

The economic policy response to the Covid-19 crisis

Note for discussion

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The dramatic social distancing measures that were needed to contain the Covid-19 outbreak and save lives have resulted in a major economic crisis. The magnitude and spread of the global decline in output exceeds that triggered by the Global Financial Crisis, if not the Great Depression. But the very nature of the crisis is unprecedented.

As in previous major downturns, developing countries are facing a decline in foreign demand and a drop of commodity prices. They are also being locked out from global financial markets, suffer capital outflows and experience a fall of remittances. But in addition to the demand shortfall and the financial stress, this new crisis involves a major supply shock. Domestically, social distancing measures drastically reduce labor supply and increase transaction costs. Internationally, supply chains break down, which may result in shortages of key inputs and potentially in higher food prices. Another important difference with previous crises is the potential, recurrent return of the supply shock until a vaccine is developed, weighing on the prospects for recovery.

A crisis of this magnitude and nature is not going to be reverted quickly. Even once the crisis bottoms out, widespread bankruptcies, increased unemployment and under-employment, and a depressed investment climate will make its effects persist. Moreover, developing countries are confronting this crisis from a weaker position compared to the Global Financial Crisis. Some financial sectors are vulnerable, corporate debt is generally high, and sovereign debt levels often constrain the fiscal space available to governments.

The response to this crisis requires a substantial mobilization of resources, and short-term liquidity will be essential to protect the poor and the vulnerable, to keep basic services running, to buffer economic activity, and to preserve human capital investments. But financial resources alone will not be enough. And in the meantime, the urge to respond to the crisis is leading governments to take measures that will further compound difficulties down the road. In this context, clarity on what to do and what not to do is as important, if not more, than the availability of financial resources.

Crucially, the nature of the response will depend on the characteristics of the countries. On the health front, the measures adopted by advanced economies to contain the spread of the epidemic may be less effective in countries with weaker health systems, crowded housing and limited access to water and sanitation. On the economic front, the stimulus packages of advanced economies rely extensively on taxes, transfers and guarantees, but measures of this sort only reach a fraction of firms and households when economic activity is largely informal. The challenges may be common to all countries, but the responses need to be tailored to the structure and institutions of individual countries.

The purpose of this note is to articulate a framework for how to respond to the crisis. The note is organized around the major challenges policy makers face, identifying in each case the options they may want to

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consider and flagging the risks. The note calls for coordinating policies and initiatives around seven major themes: 1) contain and assess the damage, 2) protect the poorest and the most vulnerable, 3) be explicit on how losses will be socialized, 4) prevent a financial sector collapse, 5) support jobs and firms, 6) organize the management of assets, and 7) leverage global support.

The note subsequently discusses how to phase an engagement along these lines at the country level, once the framework is fleshed out to take account of country circumstances. It is hoped that the note can serve as the basis for policy discussions with key decision makers in country and pave the way for operational engagements. The note should also bring together the World Bank Group and other international partners in designing and supporting the response to the crisis.

1. Contain and assess the damage

There is little developing countries can do about declining global demand, falling commodity prices or tightening financial conditions. But the response to the Covid-19 epidemic at the country level is in their hands. There is by now evidence that targeted social distancing measures, combined with testing where possible, are effective at containing the spread of the virus if they are adopted early on. And they are much less costly, from an economic point of view, than the general quarantines and lockdowns that become unavoidable if the epidemic spreads more broadly.

Targeted social distancing measures focus on the most vulnerable population groups, especially the elderly and those with pre-existing medical conditions. Large-scale testing and tracing is also important to identify who has been infected, and who can keep working and interacting socially because he or she poses a much lower risk to others.

The ability to implement these social distancing measures, and their effectiveness, likely depend on country characteristics, including institutional capacity, population density and access to services. These considerations certainly affect the way the tradeoffs between health costs and economic costs should be managed. But even developing countries with limited means appear to have been successful at adopting targeted social distancing measures early on.

Given that many developing countries are still in the initial phases of the epidemic, the first priority of their governments should be to get the Covid-19 containment strategy right. Not doing so could make the crisis much more costly. Limiting the loss of life also requires ensuring that basic medical supplies are available and that health sector workers are supported.

