EU REGULAR ECONOMIC REPORT 7

WORLD BANK REPORT
ON THE EUROPEAN UNION

Inclusive Growth at a Crossroads

Part One of Strengthening Inclusion and Facilitating the Green Transition

WORLD BANK GROUP

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Acknowledgements

This first part of the report was produced by the following core team: Emilia Skrok, Mona Prasad (co-TTLs); Reena Badiani-Magnusson, Kristina Vaughan, Emilija Timmis, Andrei Silviu Dospinescu; Nga Viet Nguyen; Matija Laco; and Paulina Holda. Managerial guidance and direction were provided by Gallina Andronova Vincelette (Country Director, EU Member States), Lalita Moorty (Regional Director, Europe and Central Asia), Jasmin Chakeri (Practice Manager, Macroeconomics, Trade and Investment Global Practice, Europe and Central Asia) and Salman Zaidi (Practice Manager, Poverty and Equity Global Practice, Europe and Central Asia). The peer reviewers were Sanja Madzarevic-Sujster and Paul Andres Corral Rodas, with useful comments received from Julie Biau and Ana Simundza.

Abbreviations

ALMP Active Labour Market Policy

AMECO Annual Macro-economic Database of the European Commission's Directorate General for Economic and Financial Affairs

CATI Computer Assisted Telephone Interviewing

COVID-19 Coronavirus Disease 2019

DG EMPL Directorate-General for Employment, Social Affairs and Inclusion, European Commission

ECB European Central Bank

ECDC European Centre for Disease Prevention and Control

EU European Union

EU-SILC European Union Statistics on Income and Living Conditions

FRA European Union Agency for Fundamental Rights

GDP Gross Domestic Product

GFC Global financial crisis

GMB Guaranteed Minimum Benefit

ICT Information and Communications Technology

IMF International Monetary Fund

ISCO International Standard Classification of Occupations

IT Information Technology

JRC Joint Research Centre, European Commission

NUTS Nomenclature of Territorial Units for Statistics

PPS Purchasing Power Standards

RER Regular Economic Report

SME Small and medium-sized enterprises

TFP Total factor productivity

US United States of America

Country Groupings Used in this Report

Central and Southeast Europe (CEE):
Bulgaria (BG), Croatia (HR), Czech Republic (CZ), Hungary (HU), Poland (PL), Romania (RO), Slovak Republic (SK), Slovenia (SI)

Northern Europe (NE):
Denmark (DE), Estonia (EE), Finland (FI), Latvia (LV), Lithuania (LT), Sweden (SE)

Southern Europe (SE):
Cyprus (CY), Greece (EL), Italy (IT), Malta (MT), Portugal (PT), Spain (ES)

Western Europe (WE):
Austria (AT), Belgium (BE), France (FR), Germany (DE), Ireland (IE), Luxembourg (LU), Netherlands (NL)

Executive Summary

The period of the COVID-19 pandemic will be marked and remembered. It will certainly be known for the ongoing health crisis that has reverberated across the world, leading to significant social impacts, rising inequality and poverty rates, and the steepest recession in Europe since World War II. It could, however, also be known as the trigger for a shift towards policies that will enhance developmental and environmental outcomes. With economies at a crossroads, it is up to governments to make this shift happen.

Countries in Europe will need to ensure a green, resilient and inclusive recovery. This report explores the impacts of COVID-19 on inclusive growth and considers the policies that are needed to strengthen resilience and to ensure that inclusivity is woven into the fabric of societies.

The response of European countries to the challenges of the pandemic has been unprecedented. Governments across the EU stepped in with policy support that limited the impact on firms and households. The escape clause on the EU fiscal rules was triggered, and support was provided both at the supranational and the national level through automatic stabilizers and discretionary measures. Fiscal support ensured a continuous flow of credit to firms, job protection schemes protected workers while monetary policy complemented these efforts by providing sufficient liquidity and ensuring favorable financing conditions. As a result, unemployment increases were moderated, and household incomes were, in part, protected.

In addition, firms and households have shown substantial resilience to the pandemic, as demonstrated by adaptation over the course of 2020 and early 2021 to pandemic realities. As a result, the second wave of infections and consequent lockdowns in late 2020 resulted in lower output losses. Firms and households — where and when possible — learned to work more effectively from home, shop online and enjoy leisure pursuits digitally. Firms also stepped up their digital footprint, providing more services online, while educational and health institutions made a sizeable transition to the online platforms. In general, most segments of the economies and societies learned to work around and with the containments and social distancing measures.

Nevertheless, despite rapidly deployed and substantial policy support as well as increased adaptation, the economic and social reverberations have been significant and uneven. Output contracted by 6.1 percent in the EU27, and between 3.6 and 5.4 million people are estimated to have fallen *into* the risk of poverty in 2020, using an anchored at risk of poverty concept. Although COVID-19 was a common shock, the magnitude of the impact diverged across the EU member states and across sectors. Southern and Central Europe reported the sharpest GDP contraction, while Northern European countries were relatively more resilient. Contact-intensive sectors like entertainment, art and accommodation were most affected compared with more pro-cyclical sectors like industry and construction. Similarly, higher skilled workers — like those in ICT and financial services — were able to transition to home-based work, while lower skilled workers had limited options. Also, freedom of movement across countries has been reduced, with repercussions for remittances and seasonal worker flows across countries. Many of these differences can be explained by a combination of factors including, *inter alia*, the availability of fiscal space, government support policies, the structural composition of the economy, the infection rate and the extent, timing and duration of the related lockdown measures.

The pandemic has exposed and exacerbated deep-seated inequalities, reversing hard-won recent progress in multiple areas, from setbacks in equalizing gender roles to halting income convergence across the EU member countries. The heterogeneity of the impact of the pandemic is leading to divergence of the standard of living across the member countries, merely 5 years since the reignition of the "convergence machine".[1] Also, higher levels of indebtedness in some countries are likely to limit the fiscal space available to countries to support recovery efforts. At the same time, with COVID-19 being a highly regressive shock, the divergence *within* countries, which already was on the rise prior to the pandemic, likely accelerated. The pandemic has had a disproportionate impact on those in the informal sectors and on low paid workers who have been unable to transition to online work and who do not have access to digital education and health facilities. Those with temporary contracts have lost jobs, and overall, the already vulnerable and youth have been more adversely impacted with expected increases in inequality.

Recovery is underway, but carefully targeted and coordinated policy support will remain necessary to continue to mitigate the impact of the crisis and help ignite a strong and sustainable recovery. The accelerating vaccination rate in the EU has improved recovery prospects and is allowing populations to look forward to gradual reopening with cautious optimism. However, health and economic risks and uncertainties remain, and vaccine hesitancy in population subgroups risks holding back progress. Reigniting inclusive growth across the EU is a pre-requisite to sustainably re-set the convergence machine. Policy support for the recovery will require complementarity between monetary and fiscal policies and a careful balancing act to ensure that support is targeted to those that need it the most without impeding the productivity of the economy and accentuating debt sustainability concerns. The EU's recovery plan is aimed at putting the member states on a more sustainable path, which will further the green transition in the recovery process. This would include repairing the damage from the COVID-19 crisis and also promoting and accelerating the green and digital transitions.

EU Member States have the unique opportunity to tailor their Recovery and Resilience Plans to support green, resilient and inclusive recovery. They can benefit from the Next Generation EU facility to provide better opportunities to their citizens. This process can also be enabled if fiscal policy is increasingly geared towards investment in education, health and infrastructure; increased upskilling and reskilling of the labor force together with strengthened labor market policies and social assistance systems; support to accelerate the green transition in a just and inclusive manner; and higher spending efficiency and effectiveness.

Note

[1] World Bank (2019): "Including Institutions: Boosting Resilience in Europe". EU Regular Economic Report 4. Washington D.C.: The World Bank.

Part I

Inclusive Growth

This section of the EU RER assesses the inclusiveness of recent developments in growth in the context of the COVID-19 pandemic. It focuses on the effect of COVID-19 on growth and public finances, the extent to which different regions, sectors, people and households have been affected by the crisis, and the ability of different populations to cope with the effects of the crisis through their capacity to absorb shocks and the coverage of support programs. It uses the most recent data available on key macroeconomic, household welfare and labor market indicators and also draws on the recently fielded COVID-19 household surveys in Bulgaria, Croatia, Poland and Romania (Annex 1). The analysis takes an EU-wide approach in addition to a breakdown of four separate geographic clusters – Northern Europe, Western Europe, Southern Europe and Central and Southeast Europe. Some granularity in the analysis is provided through country level examples. The first section focuses on developments at the macro level including the impact on growth, fiscal and external sectors. The second section assesses the impact of lower growth on poverty and inclusiveness.

Chapter 1

A Year into the Pandemic: Growth and Outlook

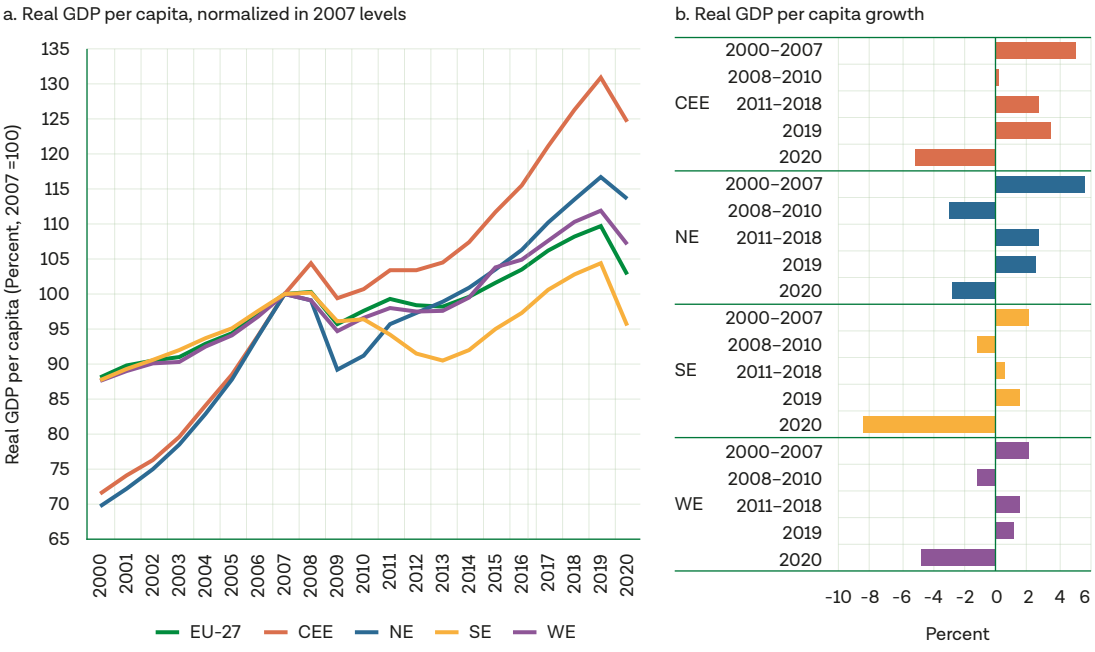
Even prior to the pandemic, growth was decelerating in the EU due to low productivity and weaknesses in international trade. The region was facing headwinds from slowing global trade, and geopolitical and policy uncertainty. In addition, structural constraints like low productivity, a rapidly aging population, lagging regions and a large state footprint in some of the member states also impeded GDP growth. As a result, the convergence process was decelerating. The COVID-19 health crisis, which quickly evolved into an economic crisis, dealt a severe blow to EU countries, as to the rest of the world.

Impact of COVID-19: swift and severe

The COVID-19 pandemic has triggered the sharpest peacetime recession in the EU, reversing recent progress in rising living standards. With an output contraction of 6.1 percent in 2020, it was the steepest recession since World War II and outweighed the impact of the global financial crisis (GFC) by a wide margin (Figure 1.1, Figure 1.2). The contraction reflects pandemic-related mitigation measures that restricted consumption and investment, reduced labor supply and production, and disrupted trade, supply chains, travel and tourism. The swiftness and severity of the impact is illustrated by the sharp decline in economic indicators in the first half of 2020.[1] Early on in the pandemic, governments stepped in with unprecedented policy support to firms and households but poverty and inequality are projected to have increased, and hard-won gains in household incomes have quickly been eroded in a highly uneven manner.

