

# THINK Outside: Covid-19 travelling faster than the speed of thought

Most economists are coming to terms with the fact that dramatic action will be needed to deal with the biggest crisis since the second world war, yet some have reservations on how to do it. Here are a few articles we have featured on THINK Outside from our trusted third-party providers to help you navigate through these uncertain times

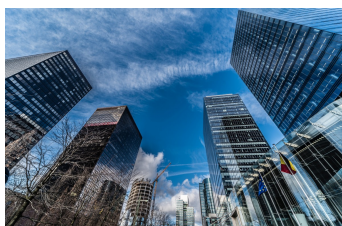
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## Introduction by Richard Baldwin and Beatrice Weder di Mauro

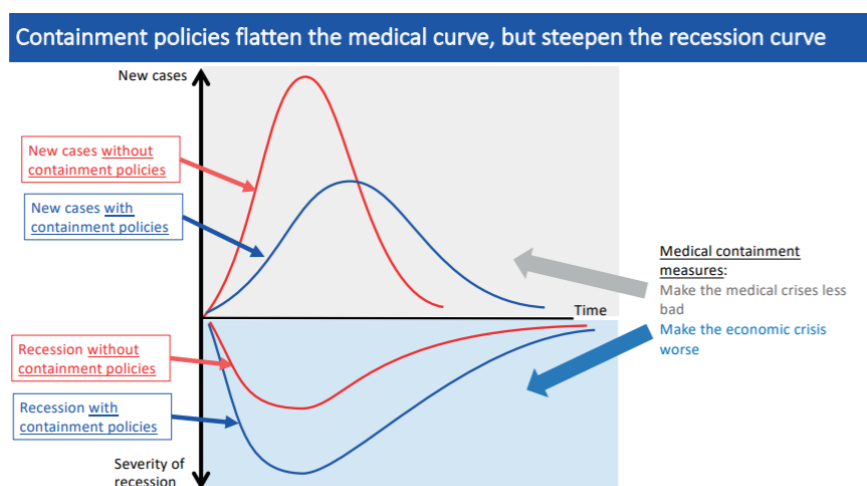
The world has been an unusual place since we published our first VoxEU/CEPR eBook on COVID-19, [Economics in the Time of COVID-19](#), on 9 March 2020. The number of COVID-19 cases and deaths have soared globally. Europe is now the centre of the pandemic but the US, given its huge population (330 million) and lack of national leadership, is on course to become the next centre. Stock markets gyrate 5 to 10% a day, sometimes up but mostly down. Other financial markets are equally volatile. Governments in Europe have imposed public health containment measures that would seem extreme in any other circumstances. Containment policies in the US are spreading without coordination or coherence as cities and states fill the leadership void. But not everything is becoming more uncertain.

The COVID-19 crisis has become more predictable in a sense. What was widely viewed as a 'Chinese problem,' and then an 'Italian problem' has become an 'everybody problem'. With few exceptions, governments initially downplay the disease until sustained community transmission takes hold. Then they impose severe social distancing policies, work and school closures and the like. This inevitably leads to almost immediate economic hardship, which then leads governments

to propose increasingly bold anti-recession measures. This was the pattern in Europe and looks set to be the pattern in the US and many other nations. All this is due to the highly contagious nature of the virus, and the inexorable implications of its explosive spread during the 'acceleration phase' of the epidemic. This eBook is an attempt to collect the thinking of leading economists on what is to be done. In addition to contributing to analysis of the rapidly evolving policy reactions, we hope this eBook will help nations get ahead of the curve – to think ahead on the medical and economic policies that will be needed. The collected wisdom of our authors also points to another critical aspect of this crisis. Without care, solutions to one set of economic problems could – for some nations – turn this economic crisis into a financial crisis, or a debt crisis, or a foreign exchange crisis, etc. Care must be taken to ensure that temporary solutions don't create long-lasting problems.

The size of the economic damage is still very uncertain, but it is certain that it will large. Governments now need to focus on mitigating that damage. This is the time to bring out the big artillery; this is not a time to be timid, but to do whatever it takes, fast.

## A key quote from the eBook



Source: Author's elaboration, inspired by illustrations in the chapter by Gourinchas.

Source: VoxEU, author's elaboration, inspired by illustrations in the chapter by Gourinchas.

"Efforts to flatten the epi curve reduce economic activity. The recession, so to speak, is a necessary public health measure. Keeping workers away from work and consumers away from consumption both reduce economic activity. This is illustrated schematically in Figure 7 [i.e. the chart above], which has a top panel (medical) and a bottom panel (economy).

