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The risks of exiting too early the policy responses to the COVID-19 recession

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The risks of exiting too early the policy responses to the COVID-19 recession [1]

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Abstract: This policy brief warns about the risks of discontinuing the policy responses to the COVID-19 crisis by pursuing exit strategies *too early and/or too sharply*. It outlines a comprehensive strategy for limiting such risks globally and offers an in-depth discussion of the European situation. Due to fiscal rules written in a pre- COVID-19 era and excessive emphasis on controlling public debt ratios, the Euro Area could be left with long-lasting scars, so its situation requires special treatment. Therefore, we articulate some policy proposals designed to preserve and strengthen the recovery in the EMU.

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1. The challenge

Since March 2020, a global recession, triggered by the public and private sector responses to the COVID-19 pandemic (Caselli et al. 2020), has shaken the global economy interrupting the expansion in most G-20 countries ongoing since the end of the 2007-2009 financial crisis. The COVID-19 turmoil is likely to induce persistent demand- and supply-side effects.

On the one hand, slack of demand might be a persistent legacy of the crisis. In line with evidence presented in Jordà et al. (2020) about the effects of pandemics in the past, the COVID-19 pandemic could be followed by a prolonged period of lower-than-expected real rates of return. This could be due to an increase in precautionary savings driven by higher unemployment risk[3] and the perception that pandemics might be a recurring phenomenon in the future. The COVID-19 pandemic also falls in the category of deep recessions that have long-lasting adverse effects on risk attitudes (Malmandier and Nadler, 2011; Giuliano and Spilimbergo, 2014).

On the other hand, there is no doubt that social distancing has accelerated digitalization, raising the share of e-commerce and inducing a change in business models, especially in the services industry. This change, in turn, is likely to stimulate sectoral reallocation of resources and a potentially painful reorganization of those metropolitan areas that were the catalyst of growth in the pre-COVID-19 era.

Furthermore, many firms are likely to remain under financial distress. The usual controversy has arisen about zombie firms' emergence due to the widespread use of state guarantees during the recession. The standard argument is that excessively generous state support artificially reduced the exit of unproductive firms and prevented Schumpeterian creative destruction.

Key policy questions concern the exit strategies from exceptional fiscal, monetary and regulatory policies. Based on a careful assessment of potential tradeoffs between supporting adequate demand levels and preserving microeconomic efficiency, this policy brief warns about the risks of discontinuing the efforts so far undertaken by pursuing exit strategies too early and/or too sharply. It outlines a coherent strategy for limiting such risks.

Another fundamental challenge concerns the unevenness of global recovery. So far, the policy response to the COVID-19 shock has been mainly concentrated in the G-20 because many developing countries lacked the necessary fiscal space (UN, 2021). Therefore, it is critical that G-20 countries' coordinated actions maintain the required stimulus to support a global recovery.

[3] Campos and Reggio (2015) provide evidence on the relationship between unemployment risk and precautionary savings.

At the time of writing, both the US and China are set on a path to steady recovery. By contrast, the lagging vaccination campaign and the third pandemic wave raise severe concerns for recovery in the EU. In our view, the Euro Area could fall into a slow recovery trap, so its situation requires special treatment. We, therefore, articulate some policy proposals specifically designed to preserve and strengthen the recovery in the EMU.

2. The policy proposals

The prominent role of macroeconomic policies adopted in response to the COVID-19 pandemic warns against a quick reversal of the emergency measures undertaken by governments, regulators, and central banks. In our view, it is of the utmost importance that monetary and fiscal policymakers set a macro-prudential framework geared to limit uncertainty and precautionary attitudes. Letting "creative destruction" work its course in the aftermath of the COVID-19 pandemic would kill not only declining firms but also profitable and growing enterprises, which would be "strangled" by an exogenous, persistent, yet temporary contraction in demand. Empirical evidence confirms that reallocation raises unemployment if it occurs during a period of generalized slack in activity (Chodorow-Reich and Wieland, 2020). Similarly, a premature liberalization of layoffs, i.e., one occurring before aggregate demand recovers, would generate cumulative depressing effects on aggregate demand. If the exceptional policies implemented to limit bankruptcies and workers layoffs were hastened, one could also expect a further depressing impact on economic activity.

