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THE COVID-19 PANDEMIC AND EUROPE

This paper looks into the impact of the Covid-19 pandemic on the European Union. The current crisis found European economies in very different situations regarding their economic fundamentals and fiscal capacities to support their economies. Thus, the need for a strong EU level policy response emerged. Europe has learned its lessons from the previous crisis and acted decisively and in a coordinated fashion. The paper discusses these policy responses and some of the longer-term challenges of the current crisis.

THE NATURE AND IMPACT OF THE CRISIS

The nature of the current crisis is very different from that of the Great Recession and European Sovereign Crisis back in 2008-13. The immediate cause is a pandemic, one that the developed world has not experienced since the Spanish flu a century ago. It has had a devastating direct human impact, a sudden surge in hospitalization and intensive care, and most sadly in death. However, most of the economic cost is because of the way health authorities reacted to the first wave of the pandemic, an almost complete shut-down of non-essential economic activities, and a surge in uncertainty. This caused a combination of supply (in sectors where teleworking was not or only partially possible) and demand (in the part where on-line sales are not or only partially possible) shocks. In turn, this translated into an unprecedented demand shock, through production links (demand for intermediate goods, B2B services, etc.) and actual or feared future decline in personal and corporate income, and a sudden surge in demand for online services, home delivery-based purchases, etc.

Like in any other major crisis, the degree of uncertainty increased dramatically, depressing investment and halting asset purchase because of the heightened uncertainty about future cash flows and asset valuation. Some of this uncertainty has been removed by a fast and coordinated policy response. Nevertheless, much of it remains and strongly interacts with previous sources of increased uncertainty in the world economy, such as increasing trade (and increasingly technological) tension between the US and China, disruptive technological and product innovation in the automotive industry (Tesla) or the pressing need to green the economy.

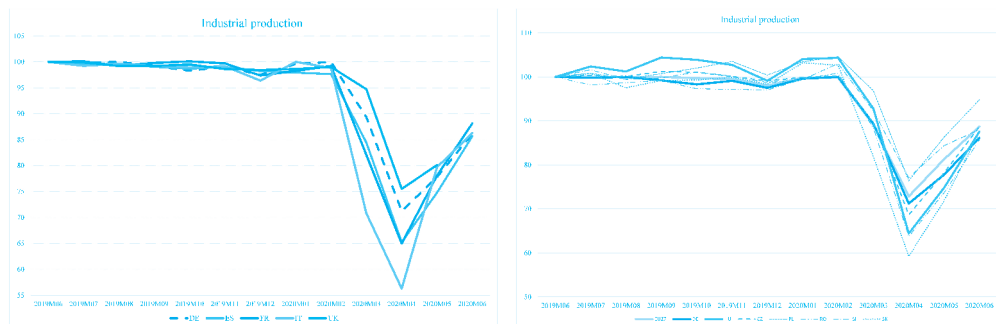
As the basic cause of the crisis is a health problem, and the only long-term solution is to develop a reliable vaccine, no economic policy response alone can resolve the crisis. The way we reacted to the pandemic in the first wave (lock-down) seems effective but unsustainable, economically and socially. As it is highly uncertain when a vaccine can be deployed, we need a more sustainable and less costly response in the second (or subsequent) phases. To find such response is also necessary as other equally deadly and fast spreading viruses can emerge in the near future.

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SHORT-TERM IMPACT

The short-term impact is a huge decline in economic activity all across the world. As Figure 1 shows, the basic shape is very similar across Europe, albeit with some important variation in the exact timing and depth of decline. The latter depends on the timing of the pandemic, with Italy being the first major hot spot in Europe, the structure of the economy and the preparedness of countries and industries for teleworking, and the severity of restrictions.

