Economic Policy Responses to the Covid-19 crisis in the Euro Area and Japan

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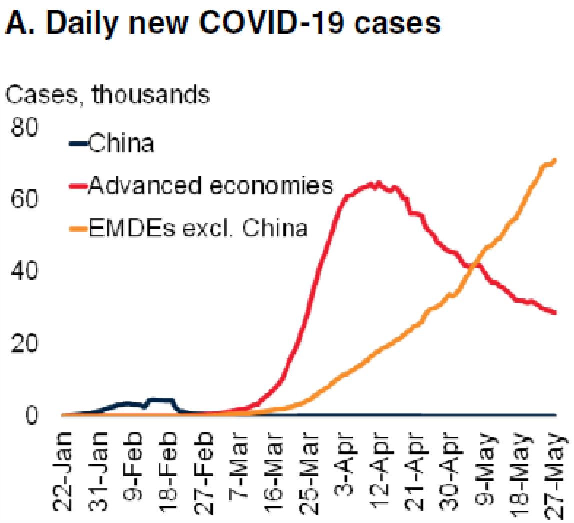
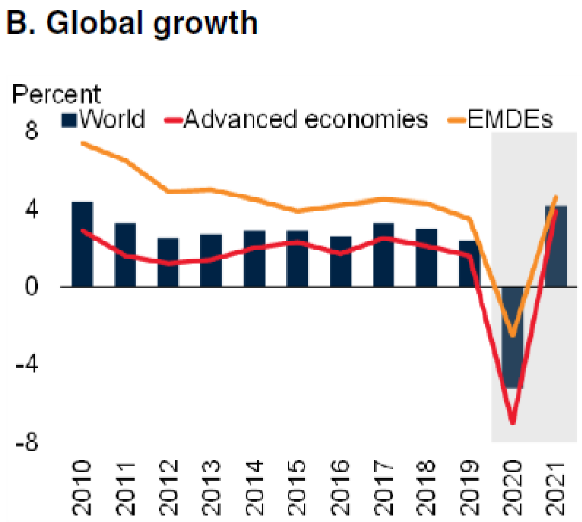
The global economic outlook

- Economic activities contracted very sharply, though we are now seeing some stabilizations.
- A lot of uncertainties. Consensus forecast is nothing less than the educated guess





Source: The World Bank, "Global Economic Prospects", June 2020

Comparison of the Corona crisis and the Global Financial Crisis

- The economic activities contracted very sharply in both crises, but the important differences also exist.

1. The cause of the economic contraction: It was near collapse of financial system that triggered economic contraction in the case of the GFC, while it was exogenous shock of the outbreak of the pandemic in the case of Corona crisis.
2. The nature of the economic contraction: Most of the initial loss of production in Corona crisis is not "recoverable," because the time--a critical element in consuming in-person services-- is forgone. This has an important fiscal implication. The governments cannot recoup foregone production and thus foregone tax revenue.
3. The distribution of burden: Crisis is always unfair in the sense that suffering is not evenly distributed among industries, regions and people. But this tendency is more evident in the Corona crisis compared with the GFC.

Actions needed and actually taken by governments and central bank

1. Actions to prevent financial crisis.
   - Critical to avoid a negative feedback from the financial system to the real economy.
   - Central banks are main actors.
2. Actions to support firms and individuals who suffered most from Corona crisis.
   - Essentially measures of income compensation.
   - Mainly, the job of the government.
3. Actions to ensure a smooth flow of credit to the private non-financial sectors.
   - Undertaken by both governments and central banks.

Issues of policy responses to the Corona crisis

- Quite extraordinary responses. But the underlying philosophy behind these initial actions was not unorthodox. Succeeded reasonably well.
- What makes me feel unease is the clear gap between the optimistic stock market developments and the gloomy statistics showing a sharp contraction of economic activity.
- The big challenges lie ahead for the next step. Critical issue is always how to strike the balance between short-run stability and long-run sustainable growth.
  - ➢ If extraordinary measures continue to be put in place, they may have the effect of obstructing the necessary and inevitable adjustments to a new economic structure corresponding to post-Corona world and thus lower potential growth rate.

The Corona crisis has changed our life

- Corporates are adjusting their way of doing business and starting to think of changing their business strategy.
- Individuals are changing their work and life style.
- How about government and central banks?

