A coordinated, unlimited and flexible insurance policy to respond to the pandemic

Gonzalo García-Andrés | Head of Economics at Analistas Financieros Internacionales | @gongarand

Theme
The COVID-19 pandemic requires a coordinated global response. This analysis highlights some of the main components.

Summary
The COVID-19 global pandemic has the potential to trigger a systemic economic crisis. A coordinated and rapid International (and European) response is essential. This analysis details the economic policy objectives that should form part of the response and its toolkit in the areas of monetary, fiscal and trade policy. Governments must be on the front line of this economic battle, working in close alignment with the steps taken by the health system to fight the pandemic, providing a coordinated, unlimited and flexible insurance policy to minimise the economic impact.

Analysis
It is already clear that the COVID-19 pandemic will cause irreparable damage in terms of human life. However, the situation has deteriorated into a systemic global economic and financial crisis. We face an unprecedented situation: fear and uncertainty have interrupted the normal functioning of the system to such an extent that the failure to take measures to provide a coordinated response to the initial shocks to businesses, households and financial entities will see the economic costs multiply. While comparisons with events over a decade ago are unavoidable, the current threat is of a different nature. This time, things have happened much faster, making the economic policy response much more urgent. Theoretically, we have the advantage of the experience of an even more serious situation and the relative success of a coordinated global response at the time. Following months of delays and mistakes, the measures adopted at the G20 summit on 2 April 2009 prevented a depression from occurring. This time, however, there is no room for errors like those that transformed the Greek debt crisis in 2010 into a protracted episode of self-inflicted instability that, at its height, threatened the survival of European monetary union.

(1) Objectives, the G20 and the European dimension
The bitter experience of the global financial crisis has shown that in a systemic situation, the objective of economic policy must be to provide a credible insurance policy against uncertainty. The origin of the shock we are facing today is of a highly different nature and is accompanied by its own dose of uncertainty (how the pandemic will evolve in each
country, the behaviour of the virus in terms of reinfection, lethality and the time taken to find an effective therapy or vaccine). After paralysing the Chinese economy (16% of global GDP at market exchange rates) for over a month (with falls of 13.5% in industrial production and 20.5% in retail sales in January-February), the spread of the epidemic and the measures needed to bring it under control are creating a series of successive macroeconomic shocks in the main developed economies and the rest of the world. However, what makes the pandemic a systemic crisis is its generation of two associated negative shocks.

The first has been the panic in the financial markets. Since the end of February, the price of financial risk assets has plummeted, accompanied by a spike in volatility and the symptoms of a dislocation of the private and even public debt markets (the US Treasury bond market has shown signs of a shortage of liquidity that point to major upheaval). From their recent highs, stocks have entered a bear market, falling by over 20% in record time. In a situation where many market segments were characterised by aggressive valuations with respect to their fundamentals, the problem is not the adjustments in prices. The concern is that we have abruptly entered a regime marked by illiquidity, risk aversion and radical uncertainty. The signs of a squeeze in the private debt markets are particularly worrying. It is not merely a matter of widening credit spreads (which remain lower than during the global financial crisis) but of the return to the loss of access to finance by borrowers with the highest level of debt and the sectors most exposed to the economic fallout of the epidemic (tourism, air transport and oil).

With their regional peculiarities, depending on the weight of financing from the market or banking system, the credit markets are the main mechanism for the transmission of financial panic into real economic costs, measured by falls in industrial production or GDP. Bernanke (2018) provides an empirical dissection of the main financial factors that depressed the economy during 2007-09. He concludes that the two key factors were stress in the short-term funding markets (interbank, monetary) and difficulties accessing new financing in the credit markets (measured by spreads in segments such as securitised or high-yield bonds).

The second negative shock from the pandemic is the fear gripping businesses and households. Despite echoes of the crisis 10 years ago, this situation is unprecedented in Europe and the US. The instinctive response is to reduce spending on major consumer goods and investment, cancel any travel and avoid spending that implies being around other people. In many sectors, this sharp drop in demand will continue even after the restrictions on mobility are lifted.

Faced with this sudden and dangerous threat, economic policy must pursue the following objectives:

- Support the effectiveness of the measures to flatten the epidemic curve.
- Minimise the loss of income and jobs during the period for which economic activity is interrupted.
• Stem the panic in financial markets, maintaining liquidity and the orderly functioning of credit markets.

• Ensure confidence in the V-shaped recovery of the economy and the temporary nature of this disruption.

