Thinking ahead for Europe

Fiscal policy in a sectoral recession and recovery

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Key point(s)

- This time is different!
- Shortfall in demand (less now of supply) is exogenous and sector specific.
- Need to distinguish between providing replacement income (necessary) and aggregate demand policies (ineffectual).
- Multiplier low – most transfers are saved.
- Fiscal rules: increased uncertainty (long and short term) suggests prudence on debts even with low interest rates.

Where are we now?

- Light at end of tunnel visible, after sharp downturn, quick recovery is taking place – but so far 'K shaped': quick for industry slow, partial for services.

- Does the recovery need to 'pushed'?

Outlook for Short-Medium run

- <u>Sectoral</u> dimension of disturbance to economy is key for policy design.

- Governments need to provide replacement income, but common sense suggests that <u>aggregate</u> demand policy cannot bring the COVID affected sectors back to previous level.

- Some economic modelling suggest that fiscal policy multipliers are lower (1/3?) than usual as households savings rates shoot up.

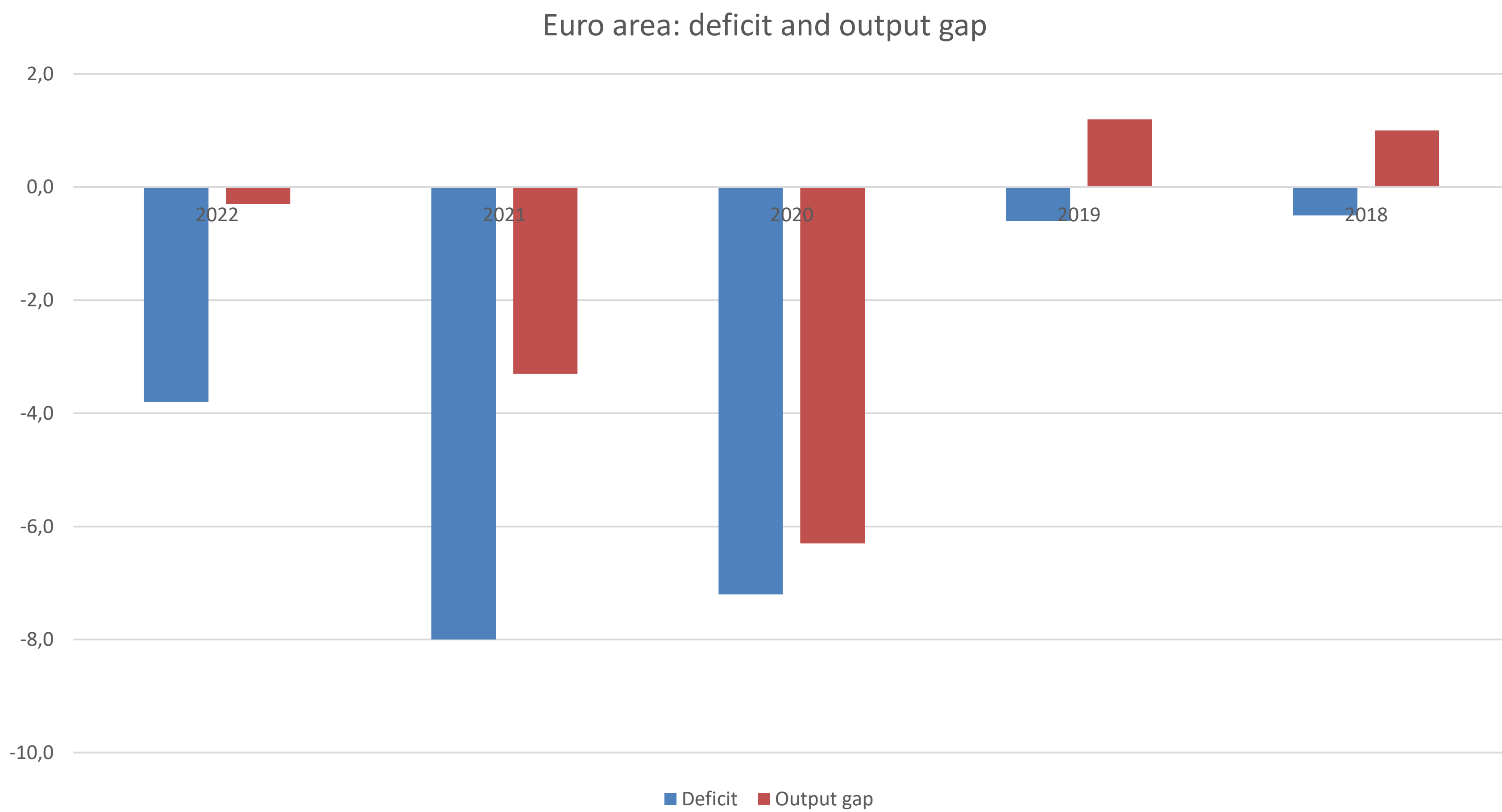
Fiscal policy after a sectoral recesion

Large multipliers do not necessarily affect the optimal timing of fiscal consolidation, however. If they remain just as large in the future, the adjustment will be as painful later. But, if they are larger now than later, this tilts the adjustment toward doing more later: Less pain now, less pain later. (Blanchard and Leigh (2013)

