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THE ECONOMIC CRISIS CAUSED BY THE COVID-19 PANDEMIC

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Abstract

In the midst of wave 4 of the pandemic, the demand for commodities seems unbridled, and the value of stock and real estate assets reaches record after record. On the other hand, container bottlenecks in the world's ports, production syncopes against the background of the crisis of raw materials, components and microprocessors, or the explosion of energy prices in Europe are less bright aspects of the period we are living in. The pandemic is not coming to an end, but since the fall of 2020, when most of the movement restrictions have been lifted, the world's population has pivoted unseen from thrift to excess. Inflation at the end of the year will be more than double compared to the last quarter of 2020, according to the NBR projections. According to some analysts, such as Valentin Tătaru, the chief economist of ING Romania, inflation could reach 6% already this autumn. The injection of money into the economy, in theory, should only begin from now on, after the approval of the National Recovery and Resilience Plan (PNRR). The almost EUR 30 billion that would help areas such as health, education, energy, energy, construction and transport over the next six years, as well as the capital market, should be a safety net in the most pessimistic scenarios. However, the labour crisis, the resolution of which is not even in the medium term, is the real time bomb that can undermine economic growth and, by extension, the absorption capacity of European funds. The areas with high

shortages of specialists are well known – construction, HoReCa, medical services and technology.

Keywords: *pandemic; economic crisis; deficit; GDP.*

JEL Classification: O11, O21

Introduction

"Companies around the world have gone from seeing the effects of this pandemic as minor to considering them a serious threat, according to a perception study by a specialist company in the UK. 41% of respondents say that the situation is now very serious, while 51% of them see it as a serious threat to the global economy" - said Daniela Șerban – ARIR President (2020). Radu Burnete, Executive Director of the Concordia Employers' Confederation (2020) recommends prudence - Both in interpretation and in predictions. "It is certain that now the economy is in a dive, but if it is a very short one we will recover quickly. If it stretches over several months or all year, then the economic effects will be massive and we can already talk about a Marshall Plan for Romania. Unfortunately, we have not been thoughtful in the years of economic growth and now the state does not have very many resources to spend in difficult times. We have entered this crisis with the largest budget deficit in the European Union, -4.4% of GDP.

"I think there will be employers who will discover that some of their employees are more productive from home or simply by chatting online. That's also a big investment in technology and it's likely going to translate into a competitive advantage for those who will invest in having some digital systems that work seamlessly." - Radu Burnete explains.

It is important not to block the financing of active companies. We remember that in 2008, financing and active lines of credit were frozen, which caused a rapid collapse in the real estate and construction sectors, dragging the entire economy after it - says Daniela Șerban - President of the Association for Investor Relations on the Romanian Stock Exchange

1. Economic crisis in Romania

The Covid 19 crisis has significantly affected the Romanian economy, which in 2020 recorded a contraction of minus 3.9% through various channels – interruptions of the supply chain in the industry, especially the automotive sector; decrease in external demand; border closures and internal restrictions. In the future,

analysts expect a strong, large-scale recovery, with annual growth of more than +7% in 2021 and above +4% in 2022, with consumer spending and fixed investments being the key factors in the recovery. [Tablou economic de la BNR: Revenirea din criza generată de pandemie este semnificativ mai rapidă decât s-a anticipat atât pe plan extern, cât și pe plan intern. Care sunt riscurile și oportunitățile pentru România? (economedia.ro)]

Following the severe impact that Covid-19 has on the economy, inflation fell at the beginning of 2020 and remained in the target range until the first quarter of this year. Thus, the National Bank of Romania has maintained a relaxed monetary policy to mitigate the recession by reducing the reference interest rate and launching its first quantitative easing program. [Criza Covid-19 a influențat semnificativ economia României în 2020 – Capital]

Amid the recovery and rising energy prices, inflation rose to almost 5% in the middle of this year and well above the target range. To stop this growth, we expect the NBR to begin a gradual tightening of monetary policy by stopping quantitative easing and raising the benchmark interest rate. However, the inflation forecast remains high, at over 4% by the end of 2021 and gradually decreasing below 3.5% during 2022.

