

Easing does it

Economic policy beyond the lockdown

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Executive Summary

The UK economy has weathered the first wave of the coronavirus storm, which required an unprecedented shuttering of one quarter of the economy and provision of government financial support to households and firms unparalleled in peacetime. The task now facing the country is how to reopen, revive, and rebuild our economy while the virus remains with us.

Whereas the mission for policy makers in the lockdown was relatively straightforward – make good losses in families' incomes and prevent the crisis from destroying viable firms – policy in the reopening phase is harder. Policy makers must generate a rapid recovery against a backdrop of fundamental uncertainty about progress on the health crisis and a very unusual sectorally focused crisis. They also do so with a more limited range of effective monetary policy instruments and a much higher starting level of government indebtedness.

So, the stakes are high. But the Government needs to act as quickly, boldly, and creatively in the recovery phase of the outbreak as it did in the initial rescue phase. Delay or relying on traditional policy levers not tailored to the nature of this crisis risks a widespread failure of firms and a return to persistently high unemployment; either would lead to long-term scarring to our productive potential.

In this report we go further than other studies by providing a comprehensive blueprint for how economic policy can support a rapid, strong, and sustained economic recovery. Our analysis not only provides a quantitative estimate of the overall size of the fiscal rescue package, which has to be larger – at around £200 billion, or around 10 per cent of GDP – than that seen in previous recessions (it was below 5 per cent of GDP in the financial crisis, for example). Second, it also shows that the exceptional sectoral concentration of the economic hit means that policy measures need to be more targeted if they are to be both effective and provide value for money. And that the policy response needs to build in the flexibility to respond either to a faster-thanexpected recovery if a vaccine or an effective treatment is discovered, or to the re-imposition of strict distancing restrictions if there is a national second wave of transmission.

To inform policy, we build an evidence-informed scenario that assumes the Government's reopening strategy unfolds as planned

The coronavirus crisis is, above all, a public-health emergency, and slowing the spread of the virus must be the highest priority for public policy. As is already clear, measures to achieve this have dramatically reduced economic activity: GDP fell by a quarter between February and April. And this unprecedented hit to the economy has already brought forward an unprecedented policy response.

As the number of infections, hospitalisations, and deaths has subsided, the Government has moved to reopen the economy, ease social distancing restrictions, and allow a growing range of businesses to resume operations. We combine this stated policy approach with data on the speed with which activity has returned following the opening up of other economies to provide an illustrative set of scenarios: these set out the fastest pace at which major sectors of the economy can recover that is consistent with the Government's stated approach.

One piece of good news is that the impact of the initial lockdown now appears smaller than originally expected by us and others. Our scenario points to a fall in GDP of around 17 per cent in the second quarter of this year, compared to falls of around 25 and 35 per cent in previous scenarios from the Bank of England and the Office for Budget Responsibility (OBR), respectively. This, combined with some real-time indicators suggesting a more rapid recovery in economic activity, has encouraged some commentators to predict a quicker return to pre-outbreak levels of output than previously expected. We disagree, because while there will be an initial swift bounce back of economic activity as the lockdown is lifted, there remains in all likelihood a significant risk of widespread business failures and a large labour market shake-out as social distancing restrictions continue and financial support is phased out.

A key insight from our scenarios is that the pace of economic recovery is likely to be highly differentiated across sectors. We expect some sectors, such as finance, to be already operating close to normal levels. Others, however, will be hit far harder, with hospitality output having fallen by over 90 per cent between February and April and the sector only now starting to open up. In our scenario, output in the hardest hit sectors remains 10 per cent down on pre-crisis levels at the end of the year. Given the interdependence between sectors – for example, elements of the UK's media sector rely upon the retail and hospitality sectors for advertising revenues – depressed activity in some sectors also acts as a wider drag on near-term output.

Our bottom-up, sector-by-sector, approach provides an illustrative – if uncertain – assessment for the economy as a whole. Based on the Government's reopening strategy succeeding, we expect the economy to recover slowly and reach its new pre-vaccine level – which is around 5 per cent lower than the expected pre-crisis level of output – by the end of the year. All this leaves GDP falling by 9.3 per cent in 2020, somewhat lower than the 14 per cent and 13 per cent incorporated in the Bank of England and OBR scenarios, respectively.

In assessing the medium-term path, it is necessary to make an assumption about the timetable for a longer-term solution to the crisis – i.e. a vaccine or an effective treatment. We make the tentative assumption that such a solution arrives at some point during next year. Given this, our scenarios envisage that the 'new normal' level of output after a vaccine or effective treatment is around 3 per cent below the pre-crisis path, in-line with the experience of permanent scarring in past recessions.

Fundamental uncertainty about the future should shape policy today

The degree of uncertainty surrounding the economic outlook is, however, vast, with significant downside risks to our main scenario in which the Government's exit strategy unfolds as planned. The most important of these is the risk of a re-emergence of the virus, leading to a second widespread lockdown (we consider that localised flare-ups can be consistent with a smooth exit). To explore the implications of that risk, we also build a scenario in which there is a 'second wave' as winter arrives in the UK. The lessons the Government has learned in dealing with coronavirus so far should mean a shorter and less severe lockdown next time around – so we assume the hit to GDP of a second wave would be three-quarters the size of the first. But this would still mean another large hit to the economy, with GDP falling 11.4 per cent this year, and a slower recovery thereafter.

So, policy must be set in a way that is robust to that risk. Measures for stimulating the economy in the reopening phase should be designed so as not to be harmful or poor value for money should a renewed lockdown arrive. And we should plan now for how the economic policy response to a second wave itself should differ from that pursued the first time around.

Policy must be designed around the specific nature of this crisis

Policy to support a rapid and sustained recovery must reflect the unusual nature of this recession. We highlight four factors that make up its distinctiveness. First, the hit to the economy is highly concentrated in sectors providing in-person services to households with output in hospitality, arts, entertainment and recreation, transport and non-food retail – which collectively make up around a fifth of the economy – falling by around a third between January and April. This is unusual relative to previous recessions, which have been more broad-based, with their epicentres in sectors producing internationally-traded goods. This pattern implies that the policy response needs to Second, there have been stark differences in the impact of the lockdown phase on families at different points in the income distribution. One third of richer families have increased their rate of saving in lockdown, while poorer families are more likely to have seen their balance sheet deteriorate: one third of those in the second income quintile have reduced the amount they are saving.

Third, higher uncertainty and recent increases in corporate debt risk holding back businesses' investment in jobs and physical capital. Finally, this crisis could lead to a return to levels of unemployment not recorded since the 1990s because the sectors most affected are labour intensive.

All this points to the need to put in place a policy package to boost demand in the hardest-hit sectors, while offsetting the temporary constraints on supply affecting those sectors. In addition, there is a need to support firms to grow by avoiding crippling them with an unsustainable debt burden.

The required fiscal stimulus will be much larger than in previous recessions

Neither the size nor composition of fiscal stimulus packages deployed in previous recessions provides a sensible guide to policy in this crisis. This is partly owing to the unique nature of the economic shock from coronavirus. But it is also because monetary policy – which has played a key role in supporting the economy in past recessions, with the Bank of England's main policy interest rate falling by around 5 percentage points in postwar recessions – cannot play a leading role in supporting the recovery this time with interest rates already close to zero.

The fiscal policy response will therefore need to be larger to compensate for this constraint on monetary policy. The response also needs to be more targeted, given the sector-specific nature of the shock. In addition, the package needs to be timely, aimed at preventing firms from failing and furloughed workers from becoming unemployed. Finally, it needs to be temporary, but with the tapering of support conditional on the pace of recovery and the evolving risk of a second wave of infection.

It is difficult to judge exactly how much stimulus is required amid such significant uncertainty. But policy makers must have a sense of this to generate a rapid recovery, so we set out the conclusion of three different approaches to this question. These examine what it would take for policy to avoid dragging on growth, to repeat the scale of stimulus provided during the financial crisis, or to follow the equivalent of a simple monetary policy rule. This exercise points to a total policy package of around £200 billion – or 10 per cent of GDP – as broadly the right overall magnitude of support. We advocate front-loading this stimulus, with elements continuing over the next two years.

The fiscal stimulus package we propose is twice as large as the 5 per cent of GDP of support that was provided in the financial crisis, reflecting the scale of the crisis and the constraints on monetary policy. However, a package of the size we propose would not be out of line with that seen in other rich countries. For example, it is still somewhat smaller than that currently being discussed in the US, despite expectations of a larger hit to the British economy.

We should support demand, as well as helping firms manage temporary supply shocks

We set out four major policies which deliver the vast majority of the support in our total package of roughly £200 billion. Starting on the supply side, we set out a range of policies designed to resist the impact of temporary supply shocks, particularly in the hardest-hit sectors:

- A programme to support the labour market, the key elements of which are:
 - A slower withdrawal of the Job Retention Scheme (JRS) for the hardest-hit sectors, at an estimated cost of £3-5 billion in 2020-21;

- The replacement of the JRS with a new Job Protection Scheme that subsidises work taking place in the hardest-hit sectors in the pre-vaccine phase, at an estimated cost of up to £5 billion per year; and,
- Measures to support inflows into other parts of the economy, including temporary employer National Insurance cuts to incentivise hiring, a £5 billion a year spending increase in the social care sector, and measures to help with job search and training for the unemployed.
- Converting existing corporate lending schemes into Income-Contingent Loans by limiting the total amount that any firm is required to repay in a given year to 5 per cent of total turnover, allowing firms to write off 90 per cent of the cost of adapting businesses to returning to safe operation, and writing off any outstanding loan principal at maturity. This would cost up to £25 billion.

On the demand side, we set out timely, targeted, and temporary measures designed to boost the economy in key areas:

- A 'High Street Voucher' scheme to boost consumption in the hardest-hit sectors. This approach is more targeted and progressive than a VAT cut, and, unlike the flat-rate cash transfers employed in the US, could not simply be saved by higher-income households. We propose vouchers worth £500 per adult and £250 per child, at a one-off cost of around £30 billion.
- Boosts to Universal Credit (UC) that target cash support to lower-income families, including a significant increase in spending targeted at children via the child and couple elements. This social security package would cost around £10 billion per year.

 An increase in investment spending to provide a sustained boost to demand, targeted at projects that would have high social value irrespective of the progress of the virus. These include investments aimed at advancing progress towards zero carbon, and improving social and transport infrastructure. This would cost around £30 billion a year over the next three years, much of which the government has already budgeted for.

We should plan now for how economic policy would respond to a second wave

A key design consideration for the policies described above is that they are robust to the risk of a second wave of the virus. For example, should a second wave occur, vouchers could be turned off, loan repayments would be revenue-contingent, and labour market activation policies could be paused. But the risk of a second wave occurring should also lead economic policy makers to prepare now for how they would respond to another national lockdown.

Although the policy objectives in a second wave should largely match those in the first lockdown, we should evolve, rather than simply repeat, the policies chosen then. The additional policy development time now available should be used to overcome some of the shortcomings of the response to the first lockdown, and to recognise that the experience of the crisis means that the appropriate policy will change over time.

For households we should aim for broader, and more equitable, coverage of support schemes. We recommend that:

- The JRS is revived for the duration of a second-wave lockdown, but with lower earnings replacement for high earners.
- The Self-Employment Income Support Scheme is also brought back, with the same earnings replacement levels as the new JRS. In addition, eligibility should be expanded to the newly self-employed, higher earners, and those with dividend income; but restricted to those who have actually suffered income hits.

• The basic and couples elements in UC should be temporarily boosted further.

These measures would narrow the gap in generosity between different schemes: the difference between average 'replacement rates' on the JRS and on UC would fall from 38 percentage points to 30, for example.

When it comes to support for firms, policy makers will need to recognise that the impact of the crisis to date in weakening balance sheets makes a repeat of widespread liquidity support insufficient. Our proposals for delivering support via Income-Contingent Loans would help to overcome this challenge.

The Government can afford to take this approach, particularly at prevailing interest rates

The necessary fiscal costs of socialising the initial impact of coronavirus on the economy have already been significant, with the JRS alone likely to cost over £50 billion. And the package described above will add substantially to that total. The total cost of implementing our policy package is £209 billion under the Government's exit strategy, and £240 billion in a second wave scenario. This additional government spending will have significant impacts on the public finances over the next five years, pushing public sector borrowing and debt to 16 and 105 per cent of GDP respectively. Those figures rise to 20 and 128 per cent of GDP in our second wave scenario.

