EU policy responses to Covid-19:
effects on money growth, inflation, and spending

Alberto Ruiz-Ojeda
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Like wars, economists consider pandemics to be external shocks, perhaps to draw a distinct line between force majeure causes and endogenous ones, that is, those that work inside the existing structure of the social institutions and mechanisms. To me, this is a very debatable feature of our received wisdom, however, unfortunately, the scope of this article is not sufficient for me to delve deeper into this on this occasion. For the purposes of this essay, we will be focussing on the EU, specifically the Eurozone, though some cross-references to other jurisdictions will be made, where considered pertinent on comparative grounds.

The method for dealing with the effects of EU policy measures follows a well-known pattern. We start with the current situation and that immediately prior to Covid and move on to the situation derived from the response to Covid-19. To finish, we will outline some prospects on the evolution of the macroeconomic magnitudes we consider (money aggregates, prices, and production) in the medium and long term. No need to bury the lede, policies themselves demonstrate that, in terms of correlation, no shock is purely external but policy-induced. The discussion on the effectiveness of fiscal expansion in times of economic distress and the interaction between budgetary and monetary moves, (particularly controversial in the EU, by the way) will lay behind the scenes.

Where we come from: the Eurozone policy reaction to the 2007- Global Financial Crisis

What Central Banks can provide governments with is time. Time to make structural reforms. No single monetary policy measure can be maintained in the long run without its own cannibalisation. Goodhart's Law masterfully sums up this reality: "When a measure becomes a target, it ceases to be a good measure"[1]. The policy response from fiscal and monetary sides to the economic contraction caused by the sub-prime bust in the US was as expected: budgetary imbalances (public deficits skyrocketing) and the Central Bank's balance-sheet expansion via QE. The Fed and the US Administration took the lead. The ECB and the EC/EC (European Commission/European Council) followed the same path once they realised that the very survival of the Euro was at stake. The diagrams below show the evolution of major macroeconomic indicators (GDP, IPC, public debt, QE Programmes, and M3 money aggregate) from 2007 to 2019 in the EU.

The Eurozone's economic performance in terms of GDP and CPI during the 2007-2019 period is shown in the following diagrams:

[1] See Goodhart C.A.E., "Problems of Monetary Management: The UK Experience", in *Monetary Theory and Practice*, Palgrave, London 1984, pp. 91-121, available at: https://doi.org/10.1007/978-1-349-17295-5_4.

Chart 1

Eurozone GDP (% and annual growth)

Source: https://www.macrotrends.net/countries/EMU/euro-area/gdp-growth-rate

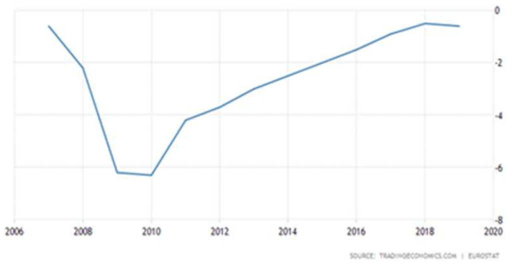
Eurozone CPI (% and annual growth)

Source: https://www.macrotrends.net/countries/EUU/european-union/inflation-rate-cpi

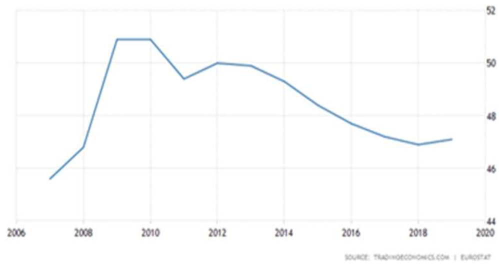
These charts show the evolution of both the public deficit to GDP ratio and the Government spending to GDP ratio of the Eurozone:

