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Monetary and Fiscal Policy Measures in the Corona Crisis - Consideration for Germany

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Abstract

Crises are often forks into the unknown. When it became increasingly clear at the beginning of 2020 that a very serious wave of infection with a new type of virus was developing in the Chinese region of Wuhan, this was initially only of secondary interest from an economic point of view. At most, the supply chains of companies that are based on preliminary products from or sales to this region seemed to be temporarily endangered by these medical problems. No one expected significant macroeconomic effects, even on a global scale. So far, economic crises have only arisen for economic reasons. This context given the monetary policy on a European level and fiscal policy measures on a German governemental level taken to combat the economic consequences of the so-called "Corona crisis" are presented and in addition their usefulness and impact subsequently assessed.

Keywords

corona pandemic, financial measures, economic policy, ECB, conjunctural stabilization

1. Introduction

The corona pandemic has led to a kind of economic shock, affecting the overall economic direction. This caused the worst economic slump since World War II. The crisis triggered a global decline in economic output and uncertainty also reigned in the financial markets. Countries had to take action and launch extensive corona aid packages. The ECB used its monetary policy instruments to initiate extensive measures. These are intended to absorb the economic damage, stabilize financial markets and safeguard purchasing power.

2. Method

Based on a selection of basic texts according to criteria of validity and relevance, which, in addition to the primary works to be examined, contain the basic framework of the analysis of the measures taken *by the German government to mitigate economic effects of the pandemic. The in-depth analysis of the literature requires the integration of further scientific texts and their evaluation.*

2.1 Measures Taken by ECB

The measures taken by the European Central Bank to achieve its monetary policy objectives are also referred to as monetary policy. An expansionary monetary policy is an expansion of the money supply (Note 1). The increased money supply compared to the demand for money lowers the interest rate in the short term. This is also known as the liquidity effect (Görgens, 2014). The low interest rate leads to expanded investment, higher incomes and rising output. Downstream, the rising investment and income again lead to higher demand for money and thus to an increase in interest rates on the money market. This is referred to as the income effect (ibid.).

Quantitative easing is a form of expansionary monetary policy (Sell, 2015). Under this form of expansionary monetary policy, central banks buy government bonds on the capital market on the instructions of the ECB, thereby massively increasing the money supply. As a result, money from the central bank flows into the banking system and the price of the purchased bonds rises. When considering monetary policy measures in the context of the corona pandemic, it is necessary to briefly look at the historical development since the 2008 financial crisis, because the current measures fit seamlessly into the program of expansionary monetary policy. The question of impact can only be answered contextually.

Quantitative easing is currently being used because the key interest rate is below zero and lowering it no longer has the desired macroeconomic impact (Reitz, 2015).

In summary, the objectives of quantitative easing are to counteract deflation, reduce long-term interest rates on the capital market and thus increase companies' willingness to invest (Conrad, 2017). Furthermore, liquidity in the banking system is to be increased and lending to companies supported. Refinancing is carried out via the money market, where banks provide each other with working capital. The prerequisite for this is that the banks would be willing to lend the money to each other, which has tended to become more difficult since the 2008 financial crisis (Fischer, 2014).

Consequently, the asset purchase program (APP) was announced by the Governing Council in 2012. Under the motto 'Whatever it takes', this initiated the ECB's ongoing expansionary monetary policy (KfW Research, 2017).

The purchase program is currently divided into four relevant programs, the Covered Bond Purchase Programme 3 (CBPP3), the Asset-Backend Securities Purchase Programme (ABSPP) and the Corporate Sector Purchase Programme (CSPP). The fourth program, the Public Sector Purchase Programme (PSPP), was adopted by the ECB in 2015 and involves the addition of public sector securities (Deutsche Bank, 2021). In particular, the focus is on government bonds on the secondary market.

As of June 2020, the cumulative purchases of the PSPP amount to €2,350 billion (ECB, 2020). The PSPP thus accounts for around 81% of the volume of the complete bond purchase program of €2,899 billion.

Following the expansion of the pandemic in Europe, the turbulence on the financial markets in 2020 now appears comparable to that of the financial crisis of the previous decade: Securities prices collapsed, liquidity was reduced and price levels were volatile (Schnabel, 2020). The monetary policy reaction was not long in coming in the context of the loose monetary policy of the previous years.

