A Contingent Economic Strategy for the Next Phase

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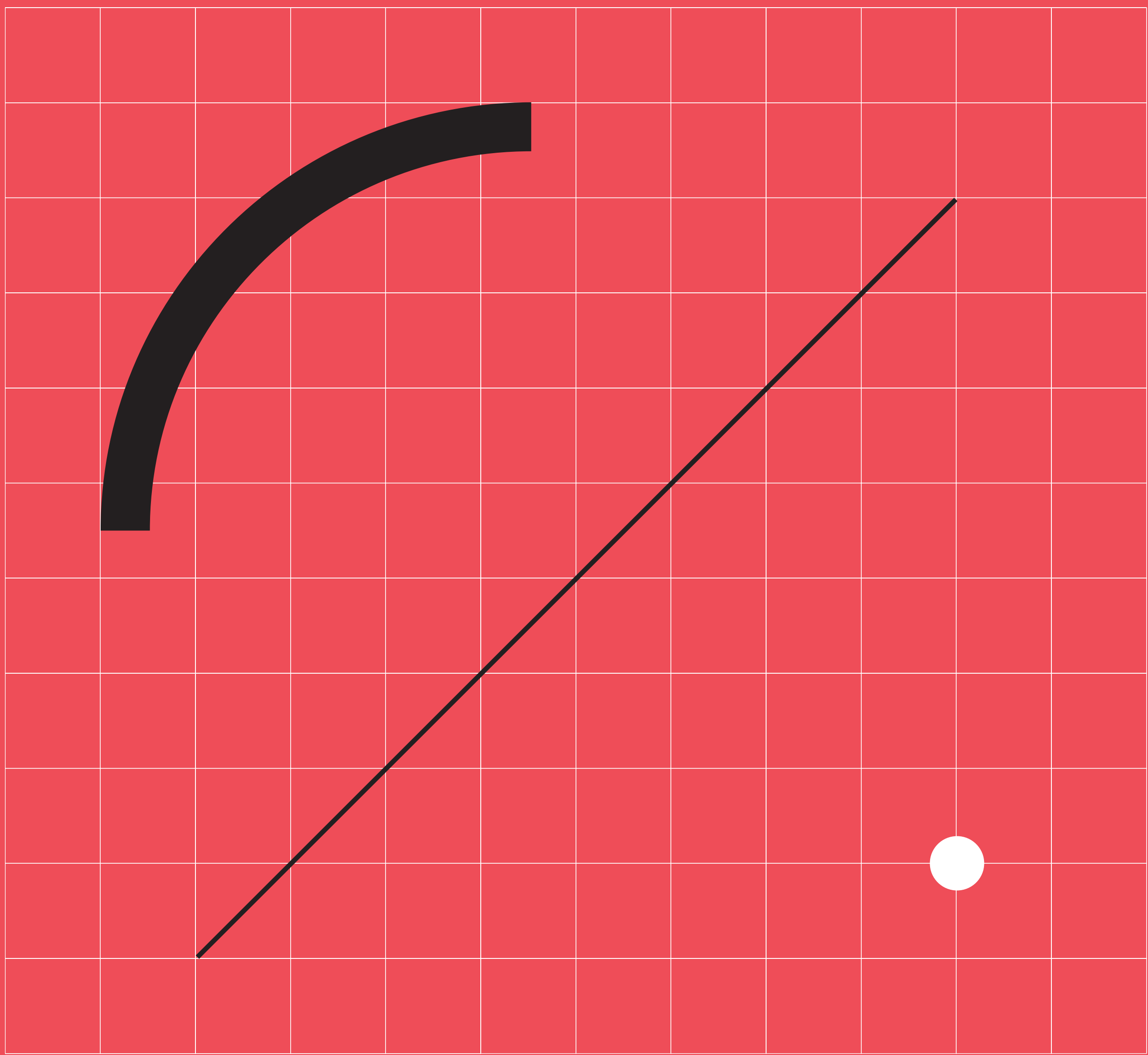

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The large-scale recovery plan adopted by the American congress under the Biden administration and the subsequent increase in growth forecasts has set off a debate in France and Europe: should we do the same? If not, are we at risk of stalling out?

In setting a macroeconomic strategy, both supply and demand must be considered. The pandemic's effects on supply will not be uniformly negative. While we must take into account lingering difficulties in certain sectors – such as business bankruptcies and lower rates of investments in 2020-2021 – we must neither forget the possibility that this crisis could have a positive impact. The accelerated adoption of digital technologies and experimentation with new organizational methods should lead to growth in productivity in the coming years and therefore growth in potential.

