

Policy Working Paper

**A POLICY FRAMEWORK FOR MITIGATING THE IMPACT OF
THE COVID-19 CRISIS**

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A. THE RAVAGE OF COVID-19

1. **This time is different.** COVID-19 is a seismic shock the likes of which have not been seen in living memory. What makes it different? For one, it is a rolling combination of a global health pandemic and an economic crisis that is unfolding at an unprecedented pace. The impact is already devastating at both the human and economic levels, in mutually reinforcing ways. Second, the crisis has turned truly global in record time, to an extent that the 2008 global financial crisis (GFC) became only after half a year or later.² The epicenter of the health crisis has shifted from China to Europe and now to the US. But the health and economic consequences are affecting every part of the inhabited world, with rising ferocity. Third, this is both a demand- and supply-side economic shock.³ The world has seen severe demand shocks (the Great Depression and the GFC) and severe supply shocks (the two World Wars, the Oil Crisis of the 1970s), but rarely the two at same time.

2. **The damage from the current crisis in Europe and Central Asia (ECA) and elsewhere is deep and multifaceted, wherein the adverse outcomes can be put in three main categories:** human suffering, economic recession, and financial and corporate sector distress.

- **Human suffering.** The first outcome relates to human suffering, mostly in the form of loss of life and deterioration of health, but increasingly also economic suffering through loss of jobs, livelihoods, and other income sources. In a little over three months since the onset, more than 120,000 people have already died worldwide and close to 2 million are reported infected.⁴ Developing ECA accounts for about 6 percent of those infected and 2 percent of COVID-related deaths. To help contain the spread of the virus, most countries in ECA, as elsewhere, have closed their borders to passenger traffic. Many workers have lost their jobs, have been furloughed, or are working on reduced work schedules. Weekly unemployment claims in the US had risen to 6.9 million in the week to March 28, subsiding only slightly to 6.6 million in the following week, foreshadowing the toll the crisis is likely to take on employment in developing ECA.⁵ Meanwhile, falling remittances and other private transfers are unduly affecting the poor

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² China and large parts of East and South Asia were still humming and commodity exporters were still benefiting from the commodity price super cycle in the initial months after the onset of the GFC.

³ It is a supply-side shock because the two critical factors of production have gone in short supply: (i) Workers are falling sick or dying and otherwise unable to physically be present at work, and (ii) Capital is drying up because its costs are rising, and cross-border flows are ebbing. It is a demand-side shock, because the people and firms, extremely unsure of their future, are cutting back on durable purchases and investment decisions. Quarantines, social distancing, and home confinements are cutting into demand, too, especially parts of the services sector (airlines, tourism, restaurants and so on). On top of it, trade flows have stalled, which adds to both demand and supply side pressures.

⁴ <https://www.worldometers.info/coronavirus/>. Quoted numbers are for April 13, 2020.

⁵ This number of claims compared with the previous record of 0.7 million reached in 1982.

and the vulnerable. In ECA, Central Asian countries, with a significant part of workforce in Russia, are already reeling under the impact of lower remittances. Adding to the challenges, many people with serious health problems are delaying seeking care, leading to worse health outcomes. In parts of ECA, following similar patterns elsewhere, people's woes are aggravated because they lose health insurance upon being laid off from their jobs. If the duration of the pandemic is prolonged, this will further hurt people (disproportionately the poor) in other ways too – including through impact on nutrition, education (the poor may pull their kids from schools), and indebtedness.

