Torben M. Andersen

Economic Policy Responses to the Coronavirus Crisis — Stabilization and Insurance

The coronavirus pandemic has caused severe health and economic consequences. Lockdowns and various other containment restrictions have served to reduce the spread of the virus, but have exacted massive economic consequences arising from the closure of economic activity and imposition of explicit or implicit frictional costs on interactions between people, hindering basic economic mechanisms on both the production and the consumer side. Standard business cycle effects, released by global declines in private consumption, investments and exports, further exacerbate the economic effects.

Torben M. Andersen

is Professor at the Department of Economics and Business Economics, Aarhus University.

The crisis has vastly changed the economic policy discussion. New types of economic policies — pandemic emergency packages — have been deployed on top of the standard tools, including automatic stabilizers and discrete fiscal policy. Monetary policy expansions or quantitative easing programs have kept government borrowing rates low, as seen by the ECB's pandemic emergency purchase program.

But what are the appropriate fiscal policy responses in this situation? Single country responses may be insufficient, either because interdependencies are not sufficiently taken into account, or because lack of fiscal space is a barrier. If single-country responses are insufficient, is it then possible to establish multi-country initiatives?

The EU has responded to the crisis by launching the program Next Generation EU (NGEU). This initiative is trailblazing since it involves grants and loan facilities to member countries, financed by EU borrowing. This is set up as a one-off temporary intervention, but if successful, it signals a new direction for EU cooperation in the fiscal area. The motivation for the program also stresses the importance of strengthening social cohesion within the EU, and the labeling of the program signals its forward-looking perspective. Through this initiative, the EU aims to take a pro-active position to overcome the economic consequences of the coronavirus crisis, rather than being seen as a part of the problem as it was perceived during the financial crisis.

LOCKDOWN AND INSURANCE

The lockdown restrictions imposed to confine the pandemic were largely an unanticipated event. The restrictions were motivated by externalities arising from the spread of the virus originating from too many and close contacts between people. These restrictions may thus be interpreted as an unanticipated "market-closure" shock; an event which is largely non-insurable.

The lockdown restrictions constrain the market mechanism, in the first place, in areas where close contact between customers and employees is important, and in workplaces where employees are in close contact. While the lockdown regulations address a health externality and thus have a collective justification, specific firms, workers and households bear the consequences and costs. Therefore, governments launched emergency packages, including direct support to firms to help cover loss of revenue, fixed costs, work-sharing arrangements, and liquidity and loan arrangements. These schemes are collectively financed via the public budget.[1]

There are two key lines of arguments in support of these emergency packages, featuring some very unusual ingredients such as direct support to companies for loss of revenue and coverage of fixed costs. These are not standard toolkits, not even when there is a need to support activity or employment in deep recessions.

The first argument is that the lockdown restrictions are effectively an expropriation of market opportunities justifying compensation. This may be interpreted as an ex post insurance of an unanticipated aggregate shock.[2] Since firms and workers had no influence on the occurrence of this shock (no ex-ante moral hazard), there is no direct incentive problem in providing the support. The same may be argued with respect to workers prevented from working, where the usual coverage offered by the social safety net may be considered insufficient for this particular type of shock (there is no ex-ante moral hazard issue here, either).

The second type of argument for the support is that it is important to preserve production capacity to increase the likelihood that a V-shaped economic recovery is feasible when lockdown and other containment measures can be removed. Perceiving the health situation and the lockdown to be temporary, it is important to minimize the risk that the economic repercussions become permanent. The negative effects of

[1] A listing is available at https://www.oecd.org/coronavirus/country-policy-tracker/.
[2] This is well known from natural disasters – see Cebotari and Youssef (2020).

the lockdown restrictions cannot be avoided, but a quick recovery upon removal of the restrictions is only feasible if production capacity remains intact. Worker layoffs—breaking job matches—and firm closure, to be followed by hiring and reopening of (new) firms are associated with substantial transaction costs, time lags and loss of both real and human capital.

