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The Challenging Cliff-Edge

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
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The Challenging Cliff-Edge

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Abstract

From an economic policy viewpoint, the harder part will come once the pandemic is over. The crisis will leave many scars that are likely to significantly slow growth down. Countering these effects will require continuous and well-targeted fiscal policy support. Monetary policy, which provided adequate support during the crisis, will have to eventually normalise its interest rates. The ECB could play a crucial role in reducing the large debts that fragilize several member countries.

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LIST OF ABBREVIATIONS

APP	Asset purchase programme
ECB	European Central Bank
EP	European Parliament
EU	European Union
GDP	Gross domestic product
GFC	Global financial crisis of 2008
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
PEPP	Pandemic emergency purchase programme
QE	Quantitative easing
TLTRO	Targeted longer-term refinancing operations

EXECUTIVE SUMMARY

- **Designing fiscal and monetary policies for COVID-19 times was the easy part**. Fiscal policy options were simple and clear. Monetary policy played a supporting role indeed, all governments in developed countries promptly adopted qualitatively similar measures, although the amounts involved vary significantly. Central banks also broadly moved in the same direction, depending on their starting points. How and when to end these policies, the cliff-edge effect, is much more complicated.
- **Demand after the pandemic may follow a see-saw pattern.** A powerful rebound is expected when households spend the sizeable savings that they have accumulated during the pandemic. Once this is done, however, the recovery might peter out. Governments may be tempted to prematurely withdraw fiscal policy support during the early rebound period.
- **Short-run effects of the pandemic may turn out to be long-lasting because of the scarring effects of the pandemic.** Consumption patterns may have changed and saving may remain high. Unemployment has been remarkably subdued so far but may burst once the support measures come to an end. International trade may be hit by concerns about global chains. Firms may not return to pre-COVID-19 investment spending as many emerge weakened from the crisis or are facing more difficult markets due to changed consumption patterns.
- **The fiscal policy relief measures will have to be withdrawn promptly once the pandemic is over**, not because they require large deficits but because their objectives will not be justified anymore.
- **The purpose of fiscal policy will change**. Relief and recovery supports are quite dissimilar in their aims and instruments.
- **A prompt end to relief measures amounts to a highly contractionary fiscal policy stance.** Monetary policy is unlikely to be able to substitute for an ill-timed retrenchment of fiscal policies. What is needed is that fiscal and monetary policies move in tandem.
- **Monetary policy will have to play a complementary, supporting role to fiscal policies.** It should ensure that the financial markets absorb the impact of pent-up bankruptcies. This will call for a continuation of the current policy: low interest rates, abundant liquidity, support to bank lending and a backstop to public debts.
- **The more difficult part will come later, when the recovery is sustainable.** The ECB should be the first to tighten its stance. After a decade of very low, indeed negative, interest rates, it will have to recover its ability to conduct standard policy by steering its interest rate well above the effective lower bound.
- **However, this will only be possible if fiscal policies play a supporting role to monetary policy normalisation.** That will mean longer-lasting budget deficits, a stance most likely to prove highly controversial.
- **The controversy will centre around the large debts of many countries.** Large public debts are indeed a source of fragility. Currently low interest rates have somehow reduced the risks but they are unlikely to remain so low forever.
- **Reducing public debt should be considered as a serious option.** This can be achieved in the euro area without defaults, without inter-country transfers and without providing incentives for fiscal indiscipline.

1. INTRODUCTION

No one foresaw the COVID-19 pandemic, an event that hopefully occurs once in a century. The measures taken during the epidemic are unprecedented and their consequences are nearly impossible to foresee with any degree of precision. In addition, most less-developed countries will not reach herd immunity for at least another year, possibly more. This will make it possible that further virus mutations will be resistant to vaccines and treatments. Uncertainty remains a major difficulty for policymakers, both as they manage the sanitary crisis and as they look forward to what comes next.

Sometime later this year, we can hope that all of Europe will have reached herd immunity. Thanks to the widely adopted relief policies so far, the economic damage will have been limited. Current policies, however, will not be justified anymore. The combination of scarring – long-lasting effects of the crisis – and high uncertainty means that policymakers must stand ready to introduce recovery policies at the time when they withdraw the pandemic-relief policies if we want to avoid a cliff-edge effect that provokes a new recession on the heels of the previous one. This can be challenging.

Section 2 briefly reviews the relief policies, focusing on their legacy. The next two sections examine which policies are likely to be needed. Starting with fiscal policy, Section 3 lists the possible scarring effects that will have to be dealt with and then details the dos and the don'ts of post-pandemic measures aiming at making the recovery sustainable. It argues that the relief policies must come to be replaced by other, equally-forceful policies. Section 4 looks at monetary policy. Paradoxically, since the post-pandemic situation could be characterised by demand shortfalls, monetary policy should be in the front seat but is unlikely to be in a position to do so. The reason is that its interest rate has reached its effective lower bound and that liquidity is already plentiful after years of the massive asset purchase programmes. The paper makes two points: the current stance must be maintained until the recovery is sustainable but then the ECB should move to escape the effective lower bound trap. The last section concludes.