All EU member states have been affected but the impact has been uneven, with Southern Europe experiencing the largest contraction. Even though COVID-19 was a common shock, the magnitude of the impact diverged across the EU states. Southern Europe reported the sharpest GDP per capita contraction (8.4 on average), while Northern European countries were relatively more resilient (2.7 percent average contraction in 2020). The asymmetry can be explained by a combination of factors including, *inter alia*, the availability of

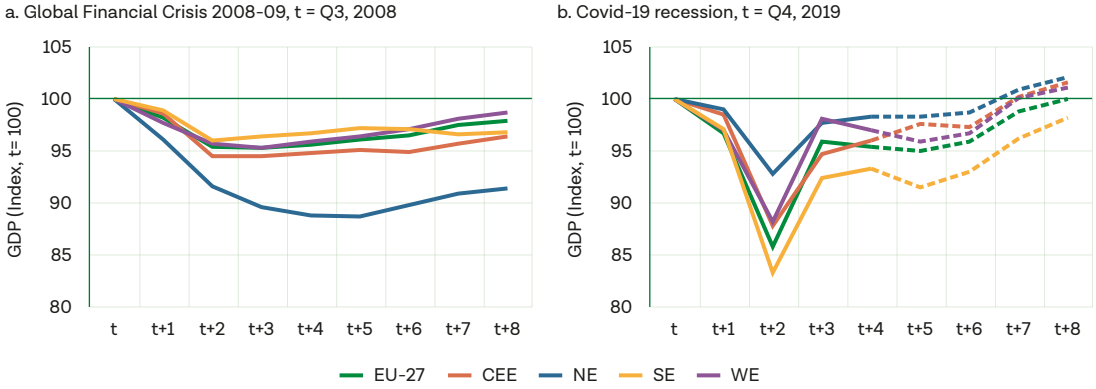
Figure 1.1 The pandemic triggered an unprecedented economic contraction across the EU



Note: Unweighted average across countries

Source: Eurostat, World Bank calculations

Figure 1.2 The COVID-19 induced economic contraction is more pronounced than the Global Financial Crisis



Note: Unweighted average across countries; dotted lines indicate forecast

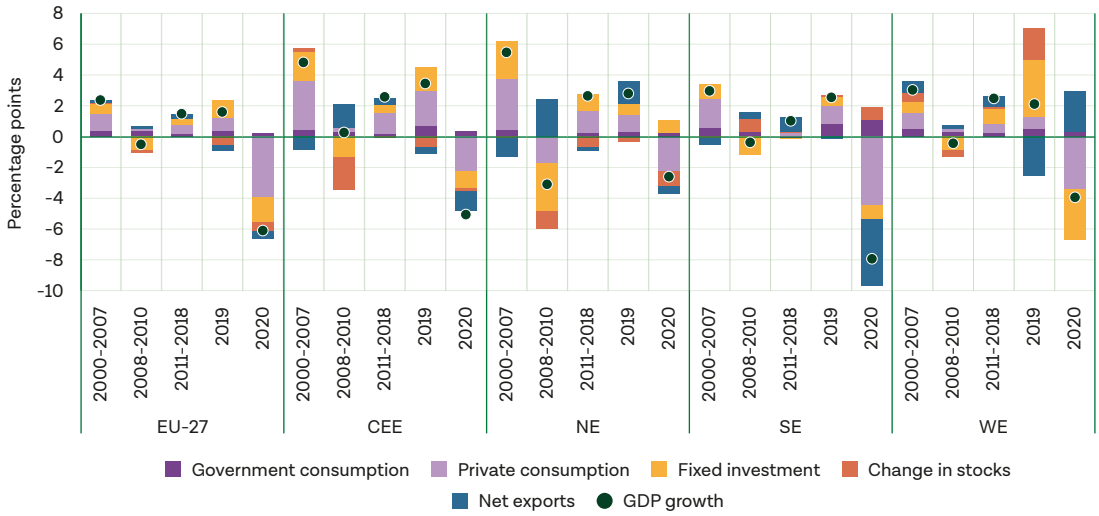
Source: Eurostat, World Bank calculations. Spring 2021 Economic Forecast, European Commission.

fiscal space, the structural composition of the economy, the infection rate and the extent, timing and duration of the related lockdown measures. Countries in Southern and Central Europe with a sizeable tourism sector, limited fiscal space and considerable health impact experienced significant output contractions.

National lockdowns brought the EU economies to a halt with a sharp decline in private consumption. The containment measures and significant mobility restrictions alongside lower incomes and increased uncertainty took its toll on private consumption and also impacted investment (Figure 1.3). Southern European countries that experienced higher infections and stronger lockdown measures recorded the largest decline in private consumption. Except for Western Europe, the contraction in net exports added to the recessionary pressures as supply chain disruptions affected export of goods and travel restrictions limited tourism. Increased government consumption supported output across all regions but was not enough to offset the negative impact of private consumption, investment and net exports.

Figure 1.3 Private consumption remains the main driver of economic activity

Contribution to GDP growth, expenditure side



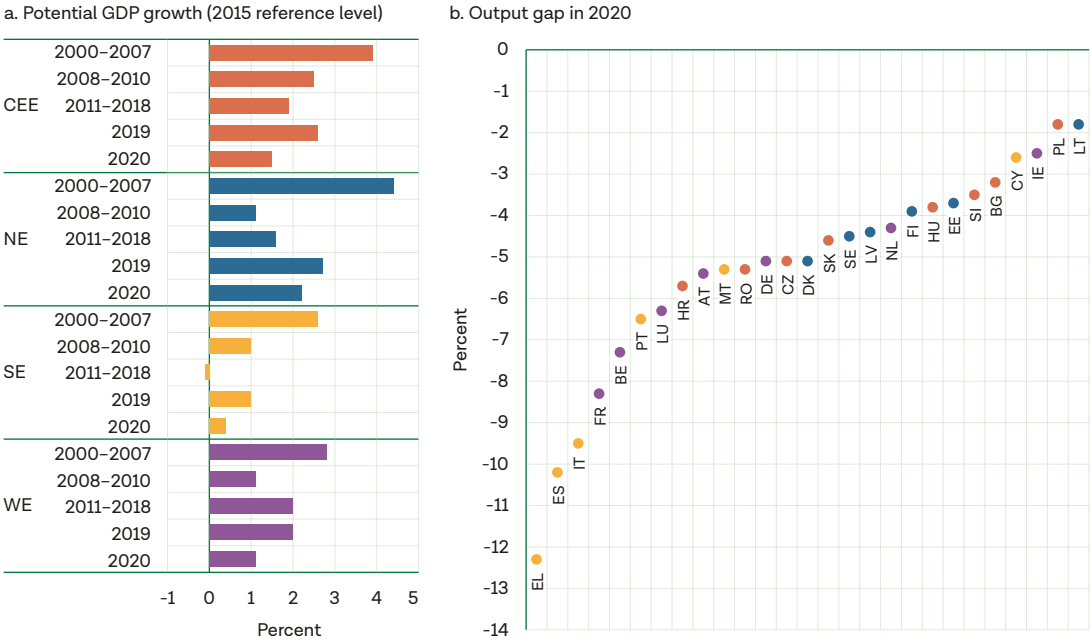
Note: Unweighted average across countries

Source: Eurostat, World Bank calculations

The containment measures also triggered substantial heterogeneity in impacts across sectors and workers. The impact on manufacturing was significantly lower than that on services. Within services, contact-intensive activities like entertainment, art and accommodation were most affected. These sectors, which are traditionally insensitive to business cycles, were more severely impacted than pro-cyclical sectors such as industry and construction. Services requiring higher skilled workers such as those in ICT and financial services were able to transition to home-based work while lower skilled workers had limited options. The differentiated sectoral impacts are largely explained by the containment measures.

The resultant fall in potential GDP growth has implications for medium-to-long term growth in the EU. Prior to the pandemic, in 2019, potential growth had been on the rise relative to the tremulous preceding decade — across Central, Southern, and Northern Europe (Figure 1.4, panel a). The pandemic halted these welcome improvements: the impaired human and physical capital accumulation alongside lower productivity negatively affected potential GDP growth (Box 1.1). Southern Europe was most affected, given the larger impact of the pandemic (Figure 1.4, panel b). Lower potential GDP growth has implications for medium-to-long term growth, highlighting the importance of policy measures to remove structural constraints. In addition, all EU27 states are estimated to post negative output gaps in 2020. This highlights that not only did the crisis affect *potential* growth, but that the *actual* economic performance fell further away from it, stressing the continued need for government support.

Figure 1.4 Further away from an even lower potential GDP growth across the board



Note: Unweighted average across countries, Output gap calculated as actual GDP less potential GDP as a percent of potential GDP
Source: AMECO, World Bank calculations

Amidst the gloom on the economic side, the buoyancy of financial markets stood in sharp contrast to weaker economic fundamentals. After a steep decline at the outset of the pandemic, financial markets rebounded, diverging from real sector developments. This divergence is largely explained by the prevailing low interest rates and significant policy measures which supported household incomes and increased liquidity in the financial system (at a time when credit demand from the real sector was relatively muted, with the exception of requests for moratoria and working capital needs). As policy support is gradually withdrawn, a correction in asset prices is possible.

Box 1.1 The impact of COVID-19 on human capital accumulation through education, healthcare and mental health

The pandemic exacted an immeasureable toll on human life. Up to June 2021, it is estimated that there have been nearly 740,000 deaths due to COVID-19 and over 33 million cases in the EU-27 (ECDC). The public health responses undertaken to combat the disease resulted in severe disruptions to daily life, with adverse impacts on health and education, and potentially long-term implications for human capital accumulation and future growth.

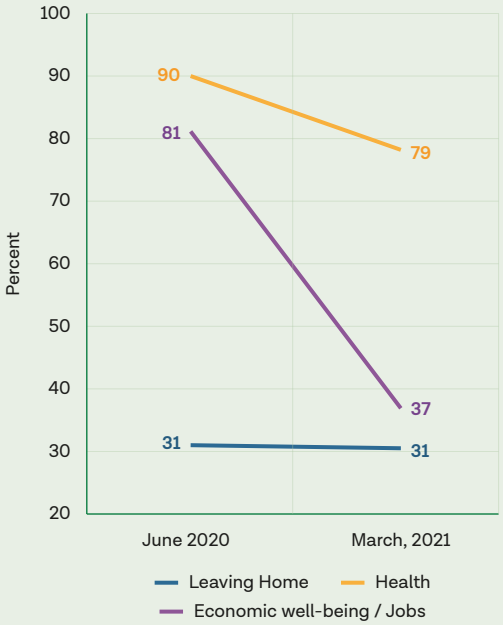
The disruption to chidren's learning induced by COVID-19 is likely to disproportionately affect vulnerable children, with predicted longer-term losses in Southern and Central Europe. Data from the rapid response surveys in Bulgaria and Romania show that a greater proportion of parents of children from less well-off and less educated backgrounds report that their child had difficulties adjusting to online learning. Across regions, losses to human capital are expected to be higher in Central and Southern Europe given fewer resources to manage the transition to online learning and lower levels of digital skill competencies. Furthermore, learning losses have the potential to be more permanent in these regions given fewer resources to remediate students. The losses in learning will be particularly deleterious if they affect foundational skills which can lower the acquisition of higher order skills with potentially long-lasting effects (Cunha and Heckman, 2007).

The resources diverted to cope with the pandemic combined with changes in health delivery and health-seeking behaviour due to COVID-19 has had a major impact on the supply and demand of medical care. Rapid response surveys in Romania showed evidence of an inability to access care, delayed care, and medication shortages. In May 2020, just over 6 percent of households in Romania who sought care reported being unable to access it; as the second wave of the pandemic took hold in late October to November 2020, this had increased to close to 11 percent. As a result of reductions in elective admissions and surgeries in Romania, by the end of 2020 the number of inpatient admissions was down by 40 percent compared to 2019. In outpatient care, there were no restrictions to the supply of care, but safety measures resulted in a reduction of the available time for in-person consultations/treatments. These constraints were partially addressed by remote consultations: in comparison to 2019, the total number of consultations in primary healthcare increased by 2 percent, while the number of services in outpatient specialty care decreased moderately by approximately 8 percent. On the demand side, a large number of patients postponed treatments or reduced contacts with health service providers.

The severe lockdowns and social isolation that were at the core of the public health response led to increased reports of deterioration in mental health, exacerbated by heigtened concerns surrounding financial security and health. Data from rapid response surveys in Croatia, suggest that concerns surrounding economic well-being and health were high, especially among lower-income households. As containment measures were relaxed, and some return to normalcy commenced, subsequent waves showed a decline in the level of concern, although it remained heightened.

Figure B1.1.1 Concern surrounding various aspects of life were heigtened during the first wave of the crisis

Percent of households expressing some level of concern, Croatia, June 2020 and March 2021



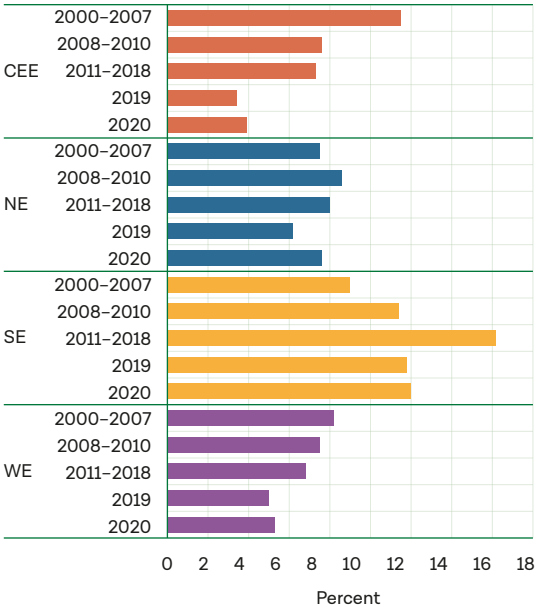
Source: COVID-19 Rapid Response Survey in Croatia, The World Bank

Unprecedented policy support and increased adaptation

Governments across the EU stepped in with unprecedented policy support that limited the impact on firms and households. Support was provided both at the supranational and national level in the form of, *inter alia*, credit guarantees, liquidity facilities, loan moratoria, enhanced unemployment insurance, wage subsidies, expanded social assistance and tax relief. In addition, automatic stabilizers and the triggering of the escape clause on EU fiscal rules also helped. Fiscal support ensured a continuous flow of credit to firms thereby preventing a liquidity crisis from morphing into a solvency crisis. Concurrently, monetary policy complemented these efforts by providing sufficient liquidity and ensuring favorable financing conditions. As a result, unemployment increases were moderated and household incomes were, in part, protected (discussed in the next section). The increase in unemployment was most pronounced in Northern and Central Europe, where job-retention schemes protected a lower proportion of jobs (Figure 1.5). In Southern and Western Europe, where a much higher proportion of jobs were supported by the government, firms cut wages and working hours rather than terminating employment, thereby limiting the impact on unemployment.[2] In addition, although investment and gross national savings fell in 2020, the decline was lower compared to the GFC.

