The EA and the US in the COVID-19 crisis: Implications for the 2022-2023 policy stance

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Introduction

Thank you for giving me this opportunity to review the euro area performance throughout the crisis and what we are recommending you should consider for this year, and of course, for next year.

What I would like to say today is that while both the euro area and the US have addressed the pandemic swiftly and robustly, their recoveries are shaping in different ways. This provides lessons and information about policies looking forward.

In that respect, I will be making three points:

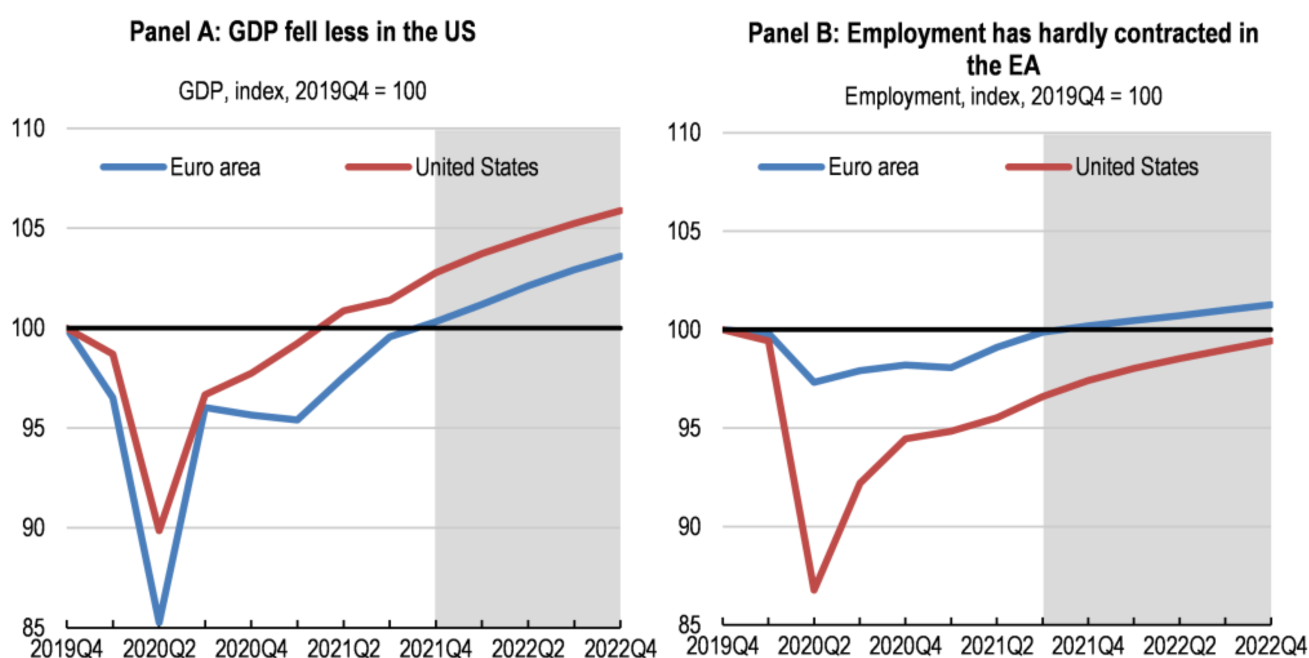
1. What should be our reference to assess the progress towards a genuine recovery from the pandemic? It should certainly not be the level of activity at the end of 2019. In the two years since then, economic activity and employment should have increased. Our reference should therefore be the pre-pandemic trend for GDP and employment.
2. The crisis is not over. We do not yet know how Covid can continue to evolve and how our economies will adjust structurally to the profound disruptions caused by the

epidemic and to its consequences. We are fortunate the euro area policy response was bold and coordinated and still leaves policy space today.

3. Fiscal and supply side policies will need to be mobilised to regain the pre-pandemic trend, and to address the root causes of inflation, too high energy prices and low trend growth.

Let’s take a look at my first slide illustrating the different shapes of the US and euro area recovery. In spite of the significant impact on GDP early in 2020, swift proactive policy reactions on both sides helped establish a fast and high bounce back. Both in the US and euro area GDP is now at or above late 2019 levels (Figure 1).

Figure 1. Recoveries in the United States vs. euro area



Note: The projection period is shaded in grey.
Source: OECD Economic Outlook 110 database; and OECD calculations.