Figure 1 Impact of the covid-19 pandemic on industrial production in different countries

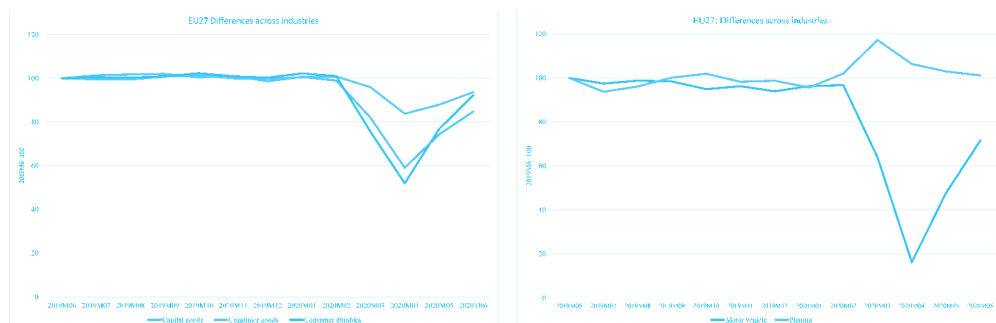


Sources: Author's own calculations based on Eurostat data.

Notes: Volume index of production, seasonally and calendar adjusted. Monthly data, 2109 M6=100.

As Figure 2 shows, the car industry was hard hit because it heavily relies on GVCs, while the pharma industry had a small uptick. As the former has a massive presence in some EU11 countries, including in Hungary, this is a major factor explaining the differences in the region.

Figure 2 Impact of the Covid-19 pandemic on production in different industries

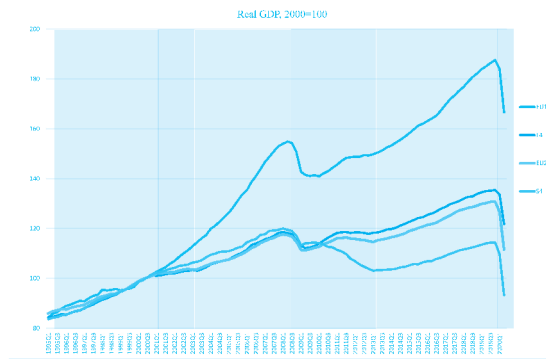


Sources: Author's own calculations based on Eurostat data.

Notes: Volume index of production, seasonally and calendar adjusted. 2109 M6=100.

The current crisis found European economies in very different situations. As Figure 3 shows, EU11 as a group have been converging rapidly since the mid-1990s (Székely and Kuenzel, 2020). For them, the previous crisis brought about only a temporary halt. Rapid convergence resumed and continued until the recent pandemic. The most developed and globally competitive member states of the EU (such as, Austria, Denmark, Netherlands and Sweden) maintained their strong position in Europe and globally. Southern European EU countries however suffered a major setback, particularly in the second phase of the previous crisis, the European sovereign crisis, and has not resumed convergence since then. That is, the outcome of the previous crisis was a sizable permanent loss in their relative income position in Europe and globally, with all its economic, social and political consequences.

Figure 3 Economic growth in the EU in good and bad times, 1995-2020



Sources: Author's own calculations based on Eurostat data.

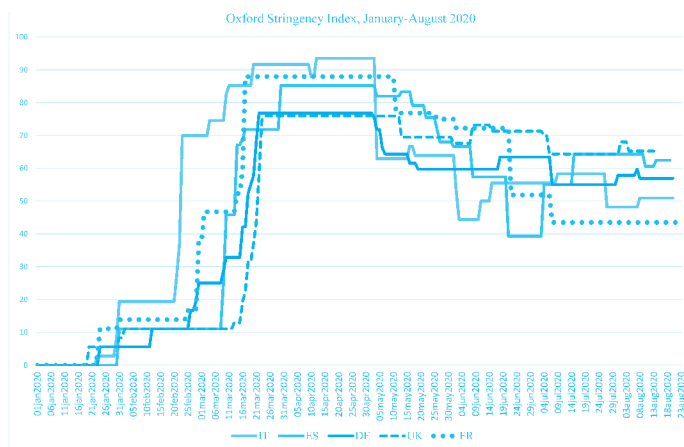
Notes: Volume index of GDP, seasonally and calendar adjusted. Quarterly data, 2000=100. EU27 include 27 EU member states as of 2020. EU 11 include member states in CEE and Baltics. F4 include Austria, Denmark, Netherlands and Sweden. S4 include Greece, Italy, Portugal and Spain.