Figure 1.5 Unemployment increases were limited by government-supported job retention schemes

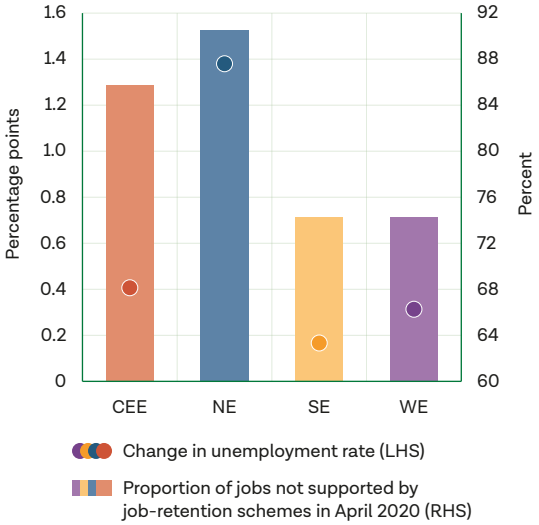
a. Unemployment rate, percent of active population



Note: Within-region weighted average across countries

Source: Eurostat, World Bank calculations

b. Change in unemployment rate in 2020 (percentage points) and proportion of jobs not supported by job retention schemes



Note: Data on job-retention not available for the Czech Republic, Malta and Romania

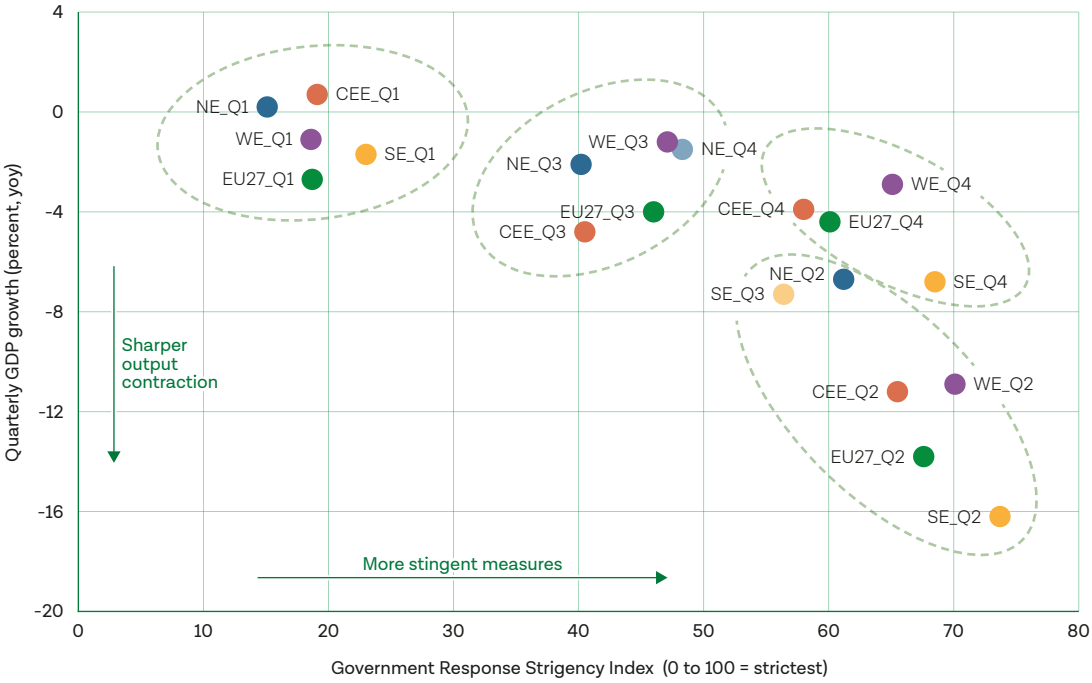
Source: Eurostat Jobs benefitting from COVID-19 governmental support measures

As the pandemic progressed, firms and households also adapted to the changed circumstances, limiting the impact on GDP in the second lockdown in Q4 2020. In general, a high degree of correlation was observed between the government stringency index[3] and GDP dynamics, especially at the onset of the pandemic. The extended, strict lockdown measures triggered strong GDP contraction in all EU countries

in the second quarter of 2020 (Figure 1.6). In contrast, in Q4 2020, while the stringency index was broadly comparable to Q2, output contraction was much lower. This reflected increased adaptation to lockdowns, restrictions and social distancing. Firms and households learned to work more effectively from home, shop online and enjoy leisure pursuits digitally.[4] In addition, exporters benefited from the rebound in global trade.

Figure 1.6 Government response stringency had a significant impact on growth, especially at the onset of the pandemic

Stringency of the response (index) and quarterly GDP growth



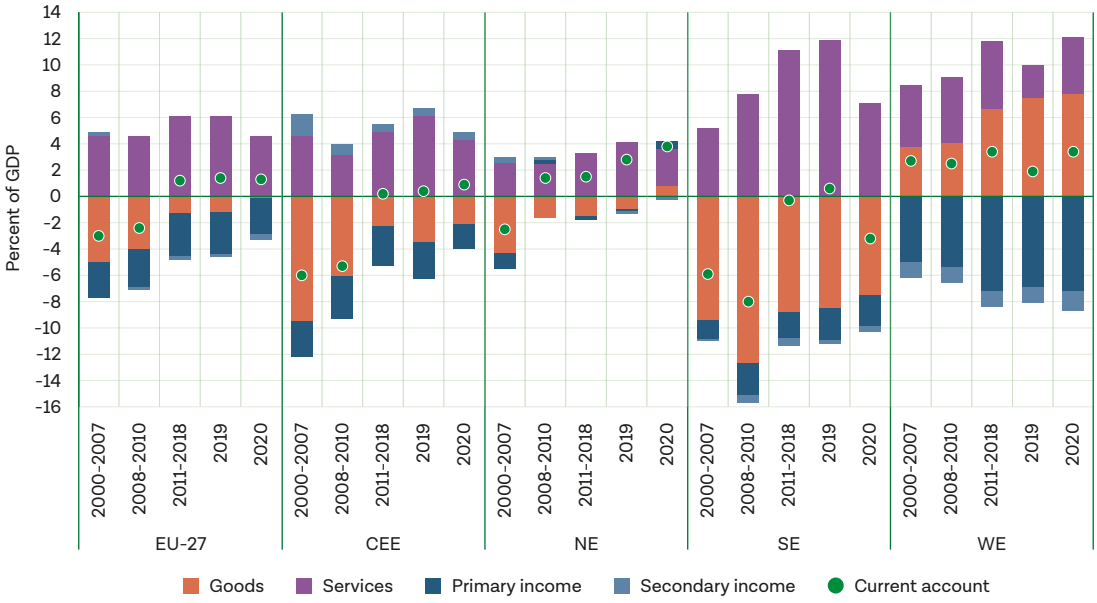
Note: Stringency index (0 – 100 index) records the strictness of 'lockdown style' policies that primarily restrict people's behavior based on 18 response indicators including school closures, workplace closures, and travel bans, rescaled to a value from 0 to 100 (100 = strictest). Derived from the Oxford COVID-19 Government Response Tracker. All indicators are calculated as 7-day moving averages.

Source: Eurostat, Google COVID-19 Community Mobility Reports, Oxford COVID-19 Government Response Tracker, Blavatnik School of Government.

Meanwhile, continued and uncertain travel restrictions resulted in tourism dependent countries bearing a larger brunt of the recession. Most countries in the EU have maintained a positive current account balance, except for Southern Europe (SE), where the exports of services were disproportionately hit by a decline in tourism (Figure 1.7). Southern Europe typically runs a deficit in goods trade and a surplus on services. In the last decade, services exports (particularly, tourism) in SE were sufficient to offset net imports of goods and net income outflows, leading to a surplus in the current account balance. In 2020, tourism-dependent countries saw a significant decline in net services due to widespread mobility restrictions. A decline in global economic activity also reduced net primary income from the rest of the world. The trade balance however improved, especially in the second half of 2020, with growth in global trade in goods. With the exception of SE, current account positions in 2020 remained broadly similar to 2019, adjusting on average less than the GFC.

Figure 1.7 Current account positions remain relatively stable

Balance of payment components



Note: Unweighted average across countries; Source: Eurostat, World Bank calculations

Rising public indebtedness

Fiscal deficits widened to levels unseen since the GFC as governments across the EU moved to limit the pandemic's impact on output, employment, and incomes. The fiscal stimulus was targeted to support household incomes, improve firms' liquidity and limit the long-term impact on productive capacity and the labor market. The largest deficits were recorded in Southern and Central Europe, which also had relatively higher deficits pre-COVID and experienced larger GDP contractions. While revenues were lower due to the output decline and tax relief measures, current expenditure increases were the main driver of the deficit (Figure 1.8). The rise in public expenditures reflect both the counter-cyclical automatic stabilizers and, particularly, the discretionary policy actions targeted to support the economy and COVID-19 related health expenditures (Figure 1.9). Both structural and cyclical factors accounted for the increased deficit and some fiscal tightening is likely going forward due to cyclical factors.

The resultant increase in public indebtedness will have lingering effects. The fiscal support measures, together with the adverse economic effects of the pandemic, pushed up the debt-to-GDP ratio by over 13 percentage points — a steeper increase than during the Global Financial Crisis (Figure 1.10). The highest increases were recorded in Southern Europe, reflecting larger fiscal deficits and sharper declines in output (Figure 1.11). However, favorable financing conditions have limited debt servicing costs. With the generous issuance of guarantee schemes in several EU member states, contingent liabilities could increase sovereign debt levels. Also, with support directed to firms, a sovereign-bank-corporate nexus is likely. This will result in increased sensitivity of public finances to firm and financial sector performance. How this nexus plays out and the challenges (if any) going forward will depend on the strength of the recovery. While a premature withdrawal of support with potential increase in non-performing loans (NPLs) could lead to increased public indebtedness, continued government support and a strong recovery could enable the rebuilding of fiscal space in EU member states.

Figure 1.8 Increased spending was the main driver behind fiscal deficits

Contribution to changes in fiscal balance, percent of GDP

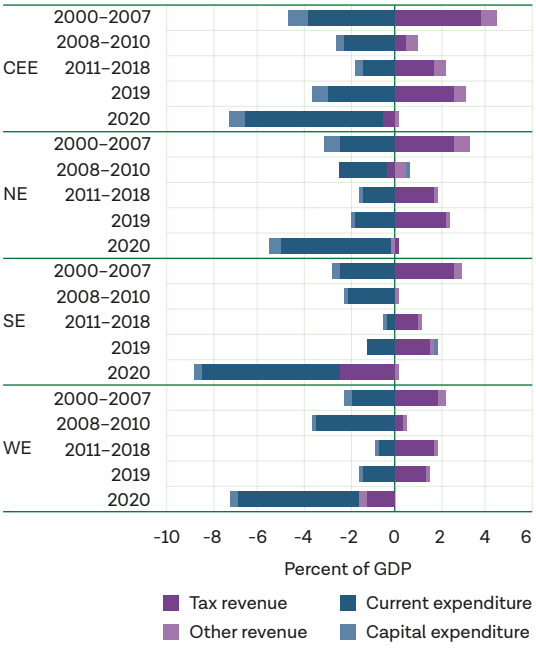
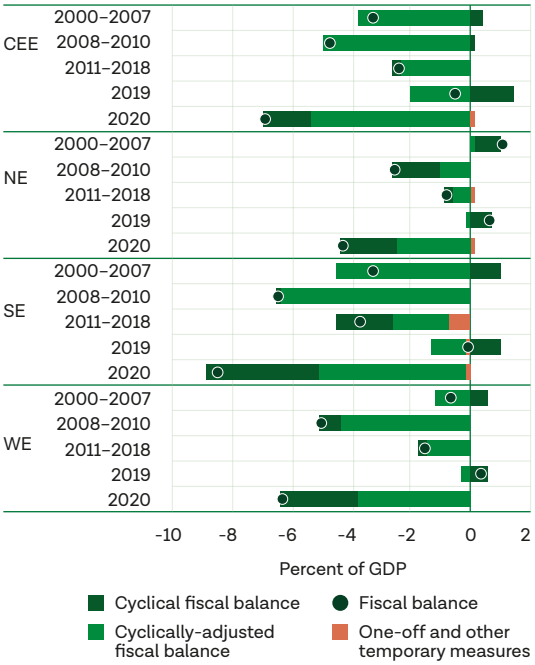


Figure 1.9 Cyclical and structural factors contributed to the fiscal deficit in 2020

Cyclical adjustment of public finance variables



Notes: Unweighted average across countries. Cyclically-adjusted fiscal balance serves as proxy for discretionary fiscal policy measures.