Chart 2

Public deficit to GDP



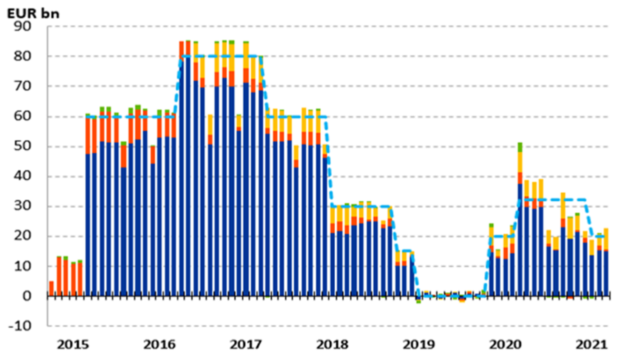
Government spending to GDP



On their part, these graphs collect the evolution of both the ECB's QE Programmes[2] (from 2015 to now), and the cumulative net purchases:

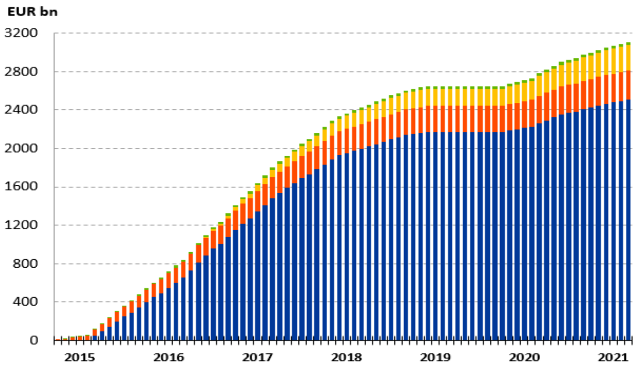
Chart 3

ECB's QE Programmes (2015-2021)



Source: ECB

Cumulative net purchases (by Programme)



Source: ECB

Finally, the M3 monetary aggregate has fluctuated since the introduction of the European common currency as follows:

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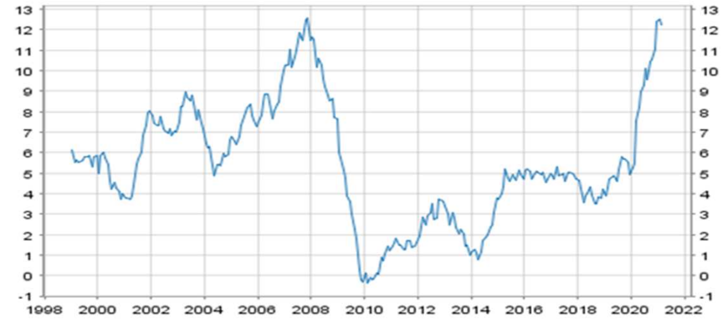
[2] Let me stand for the acronyms: Corporate Sector Purchase Programme (CSPP), Public Sector Purchase Programme (PSPP), Asset-Backed Securities Purchase Programme (ABSPP), Third Covered Bond Purchase Programme (CBPP3).

Chart 4



Source: ECB

Some provisional conclusions can be drawn from this data for the above mentioned 2007-2019 period:

1. Fiscal levers have been activated by the Eurozone's Governments as a conventional counter-cyclical resource. The correlation between the public deficit to GDP ratio and that of the Government expending to GDP is perfectly symmetrical (see Chart 2).
2. The gigantic surge in both government spending and fiscal deficit has been backed by the ECB balance-sheet expansion, that covers a large array of securities, from sovereign to private (see Chart 3). It is reasonable to think that this has profoundly distorted financial market stakeholders' behaviour and asset prices as well.
3. ECB's QE operations have coincided with a M3[3] increase in the Eurozone since 2015 onwards as Chart 4 indicates.
4. A more than modest economic productivity evolution of the Eurozone across the decade of the Global Financial crisis, as measured by GDP indicators (see Chart 1 left), would demonstrate the non-transmission of neither the monetary nor the fiscal stimuli. The effect on prices (CPI: see Chart 1 right) has also remained at an almost irrelevant level since data fluctuated inside the deflationary band.

