IN-DEPTH ANALYSIS

Requested by the ECON committee

Monetary Dialogue Papers, March 2021

European Parliament

Balanced Withdrawal of Policy Support to Avoid Cliff Effects

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
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PE 662.897 - March 2021

EN

Balanced Withdrawal of Policy Support to Avoid Cliff Effects

Monetary Dialogue Papers
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Abstract

The COVID-19 crisis has triggered unprecedented concerted economic policy response. The paper investigates potential cliff effects that may arise from the temporary nature of the measures adopted and their different phase-out schedules. It finds that the concern that premature policy tightening could jeopardise the recovery are overblown. The major challenges for economic policy lie in the medium term.

This paper was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 18 March 2021.

This document was requested by the European Parliament's committee on Economic and Monetary Affairs (ECON).

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Manuscript completed: February 2021
Date of publication: March 2021

This document was prepared as part of a series on “Path to Recovery: Dangers of Cliff Effects”, available on the internet at:
https://www.europarl.europa.eu/committees/en/econ/econ-policies/monetary-dialogue

For citation purposes, the publication should be referenced as: Gern, K.-J., *Balanced Withdrawal of Policy Support to Avoid Cliff Effects*, Publication for the committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg, 2021.

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LIST OF ABBREVIATIONS

APP	Asset purchase programme
EBA	European Banking Authority
ECB	European Central Bank
EP	European Parliament
EU	European Union
GDP	Gross domestic product
HICP	Harmonised Index of Consumer Prices
PELTRO	Pandemic emergence longer-term refinancing operation
PEPP	Pandemic emergency purchase programme
SGP	Stability and Growth Pact
TLTRO	Targeted longer-term refinancing operation

EXECUTIVE SUMMARY

- **The COVID-19 crisis has triggered unprecedented economic policy response which may lead to substantial cliff effects once support measures are withdrawn.** Policy makers responded swiftly with a concerted implementation of fiscal, monetary and prudential measures on an unprecedented scale. The paper investigates potential cliff effects that may arise from the temporary nature of the measures adopted and their different phase-out schedules.
- **The nature of the crisis has implications for economic policy.** As supply side restrictions are an important part of the problem, generalised demand stimulus is not the appropriate policy response and policies need to be more targeted. To the extent that the pandemic can be characterised as an interruptive shock it is essential for economic policy to prevent the collapse of sound production structures.
- **Short-time work schemes have been an important element policy support in the crisis and should remain so as long as activity is restrained in significant parts of the economy.** However, potential negative effects on economic efficiency may become more of a concern the longer the crisis lasts.
- **Budget plans do not suggest a fiscal cliff looming.** The deficit in the structural primary balance will decline only gradually according to Commission forecasts from autumn 2020, and governments in the euro area have in the meantime introduced additional fiscal support measures. As long as the pandemic substantially affects economic activity, the general escape clause of the European fiscal framework should remain in force.
- **Monetary policy will remain supportive for the foreseeable future.** The ECB needs to continue to act as a backstop for fiscal policy in the short-term. Measures designed to support bank liquidity and funding conditions have underpinned a strong increase in bank loans to the private nonfinancial sector.
- **Prudential rules in the financial sector have been eased and the use of capital buffers supports lending and economic activity.** The positive effect of loan guarantees and prudential easing measures is relatively persistent until the end of 2022.
- **Stimulus measures in the different policy areas have been mutually reinforcing.** The relative importance of the different policy measures varies substantially across countries.
- **The concern that premature policy tightening could jeopardise the recovery seems overblown.** Cliff effects could be particularly important in the case of fiscal measures and loan moratoria, but they need not bite. A gradual withdrawal of fiscal support is appropriate if the economy starts a sustained recovery from spring onwards as projected.
- **The medium-term risks of continued massive policy support rise with the duration of the crisis.** The longer fiscal, monetary and prudential measures to shore up the economy are in place, the larger negative side effects can be expected to be. Fiscal reconstruction after the crisis must be reconciled with the goal of sustainable and inclusive growth, which will be difficult to achieve.

1. INTRODUCTION[1]

A crisis of historic proportions has triggered unprecedented economic policy response. The economic repercussions of the COVID-19 pandemic have been dramatic in the euro area, with output dropping by 15 percent in the first half of 2020. After a phase of incomplete recovery in the summer months, renewed containment measures amid a second wave of infections have been introduced starting in autumn and are at the current juncture again weighing on the economy. Economic policy responded swiftly to the crisis with a concerted implementation of fiscal, monetary and prudential measures on an unprecedented scale.

Policy response in the case of a macroeconomic emergency needs to bold and flexible. An economic shock of the dimension created by the pandemic requires policy to respond quickly and forcefully in order to reduce uncertainty, provide vital support to firms and households, and safeguard financial stability. A timely response has to be decided in a situation where the precise manifestation of the crisis is still largely unknown, when it is still unclear how deep and how long the downturn will be and which parts of the economy will be affected most. Making measures strictly temporary allows readjustment after a certain period of time to better target those most in need and make the programmes more efficient.

The paper investigates potential cliff effects that may arise from the temporary nature of the measures adopted and their different phase-out schedules. Section 2 briefly characterises the nature of the COVID-19 shock and its implications for economic policy. In section 3, we review by policy area the support measures put in place and describe the potential for cliff effects. The interaction of COVID-related policy measures is investigated in section 4 and problems of phasing-out are discussed. Section 5 concludes.

[1] The author is grateful to Ulrich Stolzenburg for providing useful comments as well as several figures shown in the paper.

2. THE SPECIAL NATURE OF THE COVID-19 SHOCK

The COVID-19 crisis differs from "normal" recessions with respect to the industries that are particularly affected. Normal business cycles are fluctuations of economic activity that economic agents can make provisions for, e.g. by accumulating reserves during an upturn to draw upon in a downturn. The extent of such provisioning will be larger in industries with high volatility of demand and activity over the cycle (e.g. manufacturing of investment goods) than in industries that face relatively stable demand conditions and weak cyclicality (such as consumer services, for instance). In the COVID-19 crisis, industries have been severely affected that are usually confronted with relatively stable demand and thus cannot be expected to have sufficient reserves to cushion a strong decline in revenues.

Policies to contain the pandemic and behavioural responses to avoid infection are important drivers of activity. The drop of economic activity in the crisis is to a large part due to measures imposed by governments to contain the spread of the virus which represent severe temporary supply-side restrictions. Personal services industries, the hospitality sector and entertainment industries are still strongly affected, while the recovery in the manufacturing sector has already gone a long way. The change in demand also results from behavioural responses that can be seen as a preference shock in the sense that people are temporarily reluctant to engage in activities that involve social contacts in order to avoid infection risk. This preference shock might quickly reverse once a medical solution to COVID-19 is in place. This raises the question to what extent potential output has been affected by the crisis (Bodnár et al., 2020), with repercussions for the estimate of the output gap which plays an important role in the European fiscal surveillance framework (Gern et al., 2020).