Source: Eurostat, AMECO, World Bank calculations

Figure 1.10 Public debt increased sharply

Gross public debt

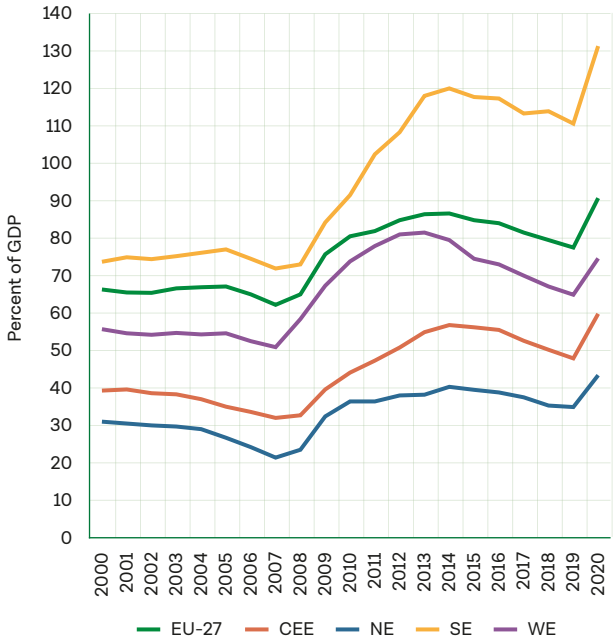
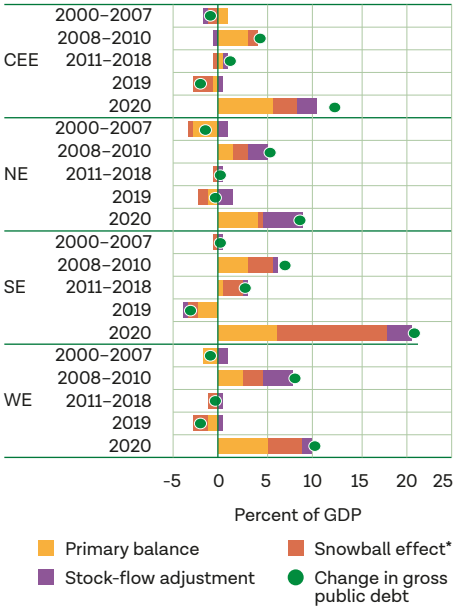


Figure 1.11 A higher primary deficit along with a lower GDP raised indebtedness

Annual change in debt ratio, percent of GDP



Note: Unweighted average across countries, *captures the joint impact of interest payments on the outstanding stock of debt, real GDP growth, inflation rate and the exchange rate effect linked to the interest rate.

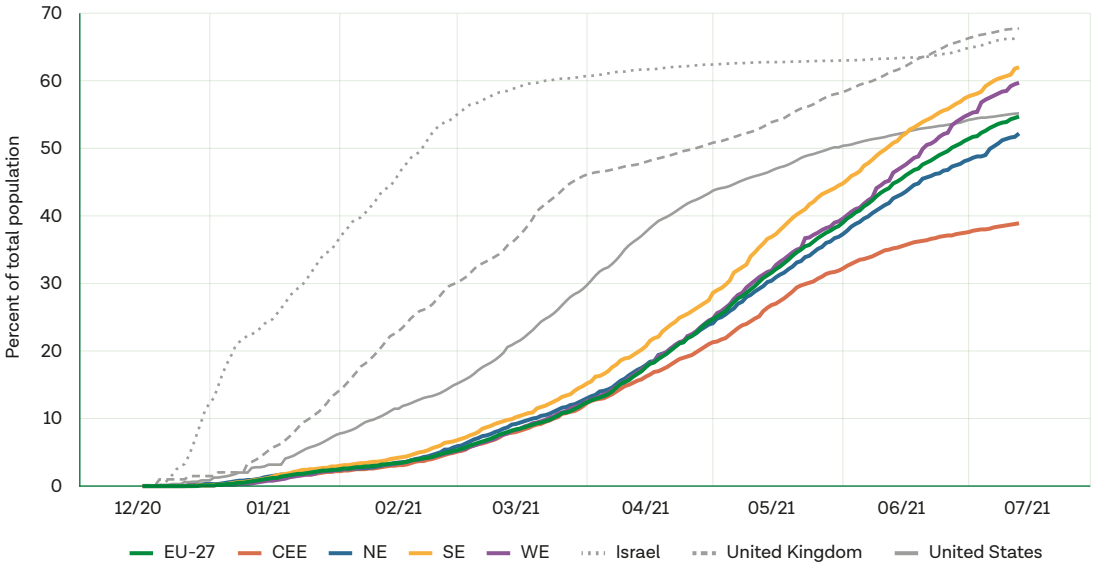
Source: Eurostat, AMECO, Debt Sustainability Monitor 2020, World Bank calculations

Recovery gaining momentum but carefully targeted and coordinated policy support still needed

The vaccination rollout in the EU27 countries is gaining momentum, improving the recovery prospects. The evolution of the pandemic and the success of the vaccine rollout are paramount to a swift rebound. The third wave of infections and supply side constraints on the availability of vaccines may have delayed recovery in some countries. However, following a slow start, especially when compared to other advanced economies, vaccinations in the EU are accelerating (Figure 1.12). Southern Europe, which experienced the strongest health and economic impact in the EU, has the highest share of people who have received at least one dose of the COVID-19 vaccine (26.2 percent as of mid-July), while Central Europe has the lowest share and shows signs of slowing vaccination rates. In addition, the introduction of the Digital COVID Certificate from July 2021 could potentially enable a recovery in tourism, in time for the summer season, supporting growth in tourism dependent countries. Also, based on the latest (2021) Stability and Convergence Programmes, the 2021 fiscal stimulus is set to be even larger than that seen in 2020 in several EU members, as some of the national level fiscal stimulus scheduled for 2020 has been shifted to 2021, providing a larger boost to the economy. Facilitated by the extension of the escape clause on EU fiscal rules to the end of 2022, this will help to avoid a premature tightening. However, recovery prospects will differ across sectors. The third quarter of 2020 demonstrated the quick demand rebound in several sectors when containment measures were eased. As the health crisis is gradually contained, manufacturing is likely to rebound sooner than services. Within the latter, accommodation and food services will take relatively longer than other business services as travel gradually picks up.

Figure 1.12 The EU27 countries still lag behind in terms of vaccination but the rollout is gaining momentum

Share of people who received at least one dose of COVID-19 vaccine



Source: Our World in Data

Note: Share of the total population that received at least one vaccine dose. This may not equal the share that are fully vaccinated if the vaccine requires two doses. EU aggregates reflect the unweighted average across countries.

Downside risks to the outlook remain. The epidemiology of the virus and the effectiveness of the vaccines against new variants will be critical in containing the health (and consequently the economic) crisis. In addition, vaccine hesitancy could also impede recovery. In addition, there is likely to be a slow

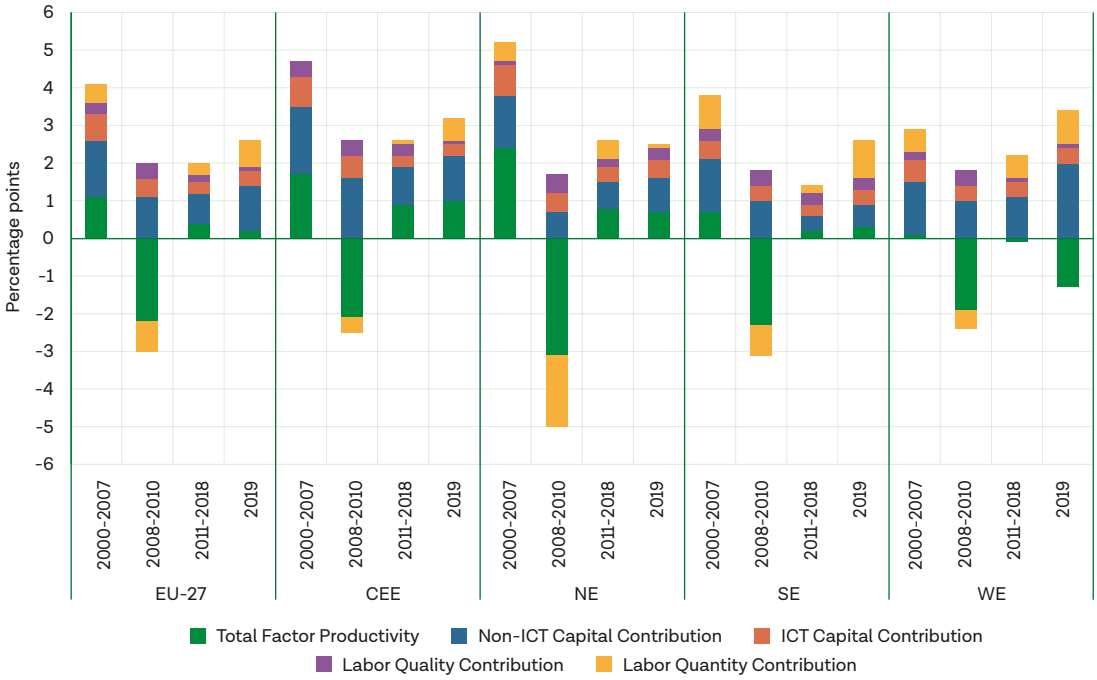
recovery of confidence among households. Survey results indicate that households are somewhat pessimistic about economic prospects and anticipate continued financial difficulties which would necessitate reduced spending on durables and on eating outside.[5] This pessimism and uncertainty could slow down the recovery process. In addition, unemployment expectations remain elevated.

Financial sector risks need to be monitored. A combination of favorable financing conditions, enhanced liquidity and forbearance measures enabled the financial sector to provide significant support to firms and households. As the recovery sets in and post-pandemic demand patterns take shape, public support measures will decline and forbearance measures will be phased out. Careful monitoring will be important to limit increases in corporate insolvencies and the heightened risk of firm zombification (Helmersson et al. 2021). The physical and transition risks to the financial sector from climate change will also need close monitoring. Increased flexibility and a strengthening of the insolvency framework will be particularly important to accommodate the orderly and timely exit of firms that have outlived their purpose, and to disincentivize the banks from evergreening loans to unproductive firms. At the same time, new lending to viable firms will be crucial to support post-pandemic growth and jobs.[6]

In addition, pre-existing structural constraints will continue to be an impediment. Prior to the pandemic, total factor productivity (TFP)[7] growth was already on the decline, and labor quality contribution was low across the board (Figure 1.13). In 2019, on average in the EU, TFP growth slowed to near-zero. While in Central and Northern Europe productivity has had a small but positive contribution to growth, across Southern European member states productivity growth was absent for more than a decade. In Western Europe, it has been negative since the GFC, with economic growth driven by capital and labor accumulation, with minimal contribution from labor quality improvements. While the pandemic's impact on productivity growth remains to be measured, it is likely to have declined further.

Figure 1.13 Productivity lull already strained economic growth before the pandemic

Contribution to GDP growth, percentage points

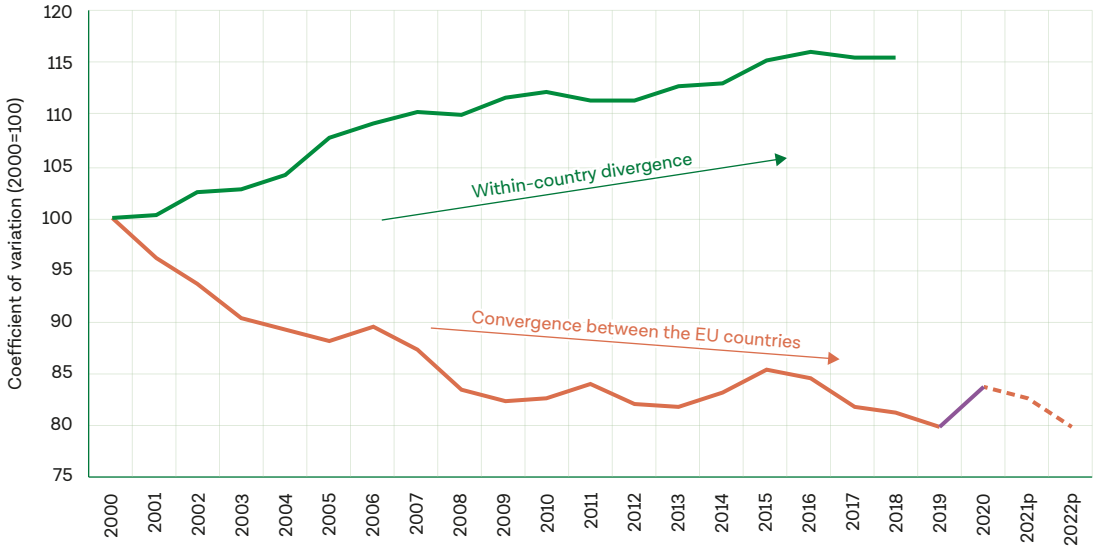


Note: Unweighted average across countries

Source: Eurostat, World Bank calculations

With varying degrees of infections, lockdowns, crisis support, pre-existing macro-financial conditions and recovery measures, the divergence among and within countries is likely to increase. Although the shock was synchronous, its economic impact was not uniform: some countries have been hit harder by the pandemic and the resultant lockdowns. Also, countries that are highly dependent on services like tourism have faced larger output contractions than those dependent on manufacturing and business services. Furthermore, differences in pre-existing macroeconomic conditions, especially the availability of fiscal space, has determined, in part, the extent of crisis support that governments have been able to provide and will also determine recovery support. This is likely to result in greater divergence of living standards between the EU countries (Figure 1.14). The divergence of incomes between countries halted the convergence process that restarted in 2015, and was largely driven by Central European countries (EU Regional Economic Report 2019[8]). In addition, COVID-19 has been a regressive shock. It has had a disproportionate impact on those in the informal sectors and low paid workers (discussed further in the next section) who have been unable to transition to online work and who do not have widespread access to online education and health facilities. Those with temporary contracts have lost jobs and overall, the already vulnerable and youth have been more adversely impacted. This is likely to increase regional disparities within countries.

Figure 1.14 The economic impact of the pandemic reversed the convergence of income in the EU27



Source: World Bank calculations using Eurostat, Ameco data

Note: Computations based on GDP per capita in PPS for the EU27 countries; within-country variation calculated based on NUTS 3 level data.

