ANALYSIS

ECONOMY AND FINANCE

ECONOMICS OF CORONA PANDEMIC IN SLOVENIA

Jože P. Damijan
April 2020

The pandemic is expected to hit hard the Slovenian economy by reducing the GDP in the range between 6% and 14%.

With proper implementation macroeconomic support measures, however, the government can save most of the jobs and mitigate the economic loss due to crisis by 60%.

The outlined economic policy measures will result in increased budget deficit and boosted public debt, though in the absence of government intervention public debt figures would deteriorate even more.

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SPREAD OF COVID-19 PANDEMIC IN SLOVENIA

With the first case officially confirmed in Slovenia on 4 March 2020, the pandemic of coronavirus disease 2019 (COVID-19) started to spread in Slovenia five weeks after first cases were confirmed in Italy. The response to the pandemic were challenging for Slovenia also due to the government change. New prime minister Janez Janša was elected a day before the first case was confirmed, while the government was appointed only 10 days later. Nevertheless, with 89 positive cases in total confirmed, on 12 March the previous government declared an epidemic in Slovenia. The government announced that all educational institutions would be closed from 16 March onwards. The new government, appointed on 13 March, stepped up the measures with all public transport and all unnecessary services in the country suspended and all hotels, restaurants and bars closed by 16 March. First fatality due to COVID-19 infection was reported on 15 March. On 20 March de facto quarantine (with some exemptions) was established in Slovenia.

As of this writing (24 April, 2020), with the number of new COVID-19 positive cases and number of hospitalized patients decreasing for days in a row, the peak of epidemics seems to be reached. The preventive lockdown measures, however, are expected to be upheld at least until early May.

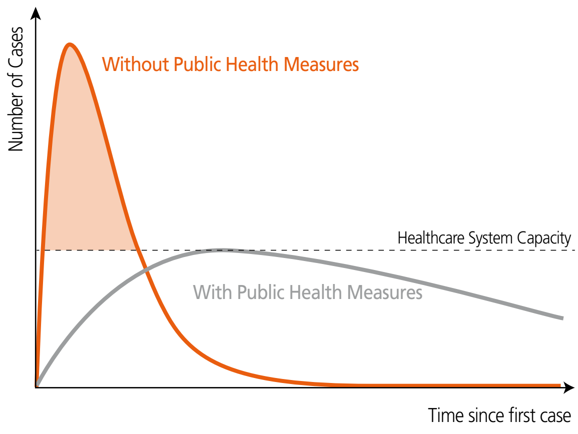
TRADE-OFF BETWEEN FLATTENING OF THE EPIDEMICS CURVE AND ECONOMIC LOSS

As demonstrated first in the Hubei region and followed by the failure in Lombardy, swift public health measures are essential to contain the epidemics. As there is an upper bound on the number of patients that can be properly treated in the short run due to limited health care capacity, the key is to flatten the infection curve.

With slowing down of the infection spread, the demand for intensive care treatment of patients can be contained, while the health care capacity, in particular ICU beds, number of skilled health professionals and ventilators, can be appropriately scaled up.

There is, however, a downside to this "flattening the infection curve strategy" as it unavoidably steepens the macroeconomic recession curve. Efficient preventive health care measures require increasing social distances with closing schools, universities, most non-essential businesses, and paying most of the working-age population to stay at home. This brings a large part of the economy to a sudden stop. The stricter the lockdown and the longer the preventive health care measures are upheld, the bigger the economic loss is.

Figure 1
Flattening the Pandemic Curve



Source: Gourinchas (2020)