Inexplicably, despite the undeniably global nature of this threat, the G20 remains almost absent. The Saudi presidency convened a videoconference of G20 leaders, but the statement was full of platitudes and short on concrete commitments. The epidemic has spread very fast and is now hitting the whole world. Emerging economies are already suffering the consequences in terms of currency depreciations and capital flight. There would be a need for a carefully prepared summit to follow in the footsteps of the successful meeting in April 2009, which prevented the destructive spiral between the financial system and the real economy that threatened to plunge the world into a depression.

After years marked by a lack of tangible achievements, it is once again time for the G20 to provide a robust, coordinated and full response to a global health, economic and financial emergency. While each country must determine the measures it adopts depending on its needs, it is nonetheless possible to provide an outline of the programme to respond to COVID-19.

The eurozone once again faces a critical juncture, without having been able to fully heal the wounds of the 2010-12 crisis or build the full institutional framework required for optimal functioning. The fact that Italy and Spain are the two countries most affected by the epidemic increases the scale of the challenge for authorities in the area. This time, however, any errors or delays may prove much more costly. The survival of monetary union may once again be on the line.

The uncertainty at this moment is extremely high. We have some idea of the lethality of the virus and the epidemic curves in China and other Asian countries. However, it is not yet clear how these variables will play out in Italy, Spain, France, Germany and the US (and much less in other major economies like India and Brazil). Nor do we know the full extent of the negative impact on GDP for 2020 and how long it will affect the potential for growth. In principle, the shock is temporary in nature. However, its impact on production and employment will depend on the effectiveness of the measures adopted. Macroeconomic uncertainty is inseparable from financial uncertainty: if investors fear an intense and protracted recession (as reflected by interest rates for public debt), they will take flight from the stock markets and private debt. If banks face uncertainty accessing funding or the risk of lending to businesses and families, they will once again withdraw, tightening access to credit.

In short, the economic policy response must provide an insurance policy in the face of these uncertainties. If the policy is credible, the agents will reduce the probability of catastrophic outcomes and the market will continue to function (albeit with significant price adjustments). The policy must be coordinated to internalise all the externalities that the situation generates among countries. It must also be unlimited, because we do not know how long the phase to flatten the epidemic curve will last or
how much it will cost. The idea of ‘whatever it takes’ exemplifies this unlimited character: it is not a matter of numbers, which will be as high as they need to be. Recall that Mario Draghi’s statement in 2012 was backed by an unlimited programme whose ultimate cost was zero because it was so credible in never had to be used. It must also be flexible, adapting to the institutional characteristics of individual countries (the strength of their automatic stabilisers, exposure to the hardest-hit sectors) and the evolution of the situation.

The following sections offer some guidelines on the measures that should form part of this economic policy programme, which, fortunately, are already being developed by the authorities in various countries affected by the pandemic.

(2) The short-term insurance policy for businesses and homes

Even before the number of cases in a country begins to rise, the pandemic already has a negative sectoral economic impact due to the fall in demand for services related to tourism, transport and public gatherings. When countries reach the steepest part of the curve and activate measures to limit movement and ensure social distancing, the economy suffers an abrupt paralysis, affecting both supply and demand.

GDP and employment will inevitably fall during this period but there are four types of measures that can ameliorate the contraction and must support the operation of automatic stabilisers:

(a) Paid leave. Workers who contract the virus or who are unable to continue working as a result of confinement measures or childcare must still be paid. The specific forms will depend on the starting point of individual countries but the State should cover part or all of the cost. In the US, where paid leave is not widespread, this measure has been one of the biggest innovations in the first relief bill to respond to the economic consequences of the virus. The faster and more generous its application, the easier it will be for social distancing to limit damage. Specific attention must be paid to small businesses and self-employed workers.

(b) Subsidies and flexibility for temporary adjustments to employment. Many businesses had recorded temporary losses even before falls in sales or the impossibility of maintaining output. To minimise the number of people losing their jobs as a result of this situation, the State should subsidise and ensure the flexibility of temporary mechanisms to reduce working hours or allow part of the workforce to stay at home. A good example is the Kurzarbeit scheme in Germany to facilitate the temporary reduction of employment without job losses. The measures announced on Friday 13 March reduce the requirements for companies to make use of this option and extend it to temporary workers.

(c) Temporary relief from tax obligations and social security. Many countries, including Spain, have already announced measures to allow the deferral of tax payments for SMEs and self-employed workers. Social security payments can also be temporarily reduced to incentivise companies to retain staff. These measures were used in 2009 and aim to provide businesses with temporary
liquidity. However, given that those who are most affected will not generate income for a period of time, they must be combined with other measures to provide access to liquidity.