- **Economic recession.** By now, it is a foregone conclusion that the global economy will slip into a recession in 2020. The only question is how deep, how long, and how widespread? The Conference Board consensus estimates from March 25 suggest a decline of US GDP in 2020 of 1.6-6 percent, with the odds rapidly moving to a worse scenario.⁶ The PMI for the Eurozone dropped from 51.6 in February to 31.4 in March – the largest decline since comparable data were first compiled in July 1998. Similarly, the services PMI in the US fell to 39.1 in March from 49.4 in February. At the World Bank, we are projecting GDP to contract in all developing regions except Asia. For developing ECA – a region that was on a steady path to recovery after reeling from the GFC and seeing an abrupt end to the commodity super-cycle, we project GDP contraction of 0.3 percent in 2020.⁷ To make matters worse, Russia and the eastern part of region have also been hit hard by the sharp drop in commodity prices, oil prices in particular.
- **Financial and corporate sector distress.** The financial and corporate sectors are likely to fall victims to economic deterioration. Unlike the GFC when the crisis originated in the financial sector before spilling over to the real sector, this time it is the real economy that is causing financial distress. Security markets everywhere have seen major corrections,⁸ financial systems are under stress, and banks are likely to see huge pressures on their balance sheets as debtors default, new borrowers disappear, and savings dwindle due to job and livelihood losses. Heightened risk aversion among investors has led to a flight from equities and to a sudden stop in capital flows to emerging markets in ECA and elsewhere. Expectations of output contraction and the Fed's "whatever it takes" approach pushed ten-year US government bond yields to 0.7 percent in late March, from 1.9 percent at the start of the year. Capital flows to developing countries have contracted by more and faster than during any previous crisis – down by more than 40 percent in less than two months. The spread on emerging market bonds relative to US Treasuries has risen to 590 basis points, the most since the GFC.⁹ Private firms – big and small, formal and informal, foreign and domestic – are being hurt by the collapse in demand, and, on the supply side, the inability of workers to come to work and the breakdown in global supply chains and transportation networks. The likelihood of large-scale corporate bankruptcies is rising as a result.

⁶ <https://www.conference-board.org/data/usforecast.cfm>.

⁷ <http://pubdocs.worldbank.org/en/107191492012467509/mpo-eca.pdf>.

⁸ S&P500 is down almost 19 percent this year and emerging market equities down 28 percent on average.

⁹ The average yields on bonds in JPMorgan's EMBI-GD bond index and comparable US Treasuries.

3. **Each of the three adverse outcomes by itself is devastating.** But their combined threat is even more ominous, because the outcomes are mutually reinforcing. A crisis in health debilitates (or, if prolonged, destroys) human capital, which in turn is harmful to economic activity. Crises that originate in the financial and corporate sectors can have a lasting impact on the real economy (case in point, the GFC).¹⁰ Economic recessions tend to cause lasting damage to the lives of people and corrode the balance sheets of banks and private enterprises, often to a lasting extent. In all cases, the poor and the vulnerable suffer the most.

B. FLATTENING THE HUMAN SUFFERING, RECESSION, AND FINANCIAL DISTRESS CURVES¹¹

4. **Pandemics and economic and financial crises tend to trace half-cycles that need to be flattened.** Under crisis conditions, aggregate health, economic, and financial indicators race away from the pre-crisis normal to a peak level of distress, and then begin to ebb before slowly getting back to normal (which need not match the pre-crisis normal). What matters for policymakers is the peak of the half-cycle and its duration and intensity. The deeper and more prolonged the crisis (the taller the peak of the half-cycle and the longer its length), the more pernicious its impact. Clearly in the case of health, flattening the pandemic curve to lower its peak and reducing the impact on people is important because it saves lives by avoiding bottlenecks in the health system if the peak exceeds the health system's capacity.

5. **A deep and prolonged recession must also, to the extent possible, be avoided for it can cause lasting damage in lost incomes and productive capacity.** Economic cycles are a regular occurrence even in normal times. If the peak of the cycle is not excessively high, things get back to normal when the economy returns to its long-term trend. But the deeper and more prolonged recessions have the potential to erode human capital, weaken the institutions of governance (often with the affected country taking an illiberal turn), subdue the commitment to globalization, and prevent firms from making long-term investments. Long periods of weak supply and demand can lead to elevated structural unemployment, permanently lower capital stock, and weakened "animal spirits". Flattening the recession curve (to contain both its height and duration) is therefore important. This should include measures to maintain basic social services, including education – as once systems are eroded, they call for disproportionately large efforts to restart effectively. The longer-term legacy of flattening a COVID-induced recession curve is likely to be elevated debt public debt and depressed real interest rates.¹² But these are, for the most part, unavoidable in service of the greater good.

6. **Finally, during episodes of deep financial and corporate distress, especially if caused by factors external to the sector, even productive banks and firms can experience widespread failures that can undercut the productive capacity of the economy and the functioning of**

¹⁰ Reinhart, Carmen, and L. Rogoff. 2011. *This Time is Different*. Princeton University Press.

¹¹ Here, flattening curves implies reducing the damage to firms and individuals. In its very basic sense, it is about minimizing the number of deaths on account of COVID-19. In an economic sense, the objective would be to keep them going by providing them liquidity support to deal with the "act of god" – so they can be at the vanguard of economic recovery as and when COVID 19 is brought under control. If timely assistance is not provided, digging the economy out of the hole will be less feasible and much more expensive in the long run.