However, policies have differed in shape and content across the OECD, and particularly between the US and the euro area.

The way support has been provided to people has been different, reflecting different labour market and welfare structure profiles.

Both approaches have had different consequences for employment, demand and inflation.

As you well know, throughout the euro area, huge efforts have been made to keep people in employment. Some countries have even prohibited layoffs.

Unlike European job retention schemes, under the US “temporary layoff” scheme, workers have lost both wages and benefits.

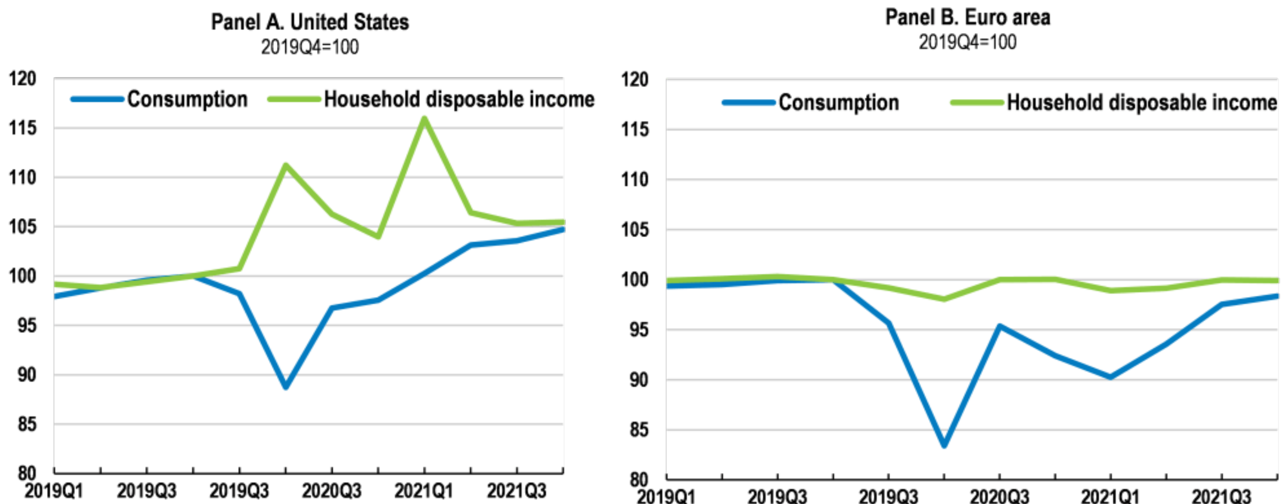
As a result, in Europe employment levels were hardly affected. On aggregate, employment is back to pre-crisis levels. In the US employment was hit hard and is still below pre-crisis levels.

There are other differences between the US temporary lay-off and the euro area job retention schemes, which affect the recovery.

In the US, lay-off compensation has remained very low. To address this issue, the US government has significantly increased income support, by sending cheques to people directly, through tax credits and by extending and topping up unemployment benefits. These were significant sums, particularly for many low-income people.

So US real household disposable income increased signficantly in 2020 and again in 2021 (Figure 2).

Figure 2. Income support has impacted consumption developments



Note: Consumption represents real private consumption expenditure and household disposable income refers to real net household disposable income. Euro area aggregates are OECD estimates.
Source: OECD Economic Outlook 110 database; and OECD calculations.

