

# Economic responses to COVID-19: “Extraordinary times call for extraordinary measures”

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The current focus of tackling COVID-19 is, rightly, on minimising the human cost of the pandemic, but the economic cost is also clearly substantial. As noted in a recent piece by Milliman Principal Fred Vosvenieks, “Coronavirus: Staying Ahead of the Risk,”<sup>1</sup> hopes of a V-shaped recovery look increasingly unrealistic.

To date the focus of economic responses has been on short-term measures, many of which might have been dismissed as unrealistic or unaffordable before this crisis began. For example, on the monetary side, substantial new quantitative easing (QE) programs are aimed at commercial borrowing<sup>2</sup> and state loans or credit guarantees for companies. Fiscally, support has been targeted to those who have lost, or would otherwise have lost, their jobs and/or income.<sup>3</sup>

The cost of this support is likely to be substantial. The Institute for Fiscal Studies has estimated<sup>4</sup> the cost of measures already announced in the UK will exceed the total fiscal support provided in the 2007-2010 global financial crisis and that this cost is likely to rise sharply.

In the medium-term to longer-term, further measures will likely be needed to help the economy recover from what the Managing Director of the International Monetary Fund recently described as “the worst economic fallout since the Great Depression.”<sup>5</sup> Recovery prospects are further challenged, because, as respected policymakers have been warning for some time, conventional and even unconventional monetary tools (such as QE) were already close to the limits of their effectiveness prior to the current COVID-19 crisis.<sup>6</sup>

Central banks are often referred to as lenders of last resort, but, as Martin Wolf, chief economics commentator at the Financial Times, has argued,<sup>7</sup> in a deep supply and demand shock such as this, governments may have to become both the borrower and spender of last resort.

Hence, fiscal and monetary frameworks that only two months ago would have been regarded as highly heterodox are now under serious consideration.

The purpose of this article is not to argue for any particular solution but rather to give an overview of some of the possible tools under consideration and to provide references for further reading.

## Extending the current monetary tool kit

In a speech on 9 January 2020, “A Framework for All Seasons,” given at a Bank of England Workshop on The Future of Inflation Targeting,<sup>8</sup> then-Governor Mark Carney argued that the Bank had a number of tools at its disposal and “that the bar for changing the regime is high.”

Ben Bernanke, former Governor of the US Federal Reserve (Fed) gave a good overview of these current and extended tools in a 2017 paper, “Monetary Policy in a New Era.”<sup>9</sup>

Within the current international tool kit, central banks could employ:

- Further extensions of QE (as already seen in this crisis)
- Forward guidance on interest rates
- Negative interest rates (discussed further below)
- Yield curve targeting (as for example already practiced in Japan)

Perhaps most distinct from current approaches, but still within current remit, central banks could:

<sup>1</sup> Vosvenieks, F. (19 March 2020). Coronavirus: Staying ahead of the risk (part 2). The Business of Risk blog. Retrieved 9 April 2020 from <https://www.thebusinessofrisk.com/?p=4619>.

<sup>2</sup> As an example, the press release from the ECB outlining such an approach in Europe is available at [https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318\\_1~3949d6f266.en.html](https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html).

<sup>3</sup> See <https://www.ft.com/content/26af5520-6793-11ea-800d-da70cff6e4d3> for an overview of programs in place by the end of March 2020.

<sup>4</sup> Emmerson, C. & Stockton, I. (26 March 2020). The economic response to coronavirus will substantially increase government borrowing. Retrieved 9 April 2020 from <https://www.ifs.org.uk/publications/14771>.

<sup>5</sup> Kristalina Georgieva, IMF Managing Director (9 April 2020). Confronting the Crisis: Priorities for the Global Economy from <https://www.imf.org/en/News/Articles/2020/04/07/sp040920-SMs2020-Curtain-Raiser>

<sup>6</sup> Two articles providing further discussion on this point are available at [https://www.brookings.edu/wp-content/uploads/2017/10/bernanke\\_rethinking\\_macro\\_final.pdf](https://www.brookings.edu/wp-content/uploads/2017/10/bernanke_rethinking_macro_final.pdf) and <https://www.suerf.org/policynotes/8209/dealing-with-the-next-downturn-from-unconventional-monetary-policy-to-unprecedented-policy-coordination/html>.

