**Europe’s and China’s response to the outbreak of covid-19**

*China and the European Union reacted swiftly to the economic fallout caused by covid-19, as their economies came to a near standstill. Negative economic growth projections of the IMF, World Bank, and OECD send shivers down politicians and business leaders’ spine. This column deals with the question what measures have been taken to dampen the economic crisis and how fears of inflation are perceived.*

Monetary and fiscal measures are taken to counter economic depressions. Monetary measures (lowering the interest and/or buying up bonds) are the central bank’s domain, while fiscal measures (lowering taxes, investing in social services and public works through deficit spending) are government’s responsibility. In short, a good-old Keynesian approach, invented by the great British economist John Maynard Keynes, later elaborated by Milton Friedman.

Previous depressions had financial-economic origins. The present one is caused by covid-19. So, countering the deep worldwide depression depends not just on the effectiveness of monetary and fiscal stimulus, but also on the time it takes to develop a vaccine against the deadly virus, or a medicine to mitigate its impact. In most countries the spread of the virus seems to be under control. However, renewed outbreaks of covid-19 in various countries, if not effectively contained, will be disastrous for any economy, as monetary and fiscal stimulus cannot go on forever.

Keynes and Friedman’s lessons have been taken to heart by Chinese and European authorities. As for Europe, soon after the outbreak of covid-19, the European Central Bank (ECB) bought up Euro’s 750 billion sovereign- and company bonds to increase the money supply. At the beginning of June last, ECB bought up another Euros 600 billion. So, ECB’s total monetary injection was Euros 1,350 billion - an enormous amount of money. Its immediate effect is that interest rates are kept low and the threat of deflation is averted. ECB’s President, Christine Lagarde, explained that ECB took the measures to prevent fragmentation of the European Union.

Regarding fiscal measures, not the Union but individual member states took them, totalling around Euros 2.2 trillion; again, an enormous sum. Some members, such as Germany and Holland, have deep pockets and a low level of sovereign debt, so they could support workers and businesses lavishly. Some even introduced a basic income for their most vulnerable citizens. But heavily covid-19 affected - and indebted countries, such as Spain and Italy, could not do so. They asked for help in the form of grants from richer fellow Union members. This was not acceptable for Austria, Denmark, Holland, and Sweden (the ‘Frugal Four’). They argued that, as a condition for help, these indebted member states should put order in their financial house to improve their international financial credibility. In response, Italy, Portugal, and Spain were furious; Italy even threatened leaving the Union. Germany’s Chancellor, Angela Merkel, got nervous and joined France in proposing a temporary Euros 500 billion multiannual financial framework (MFF); from which most-affected member states and regions would receive grants. Again, the Frugal Four were not amused. The European Commission, EU’s executive body, is now working on a Euros 750 billion rescue plan - incorporating the French-German proposal - that partly consists of grants and partly of loans - a typical compromise proposal. This rescue plan is to especially help southern European countries in co-funding their health sectors and their economies to prevent the Union’s members drifting apart.

Regarding China, the picture is different. In the past China has not hesitated in pumping large sums of money into the economy. And in 2008-2009 it worked, after the Great Recession had broken out. But now that China is facing a deeper economic depression, there is a fear among influential economists that lavish rescue policies may trigger inflation, asset bubbles, and a loss of confidence in sovereign credit. The fear of inflation is understandable: during the middle of the 1990s China’s inflation rate ran as high as 28%.

China’s Ministry of Finance announced that this year the central and provincial governments would, together, issue Yuan 8.5 trillion in new bonds. A think tank proposed that the Peoples Bank of China monetise the fiscal deficit – in effect printing money to buy and hold new government bonds. Contrary to the situation in Europe and Japan, China still has space to cut interest rates. So, critics wonder: why not cut interest rates rather than taking an inflationary road of bond buying? This concern was picked up by Prime Minster Li Keqiang, who, during the recent National People’s Congress, announced that official interest rates would be cut. He also said that banks’ required reserves would be reduced to expand money supply. He did not mention any bond purchases.

Is the concern about inflation justified? Economics textbooks say that a large infusion of money into an economy, if not leading to an equal increase in the value of goods and services, triggers inflation. But in Japan and in Eurozone countries, where huge sums of money have been pumped into the economy, inflation remains low. How come? Japan provides an explanation.

For decades, Japan has been trying to cure the economy from low inflation, sluggish growth and close to zero interest rates. Well before the covid-19 outbreak, the government had already pumped trillions of yens into the economy, with little success. Last April, the Abe administration announced extra spending plus guarantees equal to 20% of GDP. And last May, the government announced spending plans involving fiscal support, including guarantees, equal to 40% of GDP. Meanwhile, the Bank of Japan bought up roughly $600 billion in assets, pushing its already bloated balance sheet to over 110% of GDP. Japan’s government debt is now well above 240% of GDP. In response to these huge infusion of money, and piling up of debt, financial markets have not shown signs of uneasiness. Share prices increased, benefitting from the central bank’s large purchases of exchange traded funds. Apparently, the limits of Japan’s extreme monetary and fiscal policies are farther away than economists had thought.

There are no worries about Japan’s fiscal sustainability, let alone the risk of inflation. One reason why Japan has been able to borrow so much is because the rest of the economy does not spend enough: higher saving than investment is Japan’s problem. This is partly caused by the population’s composition. Japan’s population is aging; those close to retirement save more and consume less. Aggregate demand declines, installed capacity is not used fully, and investments go down. Economic growth is the result of population - plus productivity growth. So the way forward for the Japanese is to have more children or, politically less attractive, to promote immigration.

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