The recently approved Biden plan is consistent with this approach. Critics of the program essentially rely on the view that U.S. consumers' demand would endogenously rebound and absorb the forced savings accumulated during the pandemic so that the fiscal stimulus might eventually lead to a resurgence of inflation. We disagree with this view because these excess savings are unlikely to unleash pent-up demand for services due to inertia in precautionary savings and preference for consumption smoothing (Bilbiie et al., 2021). Private savings may also be instrumental for private sector deleveraging in countries like the USA, where private sector indebtedness has reached high levels. Furthermore, a successful one-off demand stimulus might lead to a one-off increase in the price level instead of a permanent increase in inflation expectations. The FED rejected concerns about overdoing stimulus (Powell, 2021) and confirmed its Flexible Average Inflation Targeting Approach (FAIT). The strong fiscal stimulus and the FED's accommodation may be seen as buying insurance against a ZLB scenario.

Macroprudential and regulatory policies must be designed to deal with the potential resurgence of non-performing loans (NPLs). Preliminary evidence suggests that the phenomenon so far has been relatively limited (Cros et al. 2021). In our view, the task of regulatory and supervisory agencies should be more straightforward now than in the aftermath of the GFC. The COVID-19 pandemic was a truly exogenous shock. A detailed business model analysis should allow separating firms whose sector is likely to recover back to normal from firms already under stress in 2019. This approach could not be adopted at the time of the GFC. That crisis was primarily triggered by a real estate boom that was both cause and effect of massive credit misallocation. There is an important caveat here because this argument fully applies only to the extent that the world goes back to pre-pandemic normal; however, the COVID-19 shock might be a game-changer for the consumption of certain services (Hodbod et al., 2020).

In virtually all countries, the fiscal stimulus has taken the form of targeted transfers to support those most severely affected by the pandemic. Policymakers should implement a change in the budgetary mix, where targeted transfers are reduced, but the fiscal stance remains expansionary until the slack is absorbed. In this regard, one can imagine forms of fiscal support to displaced workers as restrictions to layoffs are gradually lifted. In the longer term, policymakers should strengthen the fiscal safety net (e.g., unemployment benefits support to the working poor…)[4] to counteract precautionary attitudes generated by the pandemic-induced recession.

In the EU, the vaccination campaign has accelerated over the last few months. Still, substantial risks remain because anti-vaccine attitudes remain strong in a relatively large share of the population, and governments are bracing for a new immunization campaign. Besides, as national recovery plans are approved, it is now clear that requests for European loans fall short of the limits set by the EU Commission. The EU fiscal stimulus might therefore turn out to be weaker than expected. Due to budgetary rules written in a pre-COVID-19 era and excessive emphasis on controlling public debt ratios, the Euro Area could be left with long-lasting scars, so its situation requires special treatment. We recommend for the Euro Area an exit strategy based on the following points.

2.1. Monetary policy should remain expansionary for an extended period. In its recent monetary policy strategy review (concluded in July 2021), the ECB clarified its interpretation of the price stability mandate and the role of asset purchases. Regarding price stability, the ECB moved to a

[4] According to World Bank estimates, the recovery phase will be characterized by a severe and persistent increase in poverty (Lakner et al., 2021).

symmetric inflation target of around 2% (measured by the HICP) and clarified that it sees as equally undesirable outcomes both above and below the target. The ECB's clarification about its inflation target may seem minor; however, it could encompass a kind of average inflation targeting strategy (AIT) at least until the Euro Area reversed the historically accumulated deviation of the price level from the 2% growth path target (see Figure 1).[5] Regarding the asset purchases, the ECB reaffirmed the importance of the debt securities portfolios held by the Eurosystem in the strategy review. Asset purchases are to remain an integral part of the monetary policy implementation toolkit of the ECB, at least as long as the Euro Area economy is close to the zero lower bound. The QE policies pursued since 2015, coupled with the policy of reinvesting maturing debt and interest income, turned the Eurosystem into a significant player in European sovereign debt markets. From such a position, the ECB should steer the "risk-free" Euro Area yield curve (German) and influence the spreads of other Euro Area yield curves *vis-à-vis* the "risk-free" curve. Asset purchases allow the pursuit of the financial stability mandate, besides "lubricating" the transmission mechanism of monetary policy. The ECB has explicitly acknowledged this in its strategy review. There is evidence that QE has played an essential role in restoring growth in the Euro area since 2015.[6] It is likely that the pandemic emergency purchase program (PEPP), which started in March 2020, also contributed to containing the GDP contraction (Morana, 2021). The ECB de facto facilitated debt relief by buying large quantities of sovereign bonds in the secondary markets (see Figure 3) and has announced a policy of maintaining an unchanged stock of government bonds on its balance sheet at least until 2023. This relatively short-term policy horizon might become a self-defeating policy. High-debt countries could be exposed to substantial rollover risk, and concerns for the sustainability of their debt could trigger a new sovereign bond crisis. Thus, the ECB should extend the commitment to keep government bonds on its balance sheet well beyond 2023. The exact timing should prevent the taper tantrum that caused the 2013 surge in U.S. Treasury yields. In principle, the ECB might even consider asymmetric tapering actions on holdings of national bonds.