However, there are significant risks of the increase/worsening of the above forecast due to the following factors: (i) sustained increases in raw material prices and international transport costs; (ii) continuous disruptions to the supply chain; (iii) tightening labour market conditions; (iv) the rapid and continuous growth of domestic credit; (v) the increase in the current account deficit and (vi) the substantial depreciation of the leu.

Romania's public finances will continue to deteriorate and become a cause for concern. A strong pro-cyclical fiscal stimulus generated an annual deficit of -4.4% of GDP in 2019. As a result of fiscal stimulus, loan guarantees and subsidies for SMEs, this ratio has risen sharply to -9.2% in 2020. However, the downward trend of the public debt-to-GDP ratio in recent years has reversed, registering an increase to 47% in 2020 compared to 35% of GDP in 2019. External finances are another concern as the current account deficit has steadily increased from 0.2% of GDP in 2014 to 5.1% in 2020. [Criza Covid-19 a influențat semnificativ economia României în 2020 – Capital]

Analysts expect that in the first half of 2021 the current account deficit will reach the value of 6% of GDP. 17% of the deficit in 2020 and 44% of that recorded in the first half of this year was financed by foreign direct investment (FDI), well below the expected level of 75% and down from a recent high of 192% in 2016.

FDI net coverage of deficits will remain below 50%, as capital flows will gradually return to emerging markets. Together with the increased fiscal deficits this could lead to an increase in the need for external financing at critical levels. Moreover, the downward trend of the external debt-to-GDP ratio from 77% of GDP in 2011 to 49% in 2019 has reversed. In 2020, the ratio reached 58% and is expected to remain above 50% in the coming years. [Criza Covid-19 a influențat semnificativ economia României în 2020 – Capital]

2. Economic crisis in Europe

In a new discussion paper, economists at the EU's bailout fund have suggested a simplification of the bloc's fiscal rules. Their contribution comes a week after the Commission relaunched a review of the EU's fiscal rules.

The European Stability Mechanism's economists are unlikely radicals. The ESM is responsible for providing emergency fiscal support to member states in case of financial distress.

In their discussion paper [Fiscal rules (europa.eu)], the authors praise the EU's fiscal framework for having helped to improve fiscal coordination and for having contributed to a position that allowed the EU to react to the economic shock delivered by the pandemic.

Still, they see a need for the EU's fiscal rules to change. The economists claim that a "new economic reality necessitates a fresh look at the European fiscal rules."

The pandemic crisis radically changed the economic landscape, triggering temporary suspension of the fiscal rules. The crisis brought higher debt-financed spending, with its aftermath potentially further burdening public budgets. The monetary policy response to the crisis kept interest rates low and debt-servicing burdens manageable, making higher deficit and debt levels tolerable for the markets.

Post-pandemic fiscal rules should provide credible policy guidance. Well-designed and transparent rules can boost fiscal performance and prevent policy missteps. In the mediumterm, revised rules can help phase out pandemic-related discretionary fiscal measures. In the long-term, they can strengthen commitment to fiscal positions stablising public debt levels.

Fiscal rules were needed to prevent negative spillovers, inflation risks stemming from diverging fiscal positions, and potential overburdening of the European Central Bank (ECB). Monetary union sustainability required the prevention ofspillovers from unsound national fiscal policies.

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The two reference values – 3% of GDP for the deficit and 60% of GDP for the public debt, while political in character, reflected the prevailing economic reality with the 3% deficit ceiling regarded as sufficient to stabilise the economy during downturns. Together with a nominal growth of 5%, including inflation of 2%, it would stabilise debt at about 60% of GDP, not far from the EMU average at the time. Meanwhile, fiscal rules enabled the ECB to focus on its core mandate, maintaining price stability.

The European pandemic crisis response alleviates pressure on governments but cannot replace fiscal rules reform that would better handle high sovereign debt and recognise new economic realities. Grants from the European Recovery and Resilience Facility create fiscal space without burdening governments' balance sheets. Still, rising indebtedness implies governments will need to rollover increasing amounts of debt and finance newly issued debt. Repeated failures of a rules-based system to reduce public debt imply a risk that the Eurosystem and other central banks will be called upon to stabilise government bond markets in future times of stress.