¹² Jordà, Òscar, Sanjay R. Singh, Alan M. Taylor. 2020. "Longer-Run Economic Consequences of Pandemics", Federal Reserve Bank of San Francisco Working Paper 2020-09.

financial markets.¹³ Moreover, the fiscal cost of bailing out banks and firms can become prohibitive (as was the case during the East Asian crisis in the 1990s), forcing governments to then cut back on other productive spending to make the fiscal space for the bailouts. This argues for the need to also flatten the financial distress curve.

C. POLICY INSTRUMENTS TO FLATTEN THE CURVES: CRISIS CONTAINMENT AND MITIGATION (PHASE 1)¹⁴

7. **The COVID-19, a major health crisis, has also quickly turned into an economic crisis, and threatens to become a serious financial crisis, with each acting in mutually reinforcing ways.** It is no longer up to policy to forestall these outcomes. Unfortunately, the virus is in charge – and a vaccine, while in the works in several places, is still at least many months away.

8. **The immediate policy response must focus on *containing the virus outbreak and managing it in its three dimensions (health, economic, and financial and corporate)*.** Given the magnitude and broad scope of the crisis, experts almost universally agree that governments have to do what it takes, fast, and in a globally coordinated way. It is important for the policies to be multidimensional, bold, and, in some measure, unbound by convention.

9. **The sequencing of the policy responses matters.** The immediate focus must be on containing the spread of the pandemic, treating those who are already infected, and then mitigating the economic impact on households and firms. This containment and mitigation phase of the crisis response (or Phase 1) is the focus of this note. Quarantines, social distancing, widespread testing and tracking, and, in some extreme case, temporary lockdowns are the containment measures that are being effectively deployed to prevent a rampant spread of the virus. The policy imperative then shifts to mitigation. Economic mitigation involves providing a monetary lifeline to cash-strapped households and firms that are seeing a sudden stop in their incomes – with the sole purpose of keeping them afloat till the pandemic begins to ebb. This is important for ensuring that economic activity can restart quickly once the pandemic is under control. The financial burden, for the most part, falls on the budget, requiring it to use all available resources, including, if deemed necessary, monetization on a temporary basis.

10. **Governments need to move swiftly and generously in Phase 1, but should remain cognizant of the fiscal and economic realities, leaving as much fiscal space as possible for the**

¹³ It is true that when a firm goes bankrupt, the core of its productive assets (people and machinery, for example) for the most part remain intact and can be put to productive use once the dust settles. But it loses intangible assets (patents, goodwill, brand equity, R&D capability) whose contribution is much harder to revive. And in most developing countries, once business continuity is lost, it is very difficult to recover. Further, people who lose their jobs and find much less intensive and productive employment tend to lose their skills and often their motivation, engendering a hysteresis – path dependency – that takes a while to overcome.

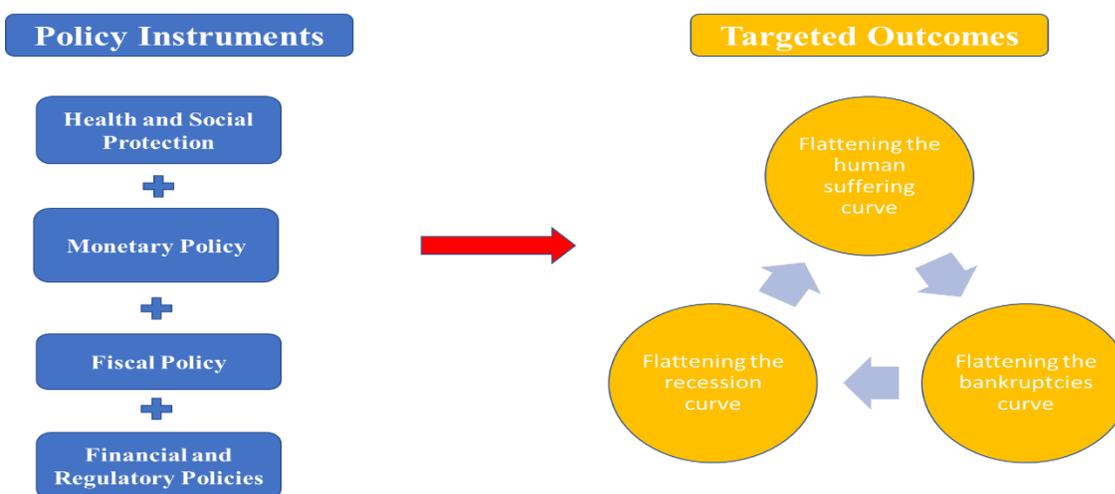
¹⁴ This note focuses on the immediate – three-four months duration – policy efforts to combat the impacts of the COVID-19. These are containment and mitigation efforts, and we also call them Phase 1 policies: they target the flattening of the pandemic, recession, and financial distress curves. Once Phase 1 policies start showing effect, policies will need to move to the next stage, or Phase 2. The transition between Phase 1 and Phase 2 will include people starting to return to work – perhaps with extensive testing and still social distancing, households starting to resume their earlier consumption patterns, children getting back in schools, and most firms reopening. The policies of the transition and the policies of Phase 2 will be the subject of a future note.