2.2. Banking supervisory and regulatory policies should contribute to avoiding an abrupt deleveraging process. Regulatory forbearance, loan moratoria, and public guarantees contributed to maintaining the flow of bank credit to SMEs and other corporates during the pandemic (ESRB

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[5] Busetti et al. (2021) forcefully argue that price level targeting is the most effective strategy in terms of stabilizing inflation and output and of reducing the duration and frequency of interest rate effective lower bound episodes.

[6] An extensive literature exists on the effects of QE policies. See, among others, Rodnyansky and Darmouni (2017), Di Maggio et al. (2020), Dedola et al. (2021), Koijen, et al. (2021).

2021 a). The gradual withdrawal of the exceptional measures requires close cooperation between the banking sector and the authorities to prevent massive bankruptcies (ESRB 20121 b). In this respect, banks should identify businesses likely to remain viable after the pandemic and what is needed for those borrowers to remain liquid and solvent. Viability-enhancing measures as debt restructurings, equity participation, and mergers should be evaluated in the context of 2021-22 European Banking Authority (EBA) stress-testing and Single Supervisory Mechanism (SSM) exercises. This notwithstanding, NPLs are likely to increase even if support measures are phased out smoothly. The EU needs a strategy for dealing with this problem which could involve the creation of European AMCs (asset management companies) outside the scope of the current EU directive, which considers their creation as one tool for the resolution of an individual bank and requires "bailing-in" private creditors. In our view, this is not the most appropriate framework for dealing with, or preventing, a systemic crisis.

Moreover, the ESM's non-taped pandemic funds could contribute to a new strategy for bank's recapitalization and support for the establishment of AMCs with the view of achieving quick disposal of NPLs. Accountancy rules could accommodate the exceptional situation by delaying the reclassification of loans for expected loss provisioning for another year or so.

2.3. Fiscal policies. Euro Area governments should convince markets they will undertake the steps necessary to prevent the conflicts that led to the sovereign bond crisis. A new phase of sovereign debt instability and austerity policies would then likely exercise similar and probably even more adverse effects, unduly postponing the recovery and triggering a prolonged phase of financial and political instability in Europe. Therefore, we articulate here two specific suggestions. **Our first proposal** is that fiscal policies should remain stimulatory until GDP has reached its pre-pandemic growth path. Thus, it will be necessary for the European Commission to maintain its waiver on applying SGP rules. This proposal should not raise concerns for highly indebted countries. COVID19-induced debt bears extraordinary favorable real interest rates for the years to come. Under a recovery scenario of nominal GDP growth at a 2-3% annual rate, this extra debt as a percent of GDP will tend to decline every year, making the future rollover of this debt easy (See Figure 2). The monetary policy strategy proposed above gives credibility to this scenario. One downside risk for this proposal would be that an over-accelerated recovery in the US induced the Fed to rein in the monetary stimulus. In that case, we recommend that the ECB policy remains focused on domestic conditions, letting the euro/dollar exchange rate absorb the interest rate differential on the two currencies.

In line with the underlying philosophy of the Recovery Plan, a sustainable growth path for the EU economy requires massive private and public investments. Unfortunately, public investments were insufficient in the Euro Area countries, possibly due to a perverse fiscal rule that requires member countries to maintain a structural budget balance at all times. Such a rule requires investments to be financed today by either more taxes or less government spending even if their benefits accrue to future generations. This is unlikely to make public investments a popular choice.

Our **second proposal** is that the balanced budget rule should apply to current government spending and taxation, but bond issues should finance gross capital spending. To overcome the risk that governments would game the system by classifying current budget items into capital spending, a prior agreement can be reached about what spending will qualify as an investment. Then European institutions can be given the authority to monitor and enforce the new rule. Another criticism is that the debt burden transmitted to future generations will become unsustainable. This objection is ill-advised because the public investment will also create productive assets, whose revenues will make it easier to service debt in the future.

