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Statement by Mr. Merk, Mr. Fragin, Ms. Koh, and Mr. Krahnke on World Economic Outlook; Global Financial Stability Report; Fiscal Monitor
(Preliminary)
Executive Board Meeting
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We thank staff for the informative set of reports illustrating the state of the global economy at this difficult juncture, describing the policy challenges ahead and trade-offs involved. While the global economy is still confronted with an unprecedented shock since the onset of the global pandemic, the latest data indicate that the drop in economic activity was probably less severe than previously expected a few months ago. Swift and considerable policy support has prevented even greater income losses and an amplification of the crisis through the financial system.

Still, it is without doubt that the crisis will leave considerable scars on the global economy, and the repercussions of this crisis will be harshly felt for an extended period of time. Subdued medium-term economic prospects imply permanent welfare losses which will likely be unevenly distributed among different income groups, age cohorts and gender and a serious setback to the global fight against poverty. With this in mind, we wholeheartedly subscribe to staff's plea for enhanced multilateral cooperation to ensure a sustained global recovery.

Fiscal policy will remain a crucial and powerful tool to foster and shape the economic recovery. Recent economic data for Germany suggests that the comprehensive measures taken to combat the Covid-19-crisis prove to be effective. To recover from the crisis, Germany will, in a sustainable manner, continue to provide all the fiscal support needed. A supportive and balanced policy mix, cushioning people and firms against pandemic-induced income losses, should be maintained as long as necessary to avoid scarring and reinforce confidence in the recovery. Governments should ensure that policy responses remain sufficiently flexible. In this context, it is also important to ensure that measures are well-targeted and **seize the opportunity to build a greener, more inclusive, more digital and more resilient economy.**

With regards to **monetary policy**, we agree in principle that given the subdued inflation outlook, there is no urgent need to exit from crisis-related measures.

The fundamental uncertainty with respect to the evolution of the pandemic complicates a quantitative assessment of the balance of risks around the baseline. Accordingly, we advocate the final assessment of the balance of risks to remain open. For the time being, downside risks are significant and include among other things, new lockdowns, premature withdrawal of policy support, tightening of financial conditions and a surge of insolvencies. Geopolitical tensions and trade policy uncertainty such as a hard Brexit represent further risks. Many of these adverse risks could coincide, thereby leading to a possible mutual amplification of shocks. On the upside, the recovery already taken place and the health system gaining experience with handling new virus outbreaks indicate that the economic normalization could also proceed faster than expected.

<u>World Economic Outlook</u>

We share staff's assessment of the near-term global economic outlook. Compared to the most recent ECB projections for the world economy (September MPE), the current IMF forecast (still) appears a bit on the cautious side. Considering the high uncertainty surrounding the baseline forecast, both projections are, nevertheless, not too far apart.

We broadly agree with the macroeconomic outlook for Germany. The upward revisions to the economic outlook and the benign perspectives for the labor market are broadly in line with recent positive surprises of incoming data. Against the background of favorable corporate profitability and financing conditions as well as ample government support, we assess the overall risk of broad-based business insolvencies in the current year with severe damages to supply capacities to be comparatively low. With regard to staff's inflation projections, the projected recovery for the German rate in 2021 seems to somewhat underestimate the positive base effect from the temporary VAT cut in 2020. *Staff's comments would be welcome*.

The long-term pandemic's economic consequences resulting from the unprecedented economic shock to the world economy are becoming increasingly apparent. A rising number of private insolvencies, a considerable drop in labor force participation, and, in particular, resource re-allocation across sectors including the reconfiguration of global value chains, will cause high adjustment costs to firms and households. Against this backdrop, staff's estimates of the medium-term potential output losses appear high, but not unrealistic. For advanced economies, the magnitude of the medium-term potential output losses is, for example, quite comparable to that attributed to the Global Financial Crisis of 2008-09.

Moreover, the pandemic will also act as a catalyst for structural change, partly also reflecting pre-existing trends, with digitization receiving a strong boost, shifting sectoral demand and changing the way we work. Accordingly, support to firms should, as far as possible, be based on a critical assessment whether the respective business model will likely continue to bear fruit in the future. We generally concur with staff on the notion of "triaging business cases" to preserve the economic substance of firms considered to be of strategic importance. However, risks for misallocation and distortion of competition could intensify with enduring government support measures. Accordingly, the focus should shift towards policies promoting a primarily market-led re-allocation of resources and the gradual withdrawal of crisis-related suspension of regulatory rules, supported by efficient corporate debt restructuring and bankruptcy frameworks and robust competition policies.