next phase (after the pandemic’s peak) when boosting aggregate demand through fiscal expansion becomes effective and important.¹⁵ A broad fiscal or monetary stimulus under current conditions – wherein the beneficiary households, unable to leave their homes, cannot spend the extra money and a vast number of firms, unable to get workers and inputs in place, cannot cater to the additional demand – may have little impact on overall economic activity. But some modicum of it may still be effective in limiting the extent of the economic contraction. In the recovery phase (Phase 2), when people start returning to work and the restrictions on movements are eased, a fiscal and monetary boost will be much more impactful. Phase 2 should also include longer-term structural and regulatory reforms that would seek to normalize economic conditions and strengthen the foundations of the health and social protection systems.

11. **There is clearly a trade-off in the short run between the aggressiveness of the health interventions and economic performance; although in the long run the impact may be positive.** Authoritative research on the 1918 pandemic suggests that places that intervened earlier and with more determination experienced stronger improvements in real economic activity after the pandemic. Pandemics have large costs, but “non-pharmaceutical interventions can lead to both better economic outcomes and lower mortality rates.”¹⁶

12. **During Phase 1 of the policy response—the crisis containment and mitigation phase—a swift and well-sequenced implementation of the following four sets of policy instruments is needed to flatten the three curves mentioned above, captured in the framework below.** The goal of these actions is to soften the inevitable blow and position the economy for eventual recovery when the pandemic is contained. For the effectiveness of the response in combatting the crisis, policies ought to be *timely, time-bound, targeted, and transparent*. Below, we also outline examples of such policies for country authorities to use while managing the crisis, while noting that their suitability, timing, and sequencing would depend on country-specific circumstances.

A Policy Framework for Mitigating the Impact of the COVID-19 Crisis



¹⁵ Blanchard, Olivier. 2020. “Whatever it takes. “Getting into the specifics of fiscal policy to fight COVID-19”. Peterson Institute for International Economics.

¹⁶ Correa, Sergio, S. Luck, E. Verner. 2020. “Pandemics Depress the Economy, Public Health Interventions Do Not: Evidence from the 1918 Flu”. MIT and The Federal Reserve Board. https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=3561560.

13. **Health and social protection:** These are the priority government policies for developing countries, ranging from testing and treatment, to hiring new medical staff, to expanding social assistance and to implementing cash transfers to households.

- COVID-19 containment, testing, diagnostic, and treatment;
- Procure additional hospital equipment to deal with a surge of patients;
- Finance mandatory hospital-based quarantine for infected patients;
- Construct new health centers, clinics, and hospitals on a fast-track basis;
- Bring temporarily doctors and other medical personnel out of retirement;
- Pay bonuses for front-line staff;
- Offset reduced or cancelled healthcare contributions;
- Cover sick leave allowances for people with health issues, not just COVID-related;
- Expand social assistance programs, provide cash transfers to households, expand or make easier conditions for access;
- Increase and expand access to unemployment benefits. Expand employment subsidies provided they support retaining employees rather than labor churning.

14. **Fiscal policy:** Measures include efforts on the revenue side (deferring filing and payment, reducing social contributions), spending (low-interest loans to firms, reprioritizing spending), and financing of larger fiscal deficits.

- Defer filing and payment of taxes, deferrals of VAT payments, accelerated tax credits;
- Cut or suspend social contributions by employees and employers;
- Provide no- or low-interest loans to firms, loan guarantees, and targeted transfers to firms;
- Pay a share of private-sector wages directly to workers, if firms retain them on payroll;
- Review spending and reprioritize outlays to health, support to households, and support to firms. Reconsider new infrastructure projects;
- As much as feasible, continue essential public service delivery (in addition to health);
- Ensure effective government business continuity;
- Communicate with donors not to reduce funding to foreign-financed projects. Discuss financing support with IFIs;
- Using existing mechanisms targeting poor and lower income families, provide financial support to low-income students and schools to keep education going as much as possible through long distance learning;
- Assess the additional financing needs, prepare a supplemental budget;

- Reprioritize public spending. Reduce lower priority spending, including on less important domestically financed infrastructure and new investment projects, toward priority spending.

