**Economic policy under the pandemic: A European perspective**

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The responses to Covid-19 have had direct economic consequences of historic proportions. In reaction to this challenge, this column was prepared by four main authors and then discussed within a large group of research-active macroeconomists who also signed the final document. The column discusses the nature of the shock and the challenges for economic policy in Europe in the current and next phases of the crisis. In addition to outlining some basic principles for guiding domestic economic policy, it also calls for clear communication of policy to minimise uncertainty, for cooperation across countries along several dimensions, and for a clear and unified strategy in the management of national debts.

This column discusses challenges for economic policy in Europe in the current and next phases of the corona crisis. We especially emphasise:

* Basic principles for guiding domestic economic policy
* The need for clear communication of policy
* The need for cooperation across countries along several dimensions and
* The need for a clear and unified strategy in the management of national debts.

**Domestic policy**

Our responses to the coronavirus have had direct economic consequences of historic proportions. These responses have been spontaneous as well as caused by policymakers’ recommendations/decrees to observe social distancing to reduce the spread of the virus and protect those at heightened risk. Output has fallen abruptly, and unemployment has soared, especially in some sectors. The impact has thus been profound, but also quite diverse across society both in terms of the extent to which different people and firms have been affected and in what ways.

Economic policymakers have addressed these challenges in their respective countries. Our purpose here is not to evaluate specific efforts, in large part because countries differ in many ways, so what is an appropriate response in one country may be inappropriate in another. Rather, our aim is to suggest some principles that we think are of general value at different stages of the crisis.

**The nature of the shock**

It is of primary importance to understand the economic nature of the ‘shock’ that has occurred. On a macroeconomic level, the pandemic represents a single, unforeseeable shock. In comparison to essentially all other recessions in modern times, this is highly unusual. In a typical recession, the nature of the shock(s) is often subject to much debate. Most recessions are commonly viewed as associated with ‘demand deficiencies’ – fears of a less bright future, lack of confidence, etc. – and thus to some extent constitute a self-fulfilling phenomenon. The standard recipe for combatting a self-fulfilling shock is Keynesian demand management: measures taken by the monetary and fiscal authorities to raise demand back up. In sharp contrast, the Covid-19 pandemic is not a self-fulfilling phenomenon; this shock is highly unfortunate but now unavoidable, and there are fundamental reasons – people’s own choices and governments’ well-motivated interventions – for why economic activity has fallen during this period.

**The key principle for policy: Bridging**

What can economic policy do, then? During the pandemic, policy can help bridge the gap between the pre- and post-corona economies. Thus, the purpose should be to make a swift return to trend possible, as soon as the health-motivated measures are lifted. The focus of macroeconomic policy should therefore be to find ways to prevent a breaking up of fundamentally healthy ties between firms and their employees, firms and their customers, and firms and their input suppliers (thus maintaining supply chains intact). If such ties are still active, it will then be possible to jump-start the economy once the virus threat has receded. Rebuilding broken ties takes time, which could make the economic recovery long and painful. There are a variety of measures that could be used here, including financial support and legislative changes to labour as well as bankruptcy laws. Our purpose here is merely to emphasise the dire need for these policies; their details must, by necessity, differ by country-specific institutional context. A concern in implementing bridging policies is that some firms and relationships really should be disrupted – recessions play a cleansing role to some extent. However, because it is very hard to pinpoint which firms/relationships these are, and to avoid unproductive lobbying efforts, we advocate policies that are broad and involve little discretion.

An important qualification to the principle we have just advanced applies to the extent the economy will change permanently because of this experience. It is likely that some things will be different: virtual meetings may become more common and alter the division of time between home and work, public hygiene requirements may become stricter, and so on. These and similar changes must be factored in, but we do not think they are major enough to call for a different kind of policy. Importantly, they do not imply a need for new or redirected industrial policy, neither national nor at the EU level.

There may also be long-lasting consequences for segments of the population that are directly affected by the crisis: children who miss out on education, people who lose their jobs and may remain unemployed for a long time, those (often women) who bear a heavy burden at home in caring for children and the elderly and who may lose out on job training and promotions, and so on. Such long-term effects are examples that we consider undesirable: they would not have occurred absent the corona crisis and must be addressed as promptly as possible.

**Transfer policy**

More generally, the corona experience will bring economic suffering to many households and it is important for governments to be generous and increase transfers to these groups. These transfers should be viewed as ‘corona insurance payments’; no such insurance existed, since the event was so unpredictable, and the government’s role now is to help partially replace this missing market. The aim of the transfers is not, as it is in most recessions, to help boost demand (output is low because we want it to be low until the health challenge is overcome), but simply help households cope with hardships.

