Series Viewpoint

2021: No time for consolidation

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Fabrizio joined Muzinich in June 2018. Prior to that he was in the public sector where he has held a number of roles including most recently Head of the Office of Italy's Minister of Finance, responsible for developing policies targeting macroeconomics, tax, finance and banking. Before that he served as G20 Sherpa and Senior Economic Counsellor to the Italian prime minister. Previously, during his time at the OECD in Paris, he also held the role of Chief of the Sherpa Office and Special Counsellor to the Secretary General in Paris, responsible for coordinating the OECD's contributions to the G20 and G8 during and after the financial crisis. He holds a degree in International Affairs from the Scuola S. Anna in Pisa and a Masters in International and European Law from the European University Institute.

During 2020, governments took measures to address the immediate economic consequences of the pandemic, including state-backed loans to small business, unemployment and retention schemes for workers, tax holidays, and income support for households. These programmes have a cost, as government deficit and debt rose precipitously.

Will we see these measures be progressively phased out in 2021, and will public finance start to consolidate?

Concerning monetary policy, in our view, any tapering or phasing out over the near term seems unlikely. The European Central Bank (ECB) in particular has provided guidance on the continuation of existing support over the next few years.[1]

We have less visibility on what could happen on the fiscal side, given the granularity of the measures and European governments' need for parliament approval. Some of the measures taken have been extended until the spring, but they still look temporary in nature.

We believe that that dislocation is happening across the global economy: in the value chain, in credit to Small and Medium Enterprises (SMEs), and in labour. We believe this dislocation is the result of the pandemic crisis and the related restriction measures taken by governments to contain the contagion. The manufacturing industry has been particularly affected, and some of the changes observed here are possibly less short-term than those experienced by other sectors.

European factories, in particular SMEs in the business-to-business sector, are experiencing tensions in their value chains, as supplies come in late or at prices materially higher than they were previously. There are disruptions in production, but logistics particularly have become less reliable and more complex than in the past.

With countries suspending flights and closing borders, businesses are failing, and competition in logistical services is less fierce than in the past. This results in upward pressure on prices in traditionally very low margin sectors, such as transport. According to a recent report by Accenture[2], air cargo capacity has been increasing during the last quarter of 2020, but it is still down 57% vis-a-vis 2019 levels. It is well possible that these changes will be mostly temporary, at least for large firms. In a recent survey by the ECB[3], firms across Europe did not see major disruptions in their supply chain.

The European credit sector is equally affected by the pandemic. In most European countries, the normal business credit mechanisms have been disrupted; existing loans are often suspended by credit repayment holidays, and new loans are benefitting from state-backed guarantee programmes. In France, for example, businesses have access to the “prêt garanti par l’Etat” [loan guaranteed by the state] until the end of June 2021. Similar loan guarantee schemes have been enacted across several European countries, which enjoy anti-trust protection, thanks to the temporary relaxation of the state aid rule adopted by the European Commission. It is difficult to assess the health of businesses until these measures are fully phased out. In the current framework, we do not know which, and how many, businesses will fail. We also do not know how long it will take to adjust the financing of surviving firms towards a “new normal” way of conducting business.

We also have yet to see the impact on European banks’ balance sheets and capital requirements. Recent communications by the European Commission and the European Banking Authority address the issue of how to tackle non-performing loans in the aftermath of the pandemic.[4]

Dislocation in employment is equally important, as the full impact of the COVID-19 crisis on the European labour market still flies well below the radar. We have seen, across Europe, large and generous job retention schemes have been essential in cushioning the impact on the labour market. Once these schemes are phased out, a sudden surge in unemployment is quite likely in our opinion.

Policy makers will be in the uncomfortable position of taking decisions facing huge uncertainty. In this context, we should learn from the mistakes of the past. We believe one of the key lessons of the global financial crisis is that we should not stop expansionary policies too early.

In our view, if fiscal contraction occurs too early in the recovery process, it is likely to lead to a slump. In addition, central banks will not necessarily be in a position to help, being already at the zero low bound or below. It is therefore necessary to continue to support the COVID-19 hit economy as long as necessary, and certainly as long as restrictions measures are in place.

To summarise our view simply; throughout 2021 we should not withdraw the support to businesses, workers, and families.

It will be costly. However, by ensuring we still have a viable economy, we believe we can then introduce investments and reforms which are needed to make public finance sustainable and the economy strong in the medium and long term.

[1]‘Monetary policy decisions’ press release from the ECB https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.mp201210~8c2778b843.en.html

[2]COVID-19: Impact on air cargo capacity https://www.accenture.com/au-en/insights/travel/coronavirus-air-cargo-capacity

[3]The long-term effects of the pandemic: insights from a survey of leading companies https://www.ecb.europa.eu/pub/economic-bulletin/focus/2021/html/ecb.ebbox202008_06~bad87fcf9b.en.html

[4]Coronavirus response: Tackling non-performing loans (NPLs) to enable banks to support EU households and businesses https://ec.europa.eu/commission/presscorner/detail/en/IP_20_2375

Important Information