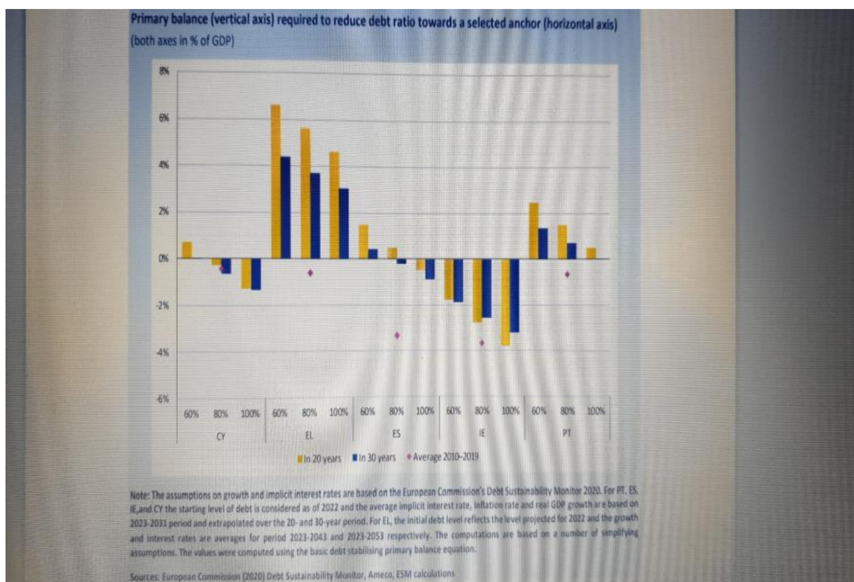

Figure 1. Primary balance to reduce debt ratio towards a selected anchor
Source: Fiscal rules (europa.eu)

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Some countries, such as Germany, France, Italy, have achieved a primary surplus of 3.5% of GDP and above and maintained it for up to five consecutive years. However, the post-pandemic debt level is higher, widening the distance to the 60% reference value and the period in which sovereigns would need to maintain high primary surpluses far beyond those maintained in the past.

Moreover, high primary surpluses achieved in the past accumulated from strong economic growth at rates substantially above those that can be expected in the longer-term. Finally, maintaining high primary surpluses for extended periods would work against the need for investment in modernisation and a greening of European economies, so inhibiting growth.

The updated European Fiscal Board (EFB) recommendations (2020) suggest a country-specific debt adjustment speed. The 2020 EFB report's proposals included an expenditure ceiling rule, a benchmark based on the trend growth of potential output, and a debt adjustment speed based either on a matrix reflecting a fixed set of variables or on a case-by-case macroeconomic scenario prepared by an independent assessor.

These measures would translate into three-year expenditure ceilings, which would encourage countercyclical fiscal policy, with its direction and speed depending on both debt levels and macroeconomic conditions, so increasing debt in bad times and reducing it in good times. The EFB 2020 proposal suggested the 60% debt-to-GDP reference value should not necessarily be achieved within the 15 year maximum set in their 2018 proposal, and could be achieved at a different speed. It also considered a differentiated debt target. [Fiscal rules (europa.eu)]

Empirical evidence suggests benefits do flow from national expenditure rules. Manescu and Bova (2020) analysed the performance of 14 national expenditure rules. Using the European Commission's fiscal rules database, 28 they concluded that such rules reduce spending procyclicality and correlate to relatively higher compliance rates. Expenditure ceilings tend to achieve better results than expenditure growth targets. A higher rate of compliance with expenditure rules could reflect governments' ability to exercise direct control over expenditures.

3. Economic recovery measures

Another strand of proposals suggests abandoning traditional deficit and debt sustainability metrics in favour of debt stocks compared to the present value of GDP or interest rate flows with GDP flows. Furman and Summers (2020) propose to shift away from traditional metrics in favour of debt stock as a percentage of the

present value of GDP, or real interest payments as a share of GDP. Hughes et al. (2019) suggest keeping the interest payments/revenue ratio commonly used by rating agencies as an alternative metric.