(d) Finance for businesses. Many businesses and self-employed workers will face a period of limited activity and suppressed revenue, which could threaten those without sufficient financial resources. To avoid the destruction of the fabric of production, it will be necessary to adopt a series of measures that will make it possible to ensure continued financing flows for businesses. On the one hand, this will involve channelling funds to banks to allow them to provide these loans and avoid excessive tightening of credit conditions from increased risk. The Bank of England and European Central Bank (ECB) have already done this with their liquidity programmes linked to new credit. On the other hand, the existing programmes of public financial entities must be scaled up and complemented with guarantee programmes in which the State assumes credit risk and liability for losses. This measure has already been announced by the German government on 13 March, with the unlimited provision of liquidity for SMEs. In Europe, the European Investment Bank (EIB) is moving forward to complement these measures by providing financing and above all by taking on risk through the European Investment Fund.

The design and application of these measures must seek to ensure the active involvement of companies, trade unions and banks. This catastrophe requires us all to participate in the search for formulas adapted to the needs of individual countries and sectors to prevent the inevitable economic damage multiplying. Depending on how long the shutdown continues, it may also be necessary to extend these measures with extraordinary steps to support specific sectors and businesses (the European Commission has already announced flexibility in the application of its State aid rules).

(3) Stabilising the financial system

Central banks have already provided a robust response to the growing signs of dislocation. However, the response needs to be sustained, cutting off any sign of escalation that can amplify the economic costs of the pandemic at the root. Despite the spectacular losses in the stock markets, the success of measures depends on keeping them focused on liquidity and the credit markets.

The measures taken by the ECB (immediate general liquidity through long-term operations, incentivised and broader liquidity to provide credit for planned long-term operations and an €870 billion increase in the asset purchase programme until the end of the year) will provide the banking system with security and reinforcement to prevent a disorderly increase in credit spreads that could jeopardise both businesses and the fiscal response capacity of the countries affected by the pandemic. In the banking sector, there is also a willingness to use macroprudential measures to temporarily reduce capital requirements and prevent them from becoming a barrier to the availability of credit. In terms of the debt markets, the ECB can make temporary adjustments to the distribution of purchases from individual countries if the circumstances of the markets require. As its chief economist Philip Lane has remarked, the ECB must increase its presence in the
A coordinated, unlimited and flexible insurance policy to respond to the pandemic
ARI 40/2020 (English version) - 8/4/2020 - Elcano Royal Institute

debt market during this period of volatility. To do so unhindered, it has already relaxed some of the current limits on purchases, especially for sovereign debt.

The Federal Reserve has cut rates to zero, reactivated its quantitative easing programme through asset purchases and has taken various steps to maintain liquidity, for both the domestic market and dollar funding outside the US, through coordinated action with other central banks.

Banks are better prepared than they were 10 years ago in terms of capital and liquidity. However, at least in Europe, the profitability of their business model is low and there is scarce room to absorb a negative shock in terms of credit risk while maintaining services for businesses and families. Following the sharp drop in the share prices of many banks and their increased credit spread risk, the authorities must pay careful attention and be ready to intervene over the coming weeks and months if there are signs of faltering confidence in the banking system. The extensive experience of the previous crisis will support the swift adoption of the appropriate measures, including capital injections, which should be centralised for the eurozone.

Ensuring financial stability will also require the financial safety net to be strengthened to ensure emerging economies are not dragged down by aversion to risk and the depreciation of their currencies. There are already signs of capital flight and economies with high volumes of dollar-denominated debt may experience a tightening of financial conditions that could exacerbate macroeconomic weakness. The G20 should adopt similar measures to those that helped stem the spread of the systemic crisis from developed countries to developing economies in April 2009. These include issuing and allocating Special Drawing Rights (the virtual currency of the IMF) to States to strengthen foreign exchange liquidity and increase the financing capacity of the IMF, the World Bank and other regional development banks.

(4) The insurance policy against macroeconomic uncertainty and rolling back the trade war

The pandemic struck just when the global economy was starting to recover from the trade war, which meant growth in 2019 was the slowest it had been since the financial crisis. The structural supply surplus once again became clear, together with the difficulty of sustaining growth in aggregate demand at the pace required to maintain full employment. Beyond the fiscal and financial measures of the immediate response, the G20 and the eurozone should commit to boosting aggregate demand in 2020 and 2021. Otherwise, the hysteresis of permanent losses, manifest in unemployment and lower investment, will act as a drag on growth for various quarters, perhaps even years.

