Q&A

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How to make policy from home – challenges for economic policy-making of the "Great Lockdown"

Even before economic activity started to plummet in the face of the pandemic, and before stringent lockdown regimes were established throughout Europe and much of the world, the turmoil in the financial markets had prompted governments and central banks to act decisively. Economic policymakers have reacted as swiftly as health officials, and maybe even more rapidly as the greatest peacetime policy packages have been announced. Policy reactions have preceded information on the magnitude of the COVID19 related fallout from the statistical offices by weeks, if not by months. World's largest central banks have announced measures that will cumulatively exceed their responses during the global financial crisis within a much shorter time span. Ministries of finance raced ahead with tax reliefs, employment subsidies and loan guarantees. The big bazookas of the global financial crisis no longer seem so big.

In the face of the peril, few thoughts were given to the potential alternatives or the long-term consequences of the adopted policies. Their goal is not even to bring the economy back to normality, whatever normality may resemble these days, but rather to ensure a mere survival of the commercial fabric of our societies throughout the health crisis. Monetary policy cannot reopen stores that are closed due to the lockdown, or production plants lacking intermediate goods as their just-in-time inventory management systems collapsed with the breakup of the production chains. Neither can large fiscal transfers induce people to get out of their homes during the pandemic and spend beyond necessities – even if commercial facilities were to open. Policymakers have set their targets at preserving as many jobs and commercial entities as possible in order to enable a swift recovery once the pandemic is resolved.

At the moment, the side-effects of the adopted extreme policies seem to be few. However, we are still at an early phase of the crisis

and formulating policies might soon prove to be an act of balancing on a knife-edge. The major potential risk of exceptional stimulus is the perennial worry of a runaway inflation. Most analysts believe that depressed demand is likely to keep inflation at bay, regardless of the supply bottlenecks. Also, inflation expectations are to remain well anchored, even below the desirable level. Still, a few observers continue to believe that inflation is the most underpriced risk of all, as only a minority of active traders have a first-hand memory of runaway inflation. And this is all aside of the inflation measurement issue, which might be somewhat of a challenge at a time when households abstain from possibly a half of their consumption baskets – from airplane tickets and tourist accommodation to eating out and having a haircut.

While rising inflation could, somewhat paradoxically, be seen as a sign of success, more observers are worried about the excessive policy accommodation backfiring without providing much of a boost. Even as the specter of "Japanification" started to haunt Europe in late 2019, no one thought of the central bank balance sheet in excess of 100 per cent and public debt in excess of 200 per cent of GDP as even a remote possibility in Europe. The negative real and, in Europe, even nominal interest rates became a norm over the past decade, sparking research on the reversal rates where the costs of further monetary accommodation start to outweigh the benefits. Simultaneously, fiscal authorities have only partly used exceptionally low borrowing costs to rebuild fiscal buffers. Using monetary policy to maintain favorable financing conditions for the government could buy some time, but it will eventually render both the monetary and fiscal policies impotent. Leverage is not only high in the public sector, but many companies have also used cheap financing to return money to their shareholders, reducing the time period they could survive without a state aid. Thus, the most recent policy reactions come on top of a hangover from the global financial crisis that has weakened the ability of both the public and the private sector to cope with the shock.

Even if we manage to get macro policies right, by preventing economic activity from going into a tailspin and inflation expectations from de-anchoring, it will only be the easier part of the policy-making process. Once the crisis is, hopefully, behind us, the economic landscape may change to such an extent that maintaining the current, lackluster growth rates could prove challenging. Simultaneously with public and private debts testing the limits of sustainability and monetary policy approaching the frontier where net gains from further accommodation are no longer so clearly visible, policymakers might have to grapple with the reversal in globalization, the increased state presence in the economy and the "zombification" of much of the highly leveraged corporate sector. During the decades of a rapid trade growth, globalization provided a boon to productivity, while keeping inflation in check. As globalization languished since the global financial crisis, "the great lockdown" is likely to push it into reverse, with all the windfalls slowly leaking away. Wholesale bailouts planned to facilitate corporate recovery from the crisis could easily reduce corporate dynamism. The rise of the government presence in the corporate sector, either as a big lender, debt guarantor or outright owner, is going to make corporate governance more complicated as states may have different goals than the owners. Also, restrictions on dividends and the need to bring the state on board for major corporates could slow down the flow of capital between the different sectors of the economy. All these challenges are intertwined, might be feeding on each other and producing negative feedback loops. Taken together, they may prove to be of a different order of magnitude compared to structural reforms of the yesterday. Coping with them will require enhanced global cooperation and extreme caution on behalf of the policy makers.

Finally, spillovers and the contagion from the worst-hit countries are one free-wheeling element that could throw a spanner into the mechanisms of the already discordant economy. The emerging markets' weathering the global financial crisis relatively unscathed was a peculiar feature. This time round, the health crisis is more likely to morph into the traditional pattern of the financial crisis as indicated by the number of emerging economies seeking shelter under the IMF umbrella. Many of the emerging markets have little scope to stimulate their economies, with huge capital outflows putting pressure on exchange rates and financing conditions in general. The possible downgrades of their credit ratings might add to pro-cyclicality. Global governance needs to be enhanced, more resources mobilized, while procedures for debt restructuring should be streamlined. After all, the global financial crisis has taught us that severe financial instability is not reserved for emerging markets only. This time round, problems experienced by the emerging markets could be the "canary in the mine".

"The great lockdown" will test policy frameworks in different areas as policies move further into the uncharted territory. During the period of elevated uncertainty, financial policies will also have to deviate somewhat from the practices of the prompt recognition of all risks and the quick resolution of underlying exposures as banks look for ways to support the economy. Recent discussion about the consistent application of the IFRS9 and the IRB in the downturn reminds of the not so recent discussions. As we did not know that before. Forbearance could thus make a come-back, but we need to weigh it carefully and restrict such practices as soon as uncertainty subsides. The "great lockdown" possibly coupled with lack of policy space will eventually have to be reflected in the balance sheets of the financial sector and will have to be resolved by it. ●