<sup>7</sup> Wolf, M. (17 March 2020). The virus is an economic emergency too. Financial Times. Retrieved 9 April 2020 from <https://www.ft.com/content/348e05e4-6778-11ea-800d-da70cff6e4d3>.

<sup>8</sup> Carney, M. (9 January 2020). Speech: A Framework for All Seasons? Bank of England. Retrieved 9 April 2020 from <https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/a-framework-for-all-seasons-speech-by-mark-carney.pdf>.

<sup>9</sup> Bernanke, B.S. (2 October 2017). Monetary Policy in a New Era. Brookings Institution. Retrieved 9 April 2020 from [https://www.brookings.edu/wp-content/uploads/2017/10/bernanke\\_rethinking\\_macro\\_final.pdf](https://www.brookings.edu/wp-content/uploads/2017/10/bernanke_rethinking_macro_final.pdf).

- Move to price, rather than inflation targeting. This would imply inflation would be tolerated, or even targeted, to overshoot at times in order to catch up for periods of deflation.

However, the COVID-19 crisis calls into question whether these tools really are adequate.

**DEEPLY NEGATIVE RATES**

In March 2020, in response to COVID-19, the central banks in the UK and US were quick to implement rate cuts taking interest rates close to zero.

Even prior to COVID-19, short-term interest rates were already negative in the Eurozone, Switzerland, Japan, Denmark and (until February 2020) Sweden.

Experience in these countries demonstrated that zero is not necessarily a floor on nominal interest rates, in part as there are costs to storage of paper money. However, a perceived effective lower bound still exists at not much below zero (say, in the 0% to -1% range) and most economies were, or now are, very close to that limit.

Insurers in many countries have gradually become used to rates close to or below zero, but may not have allowed for the risk of a potential further substantial fall deeply below zero.

In 2019, the International Monetary Fund issued the paper “Enabling Deep Negative Rates to Fight Recessions: A Guide.”<sup>10</sup> The starting point for the paper was the observation that:

*“500-600 basis points cuts in policy rates have been typical during recessions in advanced countries, but at present policy rates in most advanced countries remain too close to zero to make cuts of that size possible without using negative rates.”*

The paper then went on to explore some practical ways that monetary authorities could create deeply negative rates—for example 300 to 400 basis points (bps) below zero—concluding that this could be possible, largely by depreciating paper currency relative to electronic currency (e.g., bank deposits).

One commonly perceived barrier to creating deeply negative rates has been the existence of paper currency, and monetary academics such as William Buiter and Kenneth Rogoff have suggested that paper currency might need to be phased out. For example, see Rogoff’s “Costs and Benefits to Phasing Out Paper Currency.”<sup>11</sup>

<sup>10</sup> Agarwal, R. & Kimball, M. (29 April 2019). *Enabling Deep Negative Rates to Fight Recessions: A Guide*. IMF Working Paper No. 19/84. Retrieved 9 April 2020 from <https://www.imf.org/en/Publications/WP/Issues/2019/04/29/Enabling-Deep-Negative-Rates-A-Guide-46598>.

<sup>11</sup> Rogoff, K.S. (May 2014). *Costs and Benefits to Phasing Out Paper Currency*. National Bureau of Economic Research (NBER) Working Paper No. 20126. Retrieved 9 April 2020 from <https://www.nber.org/papers/w20126>.

<sup>12</sup> Bridgewater Daily Observations (30 April 2019). *It’s Time to Look More Carefully at “Monetary Policy 3 (MP3)” and “Modern Monetary Theory (MMT).”* Retrieved 9 April 2020 from [https://economicprinciples.org/downloads/MMT\\_%20MP3\\_MK.pdf](https://economicprinciples.org/downloads/MMT_%20MP3_MK.pdf).

**“Monetary Policy 3”: The intersection of fiscal and monetary policy**

So far, we have considered tools largely within the existing, stand-alone, monetary toolkit, but we now turn to some different approaches.

