EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS
Investment, growth and structural reforms
Economics of structural reforms and investment

Brussels, 03/03/2021

THE SECTORAL IMPACT OF THE COVID-19 CRISIS

Technical note for the Eurogroup[1]

[1] This is a technical background paper prepared by the Commission services. It does not represent the Commission position and does not bind the Commission in any way.

Scene setter: the unprecedented economic impact of the COVID-19 pandemic

The COVID-19 pandemic has resulted in the largest and most abrupt peacetime drop in economic activity in modern history. The impact has varied dramatically across sectors of the economy. In particular, high-contact services such as tourism have suffered acutely, while those that facilitate non-contact activities, like ICT support or delivery of services, were barely affected.

National and EU policies will continue to be crucial in containing the economic impact of the pandemic, promoting the recovery and shaping the nature of future growth. Immediate policy responses have provided important support to companies and workers in need. Nonetheless, the sheer size and persistence of the shock are likely to spur business failures and a decrease in employment in affected sectors in the future and lead to reallocation of resources both within, but probably also across, sectors. Whilst the crisis has intensified existing trends, such as digitalisation, changes in global value chains and the green transition, some sectors are better placed to benefit from them than others. Appropriate policies will be needed to successfully facilitate these processes.

The short-term impact of the COVID-19 crisis: an atypical sectoral recession

The contraction of economic activity varies dramatically across sectors and the pattern of the sectoral impact is very different from normal recessions. Contact-intensive services[2], usually relatively insensitive to the economic cycle, were the most affected. At the height of the first wave in the second quarter of 2020, activity in these sectors was 25% below pre-COVID-19 trends.[3] On the other hand, sectors, which usually evolve pro-cyclical were impacted somewhat less, like industry (-19%) and construction (-15%). Services with high-skilled workers and high scope for remote work like ICT, finance and real estate contracted much less (less than -10%).

The nature of the containment measures largely explains the different impacts on activities. The impact of the pandemic has been mitigated in sectors where contact is easier to avoid or teleworking is an alternative to face-to-face work and client interaction. Businesses relying on close physical interactions either in production or in delivery of their goods and services have been forced to shut down or limit/change the nature of their operations.

The prospects for a quick and strong recovery differ across sectors. As seen in the third quarter of 2020, demand can quickly rebound in the most affected sectors, once the health impact of the pandemic is contained. The Commission's predictions regarding sectoral turnover developments in the euro area point to a more muted impact of the autumn wave of the pandemic compared to that of the first wave (Graph 1). Presumably, the measures have been better targeted and avoided large-scale disruptions in production. Nevertheless, contact-intensive services, such as accommodation and food services, are expected to record a turnover barely reaching the pre-crisis levels by the end of 2021. On the other hand, industries that produce essential or digital goods, such as food, computers and

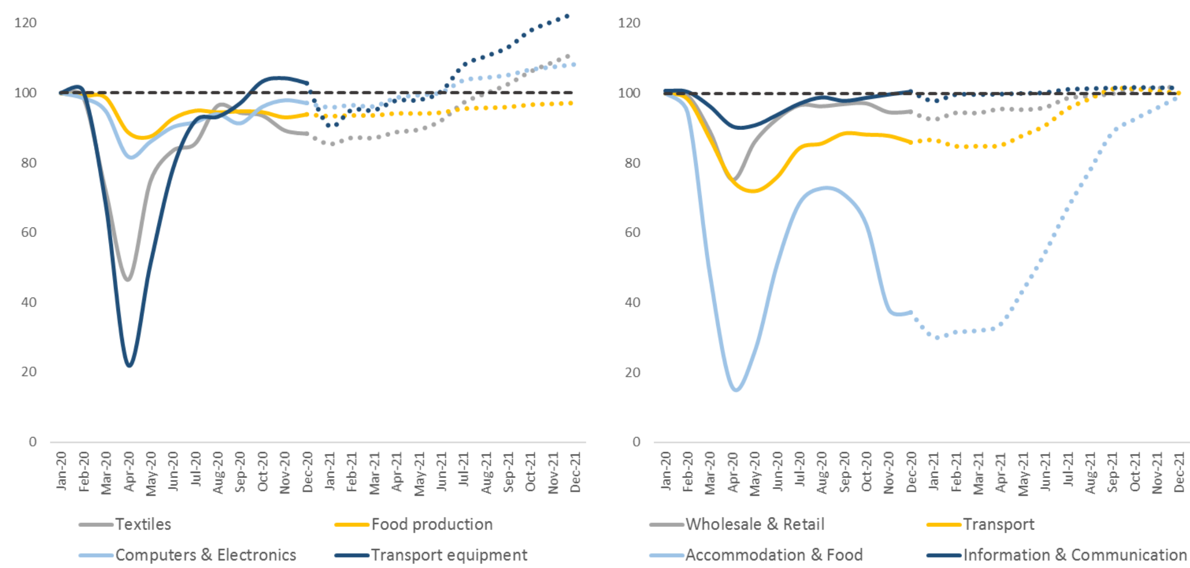
---

[2] Trade, transport and accommodation, and arts, entertainment and other service activities