When considering demand, the current situation in France does not call for a large-scale recovery plan to the level of 13 GDP points (4 for the second Trump plan and 9 for Biden's, excluding the investment plan) put in place by the United States which seems excessive to us. The measures put in place since the beginning of the health crisis to support household and business income are powerful, saving is abundant, and the lifting of health restrictions should lead to a rebound in demand.

There are, however, two main reasons for concern which call for preparing a response to the coming period of lifting health restrictions and returning to normal. For one, it is not certain that the natural rebound in consumption will be enough to make up for the consequences of the Covid crisis by the end of the year. Secondly, in the longer term of 2-3 years, setting up public finance strategies based on the assumption of a permanent loss of economic potential runs the risk of giving validation to an overly pessimistic analysis of the supply-side effects of the pandemic.

Given the nature of this crisis, there should be a clear goal of completely erasing its consequences by a combination of supply and demand measures. A first step would be, by the end of 2021, to recover the activity level of the end of 2019. A second step would be to completely make up lost ground between now and the end of 2023, and therefore fully recover the potential that was expected before the crisis.

In line with this goal, the macroeconomic strategy should combine unconditional measures (e.g., investment, employee training, support for viable businesses) as well as measures conditional on the economic situation (support for household income and demand, support for business investment). The magnitude of this conditional effort should be flexibly adapted in relation to the distance to the target.

From an economic standpoint, the response of France and other European countries to the Covid crisis can largely be considered a success. Although the support for economic activity was less than in the United States, it was better targeted and loans to businesses prevented a rise in the number of bankruptcies. Partial economic activity helped to preserve household confidence by maintaining employment for most workers. As a result, the rise in household saving in France (€165 billion expected at the end of the second quarter, or six points of GDP) remains well below that of the United States. On a macroeconomic level, France has made better use of its public funds.

As we approach summer, a different question arises: assuming that most of the health restrictions are gradually lifted, and therefore the associated support measures for households and businesses, what economic support should be considered? More precisely, what level of economic activity should be aimed for and what support should be planned to attain it?[1]

SUPPLY: AN AVOIDABLE DOWNTURN

Between now and the end of the year, some obstacles to economic activity will remain. Several sectors (events, long distance travel, aeronautics) will remain adversely affected. In September-October 2020, before the second lockdown, companies whose activity was less than 50% of normal still represented 5% to 6% of market employment. Even if it remains likely that the restrictions putting a handicap on their activity will be reduced at the end of 2021, the effects on these sectors will continue to limit their potential.

Looking further (2023-2024), the main issue will be the lingering impacts of the crisis on supply. Historically, some recessions have been associated with permanent losses, while others have not. In Europe, the financial crisis caused a significant and lasting drop in GDP. When it comes to the Covid crisis, the French Stability Program also assumes a loss of potential, quantified at 2.25%. But this is far from certain.

Certain negative impacts are clearly undeniable (delayed investment, business failures, persistent difficulties in certain sectors). However, they will not necessarily be permanent. The delay in business investment that occurred in 2020-2021 could be partly made up in 2022-2023; the vast majority of sector-based difficulties should subside and even disappear if the pandemic is brought under control; job loss remains lower than what was recorded during the financial crisis, and the rise in unemployment has remained limited. For the moment at least, there does not seem to be signs of hysteresis in the job market that would significantly reduce potential.

Above all, the specific nature of this crisis means that a number of positive aspects must be taken into account. The crisis was an opportunity to test new methods (telework, teleconsultation), to identify underused sources of productivity (reduced transportation time, streamlining of procedures, progress in medical research), and to make ongoing investments in digital technologies (e-commerce, digital services). Return to normal will offer businesses the opportunity to resume their previous modes of operation while maintaining the innovations that led to gains in efficiency. There will therefore be an inevitable increase in productivity which a recent study of the American situation puts at around 4% for the period of 2020-2022[2]. While we must remain cautious with those numbers, there is little doubt as to the true effects.

If, for the end of 2021, we can expect a potential more or less equal to that of the end of 2019, and thus below the current trend, the possibility of permanent loss – potentially above 2% acquired by the end of 2021 as provided for in the Stability Programme – is overly pessimistic. Taking the position of an avoidable loss at face value is liable to steer economic policy in an overly restrictive direction and ultimately validate a scenario that is by no means inevitable.

1 — We assume in this note that the infection will be under control by mid-2021. There are, however, more pessimistic scenarios, which, while less likely, cannot be ruled out. We have discussed them in our note *Persistent COVID19: Exploring potential economic implications* (French version: *Les implications économiques d'une pandémie durable*), March 2021. We ignore these scenarios in this paper. Clearly, if they were to occur, they would require an adaptation of the strategy, both on the supply side and on the demand side.