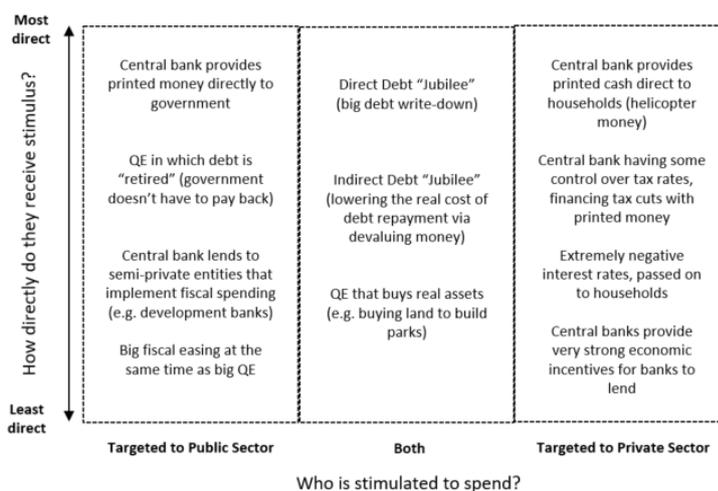
In a May 2019 piece entitled “It’s Time to Look More Carefully at ‘Monetary Policy 3 (MP3)’ and ‘Modern Monetary Theory (MMT),’”<sup>12</sup> Ray Dalio, founder and co-chief investment officer of the investment firm Bridgewater Associates, looked at a third wave of monetary policy, waves one and two being low rates and quantitative easing, respectively.

He argued that the next recession may well see the need for MP3, with fiscal policy working together with monetary policy.

Dalio’s paper included the schematic shown in Figure 1, which we have found a very useful framework for considering further options that may need to be considered.

In the rest of this paper we expand on some of these areas.

**FIGURE 1: WHAT MP3 LOOKS LIKE**



**MODERN MONETARY THEORY**

Dalio argued that one feature of MP3 would be an economy where interest rates are permanently close to zero and where taxes and spending are instead used to stabilise the economy. This is essentially a key tenet of Modern Monetary Theory (MMT).

MMT is a heterodox economic theory that states that a sovereign government with a fiat currency cannot be forced to default. They can therefore use fiscal policy to achieve full employment, and simply create new money to finance it. The ability to do so is only limited by inflation, which will only arise if

and when the economy is at full employment and resources are fully utilised.

It is a counter to the traditional theory that government spending must always be funded by taxes and/or debt issuance, and that the latter faces practical limits.

Politically, MMT has found favour in some circles, but has also been criticised by others as being a form of “magic money tree”<sup>13</sup> and likely to cause hyperinflation.

While MMT remains controversial, there currently seems to be a consensus that government debt levels will have to rise significantly in the near future. Robert Chote, head of the UK’s independent Office for Budget Responsibility, told the Treasury Committee of the Houses of Parliament recently “this is not a time to be squeamish about one off additions to public sector debt. It’s more like a wartime situation.”

#### “HELICOPTER MONEY”

In the US, the March 2020 stimulus package includes direct bank payments to most citizens.

The term “helicopter money” dates back to Milton Friedman’s 1969 book *The Optimum Quantity of Money*, where he proposed a thought experiment:

*“Let us suppose now that one day a helicopter flies over this community and drops an additional \$1,000 in bills from the sky, which is, of course, hastily collected by members of the community. Let us suppose further that everyone is convinced that this is a unique event which will never be repeated.”*

Helicopter money in Friedman’s thought experiment was a direct payment of cash to individuals, financed by the central bank printing paper money. More generally, it can encompass any fiscal program financed through printing money (as opposed to increasing government debt).

In a 2016 blog, Ben Bernanke considered the question of what tools the Fed might have left to fight the next recession. After considering negative interest rates and further extensions of QE, he turned to helicopter money.<sup>14</sup>

He concluded:

*“Money-financed fiscal programs (MFFPs), known colloquially as helicopter drops, are very unlikely to be needed in the United States in the foreseeable future ... However, under certain extreme circumstances—sharply deficient aggregate demand, exhausted monetary policy, and unwillingness of the*

*legislature to use debt-financed fiscal policies—such programs may be the best available alternative.”*

Critics of helicopter money have argued it would be inflationary or even hyperinflationary, particularly if the policy were expected to continue for an undefined length of time. In an October 2019 speech, Gertjan Vlieghe, an external member of the UK Monetary Policy Committee, argued that a pure form of helicopter money would essentially involve abandoning inflation targeting and “effectively suspends central bank operational independence.”<sup>15</sup> He also argued that in many cases what is termed “helicopter money” was in practice indistinguishable from a major debt-financed fiscal expansion.