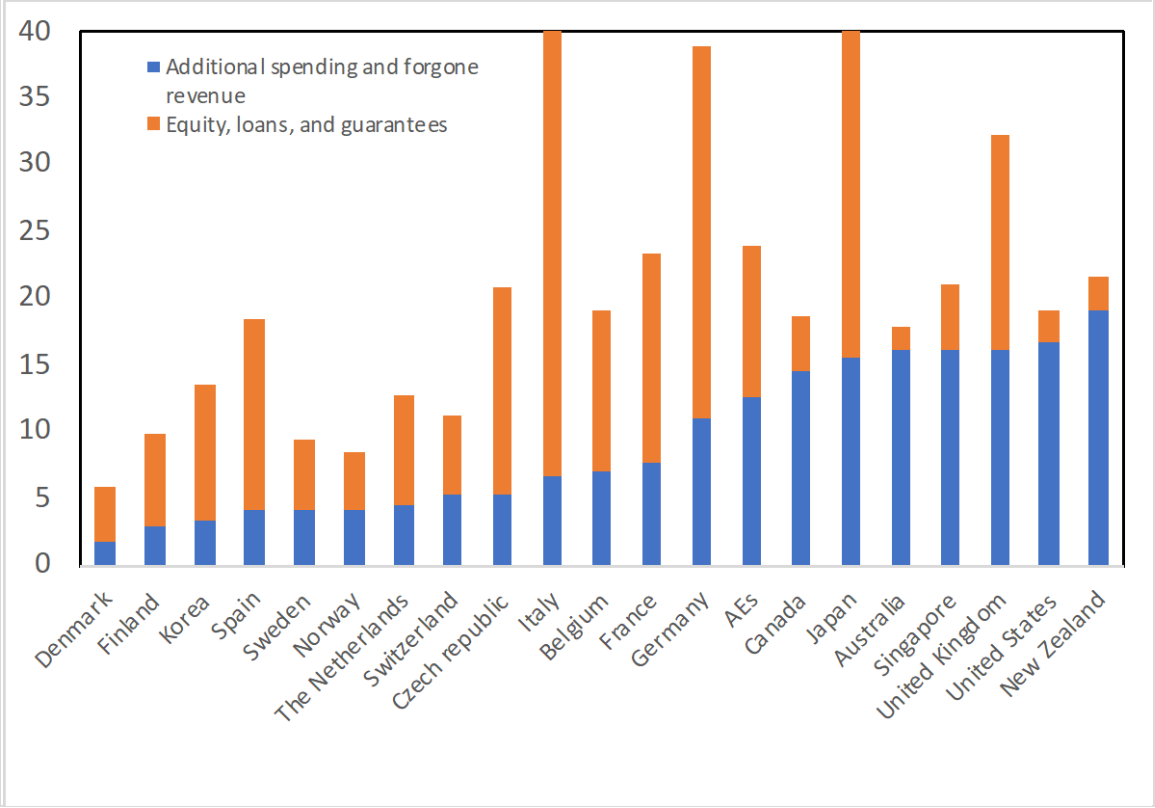
2. BRIEF REVIEW OF EXPIRING POLICIES

2.1. Fiscal policies

From the start of the pandemic, most developed countries have taken strikingly similar fiscal policy measures. The need to protect people and firms from the consequences of the pandemic and, especially, from the extensive sanitary measures decided by the authorities, was easy to recognise. The IMF's *Fiscal Monitor* provides an updated detailed list of these measures for a selection of countries. The costs of these measures are reported in Figure 1. The figure distinguishes between measures that directly affect the budget (spending less taxes) and various guarantees which may or may not eventually entail costs and yet provide relief. The countries are ranked according to the direct budgetary costs.

The difference in the uses of additional net spending and guarantees is striking. Net spending immediately increases the public debt while guarantees may add to debt sometime in the future. In many countries, especially in Italy, Germany and Japan, the bulk of assistance is provided through guarantees. This is also the case in the Nordic countries (Denmark, Finland, Sweden and Norway) where direct relief spending is limited; one reason is that these countries have powerful welfare systems which imply automatic "additional spending", without needing strong discretionary measures. At the other end of the spectrum, New Zealand, the US, Singapore, Australia and, to a lesser degree, the UK have massively raised direct spending with much more limited guarantees.

Figure 1: Costs of policy measures in selected advanced economies (% of GDP)



Source: Author's own elaboration from *Fiscal Monitor Update*, IMF, January 2021.

Notes: Data collected until end of December 2020. AES: average of advanced economies.

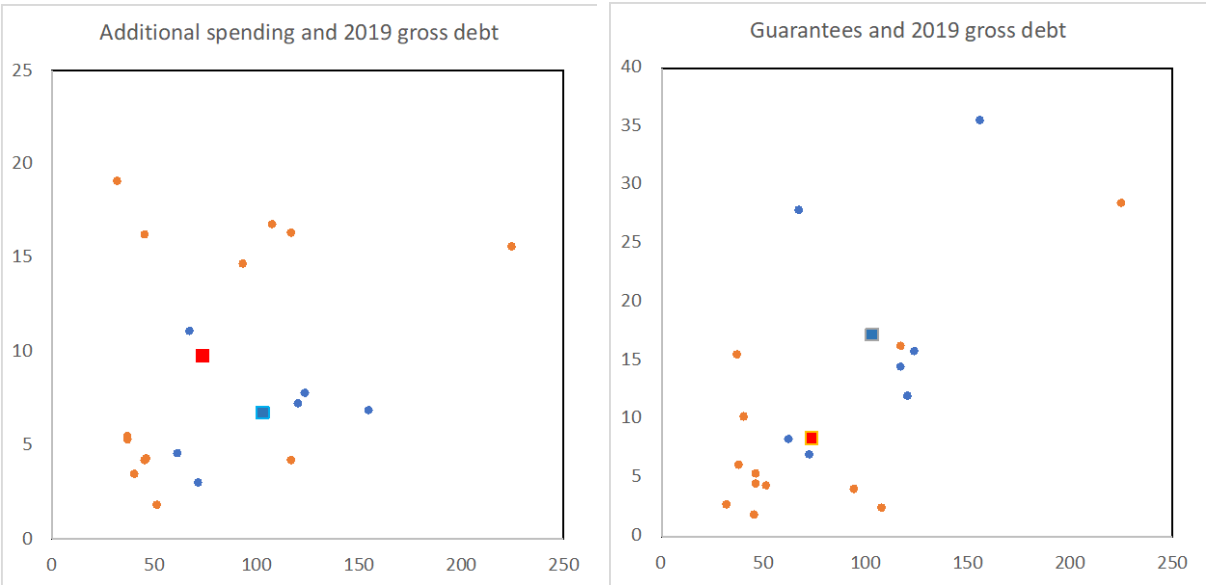
Figure 2 compares additional spending and guarantees to the pre-existing gross debt ratio in 2019. The number of countries in the Fiscal Monitor selection is too small to allow for statistical tests but there is some indication that large pre-existing debts tend to reduce the use of additional spending and to enhance recourse to guarantees. The comparison of euro area and non-euro area countries is interesting. On average, the non-euro area countries started with less debt and made use of larger amounts of additional spending and less guarantees.

A possible interpretation is that central banks outside the euro area implicitly provide a backstop for their governments while the backstop must be explicit in the euro area. In the event, the ECB has expanded its purchases of public debts, tilting it to the more indebted countries through the pandemic emergency purchase programme (PEPP), in effect indirectly financing most of official borrowing over 2020.