Figure 3 also shows an important aspect of long-term economic and social development that will be highly relevant in the current crisis, the performance of different countries in good and bad times. EU11 countries show very strong performance during good times, but are less resilient than the most developed countries in bad times. Southern European countries follow overall trends in good times (no convergence or slight divergence), but massively underperform in bad times.

HOW LONG WILL THE CRISIS LAST?

A strict lock-down in Europe slowed the pandemic but caused a huge economic shock (Figure 3). With the subsequent relaxation (Figure 4), the economy bounced back but a large second wave of the pandemic emerged. The factor that will determine how long and large the economic shock will be is the stringency of health measures until a safe vaccine becomes available, and the uncertainty surrounding this policy. Countries still need to find a way to avoid sudden changes in this regard, which greatly increase uncertainty.

Figure 4 Stringency of restrictions during the pandemic, January-August 2020



Sources: The Oxford COVID-19 Government Response Tracker (OxCGRT). Downloaded on August 25, 2020. <https://www.bsg.ox.ac.uk/research/research-projects/coronavirus-government-response-tracker>

FISCAL TRENDS PRIOR TO THE PANDEMIC

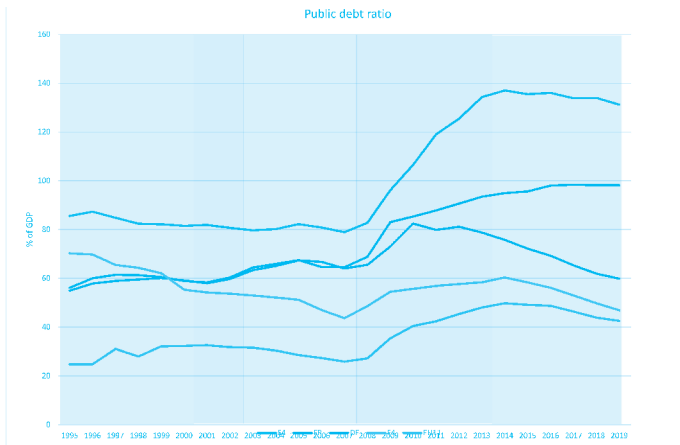
Before turning to policy responses, it is important to recall the fiscal history of Europe, as it has a major impact on policy choices at the national and European levels (Krueger, 2020). Figure 5 shows the different and diverging fiscal attitudes in the EU, driving the positions of European policy makers and politicians in the discussion on the fiscal response of the EU to the pandemic.

The group of highly developed Northern countries shown in Figure 3 and Southern European countries were in similar starting position in the mid-1990s, but followed very different paths since then. The former used good times to restore fiscal capacity, which in turn, together with strong economic fundamentals helped them during bad times. Southern European countries, on the other hand, did not improve their fiscal fundamentals in good times, which in turn limited the fiscal space they had in bad times. This, together with weak economic fundamentals explain their poor economic performance in bad times. Despite widely held beliefs, the fiscal behaviours of Germany and France started to deviate only in the second wave of the previous crisis.

Moreover, in the previous crisis, the lack of a coordinated macroeconomic policy response and burden sharing at the European level, and characteristically different fiscal approaches of EU countries led to a second wave of crisis (European sovereign crisis). The outcome was a W-shaped delayed recovery (as opposed to a V-Shaped recovery in other developed countries), which left Southern Europe with a weakened economy and a large public debt burden.

Diverging fiscal approaches became even more visible during the good times following the previous crisis. France and the Southern European member states maintained an increased public debt ratio while the Northern countries restored their fiscal capacity. Besides historical political alliances within the EU, this relatively recent divide in basic fiscal attitudes explains the strong pushback from a group of countries in the discussions on the European crisis response.

Figure 5 Fiscal behaviour in the EU in good and bad times, 1995-2020



Sources: Author's own calculations based on Eurostat data.

Notes: General government gross debt to GDP in percent. EU11 include member states in CEE and Baltics. F4: Austria, Denmark, Netherlands and Sweden. S4: Greece, Italy, Portugal and Spain.