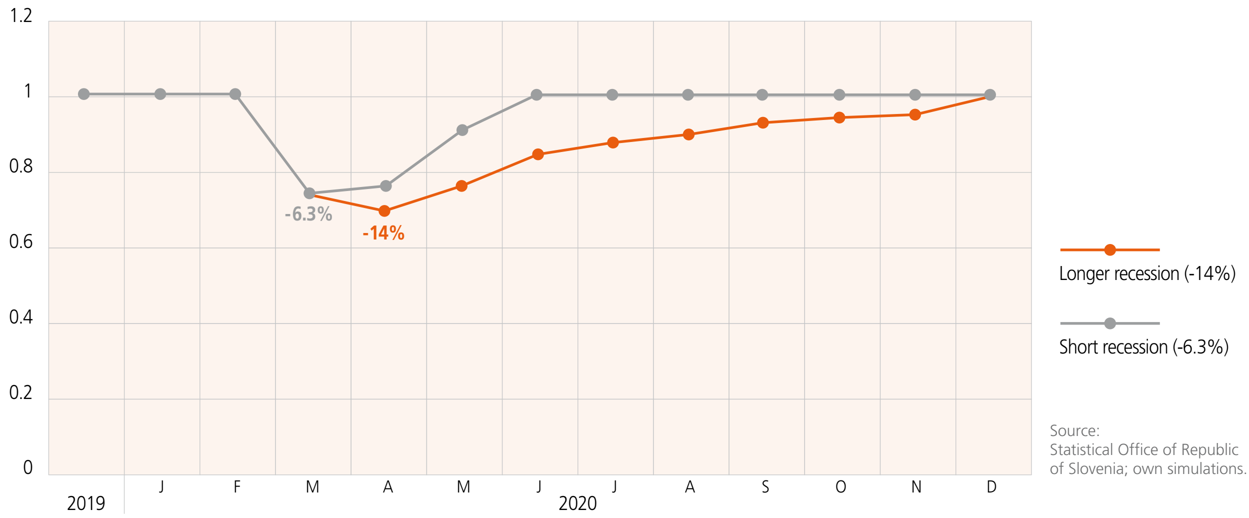
EXPECTED IMPACT OF CORONA CRISIS ON SLOVENIAN ECONOMY

In Slovenia, within a week between 16 and 23 March, an increasing part of the economy was shut down, including public transport, hotels, restaurants and catering (HoReCa sector), non-essential retail shops and joined by several large companies that followed suit of their major foreign customers (in particular in car and automotive parts industries). In mid-March, I made simulations to assess potential economic loss due to these lockdown measures (see Damijan, 2020a). Projections are based on two scenarios: (A) short recession and (B) longer recession.

In the baseline scenario of a shorter recession, I assume that half of industrial production in March and April and one quarter in May will be lost, and then returning to normal levels in June. The same scenario was used in retail, transport, catering and tourism, while for most other sectors I assumed a downturn in the range between 10% and 25% in March and April, then returning back to normal in May. Note that not all activities will suffer from the lockdown as there will be virtually no decline in the activities of public administration and defense, education, health and social care. The food industry, however, is assumed to experience a surge in production due to stockpiling behavior of people caused by psychological reasons.

In the alternative scenario of longer recession, I assume that the economy will not return to normal by June. It is expected that containment measures will stay in place longer and that recovery will be slow resulting in the return to normal trajectory only by the end of 2020. Both scenarios and GDP trajectories are illustrated in the figure below, whereby the curves depict deviations of monthly GDP activity relative to the "normal" trajectory (in case of no pandemic).

Figure 2
Projected GDP decline in Slovenia due to the pandemic, monthly deviation from normal trajectory (in per cent)



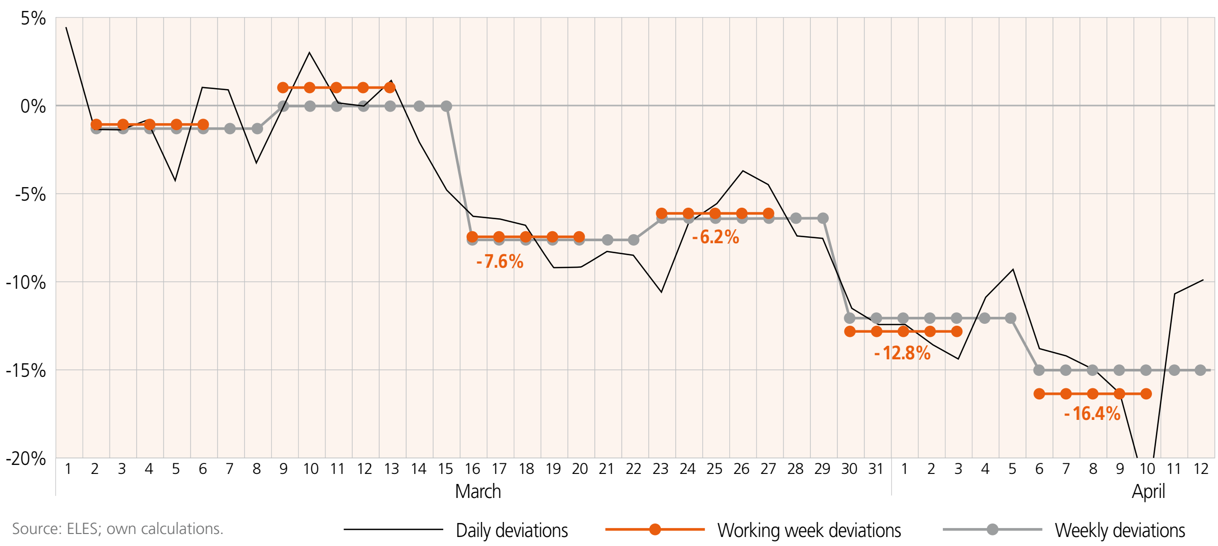
Source:
Statistical Office of Republic of Slovenia; own simulations.