Alternatively, this may be the result of the perverse effects of the Stability and Growth Pact, even though it has been suspended until end of 2021. If so, it would serve as a stern warning that the pact must be profoundly transformed before it is reinstated.

Yet another interpretation is that governments saddled with large public debts inherited from the past fear of market reactions to large additional borrowings. This interpretation strongly suggests that debt restructuring was needed after the euro area crisis started in 2010. Unfortunately, this option was quasi-unanimously rejected, sometimes put down for later under the assumption that the future will be easier than the past. This issue is taken up in Section 4.4.

Figure 2: Costs of policy measures and gross debt in 2019 (% of GDP)



Source: Author's own elaboration from *Fiscal Monitor Update*, IMF, January 2021, and *Economic Outlook*, OECD.

Notes: Data collected until end of December 2020. Euro area countries in blue, non-euro area countries in red. Large squares represent unweighted averages.

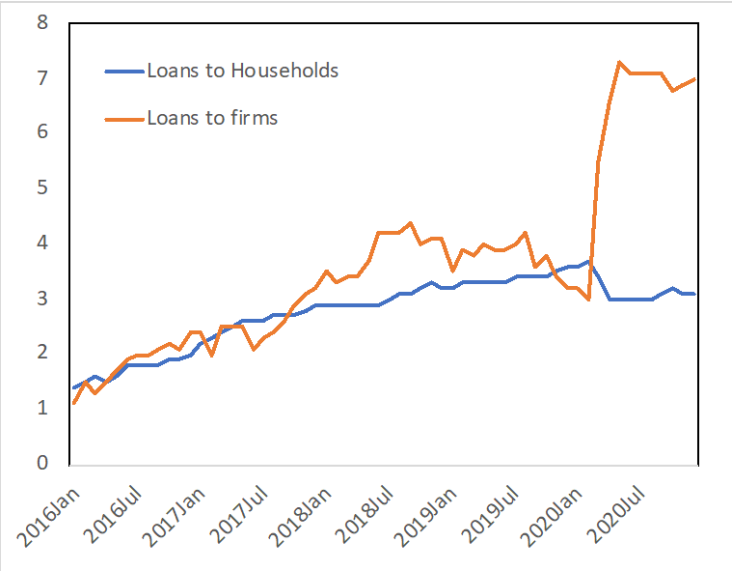
2.2. Monetary policy

The pandemic hit at a time when monetary policy was already in a bind. Since September 2019, the interest rates were set at what probably is the effective lower bound. Even though the ECB has regularly

stated that it stands ready to lower them further, it has not done so since then. Instead, the ECB has expanded its existing asset purchase programmes and created new ones to reach unprecedented levels. The PEPP provides a backstop to national public debts, and the targeted longer-term refinancing operations (TLRO) that lends at -1%, below the deposit rate of -0.5% to banks that increase their loans.

Clearly, the ECB is doing what it can but it has limited firepower and, more importantly, it is not evident what more it can do. The recession brought about by the pandemic shock is not a classic event. When people stay at home and important segments of businesses are not allowed to operate, lower interest rates and abundant credit availability can, at best, prevent further declines. Figure 3 shows that bank loans to households have fallen by very little. Loans to non-financial corporations have sharply increased but the likely cause is that governments have offered large guarantees that made granting loans riskless to banks. Alongside fiscal measures, these loans helped firms to survive during the pandemic, as intended. Of course, ample availability of cash by the ECB also helped in the relief effort.

Figure 3: Banks loans in the Euro Area (% annual increase)



Source: Author's own elaboration from ECB data.

2.3. Coordinated fiscal policy

The real innovation has been the Europe-wide recovery plan under the label NextGenerationEU. It will be financed by collective borrowing and will provide more loans to those countries that may find it difficult to borrow, at least at low costs. These loans are expected to come on stream in 2021 and to spread over 2022. While the overall amount is significant, the time line of deployment is subject to substantial uncertainty.

3. FISCAL POLICIES AFTER COVID-19

Perhaps too optimistically, it is assumed here that normal economic life will return in the second half of 2021. As it happens, the exceptional relief policies mentioned in the previous section will not be needed anymore. The essential question is: will governments need to then focus on closing the budget deficits and roll debts back or will they have to use fiscal policy to sustain the recovery? The answer depends on whether the recovery will be self-sustained or not. Starting with a methodology issue, the next section looks at four reasons why the recovery might be short-lived.

3.1. Scarring effect: short-run vs. persistence vs. hysteresis

When economists look at disturbing events, usually labelled "shocks", they usually ask whether the impact will be short-lived, or whether it will be long-lived but eventually dissipate, being persistent, or else whether they will leave a permanent imprint, a case of hysteresis.[1] For instance, when popular discussions of the COVID-19 pandemic claim that "the world will never be like before" for a large range of issues, they implicitly assume hysteresis.

This three-way distinction is crucial for policy purposes. Short-term cases can be treated with measures designed with business cycles. Persistence calls for policies that accelerate adjustments. Permanent effects that cannot be avoided require relief measures. Unfortunately, it is sometimes quasi-impossible to nearly classify events in these categories. Indeed, the borders between these categories are fuzzy. How long is the short run? Is persistence over several decades really different from permanence? Even when the borders can be defined precisely, the instruments available to economists rarely allow us to reach black-and-white conclusions. As an example, for decades now, statistical techniques have been used to distinguish between cyclical effects and trend changes. Box 1 illustrates these difficulties by looking at the broken transmission by financial markets of monetary policy to the real economy in the wake of the global financial crisis (GFC).

A specific difficulty is that short-term disturbances that normally have short-term effects, can leave a permanent impact under particular circumstances. For example, a cyclical downturn is expected to be accompanied by temporary increases in unemployment. However, it has long been suspected that people who remain unemployed for a while find it near impossible to find jobs during the ensuing cyclical upswing. Hysteresis thus transforms short-term effects into permanent ones, sometimes just persistent.[2] This is what current discussions about "scarring" now consider.

[1] Some authors consider that both persistence and permanence are cases of hysteresis. Here the term is used to describe cases of permanence, not persistence.

[2] Classic references are Blanchard and Summers (1986) and Ball (2009) for labour markets and Dixit (1992) for corporate investment.

Box 1: The global financial crisis

The global financial crisis of 2008 fragilized the financial sector. A decade later, the financial sector was still not fully transmitting monetary policy actions. This is why central banks were still keeping in 2019 their interest rates at their effective lower bounds – sometimes negative – and were often pursuing quantitative easing (QE). This impact is certainly not short-run but is it persistent or permanent?

