore with [Paul Hubert](#) in a paper entitled “Credit, bank fragility and economic performance”, to be published in the [Oxford Economic Papers](#). This paper examines the role of bank fragility in the relationship between private bank credit and economic growth in the European Union. We consider two types of bank fragility, one in terms of bank assets, and the other in terms of liability: the share of non-performing loans on the balance sheet and, in addition, the ratio of capital to assets, i.e. the inverse of leverage.

Our results are as follows. First, bank fragility, represented by non-performing loans, has a negative effect on economic growth: the higher their share of the balance sheet, the lower the growth of GDP per capita. Second, if bank fragility is included in the estimated model, in most specifications, bank credit has no effect on economic growth. The impact of credit on per capita economic growth seems to depend on the degree of bank fragility. Credit only has a positive and significant effect on per capita economic growth in a sub-sample ending before 2008 – which is in line with previous literature – and when non-performing loans are relatively low, i.e. when bank fragility is limited. Conversely, when bank fragility is high, credit has no impact on growth, whereas non-performing loans have a significant negative effect [\[2\]](#).

Omitting a bank fragility variable in the relationship between bank credit and economic growth may therefore lead to erroneous conclusions about the economic impact of financial

development.

The main implication of these empirical results is that closely monitoring and limiting non-performing loans – ex ante through prudent credit supply policies, or ex post through incentives to build up loan loss provisions – not only plays a prudential role at the bank level but also has an impact at the macroeconomic level. This monitoring of non-performing loans is critical for bank credit policy to have a positive impact on economic activity.

[\[1\]](#) See the critical summary of their work in the article by Hubert Kempf, “Diamond et Dybvig et la fragilité bancaire” [Diamond and Dybvig and Bank Fragility], forthcoming in the *Revue d'économie politique*.

[\[2\]](#) On the liability side, leverage has no impact on economic performance.

Spain: Beyond the economic and social crisis, opportunities to be seized

by [Christine Rifflart](#)

Spain has been hit hard in 2020 by the Covid-19 health crisis, which the authorities are struggling to control, accompanied by an economic recession that is one of the most violent in the world (GDP fell by 11% over the year according to the INE) [\[1\]](#). The country's unemployment rate reached 16.1% at

the end of last year, a rise of 2.3 points over the year despite the implementation of short-time work measures. The public deficit could exceed 10% of GDP in 2020, and the public debt could approach 120% according to the Bank of Spain's January 2021 forecasts. Europe has enacted large-scale support programmes for affected countries, and as one of these Spain will be the country receiving the most EU-level aid. It will benefit from at least 140 billion euros, with 80 billion of that (i.e. 6.4% of 2019 GDP) taking the form of direct transfers through the *NextGenerationEU* programme.

This aid is arriving in a very particular political context, marked by the progressive aspirations of a coalition government (PSOE-Unidas / Podemos) that has governed for just over a year, and which still appears to be solid. The commitments made in December 2019 between the two parties in a joint Pact entitled "[*Coalicion Progresista – Un nuevo acuerdo para España*](#)" [Progressive Coalition – A New Agenda for Spain] have now been included in the recovery plan sent to the EU Commission, and the first measures of the planned reforms have been included in the 2021 budget. In this difficult health and economic situation, the Spanish government could seize the opportunity provided by this crisis to carry out a thorough restructuring of the country

with the help of European funds and push through some of the social reforms announced in the PSOE-UP Pact. The needs, it must be said, are great. In 2018, the poverty rate was 19.3% among young people and 10.2% among those over 65 (compared with 11.7% and 4.2% respectively in France). Even though annual growth averaged close to 3% over the period 2015-2019, Spain's unemployment rate has remained at a very high level (14.1% in 2019), and labour productivity is still almost 25% lower than in France. There are significant regional disparities and insufficient investment, particularly public investment. But Spain could turn the corner over the next few years. The measures announced are commensurate with the government's ambitious aspirations for growth, employment, and social equity. The greater risk is probably to the government's solidity and its political capacity to implement it.

The 2021 budget, the first since July 2018!

Spain has gone two years without a budget vote, as the 2018 budget was extended twice after being amended by government decrees. But the government has finally managed to provide itself with a 2021 budget while impeccably respecting the timetable it had set out. The budget was sent to Brussels on 10 October 2020, approved on 3 December by the Congress of Deputies (Spain's lower chamber), and on 22 December by the Senate, and so was

adopted in less than three months. However, nothing can be taken for granted. The latest legislative elections in November 2019 (the fourth in four years) failed to give an absolute majority in Parliament to the socialist party PSOE, or even to the leading two parties combined (i.e. PSOE-UP, 155 deputies out of 350). So Pedro Sanchez's coalition government was compelled to seek the support of the small pro-independence and regionalist parties for the adoption of its budget. After three months of negotiations and several thousand amendments, a large majority was obtained. Of the 350 deputies in Congress, 188 from 11 different political formations voted in favour (155 from PSOE-UP, 13 from the ERC and 6 from the PNV). It must be said that a political failure would have been very unwelcome given the great needs and expectations and the favourable opportunities.

European funding to carry out the modernization of Spain's production infrastructure, as set out in the PSOE-UP Pact of December 2019

According to Spain's Finance Minister [\[21\]](#), the country is expected to receive 79.8 billion euros in European subsidies over the period 2021-2023 under the *NextGenerationEU* programme. This is over 10 billion more than the amount announced by the Commission in the spring of 2020 (69.4 billion, a revision of +14.9%), as the 2020 growth forecasts made last autumn were more pessimistic than those made six months earlier, and due

to converting the initial funding from 2018 prices to current prices. The revision concerns the allocation of the Recovery and Resilience Facility (RRF), which has increased from 59.2 billion euros to 69.5 billion, with the grant under the REACT EU programme remaining at 10.3 billion. Spain is thus now the largest recipient of EU funds, ahead of Italy, which is to receive 79.6 billion (up from 76.1 billion initially announced), i.e. 4.4% of its 2019 GDP, 2 points less than Spain. Seventy percent of this allocation is guaranteed for 2021-2022 (46.6 billion) [\[3\]](#). The balance over 2023 will have to be reassessed in June 2022, depending on the economic situation and the state of public finances in the light of the Stability and Growth Pact rules, which are likely to be restored by that date.

In order to benefit from European funds, Spain, like all its partners, has to present its National Plan for Recovery, Transformation and Resilience, which aims to stimulate short-term growth through investment and consumption [\[4\]](#), and to promote a “more sustainable, more resilient economy that is prepared for the challenges ahead”, in the words of the Commission. Ultimately, the government’s objective is to raise potential growth by 0.4-0.5 percentage points to over 2% per year by 2030.

While Spain traditionally has a low rate of absorption of European funds, this time the government wishes

to speed up the process greatly. So on 20 January (with a deadline set for 30 April), the government submitted to Brussels the 30 files in its Recovery plan presenting the investment projects and the guidelines for the reforms envisaged in the areas of taxation, the labour market, and pensions, which are intended to ensure the country's transition. It even foresees anticipating the release of the RRF funds (scheduled after the Commission examines the Recovery plan for two months) by financing the investments with debt. It must be acknowledged that the needs are immense in Spain's production system, which is marked by the importance of SMEs. At the end of 2019, 53.5% of businesses were made up of the self-employed, 40% had between 1 and 9 employees, and 5.5% had between 10 and 49 employees, in total accounting for half of all jobs. According to the government's intentions:

- 37% of the funds are earmarked for the ecological transition (250,000 new vehicles purchased by 2023, installation of 100,000 charging stations, transformation of the electrical system to 100% renewable energy by 2050, and the renovation of more than 500,000 homes for improved energy efficiency);
- 34% are for the digital transformation (with a coverage rate of 80% of the population, including 75% by 5G; development of

teleworking for more than 150,000 public jobs; training for more than 2.5 million SMEs; etc.);

- And 30% for Research and Development, education and training, and social and territorial inclusion.

