

# ENRI spring workshop - Investment after the pandemic

## Summary of proceedings

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### PROGRAMME:

1. **Long term trends** (Jan Svejnar, Reinhilde Veugelers)
2. **Implications for productivity growth** (Filippo di Mauro)
3. **Global value chains and globalization** (Giorgio Barba Navaretti)
4. **Uncertainty and investment** (Eric Bartelsman)
5. **Finance, banks and regulation** (Steven Ongena)

#### **Policy roundtable and wrap-up: Long term global trends – economics after COVID**

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### SETTING THE STAGE:

What is needed to support investment in Europe and what can be done on a policy point of view?  
We have seen the spreading of the disease and now we are experiencing the gradual relaxation of lockdown measures and we are going through phase 2 in which the economy is being restarted.  
There are a number of questions that naturally arise:

- The shape of the recovery
- Possible long lasting consequences of the crisis
- “Medical” uncertainty
- Possible transformation of the GVCs and trade
- Radical changes in preferences and behaviours?

And how all of these issues will interact with some of the structural issues and themes of the EU economy, namely the need of rendering it greener and more digital?

### Session 1. LONG TERM TRENDS

The current economic crisis is different from the past meltdowns because severe demand and supply shocks happened simultaneously and all over the world. Therefore, the key question is what EU policies are optimal in this setting – how should the EU approach the current crisis, should it devise new policies?

**Short-term perspective: “Short-term intensive care”**

It is not obvious for how long: “when we will know that we are out of the pandemic?” There is a high level of uncertainty regarding the end of the pandemic, and this obviously affect the perspective of any possible recovery path: probably it will not happen within the next 6-12 months. The EU should ensure that it has capacity to produce vaccines at large scale. Moreover, more investment in vaccines development, therapeutics and diagnostics is needed. There is a different policy menu to tackle the demand and supply shocks:

Demand shock

- i. Provide income support (for example “kurzarbeit”).
- ii. Ensure mobility of goods and services: for the single market to work efficiently, a large scale is needed. Thus coordination of national policies is necessary.

Supply shock

- iii. European and global value chains should be restored, enhancing mobility of goods and services (both intermediate and finished).
- iv. Mobility of workers should be re-established.
- v. The EU institutions should facilitate or directly provide access to finance for European companies and governments (through a combination of monetary and fiscal policy).

### **Medium to long-term rebuilding for a new post-covid world**

- vi. The EU institutions and countries should minimize economic destruction and bankruptcy by providing state aid support. **However, the policymakers should ensure the aid does not help keeping “zombie companies” alive.** Thus, there is a need for EU competition policy.
- vii. The EU should reconsider its digital strategy to support quicker adoption of digital technologies. More social distanced interactions would make the recovery more resilient.
- viii. The recovery strategy should put more emphasis on sustainability, being compatible with climate change challenge.
- ix. The EU should develop the innovation eco-system. There is a need to rethink the MFF grants and restore the mobility of researchers. Healthcare has been a neglected area in the EU policies and the current crisis shows the need to change this approach.
- x. Access to risk capital: **the EU should reconsider investments to provide more risk capital** (instead of bank loans or loan guarantees more emphasis should be placed on capital and grants).
- xi. The key question is whether **the EU needs more protectionism and self-sufficiency in strategic sectors**. Strategic autonomy does not necessarily means protectionism. The EU should diversify its value chains to be flexible and sufficiently independent (it does not necessarily mean geographically closer suppliers).

The economic shock related to the Covid-19 pandemic is huge (measured by decline in output). The scale of the shock is especially visible in the US, where the unemployment rate has increased from the all-time lows (ca. 3%) to over 15%. Therefore, the shock can be considered as the most severe since the 1930s. The sharp increase in unemployment is not visible in Europe due to government

programmes like “kurzarbeit”. On the other hand, the hi-tech sector copes with the crisis relatively well, for example Amazon has recently hired additional employees.