In order to answer the question, we need to understand why it is happening. The problem is that there are many possible culprits. First, regulation has changed to reduce the odds of facing a similar financial crisis again. The Basel Committee has made proposals, adopted in one version or another in a large number of countries. These measures require banks to act more prudently than before, which has changed the impact of monetary policies. If that is the story, the shock had short-lived effects but the ensuing regulations have permanently affected the financial sector.

A second interpretation is that the shock has led financial institutions to change their business models to protect their shareholders from huge potential losses, and this irrespective of the new regulations. This would be a permanent effect but it is possible that these changes have been a response the regulations.

Third, it takes time for badly-hurt financial institutions to clean their balance sheets up. Some financial institutions quickly bounced back while others are still reeling from the crisis: persistence for some institutions and short-run adjustment for others.

Fourth, facing a different financial sector, central banks have changed the way in which they operate as they tried to restore monetary policy effectiveness. These nonstandard tools, in turn, have profoundly affected the structure of the financial sector. If central banks eventually return to their standard mode of operations, we will have seen a case of persistence, but it could be permanent if the central banks make permanent use of their nonstandard tools.

Finally, even if regulations have played a major role, they may be changed again, possibly back to what they used to be. Alternatively, the enforcement of the rules may become weak, as has been the case in the US under the Trump administration. Permanence may dissolve into persistence.

3.2. Short-run dissaving and private investment

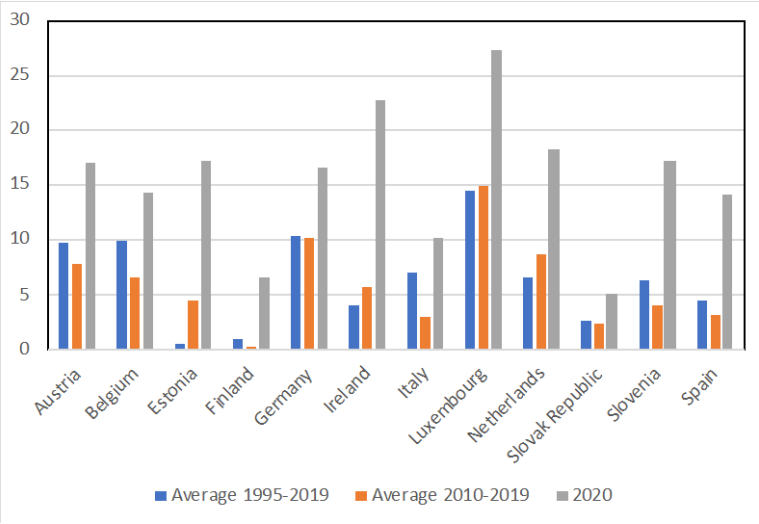
Locked down at home and yet still receiving salaries, with stores selling "non-essential goods" shut, a large number of households have increased their saving rates. Figure 4 documents this effect for European countries where data is available. In virtually all cases, the increase is very significant.

It is widely expected that much of the accumulated savings will be spent once all stores reopen for good and people can move freely and without fear of being infected. Spending could jump above pre-COVID-19 levels by as much as 10% of GDP, or more. The result would be a very large bounce back of GDP, to levels comparable to the pre-COVID-19 situation.

Like households, firms have cut down on productive investment in 2020. As they face a resurgence in demand, they could quickly respond by raising spending on investment. This would further add to the immediate post-COVID-19 growth rate.

Assuming that these widely-shared predictions occur, there would be no need for supporting fiscal policy. Instead, this could be a good time to close down the COVID-19-era budget deficits. Such a conclusion is likely to be misguided.

Figure 4: Household saving rates (% disposable income)



Source: Author's own elaboration from data from *Economic Outlook* database, OECD, December 2020.

3.2.1. Household savings

Accumulated savings offer the opportunity for a strong rebound but they are finite. Once they have spent those savings, what will household do? If they return to the pre-COVID-19 pattern, overall growth will do so too and the recovery will be under way. However, less favourable scenarios can be entertained.

- The pandemic is not over. Not all countries will get rid of the coronavirus at the same time. Europe and other developed countries will probably reach a reasonable level of collective immunity before the end of 2021 but it will take much more time in the developing world. The virus will remain active there and it will keep mutating. Whether or not these mutants are resistant to existing vaccines and treatments, the fear factor will remain. In that case, a large number of households will save for an uncertain future.
- Even though many households were reasonably well protected from the impact of the pandemic, some were not. Either they did not save at all, or borrowed from family and friends.
- As discussed below, unemployment may surge, which will make households prudent and encourage keeping a part of accumulated savings.
- There is some evidence that people who suffered hardship (wars, financial crises) become more prudent and save more throughout their lifetime.

The first three possibilities suggest persistence, the last one corresponds to hysteresis. These just are just possibilities, but policymakers will need to be ready to deal with their negative impact on growth.

3.2.2. Corporate investment

Firms in the negatively-affected sectors had clearly no reason to invest. A quick dissaving boom could radically change the situation. As with household consumption, some less encouraging scenarios are plausible.

- Many firms may have enough production capacities to meet the temporary surge in demand. Furthermore, they may adopt a wait-and-see approach if they are unsure about the duration of the consumption boom.
- Many firms have benefitted from low-interest loans guaranteed by their governments. They took out these loans as a precaution or as a mean for survival. As they emerge seriously weakened and more indebted, they may be unable to invest, often because banks will be reluctant to extend new loans.
- In normal times, on a continuous basis, some firms become bankrupt while new ones are created. During the pandemic, much of this churning has come to a halt, in part because of government support. Once the support stops, the number of bankruptcies is expected to suddenly rise. On the other hand, the creation of new firms takes time and may be reduced by the general uncertainty that will prevail.
- During the pandemic period, we have seen sizeable reallocation of demand across firms and sectors. The firms that benefitted from this reallocation have been investing quite heavily and will need little new investment once the pandemic is over, especially if some of the reallocation is undone.
- When investment is depressed for a sustained period of time, the production potential declines, which reduces demand, which further deters future investments.