According to the baseline scenario, annual GDP is projected to decline by 6.3% this year, which is comparable to the severity of the GDP downturn in 2009 (-6.8%). In case of a prolonged crisis and a slow recovery, however, this year's GDP is expected to fall by as much as 14%. These figures were later matched also by the estimates of other institutions, such as UMAR, EIPF and Bank of Slovenia, with the estimated GDP downturn in the range between 5% and 15%.

To track the actual economic activity in Slovenia after the lockdown in real time, in a recent column I made use of the data provided by ELES[1] on hourly electricity consumption. Note that statistical information on the volume of industrial production as well as data on GDP for the previous quarter comes only with a delay of almost two months. Electricity consumption as an indicator economic activity is often used to monitor actual economic dynamics of countries such as China, for which there are reasonable doubts about the accuracy of official economic activity data.

The figure below shows daily and weekly deviations in electricity consumption from the same day / week in March – April 2019. The figure demonstrates that in the first week of lockdown, starting with March 16, the consumption of electricity decreased by 7.6% as compared to the same week in March 2019. In the second week of lockdown it decreased by 6.2%, and by 12.8% and 16.4% in the third and fourth week, respectively. The lockdown seems to get traction with overall economic activity down by almost 15% in the most recent two weeks. Based on this development, the full-scale economic downturn is yet to be expected in April.

Figure 3
Deviations in electricity consumption in March – April 2020 from the same day / week in 2019 (in per cent)



Source: ELES; own calculations.

1 ELES is systemic operator of Slovenia's electric power transmission system.

MACROECONOMIC SUPPORT TO CONTAIN THE ECONOMIC LOSS

There is too much of a trade-off between the effectiveness of containing the pandemic and economic cost. The strict measures that help flatten the pandemic curve and mitigate the health crisis can make the economic crisis worse, since stricter health policy involves a larger economic shutdown. Of course, in case of larger lockdown the economic cost will be vast, but only if the recession is not counteracted by proper macroeconomic policies.

Governments of major economies have since responded by introducing extraordinary fiscal and monetary policies. There seems to exist a consensus among economists and policy makers on broad measures to be taken to contain the economic loss. These measures recognize the need to support households and businesses, through unemployment benefits, credit support, and direct transfers. As these measures will require a large fiscal bazooka, many EU countries facing high public debt burdens will find it difficult to finance it.

To reduce the problem of financing the increased budget deficits and to mitigate the borrowing cost, two EU-wide programs were launched. On 18 March 2020, ECB launched a new temporary asset purchase program of public and private sector securities, called Pandemic Emergency Purchase Programme (PEPP), to counter the serious risks of increased borrowing cost of some countries and the outlook for the euro area posed by the pandemic. This new PEPP program will have an overall envelope of €750bn, which amounts to some 5% of the EU GDP. Purchases will be conducted until the end of 2020 and will include all the asset categories eligible under the existing asset purchase program (APP). The program is said to be extended beyond 2020 if deemed necessary.

Note that allocation of asset purchases under this program across countries will continue to be the capital key of the national central banks and that a self-imposed limit to buy no more than a third of any country's eligible bonds will not apply for this program. Note also, that ECB Governing Council made is very explicit that Eurosystem member countries are free to use the assets flexibly, i.e. to finance supporting fiscal measures according to national priorities ("the ECB will ensure that all sectors of the economy can benefit from supportive financing conditions that enable them to absorb this shock. This applies equally to families, firms, banks and governments"[2]) Due to this, many see this ECB action akin to launching a "helicopter drop" program, i.e. a form of monetary financing, that was a political taboo so far.

