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RECOVERING FROM THE PANDEMIC: AN APPRAISAL OF LESSONS LEARNED

Summary

The coronavirus pandemic has taken an enormous toll on lives, health, and the economy. Even though it continues, countries around the world are planning for the post-pandemic recovery.

This FEPS Covid Response Paper provides observations from the failures and successes around the world in dealing with Covid-19 and its economic aftermath.

Professor Stiglitz explains why, even with the best policies, the economic fall-out from Covid-19 is likely to be severe: there will not be a V-shaped recovery, but rather a U-shaped one. The real question is how deep the U will be, and how long it will take before a robust recovery.

The author reviews the priorities for the recovery packages and highlights the areas in which government intervention is crucial.

Lastly, Professor Stiglitz examines the latest developments of the European response to the pandemic and puts forward a set of recommendations to complete the recovery package.

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Recovering from the Pandemic: An Appraisal of Lessons Learned

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The coronavirus pandemic has taken an enormous toll on lives, health, and the economy. Even though it continues, countries around the world are planning for the post-pandemic recovery.

But the world won't have a robust recovery until the pandemic is brought under control – which means going beyond just a reduction in the number of deaths. There has to be confidence that there won't be a recurrence. At this point, without vaccines and still little knowledge about the therapeutics, there is just too much uncertainty. We could be lucky: The virus may evolve in ways that make it less contagious or less deadly; but it could also evolve in the opposite direction.

This FEPS Covid Response paper is divided into five sections. In the first, I make a series of observations from the failures and successes around the world in dealing with Covid-19 and its economic aftermath. In the second, I explain why, even with the best policies, the economic fallout from Covid-19 is likely to be severe: there will not be a V-shaped recovery, but rather a U-shaped one, and the real questions are, how deep the U will be and how long it will take before there's a robust recovery. In the third and fourth sections, I review the priorities for the economic packages for containing the damage and accelerating the recovery, as well as the areas in which government intervention is crucial. In the fifth, I discuss a set of special challenges and recommendations for Europe.

1. General Observations on Governing the Pandemic

Around the world, we see markedly different patterns, successes and failures in limiting both the spread of the disease and the adverse effects on the health of the population and the economy. The contrast between the US and Europe illustrates a different management of the crisis: while the pandemic started earlier in Europe, it has done a better job in controlling the disease, as reflected for instance in the lower "excess deaths." On this basis, there are a few general observations to be drawn and lessons to be learned for the post-pandemic world:

a) **Among the countries with the poorest responses are countries headed by authoritarian or would-be authoritarian figures, who pay insufficient attention to science and expertise**. These include Russia (Putin), Brazil (Bolsonaro), and the US (Trump). Conversely, among **the best responses have been those of countries like New Zealand, with dynamic leaders who have a respect for and understanding of science, and high levels of social cohesion**. Controlling a contagious disease requires affecting human behaviour. Like climate change, there are large *externalities*. The externalities here are in some ways more difficult to control – it's harder to affect behaviour by simple regulations (other than locking down the economy) or by price signals (taxes). But in countries with a high level of social cohesion, individuals understand the social value of social distancing, wearing masks, and other safety measures, and adjust their behaviour accordingly. In countries without that social cohesion or a leadership to explain the consequences of dangerous behaviours, citizens are more likely to continue practices that accelerate the spreading of the disease.

b) **Among the countries with the most adverse health and economic effects of Covid-19 are those with the poorest systems of social protection.** The United States illustrates this point. This disease is not an equal opportunity virus — it targets those with pre-existing health conditions more often than others. In a country like the US, with poor overall health (among the lowest life expectancies in the advanced countries) and high health inequalities – related in part to the high levels of income inequality and to the country's failure to recognise access to health care as a basic human right – it is not surprising that there is a high level of death; nor is it surprising that those deaths are concentrated disproportionately among the poor and people of colour. And indeed, many of those with low incomes have jobs that also put them at greater risk of exposure. Without unions to protect them, and with a government that pays little attention to their on-the-job safety and health, they go to work in conditions that make contagion more likely – without testing, without masks, without protective gear, even where such protections are obviously necessary. The consequence are virus hot spots like meat packing plants. With so many Americans living paycheck-to-paycheck and without paid sick leave, workers who are sick have little choice and go to work if they can.

c) **All countries turned to government – as they always do in times of disaster.** Collective action is required. But, unsurprisingly, countries where the government has been weakened as a result of four decades of denigrating the role of the state under the banner of neoliberalism were less capable of responding. The US again illustrates this. Under President Obama, government identified the threat of a pandemic. It was even viewed as a national security threat, with the establishment of a White House office for pandemics within the National Security Council. The Trump administration disbanded that office, and decreased funding for the Centers for Disease Control and Prevention (CDC), which had been the premier agency in dealing with contagious diseases. Overall, after decades in which the role of the public sector in the socio-economic sphere has been downgraded to "calming the markets" and ensuring fiscal consolidation, we experience now a sudden demand for government intervention at all levels. The pandemic has probably opened the eyes of some of those who had not learnt from the global financial crisis and the Eurozone crisis that the market alone won't allocate investment where it has the highest social return and that social spending and public infrastructures are strategic goods to ensure the wellbeing of our society.

d) **The private sector has once again shown its weaknesses**. The same kind of short-sighted behaviour that was manifest in the 2008 crisis has been in evidence again: We built an economy that was not resilient. We sold cars without spare tires – all well and good as long as a driver doesn't have a flat tire. In this case, the private sector once again disappointed even its advocates: it was unable to produce the masks, protective gear, tests, ventilators etc, that nations required. There were persistent shortages. An undiversified global supply chain based on just-in-time production showed its weaknesses. Cutting costs by a miniscule amount increased profits in the short run but made our economies more vulnerable. The private sector, however, paid scant attention to these future risks.