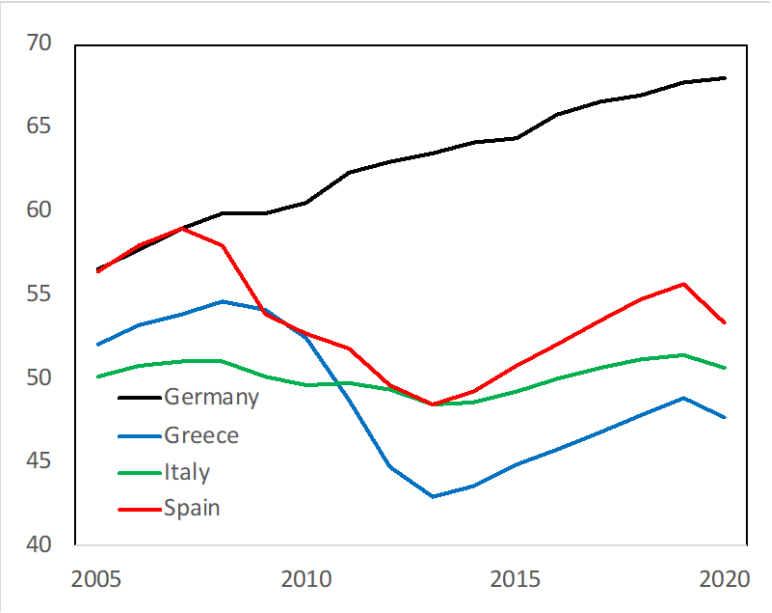
The first three possibilities suggest persistence, the last two correspond to hysteresis.

3.3. Hysteresis in labour markets

Labour markets are known to be particularly susceptible to exhibit hysteresis. Workers who lose their jobs often drift away from employability as their skills, contacts and other attachments to employment wither away. An additional factor is the end of eligibility to unemployment benefits. A big and lasting shock disenfranchises many people who quit the labour force as they give up on their chances of finding jobs, a process that often affects women. Conversely, a vigorous boom may bring back to the labour force people who had previously left.

Measures like the rate of unemployment fail to detect this phenomenon because it relates the number of unemployment people to the size of the labour force. Hysteresis implies that the numerator and the denominator both move in the same direction. Figure 5, instead, looks at the ratio of the number of employed people to the total population of working age. For a few selected countries, it looks at the impact of the GFC (2008-9) followed by the euro area debt crisis (2010-12) on the labour markets. In Greece and Spain, which were badly hit by the crisis, the employment rates strongly declined. They partly recovered after the crises but, nearly a decade later in 2019, they were still significantly lower than in the mid-2000s. The contrast with countries that were not adversely or little affected, such as Germany and Italy, is very visible.

Figure 5: Employment rates (% of labour force)



Source: Author's own elaboration from data from *Economic Outlook* database, OECD, December 2020.

Note: The employment rate is the ratio of the number of employed people to the working age population (15-74 years old)

One reason why Germany fared well is that it benefitted from strong demand for its cars and machinery from China, which was quickly growing at the time. Another reason is that it adopted the *kurzarbeit* scheme, which subsidized firms to retain workers rather than to dismiss them and trigger the hysteresis effect. Importantly, this scheme has been widely used during the pandemic crisis, which explains the limited increases in unemployment so far. However, these subsidies should end when the distancing measures are not necessary anymore. A consequence would be widespread dismissals of workers. The risk is that a key benefit from the *kurzarbeit* scheme, preventing the employment hysteresis effect, could go wasted if the cliff effect is not prevented. A long-lasting, possibly permanent decline in employment would have an equally long-lasting adverse impact on economic growth.

3.4. Hysteresis in sectoral structure

Section 3.2.2 notes that the pandemic is provoking a reallocation of activity across sectors. There is also much discussion about how the global supply chains have been deeply disturbed during the crisis. It is an open question whether these changes will become permanent. Arguments cut both ways.

For example, the lack of basic inventories of medical instruments and products at the start of the pandemic has prompted discussions in Europe on the need to be able to produce strategic goods locally. Likewise, the breakdown of global supply chains has exposed the depth of the interdependence inherent to global integration. But, hopefully, the pandemic is a once-in-a-century event. If so, it is unclear that firms will spontaneously opt for less efficient modes of production. On the other hand, governments may wish to draw lessons from the pandemic and decide on specific measures.

On the demand side, there might be more scope for hysteresis or, at least, persistence. This possibility can be examined with a few examples, noting that much more may be going on outside the radar screen.

- Many people have discovered on-line shopping.

- Corporations have replaced travels with video conferencing.
- Working from home, a rather rare practice, has become widespread, exposing both its limits and advantages.
- Individual transportation modes (bicycles, scooters, etc.) have replaced public transportation.
- There is early evidence of people leaving city centres and migrating to suburbs.
- Global tourism will be reduced as long as the virus is still active in parts of the world where vaccination lags, possibly encouraging tourism elsewhere.

Some of these new habits may well persist, partly at least. It also remains to be seen whether these changes will have lasting effects on the economy as a whole. The existence of fixed costs suggest that overall shorter-run effects may be sizeable.

3.5. Implications for fiscal policies

Table 1 summarises the discussion on potential scarring effects. A "+" indicates that there could be an expansionary effect once the pandemic is over, while a "–" suggests a contractionary (scarring) effect. It is not certain at all that the effects will be present, not even that their signs will prove to be correct. The uncertainty is large, because we have not seen such a serious pandemic for a century, and because previous pandemics were not supported by policy interventions, certainly not of the size that we have seen this time around. A reasonable conclusion, which is largely shared at this stage, is that the widely expected powerful rebound will be short-lived and could be followed by a lasting period of weak, possibly negative growth.