The broad outlines of the reforms have also been drawn up. The new orientation of the tax reform aims at greater progressiveness and more redistribution [\[5\]](#), and is already included in the 2021 budget (see below). The reforms concerning the labour market, which is still very dual, and pensions have not yet been discussed in Parliament or with the social partners, so they are still at the stage of principles, which should, nevertheless, satisfy Brussels. As regards labour market reform, the main measures presented aim at generalizing the use of open-ended contracts and tightening up on the use of fixed-term contracts; strengthening the use of flexible working time as an alternative to fixed-term contracts and redundancies; the modification of active employment policies; calling into question the 2012 reform on collective bargaining; an employment programme targeted at young people (2021-2027); and modernizing the public employment service (SEPE). The pension reform is less advanced and is giving rise to greater tension between the partners. For example, in the plan sent to Brussels the government did not include its proposal to increase

the contribution period for calculating pensions from 25 to 35 years.

Above all, however, Spain's National Plan for Recovery, Transformation and Resilience presented to the European Commission, which should lead to the disbursement of European funds, is fully in line with the [*Coalicion Progresista – Un nuevo acuerdo para Espana*](#) Pact signed in December 2019 between the two ruling coalition parties PSOE and UP-Podemos. The document's initial sections stress the importance of investing in the digital transformation, the ecological transition, and R&D and training to modernize Spain's economy and create quality jobs. The European grants provide the left-wing government with a giant opportunity to finance this project to transform Spain's productive infrastructure.

Higher taxation to finance the social measures included in the Pact

In addition to the investment projects included in the recovery plan and financed by European funds, in its 2021 budget the government launched the tax reform presented in the Pact, which is intended to finance the social measures planned or already taken. As mentioned above, the absence of a majority in the Congress of Deputies and the Senate has opened the way for negotiations with the small pro-independence and regionalist parties, and thus for concessions to obtain support. Not all the measures were approved [\[6\]](#). Ultimately, the reform should

bring in 7.7

billion euros [\[7\]](#), 1.4 billion less than what was set out in the budget

bill sent to Brussels. If we add the cost of maintaining VAT on surgical masks

at 0%, the shortfall to meet the deficit commitment comes to 3 billion euros.

The 2021 tax reform mainly focuses on large corporations and high income earners. It includes:

- **Reducing**

- the corporate tax exemption on dividends and capital gains received from foreign**

- subsidiaries from 100% to 95%. So**

- now the 5% not exempted is taxed at the general rate of 25% (30% in the

- case of banks and oil companies). This measure excludes SMEs (companies

- with a turnover of less than 40 million) for three years (expected gain of

- 1,520 million euros). In addition, the State has introduced a minimum tax

- on listed real estate investment companies (SOCIMIs) of 15% (+25 million euros);

- **A**

- 2-point increase in personal income tax (IRPP) on income over €300,000 and 3 points on**

- savings income over €200,000 (raising the rate from 23% to 26%) (a total gain

- of €490 million). This measure affects the 36,200 individuals with the

- highest incomes (i.e. according to the Ministry, 0.07% of contributors) [\[8\]](#);

- A reduction from 8,000 to 2,000 euros in the IRPP exemption

threshold for individual investments in **private pension funds** (+580 million) and an increase from 8,000 to 10,000 euros in the incentive threshold for companies;

- The tax on insurance premiums has been increased from 6% to 8% (+507 million);
- An increase in **VAT on sugary and sweetened drinks, excluding dairy products**, from 10 to 21% (expected gain of 360 million);
- The introduction of a 0.2% financial transaction tax for corporations with a capital of more than €1 billion (**Tobin tax**) and a 3% tax on the digital economy (**GAFA tax**). These taxes should bring in €850 million and €968 million respectively. Adopted in 2020, they came into force on 16 January;
- A **green tax is being introduced** with the creation of a tax on single-use plastics (+491 million) along with other measures (tax on waste, etc.) (+861 million);
- Lastly, **measures to combat tax fraud** are being taken, with an expected gain of 828 million.

This additional tax revenue is intended to cover social expenditure, in particular the **Minimum Living Income** introduced in June 2020 to reduce poverty and promote labour market integration. This will affect around 850,000 families (2.3 million people, 17% of the population). The amount of support ranges from 462 euros per month for a person living alone to 1,015 for a family. The pensions and salaries of civil servants will be increased

by 0.9%, non-contributory benefits by 1.8%, and the reference indicator used to determine eligibility for many social benefits (IPREM) by 5% (it has been frozen since 2017). The other flagship measure concerns **dependency support**, with an additional 600 million, and **education**. On the other hand, the goal of raising the minimum wage (SMI) to 60% of the average wage by the end of the legislature (to between €1100 and €1200 per month in 2023) has been temporarily suspended. After a 20% increase in 2020, the SMI therefore remains at €950 per month for 14 months. The salaries of members of the executive have been frozen this year.

After long years of political instability, it is to be hoped that, despite the difficult context, the current coalition government will be able to continue to find a basis for agreement within the different Spanish political formations in order to take advantage of the favourable opportunities and open up new and constructive perspectives.

[\[1\] For a more detailed analysis of the crisis, please refer to the *OFCE Policy Brief by Hervé Péléraux and Sabine Le Bayon: "Croissance mondiale confinée en 2020", no. 82 of 14 January 2021.*](#)

[\[2\]](#) The information must be approved by the European Parliament in the coming weeks.

[\[3\]](#) The distribution of these new amounts over 2021 and 2022 is not available. We do know, however, that of the 69.437 billion initially planned for the period 2021-2023, the State was to receive 26.634 billion in 2021, including 2.436 billion from the REACT EU fund for the purchase of vaccines. Out of the 26.634 billion received, the State is to disburse 10.8 billion to the regions, which are also to receive 8 billion REACT EU funds to strengthen their health and education systems.

[\[4\]](#) On the basis of an average multiplier of 1.2, in the budget bill sent to Brussels the government estimated the impact of the recovery plan on growth at 2.5 points in 2021. Under less favourable hypotheses (the rather slow rate of absorption of past European funds, complexity in management at the regional level, etc.), in January 2021 the Bank of Spain estimated the impact at between 1 and 1.6 points.

[\[5\]](#) According to the OECD, in 2018, the ratio between the average income of the richest 20% and the poorest 20% was 5.9 in Spain, compared to 4.6 in France.

[\[6\]](#) Thus, the tax increase on private educational and health institutions was rejected before it was even presented to the Congress of Deputies, and the tax increase on diesel (+3.8 cents per litre to 34.5 cents, compared to 40.07 on petrol) had to be abandoned. These measures were expected to bring in 967 and 500 million euros respectively.