Support to workers also helps maintain consumption and reduces risks, and this makes it possible for aggregate demand to pick up swiftly when the economy reopens. Such support is in many cases given by temporary changes of the social safety net, e.g., extended unemployment benefit periods or increasing benefit levels. Basing support on the existing social safety net raises issues since it does not generally include atypical workers. Extending support to such groups, which typically do not contribute to the schemes, raises obvious moral hazard issues. The same applies in countries with voluntary membership of unemployment insurance schemes, and where providing an amnesty allowing for "retrospective" membership[3] has been proposed.

In short, the emergency support is a means to prevent a temporary shock causing permanent negative effects on economic activity and employment. However, several ex-post incentive issues arise when such support is provided. If it is based on e.g., decline in turnover or employment, it is difficult to separate the insurable event (the direct effect of lockdown restrictions) from other events, including general business cycle repercussions or second-round effects released from the global recession triggered by the crisis. Such business cycle fluctuations are normally not insured at the firm level, since this creates obvious incentive problems and disrupts the market mechanism.

The emergency packages include both direct support and loan/credit facilities, and there is some variation across countries in the specific design of policy interventions. There are noteworthy differences between direct support and liquidity/loan arrangements. Liquidity/loan arrangements overcome a term problem but are effectively implying self-financing or insurance in the sense that e.g., firms are offered a possibility to even out the effects over time. In principle, the capability to self-insure could be built up ex-ante via consolidation and accumulation of buffers to handle negative, unanticipated events, or ex-post via capital markets in the form of loans. Due to the risk of a credit squeeze and the urgency of providing liquidity/loans to the large number of firms affected by the lockdown restrictions, public initiatives such as postponement of tax payments, loan guarantees and facilities are important and have been widespread.

[3] As an example, a new temporary work sharing arrangement is only available for employees with unemployment insurance in Denmark. An escape rule for the uninsured is provided if they pay a higher contribution fee (retrospective payment) for a certain minimum period.

A key problem with the emergency packages and the unconventional measures deployed is the implied status quo bias. This applies in particular to measures covering part of fixed costs or loss of income and work-sharing arrangements. Incentive problems arise since firms and employees may have insufficient incentives to adjust to the new situation (ex-post moral hazard problem: the consequence of the shock is worsened). This creates a risk of locking-in of resources—both real and human—in activities and jobs that do not have a future. In short, these policies protect the current situation but may impair reallocations.

The direct support to specific firms and industries in the emergency packages also has implications for industrial and trade policies. These measures may have a home bias to support domestic firms. While this may be justified as a short-term response to the lockdown, it is essential to avoid that barriers to trade develop as a result. There is a need for coordination across exit plans to ensure a level playing field.

This may be less of a problem for loans, shifting the burden onto specific firms, workers and households. The advantage of this approach is that there is some credit assessment, although the borrowing is facilitated by government guarantees, ensuring that support goes e.g., to firms with a viable business model. There is a strong incentive for firms to adjust to the new and changed market opportunities, and there is not the same status quo bias as for direct support. The downside is the privatization of risk and thus less risk sharing. Servicing debt accumulated as a result of coronavirus-lockdowns is different than servicing debt arising as a result of traditional forms of investments in the firm. The latter would have future effects on business opportunities, improving revenues and/or reducing costs, whereas the "coronavirus debt" is more such as a sunk cost. In very competitive environments, incumbent firms with a coronavirus debt may be at a competitive disadvantage in terms of new start-ups. The different elements of emergency packages thus have pros and cons, which speaks for using a differentiated approach deploying a broad set of instruments, which is also the case in many countries. Thereby it is also possible to take large sector differences and needs into account.

Finally, on the political economy side, there is also an issue of time inconsistency. The special initiatives included in emergency packages are meant to be temporary solutions in an unusual situation. But such schemes create their own dynamics, and a pressure easily develops for prolongation. This applies not only to the direct support part, but also the loans part. If a debt problem arises for many firms, a political pressure for some form of bail-out arises. It is therefore critical that the schemes are launched with explicit sunset clauses. Direct support makes sense as temporary measures providing insurance in a special situation, but support over prolonged periods

will not only have large fiscal implications, but also stifle competition and adjustment with large costs.

ARE NATIONAL POLICY INITIATIVES SUFFICIENT?

