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After Corona: A Sea of Debt

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I. Managing the economy during the Corona crisis

A deep plunge of economic activity

The Corona pandemic, in conjunction with widespread lockdown measures of governments, has hit the world economy dramatically. In a June 2020 update of its World Economic Outlook, the International Monetary Fund estimates that output will fall by almost 5% globally and by 8% in the advanced economies over the course of 2020. Figure 1 illustrates the economic setback for the eurozone and Germany as calculated by the European Central Bank. After a severe contraction in the range of 10-20% in the first half of 2020, the economies of the eurozone are expected to recover gradually in the second half of the year, making for an average recession of 5-10% for the entire year. Europe is not expected to climb back to its pre-crisis level of economic activity before 2023. The shaded corridor around the projections points to the large uncertainty surrounding any projection at this point.

Purpose and type of intervention

Facing such a massive contraction of their economies, policymakers were quick to act. Both fiscal authorities and central banks channelled huge amounts of money towards firms, households and the financial sector. It is important to point out that the task at hand differed fundamentally from the run of-the-mill stabilization policies in which policymakers routinely engage, and not just because of the extraordinary scale of the operations. Under normal circumstances, the job of stabilization policy is to offset fluctuations in the aggregate demand for goods and services so as to keep demand more or less in line with the production potential of the economy. This is to prevent both inflationary overheating and deflationary underutilization of capacities. Not so in the face of the Corona crisis. This time, the fall in economic activity was inevitable as it was predicated by the paralyzing effects of the virus and the public health measures imposed by authorities. There was no way of avoiding a major loss of output and a corresponding loss of income per capita. But if a recession is inevitable anyway, why would policymakers expend such enormous amounts of money in the face of it?

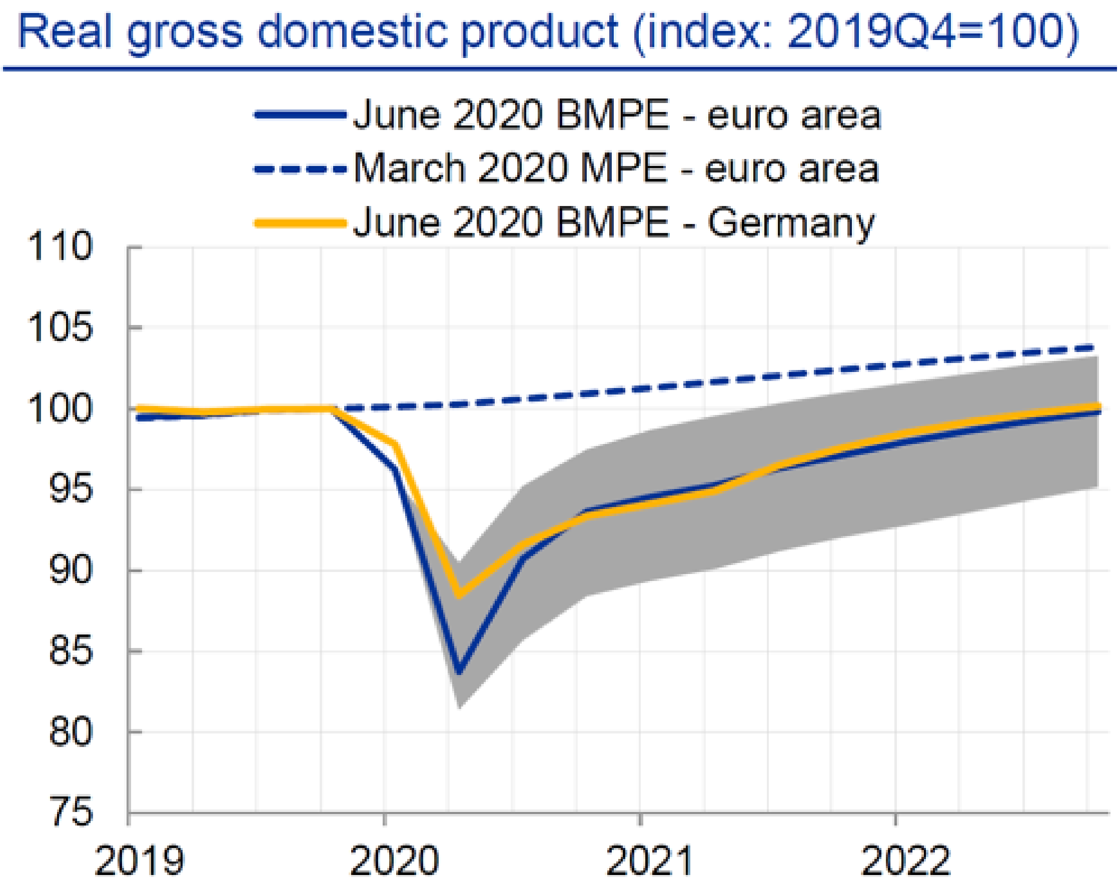

Figure 1: The Damage to Economic Activity in the Eurozone and in Germany
Note: (B)MPE = (Broad) Macroeconomic Projection Exercise. The area shaded in grey shows the range of estimates covering a mild to a severe evolution of the crisis. Source: Isabel Schnabel, Speech, June 27, 2020.