[7] Using the cash concept, the revenue changes from 6.847 billion to 5.635 billion in 2021 and from 2.323 billion to 2.135 billion in 2022.

[8] This measure reflects a fairly marked retreat from the Pact's commitments. Indeed, the IRPP was expected to increase by 2 points on income > €130,000, by 4 points on income > €300,000, and by 4 points on savings income > €140,000. An increase of 1 point in the wealth tax was included for assets over €10 million.

Waiting for the recovery in the US

By [Christophe Blot](#)

As with the economic performance of all the industrialized countries, economic activity fell off sharply in the second quarter of 2020 across the Atlantic before rebounding just as sharply the following quarter. The management of the crisis in the US is largely in the hands of the different States, and the election of Joe Biden should not change this framework since he declared on November 19 that he would not order a national lockdown. However, the health situation is continuing to deteriorate, with more than 200,000 new Covid-19

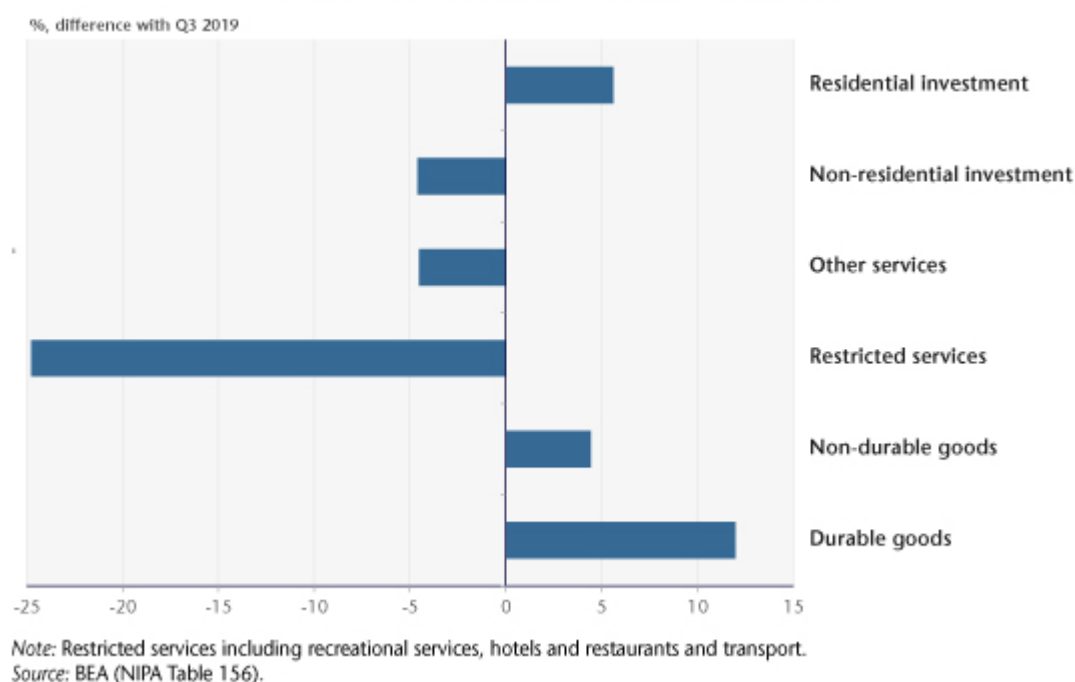
cases per day on average since the beginning of December. As a result, many States are adopting more restrictive prophylactic measures, although without returning to a lockdown like the one in the Spring. This situation could dampen economic prospects for the end of the year and also for the start of the mandate of the new President elected in November. Above all, it makes it even more necessary to implement a new recovery plan, which was delayed by the election.

As in the euro zone, recovery in the US kicked off as soon as the lockdown was lifted. GDP grew by 7.4% in the third quarter after falling by 9% in the previous quarter. Compared with the level of activity at the end of 2019, the economic downturn amounted to 3.5 points, versus 4.4 points in the euro zone. The labour market situation also improved rapidly, with the unemployment rate falling by 8 points, according to data from the Bureau of Labor Statistics for November, from its April peak of 14.7%. These results are the logical consequence of the lifting of restrictions but also of the large-scale stimulus plans approved in March and April, which have massively absorbed the loss of income for households and to a lesser extent for US companies (see [here](#)). However, the upturn in consumption is still being dampened by some ongoing restrictions, particularly in sectors with strong social interactions, where spending is still nearly 25% lower than it was in the fourth quarter of

2019 (Figure 1).

As for the consumption of goods, it has been much less affected by the crisis and is down only 12% from its pre-crisis level for durable goods and 4.4% for non-durable goods. Nevertheless, most of these support measures have come to an end, and as of this writing the discussions that began in late summer in Congress have not yet led to an agreement between Republicans and Democrats. Despite the rebound, the health impact of the pandemic and the economic consequences of the lockdown on the labour market require a discretionary policy in a country where the automatic stabilizers are generally considered to be weaker[\[1\]](#). New support measures will be all the more necessary as a further tightening of restrictions is looming and the recovery seem to be running out of steam. The initial consumption figures for the month of October point to a fall in the consumption of services, and employment also stabilized in November, remaining well below its level at the end of 2019.

Figure 1. Private domestic demand in Q3 2020



However, after the setback of the discussions in Congress, it will now be necessary to wait until the first quarter of 2021 for a new support plan to be approved and for a possible reorientation of US fiscal policy after Joe Biden's victory. In the Autumn, the Democrats proposed a 2 trillion dollar (9.5 GDP points) package, almost as much as the 2.4 trillion dollar (10.6 GDP points) package adopted in March-April 2020^[2]. The aid would, among other things, support the purchasing power of the unemployed through an additional federal payment. Although unemployment is much lower than in the second quarter, it remains above its pre-crisis level and is now characterized by an increase in long-term unemployment for which there is generally no compensation. In November, the share of those who had been unemployed for at least 27 weeks was 37 per cent (or 3.9 million people, Figure 2), and the median duration of

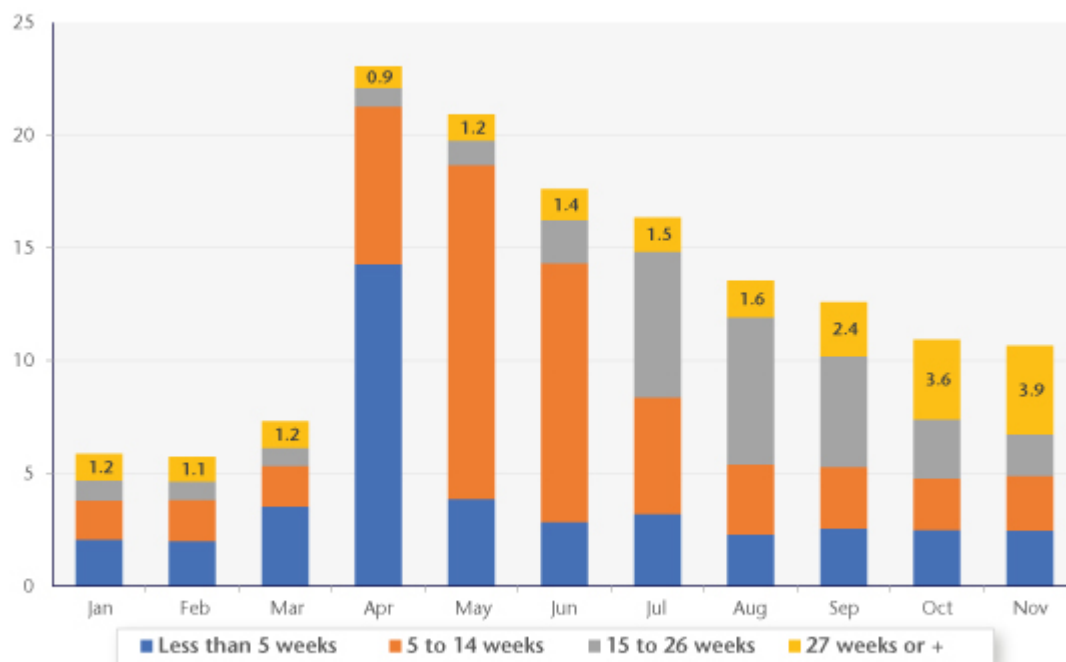
unemployment

had risen from 9 weeks at the end of 2019 to almost 19 weeks in November 2020.