In the top panel (the medical outcome), the red curve suggests what the epi curve would look like without containment policies; the blue curve suggests what it would look like with containment policies. The blue curve is a flatter version of the red curve due to containment policies. In short, containment policies flatten the epi curve.

In the bottom panel (the economic outcome), the red curve illustrates the economic losses (negative growth) when there are no containment policies; the blue curve suggests the recession's evolution when containment policies are imposed. The blue curve is steeper and deeper than the red curve in the bottom panel, i.e. just the reverse of the top panel. As Pierre-Olivier Gourinchas puts it: "flattening the infection curve inevitably steepens the macroeconomic recession curve."

This unavoidable trade-off is surely behind some leaders delaying containment policies."

The original article first appeared on VoxEU [here](#). You can download the full version of the ebook [here](#).

## Bruegel: Banks in pandemic turmoil

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Brussels' business district

As the COVID-19 spread and policy reactions have disrupted markets, bankers on both sides of the Atlantic have [called](#) for relaxation of accounting standards introduced in the wake of the Great Financial Crisis, known as [expected credit loss provisioning](#). These calls, like much bank lobbying on capital regulation, should be ignored by public authorities and accounting standard-setters. There is no perfect accounting thermometer for credit risk in banks' loan books, but breaking the current thermometer in the midst of a crisis would do far more harm than good.

Since there are two main sets of accounting standards in the world, the debate on expected credit loss provisioning is actually two different debates echoing each other. In the United States, accounting standards are set by the US Financial Accounting Standards Board (FASB), a non-profit body under oversight by the US Security and Exchange Commission. The relevant FASB standard is Accounting Standards Update (ASU) 2016-13, "[Measurement of Credit Losses on Financial Instruments](#)" (The credit loss component is also referred to in US accounting discussions as "Topic 326" or "ASC 326," where ASC stands for Accounting Standards Codification.). ASU 2016-13 just entered into force for large listed banks, since it is to be applied on financial statements starting on or after 15 December 2019. Following a further update in November 2019 by the FASB, the corresponding [date](#) for smaller banks (all large US banks being publicly listed) is 15 December 2022.



In the rest of the world, most large banks use the International Financial Reporting Standards (IFRS) set by the International Accounting Standards Board (IASB), a global standard-setting body hosted by the non-profit IFRS Foundation. The relevant IFRS standard is IFRS 9 on [Financial Instruments](#), issued by the IASB in November 2013 and [endorsed](#) three years later by the European Union, among other jurisdictions. IFRS 9 has been implemented for some time since it became effective for annual periods starting on or after 1 January 2018. Whereas IFRS 9 and ASU 2016-13 are [not identical](#), both are variations of the same principle of expected loss provisioning.

The principle's adoption by FASB and the IASB came in the early 2010s, in response to prodding from public authorities through the Financial Stability Forum (now the Financial Stability Board, FSB) as early as [March 2009](#) while the Great Financial Crisis was raging. The feeling at that time among central banks and financial ministries was that the prior established method, known as incurred loss provisioning, was leading to excessive procyclical effects when losses were indeed incurred. Better instead, the concept went, to book a provision early on, as soon as the loss is foreseeable, even if no repayment has been missed yet. There was [controversy](#) from the start on whether that might lead to a different but equally problematic pattern of procyclicality. After several years of debates, however, the two standard-setters obliged, and [research](#) published in 2017 by the Bank for International Settlements (which hosts the FSB Secretariat in Basel) concluded that this had indeed been the right thing to do.

Predictably, however, the banks were never enthusiastic about having to book losses earlier than under the previous methods, and lobbied heavily against it on [both sides](#) of the Atlantic. Such lobbying has been predictably [revived](#) by the COVID-19 shock, together with calls for more general suspension of credit loss provisioning – in other words, the recognition that loans are becoming bad, namely non-performing loans (NPLs). These calls have been relayed by various political and institutional figures, including at the EU level the [President](#) of the European Economic and Social Committee, an advisory body. In the US, the Federal Deposit Insurance Corporation (FDIC) has endorsed them in a [letter](#) to FASB on 19 March, which immediately received [support](#) from the Conference of State Bank Supervisors. In its letter, the FDIC suggests both further delaying the implementation date of ASU 2016-13 for smaller banks, and giving larger banks an “option to postpone [its] implementation”. The other major federal bank regulators, the Federal Reserve and the Office of the Comptroller of the Currency, appear not to have echoed this call, at least in the public sphere – worth noting as other recent [statements](#) on prudential policy have been made jointly by all federal regulators, as is customary.