The COVID-19 crisis can be characterised largely as an interruptive shock, and adjustments in the production structure that are necessary in the longer term may be limited. In contrast to normal recessions that usually contain elements of a correction of excess demand in the previous upturn, the COVID-19 shock can be regarded as completely exogenous. It can be argued that the structure of demand prevailing before the pandemic will largely be restored after COVID-19 is under control. To the extent that this interpretation is correct, COVID-19 can be described as an interruptive shock, in contrast to a disruptive shock that would imply substantial reallocation of resources in the medium term.

The nature of the crisis has implications for economic policy. When systemic shocks like COVID-19 (or large-scale natural disasters or political conflicts) are erratic and virtually unpredictable for economic agents (Knightian uncertainty) and private provisioning – for example, via insurance markets – is therefore no option, this calls for policy intervention beyond the usual automatic stabilisers to keep affected businesses afloat. When supply side restrictions are at the heart of the problem, generalised demand stimulus is not the appropriate policy response and policies need to be more targeted. In the case of an interruptive shock it is essential for economic policy to prevent the collapse of sound production structures. However, the longer the economy remains in crisis mode, the higher the probability of fundamental changes in the way our economies work, i.e. that businesses will have to adjust, and that economic policy should consider ways to facilitate restructuring rather than aim to conserve economic structures.

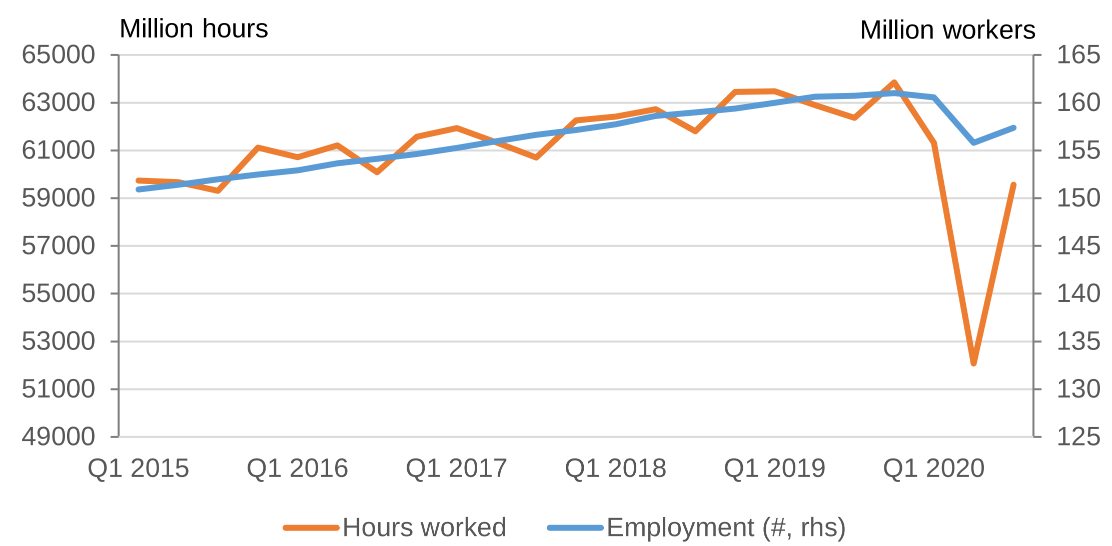
3. POLICY AREAS WITH POTENTIAL CLIFF EFFECTS

In this section we briefly review by policy area reactions to support the economy amid the COVID-19 crisis and describe the potential for cliff effects.

3.1. Labour market policy

In Europe, the COVID -19 crisis has led to a comparatively modest rise in unemployment. Before the pandemic, unemployment had decreased substantially from the high levels reached in the course of the Great Recession and the successive European sovereign debt crisis amid a sustained period of uninterrupted growth. In several countries, including Germany, the Netherlands and the UK, unemployment even declined to long-term lows. COVID-19 resulted in a reversal of recent trends in labour markets. In the euro area, the sharp drop in activity in spring 2020 led to a significant rise in unemployment, from 7.2% in February to 8.7% in July, albeit with substantial differences across countries. The increase in the unemployment rate (Eurostat definition) from pre-crisis levels to the peak registered in the course of 2020 ranged from only 0.3 percentage points in Italy to somewhat more than 3 percentage points in Spain, Estonia and Cyprus. The increase in unemployment was, however, generally small compared to the size of the fall in output, and much smaller than in the United States, where the unemployment rate as a result of the COVID-19-induced contraction of economic activity in spring 2020 skyrocketed from 3.5% in February to almost 15% in April. Similarly, the fall in the number of people in employment in the euro area between the fourth quarter 2019 and the second quarter 2020 (–3.2%) was much smaller than the rapid decline in hours worked, which fell by 18% (Figure 1).

Figure 1: Employment and hours worked in the euro area



Source: ECB.

The impact on the European labour market was mitigated by the extensive use of short-time work or furlough schemes. Short-time work schemes allow employers to temporarily reduce hours worked, even to the level of zero, while keeping the worker on the job and (partially) compensate workers for the loss of income. They had proved to be effective in smoothing employment during the Great Recession in some countries, particularly in Germany, and been operational in a number of countries before the COVID-19 crisis or been implemented as the crisis unfolded. Countries with existing schemes generally introduced temporary expansions to make them more inclusive or reduce remaining labour costs for the employers (Eichhorst et al., 2021). In addition, the length of a period of short-time work possible was typically extended. The EUROFRAME group of ten European economic research institutes in the focus section of its recent Euro Area Economic Outlook report (EUROFRAME, 2021) concentrates on the effect of COVID-19 on the labour market and provides an overview of short-time work schemes in the institutes' host countries (Table 1). The number of workers on these kind of schemes in relation to the labour force was as high as 20-30% in spring in a number of countries, including in France, Italy, Austria and the UK. The numbers on the schemes decreased substantially during the recovery phase in summer, but started to rise again more recently, reflecting the economic repercussions of renewed lockdown measures.

Table 1: Short-term work / furlough schemes

	Austria	Finland	France	Germany	Italy	Ireland	Netherl.	Poland	UK
In place before Covid-19	yes	yes	yes	yes	yes	no	no	no	no
Newly introduced	no	no	no	no	no	yes	yes	yes	yes
Extended	yes	yes	yes	yes	yes	yes	yes	no	
Characteristics									
max. possible length (months)	6 each phase	unlimited	24	24	8	unlimited	n.a.	3	unlimited
Average (effective) replacement rate (% of wage)	80 to 90% (gross)	43 to 56% (gross)	84 (net)	60-87% (net)*	80% (net) **	n.a. ***	n.a. ***	up to 50% (gross)	80% (gross)
In place until	Mar 31, 2021	Dec 31, 2020/ Mar 31, 2020	Dec 31, 2021	Dec 31, 2021	Mar 31, 2021/ Jun 30, 2021	Mar 2021	Jul 2021	no expir. date	Apr 2021
Other specific labor market support policies	yes	no	no	yes	yes	yes	yes	yes	no

Source: EUROFRAME (2021).