The EU countries have provided substantial support for the economy (relatively quick reaction of EC by loosening rules on state aid): from labour schemes to liquidity provision. **An important policy question is whether the latter should be in a form of bail-out or bail-in.**

Companies react to the crisis in a variety of ways but the prevailing trend is that they try to retain liquidity by restraining investment. This phenomenon can severely impact economic performance in the medium and long-term.

A proper functioning of the large EU market is needed to ensure long-term recovery. “Balkanization” of the single market will have adverse influence on the macroeconomic performance and may lead to relatively uneven recovery (North vs South or West vs East). Therefore, the common EU approach is necessary to tackle the crisis in the most efficient way and mitigate the aforementioned risks. Policy design to cope with the crisis should be EU-wide (coordination on the European level is highly recommended).

In the long-term we can expect deglobalisation. Suppliers will be located closer to “home” and, as a result, production in the EU can increase. However there is a new globalization wave in digital technologies and here EU is lagging behind. Investing in Science and R&D and applications to re-gain leadership positions is needed.

## **Session 2. IMPLICATIONS FOR PRODUCTIVITY GROWTH**

The presentation was based on the article “The COVID crisis and productivity growth”, published on CEPR VoxEU on 15 April 2020. <https://voxeu.org/article/covid-crisis-and-productivity-growth>

The aim of the presentation is to provide a structure to the discussion on the potential impact of COVID on productivity by analysing the channels through which the crisis may indeed shift growth and productivity. From an accounting point of view, growth is a function of labour, capital and the total factor productivity (TFP). **Dealing with labour**, no major impact on the size of labour force is to be expected (deaths a relatively low and concentrated on older people). In the short term, there may be a significant impact on labour force via the human capital accumulation channel. The sign of impact is difficult to predict because it combines positive components (e.g. schooling is often counter-cyclical, meaning that it increases in crisis times, eventually allowing for more human capital accumulation in the future) and negative components (e.g. distance learning may be detrimental for schooling performance). Looking at the medium term, while job detachment and persistent unemployment may lead to workers losing their skills, those who will manage to keep their jobs will see their IT skills improved. Again, the net impact is uncertain.

**Dealing with capital**, there will likely not be major changes in quantities. Differently from a war, in fact, the shutdown does not involve a large-scale destruction. That said, some type of capital might be *de facto* destroyed simply because there will be not a demand recovery in the future (e.g. public accommodation in far-away holiday destinations). On the bright side, there may be addition capital formation (e.g. health infrastructure). The caveat here is that additional capital may be redirected to infrastructures that cope with tail events, which means that more investments will not necessary push up productivity. In that regard, forward-looking regulations (e.g. climate change) may play a relevant and positive role.

**Dealing with TFP**, it is necessary to distinguish between 2 components: the intra-sectoral productivity and the inter-sectoral productivity. The former can be further disaggregate in 2 components, namely the “within-firm productivity” (i.e. the way firms utilizes the resources) and the “between-firm productivity” (i.e. allocation efficiency). On Within-firm productivity, the key concepts are intangibles, knowledge capital, macro burdens and cross-country barriers. **Intangibles imply considerable sunk costs**, therefore they are expensive to re-build (e.g. it will be much easier to recover for firms that kept their employees). **Policies to maintain labour may hence be important for future productivity**. On the **knowledge capital side, the crisis may be a trigger for innovation through new technology utilization**. Higher taxes and inflation that may arise from the current fiscal and monetary actions may generate burdens for the future productivity growth, hampering innovation. **The rise of cross-country barriers may have detrimental effects on productivity** because of higher transaction and repatriation costs and because of reduce labour mobility.

Regarding the between-firm productivity (resources reallocation), it is acknowledge that the size matters: **small firms are likely to suffer the most and they are likely to exit in large numbers**. Given that many empirical works find a positive correlation between firm size and productivity, the reduction of small firms may eventually increase productivity through compositional changes. However, there are caveats. It is not clear whether the shock will select on productivity as opposed to other firm features (e.g. market, power, connections, etc.). Moreover, it is not clear whether small inefficient firms exiting will be replaced by bigger and more efficient ones (this may depend on country-specific features). In addition, the **recent policies adopted to sustain the economy will have the downside effect of creating zombie-firms, which represent a risk for productivity growth**. Dealing with the inter-sectoral productivity, it is not clear how the reallocation across sectors will affect productivity growth.