A first line of defense in economic policy has been the emergency packages, as previously mentioned. They mainly work to keep production capacity and job matches intact, but do not as such create more activity. During a second phase, there is a need for more traditional fiscal policy to support aggregate demand.

Discussing fiscal policy, the automatic stabilizers are important. By definition, they kick in automatically and quietly and are therefore often overlooked in the discussion. While automatic stabilizers have the virtue of being rule-based and designed to work symmetrically across the business cycle, there are large differences in the size of automatic stabilizers across countries (Mourre, Poissonnier and Lausegger 2019). Despite calls for strengthening of the automatic stabilizers in the wake of the financial crisis, this has not happened. The automatic stabilizers are not a result of macro-design as such, but the net result of the design of the social safety net and taxation systems – see Andersen (2016) for a discussion. There is a clear correlation between the size of automatic stabilizers and the size of the public sector/welfare state. Consequently, there are huge country variations in the extent to which the automatic stabilizers counteract coronavirus shocks. Cross-country comparisons of policy interventions can thus not be gauged by just considering discrete policy changes.

Important caveats apply to the automatic stabilizers in the present situation. The coronavirus crisis obviously differs from the typical business cycle, and therefore activity is not primarily low due to lack of demand, but due to lockdown and containment restrictions. The automatic stabilizers do not target preservation of production capacity and job matches. Special and new types of interventions are needed for this purpose, as discussed above. An important lesson in terms of automatic stabilizers and insurance from previous crises is that they can cope with temporary but not permanent shocks and changes. In the design of the social safety net this concern is quite explicit. Unemployment benefits have a fixed duration, and various conditionalities built into the system serve to create incentives and make unemployed capable of finding a job (workfare and active labor market policies). This basic aspect applies to any form of insurance—whether national or multi-national—and it is therefore a key design question to ensure that there are sufficient incentives to change the situation for both employers and employees.

Designing fiscal policies in the current situation is not straightforward. While there is a general downturn and need to support aggregate demand, there are also some challenges. Risk and uncertainty concerning both health and economic developments give reason for precautionary savings, which in turn may mute the traditional effects of fiscal policy on aggregate demand. Moreover, sectors are very differently affected, with some even expanding, hence, a general increase in aggregate demand is thus problematic. Moreover, identifying the fiscal policy changes with the largest multiplier – see e.g., IMF (2020) for a discussion.

Government borrowing is a key way by which risk can be diversified across generations. This gives the government scope for risk diversification beyond what can be achieved in the market, and it is therefore essential to the argument given above for diversifying the consequences of the coronavirus pandemic. This has both an intra- and intergenerational dimension.

For fiscal policy—discretionary and automatic stabilizers—fiscal space is required. The initial position of public finances differs significantly across EU countries; a few countries have managed to reduce debt levels after the financial crisis, but for many countries this has not happened. As an emergency measure, the EU activated the general escape clause of the Stability and Growth Pact (SGP), allowing member states to depart from the budgetary requirements in the European fiscal framework. At the same time, government borrowing rates are low, see discussion above. Both factors make room not only for allowing automatic stabilizers to work but also for discretionary fiscal policies to function. However, it is important to stress that the government budget constraint has not become irrelevant – see e.g., discussion in Lian, Presbitero and Wiriadinata (2020) and Andersen (2020). Many countries have high debt levels, and unsolved sustainability issues arising due to an aging population looming (European Commission 2020).

The situation also underlines the importance of fiscal space, that is, consolidation in good times to ensure space to deal with economic crises. High debt levels reduce fiscal space and the ability to cope with negative economic events. During the coronavirus crisis, countries with lower debt levels have been able to pursue more aggressive fiscal policies (Alerbarola et al. 2020).

National policy responses may be insufficient for many reasons. Lack of fiscal space may constrain policy initiatives. There may also be non-cooperative biases in policies, including that the positive spill-over effects to trading partners are not taken into account or that national policies have a home-bias focusing on helping domestic firms but impairing competition in the single market.[4] This taps into the discussion of the lack of fiscal mechanisms in the EU, especially for euro countries. No such mechanism existed ex ante, but does it make sense to make one ex-post in the present situation? There are basically three arguments why there is a need for an EU initiative.