The private sector's short-sightedness was disturbing, as was its inhumanity, which, coupled with the distortions of the money-driven political system, have resulted in a dangerous outcome for public health. Everyone, including the US Congress, recognised that workers with Covid-19 should not go to work, expose others and endanger themselves. So Congress passed a mandatory sick leave provision – just for Covid-19. But the largest and most powerful firms strenuously objected, using their political heft to persuade lawmakers. The result was that companies with more than 500 employees were exempt, meaning nearly half of all workers, including some of those with very low pay, were denied paid leave, resulting, again, in virus hot spots like meat packing plants.

Once again, **the financial sector is among the sectors that has been the most disappointing**, particularly in the US. While the rest of the economy was put on hold, the financial sector continued its relentless collection of interest. Time didn't stop for them. The US government said it would not proceed with foreclosures on federally insured mortgages and would suspend for the moment payments on student loans. But the private sector didn't match these efforts. With usurious interest rates, fees for late payments, fees upon fees, many citizens will struggle to pay back what is owed when we emerge from the crisis. Many car owners will lose their cars – and in a country without good public transportation, this will have a disastrous effect on many lower income families.

e) **The problems are not just domestic, they are global.** Developing countries and emerging markets are being hit hard, both by the pandemic itself and by the economic aftermath. Exports are declining, capital is flowing out of these countries, the prices of many of the commodities they export are plummeting. The G-20 realised the potential tragedy in store and put a stay on the payment of official debt to the least developed countries. But again, the private sector didn't step up. Quite the contrary. So far, they were obdurate in their restructuring of Argentina's debt, demanding far more than what the IMF itself said was sustainable. **Again, we see the combination of short-sightedness and inhumanity**. It does neither the creditor nor the debtor any good to have a debt restructuring that is not sustainable, when another debt restructuring will be necessary in a few years' time. And this time, lives are clearly at stake in the debtor countries.

More broadly, there will either be orderly or disorderly debt restructurings. The countries simply don't have the foreign exchange to repay what is owed. Far better that it be done in an orderly way. In 2015, the UN passed with an overwhelming majority a set of principles to guide sovereign debt restructurings. Still, some of the big creditor countries demurred, and these principles have not been put into practice. The whole world may pay a high price.

2. Why this downturn may be long lasting

In the beginning, there was hope that there could be a quick V-shaped recovery – put the economy in the hospital for a few weeks, give it loving care and a lot of money and – magically – it would recover, picking up where it had left off. Many of the programs were designed with this view in mind: small payments now, small loan programs that would have to be repaid, enough to tide a person over during this short interlude. The scheduled date for leaving the hospital was June 1 – or at the latest a few weeks after that.

Already today, all of this seems fantasy: No one thinks that the world will be back to normal in the next few weeks – or even the next few months. Recent IMF forecasts suggest Europe and the United States may not even be back to where they were at the end of 2019 by the beginning of 2022. Some, however, still are more optimistic: they observe that the economy was fundamentally healthy before the pandemic, then the pandemic came as an exogenous shock to the system, but it will soon be put under control – or at least we will learn how to live with it – and once that happens, we will return to that golden pre-pandemic era.

1. First, however, **the economy was not really healthy before, on either side of the Atlantic**. Europe faced slow growth, particularly in the euro area. The boost to growth that the US tax bill of 2017 had provided was even more short-lived than many of its critics had thought. Growth was expected to be less than 2%. While unemployment in the US was low, there were many other signs of an unhealthy economy – not the least of which was the low and declining health of the population, reflected in a low and often declining life expectancy. Crucially, wages at the bottom were lower than they were sixty years ago, and median incomes were stagnating. Large parts of the population were suffering from hunger; and large parts depended on food stamps to survive – including many who were working full time.

   The crisis revealed a lot of the deficiencies and fragilities created by decades of minimal government intervention, erosion of the welfare state and supremacy of the market; especially fragilities related to income, health, and racial inequalities have emerged. I doubt that we can – and that we should – go back to the pre-pandemic world.

2. Secondly, **there is little reason to believe that the pandemic, at least at a global level, will be sufficiently under control to resume anything like normal life any time soon**. Until there are truly effective vaccines or therapeutics, there will be fear of a strong second (or third) wave. The continuing increase in cases in the US, Latin America, and elsewhere, make it clear that the pandemic is far from being under control.

3. Thirdly, **the pandemic has accelerated some changes that were already underway – and there will be large hysteresis effects from these changes. Economic systems can absorb slow changes but not rapid changes.** There was, for instance, an increase in online shopping, with layoffs of shop assistants and bankruptcy of some retailers as a consequence. Several jobs in this sector won't be coming back at the end of the emergency; and while some jobs will be created in on-line retail, they will not offset the lost jobs. There also was a retreat from hyper-globalisation in the years since the financial crisis; but the pandemic almost surely will accelerate this trend, with long-lasting effects.

Most fundamentally, **the crisis may induce a major structural change in the economy**, both in what is produced and consumed and how goods are produced, and those changes themselves are likely to reduce the demand especially for unskilled labour and hence to increase inequality.

1. First, **the pandemic has forced employers to realise that there is a *cost to labour* that hadn't been fully appreciated**: while computers can get viruses also, so far at least, there is greater confidence in our ability to control those viruses than human viruses. This may accelerate the transition towards robotisation, to human-replacing machines. And this, if not managed properly, will exacerbate the already unacceptable high levels of inequality.

2. Secondly, **the pandemic has revealed the *fragility of global supply chains* and, more broadly, the *lack of resilience of the economy***. Supply chains will have to be reconstructed – more diversification, more in-sourcing. And while in-sourcing itself potentially could be a source of increased employment, it is likely that much of the in-sourced manufacturing production will entail robotisation, with limited employment effects.