Ultimately, however, financing pressures should remain manageable. Indeed, the Government's borrowing costs have fallen to all-time lows – with some gilt yields now negative and those on bonds of up to nine years below the Bank of England's policy rate. In our scenarios, despite the large rise in debt, debt interest costs as a proportion of revenues actually fall. Of course, higher debt means the UK is more exposed to increases in interest rates, but the long maturity of UK debt and indications that we are in a prolonged low interest rate environment provide confidence that these risks can be managed. Financing pressures are, however, significant, with a government cash requirement this year of £438 billion. If that led to yields on government debt starting to rise abruptly, we would expect the Bank of England to step in and accelerate its purchases of debt, as it did in March, to maintain market stability. A more gradual rise in rates would be manageable, but if the rise was significant, then our view is that the Bank of England should act – in line with its remit – to prevent a forced withdrawal of fiscal stimulus that would lead to an undershoot of the inflation target. This risk would be reduced – perhaps significantly – by the Government putting in place a fiscal framework that sets a credible plan for how it will return the public finances to a sustainable medium-term position.

Getting policy right in the reopening phase is difficult, but the costs of inaction are large

While the scale of the policy package we propose is significant, so are the costs of inaction. Indeed, a simple counterfactual exercise suggests that the recovery would be significantly slower without a policy package of the kind we set out. The costs of that failure would be higher unemployment and more firm failures, and could well end up more expensive for the public finances too.

Economic policy makers face some big questions as we enter the reopening phase of this crisis, including on the right size and nature of a policy response to this very unusual shock. These questions are difficult, but we must answer them if we are to get ahead of this crisis and avoid reactively announcing piecemeal initiatives. The contribution of this paper is to set out what such a response might amount to and the thinking behind it. In making the case for a large, but targeted, policy response we hope it helps policy makers navigate an exceptionally difficult period for economic policy.

Section 1

Introduction

This report is focused on how to design an economic policy response to the coronavirus crisis that delivers a rapid, broad-based recovery during the reopening phase. Policy in the lockdown was relatively straightforward, at least in terms of its objectives: provide social insurance by making good losses in families' incomes and prevent the crisis from destroying viable firms. Such aims justified the large-scale support package put in place by the Government.

But policy in the reopening phase is much harder. Policy makers need to generate a rapid recovery against a backdrop of scarce and noisy information about the ongoing economic impact, and fundamentally uncertain progress of the health crisis. The task then is to craft an economic policy response, the size and design of which engages with both the highly unusual nature of this crisis and its uncertain path.

The role of economic policy in the coronavirus crisis

It is helpful to think of three phases of the economic policy response to the coronavirus crisis (Figure 1).¹ First, the 'lockdown' phase. Governments facing a dangerous pandemic without the technology to fight its spread (a vaccine, effective antivirals or well-developed test, track, trace and isolate programs) had no choice but to lock down their economies to stop the spread of the virus. But shutting down large swathes of the economy leads to sharp falls in GDP. Second, the 'reopening' phase when the lockdown measures are eased. At this point the economy starts to rebound (initially very quickly), but GDP remains depressed relative to its previous path because some parts of the economy continue to operate at below pre-pandemic levels of activity because of ongoing social distancing restrictions. Third, a 'normalising' phase in which the health emergency has passed, and the economy is moving towards its long-run path.

¹ For example, see: <u>this short article</u> by Ricardo Reis, 2020; and J Saleheen, <u>V, U and L: Demystifying recession shapes</u>, CRU Insights, May 2020. For a discussion of the framework for thinking about economic policy in the pandemic, see: J Smith & T Yates, <u>The</u> <u>Macroeconomic Policy Outlook: 2020 Q2</u>, Resolution Foundation, May 2020.

FIGURE 1: The three phases of pandemic policy

Stylised depiction of economic activity (or level of GDP) during the three phases of the impact of coronavirus



SOURCE: RF analysis.

Policy in the lockdown phase of the coronavirus crisis is relatively straightforward, at least in terms of its objectives: provide large-scale social insurance to families and firms, by making good losses in incomes and, in doing so, attempt to prevent damaging hits to the economy in the longer term by 'freezing' it in its pre-crisis structure. These objectives justified the unprecedented scale and nature of the UK Government's response to the crisis.² Such an approach, however, accepts intentionally large economic damage – with output falling rapidly (denoted by Point 1 in Figure 1).

The 'reopening' phase is in many ways the most difficult in terms of economic policy and is the focus of this report. Policy makers need to deliver a rapid, broad-based recovery in private-sector activity, without exacerbating the health crisis and triggering a further economy-wide lockdown (a 'second wave'). At the same time, however, waiting too long to boost the economy risks the long-term economic impact becoming more severe, with greater hardship – for example, through higher unemployment – along the way.

As policy makers confront this new phase, there are two key insights about the unique nature of this economic crisis that they must keep in mind. First, the deep uncertainty about progress in supressing the virus leads us to conclude that the risk of having to return to lockdown in the future should affect policy makers' decisions in the here and now. They can do this in two ways. First, by choosing policies now that continue to work

² For a discussion of that response, see, for example: D Tomlinson, <u>Launching an economic lifeboat: the impact of the Coronavirus</u> <u>Job Retention Scheme</u>, Resolution Foundation, April 2020. For a discussion of the costs of those measures, see: <u>Coronavirus policy</u> <u>monitoring database</u>, OBR, June 2020.

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in the event of a second wave, or at least would not be wasted in that case. Second, by preparing their economic policy response to a second wave now, so that it can be implemented in a timely way.

Second, the exceptional sectoral concentration of this crisis will continue into the reopening phase because certain economic activity remains disproportionately affected by the ongoing social distancing restrictions. Although some sectors can adapt to operating at pre-crisis levels – for example, much work in the ICT sector can be carried out remotely – others will be more constrained. An obvious example of the latter category is the hospitality sector, where restrictions on physical proximity will limit the services that firms in that sector can provide, and fear of the virus will suppress demand. This will limit the extent of any return to the pre-crisis economic path. The job for policy makers, therefore, is to get the economy operating as close to its maximum possible level (denoted by Point 2 in Figure 1), with restrictions on some sectors in place to control the spread of the virus.

Finally, an economy enters the 'normalising' phase once the long-term technology for fighting the virus emerges. In the best-case scenario, this is a cheap, widely-available vaccine. If that is the outcome, the economy should return somewhere near to its pre-crisis path. But, even in this optimistic case, there is likely to be lasting economic damage. For example, the crisis will almost certainly prompt a reduction in firms' investment spending, reducing the amount of physical capital used to produce output relative to the pre-crisis path. Past experience suggests such shortfalls are unlikely to be made up, leading to a permanent fall in the productive capacity of the economy relative to its previous path (denoted by Point 3 in Figure 1).

The rest of this report sets out our thinking on how policy makers should wrestle with economic policy in this reopening phase. It aims to inform policy in the face of very difficult decisions, so we use our analytical conclusions about the nature of this crisis to drive detailed policy recommendations and provide full costings of our proposals. To this end, this report is structured as follows:

- Section 2 provides a brief description of the Government's health policy and the fundamental uncertainty of progress on health crisis, using both to motivate two illustrative scenarios for the path of the economy: one based on the Government's intended reopening trajectory and another reflecting the potential impact of a second wave.
- Section 3 discusses the impact the virus has had on the economy. This is important in diagnosing which economic problems policy makers should be aiming to address, informing the calibration of the overall policy package.

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- Section 4 confronts the difficult issue of how to calibrate the overall size of the required stimulus. We offer three approaches to this question which recognise the unique circumstances of this recession.
- Section 5 then builds on this analysis, by setting out a package of targeted policy measures. We focus on measures targeted at alleviating the specific economic challenges of this crisis, and prioritise approaches that can work even in the event of second wave, but we propose a package that overall is large enough to generate a rapid recovery,
- Section 6 sets out how economic policy makers should respond to an intensification of the health crisis if a second wave leads to another broad lockdown. Policy makers should not simply repeat the approach taken during the first lockdown; instead, they should use the additional policy-development time now available to overcome some of the shortcomings of that approach, and to recognise that the experience of the crisis means that the appropriate policy will change over time. Implementing these changes will be more timely and effective if they are planned in advance.
- Finally, Section 7 sets out our conclusions and summarises our policy recommendations.

Section 2

Health policy and prospects for the UK economy in the reopening phase

The coronavirus crisis is, above all, a public-health emergency, and slowing the spread of the virus will be the highest priority for public policy. As is already clear, measures to achieve this will inevitably hit the economy. The extent to which those measures can be sustainably lifted will determine how quickly the economy can bounce back. But this is difficult: opening up too quickly risks stoking the rate of infection.

The Government has set out its approach to navigating these risks and opening up the economy. We combine this information, along with data on the speed with which other economies returned to higher levels of economic activity after opening up, to provide illustrative scenarios for the maximum pace at which major sectors of the economy can recover consistent with the Government's approach. Combining these sectoral scenarios provides an illustrative - if uncertain - assessment for the economy as a whole. GDP falls by 9.3 per cent this year, somewhat lower than the 14 per cent and 13 per cent incorporated in the Bank of England and OBR scenarios respectively, reflecting the smaller-then-feared GDP fall in Q2 of 'just' 18 per cent (compared to around 25 per cent and 35 per cent in the Bank and OBR scenarios respectively). But thereafter the recovery is more gradual than in those scenarios: with the economy recovering slowly to its maximum pre-vaccine level – which is around 5 per cent lower than the pre-crisis level of output – by the end of the year. Output in the hardest-hit sectors remains more than 10 per cent lower than the pre-crisis level throughout the year. This scenario is used in later sections to inform our policy proposals. But to address uncertainty around progress on the health crisis, we also set out a scenario for a second wave – which arrives towards the end of the year as the weather turns colder - in order to illustrate the sensitivity to these assumptions. Our experience so far should mean that a second lockdown is not as prolonged or as severe as the first, but it would still mean another hit to the economy with GDP falling 11.4 per cent this year and, again, recovering slowly after that.

In this section we discuss the importance of health policy for the UK's economic prospects. To be clear, we claim no particular expertise in making recommendations for future health policy, or even in assessing how the virus may progress under different approaches. Instead our approach is to take the Government's reopening policy as given, and use that to assess the possible future path of the economy based on evidence from progress elsewhere in the world. Although the resulting scenarios should be viewed as illustrative, they provide a plausible basis on which to evaluate alternative policy options. To demonstrate the sensitivity to the key assumption about progress of the health crisis, we also set out what a second wave might look like.

After the lockdown, the Government has outlined plans for a gradual reopening of the economy

The lockdown has led to an unprecedented hit to the economy. GDP data for April suggest the economy contracted by around a quarter compared with the level of output in February. This implies that if output remains around the level recorded by the ONS in April for May and June, the fall in GDP in 2020 Q2 would be around 25 per cent. That would be in line with the Bank of England's nowcast, published in May, for the scale of the contraction in the second quarter (25 per cent) but stronger than the OBR's (around 35 per cent).³ That said, as discussed below, some sectors have seen more activity in May and June, suggesting that the impact could be smaller than initially feared (see the top of the left panel in Figure 2). This is consistent with recent Bank of England analysis suggesting that economic activity returned more rapidly than expected in May.⁴

Besides the size of the hit to the economy, the other striking feature has been its heterogeneity across sectors. Sectors reliant on social interaction – most obviously hospitality and the arts – have been hit hardest. As shown in Figure 2, this is the picture that emerges from both the recent official data on economic output,⁵ and data on the take up of the Coronavirus Job Retention Scheme, using falls in employment as a proxy for the impact on economic activity.⁶

But while we are building a clearer picture of the initial impact of the lockdown, there is vast uncertainty about the future. This because the key determinant of how these sectors fare going forward will be the extent to which health restrictions can be lifted without triggering a significant increase in the infection rate. The Government has set out its attempt to navigate these choices with a phased plan for reopening the economy,

³ See: Monetary Policy Report, Bank of England, May 2020 and Coronavirus Reference Scenario, OBR, April 2020.

⁴ See A Haldane, The Second Quarter, speech, June 2020.

⁵ First estimates of GDP normally have lower data content and are revised as new information becomes available. But, for April data, this is compounded by higher non-response in the current situation. The ONS have tried to plug the gap, but these data are particularly uncertain. For more, see: <u>Coronavirus and the effects on UK GDP</u>, ONS, May 2020.

⁶ For a full discussion of the labour market impact, see: N Cominetti, L Gardiner & H Slaughter, The Full Monty: Facing up to the challenge of the coronavirus labour market crisis, Resolution Foundation, June 2020.

which is summarised in Table 1. Such a forward-looking approach is desirable because it facilitates firm planning, coordination between sectors, and the sequencing of policy measures.⁷ But, progress even on this relatively high-level plan remains uncertain and will depend on the spread of the virus.



NOTES: No data available for the accommodation & food services data from the OBR forecast. SOURCE: RF analysis of HMRC; ONS, GDP output approach - low-level aggregates & OBR, Reference scenario, April 2020.

The plan implies some degree of easing in the lockdown restrictions in almost all sectors to date (although much of the hospitality sector remains closed with easing of the restrictions there expected in the coming months). And almost all sectors that have opened up are having to operate with additional social distancing restrictions in place. These restrictions, as well as consumers' ongoing fear of the virus, will depress economic activity as long as the pandemic and these measures last.