[4] The EU Commission has temporarily allowed member states, under the state aid rules, to support businesses of all types to preserve the continuity of economic activity during and after the Covid-19 outbreak.

First, there is the insurance argument that countries have an interest in sharing and diversifying risk, as discussed above. Clearly, ex-post insurance is more difficult since the consequences of the event are known, and a pattern of net-contributors and beneficiaries arises. But still, such a scheme can have support since it may set an example for future situations where the roles have changed.

Second, there is the system argument that countries are interdependent, and it is in the interest of the better-off countries to contribute economic support to avoid a deep economic and political crisis. This applies to both fiscal and monetary instruments. The last thing needed in the current situation is a sovereign debt crisis, and the ECB purchase program is working to that effect. Single country fiscal policy initiatives may be both insufficient and inadequate since externalities/spill-over effects are not taken sufficiently into account.

Finally, there is a redistribution/solidarity argument to stand together in crisis time. That is what happens at the national level, and the question is whether it can also be brought to life at the EU level.

RISK SHARING ACROSS COUNTRIES

Even though the pandemic affects all countries, the specific country effects differ, both in the health and economic dimension. The health and economic effects are not one-to-one related for a number of reasons, including different exposure to the virus, different economic structures, policies and initial positions. As an illustration, Figure 1 shows the health and economic consequences by November 2020 assessed in terms of Covid-19-related mortality and the downward adjustment in GDP growth forecasts for 2020. It shows huge differences in consequences along both dimensions and there is no clear correlation between the economic and health implications. From an ex-ante perspective, Figure 1 illustrates the risk in terms of draws from a multi-dimensional distribution faced by all countries prior to the onset of the crisis. Ex-ante, it was not clear how given countries would be affected, but the same figure illustrates possible outcomes, and thus the scope for welfare gains from cross-country risk diversification.

The shock and its effects were not anticipated, and while national schemes may be powerful in providing insurance against aggregate shocks via the public budget and thus across time and generations, this is not exploiting the full scope for risk diversification.

Thinking of this from an ex-ante perspective, the question is how such an insurance arrangement for coping with a health shock affecting all European countries should look, see discussion in EEAG (2020). Ex-ante there is a common interest in establishing such an arrangement, but there will be uncertainty with respect to both the probability that such events occur and the consequences. The hazard includes both the health consequences and the economic effects across countries, sectors and specific firms. The emergency packages implemented in various countries retrospectively replicate part of such an insurance contract, but leave risk diversification incomplete, in particular across countries. This leads to consideration regarding the need and scope for initiatives at the EU level.

The EU system was not set up to offer automatic responses or leave room for discretionary changes to act for such purposes. The question is whether ex-post there is sufficient solidarity among member states to establish such arrangements. As a result of various political discussions, the EU has launched the program Next Generation EU (NGEU). A key element is the Recovery and Resilience Facility.

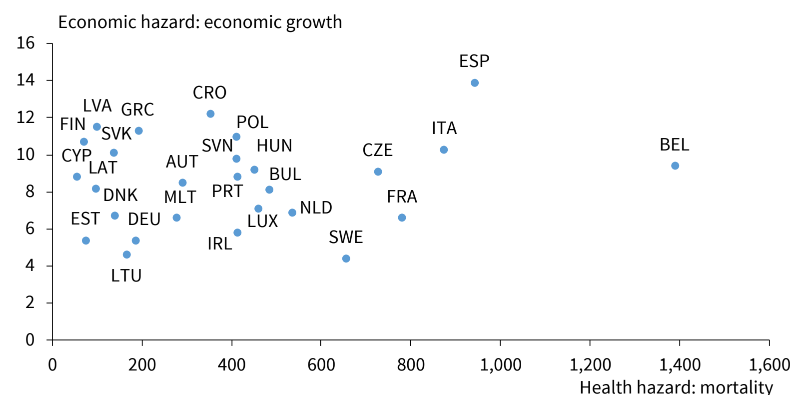
THE RECOVERY AND RESILIENCE FACILITY

The overall financial frame for NGEU constitutes EUR 750 billion (2018 prices), amounting to 5.5% of total EU GDP, and is split between grants (EUR 390 billion) and loans (EUR 360 billion). The program is financed by EU borrowing, and the repayment of the loans runs until the end of 2058. The key initiative is the Recovery and Resilience Facility (EUR 673 billion, grants: EUR 313 billion, loans EUR 360 billion), aimed at supporting recovery and resilience of member states, creating jobs and repairing the immediate consequences of the Covid-19 pandemic, while promoting green and digital transitions.[5] Each recovery and resilience plan must include a minimum of 37% of expenditures related to climate, and 20% of expenditures related to digital transformation. The credit facility offers indirect support for countries facing high government borrowing rates. Loans to a