3. Thirdly, the nasty virus acts like a tax (the revenues of which are totally dissipated) on certain activities: those in which humans come in close contact with each other. This induces large changes in patterns of consumption and production – a kind of *structural transformation*. Both theory and history tell us that markets do not manage such transitions well on their own – and the onset of this transition has been so sudden and unanticipated that the challenge of adaptation will be even greater. There's no easy way of converting airline employees into Zoom-technicians, and besides, the expanding sectors are less labour intensive and more skill intensive.

Periods of structural change, like the movement from agriculture to manufacturing, not only pose great stress for those in the declining sector (the sector out of which labour is moving), but typically they create adverse effects throughout the economic system, as the decline in incomes in one sector reverberate in other sectors. While the other sectors may gain from "substitution effects," as the composition of demand shifts, these substitution effects may be overwhelmed by adverse income effects, from the decline in incomes in the declining sector, compounded by decreases in aggregate demand that arise from increases in inequality.

These “structural Keynesian” effects are likely, in this pandemic, to be compounded by three others: beyond the *bankruptcies* with the associated large losses of organisational and informational capital, *balance sheets of households and firms have been weakened* if not eviscerated, and inevitably that will mean less consumption and investment.
Moreover, the pandemic has introduced a high level of uncertainty – even more so in countries that haven’t managed the pandemic and its economic fallout. In the midst of the Great Depression, US President Franklin Roosevelt famously said in his first inaugural address, “the only thing we have to fear is... fear itself.” In this pandemic, we have a dangerous virus to fear. We have an economic meltdown to fear. We have political, racial, and economic divides to fear.

In some countries, the underlying uncertainties associated with the disease have been compounded by uncertainties in policy: in the US, the Republicans have refused to commit even to temporary federal support for unemployment insurance to continue so long as unemployment remains elevated – the kind of assurance that was provided in the 2008 crisis. In Europe, a begrudging commitment to issue euro bonds to support the recovery has been and still is accompanied by infighting about its distribution, about whether the money should be provided as loans or grants, and the terms of the provision of assistance.

Throughout the world, there is anxiety about whether the kind of assistance that has been provided so far will be sustained – or whether it is even sustainable.

The consequence of this uncertainty will be *more precautionary behaviour.* While there may be higher spending on a short-list of goods that make us feel safer, at the aggregate level there will be less spending, be it by households on consumption, be it by firms on investment. Both will “hoard” their cash as a protection against even rainier days in the future. More generally, they will strive to maintain the options by avoiding commitments, including those associated with hiring new workers. Thus, unemployment is likely to rise.

This pervasive uncertainty will compound the challenge of adapting to the needed structural changes. Ideally, the shifts in production and demand described earlier would be met by new investments, especially in the expanding sectors. But few companies will be able and willing to invest right away in new models of production and distribution; they will wait to see how the pandemic and its economic aftermath plays out. Even firms with healthy balance sheets will show a hesitancy to make investments until there is greater clarity about the disease and the economy.

In some ways, the timing of the pandemic couldn’t have been worse. A dozen years of near zero interest rates had induced a large fraction of the corporate sector to take on high levels of debt. In the US, some firms even undertook debt in order to pay dividends and buyback shares. Private equity firms had, of course, long used high levels of debt as a core part of their business model – putting at risk the survival of many of the firms that they helped “restructure.” High levels of debt introduce a high level of fragility into the corporate sector: it makes firms unable to withstand a shock, and the pandemic represented a very large shock. And even if they don't go bankrupt, it puts them in a poor position to respond because they won't be able or willing to undertake new investments. Additional debt would make their future even more precarious – if they could find lenders willing to lend to them — and this is hardly a time to raise new equity, even by firms whose balance sheets are in relatively good shape.

All of this means that even as the pandemic comes under control and the lockdowns are eased, there will not be a quick return to a strong economy. And there will not be a strong recovery by the private sector until the underlying uncertainties are resolved.

3. Lessons from the successes and failures

As Covid-19 has struck countries across the world, some have been much more successful than others, both in containing the disease and in protecting the economy and the citizens within it. There are several common strands that differentiate the more successful countries from the rest.

The first is that they relied on the best science and experts. Of course, there is inevitably some disagreement among experts. But what is remarkable is the extent of *agreement.* There are well-known and accepted models of epidemiology, and while there was much about this disease that was (and remains) unknown, these models gave a strong warning of the risks posed by the disease. Countries that responded to those warnings did better. Those where the leadership was ignorant of science or disregarded it have suffered. This is true for economics too: notions that one should just rely on markets are particularly inappropriate when the driving force is an externality. Economists who talk about "expansionary contractions" and who advocate austerity haven't learned the lessons of the euro crisis and the multiple other crises over the past century. Nor have those economists who talk about the economy quickly recovering *on its own* without government support.

The second is recognising the enormous uncertainties surrounding the pandemic itself and its impact on the economy: even with the best of expertise, there is much that is not known, much to be learned, and plans have to be designed recognising these fundamental uncertainties. Governments that don't inform their citizens of the uncertainties and risks that lie ahead are doing them a disservice.

Third, studies show the damaging effects of misinformation and disinformation, spread especially by social media. Over the past decade, there is increasing awareness of the harms that insufficiently regulated social media can impose, and this new episode has, unfortunately, added to that. There is need for stronger regulation that protects basic freedoms.

Fourth, because the externalities associated with the pandemic are so difficult to control – apart from strong measures such as government lockdowns – *social cohesion* is critical. When individuals respect their fellow citizens (and understand the basics of science), they are more likely to take actions like social distancing and wearing masks that are essential in the control of the pandemic.