The picture resembles the well-known *double-pin* recession pattern, that is, a sudden (1 year) drop in productivity and prices, followed by a sudden (1 to 2 year) surge in productivity (far from pre-crisis levels) that turns into a lukewarm, several-year GDP stagnation in a deflationary scenario.

Where we are: helicopter money, a matter of financial virology?

Major economies' policymakers have reacted to the Covid-19 pandemic in the same way by using their (potentially) infinite capacity to issue money out of thin air. In unprecedented quantities, monies are flying out in the form of cheques, ready to be expensed and invested, into the hands of economic agents, whether firms or households. Once again, monetary and fiscal authorities act aligned (revolving doors have proven over the last few years a reciprocal circulation of characters between politics and central banking) instead of independently, as was the general rule during the 1980s, the 1990s and early 2000s.

[3] In the Eurozone, M3 money aggregate comprises the sum of currency in circulation and overnight deposits (the so-called M1), deposits with an agreed maturity of up to two years and deposits redeemable at notice of up to three months (the so-called M2), and repurchase agreements, money market fund shares/units and debt securities with a maturity of up to two years: see https://www.ecb.europa.eu/stats/money_credit_banking/monetary_aggregates/html/index.en.html#:~:text=Monetary%20aggregates%20comprise%20monetary%20liabilities,area%20residents%20excluding%20central%20government.&text=M3%20is%20the%20sum%20of,of%20up%20to%20two%20years.

This is the common feature of D. Trump's and J. Biden's presidencies. To refer to the most recent moves in the US, the non-partisan Congressional Budget Office projects a federal budget deficit of $2.3 trillion in 2021. At 10.3% of GDP, the deficit in 2021 would be the second largest since 1945, exceeded only by the 14.9% shortfall recorded last year. Meanwhile, the Fed has expanded its balance-sheet from about $3.7 trillion in September 2019 to about $7.7 trillion in April this year, as it has bought government and mortgage bonds and taken other measures to support the recovery from the coronavirus pandemic[4].

The EU's recovery plan deals accordingly with similar figures. On 21 July, EU leaders agreed on an overall budget of €1,824 billion for 2021-2027. Combining the multiannual financial framework (MFF) and an extraordinary recovery effort, Next Generation EU (NGEU), the package will help the EU to rebuild after the COVID-19 pandemic and will support investment in green and digital transitions. These elements are in addition to the three safety nets of €540 billion already put in place by the EU to support workers, firms, and countries. In October 2020, EU leaders set priorities for the EU's recovery. The Council and the European Parliament reached a political agreement on the package on 10 November 2020. The European Council on 10-11 December 2020 addressed the concerns raised in the agreement and cleared the path for the recovery package, which was finally adopted[5].

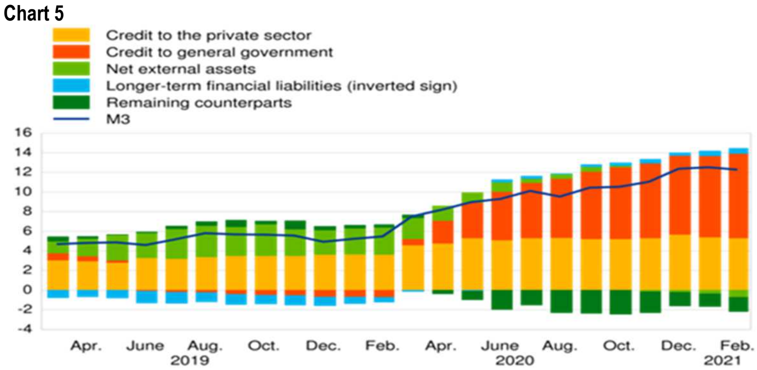
One year after the pandemic's outbreak, the Eurozone's main macroeconomic magnitudes present these inter-annual (1Q 2020-1Q 2021[6]) variations:

Table 1

GDP		CPI		Deficit to GDP		Public spending to GDP		QE cumulative net purchases		M3	
1Q 2020	1Q 2021	1Q 2020	1Q 2021	1Q 2020	1Q 2021	1Q 2020	1Q 2021	1Q 2020	1Q 2021	1Q 2020	1Q 2021
-3.3%	4.4%	1.2%	1.3%	8.00%	8.10%	10.31%	10.08%	10.03%	11.01%	9.2%	13.1%

A key factor sheds light into the connection between fiscal and monetary policy and underlines the tight dependence of the Euro area economy and debt, not to mention the sustaining role that the ECB's asset purchases Programmes pay. The following chart shows the contribution of the M3 counterparts to the annual growth rate of M3 (in percentage points):

Chart 5



Source: ECB https://www.ecb.europa.eu/press/pr/stats/md/html/ecb.md2102~128978fcc1.en.html

[4] I take this data from *Market Watch*, April 23, 2021, available at https://www.marketwatch.com/story/massive-helicopter-drop-of-money-from-fed-and-congress-raises-inflation-risk-says-manager-of-88-billion-bond-fund-11619119502.

[5] More detailed information can be found at the European Council official website: https://www.consilium.europa.eu/en/policies/coronavirus/.

[6] 1Q 2021 data are mere estimations. The sources are the same as Charts 1 to 4, respectively.

It is most certainly an ocean of debt walking hand in hand with an unprecedented halt in M3 monetary aggregate. In such a panorama, it is quite naïve to believe in the upcoming of sensible, effective structural reforms to improve the supply side troubles of the Eurozone. Demand side policies at the macroeconomic level are omnipresent, and they transfer perverse counterincentives to stakeholders.

For the moment, as shown in Table 1, the first year of the pandemic seemingly confirms the abovementioned *doble pin* (W-shape) recession pattern, at least in its first stage: a sudden decline in GDP, then a rapid recovery (as lockdowns and business restrictions soften or come to an end little by little) with a flat line in prices and a rise in fiscal expansion (deficit/debt) and broad money increase.

Let us examine hereinafter some foreseeable results of the current state of the macroeconomic framework, more focused on the monetary side but without disregarding the budgetary implications.

How different is this time going to be?

As Tim Congdon convincingly suggests, Central Banks do no run out of ammunition once interest rates have reached the *zero-lower bounce*[7]. They can increase the quantity of money in the economy by purchasing assets from both banks and non-banks. When the seller is a bank, the quantity of money is affected indirectly (the amount of the purchase increases the bank's reserves account at its Central Bank), but in the case of a non-bank, money is created in the form of a demand deposit at the seller's bank account for the same amount of the purchase.

This is precisely what the ECB is doing through the Pandemic Emergency Purchase Programme (PEPP) started on March 2020, and whose endowment reaches the phenomenal amount of €1,850 billion. By the end of February 2021, PEPP cumulative net purchases equalled €870,126 billion[8].

However, in addition to the indirect/direct effects on the quantity of money, a second transmission channel of the QE must not be neglected, the leakage from financial circulation to industrial circulation spurred by the surge in assets prices. Since Central Bank's securities purchases lower the yields issuers have to offer, both bond and equity market prices grow upwards, and that would make it attractive for securities holders to sell them out to get profits and thus spend the money earned. After a severe drop at the beginning of the pandemic, asset prices in the Eurozone have scaled in the way that can be seen in Table 2:

Table 2

Private firms' bonds		Private firms' equities		Sovereign bonds	
March 2020	February 2021	March 2020	February 2021	March 2020	February 2021
€1.44 trillion	**€1.57 trillion**	**€6.02 trillion**	**€8.04 trillion**	**€8.45 trillion**	**€9.78 trillion**

Source ECB: https://www.euro-area-statistics.org/

As stated by Tim Congdon and Juan Castañeda, asset prices and goods and services prices "do not move in insolation" in the medium and long term[9]. This transmission is not a matter of