#### **Discussion - notes**

1. Even if we accept the hypothesis that digitalization do not show up in productivity because of high long learning and reallocation costs, the shock is so sizeable that it could speed the process up a lot, eventually allowing productivity gains.
2. There is a correlation between management quality and productivity. Firms with good management and good intangibles are likely to better weather the crisis. This selection may end up in boosting productivity.
3. EIB surveys highlight that the lack of digital skills is a major impediments to investment. In this regard, COVID may play a triggering role.

Even assuming an improvement in digital skills, it is not clear whether it would be due to lagging behind firms catching up or because only leading firms – with already digital-skilled workers – will survive.

### **Session 3. GLOBAL VALUE CHAINS AND GLOBALIZATION**

Part 1: GVC definition: where are value chains which industries

#### **Regions:**

- Value chains tend to be regional e.g. EU, North America, Asian region: most interactions within regions. They are major players in the regions that supply to other regions: US, Germany,

China. There can be reallocation across regions and within regions: major players could be affected if reallocation across regions

### Industries:

- A lot depends however in what countries do: there is uneven sectoral specialization in GVC: suppliers of technology, manufacturing products. Impact of COVID-19 may be different depending on specialization. Some industries are much more globally integrated. The most integrated is computers/electronics equipment

Part 2: Firm's perspective: cost of distance and how COVID affected it

- Firms: the cost of distance
- Border crossing delays have increased.
- Risk of having spread out value chains is not perceived by companies to be higher.

Part 3: Government perspectives: transmission of shocks and re-shoring - if GVC transmit shocks

- If have large value chains there is increased risk of foreign transmission, 34.7% of contraction can be attributed to foreign transmission (Bonadio et al 2020)
- Nevertheless, if renationalize supply chain national economy would be affected by virus anyway: the final result depends on the geographical spread and intensity of the shock

Part 4: Essential public goods: idea that you should produce nationally

There is a possibility of re-shoring essential products, but it's difficult to identify essential products:

- every crisis has different essential product and we don't know what future threat will be
- it's very difficult to re-shore all essential products (you need to combine completely different factors of production)

Part 5: Re-shoring issues

Re-shoring is difficult, because:

1. Countries are heterogenous and hence it is very difficult to make any general statement:

- large core countries and small peripheral ones
- upward and downward production stages
- differing intensity of GVCs

2. Firms are heterogenous and GVC transactions are potentially very complicated transactions:

- GVC strengthen heterogeneity of firms: this is related to distributional issues and the gap between leaders and laggards firms and also uneven bargaining power (particular between large and small firms)
- These relationship based transactions emphasize relationship specific sunk costs. It is difficult for firms to get away from the GVC

## Session 4. UNCERTAINTY AND INVESTMENT

“Uncertainty and investment” is a particular interesting topics because we are going through uncharted territories. Let’s start from low frequency EIBIS data and then go to some higher frequency data. What we are uncertain about? Forward looking policy.

The EIBIS survey shows a wide regional variation in how uncertainty hit investment decision. The survey showed a decline in uncertainty as an impediment for investment in the 4th waves, with declines similar by geographic area. The variation across sector is not that large, at the same time however the improvement over time is stronger in some sector (i.e. Hotels and accommodation vs. manufacturing).