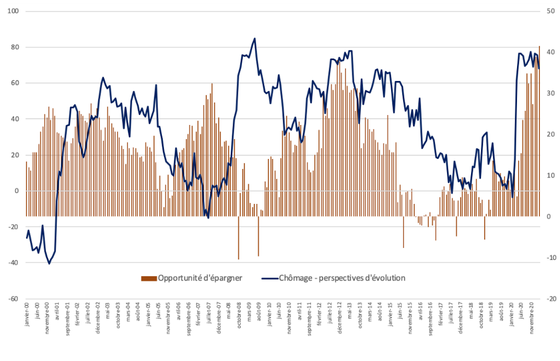
2 — See Spencer Hill, Productivity in the post-pandemic economy, Goldman Sachs, April 2021. Telecommuting alone could increase aggregate productivity by 5% (one-fifth of which would be recorded in the statistics and four-fifths of which would be reflected in increased leisure time). See José Maria Barrero, Nicholas Bloom and Steven Davis, *Why working from home will stick*, Becker Friedman Institute, University of Chicago, April 2021.

DEMAND: GREAT UNCERTAINTY

As for demand, there is no lack of purchasing power, but its outlook is uncertain. The delay in investments and the build-up of savings during the crisis combined with greater optimism about the future, should lead to both businesses and households making up for lost time and spending more in the coming months. We cannot overlook, however, that residual fears and uncertainty about the recurrence of disease outbreaks will slow business investments and household spending.

For the time being, investment is moving in the right direction and world trade has returned to its pre-crisis level. However, as the graph below shows, the share of households that consider it wise to save has reached a new historical high (since 1972). It is difficult to anticipate what their behavior will be as the danger of Covid declines. The Stability Program is based on the assumption of a household savings rate of 19.4% in 2021 and 16% in 2022, compared to 15% in 2019. It is possible to imagine a scenario in which the savings rate turns out to be much lower in the second semester of 2021, suggesting a significantly stronger demand than expected. But the opposite can also be imagined in the form of lingering caution.

Household views on unemployment and savings potential, 2000-2021



Source: INSEE, household surveys

This uncertainty has significant consequences on fiscal policy. It is still too early to know what support will be necessary, but it is better to take the risk of doing (a bit) too much than to witness a vicious circle of job concerns and cautious consumption. It is important that once the likely euphoric summertime boom passes, the economy moves into a sustained recovery phase.

A CONTINGENCY-BASED STRATEGY

Our analysis of the supply and demand outlook has two implications for fiscal policy: a more ambitious growth target, and a combination of measures to maximize the likelihood of recovery.

WE PROPOSE TWO OBJECTIVES :

1. Attain the level of the fourth quarter of 2019 in the fourth quarter of 2021. This implies a growth rate in 2021 that is about three quarters of a percentage point above the Stability Program's projected growth rate. If the recovery takes place only in the second half of the year, this requires a very robust expansion (10% annualized) in the second half of the year.
2. Reach the pre-crisis trend by the end of 2023 by completely closing the gap that will still persist at the beginning of 2022. Assuming that, by the end of 2021, the economy will have returned to its end of 2019 level, this implies an additional average annual growth of 0.7 points in 2022 and 0.3 points in 2023.

These objectives are not overly ambitious. In the summer of 2020, there was a robust economic rebound and GDP in the third quarter was only 3.5% below pre-crisis levels. In the first quarter of 2021, this decline was only 4.4% despite the lockdown. Assuming that health conditions begin to return to normal, we believe that this gap can be completely closed. As for recovering the trend at the end of 2023, this corresponds to a scenario in which productivity gains make up for lost potential.

TWO KINDS OF MEASURES

Additional measures to reach the end of 2021 objective

Our objective for the end of 2021 is more ambitious than current predictions, especially those of the government. We anticipate a series of additional measures to achieve this.

Some of these measures seem to be necessary and will affect both supply and demand. With secured loans, the Solidarity Fund, and sector-specific measures, economic policy has already done much to support supply. The new phase calls for measures to assist the recovery of viable businesses coupled with targeted support. Sector-specific tax and social security write-offs as well as debt-for-equity or quasi-equity swaps (Government secured loans) should be implemented without too much delay or caution, all while ensuring that when the government relieves debt, private creditors make a similar effort. It is also important to direct business support efforts towards restarting activity. Emergency measures focused on helping them absorb the shock of the pandemic, but not on allowing them to operate despite the temporary obstacles to normal activity. If certain sectors continue to experience productivity loss due to the health situation, temporary wage subsidies will need to be added[3]. It is difficult to estimate how much these measures could cost, but it is safe to say they would be around €10 billion.