[7] See "Can central Banks run out of ammunition? The role of the money-equities-interaction channel y monetary policy", *Economic Affairs*, 41 (2020), pp. 21-37.
[8] For a more detailed explanation and further data, we remit to the ECB's official webpage https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html.
[9] "Inflation: the next threat?", *Institute of Economic Affairs*, Briefing 7 June 2020, p. 16.

automatism, but correlations are undeniable according to the dataset at our disposal. Congdon points out the reason that would justify the difference between the broad money expansion via QE during the Great Financial Crisis and in the aftermath of the Covid-19 shock[10]. Over the 2010s, monetary aggregates increase remained mostly in the banking system pipelines, since the money injected was destined to bail out commercial banks and states by transferring their financial junk onto the Central Banks' balance-sheets, instead of expanding the credit given to firms and households. Things have changed a lot during the pandemic insomuch as money injections are spilling out to the real economy through the abovementioned transmission mechanisms, along with the huge growth of government spending that affects directly real money balances.

Let me use a metaphor. A vaccine is a homeopathical treatment, as the illness is cured by using the same evil that causes it, but in a reduced, mitigated dose that fosters the patient's own resources and makes him better off. On the contrary, fiscal, and monetary stimuli provoke a formidable flood of money that comes from outside the economy making inflation plausible. When supply-side restructuring is quite doubtful due to the political cost of reforms and institutional rigidities, economic recovery is at risk.

Final thoughts and policy proposals: is the Eurozone on the path to stagflation?

A more accurate, detailed reflexion on the potential consequences of the Eurozone's policy response to the Covid-19 shock is outside the scope of this essay. However, some final ideas and proposals should be outlined now, these are summarised in the following bullet points:

- I would like to be mistaken; however, no fiscal contraction nor money supply reduction might be expected over a period of 3-4 years. Both government deficit/debt and M3 aggregate might continue to raise to even more unprecedented amounts, at least in peacetime. The ECB's balance-sheet operations would accompany public budget expansions to prevent the Eurozone's government´s policies from financial market punishment.

- As a result, austerity policies, based on fiscal contractions (public spending reduction and tax cuts) are not in the Eurozone's medium-long run horizon. Taxes simply take resources away from productive activities and cause distortions to market operators. Aggregate demand multipliers are formidable theoretical artefacts that take for granted the absence of pro-cyclical effects. A great deal of research has recently been done to refute the Keynesian tradition on robust historical dataset[11].

- Getting back to monetary stability would be much tougher for the Eurozone than it should be in rational terms. Sadly, I recognise that the EU's constitutional counterfeits facilitate rather than refrain from monetary disequilibria[12]. In the absence of an EU

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[10] Watch the presentation entitled "Why didn't QE spark inflation after 2009 and what's different now?", Institute of International Monetary Research, February 2021, available at https://www.youtube.com/watch?v=-NbuaG8rPz4.

[11] For instance, see Capie, F., Chapman M., Marsh, C., and Wood, J., "A sensible fiscal policy for the sharp rise in government debt", *SUERF Policy Notes*, No. 181, July 2020, 9 pp., and, above all, Alesina, A., Favero, C., and Giavazzi, F., *Austerity: When It Works and When It Doesn't*, Princeton University Press, Princeton-New Jersey 2019.

[12] For this purpose, see the proposals by J. Castañeda, "A rule-based monetary strategy for the European Central Bank: a call for monetary stability", *SUERF Policy Notes*, No. 192, September 2020, 21 pp.

centralised (federal), lithe governmental decision-making (comitology is omnipresent), the ECB rises like the saviour for all seasons in the shape of a universal liquidity provider.

- Effectively, double-digit inflation would be the inevitable consequence of the failure of a rule-based monetary strategy for the Eurozone. Along with it, weak productivity recovery and private sector zombification pave the path to Japan-like stagflation.

As announced, there are many related topics that have vexed economists over the last two centuries whose treatment must be left for the not-too-distant future.