[5] See https://ec.europa.eu/info/business-economy-euro/recovery-coronavirus /recovery-and-resilience-facility_en and https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_1659.

Figure 1

Health and Economic Consequences, EU Countries

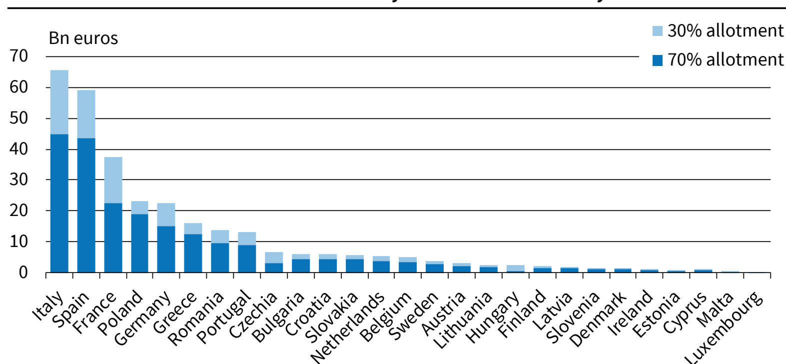


Note: The health consequence/hazard is measured by the Covid-19 related deaths from the onset of the corona-pandemic until late November 2020; the economic consequence is measured by the decrease in forecasted GDP growth for 2020 between November 2019 and 2020 by the European Commission.
Source: Our World in Data; European Commission.

© ifo Institute

Figure 2

Allocation of the Grant-Part of the Recovery and Resilience Facility



Note: Recovery and Resilience Facility 613 billion euros; 30% allocation based on summer 2020 economic forecast.
Source: European Commission, Recovery Plan for Europe. © ifo Institute

member state cannot exceed 6.8% of its Gross National Income, unless special circumstances apply.

The grants are allocated based on two keys. A fraction of 70% depends on the population size, the inverse of its GDP per capita, and its average unemployment rate over the past 5 years (2015-2019); all variables are measured relative to the EU average. The remaining 30% are allocated based on population size, the inverse GDP per capita, and the observed loss in real GDP over 2020 and the observed cumulative loss in real GDP over the period 2020-2021, also relative to EU averages.

Economic support depends on member states preparing a national recovery and resilience plan setting out their reform and investment agenda for the years 2021-23, including explicit milestones and targets. The plan is assessed based on consistency with the country-specific recommendations of the European Semester, the extent to which it strengthens the growth potential, job creation and economic and social resilience of the member state and contributes to the green and digital transitions. The plan must include explicit milestones and targets, and the funding depends on meeting these targets. The governance mechanism allows single member states to raise objections if specific countries do not fulfil reform promises.

The scheme implies common risk sharing via the part of grants allocated depending on the effects of the coronavirus crisis. The part depending on initial conditions, e.g., GDP per capita, can be interpreted either as reflecting that given shocks are more severe and thus the gains from insurance larger, the worse the initial situation, or as redistribution from the more well-off to the less well-off member states.

The original proposal by the Commission had a fund at EUR 1,500 billion, which was later reduced to EUR 750 billion. According to the initial plan, the grant allotment was EUR 500 billion, but it was reduced to EUR 390 billion. Moreover, more weight in the allocation was given to the effects of the coronavirus crisis, and the explicit conditionality on reforms, monitoring of milestones and targets strengthened. From a redistributive perspective, this was a classical battle between the net beneficiaries and net contributors. From an insurance perspective, it can be interpreted as more closely aligning the program to the consequences of the coronavirus crisis and addressing potential moral hazard problems by stressing the conditionality on reform efforts.