We increasingly hear the expression of “once a century event”

- We heard this expression often in the Global Financial Crisis.
- Further, if we were to use this expression in the past, my recollection is the Japanese financial crisis in late 1990s was a really “once a century event,” at least by the standard at that time.
- The same is true of the Great East Japan Earthquake and the severe accident at nuclear power plant.

Two questions about frequent arrival of “once a century event”

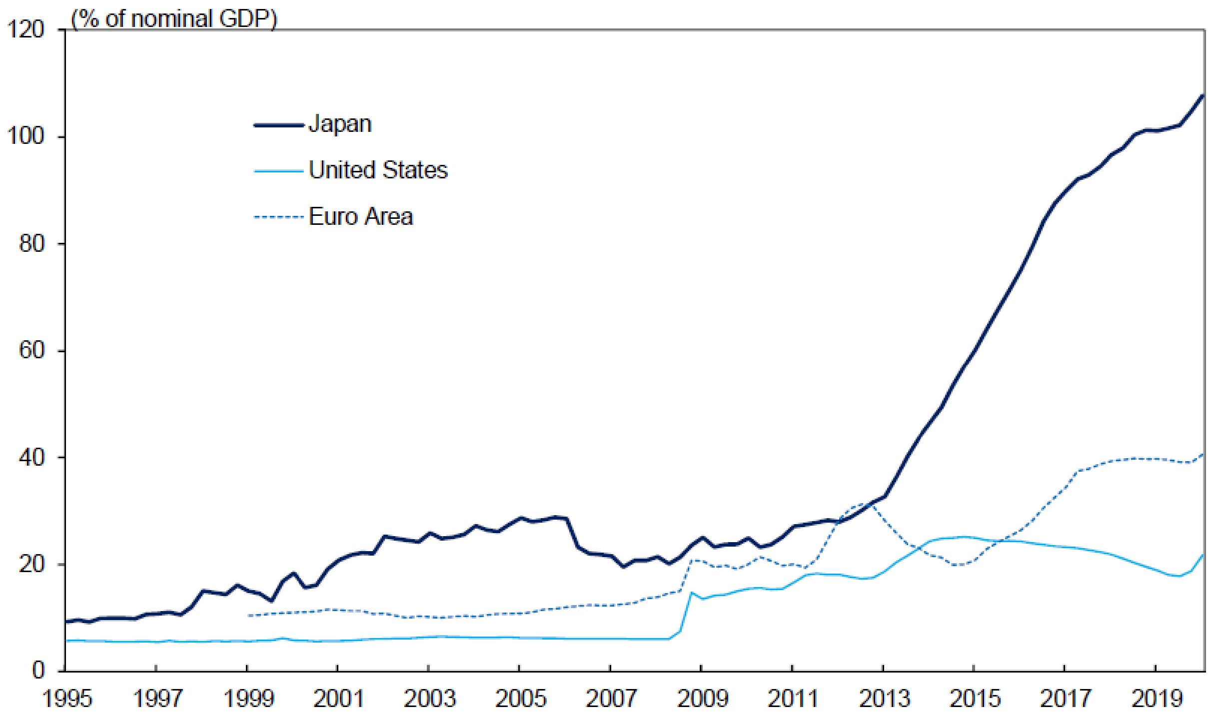
1. Why do we see “once a century event” more often?
2. Given the frequent arrival of “once a century event”, are the current framework of monetary and fiscal policy still appropriate?

Why do we need to discuss the framework of monetary and fiscal policy?

- Covid-19 itself is, of course, not caused by macroeconomic policies.
- But its economic severity is influenced in part by the capacity of government and central banks in a response to Covid-19.
- If the current policy framework is partly responsible for financial crisis, it could affect the frequency of “once a century event.”

