EMERGING STRONGER FROM THE CRISIS

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The crisis as an opportunity

Economic policy mistakes and new scope for action

By Stefan Terliesner

Huge aid packages have stabilised the economy during the pandemic. However, much of the damage will likely only start to become visible from 2022 onwards and will have a long-lasting impact. If the right course is charted now, however, companies and society as a whole could trigger a renewal.

Jan Pieter Krahnen, scientific director of the Leibniz Institute for Financial Research SAFE and professor of banking and finance at Goethe University, sees the SARS-CoV-2 pandemic from two angles: as "an abrupt interruption of economic activity, that is, as a crisis" and as "a questioning of established production patterns, that is, change". Provided that entrepreneurs, politicians and also citizens make the right decisions about adapting to a changed environment, the crisis also presents an opportunity. For example, the pandemic has shown the importance of digitalisation.

As a crisis, the pandemic is bringing with it drastic cuts in individual sectors such as aviation, retail, restaurants, hotels and cultural institutions. The plight of those affected is not yet reflected in official statistics. This is due to the suspension of the obligation to file for insolvency in combination with the aid packages. Crifbürgel, providers of information services, estimate that over 300,000 companies in Germany have financial problems. Around 16,500 additional insolvencies can be expected in 2022, they say.

State aid packages have had a stabilising effect

However, the economy is beginning to recover. After gross domestic product (GDP) slumped by 5 per cent in 2020, the German Council of Economic Experts expects growth of 3.1 per cent in 2021. According to the Council, the deciding factor for the further development of the German economy is how the vaccination rollout progresses. If vaccination capacities increase, 70 per cent of adults could be immunised by the end of the summer. Closing industrial businesses should be avoided as far as possible, they say, otherwise economic development will turn out much worse. This is because since the summer of 2020 the manufacturing sector and export industries have recovered very well. Global supply chains that were abruptly truncated in the spring of 2020 have been quickly restored. Since then, industrial production has been on an upward trend again.

State aid packages have contributed to this stabilisation (see also the diagram on page 70). They are above all compensation for the politically induced decline in demand as a result of the lockdowns. The coronavirus crisis was preceded by six financial years with budget surpluses. According to the Bundesbank (German Federal Bank), with a debt ratio of 59.7 per cent in 2019 Germany was below the reference value of 60 per cent specified in the Maastricht Treaty for the first time since 2002.

In the mechanical engineering sector, things are on an upward trend again after the crisis thanks to full order books.

Return to the Maastricht Treaty

The Maastricht Treaty agreed between the EU member states in 1992 paved the way for the monetary union, and one of its objectives since 1999 has been to ensure the euro's stability. Among others, the Treaty demands that states aim for and achieve in the medium term a debt level below 60 per cent of their GDP. In 2020, however, Germany's national debt shot up by € 27 billion to € 2.3 trillion because of the state aid for private households and companies and plunging tax revenues; this equates to 70 per cent of GDP. The aim now is therefore to reduce debt in order to meet the Maastricht criteria again.

IN A NUTSHELL

- Reducing high public debt is indeed possible, as Germany has already proven in the past.
- However, experts demand that with the recovery of the economy after a year of crisis, tax and social policies as well as local government finance ought to be realigned.
- The role of the European Central Bank and its monetary policy need to be discussed again.
- Clear equity capital requirements should be imposed on banks.

That the state is capable of achieving this was shown by its recovery after the economic and financial crisis in 2009 and 2010. At that time, the debt ratio rose to the highest level ever of 82.5 per cent. This shows that the state has already emerged successfully from a huge debt in the past. According to Volker Wieland, professor of monetary economics at Goethe University and member of the German Council of Economic Experts, this could succeed again "if there is a sustained economic recovery". It might already be possible to adhere to the debt brake again in 2022, he says.

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Along with retail, restaurants and hotels as well as the cultural sector, aviation has been hard hit by the crisis.

Save money instead of raising taxes

According to the German Council of Economic Experts, tax increases would be counterproductive because they would lessen economic activity and stifle momentum. Instead, it will be necessary to consolidate public finances as soon as the economy has recovered from the recession, says Wieland. There are two reasons for this: Firstly, it creates room to manoeuvre for stabilising the economy in the event of a large crisis in the future. Secondly, it protects against an overburdening of the welfare state because even now almost one third of the federal budget is being poured into pension insurance as a tax subsidy, which is technically financed exclusively from contributions. Demographic developments will exacerbate this problem even more: In future, fewer and fewer contributors will have to pay the pensions of more and more older people. In his book "Wie wir unsere Wirtschaft retten" ("How to Save our Economy"), Clemens Fuest, president of the ifo Institute, writes that social policy will have no option but to take a close look at its portfolio and define priorities. The book goes on to say: "Part of sustainable public finance is not neglecting state spending as investment measures, such as for infrastructure or education." Insofar as such expenditure boosts growth, it could help reduce the debt ratio. Overall, the tax system needs to be more employment- and investment-friendly. Taxes on corporate profits and income are a greater burden on growth than consumption and property taxes, says Fuest.