Table 1: Potential scarring effects

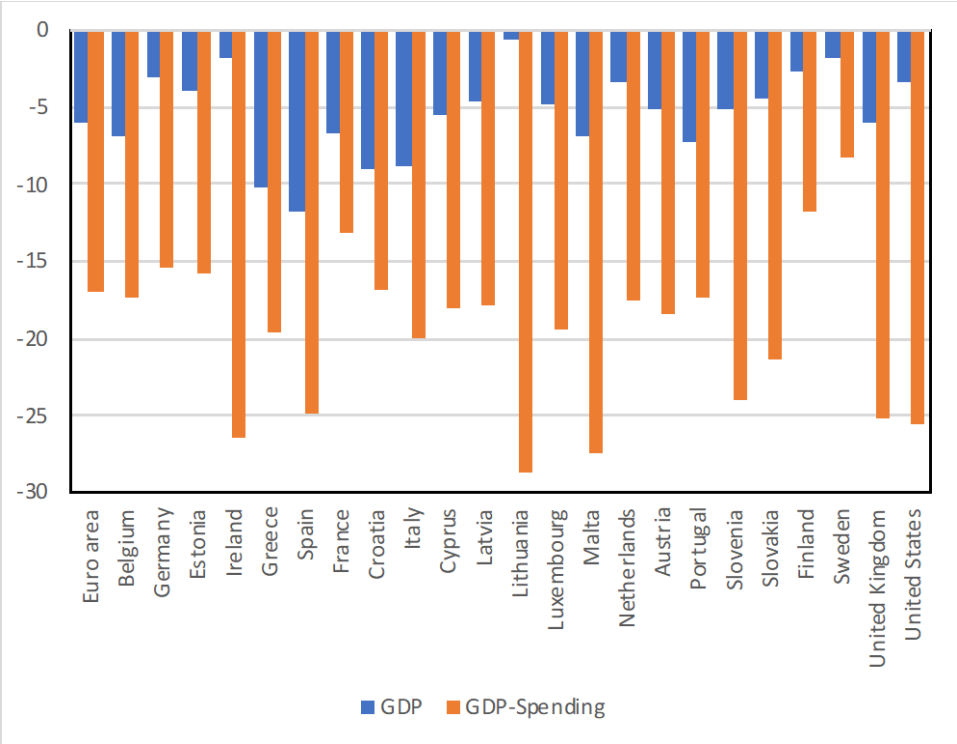
	Short-run	Persistence	Hysteresis
Large accumulated savings	+	-	
Corporate investment		-	-
Labour employment	-	-	-
Sectoral reallocation	+	-	

Governments must therefore prepare to deal with a possible slowdown following the initial rebound. Indeed, one key downside with fiscal policies is that they are long to put in place and to implement. This is crucial since monetary policy is unlike to make a contribution, as explained in the next section.

The first step is to ensure that the end of the support measures, the cliff, does not cause a recession, which could be severe. The fall in GDP growth in 2020 is spectacular, but it would have been much worse without these measures. It will take time and careful work to estimate what has been achieved. Figure 6 accordingly presents a very rough estimation. The idea is that the support measures took mostly the form of transfers to people and firms. In that sense, they directly contributed to raise the GDP. Figure 6 simply deducts the additional public spending shown in Figure 1 from actually measured GDP growth. It ignores the state guarantees (shown in Figure 1), the automatic stabilizers, the fiscal multipliers and the impact of monetary policy. This calculation suggests that, absent the support measures, the fall in GDP would have been massive. For example, looking at the euro area as a whole,

current estimates indicate that the GDP growth rate was -6%; according to the calculation, it would been -17% without the support measures.

Figure 6: A rough estimate of the effect of support measures in 2020 (%)



Source: Author's own elaboration from data from Figure 1 and *AMECO on line* database, European Commission.

Note: The blue bars represent actual GDP growth, the orange bars represent GDP growth less the support measures.

- This calculation is meant to indicate that the removal of the support measures will have a sizeable negative impact on growth. If enacted in one step, they could wipe out the effect of expected dissaving. It is not an argument for maintaining the support measures. These targeted measures were designed as a relief from the economic impact of the pandemic and the accompanying social distancing measures. Most of them will become pointless, and possibly counter-productive inasmuch as they contribute to freeze the situation and prevent necessary adjustments (the often-mentioned "zombie" problem). Rather, it is an argument for substituting different new measures at the same time as removing the previous ones. The far from exhaustive list of desirable measures, suggested by Table 1, includes:
  - Unemployment benefits. If, as expected, a large number of people lose their jobs, unemployment will soar. If the unemployment spell lasts more than during a normal business cycle, the duration and generosity of unemployment benefits must be temporarily extended. Announcing such measures early stands to prevent a serious dent in the rebound.
  - Many firms will emerge from the crisis badly scarred. The challenge is not to prolong the life of "zombie firms" while helping those that are and will be profitable. A solution is to provide partial guarantees for further bank loans. Sharing the risks with banks, and letting banks decide, should reduce the odds of protecting zombie firms.

- Personal tax reductions, if well targeted to the less well-off, would strengthen the dissaving process. These reductions should be temporary with firmly spelled out termination dates.
- Similarly, temporary investment tax credits stand to encourage firms to anticipate future spending on productive equipment. It could also help with the sectoral allocation.
- Moving up spending on climate change is another possibility. However, much of the necessary spending requires a long-run undertaking, not a temporary one. In addition, the maturation of projects will be long, possibly extending beyond the horizon during which recovery support will be needed.

The last observation points toward an important consideration. A number of precautions must be taken to avoid inasmuch as possible, wasteful or lagging measures. If the replacement spending is large enough, and the Biden plan in the US provides an idea of what will be needed, governments will come under intense pressure from interest groups. A few principles are worth being recalled.

First, by definition, recovery policies must be strictly temporary. They will need to be stopped once a sustainable recovery is in place, and this will the time when closing deficits and reducing public debts will finally become a priority. It follows that all recovery measures must be easy to roll back. Importantly, they should not be entitlements that become impossible to renege upon.

Second, long-run policies should be treated apart. NextGenerationEU has identified climate change and artificial intelligence as key priorities. Both objectives will have to be sustained for many years to come. They are not well adapted to serve as recovery policies. As indicated above, moving these policies forward can help with the recovery but this is likely to be the exception rather than the rule. The risk here is that NextGenerationEU and other structural policies are counted as part of the recovery package, are not rolled out soon enough and leave the economy stagnating. In addition, given their duration, these policies should be fully financed and not reliant on continuing deficits.

Third, the reallocation process means that certain activities will shrink. The recovery policies should not slow the shrinkage process down, for fear of locking human and financial resources in the wrong places. For instance, if travel is set to decline permanently, airlines and airplane-building should not claim public resources.

4. MONETARY POLICY AFTER COVID-19

During the pandemic crisis, the ECB's nonstandard instruments have assisted fiscal policy, with little direct impact. Indeed, as already noted, the economic crisis provoked by the pandemic was not a classic cyclical downturn prompted by a demand shortfall that monetary policy can counteract. Both demand and supply went down when people and many firms were locked down for sanitary reasons. Bringing them up was not desirable, indeed it was impossible. Furthermore, standard monetary policy had reached its limits before the onset of the pandemic.