After an initial rapid bounce-back from heavily-suppressed activity in the lockdown, some combination of a further easing of restrictions and adaption to the new environment should see output continue to recover, but progress is likely to be slow and dependent on the health restrictions. Beyond the planned easing of restrictions, there is considerable uncertainty around the timing of the final phase of this plan – i.e. when an effective treatment and/ or vaccine is in place. Crucially, uncertainty about the point at

8 Unless otherwise specified, all charts and data in this report cover the UK.

⁷ For a discussion of the linkages between sectors, see: C Lenoel & G Young, '<u>Prospects for the UK economy</u>', National Institute Economic Review 252, pages F10-F43, May 2020.

which such a long-term solution is found will affect economic decision making today, as will uncertainty about the path of infections to that point.

TABLE 1: The Government is planning to reopen the economy gradually in the coming months

Summary of the Government's strategy for reopening the economy

Phase	Step	Policies	Date
Phase 1		• 'Stay at home' guidance (lockdown)	23 March
Phase 2	Step 1	 Relax restrictions on outdoor leisure Return to work if feasible but continue to work from home if possible 	13 May
	Step 2	 Phased return to school (since abandoned) Phased opening of non-essential retail Relax restrictions on social contact 	1 June
	Step 3	 Phased opening of most remaining businesses including personal care, hospitality, public places and leisure facilities (subject to social distancing) Easing of 2m distancing rule to 1m with risk mitigation 	4 July
Phase 3		• Effective treatment and/or vaccine in place	?

SOURCE: RF analysis of HM Government, Our plan to rebuild: The UK Government's COVID-19 recovery strategy, May 2020.

Based on the Government's approach, we have built an evidencebased scenario for how quickly the economy might improve

The combination of a differential impact of the lockdown and variation in the speed that different sectors can open up means prospects for different parts of the economy will vary considerably. This is crucial to the policy response: simply setting policy given the average hit across sectors will mean far too little support for hard-hit sectors, and too much for those which are largely unaffected.

To inform policy choices, then, it is important to have a view on how output will evolve by sector. We have therefore put together a simple evidence-based scenario for how quickly each sector might be able to recover. Doing this requires four pieces of information:

- 1. The initial hit to each sector from the lockdown;
- 2. The starting point at which the Government's exit strategy starts to allow for an easing in those restrictions;
- 3. The pace at which that easing allows economic activity to increase; and
- 4. The extent to which economic activity can improve without a vaccine.

1. and 2. are described above, and 3. and 4. are drawn from mobility data reflecting the experience of other countries that have opened up earlier than the UK (see Figure 3). In particular, for the pace of increase we simply take the rate of (monthly) improvement in Germany over the past couple of months. We use data on retail and recreational mobility for sectors reliant on social interaction; and we use workplace mobility for the rest. We choose Germany partly because it is slightly ahead of the UK in terms of the point at which the lockdown restrictions were eased, but also because the rate of improvement has been relatively rapid – and so it represents a relatively optimistic case, allowing us to give a sense of what it might be possible to achieve with effective health policy. This implies an average monthly rate of increase in activity of around 35 per cent in all sectors (and it makes little difference if we choose other European countries). For the extent of improvement, we use data from Taiwan, South Korea and New Zealand, all of which have managed to drive the virus caseload down to very low levels. The experience of these countries implies that sectors reliant on social interaction will not be able to do better than 10 per cent below the pre-coronavirus level, while other sectors affected less severely by the crisis are assumed to remain only around 5 per cent down.

It is important to stress the uncertainty around these assumptions. The mobility data are a helpful guide, but the sectoral coverage will be different across countries. More importantly, differences in circumstances will mean that the UK's experience will be different. That said, these indicators provide a plausible baseline which can be used to guide the broad shape of the policy response.

The heatmap in Figure 4 summarises our evidenced-based scenario for how quickly the economy could recover under current stated Government policy. It shows that for some sectors – for example public administration and agriculture – the initial impact is minimal, and so those sectors recover quickly to their pre-crisis level of activity. At the other end of the spectrum, hospitality starts opening up from July and remains significantly restricted for the rest of the year. The relatively rapid improvement seen in Germany implies that all sectors reach their new, pre-vaccine, normal – that is, the highest path for output that can be managed without a permanent solution like a vaccine – by the end of this year.

FIGURE 3: mobility data suggest that once countries open up, economic activity returns rapidly



Change in google mobility trends to places of work: selected countries, since February 17, 2020: selected countries

NOTES: The chart displays aggregated, anonymised data to chart movement trends over time by geography, across different high-level categories of places such as retail and recreation, groceries and pharmacies, parks, transit stations, workplaces, and residential. Location accuracy and the understanding of categorized places varies from region to region. Google recommends not using the data to compare places with different characteristics. The baseline is the median value, for the corresponding day of the week, during the 5- week period Jan 3–Feb 6, 2020.

SOURCE: RF analysis of Google, Community Mobility Reports.

In order to extend our scenario beyond that point, we need to assume when a permanent solution to the crisis can be found, and what the new path for GDP looks like in that world. Uncertainty is obviously incredibly high. We assume a timetable for vaccine development and roll-out that sees sectors improve gradually toward their pre-crisis path in 2021, and come within around 4 per cent of that level by the end of 2021; this is consistent with the experience of the 1980s and 1990s recessions.⁹ This is the 'new normal' (point 3 in Figure 1). In reality, the adjustment to the new normal from the pre-vaccine path is likely to be less smooth (with slow progress, followed by swift increases in activity once a solution to the virus is found). But our smoothed scenario is consistent with the average of a range of possible outcomes in which a solution is found in one of the four quarters next year. On the probability of that occurring we offer no view, taking encouragement from news of rapid vaccine development while noting the very

⁹ In previous RF work, these recessions are characterised as 'unemployment heavy' recessions – see: J Smith, <u>Failing to plan</u> = planning to fail: The risk of recessions and the importance of macroeconomic policy in limiting the damage they cause, Resolution Foundation, July 2019. And given that, as described in N Cominetti, L Gardiner & H Slaughter, The <u>Full Monty: Facing</u> up to the challenge of the coronavirus labour market crisis, Resolution Foundation, June 2020, it seems plausible to think that unemployment could return to 1990s levels, we draw on the experience of the 1980s and 1990s recession when calibrating the size of the long-term impact. Again, this is relatively optimistic assumption, as recoveries from other recession – notably the financial crisis – have been far slower.

substantial risk that it takes longer to find a solution. In what follows, what matters in thinking through how policy should respond is that there is some temporary economic weakness that recedes gradually over time, but which policy plays an important role in counteracting, and a longer-term structural hit to the economy which, ultimately, policy cannot completely eradicate.

FIGURE 4: the reopening will affect different sectors in different ways

Actual/forecast change in GVA by sector

Sector	Apr-20	Jul-20	Oct-20	Jan-21	Apr-21	Jul 21	Oct-21	Jan-22
Agriculture	-6%	-2%	-1%	0%	0%	0%	0%	0%
Mining, energy and water supply	-8%	-2%	-1%	0%	0%	0%	0%	0%
Manufacturing	-24%	-11%	-5%	-5%	-4%	-4%	-4%	-4%
Construction	-40%	-18%	-6%	-5%	-4%	-4%	-4%	-4%
Retail, wholesale and motor trades	-27%	-18%	-11%	-11%	-10%	-9%	-9%	-8%
Transport and storage	-29%	-9%	-5%	-5%	-4%	-4%	-4%	-4%
Hospitality	-88%	-57%	-16%	-11%	-10%	-9%	-9%	-8%
Information and communication	-13%	-5%	-5%	-5%	-4%	-4%	-4%	-4%
Financial and insurance services	-5%	-2%	0%	0%	0%	0%	0%	0%
Real estate	-2%	-1%	0%	0%	0%	0%	0%	0%
Professional, scientific and technical	-20%	-6%	-5%	-5%	-4%	-4%	-4%	-4%
Administrative and support activities	-28%	-9%	-5%	-5%	-4%	-4%	-4%	-4%
Public administration and defence	0%	0%	0%	0%	0%	0%	0%	0%
Education	-34%	-34%	-14%	-11%	-10%	-9%	-9%	-8%
Human health and social activities	-21%	-6%	-5%	-5%	-4%	-4%	-4%	-4%
Arts, entertainment and recreation	-40%	-40%	-11%	-11%	-10%	-9%	-9%	-8%
Other services	-41%	-28%	-8%	-5%	-4%	-4%	-4%	-4%
Whole economy	-21%	-11%	-5%	-5%	-4%	-4%	-4%	-4%

SOURCE: RF analysis of ONS, Google mobility trends.

The key uncertainty about how the economy will progress revolves around the progress of the health crisis

The assumptions discussed above are consistent with the Government's reopening strategy proceeding broadly according to plan. They incorporate a smooth exit from the lockdown – even though they imply many sectors in deep recession through most of this year – with progress matching the experience of some of the least affected countries in the world. They are consistent with localised flare ups, but they are not consistent with a widespread increase in cases which prompts a further lockdown. This makes them interpretable as the most rapid recovery that could be safely achieved given the constraints on the supply side from measures to stem the flow of the virus, *conditional on the outbreak remaining contained*.

But it is important to understand there are risks to the downside. The reproduction rate of the virus, *R*, remains close to its critical value of one (see Figure 5). Moreover, we have seen from regional variation in England, as well as from the experience around the

world, that it is possible for the virus to reemerge. So it is far from guaranteed that the Government's exit strategy will proceed as planned. Alongside the impact of reopening, there is uncertainty about the impact of climate on the spread of the virus, and it is certainly possible that the winter could lead to a rise in *R*. Or a second wave could simply reflect a failure of containment policies, including the test, track, trace and isolate infrastructure.¹⁰ If the Government was forced to return to a full lockdown, the economic hit would be bigger in total (although the marginal hit smaller) both in the near-term and the longer-term, as the scarring effects would also be larger.¹¹



NOTES: these are estimates and so are subject to uncertainty. A 95 per cent confidence interval generally lies in the region of ±0.2 around the median estimates. SOURCE: MRC Biostatistics Unit, University of Cambridge.

¹⁰ In this paper we do not make any attempt to set out policies which would reduce the spread of the virus as this is not our comparative advantage. Nevertheless, successful test, track, trace and isolate infrastructure in other countries suggests significant returns to the Government putting significant resources into developing such a such system. Where possible, economic policy measure should support these efforts. For example, any individual who has to self-isolate as part of the test and trace programme should also be able to be furloughed if they are unable to work while self-isolating. For more on this issue, see: T Bell, L Gardiner & D Tomlinson, <u>Getting Britain working (safely) again: the next phase of the Coronavirus Job Retention Scheme</u>, Resolution Foundation, May 2020.

¹¹ For more on the risks of a second wave, see the discussion around the 'double hit' scenario in OECD, <u>Economic Outlook</u>, June 2020.

We use two illustrative scenarios to explore the impact of uncertainty about the virus on policy

Putting all this together, then, we define two illustrative scenarios to help explore the quantitative implications of policy in the reopening phase.¹² The first is a case in which the Government's reopening plan is working and the economy moves smoothly towards the new economic normal, with a long-term solution found at some point next year. We term this the 'Government exit strategy scenario'. And in the second, we consider the implications of a return to lockdown. We refer to this as the 'Second wave scenario'.

There are of course many more possible scenarios than the ones we outline. One approach could be to attempt to use scenario analysis to explore the entire distribution of possible outcomes by assigning probabilities to those scenarios. We do not take that approach. Instead we use the Government exit strategy scenario as a way of setting out a plausible central case, but use the Second wave scenario as a way of assessing how we might be able to make policy robust to the risk of a significant re-emergence of the virus. This is not our central case, but we view a second wave as a significant risk.



SOURCE: RF analysis of ONS and OBR.

The Government exit strategy scenario draws heavily on our sectoral analysis. As shown in Figure 6, the initial hit to the economy in Q2 reflects the GDP data we have for April

12 This work draws on the economic analysis in our previous research, see: R Hughes, J Leslie, C McCurdy, C Pacitti, J Smith & D Tomlinson, Doing more of what it takes, Resolution Foundation, April 2020.

and our assessment of the opening up of sectors in May and June, and collectively implies a fall in output of around 18 per cent in that quarter (point 1 in blue on Figure 6). That initial hit to GDP is around half the size of that included in the OBR's reference scenario, reflecting the smaller than expected falls in output in a number of sectors (see comparison of the red and blue bars in the left-hand panel in Figure 2). But the recovery thereafter is much slower than included in the OBR's scenario, reflecting the Government's announced recovery strategy and the time it takes for individual sectors to open up (Figure 7). Output recovers to within around 5 per cent of its pre-crisis path by the end of this year (point 2), which is assumed to be the best that can be achieved without a long-term solution, like a vaccine.

FIGURE 7: Our scenarios imply a smaller hit to GDP in the near term and then a slower recovery thereafter than the OBR and Bank of England scenarios



Scenarios for GDP growth

SOURCE: Bank of England; OBR; and RF analysis.