Tax reforms necessary

According to Fuest, a reform of local government finances, including the abolition and substitution of the trade tax, is also necessary. The coronavirus crisis has shown once again that the trade tax is a bad one because the revenue from it fluctuates considerably in the economic cycle. So far, however, politics has failed to act boldly. Not even in the coronavirus crisis has the federal government been plucky enough to use an instrument to stabilise companies that works very precisely and does not burden the state coffers more than is absolutely necessary: a comprehensive tax loss carryback. Such a loss carryback allows companies to offset losses incurred during the crisis against their profits from previous years. The only thing that was decided was to raise the maximum sum for 2020 and 2021 from € 1 million to € 5 million. Although Alfons Weichenrieder, professor of economics and finance at Goethe University – together with his colleague, tax expert Professor Philipp Lamprecht – welcomed the agreed extension of the loss carryback in July 2020 because it functions in a crisis like an "automatic stabiliser", analogous to the short-time allowance at the level of blue- and white-collar workers, it is, according to him, inadequately designed. It is bitter that legislation even entirely forbids a loss carryback in the case of trade tax because a company can strengthen its equity base via such a loss carryback. Against this background, tax payments can even drive companies with a functioning business model into insolvency, Fuest also warns, because tax payments are a liquidity outflow. If, at the same time, no money comes in because of the measures implemented in relation to the pandemic, bankruptcy threatens, he adds.

Discussion about the role of the ECB

Not only in Germany does politics use loans and subsidies for affected companies to tackle this threat. The European Union (EU) is also showing solidarity in the area of debt creation. In

February 2021, the Council of the European Union empowered the European Commission for the first time to borrow on the capital market on behalf of the Community. The vehicle for this is the EU Recovery Fund with a volume of up to € 750 billion. The fund still has to be ratified by all member states, which should happen in the summer. While critics consider that the EU is heading for a fiscal union and are complaining that Germany is de facto accepting unlimited liability for all the EU's coronavirus debts, Chancellor Angela Merkel described the EU aid as a one-off action when it was ratified by law by the Bundestag. A pending appeal before the Federal Constitutional Court could still stop the law from becoming effective. What becomes clear at this point is the extent to which the pandemic is shifting the (institutional) balance at European level.

This also applies for the European Central Bank (ECB), whose role and competences are once again a subject of discussion. In normal times, central banks react to a recession by lowering interest rates. The aim is to boost investment and consumption through cheap loans. However, when the coronavirus crisis erupted, the ECB's key interest rate was already at zero per cent. In order to stimulate the economy nonetheless, the ECB approved the Pandemic Emergency Purchase Programme (PEPP), for which – after several top-ups – € 1.85 trillion are now earmarked. The ECB can buy sovereign and corporate bonds for this gigantic sum up until March 2022. Such purchases push down the interest rate on the capital market. France, for example, was able in mid-April to borrow money at zero per cent for ten years, Italy for 0.8 per cent and Germany even at the rate of minus 0.3 per cent.

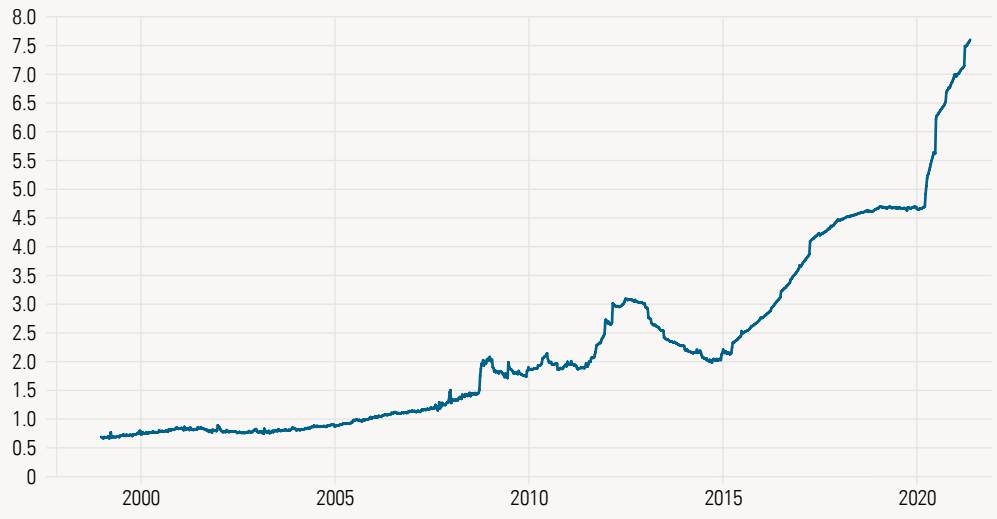
EU debt has the potential to cause inflation