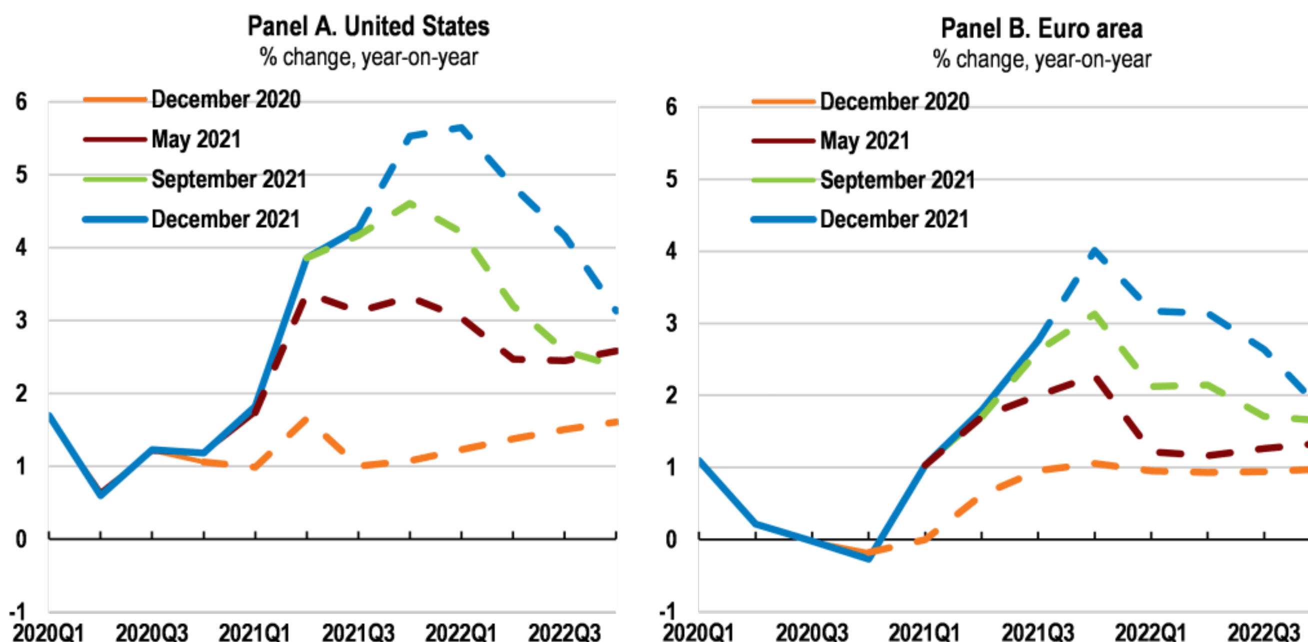
As a result, in the US consumption has returned to its pre-crisis trend on aggregate, and spending on goods has surged well above its pre-crisis dynamic.

In contrast, in the euro area incomes have remained at roughly the same level as pre-pandemic (as wages were more-or-less preserved for most workers in job retention schemes). And, consumption is not yet back to its pre-crisis level in the euro area.

These differences have important consequences for jobs, growth and inflation.

A common feature for inflation is that most forecasters, including all of us here, missed inflation developments and have repeatedly underestimated the magnitude and persistence of inflation in Europe and the US (Figure 3).