The Government exit strategy scenario should be interpreted as the best recovery that can be achieved given the supply constraints facing the economy. It is a plausible datadriven case for how quickly the economy can grow based on the pace of easing of social distancing restrictions. It is, however, not an attempt to provide a model-based estimate of the size and source of the coronavirus shock to the UK economy. This means it takes good policy as given and gives a sense what can be achieved in this case.

The second wave scenario provides a simple illustration of the overall impact of a significant reintensification of the health crisis. Smaller, more localised flare-ups of

the kind we are seeing in a number of countries are not assumed to lead to significant deviations for the path of the economy in the Government exit strategy scenario. This scenario is different, assuming that a second wave hits in 2020Q4 when the weather becomes colder, with a return to economy-wide lockdown. The loss of GDP from this second wave is assumed to be 70 per cent of our estimate for the impact of the initial lockdown (point 1 in red in Figure 6), similar to the approach taken by the OECD in its 'double hit' scenario.¹³ A smaller impact the second time round can be thought of as reflecting the UK having learnt lessons during the first wave, allowing for a more targeted, or swifter and therefore shorter, lockdown. But growth thereafter is slower, reflecting the impact of a longer period of weak activity on the productive capacity of the economy.

Falls in output are assumed to lead to a permanently lower path for supply, consistent with the scarring effects discussed above. In particular, supply growth falls back initially, reflecting weaker trend productivity growth, and lower investment. These falls are proportional to the assumed effects on these variables in the OBR's estimates of potential supply during the financial crisis. Thereafter, trend productivity *growth* is assumed to recover gradually. But potential supply never reaches its previous level owing to lost productivity growth and slightly higher unemployment. That said, because our scenario embodies a strong policy response, the rise in unemployment is not as large as in the Bank of England's scenario. All this is consistent with a gradual closing in the output gap – the difference between actual output and potential – over the five years of these scenarios. Finally, we draw upon the Bank of England's forecast for inflation which incorporates a sharp initial fall in inflation – largely reflecting falls in commodity prices, before recovering back to the Bank's 2 per cent inflation target within the subsequent two years.

These scenarios help us to think about the scale of the required policy response. But policy must also be grounded in the unique circumstances of this crisis. So in the next section we discuss briefly the implications of the supply and demand shocks hitting the economy.

¹³ OECD, Economic Outlook, June 2020.

Section 3

The economic impact of coronavirus and its implications for economic policy

In designing a policy response to this most unusual of recessions, it is crucial to understand how its effects are playing out across the economy and to tailor our approach to the unique circumstances of this crisis.

In this section we discuss those circumstances, drawing on our previous work on the impact of the pandemic. We make four points. First, that the hit to the economy is highly concentrated on sectors providing in-person services to households. This is unusual relative to previous recessions, which have been more broad-based and with their epicentres in sectors producing internationally-traded goods. This pattern implies that the policy response needs to be different to previous recessions too with much more targeting of measures at the hardest-hit sectors. Second, there is a stark difference in the impact on the finances of lower- and higher-income families. Those at the top of the distribution typically consume a higher proportion of services, and the closing of these sectors appears to have led to a sharp rise in enforced saving, improving household balance sheets. Lower-income families by contrast have seen their balance sheets deteriorate, on average - reducing savings and taking on debt. Third, higher uncertainty and recent increases in corporate debt risk holding back businesses' investment in jobs and physical capital. If this is the case, it would hobble the recovery. Fourth, given the size of the hit to economy, there is a significant risk that this crisis could lead to a return to levels of unemployment not recorded since the 1990s if policy does not respond in an effective and timely manner. If this were the case, it could take years for unemployment to fall back, particularly if large numbers of workers were forced to leave the hardest-hit sectors. This risk calls for a job-focussed policy response.

All this points to the need to put in place a policy package to boost demand for the output of the hardest-hit sectors, and which also counteract the *temporary* constraints on supply affecting those sectors. In all cases policy measures should be robust to the risk of a second wave. Understanding the nature of the hit to the economy is crucial to designing a policy response. In this section, we consider briefly the impact of the coronavirus crisis across sectors of the economy, on family finances, on prospects for the corporate sector and the labour market.¹⁴

The hit to the economy is concentrated in consumer-facing service sectors

Unlike in previous recessions, the hit to the economy has so far and will continue to be very concentrated in sectors of the economy reliant on social interaction. These are predominantly in-person service sectors - particularly hospitality; arts, entertainment and recreation; transport; and non-food retail. They collectively make up around a fifth of the economy, and output has fallen by around a third between January and April.¹⁵

Above this detailed lower level sector analysis, Figure 8 reminds us that most recessions are much more heavily experienced in the production sector, but this has not been the case this time. Although the proportion of consumption in overall final demand means that it is always a key target for stimulus measures, it is particularly important to consider how best to support the service sector this time given that it is the epicentre of the crisis.

FIGURE 8: The hit to the economy is unusually concentrated in services



Falls in GVA in major sectors of the economy: UK

¹⁴ For more on the economic impact of the coronavirus crisis, see: C Lenoel & G Young, 'Prospects for the UK economy', National Institute Economic Review 252, pages F10-F43, May 2020.

¹⁵ Source: ONS, GDP monthly estimate, UK: April 2020.

There is a stark difference in the impact of the crisis on the finances of lower- and higher-income families

There is a stark difference in the impact on the finances of families between lower- and higher-income families.¹⁶ With much of the economy closed, higher-income families have been unable to continue their previous consumption patterns. As shown in Figure 9, those on higher incomes spend a larger proportion of their income on the most affected services, such as on restaurants and hotels.





Nominal consumption split by category of spending (per cent of overall spending)

NOTES: Lockdown-affected services comprise: 'domestic services', 'sports and recreation services', 'cultural services', 'package holidays', 'restaurants and hotels' and 'hairdressers, salons etc'. SOURCE: RF analysis of ONS, LCFS.

This has led to 'enforced' saving for those at the top of the income distribution: as shown in Figure 10, over one-third of the richest fifth saw their savings increase in the early months of the crisis. By contrast, lower-income working-age families are more likely to have seen the amount they save each month fall during the lockdown, with one-third of those in the second income quintile doing so (indeed, 22 per cent cut their saving by more than 10 per cent). Concerningly, as shown in our previous work, lower-income households are also more likely to have taken on extra debt to cope during the crisis,

¹⁶ For a full discussion of this issue, see: G Bangham & J Leslie, <u>Rainy days: An audit of household wealth and the initial effects of the coronavirus crisis on saving and spending in Great Britain</u>, Resolution Foundation, June 2020; and M Brewer & L Gardiner, <u>Return to spender: Findings on family incomes and spending from the Resolution Foundation's coronavirus survey</u>, Resolution Foundation, June 2020.

with a quarter of the second income quintile reporting taking on extra consumer credit, twice the proportion among high-income families. Lower-income families are particularly likely to have increased their use of higher-cost products like credit cards and overdrafts. Lower-income families have also turned to informal loans and gifts from friends and family to make ends meet, which in many cases will not represent a sustainable income source.



NOTES: Base = all UK adults not studying or retired. Income quintiles are based on net family income prior to the coronavirus outbreak. Sample weighted to be representative of individuals but not families. SOURCE: RF analysis of YouGov, Adults aged 18 to 65 and the coronavirus (COVID-19).

A key takeaway is that, in providing any future stimulus to boost consumption, the differential impact of the crisis across the income distribution will need to be considered. For those on lower incomes, there is a need to provide more support. Apart from anything, this should increase the impact of any stimulus given the higher propensity to consume among that group.

Finally on consumption, it is worth keeping in mind that across the distribution, and particularly for those towards the top, there is a risk that the crisis will lead to lasting changes in consumption habits, with some households concerned about catching or spreading coronavirus and therefore understandably reluctant to return to spending n

in-person services.¹⁷ In this context it is worth noting that the share of retail sales taking place on-line has risen to over a third – an all-time high.¹⁸ Part of the support for those hardest-hit sectors will be encouraging a return of spending to in-person services, but only when it is safe to do so.

Higher debt and uncertainty are headwinds to job creation and investment

The extent to which some firms are able to remain in business in the face of huge falls in revenue will shape the extent of the eventual rise in unemployment. And looking ahead, their investment in jobs and physical capital will be important in determining how quickly the economy can recover.

In this context, then, it is worrying that firms face headwinds from higher debt and uncertainty, in addition to struggling in the face of the lower demand that a weak economy provides. As discussed in Section 5, firms have taken on more debt since the crisis hit to tide them over. Even at very low prevailing interest rates, servicing that debt will reduce the value of those firms, effectively raising the bar for future investment spending. Given that typical corporates have enough cash reserves to cover around three months of outflows, solvency – and not just cash flow – will becomes a bigger issue for some firms in the future. This is likely to be particularly the case if there is a second wave and return to lockdown.

The second major headwind firms face is from uncertainty which, as shown in Figure 11, remains elevated. This reflects intrinsic uncertainty about the near-term prospects for the health crisis and how social distancing restrictions will change over time. But it will also be the case that firms will be making decisions based on expectations about the longer-term impact of the crisis, particularly around the extent to which demand for their goods and services will return to pre-crisis levels. There is also significant uncertainty about the timing of a longer-term solution to the crisis which will affect decisions about whether to adapt business models in order to increase the probability of staying in business. In this context, particularly for firms in the hardest-hit sectors, even relatively low costs of adapting to the new environment may be sufficient to push some firms into closing.

¹⁷ For a detailed discussion of these issues in the context of the US, see: R Chetty, J N Friedman, N Hendren, M Stepner & the Opportunity Insights Team, 'How did COVID-19 and stabilization policies affect spending and employment? A new real-time economic tracker based on private sector data' Working Paper, June 2020.

¹⁸ Source: Retail sales, Great Britain: May 2020, ONS, June 2020.



NOTES: Series shown are: six-month option-implied volatility for the FTSE 100 (for equity volatility); and the 6-month option implied volatility of short sterling (for interest rate volatility) SOURCE: RF analysis of Bank of England.

A rapid recovery in jobs and living standards will need to be underpinned by firms investing in jobs and physical capital capable of deliver productivity increases in future. All this suggests that reducing the headwinds on firms from debt and (in so far as is possible) uncertainty should be a priority for policy makers.

This crisis could lead to a return to unemployment levels not seen since the 1990s

There is a risk that the crisis leads to a large rise in unemployment.¹⁹ Indeed, as a result of on-going sector-specific constraints, and the more common recession experience of reduced demand by households and firms across the economy, unemployment could reach levels not seen since the 1990s by the autumn, with the phasing out of the Job Retention Scheme itself potentially driving one million redundancies.

If there is a large rise in unemployment it is unlikely to fall back swiftly. Indeed, absent a timely, targeted and large-scale policy response, the unprecedented hit to overall economy could turn into a disaster in the labour market. The lesson from history is that, once unemployment rises, it rarely falls rapidly. Low inflation means it is unlikely that we will see the kind of real wage adjustment that protected jobs and hit pay after the financial crisis. And, to the extent that falls in unemployment rely on a rapid (and in this

¹⁹ For more on the impact of the crisis on the labour market, see: N Cominetti, L Gardiner & H Slaughter, The <u>Full Monty: Facing up to</u> <u>the challenge of the coronavirus labour market crisis</u>, Resolution Foundation, June 2020.

case in part temporary) reallocation of workers away from the hardest-hit sectors, history tells us that we are unlikely to see the scale of reallocation required to avoid lastingly high unemployment (Figure 12).

FIGURE 12: Speedy sectoral reallocation at the scale needed is unlikely



NOTES: The measure used is the absolute change at the industry section level from peak-to-return-topeak employment, divided by peak employment, divided by the length of the time in years taken to return to peak employment. The coronavirus scenario is a stylised calculation to illustrate the scale of sectoral reallocation that may be required for people losing work in the hardest-hit sectors. Hospitality, retail, and leisure are each assumed to lose 10 per cent of employment, which other sectors absorb according to their proportion of total employment (less the hardest-hit sectors). This change is assumed to happen over 18 months.

SOURCE: RF analysis of ONS, Workforce Jobs.

The difficulty of the labour market crisis we face is not just the scale and speed of the outflows of workers from the hardest-hit sectors, but also that they will be taking place against a backdrop of weak demand and high uncertainty. That will curtail other sectors' ability to absorb labour that leaves these employment-heavy sectors. Without significant policy action, lasting unemployment or inactivity may be a more likely result than work in other parts of the economy for those losing jobs now. Policy should therefore aim to reduce the size of the outflows from the hardest hit sectors, alongside the traditional focus on quickly returning the newly unemployed to work.

In the reopening phase, policy needs to provide stimulus in a way that recognises the nature of the underlying economic shocks

Bringing this together, then, below we set out our framework for thinking about economic policy in the reopening phase. In short, the economic hit requires policy to address the impact of the crisis on both the demand and supply sides. On the demand side, stimulus measures should respond to the shortfall in consumption, particularly targeting in-person services like hospitality and physical retail. On the supply side the priorities should be to prevent corporate debt from holding back the recovery and to resist a labour market shake-out triggered by the very significant but temporary restrictions on supply in the hardest-hit sectors (and to minimise the duration of unemployment where it does occur).