Thus, the increase in net purchases as a response to the economic consequences of the Covid 19 pandemic of 120 billion in 2020 is shown (Bundesbank, 2020). In March 2020, the ECB also adopted the Pandemic Emergency Purchase Programme (PEPP), a temporary bond purchase program, to mitigate the economic consequences of the corona pandemic (ECB, 2020). The original size of the purchase program of €750 billion was expanded in June 2020 by €600 billion to a total of €1,350 billion and eventually by an additional €500 billion (Bundesbank, 2020). The PEPP and the APP should be considered separately, so purchases under the PEPP are in addition to purchases under the APP. It should also be noted that the ECB’s self-imposed limits, which provide for a breakdown for government bond purchases according to the capital key, do not apply to purchases under the PEPP.

In addition, the ECB’s measures represent facilitation and incentive schemes for commercial banks to perform their task of supplying over-the-counter money. This is because the CISS, the indicator of systemic stress in financial markets, pointed to a serious global situation in March 2020 (ECB Working Paper, 2020).

The European Central Bank expanded its targeted longer-term refinancing operations (TLTRO-III). This instrument is used to offer banks long-term, low-cost loans. The interest rate of this long-term tender can range between -0.5% and -1.0%. Negative interest rates make it more attractive for banks to extend loans to households and companies. If banks make use of TLTROs, they must deposit collateral with the ECB in return. The list of collateral to be deposited has been expanded here. In April 2020, the ECB decided to introduce so-called pandemic longer-term emergency refinancing operations (PELTROs). According to this, liquidity buffers from recent years may be used by banks for lending. In this way, the ECB is reducing the amount of equity capital that banks need to hold. The aim of these measures is to provide banks with more liquidity so that they can pass it on to private households and companies in the form of loans in the best possible way. The aim is to boost economic performance through private consumption or investment by companies.

With the help of its expansionary monetary policy, the ECB is attempting to have an inflationary effect on the economy in the euro zone (Conrad, 2017). In May 2020, the inflation rate was only 0.1%. However, the drop in the inflation rate is essentially an effect of the sharp fall in energy and oil prices in the short term, which is making it more difficult for the ECB to achieve the agreed target (Görgens et al., 2014). In Germany, for example, the price of energy products fell by 8.5%, whereas food prices rose unusually sharply by 4.5% as a result of the Corona crisis (Dullien, 2020). If energy and food are excluded from the calculation of the inflation rate, the core inflation rate doubles to 1.2% in May 2020. Accordingly, many special factors affect the inflation rate during the corona pandemic. With the help of the PEPP and the APP, inflation is to be counteracted. The inflation rate in the euro zone is forecast to be 0.3% in 2020 and 1.3% in the following year. Due to the recovery effects in the course of the current easing measures, it is still unclear to what extent this target will actually be achieved. At present, the German Bundesbank forecasts inflation of 4% in Germany (Wiebke, 2021). The ECB’s zero interest rate policy as part of quantitative easing has been criticized for years (DZ Bank, 2020). The qualitative easing and the resulting increased tendency towards low interest rates have a positive effect on borrowers and a negative effect on savers. If the average interest rate level from the years 1999 to 2009 is compared with the low interest rates in the years 2010 to 2019, this results in large interest rate losses for savers. For example, German households had to forgo 648 billion euros in interest between 2010 and 2019, which is tantamount to monetary expropriation. For the same reason, social security funds will also be burdened. The Bundesbank is passing on the penalty interest rates imposed by the ECB to pension insurance and statutory health insurance funds. A large part of the money held by the statutory pension insurance and health insurance funds must be accessible at all times and can therefore only be invested conservatively. In addition, their reserves must be invested securely to avoid payment defaults. Negative interest rates thus incur costs in the millions every year.

Conversely, borrowers in the form of private households, companies and the state benefit from the interest savings. Companies in particular, whose business collapsed during the Corona crisis, are dependent on loans from banks. They benefit from the favorable financing conditions made possible by the low interest rates. In this way, Germany as well as other European countries also benefit from the ECB’s low interest rate policy. If the years 2007 to 2018 are considered, the interest rate policy yielded savings of 368 billion euros for Germany. In the same period, interest savings of 350.3 billion euros resulted for the French government and 261.5 billion euros for the Italian government (Jason, 2019). By comparison, Germany still had to pay 4.23% interest on its government bonds in 2007, but in 2017 interest rates were only 0.37%. The ECB’s measures during the Corona crisis continue this trend. The PEPP, with a volume of €1,850 billion, has already had the effect of increasing the liquidity of sovereigns and having an expanding interest rate-lowering effect. For example, newly issued German government bonds carry a negative interest rate of -0.4%. As a result, the government has to pay back less money than it borrows. There is thus a striking difference in the short- and long-term valuation of the measures. Thus, in the short term, the recovery effect and the support of the economy may succeed. In the long term, the consequences of a permanently expansionary ECB monetary policy are not foreseeable, except by historical comparison (e.g., with Japan).