POLICY RESPONSE

In a crisis, the short-run task for economic policy is to mitigate the immediate impact of the shock, a huge drop in household and corporate income, and to do so in a way that limits the negative impact on growth potential in the longer run (hysteresis and decline in investment and TFP growth, Dacic, 2020). Afterwards, the focus shifts to rebuilding the growth potential and strengthening resiliency. Reducing uncertainty is key, also because uncertainty reduces the efficiency of fiscal stimulus (Jerow and Wolff, 2020). What matters most is to demonstrate the capacity to act swiftly and predictably, based on a well-formulated (and well-communicated) strategy, in a coordinated fashion among fiscal and monetary sides, and national and European levels. This helps coordinate the actions of economic players and ensure market funding.

When it comes to policy response, Europe has learned its lessons from the previous crisis. Hesitant and uncoordinated policy response produces major economic and social costs, so big that it can eventually endanger the cohesion of the Union itself. Moreover, attitude to fiscal policy response to a major shock changed dramatically in Europe (and elsewhere), both in member states and at the European level. In 2009, albeit somewhat relaxing original treaty terms, the European Council made recommendations to member states to quickly (typically by 2012) eliminate excessive deficit (above 3% of GDP), starting with a major (1-1.5% of GDP) fiscal efforts in 2010. In the end, for most countries it took much longer to bring their deficits below the 3% limit. Nonetheless, the fiscal response to the crisis was massively suboptimal.

This time around, member states that had the capacity to do so, not only quickly announced their intention to allow automatic stabilizers to work fully, but also announced major new spending (discretionary fiscal response) to protect jobs, people and business.

Policy response at the European level came very fast and in a well-coordinated manner. The Commission was quick to announce the temporary suspension of the SGP by activating

the general escape clause in the Treaty (European Commission, 2020a). This made it easier for countries that had the capacity to give fiscal stimulus, and it was an important signal to the market regarding the European approach to fiscal policy in this crisis.

The European Commission made its proposal for the first major element of the EU-level response, SURE, a temporary facility to help member states to preserve employment, in April 2020. The European Council adopted a decision in May, and the Commission made its proposals to disburse funds in August. Besides disbursing funds so fast, the very fact that a political decision was in place so quick, and that the amount (up to EUR 100 bn) was macro-economically relevant helped stabilize financial markets well before the other major elements, most importantly the RRF, were in place.

Nonetheless, these steps did not tackle the issue about vastly different fiscal capacities among member states (Figure 5). To deal with this, a joint scheme of macro-relevant size including a major grant component was needed. Something, many thought, would be politically almost impossible. Still, the political decision on the Next Generation EU (NGEU), a EUR 750 bn extension of the 2021-2027 budget of the EU (MMF) was reached by mid-July (European Council, 2020). Funding from this source will help more in the medium run, and more with strengthening the growth potential and mitigating the strong impact on debt sustainability than with stabilizing demand in the short-run during the sharp downturn in economic activity.

Out of the EUR 750 bn or 5% of EU GDP in 2019 available, EUR 390 bn or 2% of EU GDP are grants and 360 bn are loans, to be disbursed until end-2026. However, as loans are long-term and for many EU countries at rates below their own borrowing rates, they have a nontrivial grant component. Moreover, as the distribution is heavily concentrated on Southern and Central and East European countries with income levels at or below EU average, the impact on these countries will be significant. The NGEU will be financed by borrowing by the Commission on behalf of the Union, This will make the Commission the biggest borrower in Europe on the sovereign bond market. The powers granted to the Commission to borrow are limited in size, duration and scope. Thus, this is not the start of the Eurobond many advocate in the discussion on EMU deepening. Nevertheless, these bonds will stay with us for a full generation.

Albeit discussion on the NGEU is still ongoing, and it is not yet approved, almost everyone agrees that the speed and coordinated manner in which policy response in Europe was taken made a huge difference. A fundamentally different policy attitude of the ECB during this crisis, a positive legacy of the Super Mario effect, also helped greatly. Monetary policy had much less room than back in the previous crisis, but it used it much more pro-actively. This explains the huge difference we see between the market reactions Italy and Spain face today, versus the hostile environment they (and even France for a short period) faced back in 2011-2013.

The NGEU is a temporary instrument dedicated to a particular problem the EU faces (European Council, 2020). As such, it is not the foundation of fiscal union in the EU/euro area.

Nevertheless, it is a major step forward in the design of macroeconomic institutions in the EU.