Notes: *Depending on family status and duration of spell of short-time work; ** with a maximum of EUR 1,100 per month; ***wage subsidy for employers.

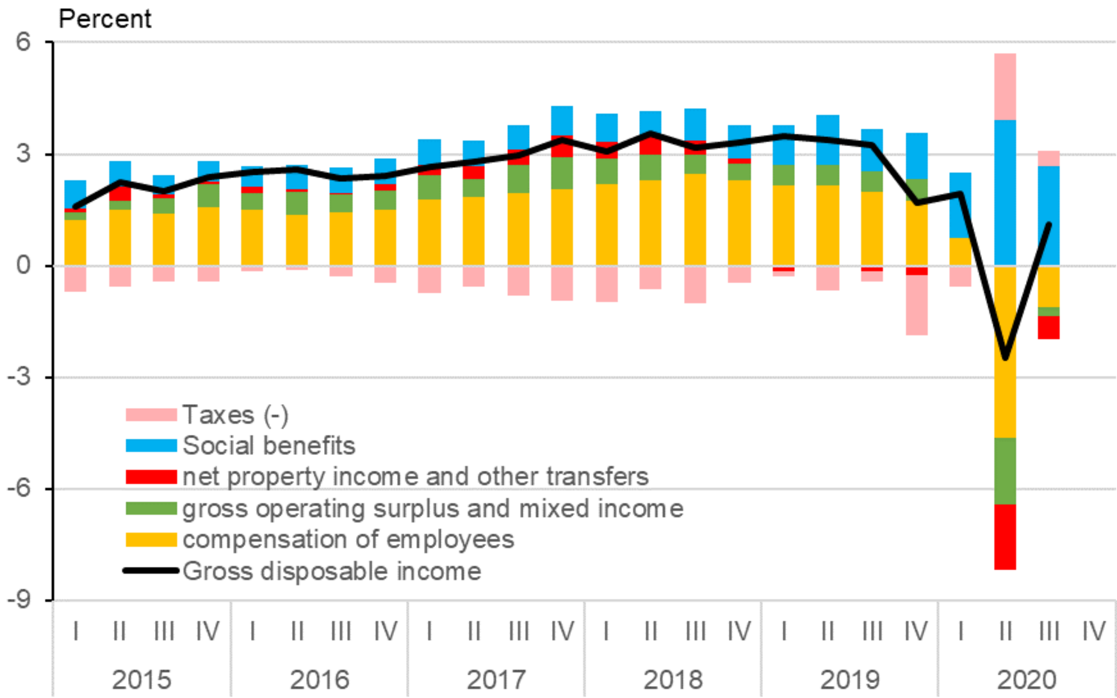
Time limits to eligibility for short-time work have been shifted out to prevent a jump in unemployment. The possibility for companies to use short-time work schemes was generally limited to a certain period of time, usually 6-12 months. An expiration of short-time work before normalisation of economic activity is largely complete can potentially lead to a strong increase in unemployment. Forecasts and realisations for unemployment in the UK may serve as an example: In its August forecast, the National Institute in London expected the unemployment rate in the UK to increase drastically to 10% in the fourth quarter 2020 from just over 4% in the second quarter, as the government had confirmed to close the Coronavirus Job Retention Scheme at the end of October, a furlough scheme designed to allow companies to keep employees through the crisis (Lenoel et al., 2020). Eventually, however, the scheme was extended to 30 April 2021, although at somewhat less generous terms. This move has probably been decisive in limiting the rise in unemployment to 5.1% by December. Similarly, in other countries, time limits for short-time working arrangements have already been extended or replaced by similar programmes to limit the negative impact of COVID-19 on the labour market.

While short-time work schemes should remain an important element of labour market policy as long as activity is restrained in significant parts of the economy, potential negative effects on economic efficiency may become more of a concern the longer the crisis lasts. Short-time work schemes facilitate the temporary reduction of hours worked so that labour input is better matched to output requirements. They are particularly effective when there are strong labour market regulations and institutions which make it difficult to adjust hours and wages at the plant level, as in most European countries. The advantage of this approach is that the link between employee and company is maintained and production can be resumed more easily. This is particularly attractive in the current situation to the extent that the nature of the COVID-19 shock is interruptive rather than disruptive. On the negative side, inefficiency can be introduced in the labour market as incentives for shifts from contracting sectors to growth sectors are reduced and labour market access for freelancers and those looking for part-time work may be limited (Cahuc, 2019). These disadvantages can be expected to become increasingly important with the duration of the crisis. Consequently, further extension of short-term schemes should be carefully designed, with possible options such as declining generosity over time and narrowing access to the program to those enterprises that remain most affected. At the same time, policy should put a stronger focus on retraining and preparing workers for internal restructuring or external mobility on the labour market, to help manage the challenge of adjustment to changes in markets and business models that may result from the crisis in the longer term.

3.2. Fiscal policy

Governments have responded quickly to the COVID-19 crisis with a broad range of measures. In the countries of the euro area (and worldwide), fiscal policy is heavily engaged in trying to mitigate the adverse economic impact of the pandemic. Governments were relatively quick to respond, with sizeable packages announced already in March 2020, almost in sync with lockdown measures. A broad range of fiscal measures have been implemented. The initial emergency packages focused on support for the health sector and those parts of the economy that were directly affected by government restrictions on economic activity (Haroutunian et al., 2021). They included the introduction or expansion of short-time work schemes to reduce the labour cost burden and the provision of credit guarantees to support liquidity in the corporate sector. Additional measures were announced in the following months in order to underpin the economic recovery after the lockdowns where eased, including packages containing generalised demand stimulus and amounting to some 4% of GDP in Germany and France. Part of the measures in these programmes and other measures included in the draft budgetary plans for 2021 partly will be effective in 2021 and beyond. Effectively, fiscal policy measures during 2020 smoothed gross disposable income of households substantially during the crisis months amid major reductions in terms of compensation of employees, mixed income and gross operating surplus (Figure 2).