Baker, Davies and Bloom: high frequency evidence on uncertainty. With the idea that when uncertainty is high there is a value in waiting for more information before investing. The source of uncertainty continuously changed and **hence it can be particularly difficult to calibrate the measure** of uncertainty in the “**investment decision space**”. One way is normalizing the mean, but then when an unexpected event happens how the other moments reacts? The VIX index hit in early March the same level of the GFC, but now is going down rapidly. They suggest using these shocks and evaluating their impact on the economy. Baker et al. have a NBER wp in which they use an indicator called Infectious Diseases that is the collection of all the news mentioning uncertainty and the COVID as a cause. Using these numbers can be useful? Yes but then there are other sources of uncertainty. One is purely medical, about the vaccine, the treatments. And then, there is a lot of uncertainty in policy (how to engineer the lockdown phases and the exit from it, and how to coordinate actions internationally). And then, there is the pure economic uncertainty. Also regarding “**measurements**”. For example measuring inflation assumes that the basket of consumptions goods does not change dramatically but it is exactly what happened. Households participants in the survey of unemployment and workforce. We have no historical matrices in which we can use these. It is difficult to use macro time series and use them with the current situation it is probably useless. What kind of macro models can be use? A mix of micro and macro. It is difficult to think to any possible historical comparison. What kind of macro models can be used? Micro and macro. Because also the usual distinction between supply and demand shock is adequate. We should use a modern input-output framework that allows to deal with different shocks simultaneously.

1) **Taste shocks** (including the increased health care needs, and precautions or social pressures introducing changes in preferences).

2) **Supply shocks**: characteristics of lockdowns, as the possible amount of work-at-home, or rules on distancing or delivery or inventories.

3) **Technology or productivity shocks** due to adjusting the value chains: shift to on-line retail distribution or online classrooms that can be permanent but also productivity losses (temporary or permanent) related to transition.

4) **Traditional macro demand story**: aggregate demand implications from income loss, credit constraints, animal spirits.

We need all these four bits in a unified framework, with enormous data needs.

## Session 5. FINANCE, BANKS AND REGULATION

### *The COVID-19 pandemic and sovereign bond risk*

The analysis of the impact of the 2007- 2009 financial crisis can have useful implications for outcomes and policies in the Corona pandemic crisis.

Various elements are combined in the picture, to provide inputs. Particularly on two main topics:

1. Bank bailouts and their costs
2. Bank inspections

Banks bailout are important because we need banks to lend. But if they absorb too many resources from the sovereign they can subtract resources from health care funding cuts; if banks do not lend there will be a cost in terms of lost business, rising in local unemployment, and for the return to the parental home for the young labour force (with consequences for pandemic).

### **Scenario of Better bank bailouts:**

- Well-capitalized banks that lend, saving treasure for the sovereign
- Maintaining quality health care
- Youngsters outside of parental homes
- Elder in more spacious retirement homes

### **Coupled with tougher bank inspections, It will result in better pandemic outcomes**

**On bailouts:** there are three phases in bailouts. Catch, restrict and release. That are all important in the current situation. The restrict phase is the one that determines the future behaviour of the bank: The harsher the (expected) restrictions, the higher the capital ratio banks will maintain (to avoid being caught) and the swifter the release will be and at higher capital ratios as well.

(Berger, Allen, Simona Nistor, Steven Ongena and Sergey Tsyplakov, 2020, Catch, restrict, and release: The real story of bank bailouts, May)

**On inspections:** there is evidence that tough in-site inspections reduce the likelihood that banks refinance zombie firms.

(Bonfim, Diana, Geraldo Cerqueiro, Hans Degryse and Steven Ongena, 2020, On-site inspecting zombie lending, May)

On the contrary with higher levels of supervisory forbearance on distressed banks, while failures (of banks and corporates) and job losses are lower in the short term, the long term consequences are a less healthy banking sector, higher NPL ratios, lower productivity growth with lower new entry and job creation.

(Gropp, Reint, Steven Ongena, Joerg Rocholl, and Vahid Saadi, 2020, The cleansing effect of banking crises, May. )

**In the short run emergency support can be efficiently channelled through banks,** benefitting from their knowledge and their soft information on the corporate sector.

( Ongena Steven, 2020, From Swiss Finish to Flying Start: Why Switzerland Performed so well in Shoveling Covid-Emergency Loans to its Small and Medium Enterprises?, May.)

