To fight the COVID pandemic, policymakers must move fast and break taboos

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COVID-19's economic impact on crumbling GDPs, collapsing tax revenues and ballooning fiscal deficits will be much larger than what has been reported thus far. Any hesitation in throwing everything but the kitchen sink at the health, employment, state aid and financial rescue interventions that are needed will literally kill citizens and destroy the economy. To combat COVID-19, central banks, including the ECB, must cross the Rubicon of monetary financing and immediately transfer the 20%-30% of GDP this will cost into fiscal coffers.

The lightning speed and gargantuan scale of the COVID-19 hit to the global economy, where large chunks of economic activity have come to a literal standstill overnight, requires a 'shock and awe' policy response that is overwhelming in both scale and speed.

Countries have launched a dizzying array of measures that range from the ECB's pandemic asset purchase programme (PEPP)[1] to the direct cash transfers[2] the US has promised tens of millions of Americans, and wage subsidies[3] rolled out across much of the EU. But these unprecedented measures are just the start.

Policymakers need to move fast and break taboos. After all, governments are the insurers, lenders, spenders, and suppliers of last resort. The risks for them to do too little, too late far outweigh the risks of them doing too much too quickly.

As GDPs crumble…

With the pause button pressed on nearly half of economic activity in the US and the EU for what is likely to be at least a period of three months, consumption, investment and trade have all collapsed. A contraction of as much as 10-20% of GDP or worse is possible. Pervasive uncertainty about the timing of the development of a viable treatment and/or vaccine means there is no light at the end of the tunnel yet. Even when we get there, the trauma of the COVID-19 meltdown will keep investors and consumers on the sidelines.

…tax revenues will collapse…

This will blow a massive hole through tax revenues. Corporate taxes that derive from profits will collapse first. Sales and value-added taxes will register a dramatic fall in line with the collapse in economic activity. The gigantic scale of job losses and/or job subsidies to stem such losses will depress income taxes. Tax revenues may fall by 30%-40%, maybe more.

...and deficits balloon...

Even as tax revenues dry up, governments need to spend unprecedented sums of money not just on healthcare and social interventions to fight COVID-19, but also on welfare payments and job guarantees. Mortgage and rental market interventions, rescuing and resuscitating private sector firms, even whole industries, and inevitably bailing out large tracts of the financial sector will require record fiscal interventions. The pincer movement of falling taxes and rising spending will drive eye-popping fiscal deficits of 10%-20% of GDP, and beyond.

...leading to counterproductive austerity

The double whammy of crumbling GDPs and ballooning deficits may drive OECD debt/GDP ratios up by 30% or so by the end of 2020 as countries scramble to borrow, mirroring the effect of the global financial crisis and its aftermath. It may push Italy and Japan past the 160% and 270% of GDP mark, respectively, and no country would be immune. Inevitably, this will fuel future calls for austerity, with the counterproductive logic and toxic politics of the EU's Stability and Growth Pact and Fiscal Compact, driving long-suffering euro area economies further into the ground.

A poisoned political economy

This will strain already fragile relations between member states, possibly to breaking point. But it will also worsen the intergenerational rift. Leaving our children with an unaffordable fiscal burden, on top of a climate catastrophe is not the legacy we wanted, nor one they might be willing to take.

There is one way out

There is, however, one way out that can both deliver the shock and awe necessary to get ahead of the pandemic, and deliver us from counter-productive future austerity, political conflict, and intergenerational schism.

Central banks must break new taboos

And that is for the COVID-19 response to be funded not by borrowing, but through the creation of new money, particularly by OECD country central banks, which include the US Federal reserve, the Bank of Japan and the ECB.

The decade since Lehman's collapse has already seen central banks break many taboos, but they must now cross the Rubicon of monetary financing. The case for them to do so has never been stronger, and in fact it may be irresponsible for them now not to do so.

The ECB and the Bank of Japan, in particular, have been struggling to hit their inflation targets, and the mass layoffs now underway will only worsen this undershoot. As large tracts of the economy have come to a dead halt, the circulation of money in the economy has been gravely interrupted. This breakdown of the normal channels of transmission of monetary policy will be exacerbated as the economic meltdown takes its inevitable toll on banks and the financial sector. With risk aversion high, and the propensity to consume and invest low, normalization is impossible in any foreseeable horizon. Printing new money can help mitigate each of these critical challenges

It is time to print, but this time for the fiscal authorities

The traditional notion of helicopter drops,[4] wherein central banks transfer cash balances to citizens, are being talked about again, but they work best when the problem is primarily insufficient demand. Moreover, the plumbing to make these drops work is not yet in place, and time is of the essence.

This crisis is different. It is governments that need to spend on healthcare, employment, critical supplies, state aid and bank rescues and are best placed for targeted interventions on all of these fronts. A one-off transfer of 20%-30% of GDP worth of cash to governments by their respective central banks may be the single best macro policy to fight the COVID-19 crisis.

It will provide the kind of lightning speed and gargantuan scale needed to outrun the meltdown and will leave no debt overhang or counterproductive future austerity. It will help avoid the kind of hesitation, from governments trying to raise cash or balance books, that can literally kill citizens and destroy economies.

A percentage of the transfer – say, 5% of the overall amount – could be set aside to help fund the COVID-19 fight in developing economies that are not in a position to either borrow cheaply or print their own money. This would be then be sufficient, alongside the issuance of new SDRs[5] by the IMF, and enhanced support from the Multilateral Development Banks and Development Finance Institutions to fund a genuinely global response to the pandemic.

Outside the euro area, the central banks' transfers to their national treasuries could be affected by crediting the treasury's account with the central bank. Article 123 of the EU's Treaty explicitly bans credit and overdraft facilities from the ECB for the EU and member states, but says nothing about helicopter drops or transfers, which are neither. Nor does it ban a one-off ECB extraordinary dividend payment of an equivalent amount to member national central banks (its shareholders), and through them to member states' governments. It will be challenged and litigated no doubt, especially in the German Federal Constitutional court, but at least the euro area will have lived to fight another day.

References

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Endnotes

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