Further Economic Policy Responses to Covid-19

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Governments around the world and multilateral institutions should be congratulated for rapidly putting together bold packages to help support the vulnerable, keep businesses afloat, and keep credit and liquidity flowing in the economy in coordination with central banks. Boldness is necessary to respond to this unprecedented crisis.

Given the magnitude of the of the crisis, more is required. Below we outline additional policy responses that could be implemented to strengthen the existing schemes. We start with labour market and transfer policies, then discuss policies to preserve firms' liquidity and solvency, policies targeting the health sector, and conclude with policies that could pave the way for the recovery as social distancing measures are gradually eased.

1. Labour market and transfer policies

The duration of unemployment benefit insurance could be extended by several months. In the United Kingdom, jobseeker's Allowance is paid for up to 182 days. Social distancing measures have frozen the labour and jobseekers will mechanically exhaust their unemployment benefits. Extending the duration of unemployment benefits through the expected period of drastically reduced economic activity would have several advantages: (a) protect these vulnerable populations, (b) reduce defaults on mortgages, and (c) preserve aggregate demand after the worst of the crisis is over. Benefit extension would not create moral hazard from job seekers as the labour market is frozen. Unemployment benefit insurance extensions have already been implemented in several U.S. states.

Many European governments have planned to pay a high fraction of wages for those not working during the crisis – this should be done only for firms that maintain their overall wage bill. In the U.K., under the current scheme, firms only have to cover 20% of workers' wages. The risk is that most firms will *lay off many workers now rather than using the scheme covering 80% of their wages*, as there is no real incentive to keep these workers. Research using Italian data in the 2007-2012 crisis showed that many firms did exactly this. An alternative would be to allow firms to benefit from the scheme *only if they maintain their overall wage bills* (e.g., within 10% of their wage bill over January-February). Another possibility would be to cover 90% of wages for firms that maintain their overall wage bills, to give them an extra incentive to participate without amending this initial scheme already proposed

Temporary public employment programs could help with temporary labour retraining and reallocation. Due to the peculiar nature of this crisis there are great asymmetries in capacity utilization across sectors. For example, alongside enormous slack in services sectors, such as restaurants and hospitality, there are immense shortages in the healthcare sector, production of medical equipment and home food delivery. Governments could establish a *temporary public employment programme to help with temporary labour retraining and reallocation*. The programme would address labour shortages, while retaining workers' attachment to their permanent places of employment. Employees would temporarily be on leave without pay, reducing employers' wage bill, but could rapidly return to their original places of employment when the crisis subsides. Similar active labour market policies were very successful during the Second World War.

The government could encourage direct bonus payments to essential workers, including health care workers directly involved in the coronavirus crisis. Governments could offer *direct payment of a bonus to health care workers*. In addition, they could *encourage employers to give a tax-free bonus* to all workers who are not able to work from home during the next two months, for example a £1,000 tax free bonus. Similar bonuses have been given in France and Singapore.

2. Preserving firms' liquidity and solvency

Establishing a moratorium of debt and mortgage payments. A priority for the next few weeks is to stop default on loan payments by firms. The Government should consider whether it can coordinate the financial sector *in a moratorium of debt payments for a fixed time period*, or until the government deems it adequate. This could be complemented with a moratorium on mortgage payments. Mortgagors have entered this crisis with leverage nearing 2007 levels.

Governments could cover rental costs and energy costs for small and medium-sized businesses, to reduce solvency risk and debt overhang for these firms. Economic activity is drastically depressed in many sectors. Because of the exceptional nature of this shock, which creates no moral hazard between firms, it is important for governments to help firms cover their costs *even beyond salary costs*. It is important to cover these costs directly to avoid debt overhang after the crisis. Interest-free loans are not enough because small firms have small profit margins and may become insolvent due to the temporary shock. This proposal is justified by the exceptional nature of the crisis. For example, governments could cover 70% of the losses incurred by small and medium-sized businesses due to rental payments and the cost of energy. These costs constitute pure financial losses because they are unavoidable and do not contribute to production later on. The rate should be high but set below the coverage offered for workers through temporary unemployment schemes, because labour should take precedence. No coverage should be offered for other costs that can help promote production in the future (such as buying intermediate inputs due to binding purchase agreements). This scheme could be extended to larger firms later, depending on how the situation evolves.

Governments could also consider injecting equity directly into certain companies. Governments must start planning and consider an injection of equity into some companies in some sectors of the economy. *Debt will not be enough, as already highly leveraged firms will have trouble taking on more debt.* What began as a health crisis could easily spiral into a financial crisis. Governments should devise a strategy to ensure that this equity injection will not lead to a wholesale nationalization of the economy or destroying its corporate governance.

3. Policies targeting the health sector

It is important to devote large additional resources to the health care sector. The Government could immediately devote large additional resources to: (i) staff the health care sector, (ii) buy the equipment (like ventilators) that will soon be needed, (iii) mobilize the resources to quickly expand hospital capacity, and (iv) direct all researchers and industry in the health field to quickly develop faster, cheaper tests as well potentially a vaccine. Government's packages could do more in this regard, especially in mobilizing innovation in the private sector, and identifying the industries that are crucial in the response. *Both financial incentives and exemption from some regulations would be adequate* in a time of emergency. One needs *war-type mobilization in the health sector* right now. This part of the package is currently lacking.

4. Paving the way for the recovery

Preparing a package of policies for the after-shock is paramount. Once self-containment is past, the economy will have to produce in overtime to recover some of the lost ground. The government must consider large stimuli at this stage, *especially to the supply side of the economy*, which is more likely to be severely impaired. Conventional stimulus to aggregate demand through government spending and transfers may merely produce inflation if the supply side is constrained as it will likely be. Supply-side reforms, like *relaxing regulations and cutting taxes, including tax credits for investment and hiring*, would provide a way to unfreeze the UK's economy as quickly as possible. *Announcing this policy package now will reduce uncertainty* and get firms ready to invest once they can get back to business.