While the ECB PEPP program is set to ease the financing problem of EU member states that were hardest hit by the pandemic, this cannot be said about the recent EU-wide agreement on "comprehensive economic policy response to the COVID-19 pandemic" (as of 8 April 2020). While Italy and other vulnerable member states were seeking an EU-wide crisis assistance, financed by the so-called "eurobonds", they had to give in to a political consensus. The economic significance of the agreed response, however, is miniscule. It can be summarized as follows:

- A greater temporary flexibility of a common EU budget in the use of EU funds;
- A €2.7bn emergency support facility from EU budget resources (amounting to 0.03% of GDP);
- An EIB lending facility for €25bn, serving to support credit flows, but may have a marginal effect;
- An ESM enhanced-conditions credit line of up to 2% of member states' GDP to be spent on healthcare-related issues. Due to the usual conditionality attached[3], this ESM program is irrelevant, and its use was already precluded by the Italian government;
- A temporary credit program by the European Commission to support national employment systems (SURE) with the maximum size of €100bn.

None of this can be of a significant support to economies whose GDP is projected to fall in the range of 10 to 20% in 2020. Member states will be left to their own financial capacity to mitigate this downturn with adequately-sized fiscal policies. ECB's pandemic program may help ease the financing problem and reduce the borrowing cost but fighting the pandemic will ultimately lead to steep increases in public debts of most affected member states.

SLOVENIA'S MACROECONOMIC POLICY RESPONSE

To contain the economic loss due to the pandemic, Slovenian legislators adopted two laws. The first (Law on Emergency Measures in the Field of Wages and Contributions, effective as of 29 March 2020) was replaced by the "Intervention Measures Law to Curb the COVID-19 Epidemic and Mitigate Its Impact on Citizens and the Economy", adopted on April 2 and effective since April 11 2020. The "Intervention Measures Law" is very comprehensive in the measures to be applied, which cover the period between 13 March and 31 May 2020, with a possible extension if needed. The Law in many instances follows my recommendations by outlining the following major measures to mitigate negative consequences of a pandemic:

2 See https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html

3 "Afterwards, euro area Member States would remain committed to strengthen economic and financial fundamentals, consistent with the EU economic and fiscal coordination and surveillance frameworks", see https://www.consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-the-comprehensive-economic-policy-response-to-the-covid-19-pandemic/

General measures:

- An 80% co-financing of salary for workers on hold;
- All contributions to both health and pension funds will be paid by the state;
- For operating companies, the state will cover the contributions to the pension funds;
- Deferral of corporate tax advance payment until January 2021;
- Any compensation for sick leave in the period of epidemic will be borne by the state;
- The status of workers not working due to reasons of protection of children, the inability of arrival at work or other reasons, will be tied to the status of workers on hold;
- An employee losing a job during the epidemic will get immediate unemployment benefit;
- Solidarity allowance is paid to pensioners with pensions below €700 (scaled in the range €130 - €300);
- State payment deadlines for payments to private suppliers are reduced to eight days.

Self-employed

- Self-employed with at least 20% drop in revenues in March 2020 are eligible for a monthly basic income of €700;
- Pension and social contributions are paid by the state until the end of May 2020;
- Deferral of income tax advance payment until January 2021.

Farmers and fishermen:

- Same as self-employed: eligible for monthly basic income of €700;
- Compensation for loss of income due to crisis;
- Public institutions will have to order at least 50 percent of all food from Slovenian farmers.

Other:

- Students: one-time allowance of €150;
- Reduction of salaries of high-ranked public officials and attendance fees for members of supervisory boards in state-owned by 30%.

The government approach to solve for inter-company liabilities and liquidity problems are to be addressed by another Law, which is expected to be adopted by the end of April 2020.

EVALUATING THE SLOVENIA'S MACRO-ECONOMIC POLICY FRAMEWORK

The macroeconomic policy framework as outlined in the "Intervention Measures Law" is, in general, a good attempt to minimize the economic cost of a pandemic, though not a perfect one. Note that in theory there would be no economic loss due to pandemic if the government would step in by fully compensating the potential loss in value added of companies and self-employed. Specifically, by fully compensating for the loss of net income of companies and self-employed (i.e. for gross labor cost and EBITDA (gross profits plus depreciation)) the state subsidies would fully replace the lost net income (value added) leaving the GDP unaltered.