## **Pandemic and Sovereign Risks**

Current work on the assessment of the impact of the pandemic in Europe on sovereign CDS spreads: a high number of cases and deaths and strong public health containment responses significantly increase the uncertainty among investors in European Government Bonds.

(Alin Marius Andrieş, Steven Ongena, and Nicu Sprincean, The COVID-19 pandemic and sovereign bond risk)

Pandemic is a test of resiliency and robustness of societies. Particularly, regarding banks, this implies a scrutiny of their role as credit grantors and allocators of resources.

## **Policy roundtable and wrap-up: LONG TERM GLOBAL TRENDS – ECONOMICS AFTER COVID**

### **Romain Duval**

1. Investment will remain depressed for a long time
2. Reallocation shock
3. Government role will rise
4. Structural reforms

1) From past crisis we know that permanent scars will remain on investment dynamics and TFP. Reasons?

a) shrinkage of supply chains and distortionary state interventions

b) high uncertainty will persist weighing on demand

c) financial distress not now, but coming through higher debt levels.

Now interest rates are already ultra low no ways of helping. And the shock is not destroying capital but labour.

2) This is a major reallocation story: look at the incredible divergence between firings (Walmart) and hirings (Amazon) or stock market returns or labor surveys (three times the usual reallocation rates).

This allow some investment upside because there will be some spending industries but there will be new spending and sunk costs (airplanes).

3) Government will be at center stage mainly for Infrastructures investment. New needs: health care and climate change. In a context of even lower rates (and high precautionary savings).

4) Foreseeable return of structural reforms, not labour market reform, but product market one. In fact, the difficulties of the SMEs and the relaxation of state aid rule pose questions that will have to be solved.

### **Chiara Criscuolo**

It was a low probability high risk event. But this can happen again, it must be taken into account. With climate extreme events or others pandemic episodes. The answer is not becoming more isolated but diversifying risks.

The threat that a world characterized by lower openness and lower interactions can be a world with less innovation (also because of lower incentives to innovate) must be counteracted. There will be winners and losers, in terms of countries, sectors and obviously firms. The first dimension, quite obviously is that of digital readiness. This clarifies also that one of the roles of government policies is to provide a proper digital infrastructure.

Some of the trends that were affecting the economy before Covid will stay there and they can even be exacerbated by the crisis. Namely the divergence (leaders and laggards story) the slowdown in entry rates (providing less competitive pressures to the incumbents and also lower innovation rates).

The issue on entry rates and start-ups is particularly worrying: it has to be avoided that this period will be the one with a missing generation of start-ups. One way to avoid this is to minimize uncertainty in regulation and try to restore as soon as possible a levelled playing field for corporates.

### **Roman Arjona**

The crisis is distorting and magnifying global challenges. These challenges clearly do not respect national/physical borders. The crisis has also strong implications in terms of inclusiveness. The impact, (through uncertainty and liquidity) on business R&D will be huge. On another point of view, the current situation put a lot of emphasis on the idea of open science and on the need of collaborative research efforts.

One policy reaction is the tentative of strengthening investment at national and EU level, possibly in a coordinated way. Europe should not sacrifice its recently emphasized focus on climate change and digitalization. Now it is even clearer the need of having a mission oriented approach, it is not only a matter of fixing markets.

The analysis of the crisis and the responses to it must be dynamics responses taking into account not only the short term, but also structural aspects embracing transformative policies.

### **Ralph de Haas**

Rebalancing corporate finance is a priority given the extent of the shock. There is wide heterogeneity in country-level distribution of small businesses and their debt and cash structure. There will be also a wide heterogeneity in responses to a possible re-thinking of GVC structure and length given the different positioning of countries.

### **Leonardo Gambacorta**

We have to carefully look at the data in order to give some evidence on the impact of the pandemic on unemployment. Pandemic has been described as a global shock but its implications are not symmetric at all. Combining the sectoral exposure to COVID-19 in different European regions with the density of small firms (that are financially more constrained and have less diversified sources of revenues) it is possible to build a regional employment risk indicator. This indicator is correlated with the increase in unemployment google search and decline in mobility.