Figure 2: Contributions to Gross Disposable Income Growth of Households

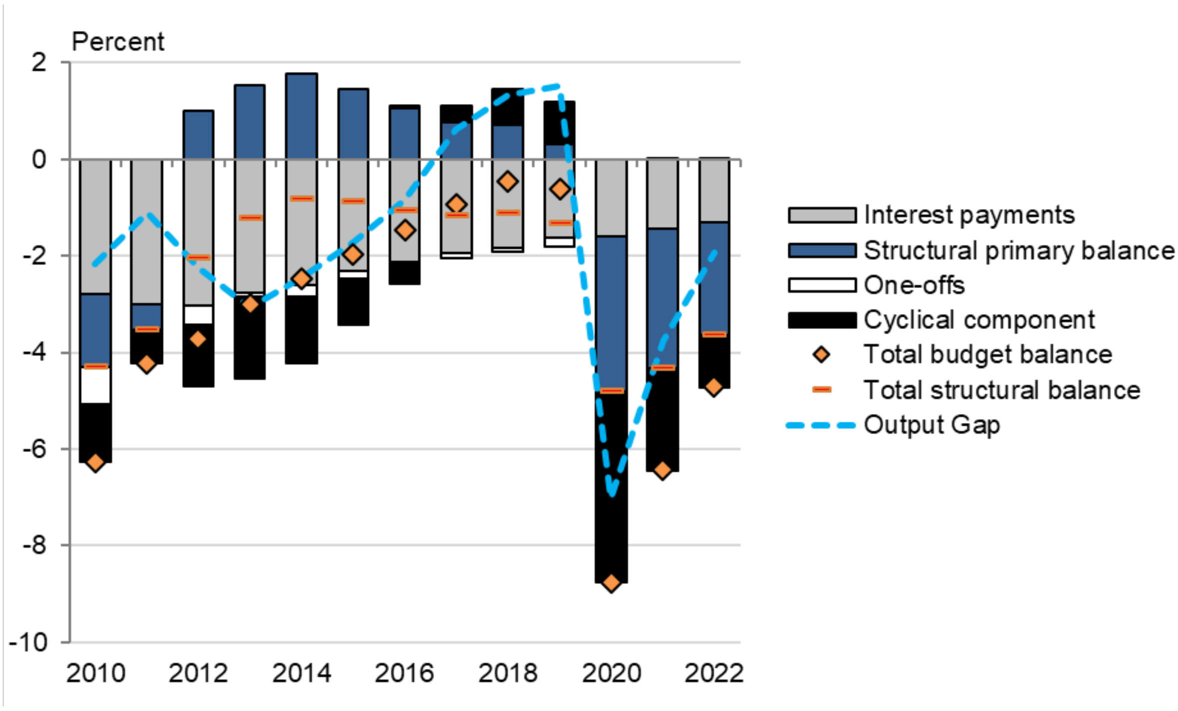


Source: Eurostat, National accounts.

The fiscal stance in the euro area is strongly expansive, with the aggregate fiscal impulse in the euro area expected to exceed 3.5% of GDP. The fiscal stance can be measured by the change in the structural primary balance, which is the total fiscal balance less the impact of one-off or temporary measures (like a bank rescue), the cyclical component (which captures the budgetary effect of automatic stabilisers), and interest payments on public debt, which cannot be directly influenced by governments.[2] In its autumn forecast, the Commission expects the structural primary balance to deteriorate by an estimated 3.5% of GDP from a small surplus in 2019 (Figure 3). The overall fiscal balance is forecast to register a hefty deficit of 8.8% of GDP due to a swing in the cyclical component by 5 percentage points. Although this deficit is relatively small compared to the general government deficit in the US and the UK, which are expected to be 13.4 and 15.3% of GDP, the fiscal impulse in the euro area is not materially different as the US deficit is coming from a much higher base and the larger swing in the UK deficit is mainly reflecting a stronger deterioration of the cyclical component corresponding to the significantly stronger decline in activity in 2020.

[2] It can be argued that temporary measures, which are a direct response to COVID-19 and the economic repercussions of measures to contain the pandemic, should be treated as one-offs and not included in the structural budget balance (Danish Ministry of Finance, 2020). The Commission, by contrast, does not categorise the fiscal implications of such initiatives as one-offs, which remain insignificant in the decomposition of the Commission forecast for the euro area budget balance in 2020–22 (see Figure 3). Stimulative fiscal measures that remain in place into 2022 and beyond should arguably not be regarded as one-offs.

Figure 3: Components of the euro area fiscal balance, 2010-2022



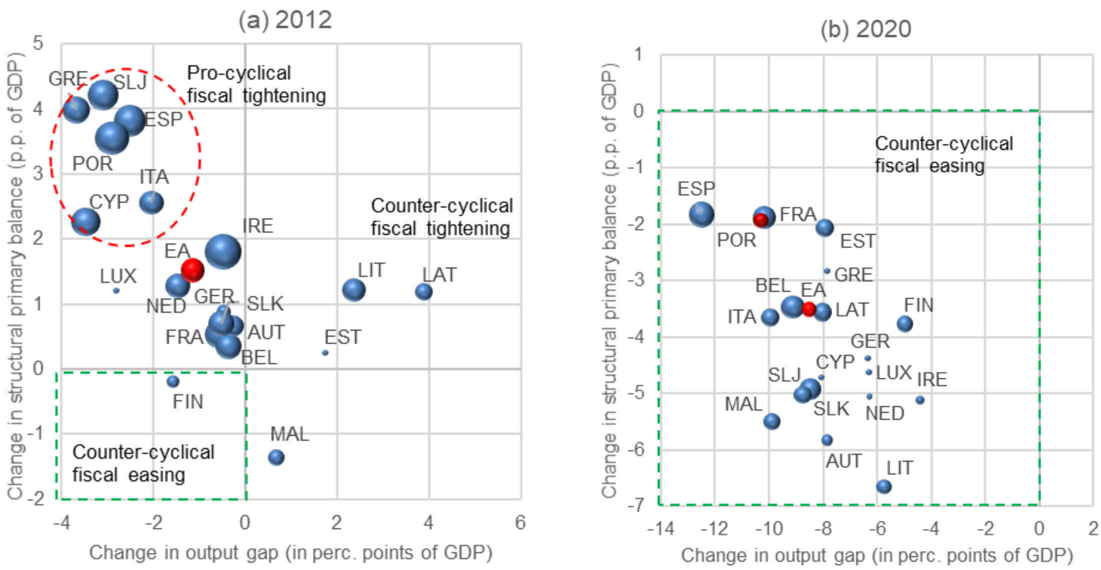
Source: European Commission (2020), autumn forecast, own representation.

Note: For reasons of representation the graph uses a mix of denominators at the cost of introducing a small degree of imprecision. Output gap, one-offs and total structural balance: percent of potential GDP; Total budget balance and interest payments: percent of GDP. The structural primary balance is derived by deducting interest payments (percent of GDP) from the structural balance (percent of potential GDP). The cyclical component is derived by deducting the structural balance (percent of potential GDP) and interest payments (percent of GDP) from the total budget balance (percent of GDP).

Commission forecasts do not suggest a fiscal cliff looming. The deficit in the structural primary balance will decline only gradually, according to the autumn Commission forecast. This forecast is based on information as of October 2020, and governments in the euro area have in the meantime introduced additional fiscal support to assist the economy amid another phase of broad lockdowns in the winter months. As a result, the tightening of the fiscal stance will be even less pronounced than projected. Progress with the implementation of the NextGenerationEU programme, especially using the Recovery and Resilience facility it contains, provides an upside to the euro area economic outlook and can provide a significant boost to the EU economy in the next couple of years (European Commission, 2021).