In addition, States whose tax revenues have decreased with the crisis could

benefit from a federal transfer, thereby avoiding spending cuts[3].

Figure 2. Number of jobless by duration (weeks of unemployment)



Source: Bureau of Labor Statistics.

However, despite the end of the suspense over the outcome of the presidential elections, the political and economic uncertainty

has not been completely resolved. Indeed, it will not be known until early

January whether the Democrats will also have a majority in Congress. They have

certainly kept the House of Representatives, but it will be necessary to wait

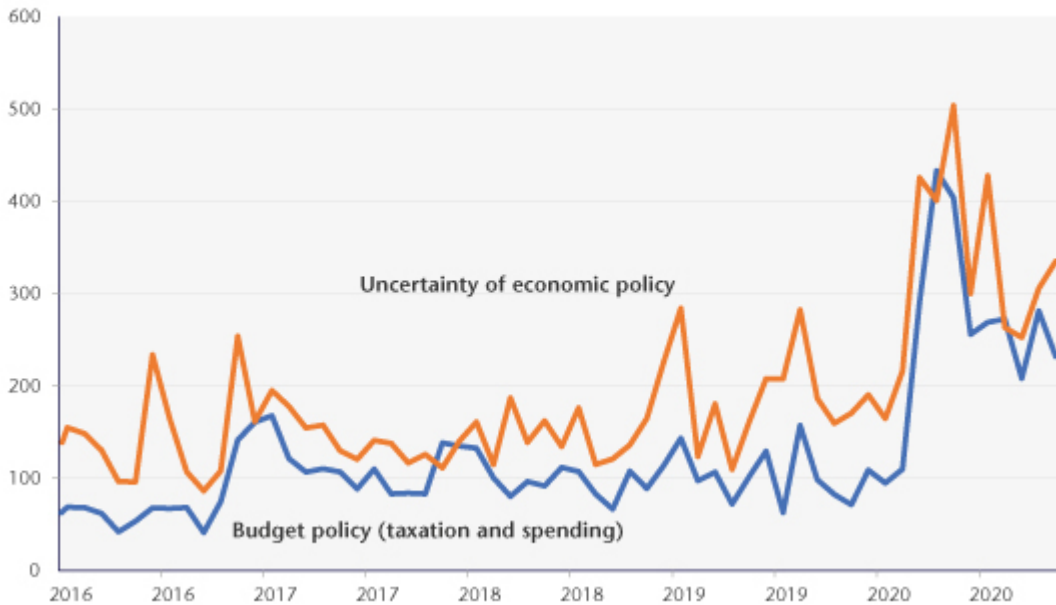
until the beginning of January for the Senate, with a ballot planned in Georgia

that will determine the political colour of the last two seats [4]. Both seats are now held by Republican senators.

However, Joe Biden won Georgia by 0.2 points against Donald

Trump, the first victory in the State for a Democratic candidate since 1992. With both State-wide senatorial elections to be contested directly, the results are likely to be close. If one of the Democratic candidates is defeated, Joe Biden will be forced to contend with the opposition. But, as [Paul Krugman](#) points out, the Republicans are generally more inclined, once in opposition, to promote austerity. This is reflected in the uncertainty indicators of Bloom, Baker and Davies, whose economic policy uncertainty rose in November (Figure 3). This uncertainty is certainly lower than in the Spring but remains higher than that observed between 2016 and 2019. During this period, growth could weaken, and then a strong recovery is likely to be followed by more subdued growth, which will have repercussions on the labour market. Regardless of the outcome, a plan will likely be approved in the first quarter of 2021, but its adoption could take longer if it is conditional on an agreement between Republicans and Democrats in Congress. However, this could be lengthy given the urgency of the health and social crisis, and could plunge a significant proportion of the most vulnerable into poverty.

Figure 3. Indicators of uncertainty about economic policy



Source : Baker, Bloom & Davis. <https://www.policyuncertainty.com/index.html>

[1] See for example Dolls, M., Fuest, C. & Peichl, A., 2012, "Automatic stabilizers and economic crisis: US vs. Europe", *Journal of Public Economics*, 96(3-4), pp. 279-294.

[2] By comparison, the European programmes are weaker, ranging from 2.6 GDP points for France to 7.2 points for the UK.

[3] Note that the States generally have fiscal rules limiting their capacity to run a deficit.

[4] Of the 100 seats in the Senate, the Republicans already hold 50. In the event of a tie between the two parties, it is the voice of the Vice-President-elect Kamala Harris that will decide between them. [A single victory in Georgia would therefore allow the Republicans to retain the majority.](#)

Sweden and Covid-19: No lockdown doesn't mean no recession

By [Magali Dauvin](#) and [Raul Sampognaro](#), DAP OFCE

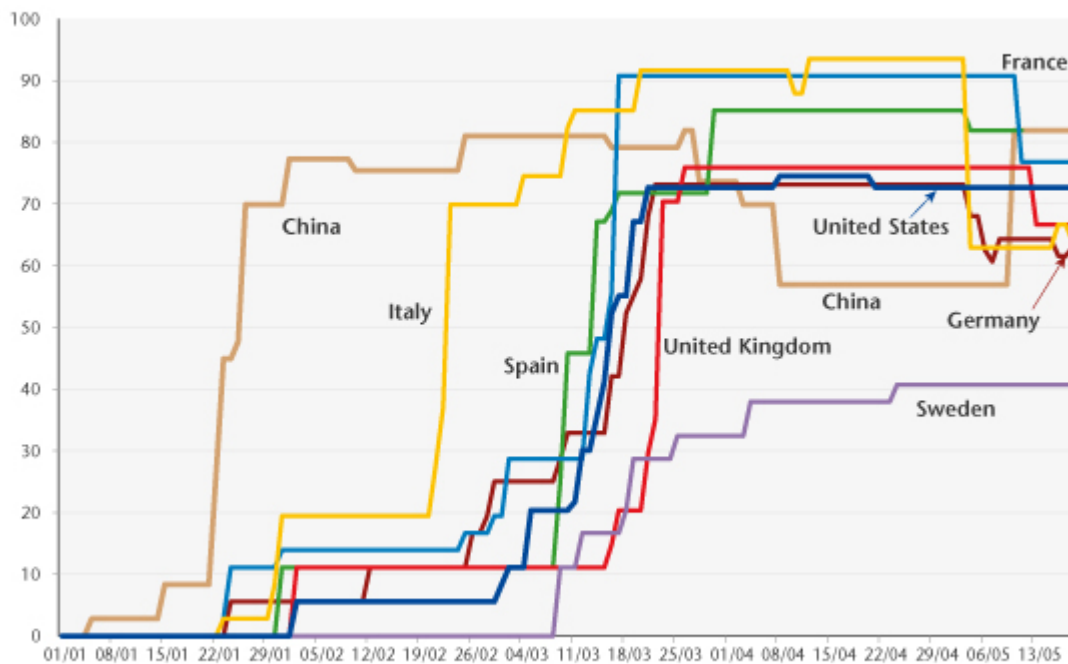
Since the Covid-19 pandemic's arrival on the old continent, a number of countries have taken strict measures to limit outbreaks of contamination. Italy, Spain, France and the United Kingdom belatedly stood out with especially strict measures, including lockdowns of the population not working in key sectors. Sweden, in contrast, has distinguished itself by the absence of any lockdown. While public events have been banned, as in the other major European countries, there were no administrative orders to close shops or to impose legal constraints on domestic travel^[1].

