

Economic effects of Covid-19 in Luxembourg

First RECOVid working note with preliminary estimates

working note
April 8, 2020

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Synthesis of the *RECOVid* working note

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While medical staff has been serving on the front lines since early March, each research discipline aims to offer its humble contribution to the battle against the pandemic. The public health crisis and the measures implemented to make it less severe are more than likely to lead to a deep economic recession which opens up the possibility of systemic collapse of the global economy or of the European financial market. Unsurprisingly, leading economists around the world have suggested plans of actions to mitigate economic damages from Covid-19. Yet, lack of hindsight and information available for research at present makes any forecasting exercise difficult.

In a working note released on April 6, *RECOVid* – a group of economists based in Luxembourg who join forces to assist the *Task Force for the Coordination of the Public Research Sector in the Context of the Covid-19 Pandemic* (Work Package 7 led by Aline Muller) – aims to rough out the subject and provide knowledge on the economic issues related to the Covid-19 crisis. The working note provides a summary of ongoing research as well as back-of-the-envelope estimations of the “direct” economic impact of the health crisis and resulting policy measures. It discusses forces that may drive to a breakdown of the global economic system and policy options that are available to decision makers to mitigate the short-run costs and the risk of a systemic collapse. It also provides suggestions for future research.

To clarify the working philosophy, *RECOVid* wishes to stress that Covid-19 crisis is above all a public health crisis that requires expertise from health scientists. The team takes no stance on the potential trade-off concerning human lives versus material goods and/or social losses in terms of interactions between people. The premise of the working note is that all priority measures should be focused on saving lives and improving health of people. The economists’ contributions and potential recommendations are adjusted/adapted to health experts’ views. The main issues covered are: What are the likely effects of Covid-19 on Luxembourg’s economy? What can be done to maximize the likelihood of a quick recovery... and to minimize the adverse effects of the crisis on inequality, poverty and welfare? What are the strategies to exit the lockdown? What are the potential long-term effects on the economy? Data and quantitative analyses are obviously needed to go further. However, in the face of such an unprecedented challenge, implementing preemptive measures and announcing future policy actions can help restore confidence in the future and reinforce trust in democracy, national and international institutions.

The main **messages to take away** from the working note are the following:

- When looking at countries at a more advanced stage of the Covid-19 crisis (China, South Korea and Italy), **large effects on output growth rates and small businesses' revenues** were identified. In Asia, the prospects of recovery are still very uncertain. In Italy, territorial disparities exacerbate the effects of the shock and a large share of population does not have sufficient resources/deposits to maintain a decent standard of living in case of a long lockdown. [Covered in Sections 2.1 and 2.2]
- In the short-run, macroeconomic damages from Covid-19 are impelled by **mechanical effects and uncertain behavioral responses**: (i) mortality and morbidity impacts labor supply and the productivity of workers; (ii) necessary measures implemented to flatten the infection curve exert mechanical effects on output; (iii) in a globalized world, disrupting global supply chains induces contamination effects; (iv) the public health crisis alone can generate panic and (potentially drastic) changes in individual behaviors. [Covered in Section 2.3]
- Assuming a baseline-as-usual trend, back-of-the-envelope calculations suggest that the current lockdown **could reduce Luxembourg's monthly output by 28 to 42%** depending on the deterioration of the international economy and budget support policy. Each month of lockdown mechanically reduces Luxembourg's annual GDP by 2.0 to 3.5%. Greater or smaller effects can be obtained if we account for cascading business and individual bankruptcies, or if we assume greater resilience. Assuming the economy will ultimately get back to normalcy, the recession due to Covid-19 is likely to be deeper than the recession induced by the 2008 financial crisis. [Covered in Section 2.4]
- As workers in "lockdown industries" have lower earnings to start with, we may fear a rise in inequality. Very preliminary and provisional estimates suggest that a short lockdown will barely increase poverty rates and inequality indices on the yearly basis. Though, **many workers in lockdown industries (e.g. wholesale and retail trade, or accommodation and food service activities) can incur income losses. Fiscal measures are needed to compensate for their losses.** In addition, the effect on well-being goes well beyond the monetary impact of the crisis. Welfare losses might be more detrimental for health professionals and for minority groups such as single-person households and households without access to internet. [Covered in Section 2.5]
- During the lockdown, generous budget support policies are unanimously recommended and have been implemented to relieve corporate cash flow and household income. Maintaining a **satisfactory state of hibernation that allows the economy to recover quickly would require a deficit equal to the loss of activity due to the lockdown.** Assuming a two-month confinement, this means that Luxembourg's government could inject 3.9 to 5.9% of its baseline-as-usual GDP in the economy. While Luxembourg can probably afford this effort, many countries (including European member states) will not be able to cope alone and will need fiscal support. [Covered in Section 2.6]
- Given the previous finding, the risk of a **systemic collapse of the financial system both globally and at the European level** cannot be excluded. This would plunge many economies into a persistent recession, with drastic effects on Luxembourg's economy. Implementing coordinated and preemptive policies such as (i) defining a lender of last resort at the European and national levels and (ii) announcing an unconditional commitment of the EU to support all European economies, would reduce this systemic risk, thereby reducing investors' fear and guaranteeing that all other fiscal policies remain effective. [Covered in Section 2.7]

- Several strategies to bring workers back to work and unfold the return of economic activity have been discussed in recent works. The most compelling one relies on **massive double testing. Its implementation in the case of Luxembourg is complex** due to the high reliance on cross-border workers. What if such massive testing fails to be coordinated across countries? [Covered in Section 2.8]
- The report also discusses some “double-edged” mechanisms that can (i) either jeopardize the recovery and lead to protectionist and populist pressures... or make global institutions stronger in the longer term, (ii) either increase global inequality... or induce more solidarity between rich and poor countries, (iii) slow down technical progress... or accelerate a transition towards a new form of digital capitalism. From a longer term perspective, the Covid-19 crisis might lead to **permanent effects**. In addition to slowing down capital accumulation, it might induce long-term changes in deep preference parameters and in political preferences, affect international linkages and cooperation, lead to a collapse of the neo-liberal model of globalization, and require increasing development assistance. [Covered in Section 3]

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