Fiscal rules are suspended at least until the end of 2021. On 23 March 2020, the Council agreed to enforce a provision of the Stability and Growth Pact (SGP), known as the general escape clause, which in case of a severe economic downturn in the euro area or the Union as a whole allows Member States of the European Union to temporarily disregard the budgetary requirements that would otherwise apply under the SGP. In light of an incomplete recovery and increased downside risks for growth amid a resurgence of the virus in autumn, the provision was decided to remain in force also in 2021. The European Commission will re-evaluate the application of the general escape clause in spring 2021 (European Commission 2020b). The measure provided governments with the flexibility to undertake the fiscal effort deemed necessary to support the economy in view of the pandemic. As a result, the fiscal policy was eased in all euro area countries in accordance with an anti-cyclical fiscal stance (Figure 4). This is in stark contrast to the situation at the height of the European sovereign debt crisis in 2012, when debt sustainability of several Member States of the periphery was questioned in financial markets and rising risk premia on these countries' government bond yields forced them to implement substantial fiscal consolidation measures, reducing demand further in economies that were already in recession. It should be noted, however, that the amount of stimulus seems to be positively correlated with the fiscal space available before the crisis rather than the depth of the economic contraction. Countries like Germany, the Netherlands, Austria and Ireland with ample fiscal space (as measured by the structural balance of 2019) and relatively modest debt levels implemented stronger fiscal efforts than countries like Spain or France that entered into the crisis with considerable structural deficits and already elevated debt levels. This evidence underlines the need to build up fiscal buffers in good economic times, in order to be able to implement appropriate fiscal responses in future crises.

Figure 4: The fiscal stance during crises: 2012 vs. 2020



Data source: European Commission (2020), autumn forecast.

Note: Bubble size represents the structural deficit in percent of potential GDP in the preceding year (structural surpluses shown as dots).

The general escape clause should be lifted once pandemic-induced restrictions on economic activity have been dropped. As long as the pandemic substantially affects economic activity, the general escape clause should remain in force. Economic activity will not fully normalise as long as there is no large-scale medical solution available since uncertainty and precautionary behaviour will remain and government restrictions will continue to be necessary to reduce social contacts. Currently effective vaccines are being rolled out in Europe, but vaccination of a sufficiently large share of the population will take time. Governments will continue to need full leeway to mitigate the social and economic damage of the crisis, at least through 2021. Once restrictions on economic activity aimed to contain the pandemic will not be necessary anymore, the general escape clause should be lifted. This could be the case in 2022, provided that vaccination rollout progresses swiftly and vaccines remain effective also against new variants of the virus. In this case, fiscal surveillance should be switched on again.

Fiscal surveillance should take due account of the increased uncertainty with respect to the cyclical position of the economy. The European fiscal framework is currently under review. It is accused of being overly restrictive and limiting the potential for growth, lacking compliance, being overly complex, and relying on shaky foundations with respect to methodology and legitimacy (European Commission, 2020c). A timely agreement on a major reform may be difficult to achieve though, given the apparent differences in policy approaches across countries and political families. In the absence of a new consensus, the current rules would have to be phased in. Under the current framework, an initial period with a transitory arrangement could be useful, in which all Member States remain under the preventive arm of the SGP and no new excessive deficit procedure would be launched. In the initial period, the Commission should consider pre-crisis estimates of potential output as a benchmark to determine fiscal adjustment needs. This is to take account of the increased uncertainty about the long-run effects of the crisis on the economy and of the criticism that the Commission method is leading to estimates of potential output (and hence the output gap) that are heavily revised over time and risk contributing to procyclical fiscal policy adjustments (Gern et al., 2020).

Further fiscal policy initiatives should be targeted and designed to promote longer-term growth. Against the backdrop of progress in vaccination – at least of those parts of the population that are particularly likely to experience a serious health problem when contracting COVID-19, especially the elderly – and helped by an expected seasonal decline in infections, lockdown measures are likely to be unwound gradually over the coming months. This would enable a gradual normalisation of economic activity, reducing the need for further fiscal support. The pace of recovery will, however, differ across economic activities, and a lifeline should remain in place for enterprises with business models that can be expected to be viable in a post-COVID-19 world, but remain seriously restrained for the time being.

The Kiel Institute has proposed to establish a mechanism of corporate stabilisation grants that would achieve targeted support in a consistent, fair and efficient way (Felbermayr and Kooths, 2020, Box 1). The main idea is to largely offset deteriorations in operating results of firms that emerge due to the pandemic via direct transfers by the government. Importantly, the payments would be proportionate to the average reduction of operating surpluses of firms in the same industry, thereby keeping individual incentives of firms to minimise losses intact. The advantage of this approach in the context of this paper is that corporate stabilisation grants work like an automatic stabiliser, self-adjusting the amount of grants according to the economic situation, and are thus by construction not running the danger of producing cliff effects.

Box 1: Kiel model of corporate stabilisation grants

In an economy-wide emergency, effective macroeconomic stabilisation requires a mechanism that prevents the collapse of sound production structures. Short-time work compensation schemes are an important instrument, but do not stabilise the corporate sector sufficiently as they do not prevent insolvency as a consequence of capital expenses and other fixed costs.

A corporate stabilisation scheme to preserve viable economic structures in the presence of a massive macroeconomic interruptive shock should meet a number of criteria, including: It should be non-discriminatory between industries, company size and legal forms; sectors that are more affected should also receive greater support; companies that were already struggling before the crisis should receive less support; the mechanism should be linked to criteria that are easy to determine and cannot be changed by companies in retrospect. It must not undermine incentives for companies to manage the crisis on their own. It must be targeted, self-adjusting and legally secure, as well as quickly operational in crises of various kinds. The instruments used to date – in Germany: particularly turnover compensation ("Novemberhilfe") and fixed cost compensation ("Überbrückungshilfen") – generally do not meet these criteria.

The Kiel model builds upon grants that compensate the lion's share of crisis-induced reductions of operating surpluses to design a consistent and (vertically and horizontally) fair policy response. The impact of the crisis is measured along sufficiently disaggregated industry averages (further differentiated by regions). Industry-wide operating surpluses are beyond the reach of individual beneficiaries. Thus, idiosyncratic success factors and productive incentives are preserved.