It is to be expected that countries will use the grants part first. The loan part is effectively an option. Most countries face low government bond rates at the moment, and hence the implicit subsidy via borrowing in the EU scheme is small. But this may change in the future, making the loans part more relevant.

The interesting question is whether the RFF will be successful. Already from the outset, the initiative is hampered by the lag in implementing the program, implying that the immediate effects are small. The grant part clearly provides temporary relief to some countries, but the critical issue is whether the program addresses shortcomings of national policies and whether the needed structural reforms are undertaken. It is in accordance with incentive problems of insurance arrangements to make support contingent on structural reforms (see also the discussion above). This is needed to prevent bailout situations from arising. For this to work, structural reforms must be precisely defined, and explicit monitoring and following-up mechanisms must be present. The present formulation of the RFF has a very broad interpretation of reforms, and it is a concern whether it will be possible to implement a sufficiently strong incentive mechanism. The track record for enforcement in the EU is not strong, as seen from e.g., the Stability and Growth Pact, rule of law and human rights issues. These problems are further attenuated by the fact that the initiative simultaneously intends to deal with the immediate consequences of the coronavirus crisis and set a trajectory for future developments.

Moreover, it is an open question whether the initiative ends up financing activities which would be undertaken in any case or, even worse, projects will little or no effect. This also applies to initiatives to support a green transition. The program may end up supporting national programs undertaken in any case, rather than activities with strong EU-network and spill-over effects which are given low priority by national governments. A dilemma in the facility is that the NGEU is intended to pursue objectives that can not sufficiently be achieved by member states alone, and yet it relies on membership initiatives. While this strengthens country-ownership to the specific initiatives, it does not ensure that policy interdependencies and network effects are taken sufficiently into account.

CONCLUSION

Unusual times call for unusual economic policy initiatives, as is the case with the emergency packages

following lockdown and containment restrictions. These schemes entail collective risk sharing and aim to protect production capacity and job matches. This is an important necessary condition for a swift recovery when the health situation normalizes. However, national initiatives are insufficient; they do not ensure efficient risk sharing and do not take spill-over effects to trading partners into account. EU initiatives can potentially address this problem and establish a cross-country insurance mechanism. The EU Recovery and Resilience Facility is an interesting initiative. It is trailblazing in the EU both in content, including both grant and loan elements, and its financing via borrowing. However, the main weakness of the scheme is that the efforts are insufficiently targeted to areas where national policies are insufficient. There is a high risk that the program will not make a sufficient impact by supporting initiatives that have been given low priority by single countries and in inducing structural reforms.

REFERENCES

Alerbarola, E., Y. Arslan, G. Cheng and R. Moessner (2020), *The Fiscal Response to the Covid-19 Crisis in Advanced and Emerging Economies*, BIS Bulletin 23, Basel.

Andersen, T. M. (2016), "Automatic Stabilizers – the Intersection of Labour Market and Fiscal Policies", *IZA Journal of European Labor Studies* 5:11.

Andersen, T. M. (2020), "Fiscal Sustainability and Low Government Borrowing Rates", *CESifo Forum* 21(1), 31-34.

Cebotari, A. and K. Youssef (2020), "Natural Disaster Insurance for Sovereigns: Issues, Challenges and Optimality", *IMF Working Paper* WP/20/3.

EEAG (2020), *Europe's Pandemic Politics*, EEAG Policy Brief.

European Commission (2019), *European Economic Forecast – Autumn 2019*, European Economy, Institutional Paper 115, Brussels.

European Commission (2020), *European Economic Forecast – Autumn 2020*, European Economy, Institutional Paper 136, Brussels.

IMF (2020), *Fiscal Monitor: Policies for the Recovery*, Washington DC.

Lian, W., A. F. Presbitero and U. Wiriadinata (2020), "Public Debt and r-g at Risk", *IMF Working Paper* WP/20/137.

Mourre, G., A. Poissonnier and M. Lausegger (2019), "The Semi-Elasticities Underlying the Cyclically-Adjusted Budget Balance: An Update & Further Analysis", *European Economy Discussion Paper* 098.