[3] The impact on sectoral activity (GDP) is measured as % deviation from a no-COVID-19 scenario (the seasonally adjusted continuation of previous trends over period 2015-19) based on quarterly sectoral national accounts data.

electronics, have maintained demand during the crisis and experienced a relatively modest drop in sales (-15% at the trough). Most other sectors are likely to experience a protracted impact over the first half of 2021 and a gradual recovery towards the end of the year.[4] Actually, industries producing durable goods (e.g. transport equipment) experienced strong declines in turnover during the spring of 2020 (almost -80% in April 2020) but are forecast to recover beyond pre-crisis levels by the end of 2021.

Graph 1. Services will take longer to recover, with the accommodation and food services sector hardest hit – observed turnover (solid) and predicted turnover (dash) indexed at 100 in January 2020



Note: Euro Area turnover-weighted average for all countries except Cyprus and Malta. Monthly turnover is available in Eurostat until Dec 2020. Data gaps for missing country-sectors and the turnover predictions are based on a simulation at the sector-level to estimate the pattern of sectoral turnover over 2021. These simulations are based on a set of variables that capture the state of the pandemic and that could explain sectoral turnover patterns, such as epidemiological information, macroeconomic growth rates, sectoral business confidence, measures of workplace and retail mobility, government stringency and economic support measures.

Source: Eurostat short-term business statistics, DG ECFIN Winter Forecast, DG ECFIN Business & Consumer Survey, OECD Economic Outlook, OECD Inter-Country Input-Output Tables, Google Community Mobility Reports , University of Oxford Government Response Tracker, Our World in Data, LFS, O*NET and own elaborations.

Policy support at both national and EU level has prevented an upsurge in unemployment so far. Extensive public support measures have contributed to preserving jobs and prevented the large scale labour shedding witnessed in previous recessions. This is reflected by the fact that reductions in hours worked mirrored drops in economic activities across sectors while employment losses have so far been more contained**.** Still, by the third quarter of 2020, around 3% of employment or almost 6 million jobs had been lost in the EU since the onset of the pandemic. The hardest hit sectors were accommodation

[4] The baseline scenario assumes restrictions to remain in place until April 2021, after which they are gradually phased out to reach pre-crisis levels by the end of the year. In the case of more adverse developments, the negative impact would be more pronounced.

and food, and wholesale and retail trade (-5.3%). These sectors also tend to rely more on young and/or low-skilled workers than sectors that were impacted less.[5]

The strong policy support has also mitigated the huge impact of the crisis on the financial health of the corporate sector. As discussed during the February meeting of the Eurogroup, the crisis has had a drastic impact on the financial situation of companies.[6] Those operating in the sectors most affected by the pandemic suffered from the largest pressure. For example, according to Commission's simulations, a vast majority of all firms in accommodation and food services would have incurred net losses over 2020, if there were no policy support. At the same time, only about one fifth of these firms would have had sufficient cash buffers to cover these losses.[7]

When containment measures will progressively be removed, a key challenge for policy-makers will be how policy support should adjust to support the recovery. Given the high degree of uncertainty, the risks of withdrawing support too early exceed those of keeping it too long. However, support measures should be closely monitored, evaluated, and adjusted to avoid subsidising firms that do not need support or are not viable. This will likely require more targeting of support. This will be crucial not only to limit economic and social damage and additional increases in public debt but also to allow for reallocation of resources towards more productive uses. At the same time, it is very difficult to assess the longer-term viability at both company and sectoral level at the current juncture. Therefore, policy support should have appropriate incentive structures built in to promote a self-selection of viable firms.

The long-term impact of the COVID-19 crisis: acting on existing trends

The main longer-term impact of the COVID-19 shock is likely to manifest through accelerating a number of existing trends, such as digitalisation, changes in global value chains and the green transition.

Accelerating the digital transition is a potential positive aspect of the COVID-19 crisis and can generate significant productivity improvements. However, some sectors stand to benefit more than others. Particularly, the ICT-related sectors are expected to reinforce its key role in the economy and emerge stronger. Manufacturing production can also gain substantially from digitalisation, including, for example, through an increasing reliance on services, whether as inputs, as activities within firms or final goods. Wholesale and retail are likely to speed up the adoption of e-commerce and *omni-channel* business models, which rely on a combination of stores, websites, and mobile apps.