Fifth, we've seen the critical role of *trust*. In countries where there is trust in government, citizens respond more strongly to the warnings and admonitions of government. In the US, there is (for good reason) neither trust in government nor in the private sector. With a notoriously mendacious president, no one takes anything he says at face value. With a private sector without moral scruples, no one can trust a company that claims to have an effective test: it has to be verified. In a well-functioning society, the government would provide that verification. But, as we've noted, forty years of undermining the government has resulted in the government agencies responsible for such verification losing their credibility.

Sixth, there has to be a commitment that the government will continue to support the economy – that the assistance being provided will be sustained. In the absence of such a commitment, and in the absence of trust that the government will fulfil that commitment, the restoration of confidence, necessary for a quick and sustained recovery, is impossible.

Finally, successful programs were designed with an eye on *implementability*, an awareness of the difficulties, for instance, of distributing large amounts of money in a short period of time, to those who were supposed to get assistance. What works in one country may not work in others. Some countries, even in the emerging markets, have shown that they can distribute funds in just a few days. The US is at the other extreme: the Trump administration has said that distributing funds to the poorest individuals – those so poor that they didn't have to file tax returns in 2019 or 2020 – may take months. The administration seems to care little about how these people will survive until then.

Some of Europe's structural and cohesion funds are also not particularly acclaimed for their prompt implementation. And even the promising Next Generation EU proposal by the European Commission is weak when it comes to its potential impact in 2020, with the majority of funds available only at a later stage. Linking this new stimulus to the EU budget has its advantages but, in the midst of the pandemic, timeliness is crucial. Special arrangements shall be made for a prompt and timely use of the funds. It is a general rule that the sooner the public sector kicks in with a stimulus, the lower the overall expenditure required to tame the downturn. And as noted before: the longer the downturn and the greater the damage to balance sheets, the more firms go bankrupt.

These ingredients of successful actions are, of course, interrelated. When there is more social cohesion, citizens are more likely to trust that government programs will be sustained as long as necessary. It will be hard to sustain programs that are perceived to be unfair in either their design or implementation. It is also hard to sustain programs that are perceived to have been incompetently administered. Both reinforce the point made earlier, that it's important to have a competent state with a strong system of social protection perceived as reflecting the interests of all citizens, *before* a crisis hits.

The discrediting of the Covid-19 program in the US has economic and political ramifications there, but a slow recovery in the US will have consequences for Europe, too. While the US has spent a large amount of money, it has been like a fire hose, spraying dollars around without making sure they get to where they are most needed. Those who received money were not those who needed it the most, or who deserved it the most, but those who had the best lobbyists – large corporations that had insufficient capital buffers because they had massive share buybacks, and that were the beneficiaries of large tax cuts in 2017, were clearly among the "undeserving" to get funds. To a large extent, large NGO's, research institutions, and universities and colleges didn't get the aid they needed.

These failures help explain the ineffectiveness of the US program (though it did help stave off the increase in poverty that would have otherwise resulted, and without government assistance the downturn would have been far deeper and the recovery even slower); but they bode ill for the political sustainability of Covid-19 programs, and if they are not sustained, the trillions spent will prove to be just temporary palliatives.

Some countries have been marred by high levels of inequalities in income, wealth, and health, and economic inequalities have been translated into political inequalities. This shapes the lens through which the failures in the Covid-19 programs are seen – for instance, the disproportionate amounts of money intended for small businesses that went to the well-off and well-connected; the failure of government to insist that all businesses—including the powerful, large corporations—provide paid sick leave; and the failure of government agencies responsible to ensure a safe and healthy workplace to insist that employers even provide masks and protective gear where appropriate.

Matters may well get worse. The divisions between the well-performing societies with high degrees of social cohesion and the others may increase. Large distributive battles may emerge in the next few years. Covid-19 itself has been an adverse "supply shock," with most severe impacts affecting those citizens at the bottom.

The US Congressional Budget Office has revised downwards its outlook for the annual real GDP in 2030 which is now 3.4% lower than projected in January.[1] This kind of a loss will require adjustments in policies, with the incomes of many differing markedly from what was expected before the pandemic. And if, in addition, something is to be done about the glaring income, health, racial and ethnic inequalities that have been exposed in some countries, the adjustments will have to be even larger.

Moments with such huge adjustments are moments of intense distributive conflict—standards of living of at least some citizens will have to decrease. We should anticipate them and be prepared that they may take hidden forms accompanied by disingenuous and specious arguments (for example, to enhance growth there have to be more tax cuts for corporations and the rich).

[1] See CBO (2020), An Update on the Economic Outlook: 2020 to 2030, July 2020

4. The Critical Role of Government Policy

The discussion in previous sections has made clear that the extent of the mid- and long-term effects of this pandemic on our society depends greatly on government policy. The better the government succeeds in controlling the pandemic, the less the pandemic-induced fear. The sounder the counter-cyclical intervention, the sooner the recession will end. Iceland and New Zealand are examples of countries that have done an exemplary job.

This crisis is markedly different from the 2008 global financial crisis, the Great Depression or the euro crisis. But there are lessons to be learned from the failures and successes of government policies in those instances; most importantly, whatever the origins of the "shock" experienced by the economy, unless there is effective government intervention, the combination of balance sheet effects, bankruptcies, and induced precautionary behaviour can give rise to a downward vicious circle.

There should be a clear set of priorities, objectives, and constraints in the formulation of government policy:[2]

(a) **The first priority is to ensure health and save lives.**

Not only should this be an objective on its own, but unless we succeed in this, we won't succeed in restoring the economy. This means adequate funding of hospitals, ensuring the provision of masks, protective gear, and tests and tracing. It also entails maintaining the overall health system, which will be challenged by the demands of Covid-19. We can't rely on the market. As we have already seen in many countries, including the US, the market was not even up to the task of supplying a simple product like masks, let alone more complex items like ventilators.