Its long-term impact will depend on how well it works in mitigating the negative impact of the pandemic, and how well recipient countries use the funds to strengthen their economies.

The quality of newly created institutions and instruments in the EU will be a decisive factor in creating the necessary political and public support for deepening European integration further. Moreover, the EU needs to find ways to tackle the issues underlying the poor long-term performance of Southern European countries. As Székely and Kuenzel (2020) argue, the working

of the institutional channel, the capacity of the EU to help and encourage its member states to improve their public and private institutions, is critical in this regard.

LONGER-TERM CHALLENGES AND RESPONSES

There are two types of long-term impact of the pandemic. First, the damage that the huge short-term shock, a massive temporary decline in economic activity and the consequent loss in household, corporate and government income, makes to growth potential. Second, the implications of changes in the way societies live and economies function after the pandemic. In both cases, the changes the current crisis causes interact with those that were going on prior to the current crisis, also caused by the previous crisis. This is true globally, as well as in Europe.

LIMITING THE DAMAGE OF THE SHOCK TO GROWTH POTENTIAL

Regarding the first type, the size of the damage depends on how big and lasting the short-term shock will be, and how quick the system can tell apart viable and non-viable business and how efficiently it can redeploy the productive assets and workers of non-viable businesses. As to the former, it is yet unclear, as right now we are just going through the second wave of the pandemic that is as big as, in some countries bigger than the first wave. As to the latter, the extent and nature of public policy intervention will be important in this regard (IMF, 2020).

First, due to the nature of measures, there is no clarity yet on which businesses are in trouble, and how large the initial spike in unemployment might be. Many countries suspended bankruptcy legislation and introduced debt service moratorium, thus we do not know how much company and bank balance sheets are hurt (FT, 2020a). Moreover, many governments introduced special subsidy schemes to support, or administrative measures to force, businesses to maintain labour contracts despite the huge decline in activity. Thus, labour statistics need to be carefully interpreted. We will have to wait well into 2021 to see how large the initial damage really is.

Second, countries' capacity to sort out bankruptcy and redeploy assets and workers differ significantly. In fact, this is one of the main reasons why growth potentials are different across countries. The nature of public policy matters too, as countries that focus too long on postponing the process may eventually hurt more of their economy than necessary. Ironically, the weaker a country in corporate restructuring the more public policy tries to postpone it.

Third, there were major changes going on in the European economy, partly because of the previous crises. Some industries in high-wage EU countries were under pressure to relocate to lower cost countries, mostly in Eastern Europe, and to restructure the remaining operations in the high-cost location. Italian textile and apparel industry is a prime example of this (FT, 2020c). A crisis wipes out companies in large number in these industries before they would have a chance to go through this process. As Figure 3 shows, such destruction was massive in Italian industry during the previous crisis. The current crisis may do the same (FT, 2020b).

ADAPTING TO THE CHANGES IN HOW SOCIETIES LIVE AND COMPANIES OPERATE

While the impact of the crisis on industry seems to be fading fast, and on services is gradually diminishing, there is likely to be a lasting impact on face-to-face services, such as tourism, catering or personal services. Judging from the nature of response by health authorities all over

the world, normality will not be restored in most cross-border face-to-face services, such as cross-border tourism, for long. Even if people would feel comfortable about travelling abroad, the prospect of sudden changes in health regulations, such as mandatory testing and quarantine will deter people from travelling abroad. Instead, demand for domestic tourism may increase.

Thus, countries with large net tourism exports in the past, such as Italy or Spain, may face a lasting decline in their tourism industry. Moreover, even in countries where total demand may not decline much, its structure might be very different from what it was before. This will necessitate major structural changes in supply, and will change relative asset prices. We should mention in this regard that Hungary has a large net tourism exports, and the structure of domestic demand for tourism is rather different from that of domestic tourism supply (large city tourism, mostly in Budapest). Thus, the hit to the tourism industry in Hungary in the short run can be even bigger than its large net exports would suggest, and reorientation will require major investment.