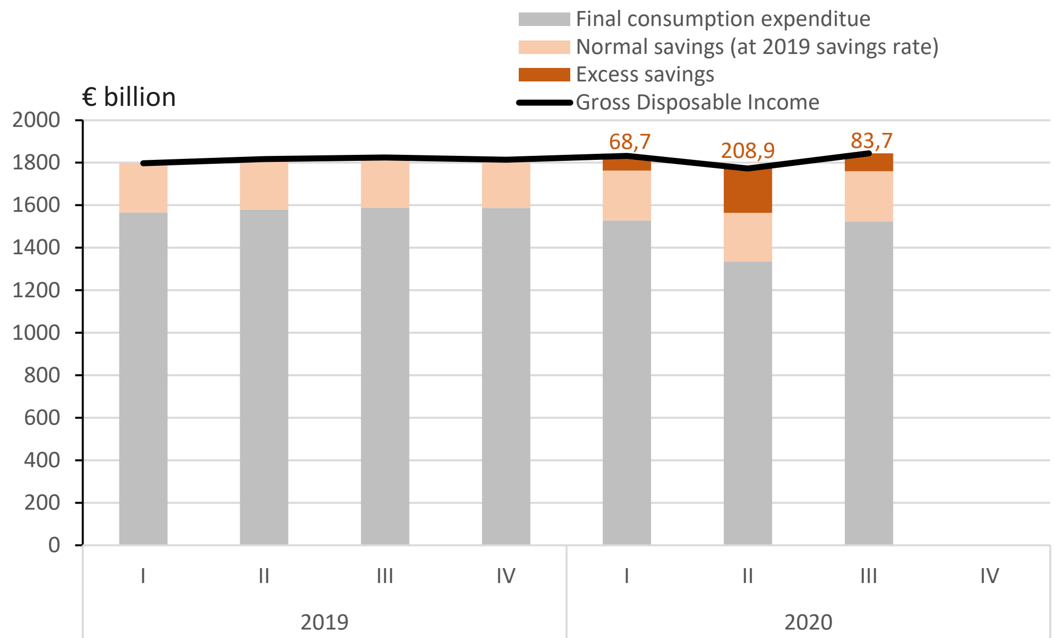
Universal criteria apply for all industries, enterprise sizes and legal corporate structures. The transfers enhance the resilience of corporates by stabilising equity buffers independently from their form of financing and without nationalising general entrepreneurial risks or hampering structural change.

To activate the mechanism for a period of no more than two years, an act of parliament is required declaring a state of macroeconomic emergency.

Source: Felbermayr and Kooths (2020).

The effectiveness of generalised demand stimulus measures such as increasing income, cutting taxes or providing benefits has been reduced by the specific nature of the crisis, as containment measures and behavioural responses have prevented consumers from making purchases. The resulting jump in the personal savings rate from around 12 to 25% in the early phase of the crisis (second quarter 2020) has only partly been reversed in the following months. This suggests that there is plenty of pent-up purchasing power to fuel consumption once a normalisation of economic activity is possible (Figure 5). Assuming that the average savings rate in 2019 was more or less normal, excess savings in the euro area amount to a cumulative EUR 360 billion up to the third quarter of 2020 (3.4% of GDP). As private consumption decreased once again by more than 3% in the fourth quarter (official figures are not yet published), an estimated EUR 100 billion of additional excess savings are likely to have been added until the end of the previous year. Unlike broad-based demand stimulus, targeted transfers to specific households, such as families or low-income households, can nevertheless be appropriate to mitigate the social cost of the crisis and may have a stronger impact on demand as these households can be expected to have a high propensity to consume.

Figure 5: Excess savings in the euro area



Source: Eurostat, National accounts.

Public investment can play a central role in the path to recovery. Gaps in public infrastructure have been diagnosed before the crisis following years of underinvestment in many countries. Additional investment needs have become evident in Europe with the political commitment for a transition towards a green economy and with the accelerated demand for IT infrastructure in the wake of COVID-19. IMF (2020) finds high multipliers for high quality public investment in terms of GDP, private investment and employment. The NextGenerationEU Programme, adopted in late July in response to the crisis and designed to complement the 7-year multiannual financial framework 2021-2027, could be instrumental in financing public investment initiatives. The programme consists of EUR 390 billion in grants and EUR 360 billion in loans. For the first time in history, the EU will issue joint debt that is not directly accompanied by claims against the receivers of funds (as in the case of EIB loans).

3.3. Monetary policy

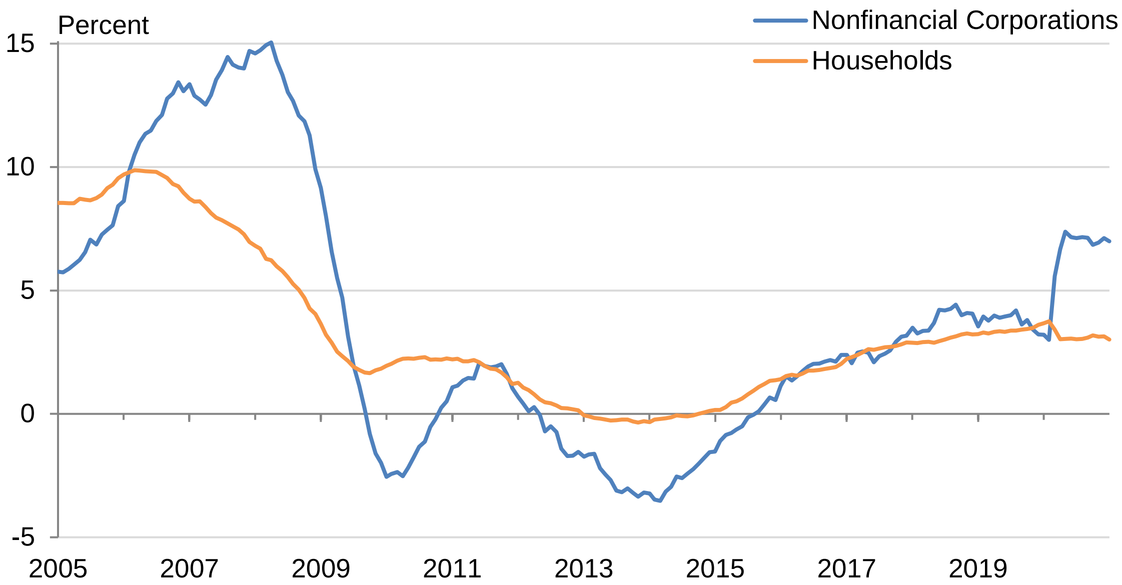
The COVID-19 crisis threatened to trigger a second euro area sovereign bond crisis and called on the ECB to act swiftly. National governments responded with bold fiscal measures in order to mitigate the social and economic damage incurred by measures to contain the virus and by behavioural changes to avoid infection. The fiscal implications of the crisis apparently led financial markets to reassess the fiscal solvency of a number of highly indebted countries. In March, increasing spreads on returns of government bonds threatened to constrain the fiscal capacity of some Member States to mitigate the crisis, and a sovereign debt crisis was looming at the most inopportune time. In this situation the ECB stepped in and announced a number of monetary easing measures, partly in response to the general deterioration of the outlook for growth and inflation, but partly also to prevent further repercussions from tensions and turmoil on financial markets.