The second priority is to assess the depth and characteristics of the crisis despite the obvious challenges of doing so. At this point there is enormous uncertainty as to how severe the global decline in output will be, and how domestic economies will be affected. Assessing the situation is fundamental to operate under common assumptions about the breadth and the depth of the crisis, to inform policy decisions, and to build consensus about them among public opinion and key stakeholders.

This is not the time for in-depth studies and foundational diagnostics. Governments should mobilize the best domestic capacity and seek international support to conduct quick assessments of the downturn and its spatial footprint relying on big data. Satellite imagery on emissions from exhausts and nighttime lights, data on cell phone traffic, ridership from vehicle-sharing applications... all these sources can be mobilized rapidly to assess by how much, and where, activity is declining.

In addition, three areas deserve special attention. First, identifying the most urgent social challenges is essential to design policy responses that protect the most vulnerable. Second are financial sector vulnerabilities. This is the time to ramp up supervision capacity and get a clear sense of the risks faced by banks, non-bank financial institutions, micro-credit providers and the like. And third, special attention should be devoted to assessing the health of strategically important firms and sectors of activity. Understanding the difficulties faced by firms whose behavior and performance can ripple through the economy is key to address them adequately.

2. Protect the poorest and the most vulnerable

The hardship from the crisis will be enormous for large segments of the population in developing countries. Many households live from hand to mouth and they do not have the resources to cope with the lockdowns and quarantines needed to contain the spread of the epidemic. Many depend on farming and self-employment, and informality is common even among wage earners. Protecting their earnings, and reaching them through transfers, is considerably more challenging than in formalized economies. Many also depend on remittances, which are collapsing as activity shuts down in host countries, with migrant workers among the most affected.

Human capital is also at risk in the current crisis. Falling incomes and disrupted supply chains raise the prospect of food insecurity. Many children depend on school meals, which become unavailable as education systems shut down. Malnutrition is a concern at every age, but in the early years of life it affects learning ability and becomes a permanent handicap.

The policy response needs to squarely tackle this social dimension of the crisis, a dimension that programs to help formal sector firms and workers cannot address. In doing so there is no real distinction between supporting micro-firms, supporting households and supporting communities.

The first line of response includes existing social protection and social assistance programs that can be rapidly scaled up and whose coverage can be extended. Many developing countries have tried and tested schemes, such as cash transfers and public works programs, that can be reinforced for this purpose. Such programs might be supplemented by mobile or digital payment channels where such platforms have sufficient coverage, identity can be established, and beneficiaries have accounts. Food distribution initiatives, especially while social distancing measures are in place, and community-driven development can also be part of the response package.

Whether support should be targeted to the neediest, or a more blanket approach should be adopted, is a defensible discussion in the context of a massive economic shock. There is a lower risk of creating perverse incentives or helping those who can fend for themselves when mostly everybody is struggling. And ensuring accurate targeting could slow down the delivery of assistance to those in need.

3. Be explicit on how losses will be socialized

The longer the crisis, the more likely that liquidity constraints will become a solvency problem. In many contexts there will be a real loss of economic value, and a key question is who should bear the losses. From an economic point of view, the answer is simple: the losses should be centralized with the government to the extent possible.

There are two main justifications for this answer, one related to economics and the other to politics. On the economic side, a shock like the Covid-19 epidemic was essentially uninsurable, and it will affect individual firms and households in radically different ways. In this context, only the government can serve as an insurer of last resort. On the political side, both the shock and the response can spread costs around the economy in a non-transparent manner. The socialization of the losses is bound to involve transfers and bailouts. This process needs to be perceived as fair for countries to maintain social cohesion.

However, playing the role of insurer of last resort requires resources. Governments in advanced economies have chosen to offer blanket guarantees and broad support to firms and households. This is an ideal solution as it ensures all economic agents that their unanticipated losses will be socialized and spread out over time. However, this ideal solution requires deep pockets, a luxury the governments of developing countries – especially the poorest – do not enjoy. To widen their fiscal space and enable socialization of a larger share of losses, developing countries need international assistance.

Serving as an effective insurer of last resort also requires institutional capacity, and developing countries differ considerably in this respect. For now, several of them are resorting to haphazard solutions. For instance, firms are allowed to skip utility payments, or households are allowed to withdraw retirement savings. These responses are understandable, but they risk making infrastructure utilities and pension funds insolvent, undoing decades of policy reform efforts.