TABLE 2: A framework for policy in the coronavirus crisis

Summary of policy approach in the reopening phase of the crisis

Policy objectives in the reopening phase

Demand measures:

• Generate as rapid a recovery as safely possible to minimise the economic damage » Targeted stimulus to support consumption in the near term

Supply side measures

- Resist effects of temporary supply shocks in hardest- hit sectors to avoid labour market shakeout
 - » Wage subsides to reduce firms' real wage costs and measures to help with adaption
- Support unavoidable reallocation
 - » More generous support for firms to stop high debt levels weighing on investment; assistance for job search

Above all, policy must be robust to risk of second wave

» Avoid measures that are wasted in that scenario

SOURCE: RF analysis.

Our approach to this crisis must be different from the recessions of the past

One way to design policy for this recovery is to look back to previous recessions and try to use the same approach this time. This would be a valid approach if all recessions
were alike, if the macroeconomic context remained unchanged, and the task was always simply a case of boosting economy-wide demand. But the sector-specific nature of the economic hit during this crisis, along with the fundamental uncertainty about the path of the virus, demand an approach that is tailored to today's unique circumstances.

Another key reason why this time has to be different is because monetary policy is unable to play a major role in this recovery. As discussed in our previous work, the low level of interest rates globally limits the ability of monetary policy to support the economy in times of recession.²⁰ This is in stark contrast to previous recessions in which rates have been cut by more than five percentage points on average, accounting for the vast majority of the overall macroeconomic policy stimulus. The constraint provided by the low level of interest rates is most obvious in limiting how far policy rates can fall: as the Monetary Policy Committee (MPC) has already cut its policy rate to an all-time low of 0.1 per cent (Figure 13), there is little or no space for rates to be cut further.²¹ But the low level of rates also limits the extent to which Quantitative Easing (QE) can be used to stimulate the economy.²² Indeed, there are good reasons for thinking that QE reaches its limit at the point at which longer-term rates fall to the same level as the lower limit on interest rates.²³ If that is 0.1 per cent – or even slightly below – then that point has been reached already (Figure 13). In short, monetary policy is close to its limits, leaving fiscal policy as the key marginal provider of stimulus in this crisis. So, in what follows, we focus on fiscal policy as the key area of policy maker action.

The nature of the shock to the economy and the constraints on monetary policy are key to shaping our framework for policy. We next turn to the required scale of the policy response, before setting out the specific policy tools we advocate using to achieve these objectives.

²⁰ See: J Smith, J Leslie, C Pacitti & F Rahman, <u>Recession ready? Assessing the UK's macroeconomic framework</u>, Resolution Foundation, September 2019.

²¹ While there is some suggestion that this rate could be cut into negative territory, this will not impart large-scale stimulus. Such a policy appears to be under consideration (for example, see: A Bailey, <u>Central Bank Reserves Can't Be Taken for Granted</u>, Bloomberg Opinion, June 2020). But our view is that this would do little to impart extra stimulus because the marginal impact of cutting rates to low levels tends to fall, and can eventually become negative. For a discussion of the reasons for this, see: M K Brunnermeier & Y Koby, <u>The Reversal Interest Rate</u>, NBER Working Paper No. 25406, 2018.

²² For a discussion of the transmission of QE, see: J E Gagnon, J Leslie, F Rahman & J Smith, <u>Quantitative (displ)easing?</u>, Resolution Foundation, September 2019.

²³ For a discussion of the reasons for this, see: G Vlieghe<u>, Monetary Policy: Adapting to a Changed World</u>, Speech given at the 2019 MMF Monetary and Financial Policy Conference, Bloomberg, London, October 2019.

FIGURE 13: Monetary policy is close to its limits with longer term interest rates below the Bank of England's policy rate (Bank Rate)



SOURCE: RF analysis of Bank of England.

Section 4

How much policy is required to generate a rapid recovery?

A key issue facing policy makers is *how much* policy support to put in place. This is a difficult judgement to get right, with significant risks from doing too much or too little, and with history not much of a guide, given the unique circumstances of this crisis. But policy makers must start from a position of knowing at least the rough size of the support they need to provide in order to achieve a rapid recovery.

In this section we address that question head on. Because of the very significant uncertainties that cloud any specific approach to quantifying the scale of stimulus required, we set out three approaches. The key takeaway from this exercise is that a very substantial level of stimulus is required. Bringing together our three approaches, we suggest that a fiscal policy package of around £200 billion, implemented over the course of the next two years, is the right order of magnitude. This is a significantly bigger fiscal stimulus than many commentators have discussed, but that reflects the fact that monetary policy is unable to provide its traditional dominant role in macroeconomic stabilisation. It is also in line with the size of the stimulus packages being discussed by other major advanced economies, for example the US.

In this section we consider the question of *how much* policy is required in the recovery phase, before turning, in the next section, to the question of which policies should be deployed to deliver it. Of course, the exact amount of stimulus required will be highly uncertain, as it always is following recessions, but especially so in this crisis given the inherent unpredictability of the health crisis. But policy makers need to start with a sense of the scale of policy support that is required. So, after noting the risks of going too far or not far enough, we provide three ways to think about this question.

By implementing measures that minimise the health risks, policy makers can push for a more rapid recovery

There are risks both from over- and under-stimulating the economy. Below we discuss those risks and how to set policy to mitigate them.

There are three key risks from overstimulating the economy. First, the most obvious risk from going too quickly is that it contributes to a re-emergence of the virus, requiring a further lockdown that would undermine economic activity and confidence in the Government's public health strategy. Second, given that fiscal policy will be playing a larger role than in previous recessions, going too far will result in large increases in borrowing, potentially prompting concerns about value for money and, ultimately, the sustainability of the public finances. Third, supply constraints could prompt a rise in inflation: although such a rise in inflation should be temporary, given the likely high levels of unemployment. If it was persistent then it could lead to an increase in medium-term inflation expectations, which might force monetary policy to tighten.

But there is also a large body of evidence documenting the economic damage from under-stimulating the economy. For example, recent work has highlighted that countries which tighten fiscal policy quickly after a recession experience significantly slower recoveries.²⁴ Indeed, such problems can be more severe when monetary policy is not able to contribute to the recovery.²⁵ And there is evidence that there is a path dependency, in that deeper and longer-lasting downturns cause lasting damage to the supply side of the economy.²⁶

How should these risks be weighed up? Of course, if the rate of infections were to increase substantially, then policy must prioritise public health concerns, ramp up social distancing measures and only implement a stimulus when it is safe to do so. This in turn means that, wherever possible, policy should be set so that it can be adjusted easily in the event of a second wave of infections. But given this, our view is that the compelling evidence on the substantial costs associated with under stimulating the economy implies that policy makers should push for a rapid recovery. Put simply, from a welfare perspective, it is better to err on the side of over, rather than under, stimulating.

But how do policy makers know how much to aim for? We provide three ways of thinking about this question.

²⁴ For a discussion of these issues, see: C D Romer & D H Romer, '<u>Fiscal Space and the Aftermath of Financial Crises: How It Matters</u> and Why', NBER Working Papers No. 25768, 2019.

²⁵ This risk is documented in B S Bernanke, M T Kiley & J M Roberts, '<u>Monetary Policy Strategies for a Low-Rate Environment</u>', Finance and Economics Discussion Series 2019-009, Board of Governors of the Federal Reserve System, 2019.

²⁶ See: O J Blanchard & L H Summers, '<u>Hysteresis in Unemployment</u>', European Economic Review, vol. 31, pages 288-95, 1987; R F Martin, M Teyanna & B A Wilson, '<u>Potential Output and Recessions: Are We Fooling Ourselves</u>?', IFDP Notes. Washington: Board of Governors of the Federal Reserve System, November 2014; and D Reifschneider, W Wascher & D Wilcox, '<u>Aggregate Supply in the</u> <u>United States: Recent Developments and Implications for the Conduct of Monetary Policy</u>', IMF Economic Review, pages 71-109, May 2015.

We take three approaches to estimating the appropriate overall stance of macroeconomic policy

The crucial but difficult question about the size of the policy package needed to deliver a rapid recovery is complicated by uncertainty about both the progression of the virus and the nature of the underlying economic hit. To address these issues, we set out below three approaches to gauging the overall amount of stimulus required.

Our first approach is the amount of fiscal stimulus it would take to stop policy becoming a drag on growth. We think of this approach as policy makers 'doing no harm', so refer to it as a 'Hippocratic' approach. Figure 14 helps to illustrate how this works. It shows in the blue bars an estimate of the quarterly impact of monetary policy stimulus measures on growth, and in the red bars, the impact of fiscal stimulus (the former is derived from the Bank of England's published policy multipliers, the latter from the Office of Budget Responsibility's (OBR's)).²⁷ In contrast to the financial crisis, fiscal policy is currently playing the dominant role in supporting the economy, with much more stimulus provided in total reflecting the unprecedented scale and speed of the shock to the economy. But, based on the OBR's current costings - which embody the assumption that the current set of stimulus measures are not replaced by new measures as they roll off - macro policy starts to exert downward pressure on growth in the coming quarters. This is shown in the dark red bars: it partly reflects the base effect of the policy boost dropping out of the growth rate. But it is also because the effects of fiscal and monetary policy on the level of GDP are assumed to be neutral in the long run. If that is the case, their effects would be expected to unwind over time. Our Hippocratic approach looks at how much fiscal stimulus would be needed to drive those red bars back up to zero over the next fiscal year. We choose next year because it is the period after the large positive effects of the current emergency support measures have had the vast majority of their effect, but before the output gap estimate in our scenario has come close to closing (we choose within half a percent as the point at which it is close to closing). By that latter point, there is a question about whether more stimulus would be warranted. This period is a crucial point for the recovery and a period in which policy has an important role to play.

²⁷ The Bank's most recent estimates suggest a temporary cut in interest rates of 1 percentage point has a peak impact of around 0.4 per cent on GDP, see: S Burgess, E Fernandez-Corugedo, C Groth, R Harrison, F Monti, K Theodoridis & M Waldron, '<u>The Bank of England's forecasting platform: COMPASS, MAPS, EASE and the suite of models</u>, Bank of England Working Paper No. 471, 2013. The OBR's multipliers are taken from, Box 3.2 on page 39 of: Office for Budget Responsibility, <u>Economic and Fiscal Outlook – July 2015</u>, July 2015. The approach employed for fiscal policy is similar to that used in the <u>Hutchins Center Fiscal Impact Measure</u>, which also displays a similar pattern for the US to that in Figure 13. While it is likely that the impact of fiscal and monetary policy depends on the state of the economy, our view is that there is an argument for thinking that monetary policy multipliers would be smaller than normally assumed given the low level of interest rates. And while the low level of interest rates should push up on the fiscal multipliers, there are reasons for thinking that supply constraints facing the economy right now might push in the other direction, making it unclear how we might aim off these estimates.

FIGURE 14: Fiscal policy is set to become a drag on growth in the coming quarters



Contributions to quarterly growth from fiscal and monetary policy

Our second approach is to look at how much support was provided by policy during the previous recession. We call this our 'Historical' approach. Again, we use estimates of the impact of fiscal and monetary policy so far that underpin Figure 14, but this time the target for policy is different: rather than setting policy over the next fiscal year (the period between the large positive impact of the current emergency support measures and the output gap being within 0.5 per cent of closing) so that the combined effect is zero, this time we calibrate it to an estimate of the impact of policy in the aftermath of the financial crisis (see Figure 15). It is worth noting that this implies slightly less of an overall positive impact from policy than in the Hippocratic approach because the impact of policy started to unwind in the second half of the year after the end of the financial crisis recession. Some have argued that such a tightening in the stance of policy was inappropriate in the aftermath of such a large recession. If so, that would imply that we need more stimulus than in the aftermath of the financial crisis and our estimate of the warranted stimulus should in fact be higher than that coming out of this approach.

FIGURE 15: Policy provided a substantial boost to the economy during the financial crisis (although most of that came from monetary policy).



Impact of monetary policy on the level of GDP in the aftermath of the financial crisis

SOURCE: RF analysis of ONS; Bank of England.

