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Finding the Right "Hall of Mirrors": The Mixed Blessings of Lessons from the Past for Shaping a Post-COVID Future*

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As economic policymakers, **we have reached a crossroads** in our efforts to contain the COVID-19 crisis. **We now face a range of scenarios** going forward.

On one extreme end, several months from now we might be in a position to "pad our shoulders" as the united efforts of fiscal and monetary policy may have stemmed the worst phase of the crisis. In this hypothetic world, the COVID-19 pandemic will undoubtedly remain in our memory as a worldwide, catastrophic crisis in many economic and social dimensions. But we may have found a way of taming the shock and its consequences.

The other end of the continuum of scenarios presents us with a much bleaker outlook: rather than mastering the pandemic, we may be confronted with multiple new waves of infections, additional shocks (e.g. from a weakening financial sector) and rising, increasingly unsustainable public as well as private debt that impede a fast recovery.

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Where exactly on this continuum our economies will stand several months from now, will depend on **several unknowns**. Many of these unknowns lie **beyond the realm of fiscal and monetary policy** – for example, when an effective vaccine will be available at a large scale.

As economic policymakers, however, **we also have considerable power in shaping the future path of the global economy**. Therefore, we cannot afford complacency: we are co-responsible for pushing the likely outcome of potential scenarios as far as possible towards the more optimistic spectrum.

So: what shall we do from here and where shall we look for inspiration when choosing the path to follow onwards from the present crossroads?

Milton Friedman once said that, and I quote,

"only a crisis, actual or perceived produces real change. When that change occurs, the actions that are taken depend on the ideas that are lying around."[1]

Our current pool of ideas to fight the COVID-19 crisis is necessarily – implicitly or explicitly – influenced by the past. The past has generated many of the ideas currently "lying around". And indeed, historical events such as the Spanish Flu of 1918[2] or the Global Financial Crisis (GFC) of 2008/09[3], have proven to be enlightening lenses and filters for selecting our way forward since March 2020.

Yet, **historical reasoning using analogies is most useful in shaping the short-run response to crises**.[4] By now, **we have already left behind that first bit of the road**. At the present crossroads, **lessons from the past may increasingly become a mixed blessing**. In my opinion, caution is due for two reasons.

For one thing, some of its characteristics and consequences make the **COVID-19 crisis**, if not an **unprecedented**, at least a once-in-several-generations event for policymakers.

For another, **focusing too much on historical comparison cases can make us blind to current challenges** which did not figure prominently on policy agendas in the past.

I. Why might this time be different?

Why then might this crisis be particularly difficult to gauge in terms of past events?

Let me start with the comparison to the GFC, which, when the pandemic hit in early 2020, frequently served as the prime reference case. Among many other observations, a particularly prominent claim regarding the differences between the GFC and the COVID-19 shock is that, this time around, **banks appear to be the solution,**

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[1] Friedman (1962), p.XVI.

[2] For example, recent research based on the Spanish Flu of 1918 appears to confirm that an uncontrolled pandemic can affect the economy more negatively than the timing and severity of countermeasures (e.g. lockdowns). In fact, in 1918, stricter countermeasures were associated with stronger recovery effects over the medium term. See Correia et al. (2020).

[3] For example, the GFC taught us that a monetary union like the euro area needs strong monetary policy signals to ensure financial stability in the short term and to prevent financial market fragmentation and an impairment of monetary policy transmission in the medium term, c.f. Krishnamurthy et al. (2018), Altavilla et al. (2020).

[4] c.f. also Eichengreen (2012, 2016) on this point, whose book "Hall of Mirrors" inspired the title of this speech.

rather than the cause, of the problem.[5] Banks seem to be much better prepared to weather the shock than a decade ago.

Since the GFC, regulators have substantially stepped up their micro and macroprudential toolkits to safeguard financial stability. Indeed, this progress on the regulatory and supervisory front has enabled banks to better cope with the initial shock and to step up their credit supply to firms and households in desperate need of bridge financing.

But this lesson from the recent past might only be half the story. In particular, **we must not close our eyes to potentially dangerous developments further down the road**.

As the pandemic continues to depress the economy, corporate illiquidity can quickly morph into insolvency. In this case, non-performing loans (NPL) on banks' books are likely to increase over time. Now: at first sight, banks are today much better equipped to digest significant losses than they were 12 years ago. At the same time, **almost a decade of structurally low profitability** in the banking sector can turn NPL resolution post-COVID-19 into a more threatening challenge to financial stability, monetary policy transmission and the economic recovery than it was in the aftermath of the GFC.[6]

Weaker corporate balance sheets following a decade of sluggish growth – which may in fact partly represent side **effects of our monetary policy response to the GFC**[7] – amplify these risks. **Hence, banking sector developments during and following the GFC might be a problematic comparison and guidepost for the crossroads we are facing**.

More fundamentally, **the very nature of the COVID-19 crisis makes the current challenges hard to appreciate on the basis of lessons from the past alone**.

One aspect that makes the current crisis particularly special is that a **substantial part of the immediate economic and social damage** it caused was **itself a consequence of conscious policy decisions**. Governments all over the globe resorted to far-reaching containment measures with a specific goal and trade-off in mind: to **reduce the costs of immediate illness and death, at the expense of immediate economic costs**.