2.2 Measures Taken by the Government

With the second Corona Tax Relief Act, the federal government pursued the goal of mitigating the economic consequences resulting from the corona pandemic through fast-acting measures. In this context, the reduction in sales tax rates in 2020 was intended to increase the incentive to consume, especially among citizens with low incomes, as the tax cut would leave them with more real income available for corresponding consumer spending (Nickening, 2015).

The savings resulting from the reduction in sales tax rates should be passed on to consumers by the economy in the form of lower prices. This should be implemented by re-labeling prices or offering time-limited price reductions that apply to all or parts of the product range.

According to media reports, the picture was mixed in this regard: While, for example, large grocery chains such as Edeka or Aldi have already announced that they want their customers to participate directly in the sales tax reduction, experts are particularly doubtful about the willingness of smaller stores to pass on the savings to their customers.

In this context, the retail sector criticized the high conversion costs for cash register systems that a reduction in sales tax would entail. The solution suggested by the German government of achieving relief through, for example, time-limited price reductions was also viewed critically in this context. Whether customers would accept this approach or complain about a lack of price transparency is still unclear. According to a study on the effects of a reduction in VAT in Europe, an average of 15% of a reduction in VAT is passed on to consumers (Benzarti et al., 2017). To the extent that the sales tax cut is not passed on to consumers, companies' profits would increase for a given level of demand. It was at this point that the criticism began in the aftermath (Dullien, 2020). Basically, the point was that tax cuts only have an indirect effect, because an increase in real incomes in economically uncertain times does not automatically lead to more consumption. An analysis by *Fuest*, *Neumaier* and *Stöhlker of* 60,000 products in the food retail sector shows that the latter has passed on almost 100 percent of the reduction, equivalent to an average price cut of two percent, to customers (Fuest et al., 2020). Nevertheless, the hoped-for positive effects in terms of consumption have not materialized (Fuest et al., 2021). "We have extrapolated these results to all households in the Federal Republic. This results in an overall economic consumption effect of around EUR 6.3 billion. This is not quite one-third of the estimated fiscal cost of the measure" (Fuest, 2021). In relation to private consumer spending in 2019, this results in an increase in domestic consumption of 0.6 percent.

In March of the previous year, Economics Minister Peter Altmaier formulated: "We will not leave companies in the lurch." An emergency aid program initially designed to cover fixed costs in staggered amounts from 9,000 to a maximum of 15,000 euros (depending on the size of the company) was intended to enable the self-employed to secure liquidity (Stiel et al., 2021). The wording "cover fixed costs" was already problematic in this context, as this almost explicitly excluded freelancers. By the end of May 2020, EUR 13.8 billion had been drawn down from the program. Meanwhile, a significant reduction in the drawdown volume to just five percent (EUR 1.28 billion out of EUR 25 billion) of Bridging Assistance II documents the problems associated with the application process. Not only does the Corona emergency aid have to be taxed as income, but for a long time it was not clear who was actually eligible to apply and who had received overcompensation or even received aid that was completely unjustified. Incorrectly granted aid must be repaid with interest. Furthermore, it is not optimal if, over the course of the pandemic, only further one-off payments help to compensate for financial losses. This is also expressed in the fact that the funds may not be used to maintain living costs.

In the further course of the pandemic, it was possible to temporarily extend the package of measures with the bridging aid III and to take into account the points of criticism, for example in the restart aid. Currently, 7,500 euros can be applied for over a period of six months. The limited usability of fixed costs is eliminated, but the aid is only half as high as the bridging allowance and extends over twice as long a period. However, it is not yet possible to make a valid judgment on the clear effectiveness of the assistance in general. A quantitative study has also shown that the aid is most effective when it is granted quickly. The suspension of the obligation to file for insolvency until the end of April significantly distorts the current data situation (Federal Government, 2021). The discrepancy in the promise made by the Economics Minister, the earmarking of the aid that was only built in after the fact and also the sluggish disbursement of the aid are also leading to a not inconsiderable disenchantment with politics and a loss of confidence (Statista, 2021; Barth et al., 2021).

Since the corona pandemic and the subsequent measures put many companies under pressure, short-time allowance is of particular importance. If an employer introduces short-time work, his employees are entitled to short-time allowance in accordance with Section 95 of the German Social Code III (Zöllner/Schwager, 2020). Here, the employment agency assumes 60 to 67 percent (with child) of the labor costs and can considerably relieve the companies via personnel cost savings.