Our third approach is to look at what a simple monetary policy rule would suggest for the impact of policy. This approach involves taking the path for the output gap and inflation in the Government exit strategy scenario and using a simple 'Taylor rule' to convert that into a guide for how far interest rates should be cut if they could fall far into negative territory.²⁸ While such a rule is designed to provide an approximation to the way central banks behave in practice – and so is not intended as a way of calibrating fiscal policy - it is a well-known benchmark for how policy might respond to news about the economy. Once we have used the Taylor rule to extract a path for interest rates, we then use the multipliers underlying Figure 14 to calculate how much fiscal stimulus would be needed to provide an equivalent impulse to the economy. As shown in Figure 16, in the immediate aftermath of the crisis there is a very large warranted fall in the interest rate. But over subsequent quarters that reverses as inflation picks up and the output gap closes under our scenario, implying stimulus should then be removed over the next few years. Together, this suggests a rather smaller stimulus package. But a key point to keep in mind here is that there is some circularity in how we are setting up this thought experiment as this approach involves us taking a scenario that is designed to be a demonstration of the impact of good policy and using it to assess what that policy should

²⁸ The Taylor rule is a stylised way of characterising the response of unconstrained monetary policy makers in response to changes in inflation and the real economy (summarised by the output gap – the difference between actual output and the level of sustainable, or potential, output). It describes monetary policy makers as cutting interest rates when output is below potential and/ or inflation is below the inflation target. See: J B Taylor, 'Discretion versus policy rules in practice', Stanford University, 1993.

be. This means this third approach will likely underestimate the size of the warranted stimulus.

FIGURE 16: A simple monetary policy rule would suggest a very sharp cut in rates followed by tightening



Estimate of the implied fall in interest rates from a simple Taylor rule

NOTES: Path implied by a Taylor rule is based on estimates of the output gap and inflation under the Government exit strategy scenario. SOURCE: RF analysis of Bank of England.

All three of our approaches deliver the same message: substantial stimulus is required

Table 3 shows the results under all three approaches. There is a range of estimates from £170 billion to £220 billion with the average just above £200 billion, or around 10 per cent of GDP. This is far from a precise exercise, but points towards a reasonable central case that policy makers should prepare a stimulus worth around £200 billion. It certainly warns against proposals for stimulus packages in the low tens of billions.

These approaches sum the amount of stimulus required between the end of the emergency support measures (for example, the CJRS and SEISS) and the point at which the output gap is expect to return to below half a percent of GDP – that is, next fiscal year. At that point, further stimulus would risk an overshoot of the inflation target. But because the exact magnitude and timing of the effects are not precise, our view is that some of the required stimulus should be implemented in the current fiscal year – supporting the economy when it is safe to do so (i.e. as emergency measures are withdrawn), as well as in subsequent fiscal years. Finally, an important point to keep in

mind is that, when assessing the size of the warranted stimulus, our mapping assumes that all the measures come in the form of high-impact spending measures: if less impactful measures are chosen than the ones we go on to highlight, then more spending might be needed.

TABLE 3: **All of our approaches suggest substantial stimulus is required** Total additional measures relative to OBR reference scenario baseline (2020-21 to 2022-

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	Size of warranted stimulus
'Hippocratic' approach	£220 billion
Historical approach	£220 billion
Taylor rule approach	£170 billion

SOURCE: RF analysis of Bank of England and OBR.

Policy makers put in place fiscal stimulus measures of less than 5 per cent of GDP (around £110 billion at today's prices) during the financial crisis, much smaller than that proposed above.²⁹ But this is not the right comparison to make, because monetary policy provided most of the policy support during the financial crisis. The inability of monetary policy to provide the same level of support this time will mean that fiscal policy needs to do more of the heavy lifting in supporting the economy. Indeed, the 'Historical' approach in Table 3 is taking the amount of stimulus provided during the financial crisis by both monetary and fiscal policy and turning it all into a fiscal stimulus package.

The size of the stimulus package appears of a comparable size to that being considered by Governments in other developed countries. Such a comparison is complicated by the fact that stimulus packages are in the process of being designed in a number of countries. For example, as shown in Figure 15, the recovery package currently being considered in the US is around 15 per cent of GDP, although this is the figure for the total stimulus passed by the Democrat-held House, but not the Republican-held Senate, and so there are more stages for the plan to pass before it goes into law. But there are also substantial packages that have already been passed into law in Japan and Germany. Indeed, it should come as no surprise that these figures are large, given the extraordinary hit to GDP across countries and the constraints on monetary policy common to all large advanced economies.

²⁹ It is difficult to assess the overall size of the fiscal stimulus put in place during the financial crisis. Attempts to sum the discretionary measures (see, for example: J Riley & R Chote, <u>Crisis and consolidation in the public finances</u>, OBR Working Paper No. 7, September 2014) come to a smaller number. But such measures exclude decisions to continue high levels of nominal spending that policy makers chose to maintain in order to boost the economy. A simple measure of the change in fiscal stance taken from the change in the cyclically adjusted primary balance suggests a boost of around 5 per cent of GDP. However, this is likely to be an overestimate of the overall amount of stimulus to the extent that the cyclical adjustment does not account completely for changes in the impact of automatic stabilisers or the economy on the overall fiscal position.

FIGURE 17: A number of other advanced countries are currently putting in place significant fiscal stimulus measures

Size of fiscal response to coronavirus as a proportion of GDP and projected real GDP fall in 2020, advanced economies



NOTES: 'On-budget' refers to policy measures that increase borrowing. The UK is presented excluding Bank of England measures.

SOURCE: IMF, World Economic Outlook, June 2020; Financial Times, 'Republicans resist calls for big stimulus package', 8 June 2020.

It is important to be clear that the thought experiments provided above do not provide a precise calibration for the overall amount of policy – and so there will be uncertainty about whether it should be larger or smaller. It could, for example, be smaller because the overall boost from past measures is not as large as our estimates suggest. If that were the case, it would take a smaller stimulus package to keep fiscal policy from dragging on growth after that. On the other hand, if any of the stimulus measures had a smaller impact on the economy than the spending measures underlying our three approaches – for example, if some came through tax cuts – the size of the warranted stimulus would be larger. Overall, then, while there are risks on both sides, we think it is not unreasonable for policy makers to focus on preparing stimulus of the order of magnitude suggested here, and then adjust in the light of the performance of the economy.

The clear conclusion from this section is that, particularly in the absence of additional support from monetary policy, considerably more fiscal stimulus will be required than the Government has set out or most commentators have called for. In the next section, we discuss the type of policies that are best suited to deliver a stimulus of this size in the context of this highly unusual recession.

Section 5

Policies for a rapid recovery in the reopening phase

In this section we set out a policy package grounded in the unique circumstances of the coronavirus crisis. These measures fall into two categories: those which are designed to help the supply side of the economy; and targeted stimulus measures aimed at restoring demand.

Starting on the supply side, we set out a range of policies designed to resist the impact of *temporary* supply shocks in the worst-affected sectors, including job subsidies and help for firms to adapt to social distancing restrictions. In addition, our supply-side measures seek to facilitate the reallocation of resources where it is warranted, including via job-search support. To reduce the burden of debt and free up more firms to drive the recovery by investing and hiring, we recommend that the repayment of government-backed loans is switched to being on an incomecontingent basis, so that they are conditional on firms' revenue levels.

On the demand side, the near-term priority is to boost consumption rapidly as soon as it is safe to do so, and in a way that recognises the specific sectoral and distributional impact of this crisis. To achieve this, we propose a new £30 billion 'High Street Voucher' scheme to give vouchers to every household in Britain, worth £500 per adult and £250 per child, to spend in the areas of the economy being hardest hit, such as face-to-face retail and hospitality. This should sit alongside a targeted boost in benefit generosity and an increase in investment spending targeted at projects that would have high social value irrespective of the progress of the virus, such as those that advance progress towards zero carbon targets and improve social infrastructure.

In all cases, a key consideration is the risk of a second wave, and so policies which would be ineffective or poor value for money in the event of second wave should not be considered in the reopening phase.

As discussed in Section 3, the nature of this crisis means that policies to support the recovery should be targeted at two key areas. On the supply side, policy makers should address the effects of what is a *temporary* disruption even in the worst-affected sectors. Here, the aim is to avoid a sharp rise in unemployment. At the same time, however, there will still be some firms going out of business, meaning unemployment will inevitably rise. So, policy in this area will also need to be complimented by measures to help people back into jobs as quickly as possible, and to ensure that firms that can grow do so.

The other key area for generating a rapid recovery is a targeted demand stimulus. This is important both to minimise long-term economic damage, but also to minimise the hardship caused along the way. Achieving this requires targeted and fast-acting stimulus measures.

In addition, policies need to be selected recognising the risk of a second wave. In practice, this has two implications. First, we need to be cautious in ensuring that policies put in place do not actively exacerbate the spread of the virus. This means providing stimulus only once it is safe to reduce social distancing restrictions. In calibrating and costing the policy measures discussed in detail below, we have taken the Government's reopening policy as given, assuming that stimulus measures are deployed as emergency income-support measures are withdrawn. If it does not prove possible to reopen as planned, then, rather than turning to stimulus, the Government should continue with its lockdown policy of making good lost income, as we discuss in Section 6. Second, any measures which would be ineffective or wasted in the event of a second wave – such as across-the-board cash transfers to households (that could be saved rather than being spend) – are undesirable because they risk significant dead-weight losses.

Below we set out a package of policies that achieves these aims, and navigates this second-wave risk. We start with policies to address the fundamental shocks to the supply side.

A range of policies are needed to ease the adjustment to temporary supply shocks

Many firms will have their costs increased and outputs constrained by social distancing measures. This means there will be a fall – and possibly a very large one in some sectors – in how much firms can produce with their existing capital, and a rise in the cost of producing what they still can. This hit to productivity will create powerful incentives for firms to reduce wage bills by laying off workers. As noted in Section 3, it is unlikely that all those flowing out of the hardest-hit sectors will simply be absorbed elsewhere in the

economy. So, policies that address these issues – and counteract the extent to which negative supply shocks lead to a labour market shake-out – should be a priority for policy makers.

But it is important to recognise that policy will not be able to stop a rise in unemployment altogether, or stop all firms from going out of business. So, to speed up falls in unemployment and bounce backs in economic output, policy will also need to support the reallocation of workers across firms and sectors – where necessary – and to allow this to take place as rapidly as possible.

Below, we discuss two sets of policies to address these supply side issues, first those which focus on the labour market, and then measures to help firms directly.

Labour market measures

Below, we summarise briefly the approach that was set out in our recent in-depth policy paper.³⁰

The jobs challenge as the economy reopens is more challenging than that faced in the lockdown phase. It will require policy action of unprecedented size and breath, that goes beyond the usual 'go-to' tools, and that is calibrated to the sectoral concentration and geographic dispersion that is characteristic of this crisis.

We must recognise that, despite the expectation of an initial swift recovery when the economy reopens, the unemployment challenge will not disappear quickly. This is due to the weakness of many firms and the absence of an exchange rate depreciation to deliver the real wage falls that protected jobs in the financial crisis. Most importantly, as described in Section 2, we are not heading for full bounce-back to the pre-crisis path, given the on-going supply restrictions in some sectors. Nor can the reallocation of labour leaving those sectors to other parts of the economy happen swiftly enough to prevent high unemployment. Reallocation on the scale we are likely to need would be unprecedented, especially because we expect the pre-vaccine phase we are now entering to be temporary. In addition, the private sector faces huge uncertainty, and the types of workers losing jobs (young and low-paid workers with low qualifications and short commutes, for example) mitigate against swift reallocation.

This means that policy needs to pursue twin objectives: protecting jobs in affected sectors more than we might do in a usual crisis; and accelerating employment entries from unemployment to facilitate as much reallocation as possible.

³⁰ See: N Cominetti, L Gardiner & H Slaughter, <u>The Full Monty: Facing up to the challenge of the coronavirus labour market crisis</u>, Resolution Foundation, June 2020.

To achieve the former, we need to do more than just reduce supply *constraints* as much as possible in the heavily affected sectors of: non-food retail, hospitality and leisure. We need supply-focused measures that reduce *labour costs*, too. These would partially address the temporary productivity shock in these sectors (which is some, but of course not all, of their challenge – reduced demand also plays a major role).

The short-term answer to this challenge, as we have recommended before, is to withdraw the JRS at a slower pace in these sectors. For example, a timetable for these sectors lagged by two months compared to that announced previously by the Chancellor, meaning the scheme would still have closed by the end of the year, would cost an additional £3-5 billion.³¹

But because paying people not to work is clearly not a sustainable solution, the Government should go further and replace the JRS with a new Job Protection Scheme (JPS) that subsidises work taking place in the hardest-hit sectors in the pre-vaccine phase. At an estimated cost of £5 billion per year, the JPS would provide a 10 per cent subsidy of all labour costs (a subsidy that is roughly calibrated to the likely ongoing reduction in activity in these sectors in the pre-vaccine period, as discussed in Section 2), capped at £2,500 per year. A quicker and more automatic approach would be to raise the threshold for employer National Insurance contributions (NICs), although this would be less well-targeted given it offers no wage-cost reductions for employees earning below the threshold of around £8,800 per year.