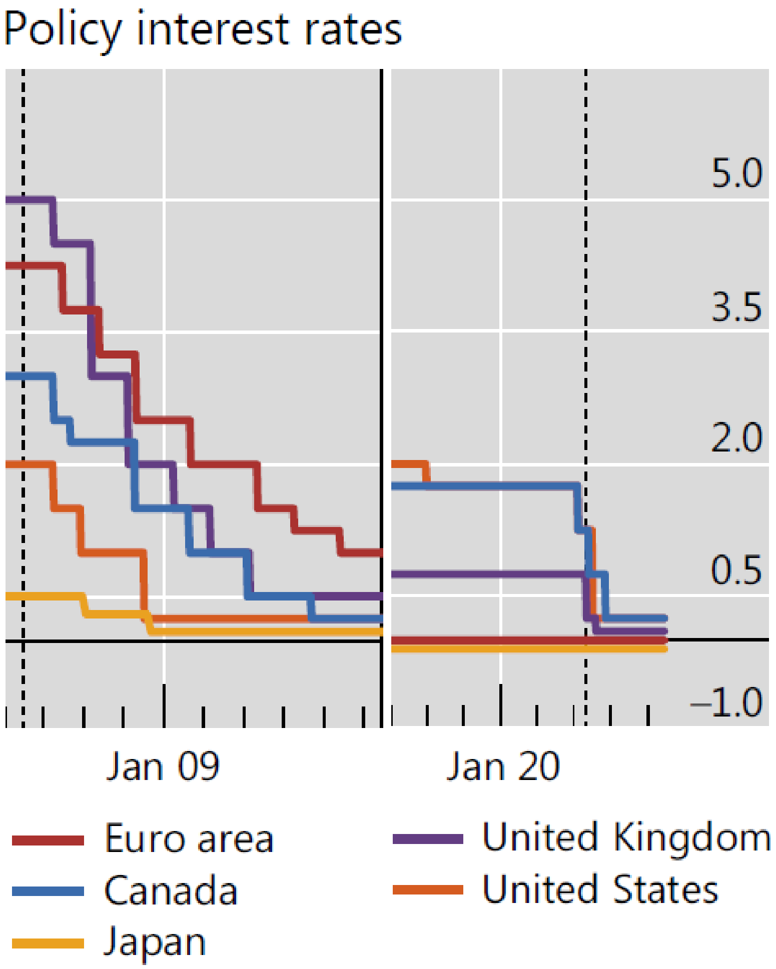
Monetary easing is prolonged

- It is right to deploy monetary policy in a response to various “shocks.” But…



Prior to Corona crisis, central bank balance-sheet already expanded enormously.

Now, no monetary policy space. We have to seriously take the fact that all countries are now stuck at zero interest rate.



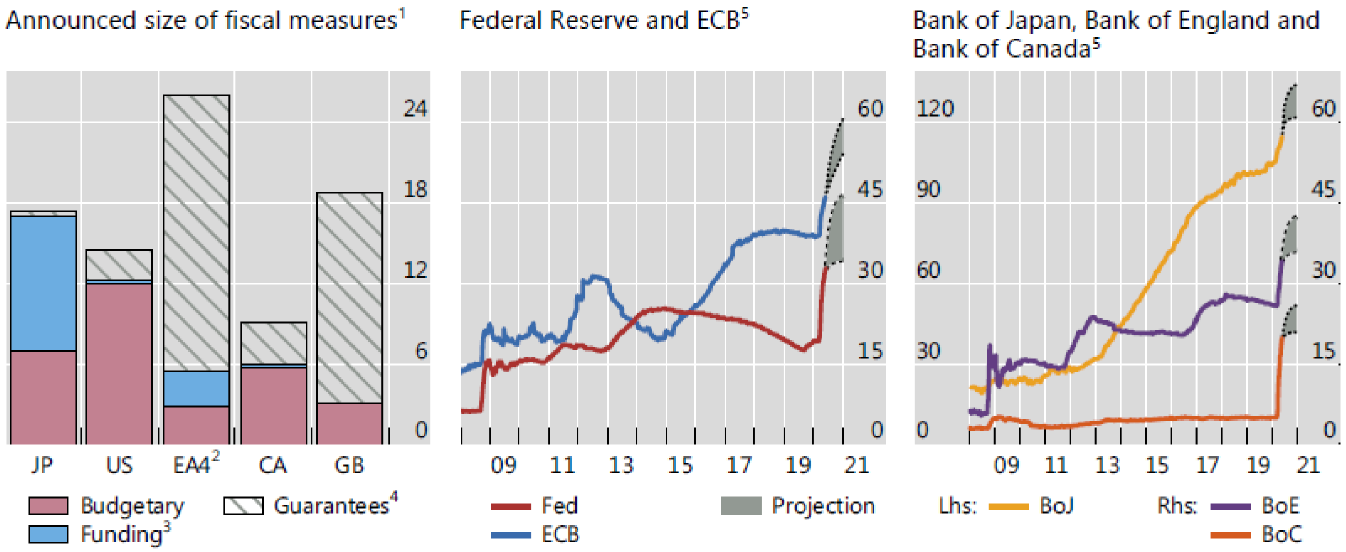
- We have to recall the once strong consensus argument among economists that aggressive monetary easing in a preemptive manner could avoid the situation of slipping into zero interest rate, which Japan experienced.
- Rhetoric aside, a meaningful space is no longer existing.