Policy support for the recovery will require a careful balancing act. The recovery remains subject to risks and uncertainties, with varied recovery patterns across countries, sectors and regions. Labor market outcomes will depend on the performance of firms, which in turn continue to, in part, rely on monetary, financial and fiscal support. Under these conditions, the continuation of policy support will be necessary to strengthen the recovery. It will also be important to maintain the complementarity of fiscal and monetary support, which is being increasingly challenged by rising inflationary pressures.[9] In addition, the increase in US yields has triggered volatility and a round of repricing across financial markets. As the recovery takes hold, it will be important for fiscal policy to remain flexible and supportive with measures increasingly targeted towards vulnerable households and viable firms. Policy makers will also need to strike a balance between providing assistance and keeping debt at manageable levels. A green, digital and inclusive transition is possible if fiscal policy is increasingly geared towards investment in

education, health and infrastructure; increased upskilling and reskilling of the labor force together with strengthened labor market policies and social assistance systems; higher spending efficiency and effectiveness; and a reformed tax system that delivers on the green transition and supports growth.

Careful formulation and efficient implementation of the Recovery and Resilience Plans (RRPs) by EU member states is paramount to support growth, inclusion and the green and digital transitions. Alongside the Multiannual Financial Framework, the Next Generation EU Funds provide substantial funding to EU member states to support their recovery with a focus on the green and digital transition. Beyond the attentive tailoring of the RRPs, efficient implementation of the plans (and increased absorption of EU funds) will be critical to fully benefit from the facility and provide better opportunities to citizens and also deliver on the Green Deal (discussed in a forthcoming segment — Part 2 — of the Regular Economic Report).

Some of the likely elements of the post-pandemic EU landscape include possible changes to value chains and a more digitized and green economy with potential winners and losers. A recent study[10] commissioned by the European Parliament suggests that the EU's value chains have been resilient during the pandemic and European industries stand to gain more from the diversification of supply chains rather than on/reshoring. On the digital transition, there is likely to be increased adoption of e-commerce with concomitant impacts on traditional retail. While increased use of ICT is expected to strengthen productivity, complementary investments are required in relevant skills development and reorganization of production structures. The pandemic has also accelerated the green transition which will require significant changes in certain sectors with pronounced effects on groups of workers. Efforts will be needed to make the green transition growth oriented and just (discussed in further depth in the forthcoming segment, Part 2).

Notes

1. Wholesale and retail trade in EU27 fell by 6.1 percent in Q2-2020, year-on-year, while industry contracted by 19.5 percent.
2. Nevertheless, in all regions, unemployment increases were, in part, contained by increased labor demand from sectors like hospitals and delivery services. In addition, some people also stopped looking for jobs actively, effectively dropping from the labor force.
3. Stringency Index (0-100) is based on the Oxford COVID-19 Government Response Tracker records the strictness of 'lockdown style' policies that primarily restrict people's behavior based on 18 response indicators including school closures, workplace closures, and travel bans, rescaled to a value from 0 to 100 (100 = strictest).
4. In a new paper on the economic effects of lockdowns in Europe, authors Olivier Blanchard and Jean Pisani Ferry, said: "The evidence, however, is clear that these countries were able to contain [virus] contagion at a lower output cost during the second confinement."
5. Based on COVID-19 Rapid Response Household surveys conducted by the World Bank in Romania, Poland, Bulgaria and Croatia.
6. Assessment based on EIB Group; SAFE (Survey on access to finance of enterprises) 2020; and Eurostat data.
7. Total Factor Productivity (TFP) captures share of economic growth attributable to factors such as technological progress, efficiency of resource allocation, management quality, and quality of institutions, among many intangible factors. Other drivers of growth include investment in ICT and traditional capital accumulation, and changes to labor quantity and quality.
8. World Bank (2019): "Including Institutions: Boosting Resilience in Europe". EU Regular Economic Report 4. Washington D.C.: The World Bank.
9. The increase in prices have been fueled by higher commodity and fuel prices, base effect and supply disruptions.
10. de Vet, J.M, et al. (2021): "Impacts of the COVID-19 pandemic on EU industries", Publication for the committee on Industry, Research and Energy, Policy Department for Economic, Scientific and Quality of Life Policies. European Parliament, Luxembourg, 2021

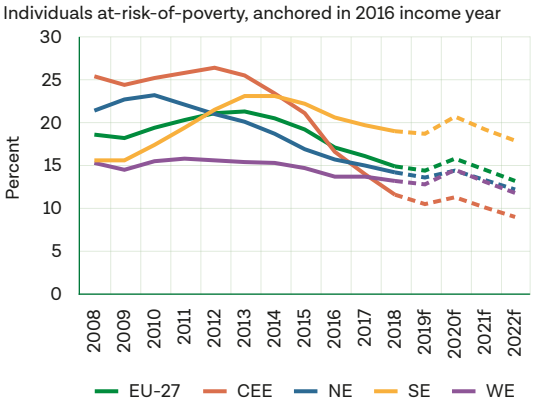
Chapter 2

Inclusion has been compromised but resilience remains highly visible

Poverty impacts have been moderated by the rapid rollout of government support measures. Poverty is anticipated to have risen, but not uniformly, due to pre-existing differences in economic, labor market, and social protection structures

With substantial output contractions, poverty is projected to rise in all regions[1], pushing progress in recent years back. However, the impact of the crisis on the poor is expected to have been moderated by the unprecedented rollout of government support measures (Figure 2.1). The share of the population at risk of poverty — using the anchored at risk of poverty concept, where the poverty line is held fixed in the 2016 income year — is estimated to have risen by between 1.0 and 1.5 percentage points in 2020, from 14.4 percent to between 15.4 and 15.8 percent. The range represents bounds for the ability of countries to protect the most vulnerable households from the impacts of the crisis. Poverty rates are expected to remain above 2019 levels in Southern and Western Europe until at least 2022, whereas they are expected to return to below 2019 levels in Central and Northern Europe by 2021.[2] Prior to the crisis, it was anticipated that an estimated 1.3 million people would be lifted out of poverty in 2020. Now, with the onset of the COVID-19 crisis, it is anticipated that 3.6 to 5.4 million people would have fallen *into* the risk of poverty in 2020 in the EU member states. Complementary and experimental[3] data from rapid response household surveys in Romania corroborate the anticipated rise in poverty, pointing to substantial increases in poverty in the early stages of the crisis, reflecting the substantial drop in incomes noted by households early in the first wave of the pandemic before the rapid rollout of government support policies took full hold and as work stoppages reached a peak.[4] The rapid rollout of government support combined with the adaptation of workplaces contributed to the moderation of poverty rates. However, and despite the impacts lessening as the crisis progressed and being cushioned by support measures, poverty rates are still anticipated to remain above pre-crisis levels (Figure 2.2). Depending on the evolution of the pandemic and the pace of economic recovery, poverty rates could remain elevated compared with pre-crisis levels beyond 2022.

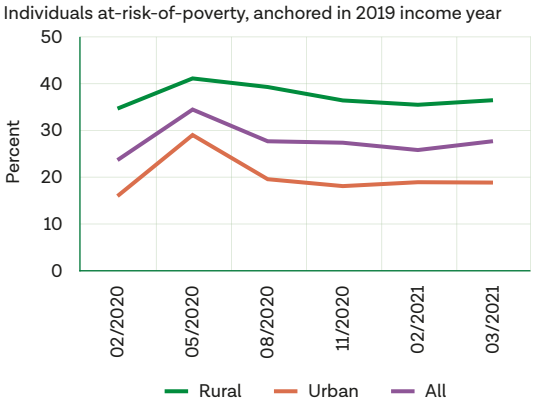
Figure 2.1 Poverty — benchmarked against 2016 lines — is projected to rise and remain elevated until at least 2022



Note: Dotted line represents forecasts

Source: Author's computation based on AMECO Spring 2021 Forecast

Figure 2.2 Experimental poverty estimates in Romania show a sharp rise in poverty early in the pandemic that have subsided as the pandemic progresses



Note: Rapid Household Surveys conducted between April 2020 and March 2021

Source: COVID-19 Rapid Response Household Survey Romania, The World Bank

Southern Europe is expected to suffer the hardest hit due to its pre-existing economic and labor market structures and limited fiscal space. The region is predicted to account for just under half of the total rise in the number of poor, while contributing to just over a third (36 percent) of the population of the EU-27. Of the additional 3.6 to 5.4 million people anticipated to fall into poverty, using the anchored at risk of poverty concept, between 1.7 and 2.6 million live in Southern Europe, where poverty rates are expected to increase from 18.7 percent in 2019 to between 20.0 and 20.7 percent in 2020. As a consequence, the share of the population at risk of poverty in 2020 in Southern Europe is projected to have returned to the peak seen in 2013 after the global financial crisis, using the anchored at risk of poverty concept. As noted in the previous RER[5], the combination of pre-existing economic structures (such as a heavy reliance on tourism), labor market structures (such as higher shares of temporary and informal workers), and limited fiscal space has left Southern European countries and populations more exposed to the economic impacts of the crisis and constrained in their policy response.

Moreover, the impact of COVID-19 is further amplified in Southern and Central Europe because of pre-existing deficiencies in the capacity of the social assistance system to act as a redistributive mechanism. Much of the decline in the at-risk-of-poverty rate before and after transfers in Southern and Central Europe is attributed to the role of pensions rather than means-tested social benefits which, are specifically targeted to the poor (Figure 2.3). Similar observations are noted when considering the comparative role of pensions and means-tested benefits in reducing inequality (Figure 2.4). These pre-existing deficiencies in the absorptive capacity of means-tested social benefits left poorer households with more limited means to cope with the impacts of the crisis.

Figure 2.3 The role of benefits targeted towards the poor in reducing poverty is limited

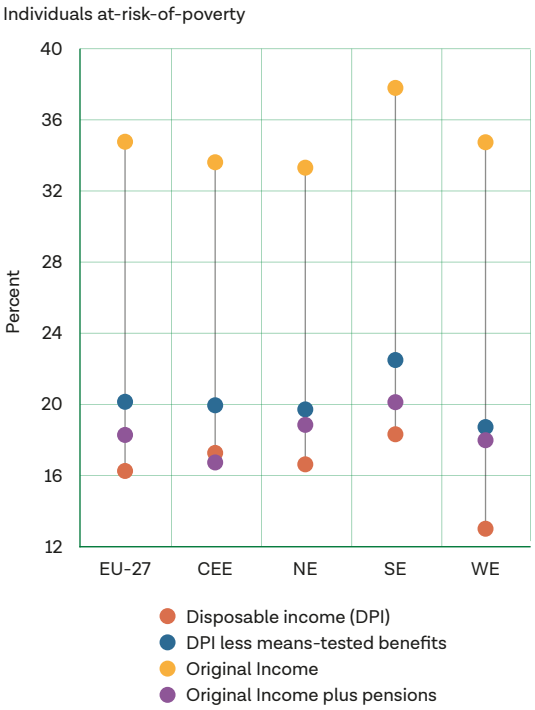
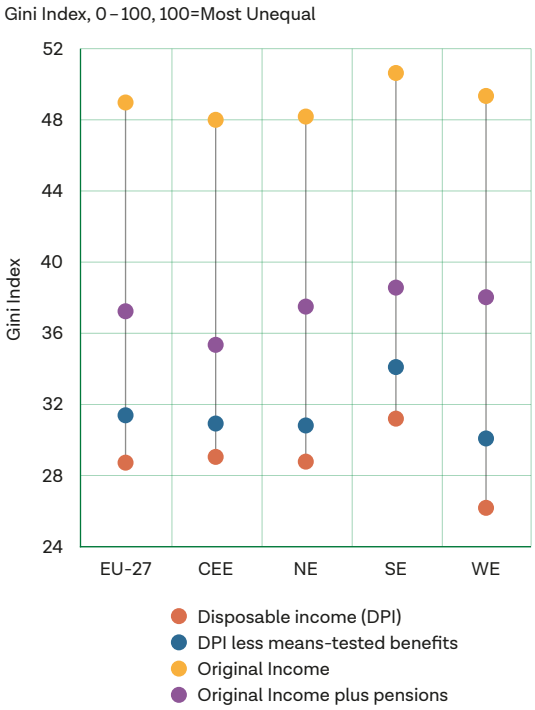


Figure 2.4 The role of benefits targeted towards the poor in reducing inequality is limited

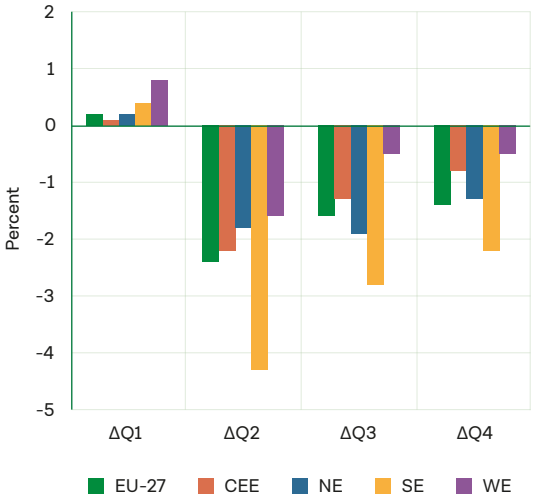


Source: EUROMOD version I2.0+, Baseline results from the EU28 EUROMOD: 2016 – 2019, Chatsiou et.al (2020)
Note: EUROMOD figures for 2016 – 2019 for all countries are based on SILC 2017 (2016 incomes).