The interventions serve mainly four purposes:

1. Funding the public health response.
A no-brainer.

2. Conservation of existing production facilities and employer- employee matches.
In the absence of massive financial support, the sudden loss of revenue suffered by firms due to the lockdown would lead to a wave of bankruptcies and layoffs. This would destroy the production facilities and networks which should be still in place if the economy is to pick up swiftly once the pandemic is under control.

3. Social Insurance.
With the inevitable retrenchment of economic activity, society must cope with a 5-10% income loss in 2020 and so would each and every income recipient, if the losses were spread evenly across the

population. Alas, they are not. For some people, income remains unchanged (civil servants, pensioners), some work overtime (health workers) and some lose 100% of their income (waitresses). Thus, the government steps in to mitigate the income losses of those worst hit. It acts as if there had been universal pandemic insurance in place.

4. Prevention of amplification effects.
Without the income support extended by governments, the economic damage done by the pandemic would be amplified by second-round effects. As people lose their income, they cut their spending across the board, including outlays for goods and services produced by sectors that are not directly hit. This secondary effect would force those sectors to cut back production as well, which adds to bankruptcies and layoffs. Financial support by the government is designed to prevent such domino effects.

The exit from the lockdown: Managing the transition

The end of lockdowns must not be confused with the end of the economic crisis. In many parts of the economy, it will take time to reboot production. International supply chains may take time until they run as smoothly as before. Consumers may be slow to return to activities (consumption of services) they deem risky, and some sectors may have to retrench for a long time, if not for ever. Economic policy will have to tread carefully during this period of transition. The objective of conserving existing jobs and firms will gradually have to give way to measures designed to facilitate structural change. But the emphasis should really be on "gradually" here. The new normal after Corona will differ from the old normal, but may take considerable time to materialize. Unemployment and the number of bankruptcies are likely to remain elevated well beyond the time when the general lockdown is relaxed. This is why mechanically withdrawing economic support in step with the reopening of the economy would be dangerous. Labor market policy will have to move from protecting jobs to protecting people. Support must be offered to firms that are viable in the longer term, but are plagued by high legacy debt due to revenue shortfalls during the Corona crisis. Needless to say, the total bill for governments will continue to rise during this transition. (Here and here are more in-depth discussions of fiscal policies during the transition).

II. The legacy of the government lifelines: A sea of public debt

How much extra debt?

The final count on the total cost of the wide range of measures taken by governments during the Corona crisis is not yet in. But it is clear that the lifelines thrown to private firms and households, in conjunction with crisis-related revenue shortfalls, will add up to real money. Where does this money come from? Governments borrow it, driving up public debt in the process. Table 1 below gives an estimate of both the increase in overall government borrowing and gross public debt from the Spring 2020 World Economic Outlook Update by the International Monetary Fund.

Current fiscal deficits, expressed in percent of GDP, are expected to climb well into double digits across the board. This is true even for Germany which was running surpluses until recently. Gross debt ratios – i.e. gross public debt in relation to GDP – are inflated both by the current deficits and by the contraction in GDP expected for 2020 and 2021.

(Percent of GDP)	Overall Fiscal Balance				Gross Debt			
			Current Projections				Current Projections	
	2018	2019	2020	2021	2018	2019	2020	2021
World	**-3.1**	**-3.9**	**-13.9**	**-8.2**	**81.2**	**82.8**	**101.5**	**103.2**
Group of Twenty (G20)	**-3.7**	**-4.5**	**-15.4**	**-9.1**	**88.6**	**90.4**	**111.2**	**113.3**
Advanced Economies	**-2.7**	**-3.3**	**-16.6**	**-8.3**	**104.0**	**105.2**	**131.2**	**132.3**
Advanced G20	-3.3	-4.0	-18.0	-9.1	**111.6**	**113.2**	**141.4**	**142.9**
United States[1, 3]	-5.8	-6.3	-23.8	-12.4	106.9	108.7	141.4	146.1
Euro Area	-0.5	-0.6	-11.7	-5.3	85.8	84.1	105.1	103.0
Germany	1.9	1.5	-10.7	-3.1	61.9	59.8	77.2	75.0
France	-2.3	-3.0	-13.6	-7.1	98.1	98.1	125.7	123.8
Italy	-2.2	-1.6	-12.7	-7.0	134.8	134.8	166.1	161.9
Spain[2]	-2.5	-2.8	-13.9	-8.3	97.6	95.5	123.8	124.1
Japan	-2.5	-3.3	-14.7	-6.1	236.6	238.0	268.0	265.4
United Kingdom	-2.2	-2.1	-12.7	-6.7	85.7	85.4	101.6	100.5

Source: International Monetary Fund, World Economic Outlook Update, June 2020.