In that process, when taking, or omitting to take, containment measures, governments answered – implicitly or explicitly – a question, which, in times of peace, is usually buried deep down in aggregate welfare considerations: **what is the economic value of human life?** No doubt, this difficult issue will stay with us when responding to new waves of infections going forward.[8]

These hard choices will also have **effects on monetary and fiscal policy**. More durable, extensive or strict containment measures may increase pressure for more monetary and fiscal accommodation in the short run to safeguard price and financial stability. Regarding monetary policy, one should, however, bear in mind that with

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[5] c.f. Giese and Haldane (2020).

[6] c.f. Ari et al. (2020).

[7] c.f. Acharya et al. (2019) for recent empirical and Liu et al. (2020) for recent theoretical evidence regarding this point. For the econometric difficulties attached to identifying the real effects of zombie lending, c.f. Schivardi et al. (2020).

[8] c.f. Rowthorn and Maciejowski (2020).

the agreement on the EU's Recovery and Resilience Facility (RRF) over the summer of 2020, the ECB's monetary policy is no longer "the only game in town". In that sense, the framework conditions for the ECB's monetary policy have changed substantially since the expansion of the PEPP in June 2020. Second, the resurgence of the pandemic in the fall has already been anticipated in previous forecasts of the Eurosystem (both in June and September) – so, they are not news in the sense of surprises for policy which would warrant urgent responses. Third, it must be clear to all of us that the further course of the economy is foremost driven by the further development of the pandemic. The most important measure to protect the economy is to find the right balance of containment, while avoiding overly damaging lockdowns. In this context, as has been shown across the world since spring, early, targeted, decisive and effective action is required by governments, with the crucial and unavoidable challenge being acceptance, compliance and cooperation among the population. No doubt, this requires determined, responsible and credible leadership.

Quite unlike any other crisis in the past, the COVID-19 pandemic thus forces us to seek answers to **questions which extend far beyond the confines of our "policy comfort zone", while laying bare how limited the power of economic policy can be without the support from other scientific disciplines**. In this sense, the **current crisis also teaches us humility**.

II. What the past may not teach us

Appropriate historical analogies for the current crisis may not only be particularly hard to find – they might also distract us from new challenges to which economic policymakers have too often turned a blind eye.

First, while the economically and socially vulnerable frequently suffer most during economic and financial crises, the **impact of the pandemic has been extraordinarily unequal** across social classes and ethnic groups even by historical standards.[9] This may in turn have important repercussions for the depth and duration of the pandemic recession, and thus also on the evolution of inflation back towards target. In that sense, the distributional impact of COVID-19 is also relevant for monetary policy.

The second area I want to call your attention to is the need to use the crisis for real change. The call for **Friedmanian "real change"** and for **"building back better"** requires us to calibrate our policy response to the crisis in a way that addresses current challenges **beyond "simply" closing the output gap**.

More specifically, we will have a **hard time finding fitting precedence** for an issue that rarely figured on economic policymakers' agendas in the past: **climate change**. While historical crises have proven a valuable laboratory to test how fiscal and monetary stimulus can boost aggregate demand[10], we have little experience on how policies should be designed in order to **score high in terms of both economic multipliers and climate impact metrics**.[11]

It would be a misunderstanding to interpret the Eurosystem's - and most other central banks' - focus on the primary objective of price stability as an indication that climate change is irrelevant for the conduct of monetary

[9] c.f. Kirby (2020) for recent evidence from the United Kingdom.

[10] c.f. Hausman (2016) and Fishback (2017) for fiscal policy and Romer and Romer (2004) for monetary policy.

[11] c.f. Susskind and Vines (2020).

policy. Here, the COVID-19 pandemic may serve us as a wake-up call. For one, the crisis has reminded us that **financial markets may systematically fail to factor in tail risks** such as pandemics or, for that matter, climate change. Moreover, given the impact of multiple shocks on **current and expected price developments**, the potential threat emanating from climate change for price stability in the medium to long term has become more tangible.[12]

Hence, the experience of the COVID-19 pandemic consolidated our belief within the ECB Governing Council that **climate change does concern many aspects of monetary policy**, including inflation, economic growth, interest rates and the transmission channels of our instruments.[13] During the ongoing ECB monetary policy strategy review, **we have thus pledged to carefully study the implications of climate change for our monetary policy strategy and operations**.

Whether and how we might approach these risks in our monetary policy decisions and operations is one of the questions we will discuss over the coming months – but it is clear that we must be prepared to **navigate hitherto unchartered waters with little historical guidance** to step up to the challenge.

III. Conclusion

Let me conclude with a recent and timely reminder from Susskind and Vines (2020) regarding the need for global cooperation in tackling big global challenges like COVID-19 and climate change:

> *“The post-Second World War institutions have served the world remarkably well. Now, following the COVID-19 pandemic, they need strengthening and reinvigorating. Because the pandemic is such a very large event, we need to realize that the world faces a very large choice. We can do what the world did in the late 1940s, when the institutional choices which were made helped to support the golden age of global growth during the 1950s and 1960s. Or we can instead allow what happened in the 1930s to happen all over again.”*[14]

I think this quote is particularly suitable to this conference, which has by now become an established tradition and which has the aim of bringing together the best minds and to exchange insights and views from both sides of the Atlantic.

As economic policymakers, **we constantly walk through myriad halls of mirrors**. We will more easily **find the right exit from these halls** if we work together to install a couple of **non-reflecting, clear-sighted windows** that allow for a steady view **on the outside world**.

Let’s pave the way for a **new golden age during the 2020s** – by drawing lessons from the past, but also by looking at the present and keeping in mind the future at the same time. ■

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[12] c.f. Schnabel (2020).

[13] c.f. Lagarde (2020).

[14] Susskind and Vines (2020), p.11.

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