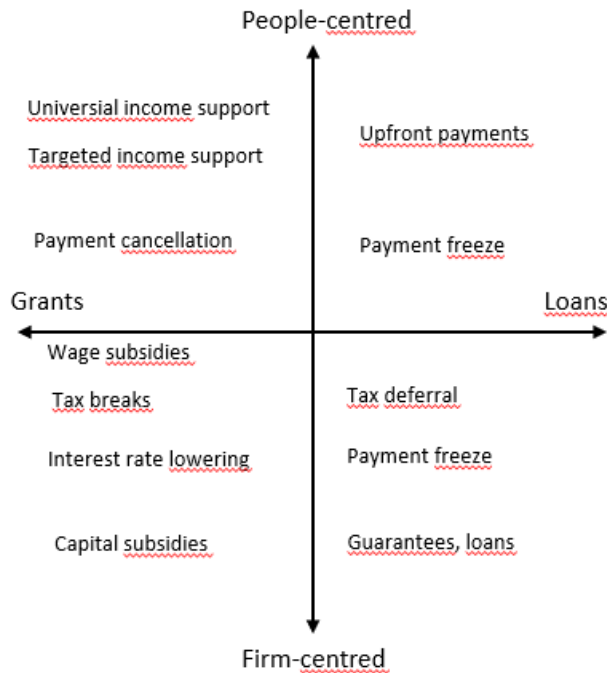


# Navigating through the COVID-19 economic policy debate: A review of proposals on how to mitigate the economic and social impact of the Great Lockdown

*This is a literature review of proposed policy measures to stabilise the real economy during and after the COVID-19 lockdown. Proposals are compared by introducing a two-dimensional framework along solvency vs liquidity and people vs firms. The discussion of solvency vs liquidity support has a long tradition with regard to bank and sovereign debt crises. An application to non-financial corporations remains absent to date but seems necessary with regard to the COVID-19 crisis causing exogenously induced solvency and liquidity problems to firms and households. The conclusion, which follows is that broad solvency support should be granted in order to avoid mass hardship and unemployment. However, these support measures should be conditional on the suspension of dividends, commitment to retain employees and commitment to future green investment.*

COVID-19 is spreading exponentially around the globe putting millions of lives at risk. Governments around the world have responded with far reaching confinement measures halting economic and social life. Such a sudden stop in activity is unprecedented during peace times. The economic consequences of the “Great Lockdown” are severe with many economies facing the biggest spike in unemployment ever recorded and possibly the sharpest contraction in economic output in history (IMF 2020). A broad-based lockdown affecting social life and economic activity has been unprecedented during peace times and before 2020 hardly anyone had made considerations on how to deal with such a situation. Within weeks, numerous contributions have been made proposing how to mitigate the economic and social consequences of the lockdown and experts swiftly agreed on the importance to “act fast and do whatever it takes” (Baldwin and Weder di Mauro 2020). While there is no shortage of proposals made, a structured overview of proposed measures remains missing.

To compare the proposed measures, a two-dimensional framework for fiscal policy responses to the lockdown is proposed. Four main categories for distinguishing the measures are proposed: solvency support (1) vs liquidity support (2), and people centred (a) vs firm centred (b) approaches (Figure 1). The discussion of solvency vs liquidity has a long tradition in banking since Walter Bagehot formulated his doctrine in 1873 (Bagehot, Goodhart). The concepts have been widely discussed in regard to the financial origin of the 2008 great recession (Blanchard & Summers 2017) and the concepts have been applied to sovereign debt during the Euro area crisis (Baldwin & Giavazzi 2015, De Grauwe). The longer and stricter the lockdown during the COVID-19 crisis continues, the deeper the losses that will be accumulated. As the lockdown continues, this will quickly challenge not only the liquidity but also the solvency of normally financially healthy households and firms. To avoid economic hardship of individuals and mass bankruptcies, policy will have to carefully distinguish between granting solvency and liquidity support. This makes it necessary to go further and apply the concepts of solvency and liquidity to households and non-financial corporations too. The distinction follows the standard definition widely used in economics textbooks (Blanchard 2017, De Grauwe 2018) and the global regulatory framework Basel III (ECB 2010). Adding the distinction between people-centred and firm-centred approaches as a second dimension has recently been suggested by leading IMF officials (Dell’Ariccia et al. 2020).



Typically, the literature argues that insolvent firms should not be rescued by the state since their business model is apparently not functioning. This implies risk sharing with equity owners and creditors through a bail. It is argued that this is preferable to minimise moral hazard and to avoid transferring investment risk to public budgets.

However, the current COVID-19 crisis and economic lockdown necessarily leads to massive losses and debt accumulation of firms, which are prevented from operating. Hence the traditional framework which suggests that insolvent entities should go through bankruptcy needs to be questioned.

Because the shock is entirely outside of the firms' and households' scope, state rescue from insolvency does not necessarily imply moral hazard. Especially smaller entities will not have the capital buffers or the access to financing options available so survive the lockdown. Thus, without the state stepping in, only large corporation can possibly survive, and even they would need to let go workers in mass numbers. The consequence would be hardship of mass unemployment on an unprecedented scale, never seen before.

Hence, while it makes sense to for the state to provide solvency support on a very broad scale, this should not come totally without any strings attached. It must be avoided that losses are socialised while profits are privatised. Hence, the conditionalities around the solvency support should include the suspension of dividends and the need to retain employees. Further, the support should be made conditional on future green investment.