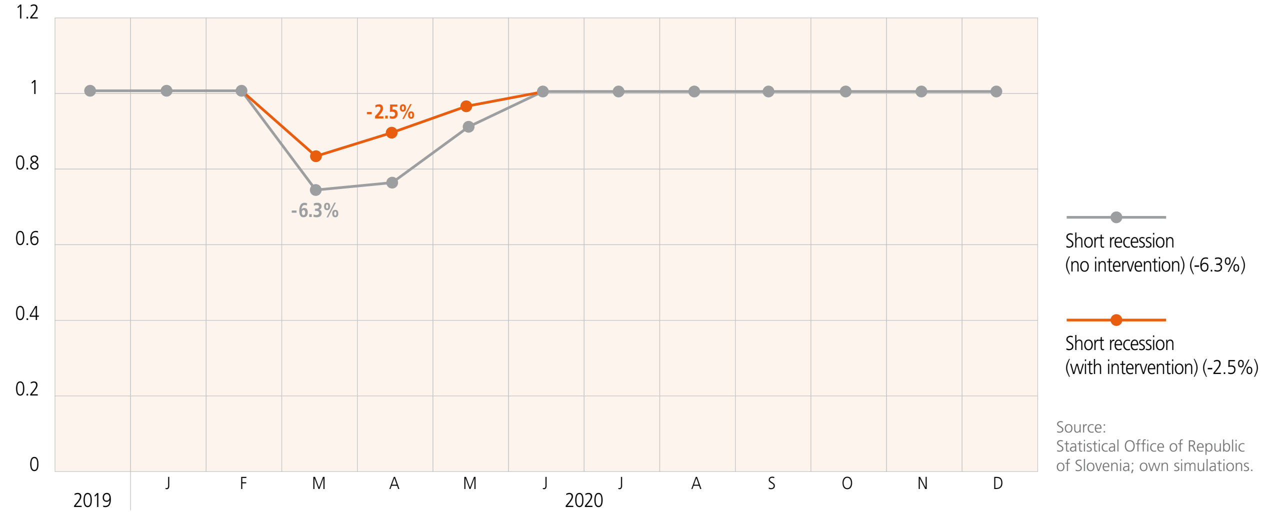
Of course, the government measures are going to less-than-perfectly compensate for the lost income during pandemic. Three major discrepancies are: (1) the government will compensate only for 80 % of salaries of workers on hold, (2) not all self-employed and farmers will be eligible for basic income, while the amount of this income (€700) will be lower than their average pre-pandemic income, and (3) government will not compensate for the lost profits and depreciation of companies (in total between 30 to 40% of companies' value added).

While the government estimates the volume of its support measures to amount to €3bn (about 6.3% of 2009 GDP), to my calculations and calculations of other economists, government measures, if applied fully for the period mid-March – end of May, might be "worth" only around €1.8bn (about 3.8% of 2009 GDP). Of this, more than €1.05bn is spent on 2.5-month compensations of workers on hold, around €350mn is spent on 2-month financing of contributions to the pension funds, around €200mn on 2-month basic income and compensation of contributions for the self-employed, and nearly €200mn to the politically-favored solidarity allowances for pensioners and students.

Evaluating these measures in terms of the impact on GDP and taking into account the monthly dynamics of impact, it can be projected that, if ideally implemented, these government support measures could significantly mitigate the recession by reducing the projected downturn by about 60%. In other words, while my assessment in the event of a milder crisis indicates a GDP decline in 2020 by about 6.3% as compared to 2020, these government measures could alleviate the recession to just 2.5% of GDP (see Figure 4).