15. **Monetary policy:** Measures include monetary easing, exchange rate flexibility, and targeted liquidity provisions.

- Cut policy interest rates if there is room, be mindful of the effect on inflation and the exchange rate;
- Allow exchange rates to be shock absorbers in bad times. The shock will not be temporary – therefore, spending foreign exchange to limit exchange depreciation is likely to be counterproductive. Countries with highly dollarized domestic economies and credit would need to be more temperate in following this course, after carefully assessing the impact of large exchange rate depreciations on their macroeconomic stability and sustainability;
- Provide liquidity to (solvent) banks;
- Where possible, Central Banks should consider swap lines to increase dollar or euro liquidity. The US Fed, the ECB, the Swiss National bank and several other central banks have entered into swap lines to ensure adequate dollar liquidity. If the crisis is prolonged, the major central banks in Europe may provide swap lines to other countries on the continent, as they did during the global financial crisis.

16. **Regulatory policies (financial, industrial, and trade):** Interventions include bank forbearance (with strict preconditions) on loan repayments and use of capital and liquidity buffers up to the regulatory limits, reductions in collateral requirements, cancellation of all unnecessary procedures for firm registration, and reductions in import restrictions and tariffs.

- Allow bank forbearance on domestic private loan repayments with certain strict preconditions so not to create financial instability down the road.¹⁷ No forbearance on credit reporting;
- Consider reducing collateral requirements for new bank loans;
- Provide credit guarantees or lend on easier terms to affected businesses and households;
- Speed up approval of loans and reduce fees and penalties, e.g., on overdraft facilities;
- Delay or reduce rent payments for government-leased properties;
- Strengthen existing or create new SME support programs;
- Delay and reduce payments for firm registration and permits. Temporarily suspend “patent” payments;

¹⁷ These conditions are: the forbearance must be time-bound, provided only to loans and borrowers that were not delinquent before the crisis began, the NPV of the loan will not change (that is, no debt forgiveness), ensuring the system has ample liquidity to support the forbearance, and the credit quality of the borrower is continuously monitored.

- Eliminate face-to-face compliance inspections, reduce the number of inspections;
- Enable more electronic processes, including for notarization. No face-to-face notarization;
- Cancel all unnecessary procedures for firm registration, reporting and monitoring;
- Reduce import restrictions and tariffs on medical equipment and relief material;
- Avoid ad hoc export restrictions. Export restrictions are inefficient, and only collectively can countries ensure products go where they are needed.¹⁸

17. **These Phase 1 policies are targeted to flatten the human suffering, recession, corporate and financial distress curves and position the economy for recovery.** They are crisis containment and mitigation policies. The set of options is expansive, and governments in ECA cannot pursue all of them comprehensively. Trade-offs among the different options need to be resolved in country engagements. How long the region's countries can sustain these policies – at great fiscal and economic costs – depends on their initial conditions, capacities, buffers, the level of infection, and on the support from international donors. One thing is clear: governments will be doing things that were unimaginable a few months ago, in some cases allowing for much higher fiscal deficits and government debt than in the past, tolerating much higher inflation, and relying on international institutions and bilateral donors to an unprecedented degree.

18. **Phase 1 policies clearly cannot last indefinitely.** At some point – sooner rather than later for most countries – governments in ECA will need to scale back the containment and mitigation efforts. Now is not the time to set timelines for abandoning these crisis mitigation policies and move to actions to restart the economy. Governments, with the support of the international community, need to continue to do all they can to limit the health, economic, financial and corporate distress in these early days of the outbreak and remain ready to shift to the Phase 2 economic policies to support the recovery. At that time, a much more robust fiscal/monetary stimulus, combined with structural reforms, will be needed to boost the economy's productive potential and develop its health systems, and fortify its resilience to future major shocks, health-related or otherwise.

¹⁸ Espitia, Alvaro, Nadia Rocha, and Michele Ruta. 2020. Trade and the COVID-19 crisis in the developing countries. <https://voxeu.org/article/trade-and-covid-19-crisis-developing-countries>.