Governments should assess what they can accomplish, given their resources and capacity, and clearly communicate how they intend to manage the real losses of economic value that are bound to happen. The statement could entail a commitment to guaranteeing the stability of the financial sector, to ensuring the continuity of basic services, to supporting small businesses and strategically important sources of employment, or to helping the poorest and the most vulnerable. Possible instruments to accomplish these objectives could include taxes and transfers, but also guarantees, debt rescheduling, clearance of arrears, or the acquisition of assets and liabilities.

A statement of this sort would coordinate expectations, help economic agents adjust to the new environment and serve as a social compact on how to manage the crisis. But the statement should also be realistic on what is feasible. Lacking the deep pockets and the institutional capacity of advanced economies, the governments of developing countries may have to spell out clear priorities, and the sequence in which the commitments to socializing the losses will be honored.

4. Prevent a financial sector collapse

In past crises, when the financial sector experienced solvency problems, this further deepened job losses and the subsequent recovery was severely hampered. In financial crises both market infrastructures and the set of contracts that underpin the conduct of business come under stress. Many debtors are unable to service their obligations and call for renegotiations, or simply default. Lenders become uncertain about the financial health of their customers. Information asymmetries worsen and moral hazard becomes more prevalent, amplifying the consequences of the initial economic shock.

Protecting payment systems is essential to process rapidly disbursed relief payments, to mitigate the sharp decline in remittance flows, and to enable customers to transact even when physical interactions are limited. Money transfer operators may need to be supported, digital platforms enabled, and customer due diligence rules simplified.

Even with a well-functioning market infrastructure, governments have an important role to play as coordinators. Upfront blanket guarantees for bank deposits may help maintain the confidence of the public. As multiple obligations are bound to fall into arrears, processing debt renegotiations on a case-by-case basis will slow down the recovery and create perceptions of unfairness. To address this risk, out-of-court debt restructuring may need to be simplified, guidance on regulatory relief measures provided, and bank resolution frameworks strengthened.

More radical measures may be considered as well, depending on the severity of the crisis. Easing financial conditions and exercising regulatory forbearance might be necessary as long as conditions remain difficult. Three buckets of measures could be considered in this respect. The first could be implemented immediately and comprises using capital buffers or easing macroprudential measures. The second can be applied at the discretion of the supervisor and includes revised enforcement approaches, recognition of public credit guarantees, or a ban on dividends and share buybacks.

The third bucket includes extraordinary measures such as moratoria on credit repayments, an automatic extension of their maturity, a freeze of the classification status of credits, an extension of past-due days to be considered non performing, or more flexible provisioning requirements. These measures allow the real sector to preserve the cash flows to meet their ongoing activity; for banks they provide immediate relief as well as incentives to maintain or provide credit. However, measures in this third bucket should be approached with utmost caution given the risks they entail.

Finally, central banks and ministries of finance should get prepared to stabilize financial markets in the event of major disruption. This involves preparing crisis resolution frameworks that identify the measures needed to mitigate volatility and to handle disorderly market functioning. Advance clarity on how to preserve international reserves will be particularly important in this context.

5. Support jobs and firms

The standard advice in the presence of adverse shocks is: protect workers, not jobs. This advice is predicated on the grounds that most shocks affect specific firms, sectors, or locations, and allowing sectoral or spatial restructuring is bound to increase efficiency. In normal circumstances, protecting jobs slows down firm entry and exit and results in slower productivity growth. Protecting jobs through transfers may also operate as invitation for rent seeking and further undermine economic dynamism.

However, the standard advice does not hold when an economic shock affects the entire economy. Employer-employee matches that took a long time to build and would remain profitable when the economy goes back to normal may be permanently dissolved due to this temporary shock. Job-specific human capital may be lost and ramping up production later on may become more difficult.

Supporting jobs and firms is thus justified in the context of a major crisis like the current one. This is something that the stimulus packages adopted by several advanced economies explicitly envision, under the form of employment guarantees, wage subsidies, working capital finance, and balance sheet and debt service relief. However, implementing similar solutions is much more difficult in environments with low capacity, constrained resources and a high degree of informality.