(b) **The next priority is to protect the vulnerable.**

This will be easier in countries that already have a good system of social protection in place and, more broadly, have strengthened public competencies, e.g. through better digital communication systems with their citizens. Unfortunately, in recent decades, under the influence of neo-liberalism, the welfare state has been weakened in many countries, making these countries ill-prepared for the onslaught presented by Covid-19.[3]

In the European Union, the new EU policy called SURE does cover income support to those who see their jobs put on temporary hold, but an EU-wide effort to secure decent living standards for most of the unemployed and those with precarious contracts is still lacking. Over the next few months, increases in unemployment are to be expected. As in the euro crisis, the countries most afflicted are the countries with the least fiscal space to respond. Europe needs to provide

[2] For a further elaboration on some of these points, see J. E. Stiglitz, Four Priorities for Pandemic Relief Efforts, Roosevelt Institute, April 2020.

[3] See J. E. Stiglitz with Carter Dougherty and The Foundation of Progressive Studies, *Rewriting the Rules of the European Economy: An Agenda for Growth and Shared Prosperity,* New York: W.W. Norton, 2020. Published by the Foundation for European Progressive Studies in Brussels in 2019 and in New York by W. W. Norton in 2020.

fiscal transfers to ensure that those households where earners have lost their jobs receive the support they need.

Income support policies makes sense from both a social and an economic point of view. Europe has already spent years debating the adoption of a re-insurance scheme for unemployment benefits. The time has come for Europe to implement such a program, to ensure that the drop in aggregate demand and consumption levels is minimised.

But the agenda to protect the vulnerable is more complex than just supporting unemployment insurance systems. Government should, for instance, extend these systems to workers which are traditionally not covered, providing health care to the self-employed and small business owners who have seen their incomes plummet.

In many countries, the unemployment insurance systems are not particularly well suited for addressing the unemployment resulting from the pandemic. Benefits are limited, both in duration and in amount, and there are strong requirements concerning job-search. These restrictions make little sense in the current context and need to be at least temporarily lifted. The amounts paid need to be increased to mitigate the suffering, and the duration of benefits should be extended at least for the duration of the pandemic and the associated economic downturn. Europe has so far been successful in avoiding the surge of unemployment that has marked the pandemic in the United States. This is partly because of stronger labour protections, but mostly because of better-designed policies. The US spent far more money for the program intended to keep workers linked with their employers with far poorer results. But if the pandemic-generated downturn is as deep and prolonged as the IMF suggests it may be, Europe could confront a surge in unemployment too, unless such programs are extended and deepened.

(c) The management of aggregate demand is crucial.

As stated above, if policymakers want to minimise the depth and duration of the economic downturn and favour a quick recovery, the management of aggregate demand has to be a priority.

Failure to do so is the key reason that in many countries the euro crisis was as deep and as long-lasting as it was. There are many aspects of ensuring adequate aggregate demand: these include programs that make sure the private sector is able and willing to spend, and that public expenditure programs fill the gap between private spending and what is required. Monetary policy will play a very limited role.

Perhaps calling the early government interventions “stimulus programs” was a misnomer, as the problem is the Covid-19 virus, not a lack of adequate demand. But as I argued earlier, we can expect that once the pandemic is under control there will still be a serious problem of insufficient adequate demand. Then, there will be a need to provide stimulus in a timely and targeted way. Resources are scarce, and with looming budget deficits (discussed below) there will be pressure to contain spending. So it is imperative that spending be targeted at areas with high multipliers. Resources also need to do “double duty,” to help the economy through the structural transformations that it has been going through – towards a green, knowledge-based economy, with greater equality – as well as the transformation imposed by Covid-19. Such spending includes green, labour-intensive investments. While large infrastructure programs typically take years to design and implement, "green investments" – for example in solar panels and renovations of buildings to increase energy-efficiency – can be designed and implemented quickly.[4] The same is true for many types of social investments and social infrastructure, such as kindergartens, schools, and youth, community and healthcare centres.

The more the government precisely targets assistance to prevent bankruptcies and the evisceration of balance sheets, the stronger the recovery (in the US, the administration of funds intended to save small businesses was in many ways perverse: using the banks as the intermediaries in providing funds to small businesses meant that the banks' best customers – the wealthy and well-connected – got first dibs).

d) Government programs should be designed to contain excesses of precautionary behaviour.

Since precautionary behaviour will be persistent and pervasive, at least among corporations and higher-income individuals, governments should think of ways to reduce the risks faced by enterprises and individuals. Governments need to take the responsibility of insuring against macroeconomic risks (that the economy will be weak for a prolonged period of time, for example, either because of a failure to get the pandemic under control or of insufficient government support for a recovery) by providing insurance against the risk that the economy doesn't recover in a timely way. Economists have long talked about such insurance – called "Arrow-Debreu securities" in honour of the two Nobel-winning economists who demonstrated that these kinds of securities were needed for economic efficiency. The reduction of risk will encourage both consumption and investment. For example, a household might receive a government guarantee that, should it borrow money to buy a car, it could interrupt the monthly reimbursements if the pandemic returns to a pre-determined level or if the family experiences unemployment. Income-contingent loans and mortgages could be used to encourage the purchase of other consumer durables, including housing. This "insurance" is not available to individuals. For instance, few states and regions have offered these risk-absorbing instruments to home buyers; even mortgage flexibility – allowing for a postponement of payments should the downturn deepen, the pandemic persist or the individual lose his job– could make a big difference. These instruments have long been discussed; now is the time to introduce them. Given the high level of uncertainty, the economy may face an extreme example of what John Maynard Keynes talked about in the Great Depression – a liquidity trap, where people hoard cash as security against an unknown future.

