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New sails for new waters: towards a Covid-19 recovery policy mix

The Covid-19 crisis that has hit the economy poses unprecedented policy challenges for both economic policy authorities. The euro area economy is experiencing the worst recession since its inception. In response monetary, prudential and fiscal policy authorities have stepped in rapidly to help the economy establish a foothold as it went into lockdown. The ECB responded forcefully by employing a multitude of instruments including the new Pandemic Emergency Purchasing Program, while prudential authorities released capital buffers. Fiscal authorities responded swiftly with major stimulus packages by supporting workers and companies facing a sudden stop of economic activity.

Now that we have moved past the impact phase of the shock, we can shift our attention toward the recovery phase. Recently, forward-looking confidence indicators look robust, while high frequency data suggest that mobility is recovering. These developments solidify the confidence in our baseline projection with a more favorable balance-of-risks. However, even if no further setbacks materialize economic activity will only approach pre-corona levels at the end of 2022. It is therefore clear that ample policy support to the economy will remain important also during the recovery phase.

At the same time, we will only learn more about the underlying state of our economy as the recovery unfolds. What we do know is that the observed increase in private sector savings as a consequence of crisis-induced uncertainty provides a strong rationale and leeway for the public sector to increase spending to lean-against the increased propensity to save. Over the medium to longer-term horizon, dissipating uncertainty will invoke a resumption of private sector activity which will allow fiscal support to be gradually withdrawn. At the same time, we have learnt that there are significant benefits to ensuring that fiscal policy moves consistently with monetary policy.

Looking ahead, the extent to which the impact on the economy will materialize as a demand versus a supply shock is still unknown. While we are fairly confident that in the near-term increased uncertainty implies a strong withdrawal of aggregate demand, in the medium to longer-run negative supply effects may very well gain relevance as businesses adjust their production processes to the new environment. Since the latter would be associated with upward price pressures, this impacts on the intensity with which

monetary policy can continue to support the economy.

Relying too heavily on monetary policy to get the job done might have contributed to perceptions of a “central bank put” in the recovery from the euro area debt crisis, where the ECB bore all of the downside risk to the economy. More generally, an important element was missing in the policy mix. Monetary policy can be successful in eliminating slack in an economy, and, indeed, euro area labor markets saw a strong recovery. But without sufficient sustainable (public and private) productive investment to put the economy onto a permanently higher growth path, it is difficult for sustainable growth to take hold.

These observations imply that the policy mix will continuously have to be adjusted in terms of composition, based on our evolving assessment of the economic outlook. A broad and encompassing policy response is important to ensure that we don't rely overly on individual measures or policy areas that could be subject to unintended side effects if they are kept in place for too long.

It is in this light that I particularly welcome the establishment of the European Recovery Fund that has been agreed upon by the European Council. It is vital that, contrary to previous crisis episodes, in the wake of this crisis productive investment does not get crowded out by the immediate need for countercyclical stabilization policies. Furthermore, the recovery fund provides an important political signal that we do not stop short at only stabilizing our economies, but also take the opportunity to address common longer-term structural challenges that enable us to sail through future storms smoother. ●