"A clearly sensible and purposeful instrument is to make it easier to qualify for short-time working benefits and to reimburse companies in part or even in full for the costs of social security contributions that normally still have to be paid even in the case of short-time working" (Bofinger, 2021)

According to the Ifo Institute's estimate, nearly 7.3 million workers were registered on short-time work in May 2020, almost five times as many as in the financial and economic crisis of 2008/09 (Raskopf, 2021). Enzo Weber, head of research for forecasts and macroeconomic analyses at the Institute for Employment Research (IAB), attests to the success of short-time work in Germany. Measured against the gigantic economic slump, labor market development has remained fairly robust. The ifo Institute estimates that the granting of short-time working benefits and, for example, the deferral of social contributions prevented the layoff of several hundred thousand employees. In addition, 80 percent of the corona-related loss of gross earned income could be absorbed (Peichl, 2021). In this respect, the short-time allowance can be considered a success in the short term.

In the long term, however, the effects may turn out differently, because in some cases the wrong incentives are set. For example, the conserving effect of short-time work on the employment structure tends to inhibit structural change in the economy (Eichhorst/Marx, 2021).

With the 600 billion economic stabilization fund, the German government is providing a stabilization instrument for large companies. Via the Kreditanstalt für Wiederaufbau (KfW), 400 billion euros in guarantees and 100 billion euros for capital measures are to be made available. In the case of individual systemically important companies, such as Lufthansa AG, negotiations are underway for the federal government to take a direct stake in these companies as a shareholder by purchasing shares (in this case

25% plus one share to achieve the lowest blocking minority), supporting them and safeguarding their competitiveness and the associated jobs (Banks, 2020).

Furthermore, tax measures have been taken to ensure the liquidity of companies. These include the fact that advance tax payments already made are partially refunded and that the amount of advance tax payments can be reduced without any problems, that the tax authorities allow deferral of the payments to be made and that enforcement measures are currently suspended (Federal Department of Finance (2020).

3. Result

In the wake of the PEPP may have a more moderate effect. “Thus, the first announcement on March 12 and the second announcement of the PEPP on March 18 did not achieve the desired effect of lowering interest rates” (Bernoth et al., 2020) The opposite has taken place: Yield trends initially improved and shifted upward at the onset of the pandemic. It was only with the announcement of the PEPP that the desired direction of a falling yield curve was achieved here. However, given the historical monetary policy of recent years, this effect is much less effective than expected. Furthermore, in the context of the pandemic and with the publication of the ECB’s catalog of measures, a negative signal effect has arisen which has caused many investors to revise their own forecasts downward with regard to their assessment of the economy, leading to an increase in risk premiums. Thus, the ECB’s monetary policy measures have hardly had any effect on the financial markets, as bond purchases have long been part of the ECB’s daily routine. In an environment of money glut and low interest rates, the transmission effect through decoupling effects on the real economy still does not play a weighty role. Rather, a violation of the ECB’s mandate would have to be investigated in this context, but this would go beyond the scope of this paper.

The German government’s package of measures - the Corona Shield - is designed to mitigate economic lag effects. In line with a Keynesian and short-term fiscal policy, the package comprises the most extensive financial assistance in post-war history (Federal Government, 2021). Only the most far-reaching measures are outlined below, as the entire catalog contains over 80 different items (Federal Economic Stimulus Package, 2021).

The FRG’s fiscal policy measures have in any case had an effect in the short term. For example, the labor market has been stabilized, consumption is slowly returning to the level of previous years and the economic recovery effects are also gradually taking hold. Of particular note are the direct procedural interventions in the form of Corona aid, tax cuts and short-time working allowances. Not only did these interventions prevent a drop in the willingness of companies and households to invest and pay; the crisis was also able to take place without any particular loss of confidence in job security and economic development. The question of how to finance the measures, however, only does not arise if, as according to Modern Money Theory, debt can be incurred unchecked. Given the current high level of intervention by the German state - intervention that cannot be reconciled with the ordoliberal ideas of

Eucken, the founding father of the free market economy (Eucken, 1940) - the sprawling fiscal policy must be accompanied by a suitable monetary policy. This has been the case in the euro area since 2020. However, a dictum by John Maynard Keynes fits in with this: “In the long run, we’re all dead” (Keynes, 1923).

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Note

Note 1. The author intentionally sticks to a general notion of money supply without focusing on the individual aggregates, since the issue is a fundamental relationship between money supply expansion, money demand and interest rates in the sense of the LM curve.