[4] Cameron Hepburn, Brian O'Callaghan, Nicholas Stern, Joseph Stiglitz and Dimitri Zenghelis in their paper in the *Oxford Review of Economic Policy,* "Will COVID-19 fiscal recovery packages accelerate or retard progress on climate change?" point out that there exists an array of green investments that are both timely, labor intensive, and have high multipliers.

Governments may also consider issuing vouchers to stimulate household spending. China is already doing this at the local level, with local governments in 50 cities issuing digital coupons that allow residents to buy goods and services they need. These coupons come with expiry dates, making them particularly effective in stimulating aggregate demand in the short run, when and where it is needed.

e) A shock like Covid-19 puts great strains on the liquidity of firms.

Companies whose cash flow has been eviscerated won't be able to pay their bills. In some cases, there is a real threat of insolvency: companies that had borrowed too much owe more than they *ever* will be able to repay. For these companies, there should be an orderly debt restructuring, of the kind provided by bankruptcy laws. But, as we saw in the East Asia crisis, standard bankruptcy laws are not up to the task of dealing with systemic bankruptcy, where firm A owes money to B who owes money to C, who, in turn, may owe money to A. Whether B can pay C depends on whether C pays A, so that A can pay B. Analytically, there is a complex set of simultaneous equations that have to be solved[5]. Practically, what we need is a *systemic* bankruptcy law, what Marcus Miller and I have referred to as a Super-Chapter 11 (Chapter 11 is the provision of the US bankruptcy code that provides for a quick and orderly debt restructuring.)[6]

The distinction between insolvency and illiquidity has long played an important role in central bank policy. Central banks were supposed to be a lender of last resort to banks who were illiquid but not insolvent. In terms of standard economic theory, the distinction was always more than a little obscure. If everyone in the market believed the bank was solvent, it wouldn't be illiquid – others would be willing to lend at reasonable interest rates. The fact of the matter is that the owners of the bank typically believe the bank is solvent, but the rest of the market doesn't, or isn't at least convinced that that is the case; and the owners – who normally are the strongest advocates of markets and market rationality – then appeal to a temporary aberration of market irrationality. The point is more general: Whenever an enterprise claims that it is solvent but illiquid and needs temporary liquidity support, it is appealing to the government to go against market sentiment. There are two implications: There is enormous opportunity for abuse, as the government (and

[5] See Tarik Roukny, Stefano Battiston and J. E. Stiglitz, 2018 "Interconnectedness as a Source of Uncertainty in Systemic Risk", *Journal of Financial Stability,* Vol. 35, pp. 93-106.

[6] See J. E. Stiglitz, Bankruptcy Laws: Basic Economic Principles," *Resolution of Financial Distress: An International Perspective on the Design of Bankruptcy Laws*, S. Claessens, S. Djankov, and A. Mody, eds., Washington, DC: World Bank, 2001, pp. 1-23; "Some Elementary Principles of Bankruptcy," *Governance, Equity and Global Markets: Proceedings from the Annual Bank Conference on Development Economics in Europe, June 1999,* Conseil d'Analyse economique, Paris, 2000, pp. 605-620; Marcus Miller and J. E. Stiglitz, "Leverage and Asset Bubbles: Averting Armageddon with Chapter 11?" *Economic Journal*, 120(544), May 2010, pp. 500-518; and Marcus Miller and J. E. Stiglitz, "Bankruptcy protection against macroeconomic shocks: the case for a 'super chapter 11'," World Bank Conference on Capital Flows, Financial Crises, and Policies, April 15, 1999.

the central bank) decides which firms will live and which firms will die; and given these risks, more political accountability is necessary.

Most countries recognised that there would be strains in the business sector, and central banks have provided unprecedented liquidity support – going so far in the US as to even provide support for the junk bond market. But too little has been done for households.

Fiscal and monetary authorities have failed to adequately note the difference between publicly listed companies and others. In the former case, typically, bankruptcy does not result in the destruction of assets. It is only a restructuring of ownership claims, with shareholders taking losses and bondholders becoming the new shareholders. Shareholders typically get well compensated for the risks they bear – there is no reason to bail them out, particularly since, in many cases, they brought this partly on themselves by having insufficient capital buffers, by paying out excessive amounts in dividends and share buybacks. But in all cases, if the public is to provide funds – and to take the downside risk that they may not be paid back – they should get some of the upside. There is a compelling case for government to take warrants or equity stakes in firms, which would at the same time reduce the risk of leaving firms with an excessive debt burden that can distort their behaviour. Moreover, when private firms get such public assistance, it should be accompanied by conditionalities–ensuring that the firm acts in a socially responsible way, paying livable wages, using green technologies, and not engaging in a variety of exploitive practices.

f) **Funds should be provided in a way to steer the economy towards the kind of post-pandemic economy we would like –** a greener economy, a more resilient economy, a more knowledge-based economy, and an economy marked by greater equality.

Never has the government intervened in the economy (outside of war time) at such massive scale. But despite the massiveness of the spending, little thought was given to the kind of economy we wanted to emerge at the other side. Strong support, for instance, should be given to universities and research centres, whose sources of revenues have been devastated and have been underfunded for years. Europe should be especially careful not to let tight budget constraints in the aftermath of the pandemic lead to underfunding these critical institutions. Despite some empty claims about becoming a "knowledge economy", very little of the pandemic money went to those knowledge institutions. Indeed, the knowledge sectors received disproportionately less support, even though these sectors were among the most vulnerable to the impact of a Covid-19 downturn, especially in countries where there is a reliance on tuition, including from foreign students.