Yet, the ECB has deployed its nonstandard instruments to support fiscal policy during the crisis. It did so, first and foremost, by making sure that there would not be a financial crisis. This called for ample liquidity provision through the various pre-existing asset purchase programmes. With its new LTRO programme, it also ensured that bank lending conditions were as favourable as possible. Finally, and crucially, it offered a backstop to public debts, especially to the highly-indebted countries through PEPP, thus making it possible for all governments to deploy fiscal policies.

When the sanitary crisis comes to an end, the ECB will still be stuck with its interest rate at the effective lower bound and ample liquidity will already be available. Once again, monetary policy will only be able to support fiscal policies for the recovery. At the same time, it will have to escape its low-for-long interest trap, a daunting challenge.

4.1. Support for fiscal policies

Section 3 makes the case for maintaining large budget deficits to support the recovery, which could take a couple of years or more. Much of this effort will address demand shortfalls, which is something that central banks can do, assuming that they have the necessary instruments. The task of the ECB will be, therefore, to keep interest rates low for even longer and to ensure that liquidity remains ample. It already indirectly financed much of public borrowings in 2020 and should continue to do so. It should also continue to backstop public debts with PEPP, possibly renamed to signal the duration of the programme. It may also encourage banks to lend with its TLTRO programme.

4.2. Financial stability

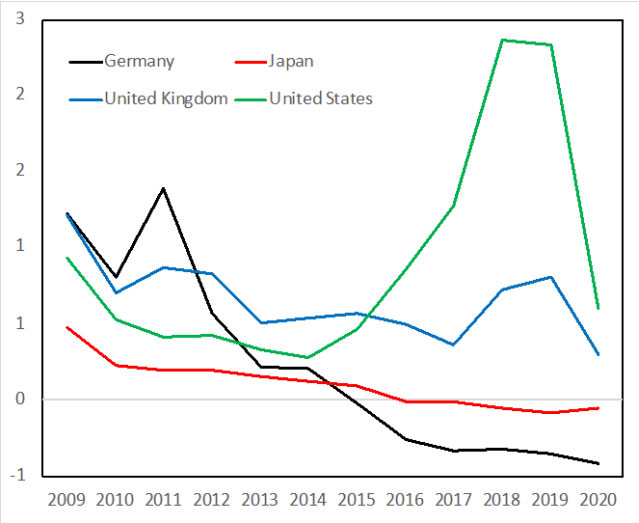
Financial stability may require further action. Many bank loans granted during the pandemic have benefitted from public guarantees. Eventual defaults will become public liabilities and increase the budget deficits, thus avoiding financing fragility. However, the reallocation process described in Section 3.4 implies that borrowings by declining firms may sour. In its role as Single Supervisor, the ECB is keenly aware of these risks. The problem is that the bank resolution system is incomplete and may be unable to effectively deal with a wave of serious difficulties.

As it stands, national governments have to face the costs of bank resolution. This arrangement implies that bank failures become government liabilities. Highly indebted countries may come under pressure, as we saw after 2010. Whether it likes or not, the ECB is the lender in last resort. Last time, it took several years for the ECB to rise up to the task. The existence of a public debt backstop is now in place and should remain in place. More innovative would be lending in last resort to banks. This would require a fully-worked out agreement between the ECB and member governments such that the central bank provides emergency liquidity while the risks remain at the national level. This would require the completion of the resolution system.

4.3. Normalisation

For nearly a decade, the euro area has joined Japan in keeping its interest rates low, even negative (Figure 6). In contrast, the UK and the US managed to lift them up during the mid-2010s, which provided them with quite some room for manoeuvre when the pandemic hit. A similar observation concerns the sizes of the central bank balance sheets.

Figure 7: Short-term (3 months) interest rates (%)



Source: Author's own elaboration from data from *Economic Outlook*, OECD, December 2020.

Why did the ECB and the Bank of Japan fail to move toward normalisation? It is a complicated issue that goes far beyond the scope of the present paper. One interpretation is that the neutral real interest rate has declined, which is critically discussed in Box 2. This popular assumption is not considered here. Without resorting to hindsight, it remains that the intention never was to keep interest rates so low for so long. It may have been assumed that normalisation could wait under the assumption that the situation would gradually improve. It did not, and monetary policy has become largely impotent in the euro area.

One lesson is that fiscal and monetary policies must be better coordinated.[3] More supportive fiscal policies would have made it possible for monetary policy to be less expansionary. Looking forward, an additional benefit from active fiscal policies would be to create the space for the ECB to finally normalise its interest rate. This may well happen in the US.

Raising the interest rate is bound to be a delicate step, though, since it will increase the cost for governments to borrow. Initially, it will not have a strong impact on the cost of servicing the accumulated debt because most governments have borrowed long term at fixed rates. Still, if the interest rate is increased while the budget deficits are still large, it could be put some governments in an uncomfortable position.

Hence the view that the ECB would not normalise until after the deficits have been significantly reduced. The risk is that, once more, many governments procrastinate, especially in already highly indebted countries. This would leave the ECB hostage to a deficit reduction that is delayed. Financial

[3] Bartsch et al. (2020) develop a "new view" on how to think of cooperation between fiscal and monetary policies.

stability would be the argument in favour of not raising the interest rate. Much the same applies to the reduction of the central bank's balance sheet.

An alternative timing would see the ECB move first, before governments have cut their deficits. The ECB would raise its interest rates well above the effective lower bound, recovering its ability to counteract the next downturn. The recovery would be supported by fiscal policies alone, taking into account the changed monetary stance, which is likely to exert a contractionary impulse. The ECB would maintain its backstop of public debt to reassure governments and financial markets while interest rates are normalised. The idea that fiscal policies should create space for monetary policy normalisation means that governments continue their efforts to support a fragile recovery longer and stronger than usual.

Box 2: The neutral real interest rate hypothesis

The neutral real interest rate is defined as the real rate such that monetary policy is neither expansionary nor contractionary when it is reached. A substantial literature asserts that it has significantly declined since the 1980s and is now possibly negative (among many others, see Laubach and Williams, 2003; Summers, 2014). Many reasons are provided, ranging from excess world savings to declining productivity gains or to demography.