Contraction in employment and the associated reduction in labor income was the main driver of rising poverty

Much of the impact of the crisis on poverty was transmitted through disruptions to the labor market brought about by stringent restrictions on movement and work. In the first wave of the crisis, many EU countries imposed national lockdowns, allowing only essential services to operate. This resulted in considerable disruption to economic activities, with some jobs and workers more severely impacted than others. The disruption caused by the COVID-19 crisis led to an increase of 0.1 and 1.6 percentage points in unemployment and inactivity in Q2 of 2020, respectively, however these indicators did not sufficiently capture the disruptions to work. The containment measures resulted in a substantial increase in absences in the first wave of the pandemic in Q2 of 2020 and to a lesser extent in the second wave in Q4 (Figure 2.5, Figure 2.6), largely due to an increase in temporary lay-offs and furloughs. The weaker impact on the labor market in Q4 is in line with relatively less stringent measures being imposed and adaptation on the part of businesses, workers and governments as the crisis progressed. There was also a decline in the weekly hours of work in 2020, but to a lower extent compared with the increase in absences.[6] The impact of the crisis on the labor market was also noticeable in the decline in employment in Q2 of 2020, though not as evident in Q4 of 2020. Despite the disruptions, the impact on labor incomes was mitigated, in part, by substantial government support packages as well as the rebound that occurred in Q3 of 2020.

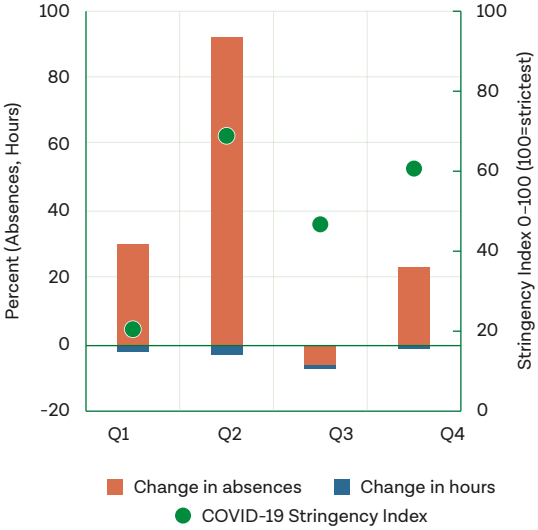
Figure 2.5 Employment declines were substantial in Q2 of 2020 — and most pronounced in Southern Europe



Note: Data excludes Germany due to an issue with the availability of quarterly data in 2020 Seasonally adjusted not calendar adjusted data

Source: Eurostat [lfsi_emp_q]

Figure 2.6 Absences increased substantially in Q2 of 2020 and to a lesser extent, hours of work



Source: Eurostat indicators [[lfsq_ewhan2]] and [lfsi_abs_q]. Authors' computations based on Oxford COVID-19 Government Response Tracker https://www.bsg.ox.ac.uk/research/research-projects/oxford-covid-19-government-response-tracker

With economies heavily reliant on tourism, Southern Europe experienced disproportionate effects of job losses. Whereas employers in all countries reacted to falling consumer demand through labor adjustments, the severity and intensity of the pandemic in Southern Europe necessitated the implementation of stricter restrictions on movement and work leading, to more severe impacts on the labor market. This was reflected in a contraction of 4.3 percent of the number of employed workers in Q2 of 2020 in Southern Europe, year-on-year — nearly double the rate of 2.4 percent in EU-27 (Figure 2.5). As noted

above, this can partially be attributed to the disruption to the summer tourism industry in Southern European countries which employed 8 percent of workers in 2019 compared with 4.6 percent in the EU-27. Though countries experienced a rebound in Q3 of 2020, the rebound was less pronounced in Southern European countries, and was swiftly followed by a second round of job losses in Q4 of 2020.

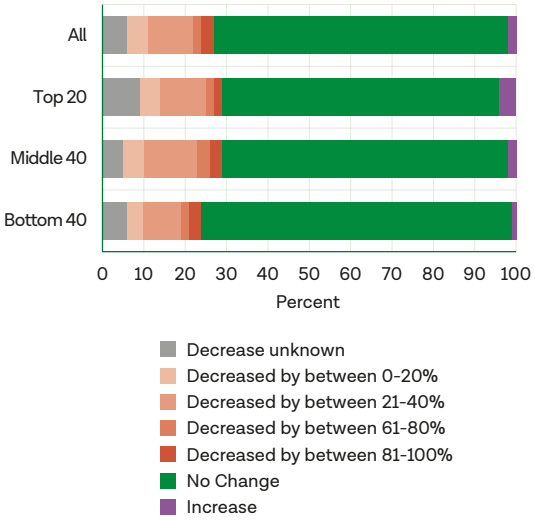
Labor market and service disruptions in key migrant destination countries led to a decline in remittances among some member states. Remittances serve as a key source of income for some households fulfilling consumption, investment and insurance needs. Remittances are often used to offset income declines due to macroeconomic shocks as they typically run countercyclical to the domestic economy. However, in the case of a common and synchronous external shock, such as COVID-19, the insurance mechanism becomes less reliable. According to balance of payments data, Croatia, Bulgaria, and Romania — three of the countries in the EU-27 with the highest proportion of remittance inflows as a proportion of GDP — saw real declines in remittance inflows of 1.5 percent, 72.5 percent, and 8.7 percent, respectively.

Labor market impacts and reduced remittances resulted in household income declines that permeated throughout the income distribution (Figure 2.7). Households in all income categories also reported increased difficulty making ends meet as compared with before the COVID-19 crisis, with disproportionately higher reports among households in the bottom 40 percent. Among those reporting declining incomes, reported drops were large: the most common drop ranged between 21 and 40 percent of household income.

As the crisis has progressed, a certain resilience has been visible — in part a reflection of responsive government policies but also related to adaptation of populations and firms to "new normal" conditions of interaction. At the time of the second wave of the crisis, fewer households reported declines to income, and more reported increases to income, as compared with the first wave (Figure 2.8). This is due in part to less stringent restrictions on movement and work at the time of the second wave and enhanced government support but also adaptation on the part of firms, through increased e-commerce, workers, through increased use of remote work, and governments, through the extension and expansion of government support programs, building upon experiences from the first wave of the crisis. However, not all households were able to achieve resilience, and marginalized communities faced substantially higher barriers (Box 2.1).

Figure 2.7 Households across the income distribution reported declines in income in Bulgaria

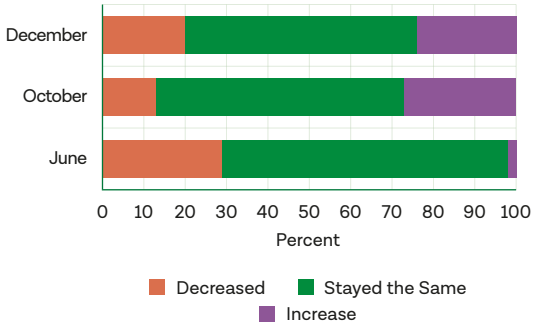
Households reporting income changes in June 2020



Source: COVID-19 Rapid Response Household Survey Bulgaria, The World Bank

Figure 2.8 Fewer households reported declines in income in the second wave of the crisis in Bulgaria

Households reporting income changes



Source: COVID-19 Rapid Response Household Survey Bulgaria, The World Bank

Box 2.1 COVID-19 impact on under-served communities, including the Roma communities

The severe restrictions on movement and work disproportionately impacted the Roma community along several dimensions. Evidence from a qualitative community-level pulse survey undertaken by the World Bank in Romania, along with data from the European Union Agency for Fundamental Rights (FRA), highlighted some of the disproportionate impacts of the COVID-19 crisis on the Roma.

The high level of Roma participation in the informal economy through self-employment, low-skilled blue collar work, seasonal work, and ad-hoc jobs left them susceptible to employment and income losses in the wake of the COVID-19 restrictions. Given the types of employment the Roma take up, they often operate without formal labor contracts, rendering members of the community ineligible for most forms of COVID-19 employment support. In Romania, return migrants and day laborers within the informal sector reported turning to the Guaranteed Minimum Income scheme and relying on child and family allowances, which were deemed inadequate to replace lost earnings. Given the disproportionate impact of the crisis on the types of employment the Roma engage in, the limited forms of support they received, and their tendency to have higher levels of unemployment and inactivity and lower levels of work intensity, a likely consequence of the COVID-19 pandemic is rising poverty and inequality along ethnic dimensions.

With limited access to IT equipment and a lack of digital skills, Roma children are likely to have been disproportionately disadvantaged by the transition to distance learning. In Romania, reports of inadequate access to electricity, overcrowding within the home, and a lack of technical literacy for parents to assist with assignments were cited as some additional barriers to remote learning. Though some efforts were made to alleviate these gaps, these often were uneven and determined by limitations of local budgets. With already high rates of early school leaving among the Roma, the COVID-19 crisis is likely to exacerbate the educational attainment divide between Roma and their non-Roma peers.

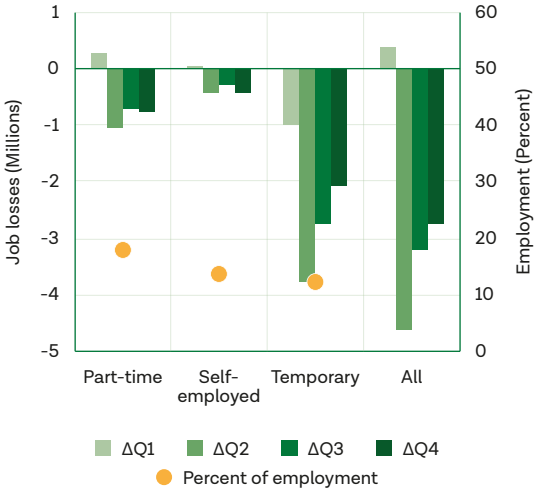
Poor housing conditions, high rates of overcrowding, and inadequate water and sanitation facilities among the Roma rendered them particularly susceptible to widespread transmission of COVID-19. Issues with overcrowding and strain on existing water and sanitation facilities were exacerbated by the return of many migrant workers to Central Europe (FRA, 2020). In Romania, almost half of the Roma live in overcrowded housing; 68 percent live in households without tap water inside the dwelling; and 78 percent live in dwellings without toilets, showers or bathrooms inside (FRA, 2016). Though there were reports of some efforts made to improve water and sanitation in Roma communities, these efforts were uneven and often deemed inadequate. Potential greater susceptibility to COVID-19 was compounded by a pre-existing lack of access to and usage of healthcare services, delaying the early detection of COVID-19 symptoms and running the risk of overloading healthcare services. While efforts were made to expand access to healthcare through the delivery of medication and access to telemedicine, these services were sometimes limited to those with health insurance coverage and often depended on the ability to systematically identify vulnerable individuals in the community.

The crisis disproportionately impacted already vulnerable workers

Within countries, employment impacts were unevenly felt — already vulnerable workers including youth, women, self-employed, low-wage workers, low-skilled workers, and those on non-standard contracts — experienced more severe impacts. Workers on temporary contracts bore the brunt of employment adjustments, accounting for over 80 percent of employment declines in Q2 of 2020 and over three-quarters in Q4 of 2020 (Figure 2.9). Firms had few incentives to keep temporary workers onboard as they often did not qualify for wage subsidy schemes, hence retaining them would come at a significant cost to the firm, particularly in the context of the relative ease with which and these employment types can be fired and rehired. Self-employed workers bore the brunt of the adjustment along the intensive margin reporting the largest decrease in hours worked (Figure 2.10) during both waves of the crisis. However, the wider impact on the labor market is likely to be tempered by the relatively small

proportion of self-employed workers in the labor force. Analysis in the previous RER noted that labor market restrictions that limit movement and societal functions were disproportionally affecting workers already considered to be economically vulnerable, resulting in a higher incidence of work stoppages. This was reflected in lower-wage workers, those with non-standard and less-secure contract types, those in low-skilled occupations (Figure 2.11) and younger segments of the labor force (Figure 2.12) disproportionately experiencing declines in employment. This earlier projection is consistent with data from the rapid response surveys that show work disruptions persisting among these employment types during the second wave of the crisis despite less stringent restrictions being in place (Figure 2.13).

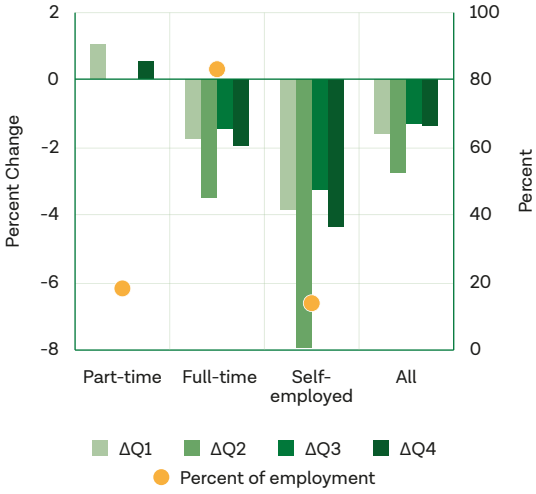
Figure 2.9 Temporary workers bore the brunt of employment adjustments



Note: Data excludes Germany due to the availability of quarterly data in 2020. Seasonally adjusted not calendar adjusted data

Source: Eurostat [lfsq_egaed]

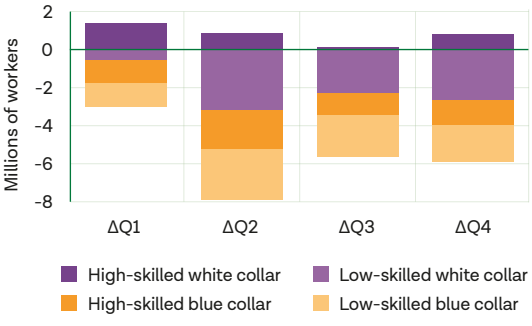
Figure 2.10 Self-employed workers reported the greatest decline in hours worked



Note: Data excludes Germany due to the availability of quarterly data in 2020. Seasonally adjusted not calendar adjusted data

Source: Eurostat [lfsq_ewhan2]

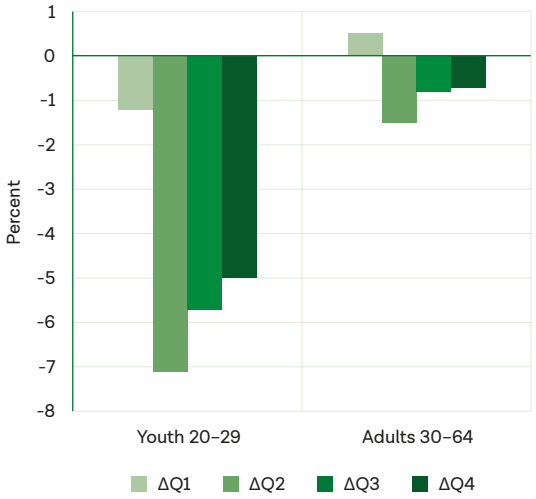
Figure 2.11 Low-skilled workers bore the brunt of employment adjustments



Note: high skilled white collar (ISCO codes 1,2 and 3) includes legislators, senior officials and managers, professionals and technicians and associate professionals; low skilled white collar (ISCO codes 4 and 5) includes clerks and service workers and shop and market sales workers; high skilled blue collar (ISCO codes 6 and 7) includes skilled agricultural and fishery workers and craft and related trades workers; low skilled (ISCO codes 8 and 9) includes plant and machine operators and assemblers and elementary occupations. Data excludes Germany due to the availability of quarterly data in 2020.