We are moving to a service sector economy, in which health, education, and caring for the aged are central; government finance for these services is critical. As noted earlier, when money is provided, it should be accompanied with conditionalities, concerning governance, treatment of workers and the environment. A few countries have done this, most have not.

g) **The direct role of monetary policy is limited in this recovery –** but it still has a crucial relevance in securing Europe's stability and, for the US in particular, attention should be paid to conduct and governance behaviour.

Two points on this:

a. Limited scope

Because of the reluctance of governments to take the needed fiscal measures, the burden of maintaining the economy at full employment has been put on monetary authorities. This has distorted the economy, contributed to increasing wealth inequality (since the super-low interest rates have been of disproportionate benefit to the rich), and enhanced instability (as the super-low interest rates helped fuel credit bubbles). After the 2008 crisis, monetary policy may have helped save the financial system, but it contributed little to the resuscitation of the economy. It clearly didn't suffice to restore prosperity quickly on either side of the Atlantic. Negative interest rates and quantitative easing at most prevented things from getting worse There are reasons to believe that negative interest rates, at least in some circumstances, may have made matters worse.

But in this pandemic, monetary policy is likely to be particularly ineffective, partly because interest rates are already so low, partly because levels of debt are already so high. Liquidity, as we noted above, can't solve solvency issues. Moreover, if our analysis is correct, interest rates are likely to remain low. As a consequence, the scope for monetary policy as part of a countercyclical macro policy will be very limited in the foreseeable future.

In Europe, though, monetary policy has a specific indirect effect that should not be underestimated. Given the peculiar structure of the EU, with a single monetary policy but several national treasuries, the policy and the attitude of the ECB are essential to avoid a second sovereign debt crisis. In a sense, monetary policy at the EU level has enabled fiscal policy at the national level to work. The liquidity measures implemented so far are of a temporary nature and are also limited – if compared to FED's ones – but markets need to be reassured that there are commitments and means towards guaranteeing the sustainability of the unavoidable national debt that will be generated to absorb the shock and relaunch the economy. Absent such commitments, Europe risks another sovereign debt crisis, which could plunge at least part of the EU into a deep downturn. The sooner Europe realises that securing the public sector(s) across the EU is in the interest of the whole European public, the better.

The concern is not just that there may be a lack of commitment; there are also constraints. But there are in fact multiple constraints on the ECB's ability to do so – whether these constraints will be binding has yet to be seen. In the past, the ECB has said that it would not buy more than one-third of any country's available bonds and would buy those assets in proportion to the size of the country's economy. If the ECB cannot buy big amounts of Italian or Spanish bonds, those countries can hardly do deficit spending, certainly not at a reasonable cost. **In particular, in order to ensure the stability of the Eurozone, in a context of expanding public debts, the ECB new purchase programme cannot remain limited in time and scope.**

b. Central banks' mandate and governance

In the US, the Federal Reserve has taken an active role in countering the economic effects of the pandemic, with a broad range of interventions providing liquidity to markets that seemed at the point of becoming dysfunctional, lending to a wide array of firms, and supporting sagging bond prices, even for junk bonds. While, as in Europe, there is a charade that the central bank does not lend money directly to the government, it is clear that that is precisely what has been happening. The Fed's balance sheet has expanded enormously, increasing in a few weeks as much as it did during the years of the financial crisis.

While the mandate of the ECB is markedly different from the Fed's – its focus is supposed to be on inflation, which is not yet a problem – its actions are similar, though its balance sheet has not expanded anywhere near the extent to which the Fed's has. The narrowness of the ECB's mandate has been questioned, as the problem of high inflation, paramount at the time of ECB's founding, has faded and as other macroeconomic problems have moved to the centre. It's now clear that ensuring low inflation and low debt and deficits is neither necessary nor sufficient for ensuring stability or growth.

With circumscribed EU budgets, the ECB plays a critical role in sustaining EU-wide economic growth. But as we have already noted, under current circumstances, the ECB's ability to do that is limited, especially with interest rates already near zero.[7]

Some worry that broadening the mandate of central banks—having them take an active role in providing funds to the private sector and buying government debts—will compromise central bank independence. Central bank independence has, I believe, always been pushed too far. In the 2008 crisis, many central banks that were de jure less independent performed better – the so-called independent banks were unduly "captured" by the financial sector. Even when not captured through flawed governance arrangements (as in the US), central banks are often cognitively captured.

As the former governor of the Reserve Bank of India, V. J. Reddy, has emphasised, what is important is not so much independence but institutional integrity and professionalism. Paul Volcker, the late distinguished chair of the Federal Reserve, put it forcefully when he said, "Congress created us. Congress can uncreate us."

But, of course, the more that the central bank gets involved in micro-economic allocations, the more politically accountable it has to be. It did so in the 2008 crisis, when it bought commercial paper and mortgage-backed securities. The former gave large enterprises access to credit at far more favourable terms than small businesses. It tilted the balance, in a way that almost surely would have been questioned within a more transparent political process. Matters may even be worse when, as in the United States, the central bank subcontracts the management of these programs to a private financial institution. The possible conflicts of interest are obvious.

[7] We say nothing about the German Court's rulings concerning what actions the ECB can undertake. It should be obvious that the EU's ability to function will be greatly impaired if national courts can override rules of the European Union.

There is one more disturbing aspect of the US interventions: it is in effect bailing out, once again, some in the private sector for reckless decisions, e.g. concerning the size of their indebtedness. Such bailouts create a moral hazard problem: firms can assume that even if they issue excess debt, there are big and important contingencies where their reckless behaviour would have big consequences, from which they will be saved. In Europe, there is little debate on the ECB asset purchase programme for private securities, though the moral hazard problem is emphasized with respect to the possible bailout of member states.

5. Europe's Still Incomplete Response

Parts of Europe were hit early and hard by Covid-19. By now, the disease has spread to most parts of the continent and has affected every economy.