Face-to-face services will face major challenges domestically as well. Restriction on capacity use are likely to remain until a safe vaccine is available. Switching to alternative service delivery will require new firms, new business models, massive investment and different skill structure. Digitalization and cost efficient home delivery will be key, and not only in these industries. Countries that have done less well in the past quarter of century (Figure 3) are weak exactly in these areas, but this will be a major challenge for CEE as well. There are major differences within this group, with Estonia leading the pack and Hungary being in the middle. Before feeling too comfortable with this, one should perhaps focus on the distance from countries that are the best in this regard. This distance for Hungary is perhaps increasing, particularly regarding SMEs.

This health crisis also revealed some of the absurdities of the way low value-added businesses in Western Europe coped with competitive pressure in the EU. For example, the wages food processing plants in Western Europe can afford to remain competitive with companies from CEE by appalling working and living conditions that only people from deeply depressed parts of

Eastern Europe are willing to accept (FT, 2020c). Hopefully, strengthened regulation and enforcement will help eradicate this practice.

Relocation of production in these sectors may potentially benefit CEE, but only the least developed part and only if they can attract foreign and domestic firms that want to relocate, and if they can offer them the necessary pool of unskilled labour. None of these is easy, as there is a reason why these regions were not attractive before the crisis.²

The Covid crisis can also accelerate changes in the way academic research is done and disseminated. New research emerging in the wake of the crisis uses real-time data collected by private firms in the new economy (Google, Apple, fintech) extensively, interacts in virtual conferences and seminars, and publishes its results in real-time but still vetted, online and free academic journals, such as Covid Economics (<https://cepr.org/content/covid-economics>). None of these is new in itself. What is new is the speed of change. This creates a sharp contrast with traditional

² Incidentally, Boston (East Anglia), the town that had the highest share of Leave votes in the UK had such a meatprocessing factory that invited a huge influx of CEE workers living in overcrowded houses. Apparently, this might have been a major factor creating the strong support for Brexit (Nyilas and Szilagyi, 2019). So by wiping out such firms in Western Europe, the crisis might help reduce anti-EU sentiment.

forms, which are slow and captured by establishment, thus oligopolic and priced accordingly. They are also fundamentally unfair, as they discriminate against the unprivileged.

These are general, global challenges that every country in the world face, of course in different ways and to different extents depending on the characteristics of the economy concerned. But the EU is not only a collection of countries, it is a deeply, even if not fully, integrated union of countries, with institutions that create idiosyncratic developments.

IMPACT ON THE EU

A crisis always poses a major challenge to the EU and to its member states, as it shocks the system, creates major disruption to the economy and destroys productive capacities. All these create major social costs, which in most cases is distributed very unequally. Social costs can be further aggravated and made more unequally distributed by poorly designed policy responses.

At the same time, a crisis is always an opportunity to introduce, in most cases long overdue structural reforms that can enhance the growth potential and resilience of the economy. This is equally true for the EU as a whole and its individual member states. As we saw it before (Figure 3), the impact of previous crises on EU countries was rather different, both in the short and long run, also reflecting different policy responses, before, during and after crises.

Albeit sometimes with major delays, the EU responded to the previous crisis with major structural reforms, such as the Banking Union, Credit Market Union, and enhanced policy coordination (European Semester). Moreover, as the immediate policy responses in the current crisis demonstrate, it has learned its lessons on the importance of timely and well-coordinated policy response. Well coordinated among fiscal, monetary and prudential policies at the European level, and among member states.

Just before the crisis, the new Commission formulated a strategy centering on a green deal and digital transformation and digital single market in the area of economic reforms. Moreover, the completion of the Banking Union (BU), the creation of a European deposit insurance system (EDIS), and capital market union (CMU) were also central elements. If anything, these elements will be even more critical after the pandemic is over.

Europe is behind its major competitors in digitalizing its economy, particularly the SME sector, and differences among member states in this regard are large. Moreover, the lack of a digital single market and underdeveloped financial system that can provide (equity) financing for emerging innovative firms in high-risk industries is a major handicap vis-à-vis the US. It is not just by chance that very few leading global firms in digital services emerged in Europe.

Most funding from NGEU is for investment to strengthen growth potential and improve resiliency. It is tied in with the new priorities of the Commission, and it promotes flanking reforms. However, it will be essential to implement it well so that the outcome is in line with the stated goals. Moreover, EU help should be additional to national efforts and not a substitute for them. NGEU should not crowd out but rather crowd in national efforts, private and public.