Figure 3. Inflation projections have been repeatedly revised upwards

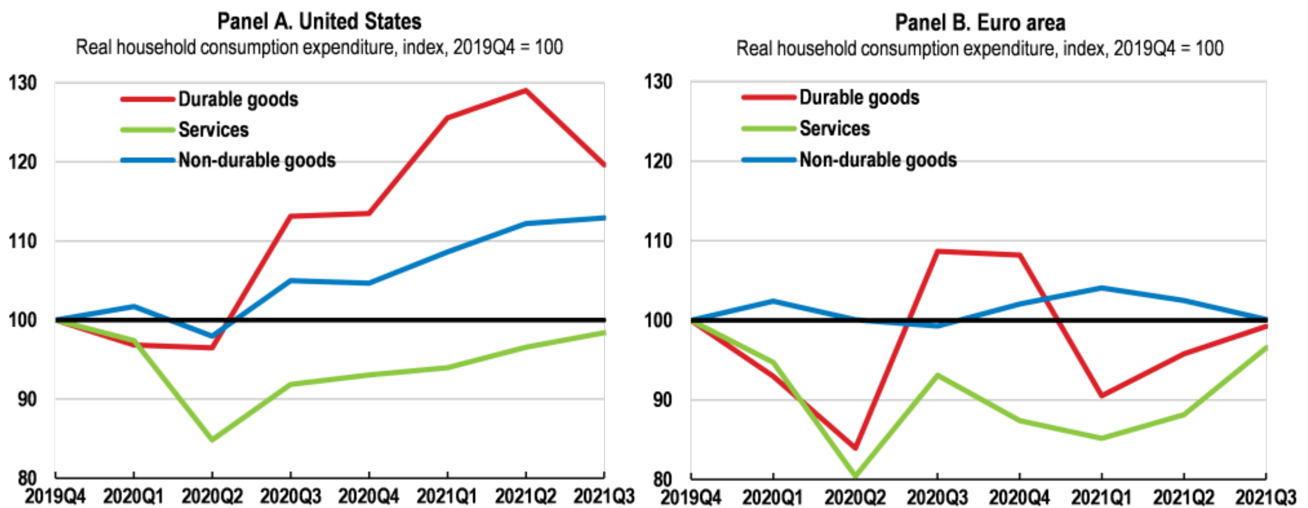


Note: Panel A – Dashed lines represent projections for the personal consumption expenditure deflator. Panel B – Dashed lines represent projections for the headline harmonised consumer price index.
Source (both panels): OECD Economic Outlook 110 database; OECD Economic Outlook 109 database; OECD Economic Outlook 108 database; and OECD calculations.
One reason is disruptions and bottlenecks caused by the pandemic, limiting supply and pushing prices up. As the pandemic lasts and, as many Asian countries supplying essential industrial components pursue strict anti-COVID restrictions, these tensions will take longer to recede than we expected, possibly lasting up to 2023.

This fact is common to the euro area and the US, but there are two marked differences that trigger differences in inflation.

With the consumption boom in the US I mentioned earlier on, concentrated on goods and in particular durable goods (Figure 4), pressures on prices, especially for durable goods such as cars, have shot up.

Figure 4. Very strong demand for goods, in particular durable, in the US



Note: The data on panel B represent an average of euro area member countries weighted by nominal consumption expenditures. Non-durable goods incorporate semi-durable goods. Services and non-durable goods are available only for Austria, Estonia, Finland, France, Germany, Ireland, Italy, Latvia, Luxembourg, the Netherlands and Portugal.

Source: Bureau of Economic Analysis; Eurostat; and OECD calculations.

Inflation in the US is – to a significant extent – a direct consequence of the support to income, combined with inelastic or distorted supply.

But this is a US, not an euro area feature – and we should not be looking through US lenses when examining and discussing the EA.

The largest driver of inflation in the euro area is energy prices and we all know why: weather, low gas stocks and reserves, delayed maintenance in infrastructure, not enough investment, in particular in renewables, geopolitics, all of which cannot be resolved rapidly.

Different drivers of inflation call for different policy responses. While the US should gradually remove policy accommodation – which it is already doing for fiscal and has announced for monetary – the euro area has not gone to such an excess (on aggregate) and therefore has different policy requirements.

So what can we make of this looking forward?

Policy stance for 2022 and 2023

The euro area has successfully preserved income and jobs, keeping them in line with their pre-crisis level. This is less the case for demand as not only has consumption not recovered, but investment is also lagging behind –though this may change with NGEU.

The objective should now be to get GDP, employment and income up to pre-crisis trends – not just levels. And better, if possible: recall that GDP growth was 1.4% on average in the euro area for the decade pre-crisis, 2.2% in the US, and we were discussing the "great stagnation".

What does that imply for policies looking forward?

- The main driver of inflation in the euro area is not excess demand faced with supply shortages on aggregate, it is energy prices, and that means monetary policy is not the main tool to address it. On this, in the context of rising rates in the US we should recognise that the ECB has a challenging task to keep long term yields at low levels.
- The energy situation is calling for a vigorous acceleration of investment in clean energy, rebuilding of stocks, and long-term planning to smooth energy bills and ensure the current winter situation is a temporary phenomenon. Clearly, there have been some policy and coordination failures here. The EU does not have the energy mix, infrastructure and policies to undertake the sort of rapid transition that is consistent with our emissions reductions commitments. Accelerating the operational implementation of the Green Deal will be crucial.
- Employment, participation and hours of work, on aggregate across the euro area, in spite of a swift

recovery, remain lower than in the US. This is central to potential growth and there is no room for complacency about the job situation. If GDP per capita is to rise above the trend expected prior to the crisis, reducing the debt burden, huge efforts are needed to bring more people into better jobs. This requires structural policies alongside ongoing demand momentum.
- Fiscal policy, on aggregate, should remain agile and flexible to adapt to the evolving situation.

On the basis of the review I have just gone through, there is no reason to tighten the fiscal stance beyond removing those emergency programs that are no longer needed.

There is only a stronger case for adjusting fiscal policy in countries where consumption is clearly excessive, pushing inflation well above the euro area level.

The European Commission should be commended for having relaunched the European governance work, including the fiscal framework. As it will take time to reach a consensus, there are grounds for defining the 2023 fiscal stance on the ground I have laid out above, independently from any institutional framework.

Brussels, 17 January 2022