In order to remedy the educational gaps that developed during the health crisis, it would also be useful to put a large-scale tutoring program in place for primary and secondary students. This tutoring program of 10 hours per week, staffed by university students and recent graduates (perhaps also high school students) could be implemented in all schools and run from September to December. If we are able to mobilize the corresponding human resources, we could also accelerate vocational training courses in order to encourage the retraining of people who permanently lost jobs during the health crisis. On a macroeconomic level, these measures are expensive. For example, the tutoring program alone could cost up to a billion euros.

From a standpoint of restarting demand, however, these measures risk being insufficient. To achieve our suggested objective for the end of 2021, if the savings projections of the Stability Program prove correct, and assuming a multiplier close to 1, an additional €20 billion or so should be injected into the economy. As we have explained, however, these savings projections are subject to considerable uncertainty. It is not impossible that savings will be lower and consumption higher, in which case the necessary fiscal effort will be more limited.

We therefore propose the following approach. The most effective way to stimulate demand in a context of abundant savings is to support categories of income with low savings and high propensity to consume (the working class, second-line workers, young professionals, students). Targeted support could therefore be put in place, even before the summer, in order to encourage consumption. It is possible to consider €5 billion in benefits for households in the lower half of income distribution (less than €22,000 per consumption unit) which preliminary studies show have often experienced a loss in purchasing power[4]. This would represent an average of €350 per household, or 1.8% of the average income of this category.

Depending on the recovery's strength during the summer, a new series of targeted benefits could be planned for the beginning of the school year (e.g., back-to-school allowance) of an amount to be determined then, up to €5 to €10 billion. If these benefits were targeted in the same way as the first ones, it would increase the purchasing power of the poorest 50% of the population between 1.8% and 3.6%. To counter potential stagnation in demand, the possibility of temporarily reducing the VAT rate followed by its gradual increase could also be considered for the start of the 2021 school year. The probability, however, of resorting to such a measure seems low given the current economic climate.

Measures to achieve the objective for the end of 2023

Of the €100 billion allocated in the recovery plan, €40 billion will have been invested by the end of 2021. At this rate, the quasi-totality of the funds will have been allocated by the end of 2022. Developed at a time when the government anticipated a quick exit from the health crisis, this plan risks being insufficient if the economic situation's return to normal takes until 2023. This points to the need to add an additional package, preferably in coordination with our major European partners, from 2022 onwards. A package of up to 40 billion euros could be planned for the years 2022-2023. If we assume that the savings rate will eventually return to its pre-crisis level, and that private demand will remain weak (as it was in France before the Covid crisis), this level of additional spending should not lead to the economy overheating and excessive inflation.

What would this package include? It could naturally

3 — On these two points see our article with Thomas Philippon *A new policy toolkit is needed as countries exit Covid-19 lockdowns*, PIIE, June 2020

4 — The EPICOV Inserm-DREES survey indicates that 35% of households in the first decile and 30% of households in the second and third decile declare that their financial situation worsened during the first confinement, compared to 15% of households in the three lower deciles. See Insee, France Portrait Social 2020.

extend certain measures taken in 2021 in order to continue investment in workforce mobility and training, which has largely been lacking during the lockdown and continues to be massively insufficient (in March, only 15% of companies made use of training for their employees on partial unemployment. This is better than most advanced countries, but we can't help but seeing a missed opportunity to reinforce skills[5]). The same goes for supporting employees from sectors facing difficulties and their transitions to new jobs, which could take the form of a two-year investment program in training and professional mobility. Such a plan would take over from the Skills Investment Plan. It is also clear that much can be done to strengthen the health system, increase investment in education, promote cutting-edge innovation in order to avoid Europe falling behind the United States and China, and step up the fight against global warming. There is no shortage of work to be done.

THE SCALE OF THIS EFFORT

We therefore propose an increase in spending of about €50 billion beyond current plans, plus €10 billion of contingent spending (and, if necessary, a reduction in the VAT), from 2021 to 2023. This is not an insignificant amount, even if it does not come close to the scale of Biden's three plans, which are in part dedicated to remedy the distinctly American deficiencies in social protections, access to education, and infrastructure, none of which we feel is necessary for France.

Of course, no policy is without affiliated risks. Additional spending and, in consequence, a larger deficit (for we do not believe that the time is right for substantial tax increases) entails ex-ante a less favorable debt trajectory. But to the extent that these expenditures are justified and that they will revive the economy through both supply and demand, their effects on both the debt-to-GDP ratio and on investor perceptions should be minimal, especially if they are temporary and clearly aim at improving the employment rate and productivity. The contingent nature of the stimulus measures should limit the risk of the economy overheating, a risk that is in any case much less present than in the United States.

If other members of the European Union support their economies in the same fashion, effects on the external balance should be limited. It is, however, important to improve competitiveness and external balance in the long term. This must be another objective of supply-side policy measures.

5 — Acemo-Covid study, April 2021.