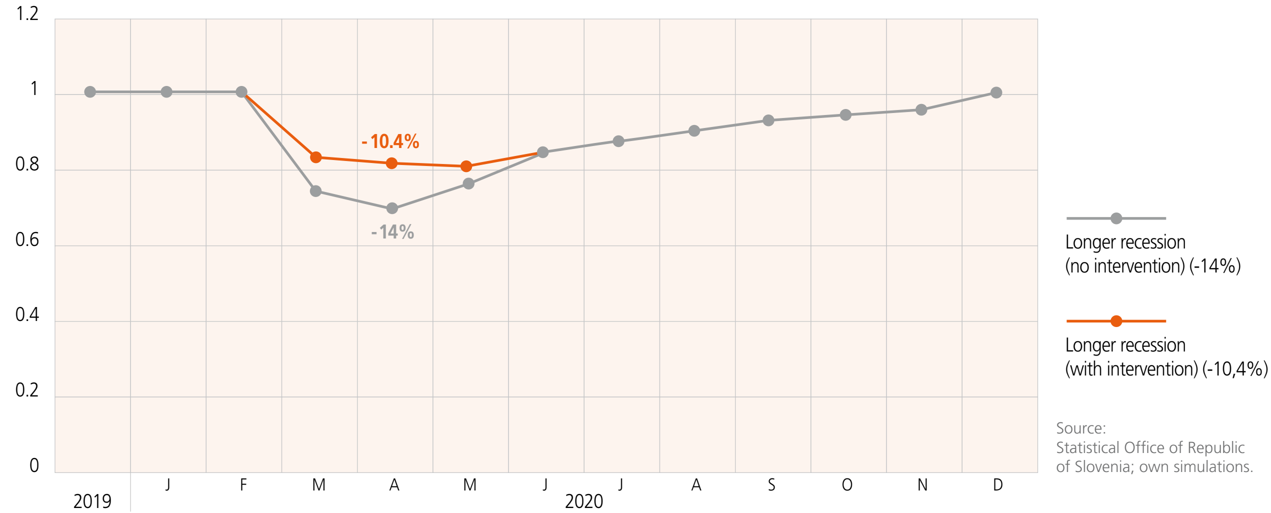
In the event of a deeper and longer recession, the output (value added) decline will be bigger in April and May than projected in the short recession scenario, but at the same time, the recovery will be slow and the economy will only get back to normal trajectory by the end of 2020. In this case, my simulations show a GDP drop of as much as 14%. These government support measures will only mitigate part of the downturn in the second half of March and April and May, but not later (unless there is an extension of the meas-

Figure 4
Monthly GDP decline in Slovenia in 2020 due to the pandemic in case of a short recession, with and without macroeconomic policy intervention (in per cent)



Source:
Statistical Office of Republic of Slovenia; own simulations.

Figure 5
Projected monthly GDP decline in Slovenia in 2020 due to the pandemic in case of a longer recession, with and without macroeconomic policy intervention (in per cent)



Source:
Statistical Office of Republic of Slovenia; own simulations.

ures). In this case, government measures would manage to alleviate the GDP decline by just under 4 percentage points and the overall GDP decline at the annual level would still be a whopping 10.4%! (see Figure 5). In the event of a slow recovery, the government will, of course, have to extend the above fiscal measures all the way through the fall to mitigate the recession as much as possible.

KEY ASSUMPTIONS AND THE WAY FORWARD

Of course, the above estimates are valid only under certain assumptions. There are at least three key assumptions. Firstly, obviously, assessment of the effectiveness of government interventions depends on the fact that my estimates of GDP downturn correspond to what would actually happen in the economy without government intervention.

Secondly, the assessment of the effects of government measures is based on the assumption that the measures will be implemented optimally. That is, all affected companies will be able to receive wage compensation for employees on hold, next on the expectation that all companies that will continue to work will be eligible for exemption from the pension fund contributions and that more than two-thirds of the self-employed will be entitled to basic income and social security exemptions. This assumption is rather delicate given the government's quite restrictive conditions on the eligibility for receiving assistance.

And thirdly, the key assumption is that in the second package of measures (to be adopted at the end of April 2020), the government will efficiently solve for inter-company liabilities and provide liquidity to companies. This can be done either through the purchase of these outstanding liabilities between companies or with an effective loan guarantee scheme. This latter condition is crucial. Without it, there will be a collapse of the economy within two months due to increased illiquidity. This will, however, entail a wave of corporate bankruptcies, layoffs and rising unemployment and the need to recapitalize banks. In this case, the first package of government support measures will not be very effective either, as the share of operating companies will decrease, and companies will prefer to lay off employees instead of temporary putting them on hold.