We think that the above changes should be enough to fix governments' reluctance in applying for loans extended from the European Commission, enabling the EU fiscal stimulus to exercise its expansionary force in full.

Reform of the economic governance of the Euro area is long overdue. The focus should shift towards medium-term debt sustainability and quality of public expenditure instead of mechanistic compliance with debt/deficit targets that would likely backfire in the face of increased dispersion in national debt ratios. In the Euro Area, sustainability requires mutualizing the national government debts and centralizing fiscal capacity in the longer run. Achieving this will take a long time. An essential step in that direction is the implementation of the Next Generation EU program. This is the most extensive stimulus package ever financed through the EU budget, marking a meaningful change relative to the austerity policies recommended in the recent past to foster public debt sustainability. EU leaders have agreed to a recovery package of EUR 1.8 trillion that combines the EU budget for 2021-27 and the Next Generation EU program. Under the agreement, the Commission will borrow up to EUR 750 billion on the markets, which is unprecedented in the history of European integration.

The package is designed to fight the COVID-19 crisis, sustain recovery in Europe, and start the green transition towards a carbon-free economy by 2050. Accomplishing this transition will require massive public and private investment in the research and innovation sectors, digital technologies, health and medical programs, sustainable agriculture and animal farming, green energy production, and sustainable transportation systems. The EC should foster the idea that common EU objectives, such as preventing future health crises and supporting the green transition, cannot be delegated to national governments and require joint issuance of European sovereign bonds.

3. Conclusion

We argue in favor of a common exit strategy based on the following points:

1. The monetary policy stance should remain expansionary for an extended period, tolerating a foreseeable overshooting of long-term inflation targets. In this regard, FAIT provides an appropriate framework for Central Bank strategy in the following years. Essentially, higher-than-normal inflation should be tolerated until the price level reaches the original 2% growth path. The recent ECB´s monetary policy strategy review goes a long way in that direction.

2. The banking supervisory and regulatory policies should avoid an abrupt deleveraging process.

3. The fiscal policy should remain stimulatory until GDP growth reaches its pre-pandemic path.

4. In the EMU, we argue in favor of a Golden Rule that frees public investment expenditure from the straightjacket of the current EU economic governance.

The perceptions of the post-pandemic risks differ sharply between the US and Europe. In the US, there is a growing perception that inflation may become the number one risk during the recovery from the pandemic. This creates the danger that the US Fed feels compelled to start fighting inflation early on, thereby harming the recovery. In Europe, there is little fear of inflation in the post-pandemic recovery period. This difference in perception has much to do with the fact that the US monetary and fiscal policy mix has been powerful. In contrast, the policy mix in the EU, and particularly in the Euro Area, has been much more cautious.

The risk perceptions in the post-pandemic period in the EU, and particularly in the Euro Area, emanate from the surge in government debts during the pandemic. We have argued that this debt accumulation should not be of great concern. However, the political momentum in some countries of the Euro Area to restore fiscal discipline is strong. This will create a risk that the fiscal rules will be restored too early, leading to pressures to impose misguided fiscal discipline, thereby harming the economic recovery. Thus, while in the US, the risk of an early exit from monetary-fiscal stimulus originates from a fear-for-inflation, in the EU, it arises from a fear-of-government-debt. Franklin Roosevelt's dictum "what we should fear most are our own fears" remains highly relevant in Europe and the US. We could say that our proposals are fearless.