Source: BIS (2020)

Fiscal policy space is also constrained by a high level of government debt, though different in countries

Fiscal measures and central bank footprints

In percentage of GDP Graph 3



[1] Data as of 13 May 2020and taken from IMF (2020a) and IMF (2020b). The data might not be complete due to uncertainty about the actual fiscal spending. [2] Weighted averages of DE, ES, FR and IT based on GDP and PPP exchange rates. [3] Equity injections, asset purchases, loans, debt assumptions, quasi-fiscal operations and use of extra-budgetary funds. [4] Guarantees on loans and other contingent liabilities, including fiscal backing for central bank programmes. [5] Balance sheet projections are until end-2020 and are expressed as percentages of Q4 2019 GDP. Scenarios are based on central bank announcements up to 4 June 2020 and on the assumptions reported in Table A1 in the online appendix.

The situation becomes more serious, if the second or the third wave of Covid-19 hits our society.

Source：Cavallino and Fiore," Central banks' response to Covid-19 in advanced economies",2020

“Policy rate is low just because a natural rate of interest has declined”. Is this fully convincing?

- I do not deny various structural factors are pushing down a natural rate of interest.
- But we should recognize that a part of a decline is due to prolonged monetary easing itself.
  - Front-loading of future demand
  - Currency depreciation
- What Japan experienced over the past 20 years and what other developed economies experienced over the past 10 years are more than short-term "shocks."

Rethinking is needed for the prevailing model of monetary policy, although it is somewhat overdue

- A decline in an equilibrium or natural rate of interest is partly of central banks own making.
    I. The effectiveness of monetary easing derives from front-loading future demand to the present by increasing debt. This strategy could work if the shock hitting the economy is temporary. Otherwise, demand to be front-loaded will inevitably decline, which calls for a further decline in interest rate.
    II. Since investment is undertaken according to expectations of profitability, the proportion of productive investment will decline over time, reducing productivity growth and natural rate of interest.
    III. Aggressive monetary easing will suppress credit spread, which could lead to lower productivity growth by reducing the efficiency of credit markets.
- On top of that, accumulating financial imbalances such as increased leverage, maturity mismatch and elevate asset price are concerning. If financial crisis occurs due to accumulated financial imbalances, it could trigger another "once a century event."

Going forward, should we worry about inflation or deflation?

- Economists tend to argue that it is enough to simply raise rates at the first signs of inflation. But this is misguided. The real problem is low growth, not inflation, at least in the short-run.
- The same is true for the argument of scary of deflation. The dangers usually associated with deflation -- typified by the Great Depression in the 1930s -- was in fact the product of a collapse of the financial system.
  - "Deflation is a threat posed by a critical breakdown of the financial system." (Paul Volcker)

Rethinking is also needed for fiscal policy or more broadly the role of government

There are several roles that governments have to play, but the Corona crisis quite convincingly has shown two vitally important roles of government.

1. To absorb risks such as natural disaster and the pandemic, which private individuals alone cannot bear.
   - Prior to the Corona crisis, the prevailing argument was fiscal policy should take more active role in economic stabilization, given limited monetary policy space. But the limit of front-loading of demand applies to fiscal policy as well eventually. The real constraint is not zero lower bound of interest rate, but a declining potential growth rate.
2. To redistribute income. It has become clear to maintain fairness of income and wealth distribution both as an ex ante and as ex post, which is the basis for sustainability of the society and the economy.
   - The Corona crisis seems to have created a general sense of sympathies with others, which is welcome sign. But this should not stop at the level of emotion. What is needed is to realize those sympathies in a concrete form, namely, accepting a hike in tax rate.