In developing countries, support to jobs and firms will have to be based on a dual approach. A first track should be geared to important employers or exporters, those with significant backward and forward linkages or those in sectors such as logistics and utilities that enable other economic activities. Due

consideration should also be given to those firms that employ a larger share of women and socially disadvantaged groups.

Support for this first group of firms should be targeted to their circumstances. Instruments may include fiscal measures, including wage bill subsidies and the deferral of taxes and social security contributions. Access to subsidized loans, partial credit guarantees, and the provision of equity or quasi-equity could be effective as well. Support would be administered through the budget or through commercial banks that are adequately incentivized and protected to do so. It could also rely on dedicated recovery funds bundling financing from a range of domestic and international sources with public support leverage.

The second track would focus on smaller firms that cannot be efficiently reached through tailored approaches. For firms in this group, the goal would be to ensure the availability of finance in a context of mounting working capital needs. Support would be triaged by commercial banks, microfinance institutions, digital lending platforms, corporate supply chains or other intermediaries. Incentives such as portfolio risk-sharing and guarantees would need to be provided to these intermediaries to enable the socialization of potential losses.

An important question is whether support should be conditional on specific measures or behaviors by the beneficiaries. In some advanced economies support is linked to commitments to keep workers on the payroll and to caps on dividends and executive compensation. Compliance with such conditions would be more difficult to enforce in developing countries with low capacity. But it should be possible in the case of strategically important firms and sectors. And this kind of conditionality would contribute to the political viability of the support program.

6. Organize the management of assets.

To prevent a financial sector collapse and support jobs and firms, governments may need to transfer downside risk and losses to public balance sheets. Socializing the losses may require taking ownership stakes in financial sector institutions, through recapitalization, and in strategic employers. These moves will entail a change in the relationship between the public and the private sector, potentially leading to an implicit nationalization of important segments of the economy.

In countries with weak institutions, significant state ownership opens the door to political patronage, the distribution of favors, and potentially to corruption. Total or partial nationalization of important segments of the economy is bound to reduce competition and dynamism over time. The process of acquiring, managing and divesting assets may also be perceived as biased toward well-connected businesses and a gateway for personal gain. Such perception would be extremely damaging as it would undermine confidence in the government. It may also dissuade civic-minded policy makers from making decisions that are badly needed because of the personal consequences such decisions could have.

To address these risks, strong arrangements need to be put in place to manage the newly acquired assets at arms' length from politicians. These arrangements need to ensure transparency and accountability, perhaps under the form of sovereign wealth funds or asset management companies that build on the best examples from countries at similar development levels. Management skills from the private sector will need to be brought in, with reputable international partners contributing to the integrity of decisions.

In the medium term, the priority has to be the divestiture of state assets to the private sector. Individual cases will need to be reviewed, and balance sheet repair solutions designed. Benchmark-linked sales of

government shares in companies will have to be arranged. While this is not an immediate priority, government should communicate clearly on the direction of travel, establishing a timeline and setting up sunset clauses wherever appropriate.

7. Leverage global support

Many key economic policy decisions to address the crisis need to be made at the national level, but protecting global trade, international capital flows and policy coordination across countries will also be critically important. Concerted action is key for the overall policy response to be more than the sum of national-level measures. The largest economic powers and major international organizations have a central role to play in this respect. But national policy decisions also need to keep in mind the importance of preserving an open world.

Starting with international trade, it is understood that the movement of people across borders may need to be temporarily constrained, to constrain the spread of the epidemic. But borders should remain open to movements of goods and services, to international capital flows, and to remittances.

Most critically, a repeat of the food crisis of 2008-09 needs to be avoided. Individual countries could be tempted to curtail exports of food in order to keep domestic prices under control, but the cascading consequences of such decisions will make everybody worse off, as was the case a decade ago. The disruption of international supply chains could lead to a spike in prices, with devastating consequences for the poor. The logic is similar for the medical supplies that are needed to address the health emergency. Governments should commit to protecting international trade to contain these risks.