Given the multiplicity of measures and their qualitative nature, it is difficult to break down all the decisions taken, and in particular to express their intensity. Researchers at the University of Oxford and the Blavatnik

School of Government

have nevertheless built an indicator to measure the severity of government responses [\[2\]](#). This indicator clearly shows Sweden's specific situation with respect to the rest of Europe (Figure 1).

Figure 1. Index of severity



Source: T.Hale, S.Webster, A.Petherick, T.Phillips and B.Kira (2020). Oxford COVID-19 Government Response Tracker.

The mobility data supplied by Apple Mobility provides a complementary picture of the severity of containment measures across countries. At the time of the toughest lockdowns, automobile mobility was down by 89% in Spain, 87% in Italy, 85% in France and 76% in the United Kingdom. The decline was less severe in Germany and the United States (about 60% in both countries). Sweden ultimately saw its traffic reduced by “only” 23%. While these data should be taken with a grain of salt, they also give a clear signal about the timing and scale of the lockdowns in different countries, once again pointing to a Swedish

exception.

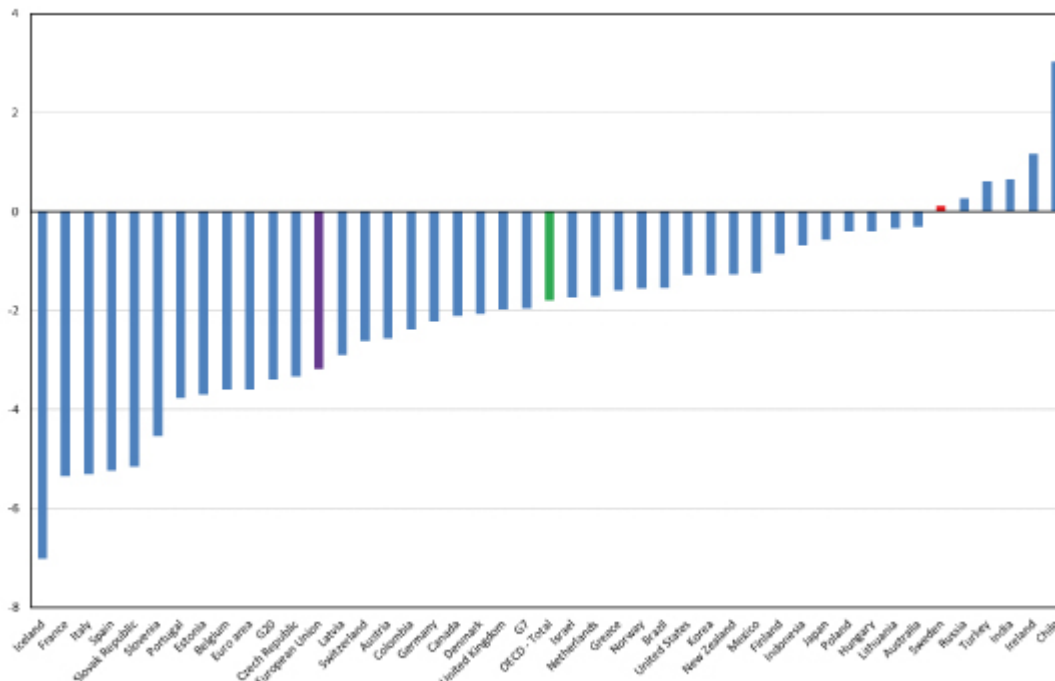
During the first half of May, the various European countries began to gradually ease the measures taken to combat the spread of the Covid-19 epidemic.

Sweden's

GDP resists in Q1

In our assessment of the [impact of lockdowns on the global economy](#), we highlighted the correlation between the fall in GDP observed in the first quarter and the severity of the measures put in place to combat Covid-19. In this context, Sweden (in red in Figure 2) fares significantly better than the OECD member countries (green bar), and especially the rest of the European Union (purple bar). Although this is a first estimate, GDP has not only held up better than elsewhere, but has even stabilized (-0.1%). Only a few emerging economies, which were not affected by the pandemic at the beginning of the year (Chile, India, Turkey and Russia), and Ireland, which benefited from exceptional factors, performed better in the first quarter [\[3\]](#).

Figure 2. GDP Growth in Q1 2020



Source: OECD.

The relative resilience of Sweden's GDP in the first quarter seems to suggest that the country might have found a different trade-off between epidemiological and economic objectives compared to other countries[4]. However, this aggregate figure masks important developments that need to be kept in mind. In the first quarter, the stabilisation of Swedish GDP was due to the positive contribution made by foreign trade (up 1.7 GDP points) to a rise in exports (up 3.4% in volume terms), particularly in January, before any health measures were taken.

In the first quarter, Swedish domestic demand pulled activity downwards (by -0.8 GDP points due to household consumption and -0.2 GDP points due to investment), as in the rest of the EU. The

shock to domestic demand was of course more moderate than in the euro area, where consumption contributed negatively to GDP by 2.5 points and investment by 0.9 points. Nevertheless, the physical distancing guidelines issued in Sweden must have had a significant impact during the first quarter.

In a troubled global context, Sweden will not be able to escape a recession

If we assume that the avoidance of a lockdown and the relatively limited administrative closures (confined to public events) did not give rise to any significant shock to domestic demand – which seems optimistic in view of the first quarter data – Sweden will nevertheless be hit hard by the shock to international trade[\[5\]](#).

According to our calculations, based on the entry-exit tables from the World Input-Output

Database (WIOD)[\[6\]](#) and our estimates related to the lockdown shocks in [Policy Brief 69](#), value added is expected to fall by

8.5 points in Sweden in April due to the containment measures taken in the rest

of the world. The shock will hit its industry especially hard, more or less in

line with what we estimate globally (-19% and 21%, respectively).