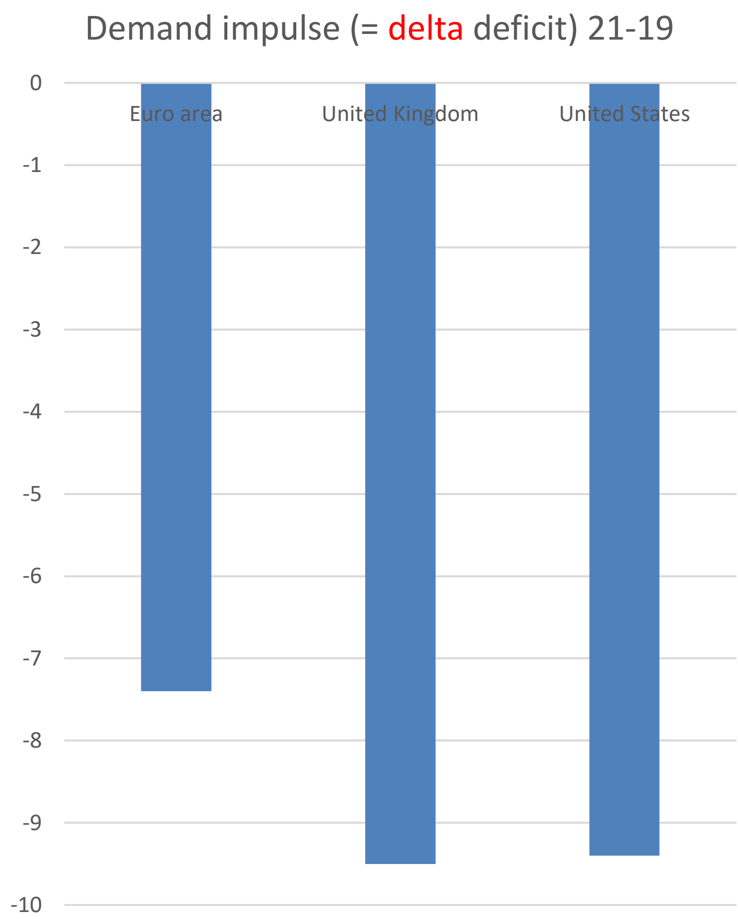
<u>Today multipliers low</u> => start consolation early

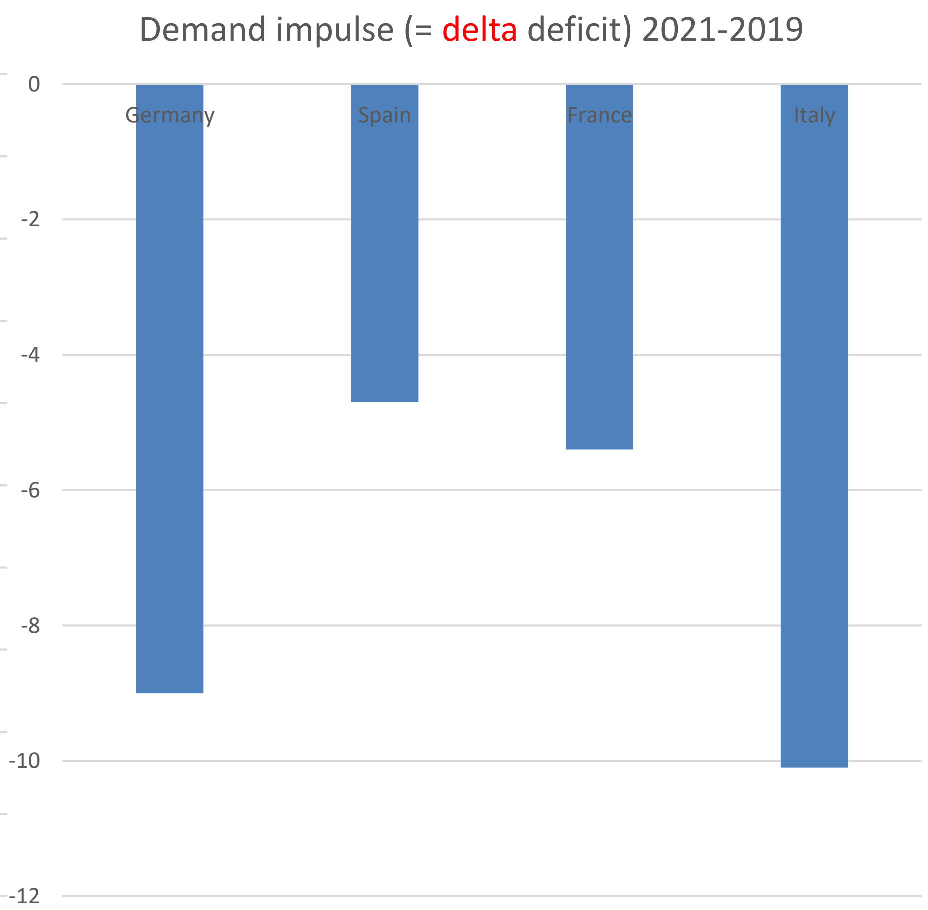
(Same applies to hysteresis effects.)

Replacement income versus demand impulse (=deficit > output gap)



Demand impulse: G-3 similar, big differences inside euro area





On fiscal rules

- Large shocks might be more prevalent than we thought before the crisis,
- If cost of high debt is convex: need to limit the increase in debt during the crisis, and to reduce debt levels once normal times return.

An aside:
How to foster adjustment?

Sectoral shocks will be both transitory (e.g. travel); and permanent (e.g. digitalisation of economy).

- Need to facilitate adjustment while maintaining targeted income support.
- Policy proposition:

Short term working time schemes should be used to foster adjustment: Workers should be able to keep their replacement income even if they take a second, part time, or temporary job, or better change to another a sector. Government can only gain if people produce something instead of sitting idly at home.

Conclusions

Crisis/recovery is sectoral, aggregate demand policies are thus of limited usefulness. Applies to both monetary and fiscal policy.

Unprecedented fiscal effort at national and EU level should be used to foster adjustment. Income support, such as furlough schemes should be made more flexible, allowing for second jobs and/or switches to new sectors.