Source: Eurostat [lfsq_egais]

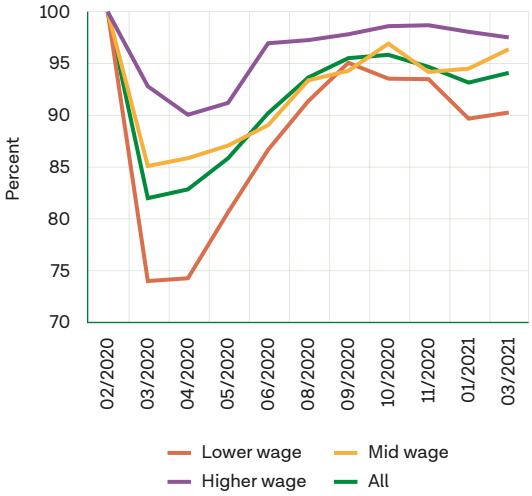
Figure 2.12 Youth disproportionately reported employment losses



Note: Data excludes Germany due to the availability of quarterly data in 2020.

Source: Eurostat [lfsq_egais], [lfsq_egaed]

Figure 2.13 Lower-wage workers were less able to continue work at all points in the pandemic

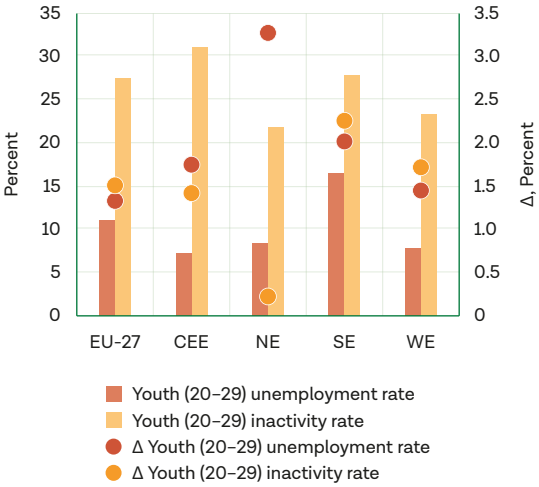


Source: COVID-19 Rapid Response Survey in Romania, The World Bank

The impact of the crisis on these employment groups was exacerbated by lower levels of coverage by government support schemes. Workers on temporary contracts — which tend to overwhelmingly be held by young people — were often excluded from government wage support schemes and typically do not qualify for unemployment insurance due to the stringent qualifying requirements. Self-employed workers were also less likely to be covered in job retention schemes and tended to receive less consistent and less generous forms of support when covered by alternate schemes. Self-employed workers are often not beneficiaries of unemployment insurance schemes with few countries mandating coverage. Informal workers who are often unable to provide proof of employment were excluded from government support schemes and similarly do not qualify for unemployment insurance.

The impact of the crisis on youth merits special attention given the potential for long-term scarring effects if not appropriately managed. Youth disproportionately experienced employment declines during the adjustment periods of the crisis with a contraction of 7.1 percent during Q2 of the crisis compared with 1.5 percent among older populations (Figure 2.12). The disproportionate adjustment borne by youth is likely due to their tendency to be employed in non-standard employment types, particularly temporary employment, and in sectors and occupations hardest hit by the crisis. Declines in youth employment gave way to increased youth inactivity and increased youth unemployment (Figure 2.14). Southern European countries, which had the largest rates of youth inactivity prior to the crisis in 2019, recorded the largest increase in youth inactivity in 2020. Youth seeking to (re)-enter the labor market in a recession can potentially face a persistent wage penalty lasting over a decade (Kahn, 2006; Oreopulous, Watcher and Heisz, 2006) due to underemployment and its associated persistence through signaling effects. Youth attempting to transition out of unemployment may find it difficult to do so in a slack labor market and it has also been shown that there are potential scarring effects to unemployment whereby the experience of unemployment increases the likelihood of future unemployment and/or reduced future earnings due to human capital effects and signaling effects (Scarpetta, Sonnet and Manfredi, 2010).

Figure 2.14 Increases in youth inactivity was highest in the Southern Europe



Source: Eurostat [lfsa_ugan] [lfsa_agaed]

The nature of work of some jobs did not support resilience, particularly among those jobs that were not amenable to remote work. Analysis in the sixth RER estimated that one out of eight jobs would continue to be at risk of employment and income losses as countries emerged from the lockdown phase given the degree of face-to-face interaction required to perform tasks. Women were projected to face a greater risk

of not resuming work, with one in five women considered to face difficulty returning to work compared to one in ten men. This was largely due to occupational segregation, with women more likely to be in jobs not amenable for remote work. The "true" proportion of women who will face difficulty returning to work is likely higher, given the difficulties in balancing work with the additional care responsibilities brought on by the COVID-19 crisis (Box 2.2).

Box 2.2 Impact of the COVID-19 pandemic on women

Women were disproportionately impacted by work disruptions during the pandemic. Women experienced a greater decline in the index of total hours worked — which accounts for declines both due to temporary absences and decreases in hours worked for those who continued to work. The index declined by 15.8 percent for women in Q2 of 2020 compared with 14.6 percent among men. Much of this decline can be attributed to a higher share of absences among employed women (21.4 percent) compared with employed men (16.7 percent).

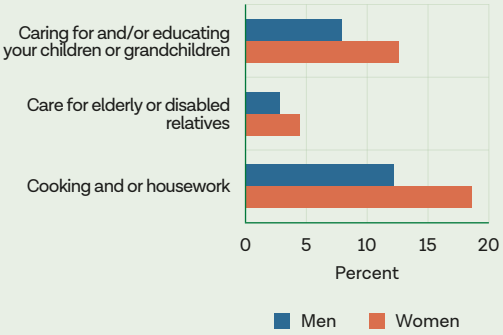
Women are overrepresented, both among essential workers and in the sectors hardest hit by the crisis. The high proportion of women in essential sectors such as health services (76 percent) and education (73 percent) afforded them some level of job security. However, women were also overrepresented in some of the hardest hit sectors, such as food services (61 percent), retail trade, except motor vehicles and motorcycles (63 percent) and accommodation (61 percent).

The overrepresentation of women in frontline occupations left them at risk of contracting COVID-19 adding to the stress of an already challenging work environment. Women are overrepresented in the health and human services and the residential care sectors, and accounted for 75 percent and 81 percent of employment, respectively, in 2019. The high degree of inter-personal contact required to perform these tasks left women at a disproportionately higher risk of contracting COVID-19. Additionally, the increased demands put upon health and care workers to cope with the pandemic could have resulted in declines in mental and physical health among women, exacerbated by challenges in coping with increased care responsibilities at home.

Women disproportionately shouldered the increased burden of care responsibilities brought on by the crisis. Prior to the COVID-19 crisis, women were already undertaking the bulk of care responsibilities in most countries. With the increase in demand for care responsibilities brought on by the closure of schools and increased incidence of teleworking, women reported shouldering more of the increased responsibilities (Figure B2.2.1).

The COVID-19 pandemic also led to increased reports of gender-based violence. An unintended and unfortunate consequence of the severe lockdowns and restrictions on movement was a rise in the instances of gender-based violence. Several countries reported a surge in the reports of domestic violence around the timing of the first lockdown.

Figure B2.2.1 Women shouldered more of the increased care responsibilities brought on by COVID-19



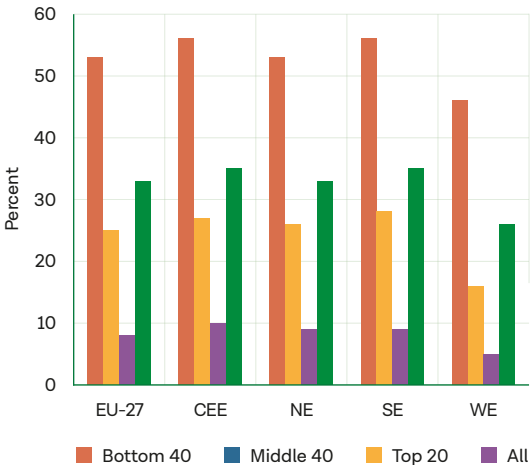
Source: Eurofound (2020), Living, working and COVID-19 dataset, Dublin, http://eurofound.link/covid19data

Deterioration of household income leading to worsening financial vulnerability and economic distress

In line with deteriorating incomes, households have shown signs of economic stress, particularly among income groups that suffered higher financial vulnerability prior to the COVID-19 crisis. The ability of low and middle-income households to face unexpected financial expenses was impaired prior to the COVID-19 crisis, particularly among households in Southern and Central European countries (Figure 2.15). Consequently, these same income groups disproportionately reported higher levels of economic stress owing to the impacts of the COVID-19 crisis on household finances (Figure 2.16).

Figure 2.15 Low and middle-income households were showing signs of financial distress prior to the COVID-19 crisis

Households reporting an inability to face unexpected financial expenses

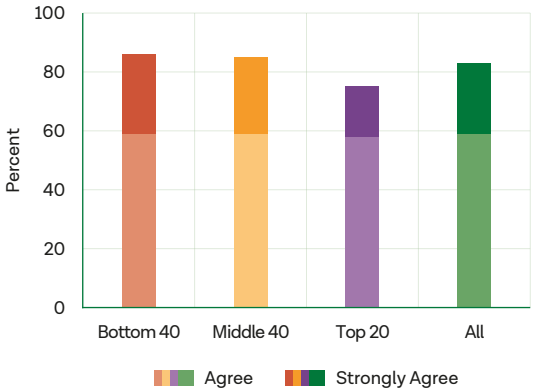


Note: Data is from income year 2018

Source: Author's computations based on EU-SILC

Figure 2.16 Reports of economic stress were highest among low and middle-income households

Households reporting economic stress

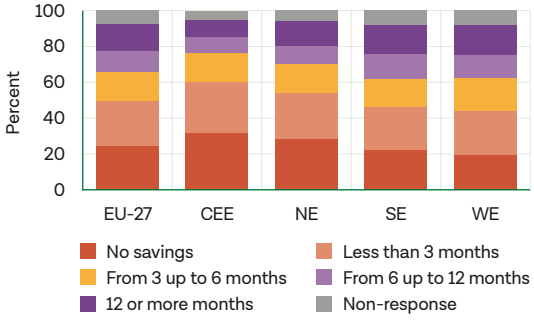


Note: Rapid Household Surveys conducted in June 2020. The question was asked as "I am worried about the economic well-being of myself or my family members" and was part of a module geared at assessing concerns that the head of household or adult respondent may have regarding COVID-19.

Source: COVID-19 Rapid Response Household Survey Croatia, The World Bank

Moreover, limited savings compromised the ability of vulnerable households to cope with the impact of the crisis, particularly among Central European households. When faced with a shock, households typically resort to savings or borrowings to smooth consumption. Given that COVID-19 was a symmetric and synchronous shock, all households were impacted at the same time and many of the vulnerable households have comparatively lower levels of financial access. These factors limited the ability of vulnerable households to cope with the economic fallouts of the pandemic. A relatively high proportion — around 60 percent — of households in Central Europe reported less than 3 months or no savings to deal with the impact of the crisis in June/July 2020 (Figure 2.17).

Figure 2.17 The proportion of households reporting adequate savings was lowest in Central European



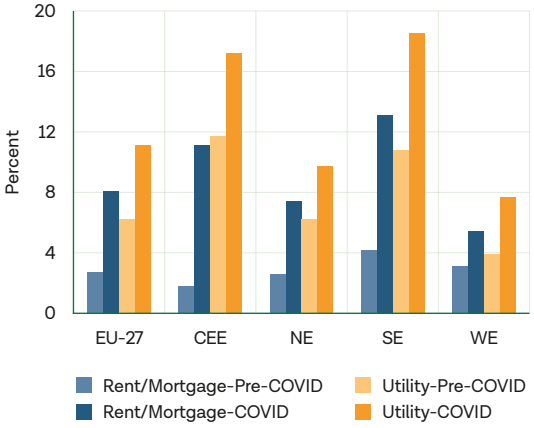
Note: Low reliability (*): Cyprus, Latvia, Luxembourg, Malta and Poland.