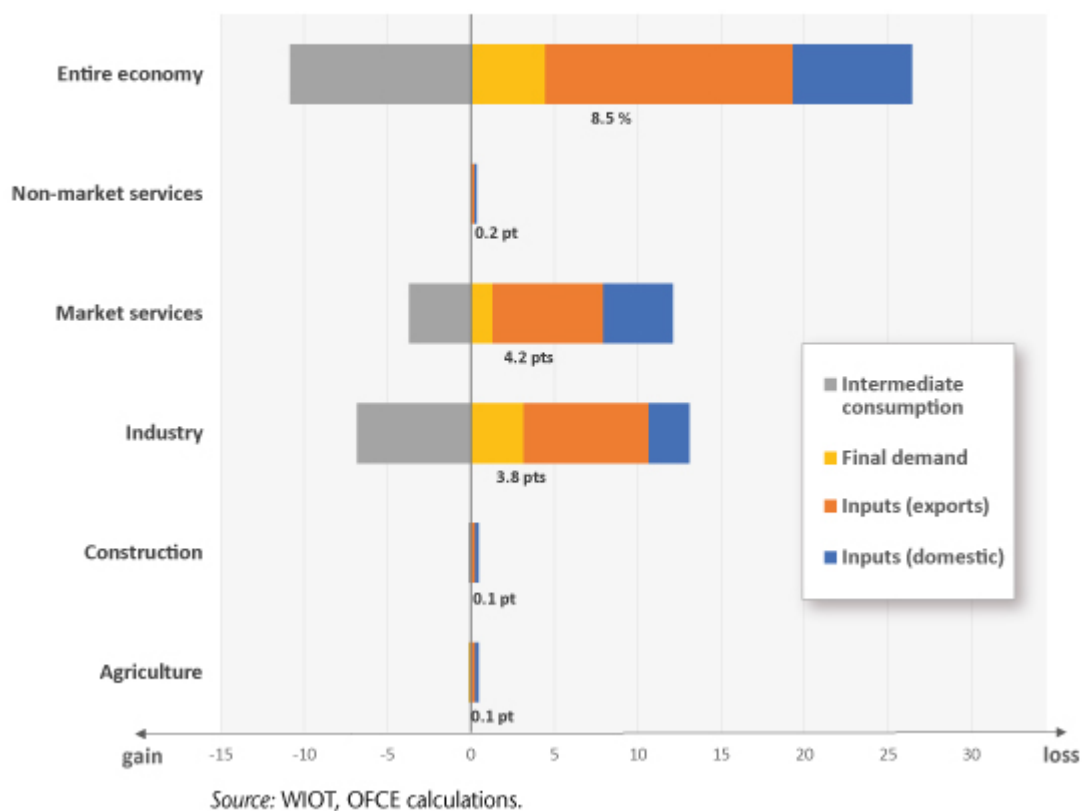
Unsurprisingly, the *refining industry* (-32%), the *manufacture of*

transport equipment (-30%) and *capital goods* (-20%), and the

other

manufacturing industries sector (-20%) will be hit hardest by the collapse of global activity. Since a significant share of output is intended for use by foreign industry, the worldwide containment measures will lead to a reduction of almost 15 points in Swedish output in April (Figure 3). The same holds for commercial services: exposure to global production chains is hurting *transport* and *warehousing* (-15%) and the *business services* sector (-11%). Ultimately, the containment measures will have an impact mainly through their effect on intra-branch trade.

Figure 3. Contributions to the reduction in value added in April in Sweden



The weakness of Swedish manufacturing, weighed down by international trade, seems to be confirmed by the first hard data available. According to

the [Swedish Statistical Office](#), exports fell by 17% year-on-year, a figure comparable to the decline in world trade as measured by the CPB for the same month (-16% by volume). Given this situation, manufacturing output will be 17% lower in April than a year earlier.

*What
could be said about domestic demand in Q2?*

In a context of widespread uncertainty, domestic demand may continue to suffer. Indeed, Swedish households can legitimately question the consequences of the shock for jobs – mainly in industry – described above. On the other hand, fear of the epidemic could deter consumers from making certain purchases involving strong social interactions, even in the absence of legal constraints. What do Swedish data from the beginning of Q2 tell us about Swedish domestic demand?

In Sweden, consumer spending fell in March (-5% year-on-year). Note that the country's precautionary guidelines and physical distancing measures were introduced on 10 March. The fall steepened in April, after the measures had in force for a full month (-10% year-on-year). The measures in place hit purchases of clothing (-37%), transport (-29%), hotels and catering (-29%) and leisure (-11%). While the data remain patchy, May's retail sales, an indicator that

does not cover the entire consumer sector, suggest that sales were still in a dire state in clothing stores (-32%). In addition, new vehicle registrations continued to fall in May (-15% month-on-month and -50% year-on-year). Pending more recent data on activity in the rest of the economy, the volume of hours worked^[7] in May remains very low in hotels and catering (-50%), and in household services and culture (-18%), suggesting that significant and long-lasting losses to business can be expected.

On the positive side, the data show a trend towards the normalization of household purchases in May for certain consumer items. As in other European countries, the recovery was particularly strong in household goods, where retail sales returned to their pre-Covid level, and in sporting goods, while food consumption remained buoyant.

Ultimately, the health precautions taken by Sweden since the onset of containment measures are akin to those implemented in the rest of Europe since the gradual easing of the lockdowns. While the shocks to the consumption of certain items are less severe than those observed in France, it is noticeable that, in the context of the epidemic, some consumer goods could be severely affected even in the absence of administrative closures. In addition to the recessionary

impact imported from the rest of the world, Sweden will also suffer due to domestic demand, which is expected to remain limited particularly in certain sectors. The Swedish case suggests that clothing, automobile, hotel and catering, and household services and culture could suffer a lasting shock even in the absence of compulsory measures. According to data available in May, this shock could reduce household consumption by 8 percentage points, which represents 3 GDP points. How lasting the shock is will depend on the way the epidemic develops in Sweden and in the rest of the world.

[1] The Swedish institutional framework helps to explain in part this differentiated response, which focuses more on individual responsibility than on coercion (see <https://voxeu.org/article/sweden-s-constitution-decides-its-exceptional-covid-19-policy>). The country's low population density could also help explain the difference in behaviour vis-à-vis the rest of Europe but not in relation to its Scandinavian neighbours.

[2] This indicator attempts to synthesize the containment measures adopted according to two types of criteria: first, the severity of the restriction for each measure taken (closure of schools and of businesses, limitation of gatherings, cancellation of public events, confinement to the home, closure of public transport, restrictions on domestic

and international travel) and second, whether a country's measures are local or more generalized.

For a discussion of the indicator see [Policy brief 69](#).

[\[3\] Booming exports in March 2020](#) (up 39% in value) driven by strong demand for pharmaceuticals and IT offset the fall in Ireland's domestic demand during the first quarter.

[\[4\]](#) This post on the OFCE blog does not focus on the effectiveness of Swedish measures with regard to containing the epidemic. Mortality from Covid-19 is higher in Sweden than in its neighbours (Norway, Finland, Denmark), suggesting that it has run more epidemiological risks. This is provoking a debate that goes well beyond the purpose of this post, but which does deserve to be raised.

[\[5\]](#) International trade may actually impact growth more than expected due to constraints on international tourism. In 2018, Sweden actually ran a negative tourism deficit of 0.6% of GDP (source: *OECD Tourism Statistics Database*), which could have an effect on domestic activity if travel remains limited, especially during the summer.

[\[6\]](#) Timmer, M. P., Dietzenbacher, E., Los, B., Stehrer, R. and de Vries, G. J. (2015), "An Illustrated User Guide to the World Input–Output Database: The Case of Global Automotive Production", *Review of International Economics*., 23: 575–605

[\[7\]](#) In May, the volume of hours worked was down 8% year-on-year (after -15%). The recovery in hours worked in May was due mainly to manufacturing and construction. The recovery was less pronounced or even non-existent in business services.