Quite a few governments have an interest in the ECB continuing to purchase enormous numbers of sovereign bonds because such governments – instead of setting priorities when spending money or tackling reforms – simply take out new loans. Liberal economists such as Wieland and the Kronberger Kreis (the scientific advisory board of the Market Economy Foundation) see in this a conflation of monetary and fiscal policy, although the ECB is independent – or rather should be, according to the Treaty on the Functioning of the European Union. The Kronberger Kreis warns in a study against a "fiscal dominance of monetary policy". The ECB must present a plan, they say, on how it intends to reduce the high stock of sovereign bonds on its balance sheet.

Important to know: The ECB pays for its bond purchases – metaphorically speaking – with money it prints itself. Nowadays, no printers churn out banknotes for this purpose, but instead the ECB credits a corresponding sum to the commercial banks' accounts at the central bank. As a result, the central bank's balance sheet total is rising rapidly and currently stands at around € 7.5 trillion (see diagram below.) The potential to cause inflation is building up here because there is no real production of goods and services behind the "printed money". Wieland, like Otmar Issing, president of the Center for Financial Studies at Goethe University and former chief economist at the ECB, sees the danger of monetary financing of governments, which is

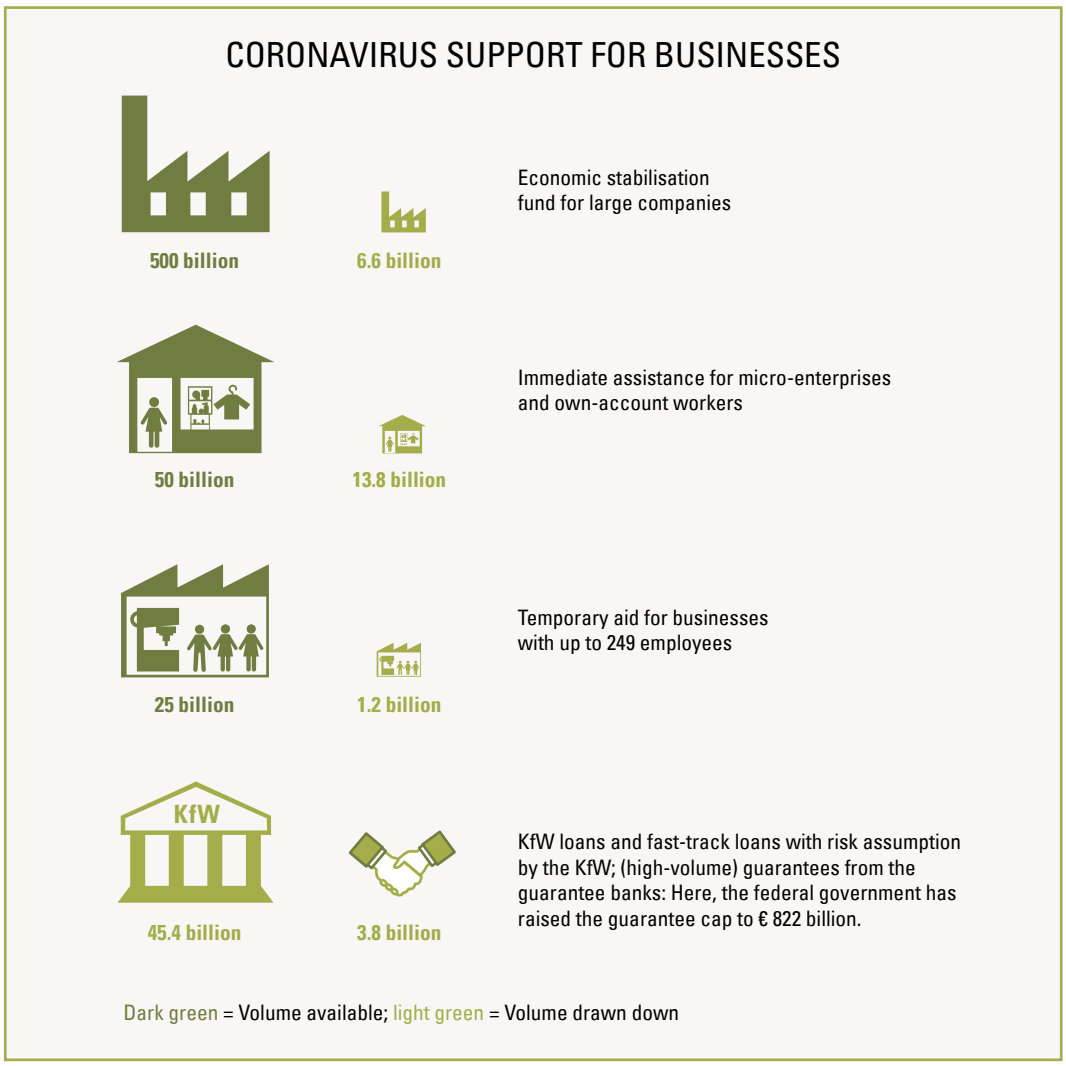
RISING BALANCE SHEET

ECB balance sheet development since 2000. Figures in trillion euro.



Source: European Central Bank

Photo: telesniuk/shutterstock



Source: German Council of Economic Experts – Annual Report 2020/21

forbidden for the ECB. In the pandemic, this route is justifiable for monetary policy reasons. But when the justification for it disappears, then the ECB would have to react, he says.

Savings glut pushes Bitcoin price up

Even without this problem, the greatest danger of a new economic and financial crisis occurring lies perhaps in the ECB's departure from its very relaxed monetary policy. If inflation goes up sharply, the ECB would be obliged to raise the key interest rate because an uncontrolled increase in general price levels is dangerous. Inflation devalues savings and makes it almost impossible for private individuals and businesses to calculate. Germany went through this painful experience during the Weimar Republic. After the First World War, the German economy was in tatters and the state was de facto bankrupt. In order to fulfil its payment obligations nonetheless, the Reichsbank printed money on a massive scale until inflation in Germany exploded. Especially in 1923, the Mark lost value dramatically fast. According to the statistics portal Statistia, in November 1923 one US dollar cost around 4.2 trillion Marks. Also worth noting: If the prices of cryptocurrencies such as the Bitcoin are rising sharply at present, this also has to do with the money glut. Andreas Hackethal, professor of personal finance at Goethe University and researcher at the Leibniz Institute for Financial Research SAFE, however, prefers to call this phenomenon a "savings glut" and points out that it is also the reason why share prices are being driven up because citizens forced to save during the lockdown have more money to invest, he says. In his view, the problem is that many new stock market investors "do not invest broadly and calmly according to the textbook, but instead often gamble via trading apps and are taken in by fraudsters promising quick money." This could harm the share culture just awakening in Germany, despite shares being an important element of providing for old age.