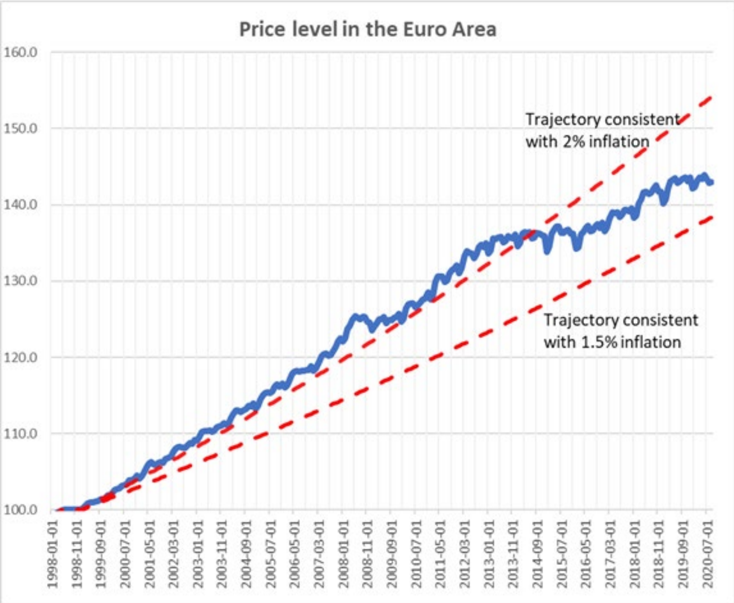

Figure 1

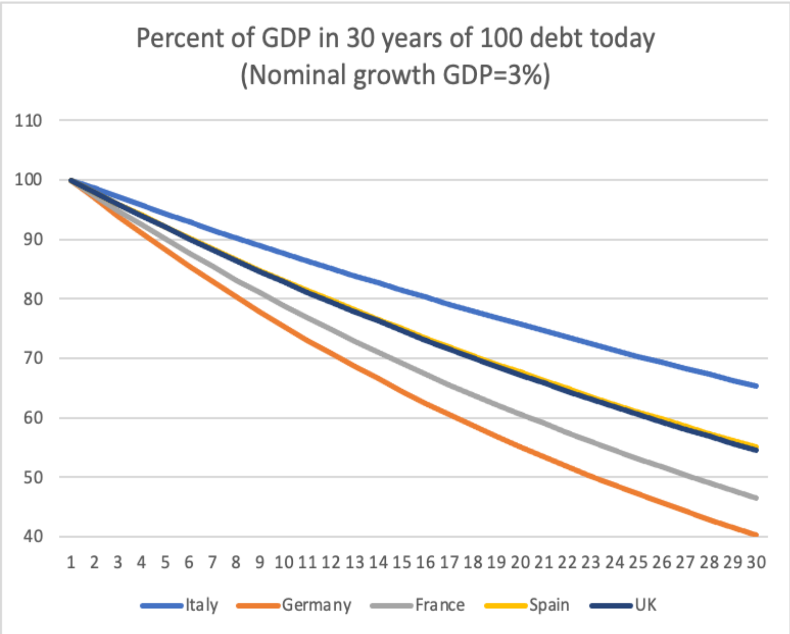

Figure 2 This chart simulates the path of debt-to-GDP 30 years in the future following a debt issue today (normalized at 100). It is assumed that governments issue 30-year bonds. We used the yields on these national bonds in February 2021 and yearly nominal growth of GDP = 3%.

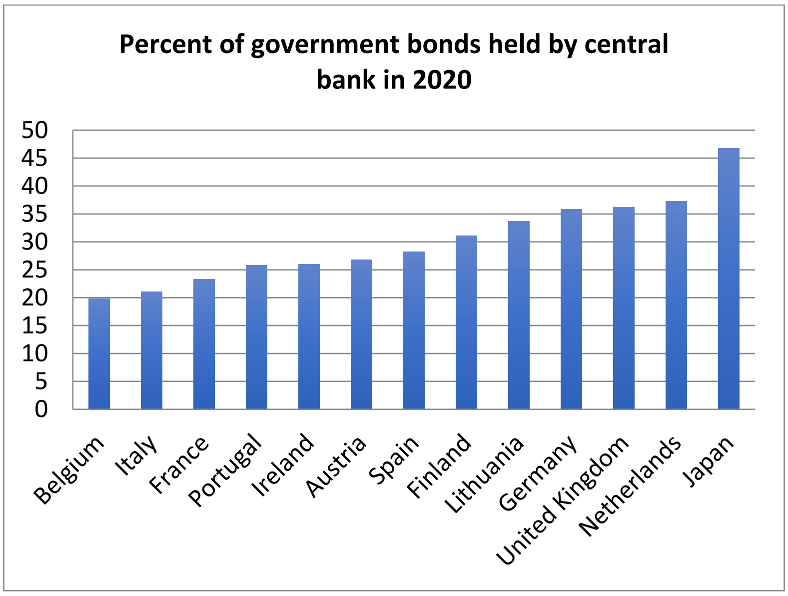

Figure 3 Source: OECD, Economic Outlook 1

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