When the euro was founded, there was much concern about what would happen if there were an asymmetric shock affecting one country much more than other countries. The euro had taken away two of the critical adjustment mechanisms – the exchange rate and the interest rate – and not only hadn't put anything in their places, but the EU imposed an additional fiscal constraint to the Stability and Growth Pact with the fiscal compact, further circumscribing the ability of Member States to employ countercyclical measures, and to carry out fiscal and therefore industrial, innovation and investment policy.[8]

Maybe because this Covid-19 crisis is exogenous and more symmetric than the one presented by the 2008 financial crisis, the EU Member States have been able to provide a response that is more solid than the temporary liquidity that the ECB provides with the pandemic emergency purchase programme. What the ECB is doing is indeed crucial. As mentioned in the previous section, it allows for fiscal policy at the national level.

Now, Europe is launching a combination of measures that together almost double the financial firepower of the Union. The freshly created Next Generation EU fund, consisting of €750billion in grants and loans, is complemented by the so-called 'SURE program' (temporary Support to mitigate Unemployment Risks in an Emergency) for loans to Member States to cover short-time work schemes, and by a dedicated credit line via the European Stability Mechanism for financing direct and indirect healthcare-, cure- and prevention-related costs due to the COVID-19 crisis.[9] In addition, the European Investment Bank has announced an emergency support package for small- and medium-sized enterprises of up to €200 billion.

On the positive side, the design of the European recovery packages seems much more thoughtful than the US's, with more of a vision of the kind of post-pandemic economy that Europe seeks. In particular, the EU has understood that the

[8] See FEPS Report "[Rewriting the Rules of the European Economy]()".

[9] The credit lines are designed to be a protection or insurance and are limited in size to 2% of the country's 2019 GDP. Should all 19 euro area countries draw from the credit line, this would amount to a combined volume of around €240 billion. Countries taking up the credit line will be subject to what is referred to as "enhanced surveillance" by the European Commission.

European Green Deal and green investment is a key and necessary component of the recovery.

On the other hand, the debate within Europe about how to provide assistance has been somehow disturbing. With so many of the most-afflicted countries already overburdened by debt, the answer to the question of how much of the money should be given in the form of grants rather than loans should have been obvious. The political compromise showed less solidarity than one might have hoped.

If the opening to joint borrowing is a good step forward, the rebates requested by countries and the curtailment of community programmes (Just Transition Fund, Horizon Europe, InvestEU, EU4Health) in favour of nationally determined measures (Recovery and Resilient Facility) speak volumes about the inability to perceive the value of European-wide action, besides the cold account of money given by the EU.

There needs to be more solidarity among European countries and more trust for common institutions. **Even in this emergency, with the creation of the Next Generation EU, the European budget has been temporarily expanded to only a little less than 2% of the EU GDP. In the US, by contrast, the federal budget is 21% of the US GDP.**

As I said in my book, *The Euro,* **there cannot be an effective Union unless, at least to some extent, Europe becomes a transfer union, i.e. there have to be funds for internal redistribution and adjustments**. There is no other way for a common currency area experiencing different shocks (as in the current case, how they have been affected by the pandemic, and more generally, with asynchronous business cycles), with different economic structures, resulting in different responses even to the same shock, limited flexibility in their adjustment processes, and limited and differential capacities to cope with the consequences of various shocks.

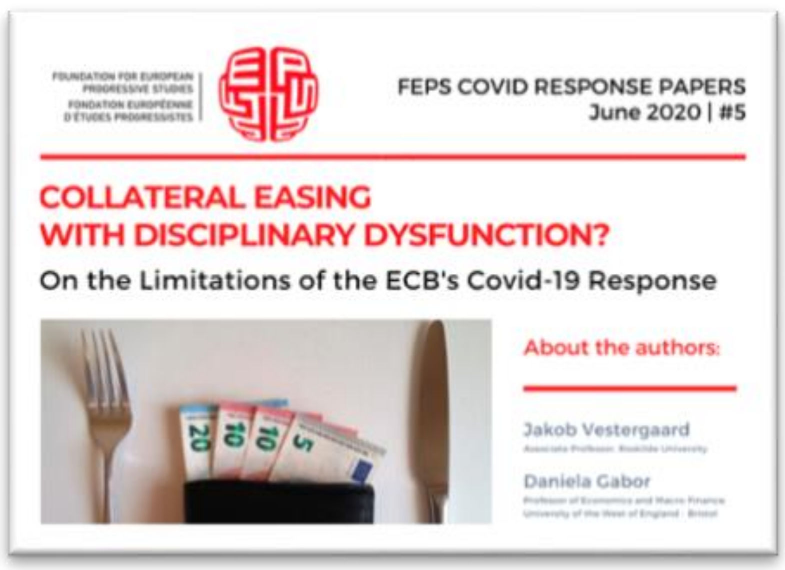
On top of expanding the firepower of the ECB permanently and increasing the transfers related to the EU budget, two other sets of policies will be required to complete the response to the pandemic.

First, **an expansion of the income support scheme to the unemployed and people with precarious work contracts,** perhaps with an expansion of the SURE programme or a fully-fledged EU-wide unemployment benefit scheme. Such an income support scheme is essential to maintaining aggregate demand, and as mentioned earlier, sustaining the aggregate demand is a necessary strategy for a prompt recovery.

Second, **Europe needs a new set of fiscal rules that are better able to address downturns and recessions**. The approach towards investment has changed in Europe and it is now time to formalise this new vision into new rules that do not restrict such productive public spending.

In many ways, the future of Europe and the European project depends on how Europe responds, collectively, to Covid-19. The approval of the 750 billion Euro fund is an important first step. But it is just that—the first step.

FEPS COVID RESPONSE PAPERS & WEBINARS



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