It is crucial, therefore, that the government, in the second package of measures, puts in place an effective mechanism for maintaining the liquidity of companies and paying off their mutual obligations. Here, I would emphasize in particular the following: (1) direct state compensation of receivables of publicly owned electricity, gas and other utility providers from their commercial customers, (2) the assignation mechanism for payments of liabilities between undertakings, (3) loan guarantee scheme for companies for the repayment of liabilities to suppliers, and (4) a general moratorium on repayment of principal from bank loans for a period of at least 6 months and compensation of banks' claims on the interest.

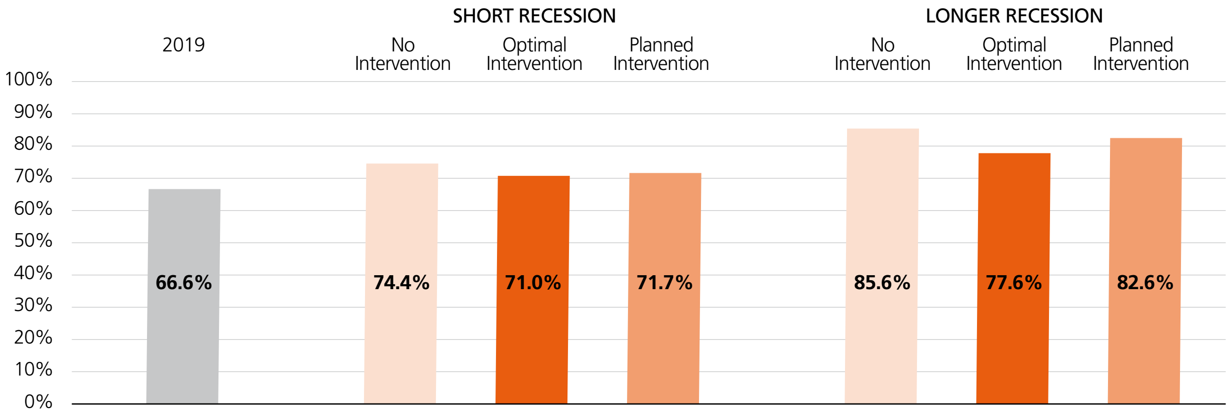
IMPLICATIONS FOR PUBLIC DEBT

As mentioned earlier, financing of outlined support measures will result in increased budget deficit and boosted public debt for most of the countries. So far, with public debt at about 66% of GDP and yields on 10-year government bonds at 0.7%, Slovenian government faces no problems regarding refinancing and additional borrowing in international financial markets. In addition, the pandemic program (PEPP) launched by the ECB enables Slovenian government to acquire additional assets in the amount of €2.52bn. This amount is sufficient to cover the macroeconomic policy intervention in the event of a shorter recession. In the case of a longer recession, government support measures will have to be stepped up to at least €3.6bn. In both cases, the public debt is projected to increase to about 71.7% and 82.6% of 2019 GDP, respectively.

It is, however, important to keep in mind that no government intervention is actually a no option for the government. In case of no intervention, the pandemic would lead to a full-blown recession (decline in GDP), while automatic stabilizers in the form of unemployment benefits and increased social transfers would kick in. Due to increased budget deficit and much lower GDP levels, this would result in elevated public debt figures, exceeding those in case of planned intervention: 74.4% vs. 71.7% of GDP in case of a shorter recession and 85.6% vs. 82.6% of GDP in case of a longer recession (see Figure 6).

Hence, it is of utmost importance for the government to intervene timely and with a full-scale macroeconomic policy program as this not only saves jobs and keeps companies alive, but also contributes to healthier public finances as compared to no intervention alternative.

Figure 6
Projected public debt in case of no intervention vs. planned government intervention (as a % of GDP)



Note: Optimal intervention refers to the case of full compensation for the companies' loss of value added.
Source: Statistical Office of Republic of Slovenia; own simulations.

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ABOUT THE AUTHOR

Jože P. Damijan is a Full Professor at the University of Ljubljana and Visiting Professor at the University of Leuven, Belgium. He served as Minister for Growth in the Slovenian government. He is one of the internationally most cited Slovenian economists. He publishes regularly in major Slovenian newspapers and runs the most read economics blog in Slovenia (**DAMIJAN blog**).

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Friedrich-Ebert-Stiftung
Regional Office for Croatia and Slovenia
Praška 8 | HR 10000 Zagreb | Croatia

Responsible: Türkan Karakurt,
tuerkan.karakurt@fes.hr

www.fes.hr

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