#### UNIVERSAL BASIC INCOME

To date, the programs announced by the UK government to support employed and self-employed people who have lost their jobs are temporary and targeted to those who have directly lost income. But political pressure remains to extend these measures more widely, in either scope or time.

Government support for incomes may increase interest in the concept of Universal Basic Income a regular guaranteed payment to all (or almost all) citizens at a subsistence level of income, and which could potentially replace other forms of welfare.

The concept can be dated back to at least Thomas More’s *Utopia* in 1516. Milton Friedman’s 1962 book *Capitalism and Freedom* proposed a negative income tax, a form of Universal Basic Income.

More recently it has found favour as a potential solution to the issues presented by automation of jobs. Economists are divided on what the resulting economic effects of such a policy could do. Their examples include a reduced incentive to work and reduced affordability. A number of small-scale pilot programs<sup>16</sup> have attempted to test these factors.

#### DEBT MUTUALISATION

Not all governments are sovereign in the fiat currency in which they issue debt. Internationally, many countries borrow on the US dollar market and in the Eurozone individual governments are responsible for their own debt.

The Eurozone does have the European Stability Mechanism<sup>17</sup> (ESM) in place but this is limited in scope. In response to COVID-19, some EU countries have argued for the existence of jointly guaranteed “Coronabonds,” with nine countries (Belgium, France, Greece, Ireland, Italy, Luxembourg,

<sup>13</sup> Ormerod, P. (11 April 2019). Modern Monetary Theory? More like Magic Money Tree. Retrieved 9 April 2020 from <http://www.paulormerod.com/modern-monetary-theory-more-like-magic-money-tree/>.

<sup>14</sup> Bernanke, B.S. (11 April 2016). What tools does the Fed have left? Part 3: Helicopter money. Retrieved 9 April 2020 from <https://www.brookings.edu/blog/ben-bernanke/2016/04/11/what-tools-does-the-fed-have-left-part-3-helicopter-money/>.

<sup>15</sup> Vlieghe, G. (15 October 2019). Speech: Monetary Policy: Adapting to a Changed World. Bank of England. Retrieved 9 April 2020 from <https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/monetary-policy-adapting-to-a-changed-world-speech-by-gertjan-vlieghe.pdf>.

<sup>16</sup> Wikipedia: Basic Income Pilots. Retrieved 9 April 2020 from [https://en.wikipedia.org/wiki/Basic\\_income\\_pilots](https://en.wikipedia.org/wiki/Basic_income_pilots).

<sup>17</sup> ESM. About Us. Retrieved 9 April 2020 from <https://www.esm.europa.eu/about-us/intro>.

Portugal, Slovenia, and Spain) arguing in a letter to the president of the EU Council that:

*“... we need to work on a common debt instrument issued by a European institution to raise funds on the market on the same basis and to the benefits of all member states, thus ensuring stable long-term financing for the policies required to counter the damages caused by this pandemic.”<sup>18</sup>*

More generally, mutualisation and guarantees of debt, both internationally and domestically (e.g., public guarantees of private debt) may emerge as a new policy tool, with a corresponding impact on the credit spreads and perceived creditworthiness (through credit ratings) of different debt issuers.

Debt jubilees—private and public sector debt write-offs or extensions—may also become necessary, with obvious impacts on the banks and investors who provided the debt.

## Conclusion

The economy after COVID-19 may look very different from before the crisis and may involve the use of hitherto unfamiliar fiscal and monetary tools. These tools in turn have the potential to fundamentally change conventional economic relationships and market conditions.

The insurance industry is going to have to adapt to this new environment. In particular, as part of their risk assessments, insurers will need to consider what the new economic regime may look like after COVID-19, and what the implications for their balance sheets may be.

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<sup>18</sup> Financial Times. Nine Eurozone countries call for 'coronabonds.' Retrieved 9 April 2020 from <https://www.ft.com/content/258308f6-6e94-11ea-89df-41bea055720b> (subscription required).



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