The ECB responded with another large increase of asset purchases. On 18 March 2020, the pandemic emergency purchase programme (PEPP) was announced with an initial volume of EUR 750 billion until the end of 2020 (ECB, 2020a) on top of the EUR 20 billion asset purchases under the framework of its existing asset purchasing programme (APP). PEPP was endowed with more flexible provisions with respect to the allocation across jurisdictions. In addition to asset categories eligible under the existing APP, non-financial commercial paper is also eligible for purchases under the PEPP. Moreover, a waiver for the eligibility requirements was be granted for securities issued by the Greek government. The envelope of the PEPP was increased by EUR 600 billion in June and another EUR 500 billion in December, and the time frame was extended to at least mid-2021 in June and to at least March 2022 in December. Principle payments from maturing securities under the PEPP will be reinvested until at least the end of 2023. The ECB also committed to continue with net purchases under the APP at the current pace until shortly before starting to raise key ECB interest rates.

The economic impact of the asset purchases has been substantial in the acute phase of crisis, but it remains unclear what the contribution of additional liquidity is – once uncertainty has returned to normal levels. After the PEPP was announced in response to increasing signs of market fragmentation, there were first indications of stabilisation in early April that continued and became more evident during May. The ECB attributes these developments to the PEPP (Lane, 2020), which is consistent with evidence from asset purchases at the height of the crisis during other episodes. The ECB itself estimates that the PEPP decision, together with the scaling-up of the APP, have reduced GDP-weighted 10-year sovereign yields by almost 45 basis points (Hutchinson and Mee, 2020). The emergence of the COVID-19 pandemic and the massive restrictions of economic activity as a result of measures to contain it have been a singular event that led to an almost unprecedented surge in economic uncertainty. In such an environment, the assumption of risk by the central bank by provision of additional liquidity against unusually weak collateral and through unusual channels makes a huge difference and is an appropriate response. However, the value added of a continued expansion of the central bank's balance sheet is more questionable in a situation of "normalisation", with the economy recovering and the possibility to exploit experience and increased knowledge to implement a more targeted policy response to new increases of COVID-19 infections (Beckmann et al., 2020).

Another part of the ECB response consisted of a number of measures designed to support liquidity and funding conditions. These included an improvement of the conditions of its targeted long-term refinancing operations (TLTRO III) and the introduction of pandemic emergency longer-term refinancing operations (PELTROs) for banks that hit the TLTRO bidding limits, banks with non-eligible lending and banks who do not apply for TLTRO due to excessive complexity. PELTROs were initially planned to be offered until the end of 2020, but in December the ECB decided to add four additional PELTROs in 2021 on a quarterly basis. In addition, the ECB implemented several rounds of collateral easing measures and expanded the range of eligible assets under the corporate sector purchase programme (CSPP) to non-financial commercial paper in order to provide liquidity and support bank lending. The collateral easing policy has been criticised as being indecisive as the ECB continued to seek to strike a balance between liquidity provision and risk control (Vestergaard and Gabor, 2020). The evidence of a strong increase in bank loans to the private nonfinancial sector, particularly corporations, however, does not support the concern of insufficient incentives to provide credit (Figure 6).

Figure 6: Euro area credit growth: loans to Non-MFIs



Source: ECB.

Note: Monthly data. Annual growth rate of loans (adjusted for loan sales, securitisation, and notional cash pooling) from euro area monetary and financial institutions to the private sector.

3.4. Prudential measures

Prudential rules in the financial sector have been eased to facilitate moratoria on loan repayments. Many euro area countries implemented support for the private nonfinancial sector in the form of general moratorium, payment holidays stemming from public measures or industry-wide payment relief (EBA, 2021). The decision which borrowers qualify for these programmes is usually left to the banks. In April 2020, the European Banking Authority (EBA) provided guidance on the application of the prudential framework with respect to these generalised measures. The guidelines sought to ensure that banks were able to grant payment holidays to customers as a regulatory measure to fight the impact of the COVID-19 pandemic. Under normal circumstances, a bank must then make a provision in its accounts for a loan that is not repaid after three months, which is automatically considered non-performing. According to the guidelines, banks can grant additional moratoria without affecting their balance sheet, when certain conditions are met. These include inter alia that the moratorium was launched in response to the COVID-19 pandemic and has to be broadly applied. This does not apply to new loans granted after the launch of the moratorium. The guidelines were phased out in September, but reintroduced in December in face of renewed implementation of lockdown measures although with some modifications to limit the risk of an undue increase in unrecognized losses on the banks' balance sheets. The modified guidelines apply until 31 March 2021.

The use of capital buffers supports lending and economic activity. Measures adopted by macroprudential and supervisory authorities included temporary capital relief through lowering macroprudential buffers, allowing banks to fully use capital buffers, and adjustments to the composition of Pillar 2 requirements (P2R). These measures amount to more than EUR 20 billion of Common Equity Tier 1 capital held by euro area banks (ECB, 2021b) and can be expected to facilitate the absorption of credit losses and support lending to the economy (ECB, 2020).

Bank supervisors need to strike a balance between supporting the economy and keeping the financial system sound. The regulatory response to the COVID-19 crisis complicates the assessment of the risk profile of banks. Key prudential measures of asset quality and regulatory capital may not accurately reflect bank's financial soundness, especially if loss recognition is delayed as a consequence of applying the guidelines on loan moratoria. Early exit from the regulatory relief measures could lead to premature tightening of credit supply and weigh on the recovery, but waiting too long may undermine confidence in the regulatory systemic stability (Ehrentraud and Zamil, 2020).

4. THE INTERACTION OF COVID-19-RELATED POLICY MEASURES AND PROBLEMS OF PHASING OUT

Stimulus measures in the different policy areas are mutually reinforcing. Fiscal policy has been quick to assist vulnerable households and ailing businesses by direct transfers, tax relief measures and liquidity support, and funded large-scale utilisation of short-time work and furlough schemes to relieve firms and keep workers employed. Monetary policy has lowered the overall level of bond yields and, in combination with the creation of a large-scale common European fiscal initiative, has effectively prevented an increase in interest rate differentials, enabling all euro area countries to issue debt in sufficient quantity at favourable terms. The central bank has provided additional liquidity for banks at exceptionally low interest rates and lowered collateral standards to support the flow of credit to the non-financial private sector. Support measures for households and firms, together with loan moratoria, have reduced the likelihood of corporate defaults and insolvencies and – in combination with loan guarantees – supported bank solvency ratios. At the same time, prudential authorities have increased the bank lending capacity by freeing up bank capital and reducing the need for provisioning, in order to strengthen the capacity of banks to provide credit for the private sector and businesses afloat. According to ECB simulations (Rancoita et al., 2020), without prudential policies, the stimulus to the economy provided by government loan guarantees would have been one percentage point lower. They have also increased the impact of the additional monetary policy (by 0.3 percentage points of GDP).