Does the extra debt make future generations poorer?

The ability of governments to raise the needed amounts of money, what economists call "fiscal space", was generally not an issue – at least for those governments of advanced economies whose bonds are considered safe assets by investors. But questions arise nevertheless:

- Will debt service absorb too much tax revenue in the future?
- Will future generations have to pay the bill for the Corona crisis?
- Is the debt sustainable, or else, how quickly can it be paid off?

Before answering these questions, it is important to do away with a fundamental misconception about public debt. Contrary to a widely held belief, *current public debt does not per se mortgage the future of a society and its economy*. The belief that it does, derives from a mistaken analogy with private individual debt. Clearly, whether or not there is a mortgage on my house makes a difference for my net worth and hence for the amount of consumption I (or my heirs) can afford in the future. In public finance, this is true only in an accounting sense or if the government borrows abroad. Apart from foreign debt, the management of public debt is fundamentally about transferring money between one group of citizens (taxpayers) and another (bond holders) – not between the present and the future.

This is not to say that piling up public debt is costless to society under all circumstances. If current debt service is habitually financed by new debt, debt may well explode and government is in for trouble. Also, taxing households and firms in order to pay off bondholders, distorts and reduces productive activities, which detracts from aggregate real incomes. However, this is a minor issue for the additional borrowing caused by the Corona virus as many governments can borrow at extremely low, if not negative interest rates.

Another reason why current government borrowing can hurt future generations is when public and private borrowers compete for scarce funds on the capital market. In that case, the government crowds out productive investment that could have improved the future productivity of the economy. But again, this is not a relevant consideration under current circumstances. The reason interest rates have been so low for many years now is an excess supply of funds on the capital markets. In the absence of capital scarcity, public borrowing does not compete with private investment. Quite on the contrary, by stabilizing the economy, it may actually encourage more private investment.

Who pays for the pandemic?

As explained above, the actions taken by governments had an effect *as if* collective insurance against Corona damages had been in place, pooling the risks residents were exposed to. If a Pandemic affected all firms and households in exactly the same way, there would not be much of a case for collective insurance. Everyone would suffer an income loss roughly corresponding to the lost GDP per capita and would soldier on all the same. Governments stepped in because the costs of the pandemic have affected households and firms in a highly unequal manner, putting the fabric of the economy, and of society itself, in danger. The government acted *as if* the economic fallout of the pandemic had been insured. Except that no one had to pay any insurance premium beforehand to cover the damages. Hence the public debt.

So who ultimately bears the economic cost of the pandemic? The answer is straightforward: In terms of material well-being, the bill is being paid right now in the form of lost production, lost national income, and consumption foregone. The public debt incurred in the process does not change this fact. As explained above, the notion that public debt is a means of rolling over the cost of current government spending to future generations is mostly a myth. If government debt is carried forward, so are the private sector's claims on the government. The material resources available to the population for consumption or investment in each period have been affected by the pandemic, but not by the public debt entailed. The very same deficit-financed government spending that has led to a surge in public debt has prevented the economic crisis from spiralling out of control and has prevented production and investment from contracting even more than they did. Far from burdening future generations, today's deficits save future generations from inheriting an economy that would be significantly weaker and less productive in the absence of these deficits.

Is inflation around the corner?

When and how should the debt be repaid, if at all? A widely shared fear is that the money poured into economies in response to the Corona pandemic will eventually stoke inflation. Indeed, as governments have made an effort to stabilize incomes even where production was closed down, they have created purchasing power in excess of goods and services actually available for consumption. While potentially inflationary, such excess purchasing power has not led to an increase in spending. Quite on the contrary, saving rates have shot up, in effect bottling up the purchasing power in bank accounts or other assets. In the same vein, the loads of liquidity provided by central banks to the financial sector have largely been stowed away in bank balance sheets rather than spilling over to the goods market. As the International Monetary Fund is right to warn, raising taxes too quickly to pay off the new debt would be largely self-defeating as it would only delay the recovery of the economy. At some point down the road, the excess purchasing power created by governments today may well fuel the effective demand for goods, creating inflationary pressure. If and when that happens, the time will have come for governments to withdraw their money again from the economy – time, that is, to collect the premium for the social insurance provided today.

About the Author

Oliver Landmann is Professor of Economics Emeritus at the Department of Economics and Behavioral Sciences at Freiburg University. He is engaged in the Joint Freiburg-Nagoya Project Group Programme 2018-19, co-sponsored by FRIAS and the Institute for Advanced Research at Nagoya University.