It seems like it's raining billions

[Jérôme Creel](#), [Xavier Ragot](#), and [Francesco Saraceno](#)

The second meeting of the Eurogroup did the trick. The Ministers of Finance, after having once again laid out their divisions on the issue of solidarity between euro area Member States on Tuesday 7 April 2020, reached an agreement two days later on a [fiscal support plan](#) that can be put in place fairly quickly. The health measures taken by the Member States to limit the spread of the Covid-19 pandemic will enjoy better short-term financing, which is good news. The additions to Europe's tools for dealing with the crisis will be on the order of 500 billion euros – this is certainly not negligible, and note that this comes on top of the efforts already put in place by governments – but this corresponds mainly to a new accumulation of debt by the Member States. The net gain for

each of them, as we shall see, is actually quite marginal.

The Eurogroup will propose the creation of a credit line (Pandemic Crisis Support) specifically dedicated to the management of the Covid-19 crisis within the framework of the European Stability Mechanism (ESM), without strict conditionality (meaning that recourse to the credit line will not imply any control on the part of the EMS over the future management of the Member State's public finances). The creation of the credit line was inspired by the proposal by [Bénassy-Quéré et al. \(2020\)](#), the [advantages and disadvantages](#) of which we presented to the Eurogroup meeting on 9 April 2020. The amount allocated to this credit line represents around 2% of the GDP of each euro area Member State, or nearly 240 billion euros (in 2019 GDP).

The lending mechanism proposed by the European Commission to supplement the partial unemployment programmes of the Member States – [it goes under the name of SURE](#) – will clearly see the light of day and will be endowed with 100 billion euros. For the record, the three main beneficiaries of SURE cannot receive a combined total of more than 60 billion euros in loans.

Finally, the European Investment Bank (EIB) will grant an additional 200 billion

euros, mainly to small and medium-sized enterprises in the EU Member States. In total, the euro area countries will have 480 billion euros in additional financing capacity.

Table 1 below

presents a breakdown by country of the amounts in play. As part of the 240 billion euros of Pandemic Crisis Support, Germany will be able to benefit from a borrowing capacity of nearly 70 billion euros, France nearly 50 billion euros, and Italy and Spain 35 and 25 billion euros respectively. These amounts correspond to 2% of the 2019 GDP of each country. At this point, there is no indication of whether the Member States will draw on this capacity. The advantage in doing so depends crucially on the difference between the interest rate at which they can finance their health and economic expenses without using the EMS and the interest rate on loans made by the EMS. The financing cost without going through the EMS is the interest rate on the country's public debt. The cost of financing through Pandemic Crisis Support is the interest rate at which this credit line is itself financed, that is to say, at the lowest rate on the market, i.e. the German rate. So it is obvious that Germany has no interest in using this credit line. Of the 240 billion euros allocated to Pandemic Crisis Support, the 70 billion euros for Germany is thus useless. For countries other

than Germany, the use of Pandemic Crisis Support depends on the difference between their interest rate and Germany's rate, the infamous spread. If the spread is positive, using the EMS effectively reduces the cost of borrowing. But as shown in Table 1, the gain enabled by Pandemic Crisis Support is rather low. For Greece, whose spread vis-à-vis Germany is the highest in the euro zone, the gain would come to around 0.04% of GDP in 2019, i.e. a 215 basis point spread multiplied by the amount allocated to Greece for Pandemic Crisis Support (3.8 billion euros, which corresponds to 2% of its GDP of 2019), all relative to its 2019 GDP. For Italy, the gain is on the same order: 0.04% of its GDP. Expressed in euros, Italy stands to gain 700 million euros. For France, whose spread vis-à-vis Germany is much lower than that of Italy, the gain could be 200 million euros, or 0.01% of its GDP in 2019.

Assuming that the amounts allocated by the EIB are prorated to the country's size (measured by its GDP in 2019), and that Spain, Italy and France benefit from 20 billion euros each under SURE, the total interest rate savings would reach, respectively, 680 million, 1.5 billion and 430 million euros (0.05%, 0.08% and 0.02% of GDP). At a time when it seems to be raining billions, these are not big savings. Unless you think of it as a metaphor. Like rain before it falls, the billions of euros are not really euros before they fall.

Table 1. Distribution of amounts allocated as part of Pandemic Crisis Support (PCS), and each country's potential gains, including from the use of additional EIB and SURE financing

	Max amount of PCS	10-year spreads	Max. gain from use of PCS and other additional financing				
			PCS	EIB*	SURE**	Total	Total
	Billion euros	Base points	Million euros				% of GDP
Germany	68,5	0	0	0	0	0	0
Austria	8	43	34,3	20,9	5,8	61,0	0,02
Belgium	9,4	52	49,1	30,0	8,3	8,8	0,02
Cyprus	0,4	204	9,0	5,5	1,5	16,0	0,07
Spain	24,8	113	280,7	171,3	226,0	678,0	0,05
Estonia	0,6	nd	nd	nd	nd	nd	nd
Finland	4,8	40	19,3	11,8	3,2	34,3	0,01
France	48,3	44	212,6	129,8	88,0	430,4	0,02
Greece	3,8	215	81,5	49,7	13,7	145,0	0,08
Ireland	6,9	55	38,0	23,2	6,4	67,5	0,02
Italy	35,5	195	693,1	423,1	390,0	1506,2	0,08
Latvia	0,6	nd	nd	nd	nd	nd	nd
Lithuania	1,0	nd	nd	nd	nd	nd	nd
Luxembourg	1,3	nd	nd	nd	nd	nd	nd
Malta	0,3	90	2,4	1,5	0,4	4,2	0,03
Netherlands	16,1	26	41,9	25,6	7,1	74,6	0,01
Portugal	4,2	124	52,3	31,9	8,8	93,0	0,04
Slovakia	1,9	77	14,5	8,9	2,4	25,9	0,03
Slovenia	1,0	107	10,3	6,3	1,7	18,3	0,04

* Assuming that the use of additional EIB financing is fully distributed in proportion to the country's relative GDP compared to that of the EU (in 2019).

** Assuming that Italy, Spain and France obtain 20 billion euros each and that the remaining 40 billion euros are distributed in proportion to the relative GDP of the countries compared to that of the euro zone (in 2019).

Sources: Ameco (PIB 2019), Financial Times (Spreads, 10 April 2020).

Does the fall in the stock market risk amplifying the

crisis?

By [Christophe Blot](#) and [Paul Hubert](#)

The Covid-19 crisis will inevitably plunge the global economy into recession in 2020. The first available indicators – an increase in the unemployment rolls and in partial unemployment – already reveal an unprecedented [collapse](#) in activity. In France, the OFCE's [assessment](#) suggests a 32% cut in GDP during the lockdown. This fall is due mainly to stopping non-essential activities and to lower consumption. The shock could, however, be amplified by other factors (including rises in some sovereign rates, falling oil prices, and capital and foreign exchange movements) and in particular by the financial panic that has spread to the world's stock exchanges since the end of February.