**A golden opportunity for structural change?**

Should the corona crisis be used as an opportunity to induce structural change in support of other long-term, laudable goals, such as the efforts to slow climate change? Is this an opportune time to ‘kill’ airlines or other sectors/modes of production? We think not. Such measures would exacerbate the recession beyond what is called for, and unemployment and human suffering would be an even bigger challenge. Long-term goals should be pursued, but only once we are on firm ground again.

**Uncertainty and forward guidance**

Finally, it is important to address the uncertainty that remains. Although lockdowns are now gradually being lifted, it is still highly unclear for how long restrictions on our modes of interaction will remain. It all depends on the evolution of the virus – it is entirely possible that we will experience a rebound and return to tighter restrictions – and on the results of our attempts to find a vaccine or powerful treatment for the virus. In a pessimistic scenario, we still have a long way to go before the health situation is under control; in an optimistic one, a vaccine will be found and mass-produced soon. Economic policy must take these hard-to-predict medical factors into account. Thus, economic policy, even when conducted appropriately, will be hard to predict.

Can policy really mitigate this uncertainty? Yes, policymakers must do all in their power to minimise it. Policy uncertainty itself can become the seed of a more traditional prolonged recession. Businesses may hold back investment, freeze hiring, and put R&D on hold in fear of a poor recovery, causing the corona crisis to be substantially more drawn out and painful than necessary. A key strategy for policymakers here is to clearly communicate future policy intentions. This could be achieved in a ‘conditional’ fashion, i.e. with maintained flexibility to deal with future contingencies. Such an approach is well-known from monetary policy – it is called ‘forward guidance’. It requires careful design, but the idea is that the communication of future policy intentions provides businesses with key signals that can help them design their efforts to rebuild their activities and also allows households to better evaluate the extent to which there is a real need for precautionary savings. In this case, the conditioning requires close collaboration with health agencies so as to clearly define scenarios and the plans contingent on them. Appropriate forward guidance, in particular, involves being clear about what is uncertain and what is not. In the health policy domain, our assessment so far is that most governments have failed to provide proper forward guidance: they are not clear on what the long-run strategy is, instead merely focusing on current measures. The need for signals to the economy is dire: both economic policy and health policy need to do a much better job of guiding us forward.

**Cooperation across borders**

Initially, as the health crisis unfolded, many countries took swift unilateral actions to close their borders to foreign citizens and to trade. Some might argue that the Covid-19 crisis has demonstrated the dangers of open borders and that countries should rely more on self-sufficiency. In our opinion, this is a dangerous path to take which will not only hamper prosperity but also hinder our ability to deal with future crises and possibly prompt populistic dangers to democracy. Instead, as we move into the next phase of the crisis, international cooperation and openness must be re-established. Countries need to pull together and avoid unnecessary and inefficient pressures to become inward looking.

A unique feature of the Covid-19 crisis is that it has impacted much of the world economy at roughly the same time. The economic impact has been felt everywhere, even where the health consequences so far have been mild. This common shock feature has important consequences. The world economy is closely interrelated through international trade in finished goods and services as well as in intermediate inputs, and through flows of ideas, capital and people. The combination of close trade links and a common shock makes it hard for individual countries to recover from the crisis due to the lack of foreign export demand and severed global input supply chains. Such interlinkages across economies are particularly strong within Europe, where not only are trade links very tight but there are is also substantial cross-border movement of both labour and capital. In fact, one of the most important strengths of Europe is the relative absence of trade barriers, in effect turning it into something closely resembling one large country, equal in size to the United States. Europe’s effective total size is a large asset especially in challenging times such as these.

It is vital for the productivity of our economies that trade links are resurrected as quickly as the health concerns allow and to establish multilateral cooperation. Bilateral deals may put health concerns at risk as countries bargain over access to each other’s economies. There is a risk is that we will end up in waiting games where each country holds off until others ease up their lockdowns and open their borders. Avoiding such adverse outcomes can and must be avoided through broader international cooperation. This extends to the effectiveness of stimulus policies, where externalities through export demand introduce a temptation for individual countries to rely on other countries stimulating their economies and bearing the fiscal costs. Should all countries do so, the end result would be inefficient delays to the recovery.

It is likely that the path ahead will require stronger economies to carry a heavier weight. This is a price worth paying not only for purely economic reasons beyond arguments regarding solidarity towards those economies hard particularly hit by the Covid-19 crisis. Specific agreements, such as domestic bridging policies, should be clear on conditionalities, but chiefly aim at recognising the interdependencies of our economies and the mutual benefits of lifting restrictions on trade and travel as promptly as possible. Ideally, opening-up dates will differ across countries, because different countries will be at different stages of dealing with their health crisis. In fact, policy heterogeneity has most likely contributed to the differences in what can be considered ‘ideal’ opening-up dates for trade and travel in different parts of Europe. However, these differences cannot be eliminated, and international collaboration must therefore respect them in order not to risk reviving the virus in countries that have managed to contain its spreading. That is, mutually beneficial plans in this area will involve the lifting of international barriers that are not necessarily simultaneous.