This assumption is currently in vogue. It implies that, to just have a neutral policy, central banks must keep their interest rates very low or even negative, which matches the recent experience. Critics, however, contend that the evidence is weak and sometimes contradicted (a good review is provided by Borio et al., 2019). The intriguing counter-argument is that low for long interest rates lead to low estimates of the neutral real interest rate, which in turn leads central banks to keep their interest rates for long.

4.4. Public debt reduction

Very large debts fragilize countries because they are open to adverse market reactions. The debt crisis has already shown how the financial markets can suddenly panic, moved by small events. For this reason, reducing large public debts should be actively considered. A natural solution would be to reduce public debts at once, without waiting for the many years required to bring them down through sustained budget surpluses.

Public debt reduction is contentious, for good reasons. First, most governments rightly consider that public debts must be honoured. A default stands to undermine the reputation of a country and to hurt those who hold the debt, private citizens and financial institutions. Within the euro area, there is the additional fear that it would hurt the reputation of all member countries. Second, if the ECB is then forced to intervene, low-debt countries fear that the result would be income transfers to the high-debt countries, which they rightly refuse to contemplate. Third, the risk is to create a precedent that would undermine fiscal discipline in the euro area.

These considerations are correct, but a collective debt reduction programme does not have to involve defaults or income transfers, nor to create a precedent. The PADRE (Politically Acceptable Debt Restructuring in the Eurozone) plan of Pâris and Wyplosz (2014) avoids all three pitfalls. In brief, it works as follows.

- The ECB (or another European institution) purchases significant amounts of national debts at market price, in proportion to the central bank's shareholding key. It then transforms these debts in perpetuities that serve a zero-interest rate, in effect wiping them out.
- Inasmuch as the purchased debts yield a positive return, this transformation inflicts a loss to the central bank. It will reduce the ECB's profits but this will be at governments' expense since the profits are redistributed to national central banks according to the shareholding key, which then pass their own profits to their own governments. In that way, each country will end up reimbursing the ECB for its losses, without any inter-country transfers.
- In practice, the ECB would stop paying all member countries any profit until the losses are fully reimbursed. In this way, the debt reduction ends up being fully paid by member governments, but slowly over time. This process could take decades. Declining national public debts would eliminate the spectre of a debt crisis.
- Finally, the PADRE plan also deals with the risk that, once their debts have been lowered, some governments abandon fiscal discipline. To that effect, it envisions a formal compact that includes three components. First, it precisely defines fiscal discipline. Second, it calls upon the ECB (or another independent institution) to determine when a country breaches discipline. Third, in that case, the ECB is mandated to transform the perpetuities back into the original bonds and to sell them in the market. This process, which comes about in a succession of instalments, will put increasing pressure on delinquent governments as markets grow increasingly concerned.

The first step of the PADRE plan is already completed as the result of the asset purchase programmes of recent years. Actually, as long as the ECB holds the bonds that it has acquired and keeps rolling them over, as it does, national public debts are reduced in proportion. They are not traded in the markets, which only hold the remaining bonds and are much less concerned about risks defaults. Thus, the current situation almost mimics the first step of the PADRE plan. The next steps are missing, however. The ECB has not promised to keep rolling the bonds over, which would resemble the transformation into perpetuities. In fact, it may want not just to raise the interest rate but also to reduce the size of its balance sheet. Furthermore, the combination of a weak fiscal discipline mechanism, the Stability and Growth Pact, and the absence of a compact as in the PADRE plan, means that the current informal arrangement provides incentives for governments to be fiscally undisciplined.

5. CONCLUSIONS

In many ways, designing fiscal and monetary policies for COVID-19 times was the easy part. Fiscal policy options were simple and clear; indeed, all governments in developed countries promptly adopted qualitatively similar measures, although the amounts involved vary significantly. Central banks also broadly moved in the same direction, depending on their starting points. How and when to end these policies is much more complicated.

Scarring effects will differ from country to country. Where they are significant, the risk is that early rebound linked to household dissaving will evaporate, calling for continuing demand-side support, and possibly supply-side assistance. Following a year or two of historically large budget deficits, many governments will tend to ignore that risk. Large public spending cutbacks would then likely lead to a second recession. Monetary policy is unlikely to be able to substitute for an ill-timed retrenchment of fiscal policies. What is needed is that fiscal and monetary policies move in tandem.

The fiscal policy relief measures will have to be withdrawn promptly once the pandemic is over, not because they require large deficits but because their objectives will not be justified anymore. Yet, fiscal policy will be needed if, as widely expected, the longer-term effects of the pandemic exercise downward pressure on economic growth. Once households have decumulated their savings amassed during the pandemic, demand is unlikely to go back to pre-crisis trends, because of reasons such as rising unemployment and possible fears of COVID-19 mutations as much of the developed world will remain unvaccinated. Firms may not return to pre-COVID-19 investment spending as many emerge weakened from the crisis or are facing more difficult markets due to changed consumption patterns. These scarring effects will call for classic demand support along with assistance to the reallocation process on the supply side.

Monetary policy will have to play a complementary, supporting role to fiscal policies and ensure that the financial markets absorb the impact of pent-up bankruptcies. This will call for a continuation of the current policy: low interest rates, abundant liquidity, support to bank lending and a backstop to public debts. The more difficult part will come later, when the recovery is sustainable. The ECB should be the first to tighten its stance. After a decade of very low, indeed negative interest rates, it will have to recover its ability to conduct standard policy by steering its interest rate well above the effective lower bound. To that effect, it will be the turn for fiscal policies to play a supporting role to monetary policy normalisation. That will mean longer-lasting budget deficits, a stance most likely to prove highly controversial.

The controversy will centre around the large debts of many countries. Large public debts are indeed a source of fragility. Currently low interest rates have somehow reduced the risks but they are unlikely to remain so low forever. Reducing public debt should be considered as a serious option. This can be achieved in the euro area without defaults, without inter-country transfers and without providing incentives for fiscal indiscipline.

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From an economic policy viewpoint, the harder part will come once the pandemic is over. The crisis will leave many scars that are likely to significantly slow growth down. Countering these effects will require continuous and well-targeted fiscal policy support. Monetary policy, which provided adequate support during the crisis, will have to eventually normalise its interest rates. The ECB could play a crucial role in reducing the large debts that fragilize several member countries.

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