A credible programme is required to convince businesses, families and the financial system that this is a temporary crisis from which we will emerge strong, investing, consuming and creating jobs. All G20 economies will need to choose the best combination of macroeconomic policies to coordinate this programme to reactivate the economy, which must include shock measures for the most affected sectors. In many emerging countries, there is still enough room for manoeuvre in monetary policy to respond effectively and, given the pandemic’s deflationary potential, this may prove a
useful and flexible instrument. This time, however, the bulk of the response must necessarily be fiscal.

In the US and the eurozone, the stimulus from low interest rates and even the resumption of nonconventional measures is much more limited. Some experts believe the time has come for monetised fiscal expansion (so-called ‘helicopter money’). While this may be the case, we must remain practical: there is no time to engage in doctrinal battles or prepare the necessary legal and institutional framework. It suffices to design a coordinated programme of fiscal and monetary expansion, which is now inevitable. Furthermore, it would be dangerous to lend credence to the idea that macroeconomic policy is nearly exhausted in developed countries. This would weaken all credibility of the insurance the economic policy programme seeks to provide and it is simply false. It is a matter of political willpower: despite the level of interest rates and the high volume of public debt, States still have the capacity to provide stability through their budgets and the balance sheet of central banks. As shown by the historic minimum returns on public debt assets, the demand for risk-free or low-risk assets is extremely high in the current climate and is able to absorb a significant increase in supply. As Mankiw (2020) remarks, now is not the time to worry about public debt.

The choice facing the eurozone is stark: the ECB’s interest rates are already in negative territory and there are numerous countries with limited fiscal capacity. The Council has activated the general escape clause for fiscal rules to facilitate coordinated fiscal expansion. While the ECB maintains an active and flexible presence in the debt markets, this temporary increase in deficits must not create financial stress for the most indebted States. Gourinchas (2020) proposes that the European Stability Mechanism issues eurobonds to finance part of the response. There is no doubt that if the eurozone already had a shared fiscal capacity, this would be the right way to proceed. However, this is not the case and this is no time to fight protracted political battles. We must take advantage of the fact that the German government has stated on this occasion that it has the financial firepower to respond and is willing to use them. Yet, the Euro Area fiscal support falls short by at least three percentage points of GDP, so there is a need to add a European layer, financed with joint debt as an exceptional and temporary measure.

Beyond classic macroeconomic policy, China and the US have a powerful instrument that can jump-start confidence in the global economy. Despite the agreement reached in December to halt the trade war, with China making commitments in various areas and the US agreeing not to implement its final wave of tariffs, the trade barriers between the two major economies are much higher than they were a year and a half ago. The two powers could accelerate phase two negotiations and either fully or partially rollback with immediate effect the tariff increases imposed in recent months. The pandemic clearly shows that interdependence generates threats that are extremely unpredictable and hard to manage. Protectionism is a political obstacle that impoverishes us and has no place in a world like ours as we confront the coronavirus.

These measures can also be supported by a commitment to reduce barriers to trade for medical supplies needed to fight the pandemic and provide proper treatment for the most vulnerable people who contract the virus. As Bown (2020) notes, the US has introduced temporary exemptions from tariffs on certain key products from China required for the
A coordinated, unlimited and flexible insurance policy to respond to the pandemic
ARI 40/2020 (English version) - 8/4/2020 - Elcano Royal Institute

health response to the coronavirus. Many other health products remain subject to high tariffs. However, this problem is not exclusive to China and the US. France, Germany and South Korea have all announced restrictions on the export of medical equipment. In the case of the two European countries, this decision is cause for concern and goes against the Commission’s call to uphold the single market. After various meetings at which the US has avoided adopting a clear position in favour of an open trade system, the G20 now has the opportunity to reach an agreement that uses the power of trade to ensure that the countries that do not produce the required equipment can also treat the most vulnerable patients affected by the pandemic.

Conclusions

The economic authorities are accelerating the pace and ambition of the adoption of measures to respond to the pandemic. There will be a lot of bad news over the coming weeks and the sense of anxiety and fear will only get worse. Following the measures taken by central banks, governments and the European Commission, we must keep up the momentum to respond adequately to the threat. Measures must be implemented swiftly to ensure they take effect as soon as possible and there is an urgent need for international coordination in the response. However, the G7 is not the right forum. Instead, leadership by the G20 would show the world that we will tackle the pandemic using all possible resources, with everyone working in unison. For the eurozone, the following weeks will be decisive: we will use its instruments and institutions to their full potential in a spirit of cohesion and unity in the face of adversity.

Governments must be on the front line of this economic battle, working in close alignment with the steps taken by the health system to fight the pandemic. However, we can only win if all of us –businesses, workers and banks, supported by the insurance policy provided by the State– behave responsibly and play an active role in overcoming the crisis.

References


OECD (2020), Economic Outlook, March.