International cooperation will also be critically important to mobilize financial resources toward developing countries. There is a global dimension to the socialization of losses from the crisis, in addition to the domestic dimension. Multilateral organizations need to actively engage in the mobilization of financial resources in the form of fast-disbursing budget support, while the central banks of advanced countries should make foreign exchange available through swap lines with their counterparts in developing countries. These moves are critically important to ensure that developing countries have the fiscal and monetary space they need to implement their policy responses to the crisis.

Private sector resources should also be mobilized through risk-reduction initiatives, both to widen the resource base for recovery at a time when net private flows to developing countries have collapsed, and to add implementation capacity in weak administrative environments. Donor funds could be leveraged to arrange a large-scale pooling of risks, with a particular focus on the poorest countries where risks are perceived to be significant even in the best of times.

Standardized, rapidly replicable portfolio risk sharing or guarantee schemes could combine funding from multiple sources to support lending to small firms by banks and microfinance institutions. Multi-country funds with layered risk structures could leverage financial support from international financial institutions as well as private sources to support a revival of investment, and to strengthen or restructure corporate and bank balance sheets. Insurance products facilitated by international financial institutions could anchor capital optimization schemes. Partnerships with corporates that have large supply and distribution networks can provide alternative channels for reaching smaller enterprises where banking sectors have insufficient reach.

Finally, an important area where international cooperation could make a difference is the availability of medical supplies and the development of new tests, treatments and vaccines. At a time when countries are understandably giving priority to their own citizens, centralized procurement of ventilators and other critically important equipment could help developing countries organize their response. Advance purchase commitments could be used to encourage pharmaceutical firms to introduce innovations that benefit the entire world, even if developing countries do not have the means to pay for them. International cooperation could also be mobilized to transfer supplies and expertise across countries that are facing the outbreak of the Covid-19 epidemic at different points in time.

8. Link immediate response to sustainable recovery

The urgent task for the international community is to provide support, including liquidity, to developing countries as their health systems become overloaded, their tax revenues falter, jobs are lost and their ability to provide basic services is challenged. In the near term, budgetary support, lifelines for businesses and technical advice to governments will be the main priority. This is also the time to protect global trade, international financial flows and effective policy coordination across countries. In parallel, an effort is needed to ensure that the necessary medical supplies are available, and that the development of tests, treatments and vaccines is supported.

As assessments of the magnitude and nature of the damage are being produced, and economic policy responses are articulated, it would be premature to aim for strong policy commitments except those crucial to enabling the crisis response and unblocking the recovery. The experience of the East Asian crisis, when major reforms were adopted before being fully owned should serve as a cautionary tale. Eventually many of those reforms were undone, or implemented half-heartedly, and the relationship with the international community suffered as a result.

International financial institutions and bilateral donors should consider a two-phased approach. During the next three months, priority should go to support packages that create fiscal space to support the delivery of basic services, to protect the poor and the most vulnerable, and to safeguard firms and jobs. Advice should also address financial sector supervision and resilience. But while these packages and advice are being set up and delivered, a broader vision on how to respond to the crisis should be articulated, with ownership by developing country governments and support from the international community.

The agreed vision must go beyond addressing immediate crisis needs and draw out the path towards a vigorous and sustainable recovery. Any delay in “restarting” economies will be costly economically and in terms of livelihoods, but also in causing lasting damage to human capital and balance sheets, and therefore to future growth.

Many of the actions proposed above will help prepare the recovery. Supporting the poorest and the most vulnerable will help keep children in school and limit the risk of malnutrition. Protecting jobs and firms will preserve productive employer-employee matches and sectoral expertise. Managing the assets that may need to be acquired by governments in a professional and transparent way will preserve their profitability, and orderly divesting them will boost private sector dynamism. Seen this way, even the short-term response to the crisis will help kickstart the economy.

However, the preparation of the recovery phase should go farther than this. Countries should seek to reclaim their long-term agenda, including the Sustainable Development Goals. Jobs and economic transformation should be at the center of this forward-looking thinking. Redoubling investment in resilient

infrastructure and building human capital will have to be essential ingredients of this vision. Established priorities such as gender and climate, each with unmet economic potential, will present significant opportunities for inclusive and sustainable economic growth. The second phase of the crisis response should therefore build on the immediate response and focus on creating the policy and institutional conditions for this recovery to take hold.