Post-pandemic, governments will have to address investment shortfalls and ensure additional funding to meet targets set by key European initiatives and also to boost growth. Productive investment enhances growth and reduces risks to medium-term debt sustainability. The European Green Deal sets ambitious goals in the commitment to a zero-carbon transition and keeping pace with the digital revolution, while rebuilding Europe's social cohesion will also demand substantial investment efforts.

The European Commission has projected that the current 2030 climate and energy targets will necessitate €260 billion of extra investment each year, about 1.5% of 2018 GDP. The European Investment Bank (EIB) estimated an overall infrastructure investment gap of about €155 billion per year (about 1% of 2018 GDP) to attain the goals the EU wishes to achieve by 2030, including 'climate and energy' and broadband penetration. A similar gap of 1% of EU GDP exists in information and communications technology compared to the US. [ESM economists want to raise public debt limit to 100% of GDP – EURACTIV.com]

Any change to the future fiscal framework and its adoption timeline will depend on political, legal, and economic factors, and should be carefully calibrated. The pandemic crisis required the activation of the general escape clause, and the aftermath generated questions about the duration of the clause and the relevance of existing rules. Key decisions on fiscal guidance for 2023 will be taken between March and May 2022, and the discussions on any new rules will be shaped by both economic arguments and political considerations. [ESM economists want to raise public debt limit to 100% of GDP – EURACTIV.com]

Taking decisions on fiscal guidance and potential reform of the fiscal framework matters for market perceptions. Markets' attention has shifted from the immediate crisis response to post - 2021 fiscal policy plans. As the pandemic crisis abates, markets will increasingly scrutinise EU sustainability and national policy responses. Temporary fiscal support will have to be gradually phased out to maintain sustainable debt levels.

The deficit reference value has been a reasonable and emprically backed anchor. The fiscal deficit growth elasticity implied that a 1% decrease in output would lead to a 0.5% deficit increase. With a deficit at about 1.5% of GDP in normal times, a 3% output gap – consistent with a typical recession – would push deficit to 3% of

GDP.57 The 60% limit for debt-to-GDP reflected the average value in the euro area, and was linked to the 3% deficit limit through the basic debt accumulation equation. In a steady state, a country's debt-to-GDP ratio should converge to a level that equals the deficit ratio divided by the nominal growth rate of GDP, at the time expected to hover around 5%. The framework's simplicity made political buy-in easier. [ESM economists want to raise public debt limit to 100% of GDP – EURACTIV.com]

Conclusion

A vigorous economic recovery is taking place in Europe, in developed economies, in many regions of the globe. In the Romanian economy, the recovery, in terms of GDP dynamics, goes beyond numerous forecasts. The International Monetary Fund (IMF) (2021) speaks, in its latest estimate, of 7% increase in Gross Domestic Product (GDP), and the World Bank's estimate is approaching this forecast. "More recent data available suggests even higher growth. It seems that we have underestimated the resilience of the domestic economy in the very critical period of 2020, its benevolent sectoral diversity. On the other hand, the pandemic and its effects in the economy and society leave deep traces, and the gdp return to the pre-pandemic level does not equate to the disappearance of economic and social wounds", notes Daniel Dăianu.

It is essential that, in the years to come, the public debt that has already reached the threshold of 50% of GDP, even if it will grow, stabilizes (public finances are sustainable), and this desideratum depends essentially on budgetary consolidation – which, in turn, depends on a firm step of average annual adjustment of the budget deficit of 1.5 percent of GDP (a cumulative reduction of the deficit of about 6 percent of GDP) in the range of about 6 percent of GDP) in the range 2021-2024. It is worth mentioning that Romania is under the incidence of the Excessive Deficit Procedure (EDP), even if the rules will be reactivated only from 2023.

The recovery of the real economy from the crisis generated by the pandemic is significantly faster than anticipated both externally and internally, paving the way for a high economic growth rate in 2021. With the foreshadowing of the gradual reduction of multiple uncertainties, the expectations regarding the evolution of the Gross Domestic Product (GDP) for next year are also favorable.

The impact on prices generated by the particularly rapid return of demand in the economy, simultaneously the jump in commodity prices and the visible bottlenecks in some segments of the production chains, is expected to moderate significantly in the course of 2022.

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