Cooperation would ideally occur at the global level, but Europe is in a good place to at least act as a unified region, given its existing political institutions. In fact, Europe has already done a lot. The ECB has implemented its Pandemic Emergency Purchase Plan providing €750 billion for asset purchases. The EU has also launched a number of other initiatives, including the ESM Pandemic Crisis Support, the EIB Pan-European Guarantee Fund, the European Commission’s SURE plan, and, perhaps most ambitiously on the fiscal side, the Next Generation EU recovery package aimed at mainly medium- and longer-term needs. What are still missing, though, are policies that will give the hardest hit EU countries the ability to address the pressing need for bridging policies without the risk of setting off unstable debt dynamics.

Another important aspect of international cooperation involves the exchange of information on experiences of dealing both with the health challenges of the coronavirus and its economic repercussions. We are in unchartered seas and good policy and science need to be built on data which will help us design better policies in the area of health as well as economic policies. It is important to keep collecting and analysing these data, but also to share the knowledge effectively. A number of questions remain. Will there be new waves of infections? How rapidly will the different economies recover? Is there a need for structural changes? These questions can best be addressed jointly. One might even imagine that there is a role for increased European cooperation in health, such as increasing the portfolio of responsibilities of the European Health Agency. Similarly, an independent scientific economic committee could evaluate and coordinate policies for the economic recovery in the different regions of Europe. The scientific team could develop specific strategic development policies and provide guidance to the relevant national ministries for speeding up the regional recovery.

**Dealing with debt**

The crisis will very likely have first-order impacts on government budgets. Tax revenues have fallen due to the decline in activity, while spending on the health sector has increased. Government-provided transfers have also increased as workers have lost their jobs, prompting governments to step in to (at least partially) compensate workers and firms for losses of income. The decline in GDP has also meant that the debt burden has increased when measured relative to the size of the economy. All factors point to larger deficits and more debt.

Going forward, substantial fiscal stimulus policies are needed to get the economies off the ground again, and the bridging policies we propose will have to remain in place until the health situation improves significantly. Some countries are in a good position to keep spending for some time yet due to strong government finances at the onset of the crisis. Others have much less fiscal space to stimulate their economies. The countries hit hardest by the pandemic, such as Spain, Italy, and Belgium, are also saddled with large initial levels of government debt.

Given the low current interest rates, it seems mutually beneficial for European governments with stronger budget positions to ‘invest’ in countries with weaker budgets. International dependencies make such interventions particularly valuable, as they will enable a swifter exit from the Covid-19 recession in all countries. However, larger debt may increase the default risks, triggering a rise in the required return on sovereign debt in vulnerable countries. Such beliefs can create self-fulfilling defaults also when the sovereign is able to pay normal interest on its debt. Such an outcome is not in the interest of creditors, whoever they are. Indeed, a sovereign debt crisis could further cripple the international economy as it tries to recover from the pandemic.

There is consensus on how to mount a bulwark to protect vulnerable economies against such debt crises: a lender of last resort must guarantee that countries’ borrowing needs are fulfilled. Although the European Stability Mechanism provides a mechanism to achieve this, the funds available are limited to €500 billion. This might be insufficient. For example, Italy’s government debt alone is five times larger than this fund. The von der Leyen plan proposes to raise €750 billion by issuing European Union debt. This revenue should be allocated to a fund that serves as such a bulwark to address the issue of potential debt crises, rather than using the funds to initiate new spending through, for example, industrial policies. Countries must be allowed to use the new debt to achieve two aims: implementing the needed bridging policies while at the same time avoiding a debt crisis. New and costly industrial policies may compromise the ability to achieve either goal.

Concretely, we are proposing to (i) raise a bigger fund to avert debt crises and (ii) give the receiving governments more say in how to use the funds, rather than tying them to specific industrial policies with long-run goals.

Economic science does not offer a recipe for who should eventually service this debt. It is a political question whether it should be shouldered jointly by all countries or ultimately borne by the countries in need. In any case, the transfers should be accompanied by conditionality aimed at reforms achieving more efficient tax collection and better functioning economies. For example, greater property taxation can be a robust way to increase domestic tax revenue without stifling the economy. Regardless of the chosen solution, the issue must be recognised, discussed, and addressed to avoid very costly outcomes. During the European debt crisis ten years ago, a major problem was policy uncertainty (over whether countries would be bailed out, and so on). This time, the stakes are higher because the debt burden has risen and Europe’s populations are older. It is imperative to avoid repeating past mistakes.

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