Such calls should not be heeded. By mid-March in both the [euro area](#) and the [United States](#), banks have been granted [very significant](#) capital relief – namely, they can let losses eat into their capital buffers as these have been built up significantly over the last decade in application of the global prudential accord known as [Basel III](#). This welcome action implies that banks have a considerable capacity to absorb losses in the near future, without being in breach of their regulatory and supervisory capital requirements. The ECB has [estimated](#) the corresponding leeway for the core capital measurement at €120 billion, a massive amount. No miracles will (or in fact, [should](#)) happen in terms of credit expansion, given the parlous economy, but credit will not unduly contract as an effect of procyclical regulatory constraints, and financial stability is protected. Those decisions were made swiftly – not least in the euro area, where ECB Banking Supervision has acted at a pace that would have been [impossible](#) in the pre-banking union era given challenges of coordination and stigma effects. Banking union remains dangerously [unfinished](#) and has not achieved its stated aim of breaking the bank-sovereign vicious circle, but even in its halfway-house status this episode demonstrates its tangible benefits.

Because the capital relief allows banks to absorb significant losses, changing the loan loss provisioning method now is unnecessary. It is also undesirable, because there is significant value in reassuring investors and the broader public that banks are not allowed to hide bad news and move stealthily towards “zombie” status. At a more basic political level, this is not the time to give the banks special favours if these can be avoided. Longstanding [experience](#) suggests that supervisory forbearance – namely, allowing banks to pretend they meet regulatory requirements when from an economic standpoint they don’t – should only be considered as a last resort. It is not justified under the present circumstances (Loan forbearance by the banks themselves, namely letting borrowers miss scheduled payments without triggering collateral execution, is a separate matter.).

In the euro area, there is an additional dimension given the ongoing [discussion](#) about cross-border risk-sharing and solidarity. While political difficulties abound, there is willingness to share some of the burden of fighting the pandemic and preventing economic collapse – but that cannot be expected to extend to bank rescues. Italy is at the centre of current concerns, both because of its high sovereign indebtedness and its tragic exposure to the pandemic. The Italian Banking Association has [lobbied](#) for supervisory forbearance. Italy’s true priorities do not lie there.

The ECB has complemented its March 12 capital relief decision with additional [guidance](#) on March 20, allowing the banks to provision as few losses as possible within the constraints of IFRS 9 and providing favourable interpretations on related matters, eg, not classifying loans in arrears as NPLs if they are covered by a government guarantee. Simultaneously, the ECB has made it [explicit](#) that it rejects “[supervisory] forbearance for NPLs” and that “[i]t remains crucial, in times of distress, to continue identifying and reporting asset quality deterioration and the build-up of NPLs in accordance with the existing rules, so as to maintain a clear and accurate picture of risks in the banking sector”. In the UK, the Bank of England has taken a similar [stance](#). In the US, the FASB should resist the FDIC’s pressure to exempt large banks from implementation of ASU 2016-13. Smaller banks are a less critical concern, with potential space for compromise on implementation schedules.

The last few days have spectacularly illustrated the ancient wisdom that bank lobbying on capital and accounting should generally be resisted in the public interest. Banks had lobbied tooth and nail against Basel III, its multiple buffers, and related constraints on capital, leverage, and liquidity. But thank God for Basel III: Having these buffers in place is precisely why authorities were able to provide a credible response (so far) to concerns about banking sector stability in the pandemic crisis. Authorities should implement the accord’s [remaining items](#) in due time, and steadfastly resist appeals for undue supervisory forbearance. The banking system is critical to society and requires attention and support. In doing so, however, tough love is preferable to complacency.

*The original article first appeared on [Bruegel](#)*

## VoxEU: Covid Perpetual Eurobonds - Jointly guaranteed and supported by the ECB

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We do not know yet how large the economic damage of this pandemic will be. But under plausible scenarios, government support to the economy will be in the double digits as a percentage of national incomes. How can such amounts be financed, without sparking a second sovereign debt crisis in the weaker euro area countries?

The ECB's new Pandemic Emergency Purchase Programme (PEPP), launched last week, has bought precious time. But PEPP is mainly designed to reduce liquidity strains and avoid an immediate run on the debt of highly indebted euro area countries. Some of the financing needs will be absorbed by the monetary expansion implied by PEPP. But allowing for only temporary deviations from the capital keys in the ECB asset purchases could limit the extent of the monetary support to the highly indebted countries. More needs to be done. We must find alternative financial arrangements that shield the euro area against a return to 2011-like crises.