GFSR

Overall, we concur with the GFSR's analysis of the impact of the Covid-19 shock on the real economy and its effects on financial stability. We agree that extensive policy measures by monetary, fiscal and prudential authorities have helped maintain the flow of credit to the real economy and avoid adverse macro-financial feedback loops. The pandemic has also once again proven the importance of building up sufficient buffers in good times to increase resilience. In the first phase of the crisis, there was a looming illiquidity-insolvency spiral, which could have resulted in a liquidity crunch in the corporate sector. **Meanwhile, the situation has stabilized but risks remain high.** While on an aggregate level banks are better capitalised than they were before the global financial crisis and are likely to withstand expected losses, the future course and length of the pandemic and the economic recovery remain highly uncertain. **We fully agree that banks should be encouraged to use available capital buffers to support the flow of credit to the real economy.**

Staff rightly accentuates that policy makers need to make sure that structural changes and sustainability considerations are taken into account appropriately. Here we face a trade-off between the short-term stabilization of the economy and potential negative effects of prolonged policy support, with consequences for medium-term financial stability.

We welcome staff's efforts to conduct a stress-test exercise, which covers a broad range of banks from several regions and models the effect of policy measures on bank capitalization. One worrisome result of the stress test is a significant tail of G-SIBs whose capital levels could fall close to or even below minimum capital requirements. **However, we would read the results with a bit of caution**. The analysis comprises a very heterogeneous sample, whereas the econometric models employed may provide a better fit for some banks' business models than for others. Moreover, the model assumes that support measures are kept in place throughout the three-year horizon, and that announced guarantee programs apply to all, not only to new loans. In addition, it is assumed that the full amount of announced guarantees is used (full uptake). This may overstate the mitigating effects of support measures.

As in other countries, German banks today are much better capitalised to weather potential losses than at the outset of the global financial crisis. Similar to the analysis in the GFSR, we find that the German banking sector overall should be able to cope even with a very adverse scenario including a large drop in housing prices. Yet, in such an adverse scenario, some individual banks could get into difficulties.

Support measures are important in mitigating the fallout of the crisis. However, banks could use capital related relief for other purposes than lending, such as to distribute profits – if only to avoid an assumed stigma effect. For this reason, the ECB recommended that banks refrain from distributing profits or buying back shares. Although this recommendation is not legally binding and may weigh on investors' willingness to provide funds to banks, it is likely to have an impact, being a public communication from banking supervisors.

We agree that support measures should not become a "new normal". They should be carefully withdrawn when the crisis recedes. Structural adaptations and losses cannot be kept in check over the long run. Moreover, we should make sure not to impede the information content of balance sheets and benchmark quotas by regulatory exceptions.

Regarding the position of EMEs, we agree that economies with an insufficient domestic investor base may be particularly vulnerable. Portfolio outflows have never been as extreme and broad-based as in early March – not only for EMEs but also for AEs. While this trend has partially been reversed, the increase in non-financial corporate bond issuance in hard currency and increased sovereign reliance on foreign currency debt may put an additional burden on EMEs in case of a re-evaluation of risk.

We support the efforts of staff to introduce the local stress index (LSI) to summarize local bond and currency market conditions. The index only includes measures of local market liquidity and stress, without controlling for external factors, like policy rates or external conditions. This offers the advantage of reflecting the immediate conditions faced by market participants. Going forward, it would be helpful to assess the sensitivity of these conditions to external factors, to gauge to which extent they are under the influence of central bank policy instruments.

As asset purchase programs (APP) are a novel policy instrument in many EMEs, we welcome staff's investigation of their impact on local market stress levels. At the same time, with a single shock driving the introductions of APPs into countries' intervention toolset and the pandemic still ongoing, it is difficult to draw firm conclusions at this point. We would therefore encourage a cautious interpretation of the results. At this stage of the analysis, it might be useful to supplement the cross-country analysis with more detailed analyses of the differences between APP and non-APP countries that could have contributed to the results. The empirical analysis shows that APPs had an immediate impact on sovereign bond yields while the effect on exchange rates was limited. It is noteworthy that the effect of domestic policy rate cuts is insignificant, leading to additional support to the use of novel APPs. However, given the statistical uncertainty of these estimates, **conclusions should be made with the appropriate caution and considered provisional.** Moreover, we agree with staff's view that APPs can be helpful, but that they should not be regarded as a panacea to improve market conditions. As a consequence, in our view, the benefits of asset purchases must be carefully weighed against the risks resulting from an APP-driven increase in market valuations.

Fiscal Monitor

We welcome staff's analysis of the fiscal responses to the crisis. We agree with staff that **comprehensive fiscal responses were and continue to be essential to effectively contain the COVID19-crisis – by stabilizing the economy in the short term but also by avoiding high social and economic adjustment costs in the longer term. In that regard the crisis provides an opportunity for transformative measures to foster resilience and sustainability through investment and innovation.** Public investment programmes notably in infrastructure, green mobility, energy transition and digitization set incentives for and can crowd in additional private investment, thereby increasing future growth. That said, **to ensure that public investment is efficient and effective,** identifying projects and overcoming planning capacity limitations are a challenge to be met.