The second objective – supporting greater flows of workers between sectors – should be achieved via:

Significant public spending to deliver job creation at the scale needed. There are
two clear candidates for investment in labour-intensive, geographically dispersed
sectors with relatively low qualification requirements that would also support
longer-term policy goals: social care, and retrofitting houses to become more
energy efficient. We cover the latter in our discussion of investment spending,
below. In addition, we suggest permanently increasing current spending on
social care by £5 billion per year (distributed to local government). This would
add an additional 180,000 workers, bringing the ratio of care workers to the older
population back to its peak, and would additionally facilitate a move to the real
Living Wage. Unlike investment in home retrofitting (and other investment projects,
discussed below) which could be 'lumpy' and temporary, this social care spending
needs to be both swift and permanent.

³¹ T Bell, L Gardiner & D Tomlinson, <u>Getting Britain working (safely) again: The next phase of the Coronavirus Job Retention Scheme</u>, Resolution Foundation, May 2020.

- Hiring incentives via a temporary increase in the employer NICs threshold in the non-hardest-hit sectors, for new hires into expanding firms. Such a scheme might be expected to cost up to around £1.3 billion per year.
- The 'go-to' labour market activation tools that have been shown to work in previous crises. These include increased Jobcentre Plus advisor capacity; job guarantees and apprenticeships targeted at young people within the Prime Minister's recently announced 'Opportunity Guarantee'; and targeted training investments directed to both individuals and colleges. We might expect this package to cost around £6 billion per year over coming years.³²

Recommendation

The Government should reduce employment outflows from the hardest-hit sectors with a temporary extension to the Job Retention Scheme in these sectors, and then replace it with a Job Protection Scheme, subsidising 10 per cent of wage costs up to a cap. The Government should boost employment inflows via: significant public spending to support jobs in social care and home retrofitting, temporary employer National Insurance contribution threshold increases for new hires into expanding firms, and comprehensive activation support including training and job guarantees.

Measures to support the corporate sector and to help it adapt to coronavirus

The measures discussed in the previous sub-section will push down on firms' labour costs, reducing the need to cut wages or lay workers off. But many firms will have been operating at depressed turnover levels for a number of months, and may have run down cash reserves and taken on additional debt. In this context, policy has a key role to play in ensuring not only that viable firms can continue to operate, but also that they are able to generate growth in jobs.

Although the Government has also provided grants, business rate reliefs, and VAT payment holidays, the centrepiece of its support to business has come in the form of government-guaranteed loans which are expected to total around £50 billion.³³ So far, just

33 Coronavirus policy monitoring database, OBR, June 2020.

³² The youth-focused job guarantee in the previous crisis, the Future Jobs Fund (FJF), created just over 100,000 jobs over around 15 months, at a cost of around £700 million. We have previously argued that the central role for local authorities in delivering job guarantees (both in terms of directly creating jobs and brokering those created in the private sector) means we must be realistic about the volume of opportunities such a scheme can bring, particularly given the reduction in local authority capacity over the past decade. Planning to double the FJF annually would be a stretching target. In addition, we suggest around £2.5 billion for training investments (which would both increase college funding and allow for greater provision of maintenance loans to support around 650,000 students - a number that is in line with our previous estimates of the additional number of 18-24-year-olds that we expect to be unemployed in the current crisis), and a similar amount for increasing work-search support within jobcentres. See: N Cominetti, L Gardiner & H Slaughter, The Full Monty: Facing up to the challenge of the coronavirus labour market crisis, Resolution Foundation, June 2020; K Henehan, Class of 2020: Education leavers in the current crisis, Resolution Foundation, April 2020.

over £40 billion in government-guaranteed loans have been made. Over the past three months, this has taken the form of over 50,000 Coronavirus Business Interruption Loans (CBILS), more than 300 of which have been for large businesses (CLBILS for firms with turnover of more than £45 million); and over 900,000 small-business-focused Bounce Back Loans (BBLS).³⁴ This is undoubtedly a large share of all lending to corporates: it compares to around £200 billion of new private lending forecast in the 12 months to March 2021.³⁵ And government-guaranteed lending is expected to account for the bulk of net bank lending to UK corporates over the rest of the year.

These schemes were designed to help firms overcome a brief and self-contained interruption to their cash flow. But, as discussed in Section 2, even in the relatively optimistic case of our Government exit strategy scenario, many sectors will be operating at below-normal levels of turnover for the foreseeable future. So, there is a significant risk that the need to service these debts increases the chances that some firms go out of business. A recent report from The City UK's Recapitalisation Group estimated that UK businesses could have around £100 billion in unsustainable debt by the first quarter of 2021, including around one-third of lending provided through government schemes.³⁶

Moreover, for those firms that continue to trade, the increase in debt is likely to prove a significant headwind. The need to service those debts will further erode cash flows. And this, combined with heightened uncertainty, will inhibit firms from making investments that would boost jobs or productivity. Indeed, there is widespread evidence that recoveries that take place against a backdrop of elevated debt levels are slower and more protracted.³⁷

To address these problems, the Government should transform all three of its current loan schemes – CBILS, CLBILS, and BBLS – into an Income-Contingent Loans Scheme, by making the following changes to the loan terms:

• To prevent loan repayments from becoming a burden on the financial recovery of the firm, or even forcing it into administration, the Government should limit the total amount that any firm is required to repay in a given year to 5 per cent of total turnover, with the difference covered by the Government guarantee. This approach would take advantage of the Government's ability to serve as a 'patient creditor', and reduce the number of guarantees fully called.

³⁴ HM Treasury, <u>HM Treasury coronavirus (COVID-19) business loan scheme statistics</u>, June 2020.

³⁵ The City UK, <u>Recapitalisation Group: Interim Update</u>, June 2020.
36 The City UK, <u>Recapitalisation Group: Interim Update</u>, June 2020.

³⁷ For evidence of the impact of debt, see for example: Ò Jordà, M Schularick & A M Taylor, '<u>When Credit Bites Back</u>', Journal of Money, Credit and Banking, vol. 45, pages 3-28, December 2013; and for evidence on the impact of uncertainty, see: N Bloom, 'The Impact of Uncertainty Shocks', Econometrica, vol. 77, pages 623-685, May 2009.

- Firms should be allowed to write off against the loan principal 90 per cent of the cost of any investment in the adaptation of business premises or production processes required to enable the business to return to safe operation during the pandemic. This would reduce the effect of uncertainty caused by the crisis by lowering effective adaptation costs. The cost of this immediate, investment-related write-off should be met by the Government guarantee.
- If the loans are not fully repaid by the time they mature (given the cap on repayments, discussed above), then the principal should be written off to give the firm additional balance-sheet cash-flow relief. The cost of the write-off would also be covered by the government guarantee, so that the sponsoring bank would receive more than 80 per cent of the full value of the loan.

As discussed below, these changes would be all the more important in the event of a second wave, during which it would likely be necessary to extend a further round of government-guaranteed credit to the corporate sector. Without changes like these, many firms would not be able to take on another round of debt.

Recommendation

The Government should transform all three of its lending schemes (CBILS, CLBILS and BBLS) into an Income-Contingent Loans Scheme limiting repayment to 5 per cent of turnover. If the loans are not repaid by the time they mature, the principal should be written off with the cost covered by the Government guarantee. In addition, firms should be allowed to write off up to 90 per cent of the cost of adapting their businesses to operate safely during the pandemic.

Targeted demand stimulus measures

As discussed in Section 3, residual fears about contracting or transmitting the virus and uncertainty about future employment and earnings prospects are likely to weigh on consumption well after lifting of lockdown restrictions. Uncertainty about the strength of future consumption and the viability of certain firms is, in turn, likely to act as a drag on business investment for some time. So, measures to generate a rapid – but safe – recovery in consumption and investment demand will also be crucial. In previous recessions, monetary policy would normally play a key role in delivering such support. But, as discussed in Section 3, large-scale support from monetary policy is not possible given the proximity to the lower bound. For that reason, we discuss below a range of fiscal policies to boost demand.

Consumption support

The combination of social distancing restrictions and individuals' efforts to avoid contracting or transmitting the virus has driven a sharp contraction in consumption. Face-to-face retail, transport, tourism, hospitality, entertainment and in-person services have been particularly hard hit, either because of enforced closures or the challenges of operationalising social distancing restrictions. In the first half of June, only around 40 per cent of surveyed firms in the arts, entertainment, and recreation sectors and around 45 per cent of firms in the accommodation and food service sectors were open for trading, compared to around 85 per cent of firms across the economy as a whole.³⁸ Although the easing of social distancing restrictions has meant that some firms have been able to recover consumer activity in these hardest-hit sectors, footfall in retail shops was still down 45 per cent year on year in mid-June.^{39,40}

Even after most face-to-face retail and service businesses were allowed to reopen on 4 July, consumption in these sectors is unlikely to spontaneously return to pre-outbreak levels, because many people will continue to be apprehensive about returning to previous social consumption habits for fear of contracting or spreading the virus, and because on-going restrictions will reduce capacity. Countries ahead of the UK in reducing the number of coronavirus cases and lifting lockdown restrictions still have depressed consumption: for example, retail consumption in France remains 9 per cent down on a year ago.⁴¹

A tepid recovery in face-to-face retail, hospitality, and other social consumption sectors is likely to represent a serious drag on the wider economic recovery. It would also exacerbate the already heavy focus of the labour market shock on low earners, who disproportionately work in such sectors.

All this implies there is a strong case for demand support to be targeted towards face-toface consumption, particularly in the aftermath of social distancing restrictions.⁴² But the key question is: how?

Much of the discussion of what the Government can do to stimulate consumption has focused on temporarily cutting the VAT rate, as was done in the aftermath of the financial crisis in the UK, or on sending cheques to households, as was done recently in the US.

³⁸ Source: Coronavirus and the economic impacts on the UK: 18 June 2020, ONS.

³⁹ V Romei & J Burn-Murdoch, English shoppers' return points to a gradual retail recovery, Financial Times, June 2020.

⁴⁰ This is likely to reflect individuals' steps to reduce their risk of becoming infected or passing the disease onto others. This phenomenon is referred to as equilibrium social distancing by social scientists incorporating economic behaviour into epidemiological models. For a discussion of equilibrium social distancing, see: see: J Smith & T Yates, <u>The Macroeconomic Policy</u> <u>Outlook: 2020 Q2</u>, Resolution Foundation, May 2020.

⁴¹ Source: Monthly survey on retail trade: 2020 May, Banque de France, June 2020.

⁴² Despite the food retail sector performing strongly during the crisis, it would make sense to include that sector in order to allow people to buy essentials with the vouchers too.

However, it is unlikely that either of these will prove to be the most targeted approach to boosting consumption spending. This is because:

- A high proportion of any cash transfer is likely to be saved by households, given many households' concerns about their future prospects, especially higher-income ones who have already experienced rising savings through the crisis.⁴³
- A VAT cut would provide less support to lower-income families given they spend more on goods and services that are VAT exempt or zero-rated.
- It is impossible to target cash transfers, and difficult to target VAT cuts, on the face-to-face retail and service sectors that are most in need of support. A sectorally focused VAT cut would be preferable to an across-the-board reduction, but it would not be a very effective stimulus for the crucial bricks-and-mortar retail sector, because the move would also benefit online shopping (the proportion of retail purchases made online rose from around 20 per cent in February to 32 per cent in May).⁴⁴
- A second wave of the virus would render a VAT cut both expensive and ineffective, requiring a further expensive round of stimulus to kickstart consumption once the virus has once again subsided.

These considerations drive us towards two policy conclusions. First, the most costeffective means of stimulating consumption would be to issue time-limited vouchers which can be used for face-to-face retail and services.^{45,46} We propose that the Government introduce a 'High Street Voucher' scheme, with vouchers worth £500 per adult and £250 per child distributed, at a cost of £30 billion overall (or £27 billion if only 90 per cent are spent).

Consumption vouchers of this sort have already been deployed in China, Taiwan, and Malta, and are under consideration in other countries – see Box 1. Compared with stimulus cheques or VAT cuts, vouchers have a number of advantages as a mechanism for restarting consumption post-lockdown. Perhaps chief among these is the relatively low deadweight loss of such a scheme, because the vouchers can be targeted towards domestic, non-tradable sectors in a timely manner. Unlike cash transfers, vouchers can also be time-limited to ensure that the money cannot be saved and so is spent when the

⁴³ M Brewer & L Gardiner, <u>Return to spender: Findings on family incomes and spending from the Resolution Foundation's coronavirus</u> <u>survey</u>, Resolution Foundation, June 2020.

⁴⁴ Source: ONS, Retail Sales.

⁴⁵ Businesses qualifying to receive the vouchers would have to have physical (i.e rateable) premises. Compliance with social distancing regulations would be a requirement for businesses to qualify for accepting the vouchers.

⁴⁶ Depending on the initial implementation period, it is possible that some small subsectors are not able to take advantage of the scheme as they are still effectively closed. If that is the case, other ways will need to be found to support those areas of the economy.

economy needs it. And, in the event of a second wave, they would simply be deactivated, limiting the deadweight cost of stimulating an economy which cannot respond.