Finally, it is also important to set up a task force to elaborate a contingency plan to support the economy in case the epidemic lasts for over 6 months. Most current discussions operate under the assumption of short-run disruptions of at most three months. Epidemiological research and the current situation in China suggest that the crisis could be much longer, and that disruptions to economic activity (e.g. through social distancing and establishment closures) *could continue for a year or more.* Due to budget constraints, it will not be possible for governments to support all sectors and cover workers' wages for a year. A task force should be set up right away to develop crises scenarios to identify the tradeoffs and key sectors, firms or households that should be supported in priority in case of a prolonged crisis. In this way governments *would be prepared if the situation were to deteriorate further*.

APPENDIX A – COVERING NON-WAGE COSTS FOR SMALL AND MEDIUM SIZED FIRMS

In this appendix, we discuss why it is essential to cover non-wage costs for small and medium size businesses. For concreteness, we illustrate how the proposal could be implemented in the U.K.

Diagnostic. The confinement shock depresses economic activity drastically for many sectors. Because of the nature of this shock, which creates no moral hazard between firms, it seems legitimate to consider government intervention to help firms cover their costs even beyond salaries. The goal is twofold:

(i) Liquidity: must make sure that firms do not go bankrupt because of liquidity problems during the confinement period. This is a standard "lender of last resort" issue, but with an unprecedented scale (see below).

(ii) Solvency & debt overhang: must avoid debt overhang for firms after the end of the confinement. In sectors where profit margins are small, debt-ridden firms may become insolvent after a long period of confinement. This pleads for providing a **transfer** to directly cover some of the costs ("pure losses") incurred by firms in the most vulnerable sectors. This could be called an **"insurer of last resort" policy.**

Challenges. These two goals raise two main challenges:

(i) Scale & timing: The liquidity issue is common to all major economic crises. But today the scale of the issue is different – most firms may need a credit line, and may need it quickly. This may pose operational challenges (standard credit facilities may be overwhelmed, as was the case in other countries like France).

(ii) Scope: The government may want to cover directly the losses of some firms beyond wages but the program should be structured to minimize cost to the government and avoid moral hazard from firms (which need to be incentivized to minimize the cost of the shutdown instead of letting the government incur the losses). It is useful to distinguish between two types of non-wage costs that firms will incur:

   a. Pure losses: costs that the firm can't stop paying and that are a pure loss, for example: (a) paying **rent** when the facilities are closed; (b) specific subsets of total cost of capital such as **interest payments**; (c) specific subsets of total cost of **energy** (e.g. to maintain the production area at the right temperature). The state could offer to cover most of these losses.
      i. Note: it is difficult to be precise about the nature of these costs, which are likely to vary across industries and across the firm size distribution. We propose to start with rents and energy costs.
   b. Committed costs where intertemporal substitution is possible: for example, (a) firms forced to buy intermediate inputs now because of **binding purchase agreements** but could use them later when production resumes; (b) **financial costs of debt** (interest + principal). For this category of costs, the state may only want to provide liquidities at a small or zero interest rate.

Proposals. Given these goals and challenges, the following could be proposed:

- 1. **Extending loans to firms directly via HMRC**
    - If there is an operational challenge in providing liquidity quickly to many firms, HMRC could leverage its existing relationship with all firms in the country.
        - This may not be necessary for liquidity purposes, as there is already a Coronavirus Business Interruption Loan program (to be launched this

coming week); **it remains to be seen whether this program can manage the large number of firms that will probably apply**
        - A direct transfer form HMRC would make it possible to give a direct transfer to firm to cover their pure losses (cf proposal 2 below)
    - An alternative approach would be to allow firms to have **large overdrafts** with their current bank, with a **100% state guarantee** (guarantee in business interruption loan is 80%, which may be enough)
- 2. **Offering to cover most of "pure losses", with ex-post verification**
    - Firms can be told today that they can use the various credit schemes to get zero interest loans to cover their costs during the shutdown, including both "pure losses" and "committed costs"
        - The proposal is that a *large transfer* could be offered for pure losses, while committed costs could get a zero-interest rate with a potential haircut
    - It could be announced right away that **pure losses will be covered by the state ex post** at a rate of 70%
        - Because workers are the priority it seems sensible to remain below the 80% coverage rate the government offered for wages
        - Firm will have to report their "pure losses" to HMRC and will be allowed to not pay back the fraction of their direct loan from HMRC corresponding to this amount. As a starting point, rents and energy bills could be listed as the only eligible expenses.
    - With time ex-post, it will be possible for HMRC to **check** that the reported pure losses qualify as such. For example, use data on firms' **bank accounts** to prove amount of recurring costs in prior months (this should be easy for rents and energy bills).
    - For "committed costs", it could be announced right away that the government may offer a "haircut" ex-post. The level of the haircut could be decided ex post depending on the strength of the recovery.
- Costing:
    - It is difficult to estimate precisely what the cost of covering pure losses would be for the govt, but the order of magnitude should be below 4% of GDP for a 2-month shutdown, which seems feasible at prevailing interest rates on govt debt
        - If seems too costly, proposal could be tailored to focus on industry with smallest profit margins, for which debt overhang is likely to be most important
- Comparing this proposal to existing schemes:
    - **The idea of covering firms' pure losses related to non-wage costs does not seem to have been considered so far**. The only scheme that gets close to it is grant funding of £25,000 for retail, hospitality and leisure businesses with property with a rateable value between £15,000 and £51,000. More should be done to avoid debt overhang when the crisis is over.