Progress with the above-mentioned elements of European integration would no doubt help strengthen the growth potential of the EU after the crises. However, we should also keep in mind that deeper integration can have other consequences as well. So far, it has unleashed strong market forces, which in turn accelerated relocation of firms and labour, across countries within the EU and across regions within countries. Countries and regions with good quality public and private institutions (and hence also with good infrastructure and skilled labour) benefitted from

this agglomeration process in a major way, while those with poor quality institutions suffered negative consequences. All across the EU, even in very successful countries, such as Germany.

The major problem the EU faces in this regard is that while it was very successful in promoting trade and FDI, it has been much less successful in promoting good institutions (Buti and Székely, 2019, Székely and Kuenzel, 2020). As the current crisis is likely to strengthen agglomeration forces further, the EU needs to find ways to promote good institutions.

Regarding CEE and within this Hungary, if reshoring parts of GVCs by European firms becomes a major trend, the region is well positioned to benefit from this process. However, there are important steps governments in the region can take to facilitate this process, such as improving public institutions, including at subnational level, business environment and regulation, and reducing corruption. Equally important is to ensure that differences across regions within a country are also reduced. Improving skill structure and labour market institutions, and again reducing the degree of unevenness across regions in this regard, is also important.

However, CEE is much less well-positioned to benefit from a digital single market. With few exceptions, it is way behind leading countries regarding digitalization, much more so than in many other dimensions that are important for economic and social development.

COVID-19 PANDEMIC AND FAIRNESS AS A EUROPEAN VALUE

We tend to think of social fairness as core value in Europe, essential to maintain social cohesion, which in turn is an important part of deep growth fundamentals in Europe (and elsewhere). Indeed, some EU countries are among the least unequal societies in the world, not only from Western and Northern Europe, and not only regarding income, but also education and health. Slovenia and Czechia also belong to this group. Nevertheless, in reality, fairness has remained more of a national than European concept (Székely, 2020). Some of the EU countries have very unequal societies, both in CEE and Southern Europe. So while the US has much more social inequality overall, it is more homogenous across its member states in this regard than the EU.

As we argued above, the Covid crisis is likely to have different impact on EU countries and their regions. Moreover, the impact on different parts of society is also likely to be different (Abay et al., 2020, Blundell et al., 2020, Hacıoğlu Hoke et al., 2020). With EU countries having rather different fiscal and institutional capacities, unless EU level policy instruments are adequately sized and are implemented efficiently, fairness will become a less of a European value and more the privilege of citizens of some EU countries. Moreover, unless differences in the quality of (public and private) institutions among EU countries are narrowed, deeper economic integration and reforms necessary to address new challenges, most importantly digital single market and capital market union, are likely to expose further the absence of fairness as a European concept.

THE POLITICS AND POLITICAL ECONOMY OF EUROPEAN INTEGRATION

At the beginning, when Italy fought the first wave of this devastating pandemic, the EU was late with taking action, and uncoordinated (and insensitive to the European dimension) national measures led to an outcry in Italy about the lack of European solidarity. When the mounting cost of the crisis confronted fiscal reality in Southern Europe, a similar wave of outcry emerged.

On the other hand, when the European Commission floated its proposal for SURE just in one month, and skilfully ushered it through an overly complex European decision-making process in less than two months, sentiment in hard hit countries started to change. The rapid political decision on NGEU improved public opinion about the EU and European integration further.

What a difference compared with the previous crisis, or with times when the Commission wanted to regulate how olive oil is kept on restaurant tables. The lesson seems clear. Well-functioning European institutions with good leadership that can deliver what people in Europe need, especially in crisis time, will help deepen European integration and remove barriers that seem unsurmountable. It does matter how European Treaties allocate rules and functions, but what matters perhaps even more is how European institutions work. As this crisis showed, they can lead in any area, irrespective of how formal responsibilities are distributed in that area, if they can generate useful ideas and offer fast and efficient implementation.

But before celebrating too early, the focus is better kept on implementation, which is still to come. Poorly implemented ideas do little good, no matter how good they are.

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