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Europe and Economic & Business Policies

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ESCP Impact Paper No. 2020-44-EN

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Abstract

This article uses a standard Dynamic General Equilibrium framework to study the macroeconomic impacts of the 2020 lockdown and the ECB's Pandemic Emergency Purchase Programme (PEPP) on the Euro economy.

Keywords: PEPP, Unconventional Monetary Policy, The Great Lockdown, Economic Policy

Macroeconomic Impacts of the ECB's Pandemic Emergency Purchase Programme

The Corona crisis has forced the European Central Bank into action. The ECB has committed to a host of interventions, such as lowering the standing facilities to the historic value of -0.75, providing up to €3 trillion in available liquidity and implementing the Pandemic Emergency Purchase Programme (PEPP), which is the subject of this article. The ECB's Asset Purchase Program (APP) was started in March 2015. The stock of Eurosystem APP bonds stood at €2,783 billion at the end of March 2020 (ECB report). The APP that was at its lowest level in 2019 has been reinforced in 2020 under the PEPP, by injecting an envelope of €750 billion in addition to the €120 billion planned before the crisis. This program, representing about 7.3% of Euro Area GDP, is temporary until the end of 2020 and is likely to be continued in 2021. The economic history, especially the Great Recession in 2008, outlines that such actions are necessary to address the significant challenge posed by the Corona outbreak to our economy.

Figure 1: Economic recession due to the Corona outbreak. Source: Eurostat 2020

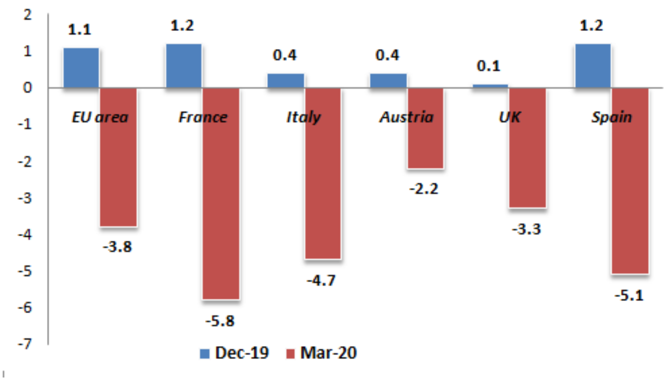


Figure 1 shows the recession caused by the outbreak in the Euro Area. The pandemic reversed all our forecasts for growth and medium-term inflation which were targeted by the previous easing in financial conditions. If this challenge is not addressed correctly, it could threaten our financial stability and may lead to a macro-financial feedback loop that would create a situation similar to the Great Recession. As a result, quick actions are required to ensure that this shock does not escalate into a huge financial crisis with self-fulfilling spirals and chains of bankruptcy. This article uses a standard Dynamic General Equilibrium Framework (Auray et al., 2018) to study the impact of the lockdown and the PEPP on the Euro economy.

The COVID-19 pandemic has already influenced every aspect of our lives. It has economic, humanitarian and social consequences which will stay with us for longer than a season. Economically speaking, the COVID-19 pandemic can be considered an intense shock to economic sectors from the external to real economy. The most visible impact, and potentially the most significant one, is the devastation of the labor market caused by the imposition of the Great Lockdown, a unique event in our history.

Figure 2: Impact of the lockdown in two scenarios: i) if the labor market recovers fast, ii) if the labor market recovers slowly.

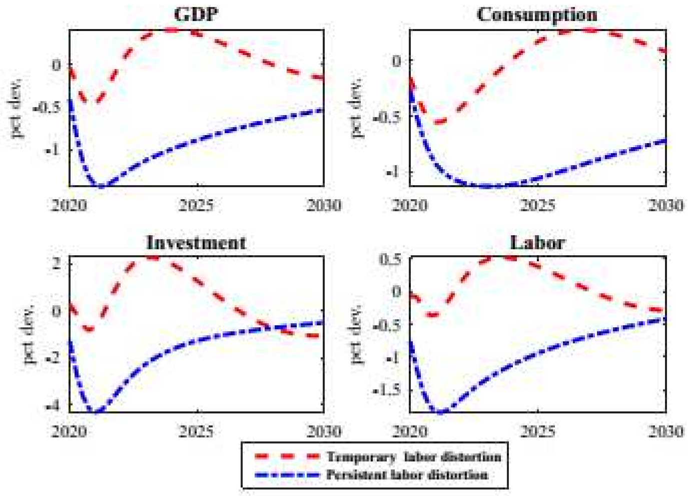
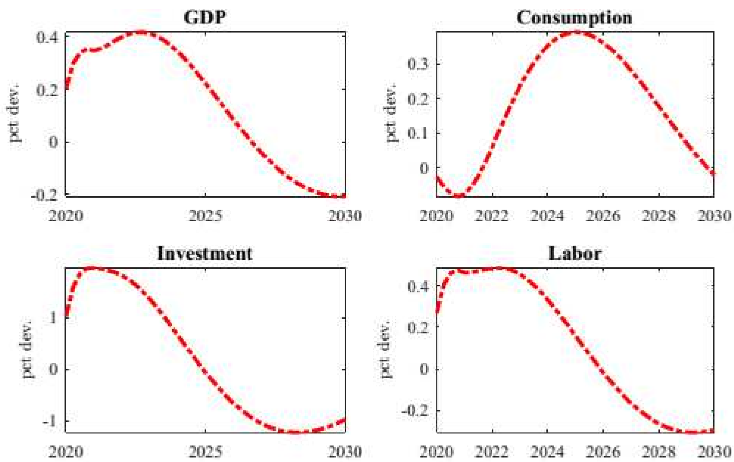