## COVID controls

We propose that countries issue 50-year or 100-year bonds, or even perpetuities (also known as perpetual bonds or 'consols', i.e. a fixed-income security with no maturity date). The ECB should stand ready to buy them to keep the interest burden low enough to avoid adding to debt sustainability concerns. There are clear economic rationales for this:

- A shock the size of the COVID crisis is like a war, and thus its financing is optimally distributed over several generations.
- The new securities could be issued quickly with conditions that could be crafted to the problem at hand.
- The bold action would provide a signal of the 'what ever it takes' type and thus rule out the nightmare scenario of a new euro area crisis arising in the midst of the COVID crisis.

Member states should jointly issue a large amount of very long maturity COVID Eurobonds backed by their joint tax capacity. Each country would issue its own bonds, but the bonds would otherwise be identical. Their common rating would be the result of all bonds being guaranteed by the joint tax capacity of the countries participating in the joint issues.

There are several advantages to COVID Perpetual Eurobonds:

- With the support of the ECB, interest rates could be kept very low, and the solvency risk would be limited to the unlikely event that countries renege on their initial agreement.

For instance, with an interest rate of, say, 0.5%, servicing a debt of 10% of GDP with COVID Perpetual Eurobonds would only cost 0.05% of GDP every year – a negligible amount.

- The very long maturity of this additional debt implies that the risk of a funding crisis on the existing debt of the highly indebted countries would not arise.

The same cannot be said about a short-term credit line issued by the ESM.

- Inflation is clearly not a current threat; on the contrary, the danger today is deflation.

Monetary financing of the needed fiscal effort is part of the optimal policy response.

- This financial arrangement would not hinder ECB independence in case inflation risks were to emerge in the future.

The ECB would remain free to reduce the size of its balance sheet if needed.

These new securities would be complementary to other proposals made recently.

## Improving on the Benassy-Quéré et al. proposal for a COVID-related credit line

The proposal to create a new COVID-related credit line at the ESM – as proposed by Benassy-Quéré et al. (2020) – could immediately add funding of up to 3.4% of the euro area's GDP. This proposal is a step in the right direction, but it has a few limitations.

- First, the amounts available remain small relative to the likely needs, though they could be

- increased by raising ESM capital.
- Second, the maturity of the loans granted to individual countries is as important as their magnitude.

These 'multi-generation' maturities are not possible with an ESM credit line. As a result, there is the risk that a sovereign debt crisis is only postponed and not avoided, or alternatively that the fiscal policy action is limited to a size that will not provide adequate support.

- Third, by its statute, the ESM can only lend to a country if public debt is sustainable.

This implies that a prerequisite to any ESM lending is some kind of debt-sustainability analysis. The outcome of such analysis cannot be taken for granted in the current situation.

- Fourth, the ESM was designed to support individual countries during a financial crisis, not to finance a large common shock.

By the same light, it is important that ESM funds remain available for its original purpose, particularly once the peak of the crisis is past.

- Fifth, the ex-post conditionality – which is legally required for ESM lending – could be a barrier to the effective usage of the funding.

During the COVID crisis, which may last a year or more, euro area countries will need to borrow not only to invest in medical infrastructures, but also to provide income support and inject capital to prevent bankruptcies. It is important that any ESM credit lines explicitly allow for this.

- Finally, the ESM is an inter-governmental institution, over which national parliaments of individual countries retain veto rights.

There is thus a risk that the design and implementation of the credit line could be distorted by a zero-sum logic rather than reflecting the common interest.

Each of these limitations could be overcome by re-writing ESM rules and that of its Treaty. We view this as a step towards a first-best institutional setup for COVID crisis financing. The ESM could eventually become the 'euro area Treasury Department' thus allowing fiscal and monetary policy to be coordinated as in 'normal' countries. But the road to the first best would take time, and the negotiating process among members would create ex ante uncertainty about the outcome.

Time, however, is not something we have a lot of at this point in the COVID crisis, and uncertainty about the outcome of rule-changing could, by itself, be destabilising.

## Seizing the historical moment

The financing arrangement for Perpetual Eurobonds should be enacted immediately. Postponing it would be counterproductive, for two reasons. First, because an immediate response would be much more effective in preventing economic collapse. Second, because it is now clear that all countries have been hit by a common exogenous shock; in one or two years, there will be more recriminations about moral hazard and policy mistakes, and a coordinated response would be politically even more difficult.

We are living through a critical historical juncture. If mismanaged, the looming economic crisis

would disrupt the European project, with far-reaching political implications. The alternative to a bold coordinated response is to continue to bend the existing institutional framework with ad hoc adjustments that undermine its long run credibility, until it will eventually break.

*The original article first appeared on [VoxEU](#).*

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