Source : Eurofound (2020), Living, working and COVID-19 dataset, Dublin, http://eurofound.link/covid19data

These findings corroborate with data from the COVID-19 rapid response surveys in selected Central European countries, which showed a limited amount of savings to deal with the impact of the COVID-19 crisis, especially for households towards the lower end of the income distribution. Limited ability to cope with the fallout of the crisis could have potential implications on human capital accumulation among the vulnerable households, impairing the progress on convergence within countries.

Furthermore, the proportion of households reporting arrears rose compared with pre-crisis levels, particularly among households in Southern and Central Europe (Figure 2.18)[7]. The financial situation of households deteriorated as the crisis endured and economic reserves were depleted, resulting in increased defaults on obligations. These defaults are likely to have implications for the financial sector, especially in countries that have a high share of consumer loans in the overall portfolio. In addition, the proportion of households in arrears is likely to rise further when government support measures are phased out and moratoria are unwound which, if not managed appropriately, could prolong the recovery process for vulnerable households.

Figure 2.18 The proportion of households reporting arrears was highest in Central and Southern European countries



Note: Low reliability (*): Cyprus, Latvia, Luxembourg, Malta and Poland.

Source : Eurofound (2020), Living, working and COVID-19 dataset, Dublin, http://eurofound.link/covid19data Eurostat [ilc_mdes06], [ilc_mdes07]

Higher levels of economic sentiment give cautious optimism about an emerging recovery. Off the back of vaccine rollouts and the relaxation of some restrictions, the economic sentiment index has continued the trend of increase observed since January 2021, surpassing pre-pandemic levels in February 2020. Increased optimism among consumers and firms has led to a steady increase in the sentiment index in 2021. Despite these indicators trending in the right direction, restrained purchases among consumers owing to financial losses and concerns about future economic security will likely temper the pace of recovery.

A careful transition of government support and inclusive growth policies is needed going forward

Governments across Europe sought to incentivize employers to retain workers, mainly through job retention schemes. As reduced business revenue led to falling profits, governments around Europe stepped in to offer wage support to businesses to reduce labor costs in order to facilitate employee retention. The design of programs varied substantially across countries, including for example short-term work schemes (where only hours not worked are subsidized) and wage subsidy schemes (hours worked and not worked can be subsidized). There was also variation in the proportion of wages the government covered, however, most schemes had requirements of employee retention as conditions to receiving the support.

As the crisis endured, governments adjusted the coverage, generosity and scope of their assistance packages. As it became increasingly clear that the crisis would be prolonged and that workers and households would need additional support, governments revised their assistance packages. Amendments included increasing the duration and generosity of support to workers, including previously excluded

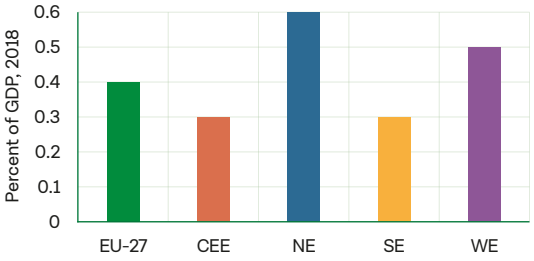
workers such as self-employed workers in alternate income support schemes, expanding and waiving qualification requirements for unemployment benefit schemes, extending and expanding support for parents and caregivers, increasing cash and in-kind support to vulnerable populations such as the elderly, homeless and those with disabilities, and expanding moratoria provisions.

However, few governments adjusted guaranteed minimum benefit schemes, leading to gaps in coverage among some categories of vulnerable workers and households. In the absence of coverage or inadequate coverage by wage support schemes, unemployment benefit schemes and other such schemes tied to full-time formal employment, it is likely that informal and non-standard workers resorted to the Guaranteed Minimum Benefit (GMB) schemes to supplement shortfalls to income. However, most GMB schemes were not adjusted in response to the COVID-19 shock and some suffered from pre-existing deficiencies, rendering the GMB an inadequate coping mechanism. There were also reports in Romania of households, particularly the Roma, relying on continued access to the child and family allowance benefits as their sole source of income as remittances and informal work had dried up (Box 2.1). As the schemes were not intended to be income replacement schemes, they are likely inadequate in supporting households who have experienced substantial shocks to income.

With the crisis still unfolding and impacts being felt, in the short-term, governments support schemes will remain essential to bolstering the resilience of households and workers. Given the longevity of the crisis and the impact on vulnerable households and workers, most governments have opted to extend the duration of support to mid-late 2021, with some adjustments to targeting. This guarantee of support will help to bolster the resilience in the short-term, but as government support is eventually unwound and moratoria are lifted, the transition to more regular forms of support will have to be carefully managed to minimize the long-term effects of the crisis.

To ensure recovery is inclusive, targeted active labor market policies (ALMPS) will be needed to support vulnerable workers. In the medium-term governments will need to pivot to implementing policies to facilitate recovery in the labor market through the use of active labor market policies targeted to unemployed and inactive workers. Special attention should be given to already vulnerable workers such as youth, the self-employed, the informally employed, those on non-standard contracts, who were more likely to face employment adjustments during the crisis and tend to traditionally have long spells of unemployment and or durations outside the labor force. These measures will be particularly important in Southern and Central Europe, which was harder hit by the crisis but showcased lower expenditure on labor market policies before the pandemic (Figure 2.19).

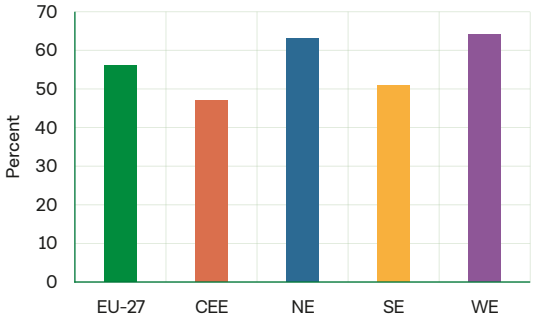
Figure 2.19 Expenditure on Active Labor Market Policies is lowest in Southern and Central European countries



Note: Total expenditure on LMP measures (categories 2 – 7), which covers activation measures for the unemployed and other target groups including the categories of training, job rotation and job sharing, employment incentives, supported employment and rehabilitation, direct job creation, and start-up incentives. Due to data limitations, data for the EU-27 is from 2011, data from Italy is from 2015.

Source: European Commission — Directorate-General for Employment, Social Affairs and Inclusion (DG EMPL) [lmp_expsumm]

Figure 2.20 Southern and Central European countries have the lowest level of digital skill competencies



Source: Eurostat [isoc_sk_dskl_i]

The generosity of the GMB schemes could be temporarily increased whilst strengthening the activation components. A temporary increase in the GMB could provide adequate support to individuals excluded or inadequately covered by other income support schemes who experienced substantial shortfalls to income. Further adjustments to the GMB scheme should be made depending on the status of the economy and the labor market. Further strengthening the activation component of GMB schemes with an increased focus on ALMPs would assist with the labor market recovery and also release fiscal pressure on an already stretched government resources.

Although the crisis has brought its challenges, it has also provided opportunities to pivot towards more sustainable growth with a renewed focus on fostering resilience and cohesion

Active labor market policies for worker reskilling and skill upgrading will be paramount to ensure segments of the population are not left behind as the countries embark upon their green and digital transitions. In the medium-term, governments should also ensure the labor market is well-equipped to take advantage of the accelerated process of digitization and the shift towards a green recovery brought on by the COVID-19 pandemic through facilitating the re- and up-skilling of the labor force through expenditures on ALMPs.

Digital skills are increasingly in demand in the workplace, with most jobs requiring basic digital skills as a pre-requisite qualification. Before the crisis, Southern and Central European countries were characterized by low levels of digital skill competencies in the current and potential workforce (Figure 36). Now, with the acceleration of digitization brought on by the COVID-19 pandemic, these regions risk getting left further behind unless substantial investments are made to equip the current and future workforce with the requisite digital skills.

As countries embark upon decarbonization in line with the goals of the European Green Deal, there will necessarily be labor market adjustments as countries transition away from coal-intensive sectors. The transition towards greener economies will require substantial re- and up-skilling of workers through expenditures on ALMPs in order to minimize the adjustment costs of these transitions. Appropriately managed transitions are especially important for Central European countries which tend to have higher levels of direct and indirect employment in coal-related activities (JRC, 2018)[8].

Longer-term resilience hinges on strengthening the coverage of self-employed and those on non-standard contracts in addition to strengthening the adequacy and coverage of social assistance systems in order to increase resilience to shocks for vulnerable households and workers. In most countries in Europe, there is no mandatory unemployment insurance for the self-employed. Though in theory many countries have unemployment protection for part-time and temporary workers, the onerous qualification requirements often preclude these employment types from accessing benefits in practice. In some countries, social assistance systems tend to be characterized by issues with coverage and adequacy, limiting their efficacy in insulating vulnerable households from shocks. The COVID-19 crisis has highlighted the vulnerability of these employment and household types to shocks and underscored the need to ensure social protection systems provide adequate insulation against shocks.

Notes

[1] Expected impacts on poverty during the crisis are sensitive to whether using a relative measure — such as the at-risk-of-poverty rate, where the poverty line is updated yearly with shifts in median income — or an absolute measure, such as the anchored at risk of poverty concept where the poverty line is anchored at a fixed moment in time. People at risk of poverty (AROP) have an equivalized disposable income below the risk-of-poverty threshold, which is set at 60% of the national median equivalised disposable income (after social transfers). The estimates produced in this piece use an absolute measure, the anchored at risk of poverty concept with lines anchored to their 2016 level. EC (2021), drawing from Christl et al (2021), use simulations to assess the shift in market and disposable incomes during 2020, drawing upon EUROMOD. These estimates suggest a small decline in the share of the population in the EU using the relative at risk of poverty concept, partly reflecting declines in poverty lines that are benchmarked against updated median income. However, when using an anchored at risk of poverty concept with lines held fixed to 2019 values — as used in this analysis — these simulations show an increase in the share of the population at risk of poverty in 24 member states, from an average of 16.3 percent to 16.6 percent. Earlier estimates using anchored at risk of poverty concepts suggested an increase in absolute at risk of poverty measures of 1.7 percentage points (Almeida et al. 2020).

[2] Poverty is measured using the anchored at-risk-of-poverty concept, that is the proportion of individuals with equivalized disposable income after social transfers below 60% of the national median income anchored in 2016 income year. Poverty projections are computed using pass-throughs from output projections to household income where the pass-through is constructed based on historical correlations between GDP per capita growth and household income. The lower-bound projections assume full pass-through between GDP per capita growth and household income in positive periods of growth and a 50 percent pass-through between GDP per capita growth and household income in negative periods of growth. The upper-bound projections assume full pass-through between GDP per capita growth and household income in positive periods of growth and a 70 percent pass-through between GDP per capita growth and household income in negative periods of growth.

[3] The experimental approach used estimates a concept of transitory poverty, notably the share of the population whose monthly income would place them at-risk-of-poverty, where the at-risk-of-poverty line is anchored in 2018 levels and normalized to reflect differences in income aggregates captured using the high-frequency survey data. This approach differs from traditional at risk of poverty measurement that uses annual incomes as the base of the measure.

[4] Rapid Response surveys were fielded in Bulgaria, Croatia, Poland and Romania at various points during the crisis to gauge the impact on households as the crisis progressed. Though the raw data are not publicly available, data on select indicators are accessible through the COVID-19 Household Monitoring Dashboard https://www.worldbank.org/en/data/interactive/2020/11/11/covid-19-high-frequency-monitoring-dashboard

[5] World Bank (2020): "Restarting Resilience: The Impacts of the COVID-19 pandemic on Inclusion in Europe". EU Regular Economic Report 6. Washington D.C.: The World Bank.

[6] Absences refers both to the planned, desired absences (e.g. annual holidays, leave) and on the other side, the unplanned, undesired absences (e.g. illnesses, lay-offs) (Eurostat). Individuals who are temporarily laid off or furloughed due to COVID-19 measures would be captured in layoffs. Hours refers to the actual weekly hours worked by employed individuals who reported working hours of one hour and more in the reference week and therefore excludes individuals temporarily absent from work and/or temporarily laid off.

[7] The question refers to arrears in the preceding 3 months.

[8] "EU coal regions: opportunities and challenges ahead", JRC Science for Policy Report (2018)

Annex 1
Methodology for the collection of COVID-19 Rapid Response Survey data

The World Bank is undertaking high-frequency phone surveys in Bulgaria, Croatia, Poland, and Romania, in collaboration with respective government agencies engaged in the monitoring of the impact of COVID-19. These surveys monitor the potential negative effects of the pandemic on households. The surveys are designed to be nationally representative and are conducted using Computer Assisted Telephone Interviewing (CATI). In order to gauge the impact of the crisis at different points of time during the pandemic, the surveys were repeated at regular intervals according to the schedule outlined in the table below. Future rounds of surveys are being planned in all four countries.

Table A1.1 Schedule of COVID-19 Rapid Response Surveys

	Sample Size	Wave 1	Wave 2	Wave 3	Wave 4	Wave 5	Wave 6
Bulgaria	1500 households	June 2020	October 2020	December 2020/January 2021	March/April 2021	June 2021	
Croatia	1500 households	June 2020	December 2020	March 2021	June 2021		
Poland	1500 households	May 2020	July 2020	May 2021			
Romania	1500 households (Wave 1, 3, 5) 2240 households (Wave 2, 4, 6)	May 2020	July/August 2020	October/ November 2020	December 2020/January 2021	February/ March 2021	May/June 2021

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