The relative importance of the different policy measures varies substantially across countries. While short-time work schemes are an important instrument to support firms and households in all countries, among the larger economies they are particularly heavily used in France and the Netherlands. Direct support of firms and households is relatively important in Germany and Italy as a proportion of total support, whereas the use of tax deferrals is particularly pronounced in the Netherlands. With respect to guarantees, Spain and France stand out. The significance of payment holidays is disproportionally large in Italy and France, while the release of capital buffers in the banking sector is especially important in the Netherlands and in Spain.

Cliff effects could be particularly important in the case of fiscal measures and loan moratoria, but they need not bite. Direct fiscal support measures are generally expiring relatively early and would on current schedules to a large extent be withdrawn in the course of the first half of 2021. They can, however, easily be extended or adjusted to changing circumstances, if necessary, and experience suggests that this will be the case. A gradual withdrawal of fiscal support is appropriate if the economy starts a sustained recovery from spring onwards as projected, on the back of a seasonal decline in infections and the rollout of vaccines that allows current pandemic-related restrictions on economic activity being progressively lifted. Output of goods and services that have not, or only to a limited degree, been available during the pandemic (such as restaurant visits, entertainment and cultural activities, and travel) can be expected to rebound quickly as soon as circumstances allow, given presumably high pent-up demand and the large amount of excess savings. A decline of transfers to troubled firms and households would largely reflect the normalisation of economic activity and should not be regarded as fiscal tightening. Premature termination of important support measures would, however, be contractionary and would risk being reinforced by adverse effects on bank's balance sheets and bank capitalisation. It should be avoided, although a gradual reduction of the fiscal burden through a careful re-adjustment of measures with the aim of better targeting those most in need may still be possible without jeopardising the recovery. An extension of loan moratoria will be more problematic due to the associated negative impact on bank revenues, but is less significant as a share of overall support. The positive effect of loan guarantees and prudential easing measures is by contrast relatively persistent until the end of 2022, according to the ECB simulations.

Monetary policy needs to act as a backstop for fiscal policy in the short-term, but in the medium-term sufficient fiscal space to cope with another crisis needs to be created. Fiscal policy is the appropriate instrument to deal with the economic fallout of the COVID-19 pandemic as it can deliver targeted support with respect to the object, the dosage and the timing of measures. Monetary policy should be concerned with the repercussions on the macroeconomic level, respond to increased levels of uncertainty and downward pressure on consumer prices, and stabilise financial markets. In the euro area, with its unique institutional architecture consisting of a common monetary policy and fiscal policy at the national level, the ECB also needs to mitigate financial fragmentation stemming from different sovereign risk profiles across countries. The PEPP has been instrumental in arresting the rise in risk premia that was observed in the early phase of the crisis. Without the intervention of the ECB, a number of governments would probably not have had the fiscal capacity to adequately respond to the crisis. A substantial increase in government bond yields remains a serious risk for the fiscal outlook in high-debt countries like Italy (Consiglio and Zenios, 2020).

The ECB is in a position where fiscal dominance is a valid concern. Fiscal dominance is a situation where the central bank neglects its objective of maintaining price stability in order to support government spending (Fiedler et al., 2020). This may not be a problem as long as inflation is below target and monetary and fiscal policies are strongly complementary, as is currently the case (Schnabel, 2020). While it appears that a sustained increase in underlying inflation is unlikely for the foreseeable future, implying that interest rates can remain low and much higher debt-to-GDP ratios are sustainable (Blanchard et al., 2020), it cannot be ruled out that the repeated provision of large amounts of liquidity into the economy will eventually lead to a substantial increase in consumer price inflation. Governments should use the coming years to reorganise EU institutions and reduce debt to levels that appear sustainable also in a less benign interest rate environment. Institutional reform should include the introduction of a fiscal backstop mechanism, either on a permanent or a temporary basis, in order to safeguard effective monetary policy independence in the longer term (Gern et al., 2020).

The medium-term risks of continued massive policy support rise with the duration of the crisis. The longer fiscal, monetary and prudential measures to shore up the economy are in place the larger negative side effects can be expected to be. Structural adjustment could be suppressed that may be necessary to cope with the longer-term implications of the pandemic, such as an accelerated utilisation of digital business models and a recalibration of international value chains. This would reduce potential output in the longer run. With regulatory relief measures in place, credit risks continue to rise on the bank balance sheets without being fully reflected in benchmarks to assess the health of financial institutions (e.g. non-performing loans ratio or Tier 1 bank capital ratio). Financial stability could be at risk, if credit losses that eventually materialise after the end of loan moratoria become too large. Prudential authorities need to strike a delicate balance between continued support of borrowers facing difficulties due to the pandemic and the assumption of insolvencies that appear unavoidable in a scenario of prolonged crisis.

Fiscal reconstruction after the crisis must be reconciled with other goals on the European agenda. Economic policy needs to regain fiscal space after the crisis in order to prepare for the next major macroeconomic challenge that will inevitably come. This should, however, be achieved in a growth-friendly way, preserving public expenditure for productive investments, education and research. Common funds provided by the EU, such as in the NextGenEU framework, can potentially play an important role in stimulating potential growth and supporting the transition towards a carbon-neutral economy, particularly if they are directed to countries with high debt levels. But achieving both fiscal consolidation and sustainable and inclusive growth will not be possible without the implementation of structural reforms at the national level and appropriate changes in the European institutional framework.

5. CONCLUSION

Economic policy makers in the euro area have successfully managed to implement a strong response to the pandemic. Economic policy responded swiftly with a concerted implementation of fiscal, monetary and prudential measures on an unprecedented scale. The paper investigates potential cliff effects that may arise from the temporary nature of the measures adopted and their different phase-out schedules.

The concern that premature policy tightening could jeopardise the recovery seems overblown. Simulations suggest that cliff effects are particularly important in the case of fiscal measures and loan moratoria, but they need not bite. Fiscal policy has shown that additional measures will be implemented if necessary. A gradual withdrawal of fiscal support is appropriate provided the economy starts a sustained recovery from spring onwards as projected.

The major challenges for economic policy lie in the medium term. The medium-term risks of continued massive policy support rise with the duration of the crisis. The longer fiscal, monetary and prudential measures to shore up the economy need to be in place the larger negative side-effects can be expected to be, with corresponding negative impacts on potential growth. Fiscal reconstruction after the crisis must be reconciled with the goal of sustainable and inclusive growth, which will be difficult to achieve.

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The COVID-19 crisis has triggered unprecedented concerted economic policy response. The paper investigates potential cliff effects that may arise from the temporary nature of the measures adopted and their different phase-out schedules. It finds that the concern that premature policy tightening could jeopardise the recovery are overblown. The major challenges for economic policy lie in the medium term.

This paper was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 18 March 2021.

PE 662.897
IP/A/ECON/2021-13

PDF ISBN 978-92-846-7874-7 | doi:10.2861/440647 | QA-05-21-036-EN-N