The productivity effects of the digital transformation will, however, take time to materialise. Despite the ongoing digitalisation, labour productivity has stagnated over the past decades. This reflects the fact that investments in digital infrastructure need to be complemented with other investments, such as the reorganisation of production structures, development of new business models, skills for the digital

[5] See e.g. Fana et al. (2020) "*The COVID confinement measures and EU labour markets*". JRC Working Papers 120578.

[6] European Commission "*Corporate Solvency of European Enterprises: State of* Play". Note to the Eurogroup Working Group 1 February 2021

[7] These simulations consider firms with 10 employees and more. In terms of policy support, they only consider the contribution of short-time working arrangements to limiting the wage costs.

economy, as well as flanking policies promoting competition and an efficient resource reallocation in the economy.

A faster digital transition can produce new policy challenges in terms of higher concentration of market power in some sectors or labour market mismatches. The nature of digital technologies, characterised by low reproduction costs and strong network effects, may result in winner-takes-most dynamics, potentially affecting the degree of competition. In the retail sector for example, the ability to invest in digital tools is expected to increase the market power of major retail firms. At the same time, the increased adoption of automation technology and teleworking might also further skew labour market demand towards high-skilled, high-wage employment, and lead to less jobs in the lower-end of the skills and wage distribution, especially in the service sector.

The supply chain disruptions caused by COVID-19 may stimulate tendencies towards re-shoring in specific sectors in Europe, while other factors may favour globalisation. For example, policy discussions are ongoing to address strategic dependencies in the EU by securing the supply of critical raw materials and pharmaceuticals and by supporting the development of strategic digital infrastructures and key enabling technologies.[8] In addition, some of the consumer preference shifts might become structural. For example, changes in the configuration of the tourism sector, such as traveller preferences towards domestic destinations, could be persistent even after the recovery. On the other hand, some developments may actually favour globalisation. For instance, the increased use of digital means in reaction to the COVID-19 pandemic has made it easier to work closely with service providers and experts located far away and may thereby provide a boost to offshoring/outsourcing in services.

Re-shoring can entail significant costs in terms of efficiency and productivity growth. In industrial sectors, reshoring could allow firms to keep manufacturing closer to other business activities, such as R&D, design, and sales. Diversification of suppliers can reduce risks but can be inefficient in terms of foregoing economies of scale and lack of suitable suppliers. Building in redundant inventories also reduces risks but can be costly. In this respect, a recent ECB survey shows that many companies are currently not seeking to internalise more parts of the supply chain.[9]

The COVID-19 crisis has acted as an accelerator for the support to the green transition, which was already high on the EU agenda with the European Green Deal. At EU level, the Commission maintains the implementation of the Green Deal roadmap as a new growth strategy to build a more resilient, sustainable and fair Europe.[10] In this context, one of the main priorities of the Recovery and Resilience Facility is to support this reform effort and boost green investment.

Achieving the agreed climate and environmental EU-level targets will require significant changes in all sectors, which will be more pronounced in some of them, as well as for workers. The green transition

[8] European Commission, (COM), 03/2020a. "Making Europe's businesses future-ready: A new Industrial Strategy for a globally competitive, green and digital Europe" https://ec.europa.eu/commission/presscorner/detail/en/ip_20_416

[9] European Central Bank (ECB), 2021. "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

[10] COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS: Adjusted Commission Work Programme - 2020 COM(2020) 440 final

based on a stronger reliance on clean and renewable energy, higher demand for energy efficiency and faster rate of building renovation, would particularly affect energy, transport, construction and manufacturing. The green transition is also expected to boost low- and medium-skilled employment, e.g. in construction and manufacturing producing renewable technologies. For many workers the transition would require substantial reskilling to move to alternative solutions or other sectors and occupations.

Policies to support structural changes and boost resilience

These structural changes need to be supported by appropriate reforms and investments. The new recovery instrument NextGenerationEU, with the Recovery and Resilience Facility as its centrepiece, is crucial in this respect. While helping the way out of the crisis, NextGenerationEU aims to promote job creation and sustainable growth and modernise EU economies to make them more resilient and better prepared for the challenges and opportunities of the green and digital transitions.

Reforms that help firms and workers realise their full potential while adapting to changes, including by facilitating labour and capital reallocation, should be an integral part of the policy mix. Key policy pointers include adequate and efficient investments in education and training, as well as in digitalisation, research and innovation and intangible assets in general, a well-functioning public administration and the removal of barriers to the entry, growth, restructuring and/or exit of firms.

Questions for discussion:

- *What are the policy lessons from the first two waves of the pandemic in terms of containing the health impact, while limiting the economic and social impact?*
- *What are Ministers' views on how to design a policy mix combining measures to support firms and workers hard hit by the crisis and facilitate resource reallocation, including to promote the green and digital transition?*
- *What are Ministers' views on how public support for the business sector should be targeted, and through which policies?*