Since 24 February 2020, the first precipitous one-day fall, the main stock indexes have begun a decline that accentuated markedly in the weeks of March 9 and 16, despite announcements from the [Federal Reserve](#) and then the [European Central Bank](#) (Figure 1). As of 25 April, France's CAC-40 index had fallen by 28% (with a low of -38% in mid-March), -25% for the German index and nearly -27% for the European Eurostoxx index. This stock market crash

could revive fears of a new financial crisis, only a few years after the subprime crisis. The fall in the CAC-40 in the first few weeks was in fact steeper than that observed in the months following the collapse of Lehman Brothers in September 2008 (Figure 2).

Figure 1. Changes in the main stock market indexes

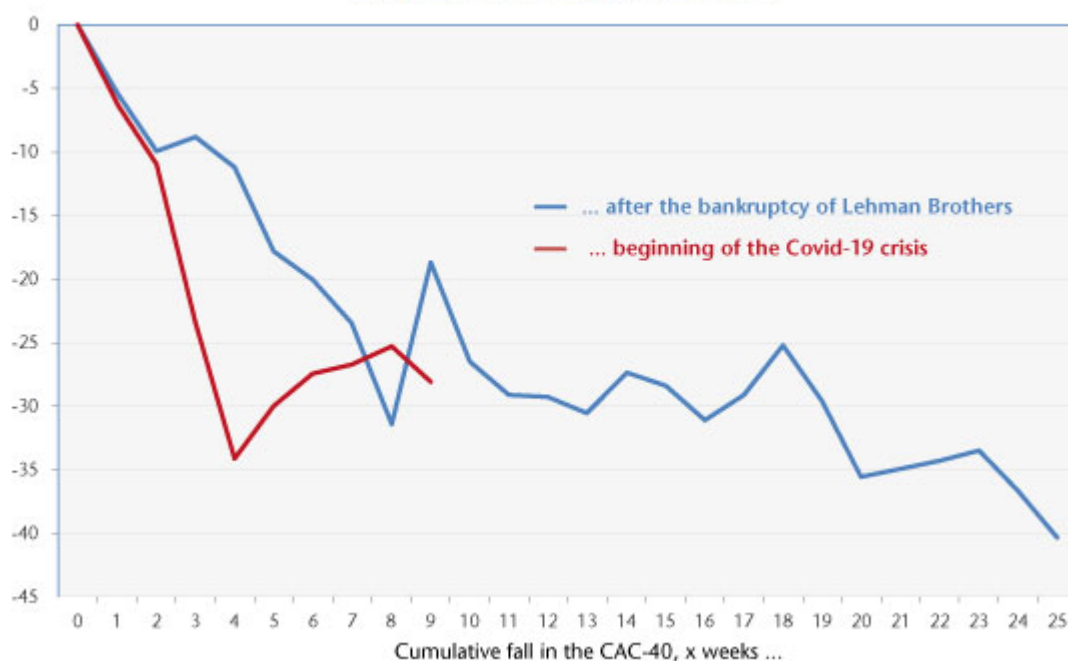


Source: Eikon Datastream. Base 100: average for the year 2019.

While the short-term impact of the Covid-19 crisis could prove to be more severe than that of the 2008 financial crisis, the origin of the crisis is very different – hence the need to reconsider the impact of the stock market panic. In the financial crisis, the origin was in fact a banking crisis, fuelled by a specific segment of the US real estate market, the subprime market. This financial crisis then caused a drop-off in demand and a recession through a variety of channels: higher risk

premiums, credit rationing, financial and real estate wealth effects, uncertainty, and so on. While some of these elements can be found today, they are now being interpreted as the consequence of a health crisis. But if there is no doubt that this is at the outset a health and economic crisis, can it trigger a stock market crash?

Figure 2. Fall in France's CAC-40 index in the Covid-19 crisis compared with the post-Lehman Brothers collapse



Source: Eikon Datastream.

Another way of posing the question is to ask ourselves whether the current stock market fall is due entirely to the economic crisis. Share prices are in fact supposed to reflect future changes in a company's profits. Therefore, expectations of a recession, as demand – consumption and investment – and supply are constrained, must result in a reduction in turnover and future profits, and therefore a fall in share prices.

However, the financial

shock could be magnified if the fall in stock prices is greater than that caused by the decline in corporate profits. This is a thorny issue, but it is possible to make an assessment of a possible over-adjustment of the stock market, and thus of a possible financial amplification of the crisis. The method we have used is to compare changes in profit expectations (by financial analysts) since the beginning of the Covid-19 crisis with the fall in equities. Focusing on CAC-40 companies, profit expectations for next year have been cut in the last three months by 13.4% [\[1\]](#). This reduction should therefore be fully reflected in the change in the index. In fact, the fall there was much larger: -28%. This would result in an amplification of the financial shock by just under 15 percentage points.

This over-adjustment by the stock market can be explained by, among other things, the current prevailing uncertainty about the way lockdowns around the world will be eased, and thus about an economic recovery, as well as uncertainty about the oil shock that is unfolding concomitantly, with determinants that are both economic and geopolitical. This over-adjustment may therefore not be wholly irrational (with regard to the supposed efficiency of financial markets), but the fact remains that it has led to major variations in the financial assets of consumers and

business.

Variations like these are not neutral for economic growth. On the consumer side, they contribute to what are called the wealth effects on consumption: additions to a household's assets give it a sense of wealth that drives it to increase its consumption [\[2\]](#). This effect is all the greater in countries where household assets are in the main financialized. If a large portion of household wealth is made up of equities, then changes in share prices strongly influence this wealth effect. The portion of shares (or of investment funds) in financial assets is quite similar in France and the United States, respectively 27% and 29%. However, these assets account for a much larger share of the disposable income of American households: 156%, compared to 99.5% in France. As a result, French households are less exposed to changes in share prices. Empirical studies generally suggest a greater wealth effect in the United States than in France [\[3\]](#).

As for business, these changes in stock market valuations have an effect on investment decisions through collateral constraints. When a company takes on debt to finance an investment project, the bank demands assets as collateral. These assets can be either physical or financial. In the event of an increase in equity markets, a company's financial assets increase in value and allow it

greater access to credit

[4]. This mechanism is potentially important today. At a time when companies have very large cash requirements to cope with the brutal shutdown of the economy, the sharp decline in their financial assets is restricting their access to lines of credit. While the financial amplification factors are not reducible to the financial shock, the recent changes in the prices of these assets are nevertheless giving an initial indication of how the financial system is responding to the ongoing health and economic crises.

[1] The data comes from Eikon Datastream, which for each company provides analysts' consensus on the earnings per share (EPS) for the coming year and the following year. We then calculated the weighted average using the weight of each CAC-40 company in the index of the change in these expectations over the past three months. The fact that a 13.4% decline in profit expectations for the next year will give rise to a 13.4% decline in the stock price is made on the assumption that profits beyond the next year are not taken into account, or, in other words, that their current net value is zero, which is to say that investors' preference for the present is very strong today.

[2] More formally, we can speak of a propensity to consume that increases as wealth increases. Wealth effects can

be
distinguishable according to whether they are purely financial
assets or also
include property assets.

[3] See [Antonin, Plane and Sampognaro \(2017\)](#) for a summary of
these estimates.

[4] See [Ehrmann and Fratzscher \(2004\)](#) and [Chaney, Sraer and
Thesmar \(2012\)](#) for empirical assessments of this transmission
channel
via share prices or property prices, respectively.