Figure 2 compares the response of the economy to the labor market distortion in two scenarios:[1] if the labor market is able to recover rapidly and return to its pre-crisis situation, or if the labor market is not flexible enough and the distortions persist. The figure indicates that the economic response to the lockdown is highly dependent on the ability of the labor market to absorb such shocks. If the labor market recovers fast, the impact of the lockdown disappears in less than 2 years. However, if the shock persists, the damage is more severe and long lasting. Initiatives such as Partial Unemployment are pivotal but more is expected from governments to support the labor market and assure a fast recovery. This is in line with ECB president Christine Lagarde's warning that Euro Area economic growth depends *"crucially on the duration of the containment measures and the success of policies to mitigate the economic consequences for businesses and workers."*

Figure 3: Impact of the ECB's PEPP in response to the Corona outbreak 2020.

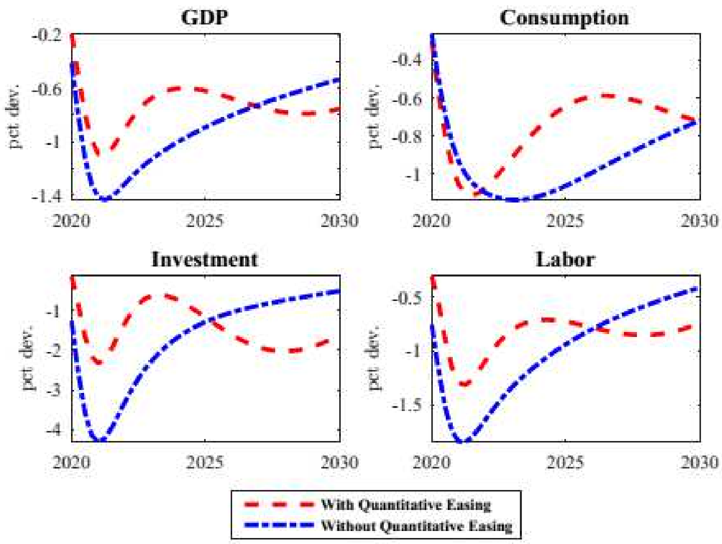


The PEPP aims to address illiquidity. The ECB estimate shows that the European governments namely Germany, France, Italy, Spain and the Netherlands will issue more than €1 trillion of sovereign bonds in 2020. As a result, a higher premium is needed by investors to absorb such a huge supply in the balance sheet. The PEPP helps this action by reducing the duration risk. Figure 3 illustrates the impact of a pure PEPP without

[1] The shock is a 10% negative shock to the labor disutility of households. By its nature but not its volume, this shock provides a similar situation to the current lockdown situation.

considering the impact of the lockdown. The figure shows that such a program has a positive impact on GDP, investment and labor participation. Figure 4 indicates that the PEPP is not necessarily enough to totally absorb the adverse impact of the lockdown but could be of great assistance in reducing the damage. These measures help stability, improve market liquidity and mitigate volatility. In addition, they have positive impacts on welfare (in the form of consumption percentage equivalent) as it is presented in Table 1.

Figure 4: Impact of the ECB's PEPP in the presence of the lockdown if the labor market distortion persists.



The bottom line of this article is that monetary policy will not suffice for a recovery to occur. Monetary policy without additional fiscal responses *"would strain the bounds of monetary policy, calling into question the effectiveness of the institution that deploys it"* (Bank of England governor Andrew Bailey).

Table 1: Welfare effects of the PEPP 2020

Vision	Percentage
5 years	0.0246
10 years	0.2310
lifetime	0.0304

This crisis has affected both the supply and demand sides of the economy. The PEPP is of great benefit but is not enough. First, governments need to run some structural reforms to invigorate the labor market and reduce distortions. Second, governments should fully support their health system. Third, timely and targeted fiscal policy is needed to help households and firms regain what they lost during the crisis.

Conclusion

This article can be concluded neatly by a quote from Kristalina Georgieva, IMF Managing Director: *"We strongly support the extraordinary fiscal actions many countries have already taken to boost health systems and protect affected workers and firms. We welcome the moves of major central banks to ease monetary policy. These bold efforts are not only in the interest of each country, but of the global economy as a whole. Even more will be needed, especially on the fiscal front."*

Reference

Auray, S., Eyquem, A., and Ma, X. (2018). Banks, sovereign risk and unconventional monetary policies. European Economic Review, 108, 153–171