We appreciate the idea to outline fiscal policies separately for different phases of the pandemic. Generally speaking, while countercyclical fiscal policy stances are needed to counter pandemic-induced recessions, thereafter, prudent fiscal courses will be necessary with a view to reducing high public debt ratios. We acknowledge staff's word of caution that temporary policies - which provided essential support in the short-term - may have detrimental effects if they become permanent.

While not pertinent at present, governments should gradually shift from crisis management to high-quality fiscal consolidation once the recovery is firmly on track especially when debt levels are high, often resulting in higher borrowing costs. There will be more clarity on which post-crisis growth path our economies will take and how extensive the country-specific need for consolidation will be in structural terms. Well-designed fiscal rules and budgetary frameworks should promote the pursuit of credible fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while allowing for budgets better geared to investment, esp. green and digital, growth and resilience. Further consideration could also be attached to strengthening automatic stabilizers and conducting spending reviews to identify opportunities to reprioritize spending towards policy areas with maximum transformational impact. Fully restoring sound public finances would in turn also relieve monetary policy.

On a final note, we welcome staff's thorough and insightful analyses on the economic effects of the Great Lockdown and climate change mitigation strategies would highlight a few comments:

WEO Analytical Chapter 2: The great lockdown: dissecting economic effects

Given the rapidly evolving situation, some results, however, already appear refuted by actual developments. This particularly applies to the economic outlook. Some global mobility indicators have almost returned to pre-crisis levels, contradicting staff's assessment that the recovery will be slow. Furthermore, the evidence on the strong effect of voluntary social distancing is not as clear-cut as suggested. Covid-19 infections – the preferred indicator – is not a significant predictor of any traditional macroeconomic indicator scrutinized. Staff also emphasizes the finding that lifting lockdowns tends to have a more modest impact on mobility compared with the impact of a lockdown tightening. While this is true statistically, lifting restrictions still boosts mobility by close to 20 % over one week. We are also not convinced by the observation that job postings (a lagging indicator) did not pick up immediately after lockdowns were eased. The sample mostly consists of countries that relied on short-time work schemes to adjust labor input. In the US (not in the sample), by contrast, which adopted a different policy approach and initially experienced a large decline in employment, job openings have surged again during the past months.

We concur with staff that the distributional consequences of lockdowns are an important field of research. Differentiating economic effects by gender and age groups is an interesting starting point. A growing body of scientific evidence supports the conclusion of the negative impact of the crisis to fall disproportionally on women and young people. This special chapter makes a further contribution to this research strand by using novel mobility data. At the same time, we feel that some caution is still warranted in interpreting staff's results, which show economically modest differences for a very specific and small sample of countries (Italy, Spain, and Portugal). Accordingly, further analytical work, as well with a view to the digital divide, is needed to better inform policymakers' response to arising distributional effects.

Finally, we appreciate the IMF's call for additional research on the effects of contact tracing and more targeted containment measures. Tentative evidence from recent months seems to suggest that those might also be successful in limiting the spread of COVID-19, probably at much lower economic costs. We would therefore welcome further research in this field to elaborate alternative ways to strict lockdowns to deal with increasing numbers of new infections.

<u>WEO Analytical Chapter 3: Mitigating climate change – growth and distribution-friendly strategies</u>

While we agree that the transition to a low-carbon economy will benefit from a combination of higher carbon prices with green investment policies, the conclusions regarding necessary policy measures and their effectiveness appear too optimistic to us. For example, the carbon price path considered necessary to reach net zero carbon emissions in 2050 is rather at the low end compared to those used in large-scale integrated assessment models (IAMs), as outlined in other similar studies (see e.g. NGFS, 2020, NGFS Climate Scenarios for central banks and supervisors).[1] This implies high confidence on the extent to which green investment policies will reduce emissions. Staff's analysis would further benefit from a more open discussion of the manifold and vast uncertainties surrounding long-run climate (policy) simulations and their implications for climate policy. This includes uncertainties on the regional distribution of economic damages, on the risk of catastrophic outcomes, on the feasibility of climate policies due to free-riding, and on substitution elasticities.

[1] Moreover, the assumption of an annual carbon price growth as low as 7% contrasts with the outcome of initially much higher growth rates in other IAMs required to maintain the temperature increase at safe levels.

We agree with staff's assessment on the important impact of climate change mitigation policies in directing innovation to climate mitigating technologies, shifting electricity generation to renewables, and reallocating employment toward low-carbon activities. The conclusion that such mitigation measures did not harm activity in a broader sense, however, is a bit too general given that the empirical analysis just covers employment effects but not GDP effects. *Staff comments would be appreciated*.

We agree with the interpretation that green investment can act as a buffer against the large economic cost of carbon pricing. However, the outlined structural shifts in employment and private investment may potentially entail some unexamined downside risks to the simulated path of economic growth.