Clear equity capital requirements for banks

The phasing out of the COVID-19 aid packages for companies could also become dangerous for the banks. Banking expert Professor Jan Pieter Krahnen speaks of a "cliff-edge effect" that the

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institutions responsible for banking supervision fear. Without aid packages, an abrupt increase in insolvencies would threaten, he says, which would also have negative consequences for the lending banks. In cooperation with international researchers, SAFE has therefore analysed scenarios for combating banking crises. Krahnen himself is of the opinion that clear equity capital requirements should be imposed on banks, which they must adhere to by whatever means. Behind this is the principle of liability, which by its very nature contributes to responsible business practice. To get banks to show loan defaults in their books in a correct and timely manner, the SAFE research team proposes better credit quality checks and appropriate accounting rules for banks. Without such incentives, unviable companies would receive further financing – something commercial banks tend to do.

Return to realistic balance sheets

Tobias Tröger, professor of private law, commercial and business law and SAFE researcher, is also dealing with risks in the banking sector. And he too criticises the fact that current balance sheets do not mirror the banks' actual solvency status. Ultimately, this endangers financial stability, he says. He recommends that the ECB and the other supervisory authorities use the planned stress test in 2021 to produce a realistic representation of the asset quality of banks in the euro area. This would imply, he adds, "an immediate return to realistic accounting methods in line with the International Financial Reporting Standards (IFRS)." The application of the IFRS 9 standard was attenuated in early 2020 because of the coronavirus crisis. The outcome: Many economic consequences of the pandemic will only become visible from 2022 onwards. Risks are lurking here for financial stability and the ability to finance the welfare state. Other dangers concern the cohesion of society as well as of the EU and the eurozone. At the same time, the pandemic offers an opportunity for restructuring – at the level of companies, states and the EU, for example in digitalisation, education and investments in a self-sustaining recovery. ●

ABOUT

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Professor Volker Wieland, born in 1966, is professor of monetary economics and managing director of the Institute for Monetary and Financial Stability (IMFS) at Goethe University. He has been a member of the German Council of Economic Experts since 2013. His research interests include monetary and fiscal policy, economic cycles and macroeconomic models. He has built up the open database Macroeconomic Model Data Base (www.macromodelbase.com), which allows a comparison of over 150 models.

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