Early experience from other countries suggest that vouchers can be provided in paper, smartcard, mobile, or electronic form. And could be distributed through either the electoral register or council tax records.⁴⁷ Other countries have limited the time window for their use to anywhere between two weeks and six months, but we propose to give individuals a full year to use their vouchers, given the larger amounts proposed and the UK's slower forecast recovery. This should be sufficient for those who are fully shielding to also take advantage of the scheme. But, if not, it would be necessary to find a way to allow people in that group to spend the vouchers when safe to do so. In the event of a second wave of transmission, either national or local, the vouchers could be deactivated for the affected businesses and reactivated once the virus has once again been brought under control. The vouchers could be used to promote good public health practices by making adherence to social distancing guidelines a requirement for businesses to qualify, with spot checks to ensure compliance.

BOX 1: Consumption vouchers – the experience from other countries

Consumption vouchers have been used by governments in China, Taiwan and Malta to try to support their faceto-face retail, hospitality and service sectors in the wake of the coronavirus outbreak.

 In China, the schemes have been funded and administered at the municipal level, with over 19 billion yuan (£2.1 billion) in vouchers issued in over 170 cities since March.⁴⁸ Amounts and delivery mechanisms vary, but the city of Beijing announced in early June a plan to issue 10 billion yuan (£1.15 billion) in consumption vouchers which could be used in both physical and online establishments for a 14-day period.⁴⁹ In April, the city of Wuhan issued 500 million yuan (£57 million) in consumption vouchers, but only for use in businesses with physical premises such as restaurants, shopping malls, convenience stores, and cultural, sports and tourist venues. The vouchers can only be used where the value of goods or services being

⁴⁷ Councils would need to administer the system for new joiners, and this would require greater fraud checks. Data on the number of children could be taken from child benefit database, although one downside of this approach is that it will exclude some (but not all) kids in households earning over £60,000.

⁴⁸ W Tianyu, Cash or vouchers? Dilemma on how to spur China's pandemic-hit consumption, CGTN, May 2020.

⁴⁹ Global Times, <u>Beijing to roll out 10b yuan consumption vouchers</u>, June 2020.

purchased is three or more times the value of the voucher.⁵⁰

 In Taiwan, so-called 'Triple Stimulus Vouchers" worth up to NT\$3,000 (£82) can be purchased for NT\$1,000 (£27) from the central government. The vouchers can be used to purchase goods and services at retail shops, restaurants, markets, cultural venues, hotels, and rail transport outlets. They cannot be used online or to purchase cigarettes, stocks, or coupons.⁵¹ All Taiwanese citizens and their foreign spouses can purchase the vouchers from 15 July, in either paper or electronic form.⁵²

 In Malta, residents are being given €100 (£90) in five €20 vouchers which can be spent in the island's bars, hotels, and restaurants that have suffered from the collapse in global tourism. The physical vouchers are being mailed to all residents over the age of 16, and 80 per cent of them have to be spent in restaurants, bars, nightclubs, or other hospitality venues.⁵³

Recommendation

The Government should put in place a £30 billion 'High Street Voucher' scheme to provide a timely and targeted consumption boost to the hardest-hit sectors.

Second, in addition to consumption vouchers, to the extent that cash transfers have a role to play they should be targeted at lower-income households. This would reflect the fact that these households' balance sheets are more likely to have deteriorated over the lockdown period, reinforcing lower-income households' generally higher marginal propensity to consume.⁵⁴

The social security system is a good mechanism for delivering such cash support. It is one that the Government has already turned to in this crisis, with a £20 per week uplift to Universal Credit (UC) and tax credit entitlements, and changes to housing support. Previous Resolution Foundation research has recommended that these increases should be made permanent, and that further steps that should be taken to protect families' incomes through the crisis and recovery period. These include limiting UC's capital rules

⁵⁰ Q Xijia, <u>Wuhan doles out 500 million yuan consumer coupons to boost consumption</u>, Global Times, April 2020.

⁵¹ H Tzu-ti, <u>Taiwan's stimulus voucher scheme to kick off July 1</u>, Taiwan New, June 2020.

⁵² L Hsin-Yin, Stimulus vouchers to be issued to Taiwan nationals, foreign spouses, Focus Taiwan, June 2020.

⁵³ Reuters, This round's on us - Maltese government hands out vouchers to boost tourist trade, June 2020.

⁵⁴ Z Canbary & C Grant, <u>The Marginal Propensity to Consume for Different Socio-economic Groups</u>, Brunel University Working Paper No. 1916, October 2019.

that prevent those with high savings from receiving support; extending the £20 per week increase to contributory benefits; and suspending the benefit cap.⁵⁵

These steps would help stimulate consumption in the recovery, and on top of these the Government could make further improvements to UC's generosity. We suggest that these should be focused on couples and families with children, who have benefited less perhead from the £20 per week uplift per family. A child-focused boost would be particularly well-targeted, given evidence that the lowest-income families with children have increased rather than reduced spending (despite income falls, and severe restrictions on opportunities to spend) during the lockdown.⁵⁶ For example, a £20 per week increase in the couples element in UC,⁵⁷ and a £10 per week increase in UC's child element (with equivalent increases in tax credits), would boost incomes by around 5 per cent in the bottom quartile (Figure 18).

FIGURE 18: A boost to Universal Credit for larger families would be welltargeted at the poorest

Change in income resulting from increases to Universal Credit and tax credits targeted at couples and children, by after-housing-costs disposable income quintile: UK, 2020-21



NOTES: Assumes Universal Credit is fully rolled out; accounts for benefit take-up. This modelling is based on the population in 2018-19, and so is likely to represent an under-estimate given lower employment and earnings today.

SOURCE: RF analysis of DWP, Family Resources Survey using the IPPR tax-benefit model.

⁵⁵ M Brewer & K Handscomb, <u>This time is different – Universal Credit's first recession: Assessing the welfare system and its effect on living standards during the coronavirus epidemic</u>, Resolution Foundation, May 2020.

⁵⁶ M Brewer & L Gardiner, <u>Return to spender: Findings on family incomes and spending from the Resolution Foundation's coronavirus</u> survey, Resolution Foundation, June 2020.

⁵⁷ The vast majority of couples eligible for Universal Credit have children, so in practice this increase in the couples element would also be very child-focused. See: D Finch & L Gardiner, <u>Back in Credit?: Universal Credit after Budget 2018</u>, Resolution Foundation, November 2018.

Such increases would be worth around £8 billion per year,⁵⁸ with other changes to benefits generosity and eligibility criteria mentioned above adding around another £2 billion to the costs of this policy package.⁵⁹ We have previously recommended that the existing £20 per week UC (and tax credits) uplift and changes to housing support should be extended beyond the current financial year, costing £8 billion annually. The further child-focused increases we recommend should be maintained for as long as consumption support is required (for example, throughout the pre-vaccine period), and potentially longer.⁶⁰

Recommendation

The Government should make the recent increase in Universal Credit and tax credits permanent; extend this to contributory benefits; broaden support by easing the benefit cap and capital tests; and (at least temporarily) raise the child and couples elements in Universal Credit and tax credits to target more support towards children.

A package of measures for public investment

For an economy operating under supply restrictions, there is a case for the Government to skew its stimulus measures towards increasing final demand (rather than, say, increasing the incentives for families and firms to increase spending on goods produced by private firms). A key area in which the Government can increase final demand is public investment. Increases in such investment can take longer to ramp up than other measures discussed above,⁶¹ but planning to increase investment as quickly as is possible has the benefit of providing sustained demand support over the medium term. Public investment is a particularly attractive option for fiscal stimulus because it has a relatively large effect on the economy. OBR estimates are that every percentage point of GDP spent on public investment results in an equal impact on output. This ratio of one is far higher than, for example, the 0.3 ratio for VAT cuts.⁶² Although investment may be challenging to ramp up quickly, the benefits in terms of fiscal multipliers and the

⁵⁸ We estimate that these changes would cost £6.7 billion based on 2018-19 employment and earnings levels. We then provide an approximate uplift to £8 billion, to reflect higher unemployment and earnings and hours falls in the current period. This is of the same order of magnitude as the OBR's revision to the costing of recently announced social security changes (to £8 billion, compared to the Government's £7 billion initial estimate) on the basis of this labour market deterioration.

⁵⁹ Mirroring the £20 per week uplift in Jobseeker's Allowance would cost around £300 million per year on current caseloads. We estimate that changes to the benefit cap and UC capital rules could be calibrated to bring total costs to around £2 billion per year.

⁶⁰ Indeed, there is a case for maintaining some or all of the increase indefinitely given long-term declines in the value of child-focused benefits, although beyond the crisis period this would need to be paid for with higher taxes. See: T Bell & L Gardiner, Locked in?: <u>The triple lock on the State Pension in light of the coronavirus crisis</u>, Resolution Foundation, June 2020.

⁶¹ G Atkins, G Tetlow & T Pope, <u>Capital spending: Why governments fail to meet their spending plans</u>, Institute for Government, February 2020.

⁶² For a discussion of the OBR's fiscal multipliers, see Box 3.2 in: Office for Budget Responsibility, <u>Economic and Fiscal Outlook – July 2015</u>, July 2015.

sustained support it can provide to the labour market make it an integral component of a fiscal stimulus package.

Therefore, it is welcome that the Government has already set out plans that build on the increases in investment proposed in Budget 2020. These include 'accelerating' £5 billion of spending, including a new spending commitment to a £1 billion rebuilding programme for schools in England, as illustrated in Figure 19. Much of this investment spending was already factored into planned capital spending measures of £5.5 billion set out for 2020-21 in the Budget (increases that ramp up to 3 per cent of GDP, or £35 billion per year, in 2024-25). Given the magnitude of fiscal stimulus required (set out in Section 4), as well as investment spending's high fiscal multipliers, the Government should look to spend significantly more than set out in the Budget, for the coming years. A potentially achievable level of public investment increase that Government should seek to match is that seen in the aftermath of the financial crisis. Total gross investment increased by around £28 billion in today's money from 2007-08 to 2008-09, so the Government could aim to achieve around half of this increase (£14 billion) in the remainder of the 2020-21 fiscal year. Of course, much depends on how quickly investment spending can be ramped up. The focus in the Government's plans so far on projects that can be meaningfully implemented within the next six months is welcome, and should now be redoubled.

FIGURE 19: The Government's 'New Deal' so far falls short of investment spending post-financial crisis



Additional public sector gross investment spending, by investment type: UK, 2020-21

SOURCE: No.10, 'Build build': Prime Minister announces New Deal for Britain, June 2020.

Aside from the immediate stimulus effects of investment, increasing capital spending allows the Government to address some longer-term policy challenges.⁶³ Although much of the Government's Budget 2020 investment plans have not been publicly allocated to projects, early indications suggest green and social infrastructure could be prioritised more meaningfully. The Prime Minister's 'New Deal' was disappointingly light on 'green' infrastructure plans, re-iterating commitments to re-forestation worth £650 million over the next five years, and £40 million for local conservation projects, but failing to commit to larger-scale capital adaptations necessary to meet Net Zero by 2050.⁶⁴ In terms of social investment, in addition to the 'New Deal' package, the Government has re-iterated its commitment to a £12 billion Affordable Homes Programme, promising 180,000 'affordable homes' over the next five years to reverse the decline in the ratio of social homes to families since the turn of the millennium.⁶⁵

In the nearer term, the focus of public investment also has an important role to play in directly, although not immediately, creating jobs to mitigate the unemployment impact of the crisis. This should influence the types of public investment that should be considered. So far, the economic impact of the crisis has been broadly spread geographically.⁶⁶ In terms of public investment, this means that programmes that are also geographically dispersed are likely to be most effective in supporting the labour market, as opposed to large-scale infrastructure projects that are concentrated in one location. Here, as argued in previous work,⁶⁷ and as advocated by the TUC⁶⁸ and the CBI,⁶⁹ projects such as home retrofitting are particularly well-suited. These would have the capacity to deliver over 100,000 jobs dispersed widely across the country, while also contributing to longer-term strategic goals.

Recommendation

Public investment should increase by £14 billion this financial year, and further in the years ahead, with a greater focus on making progress towards net zero and building social homes.

⁶³ See: A Bailey, R Hughes, L Judge & C Pacitti, <u>Euston, we have a problem: Is Britain ready for an infrastructure revolution?</u>, Resolution Foundation, March 2020.

⁶⁴ No.10, 'Build build build': Prime Minister announces New Deal for Britain, June 2020.

⁶⁵ For more on housing investment needs see: A Bailey, R Hughes, L Judge & C Pacitti, <u>Euston, we have a problem: Is Britain ready for</u> an infrastructure revolution?, Resolution Foundation, March 2020.

⁶⁶ See: N Cominetti, L Gardiner & H Slaughter, <u>The Full Monty: Facing up to the challenge of the coronavirus labour market crisis</u>, Resolution Foundation, June 2020.

⁶⁷ N Cominetti, L Gardiner & H Slaughter, <u>The Full Monty: Facing up to the challenge of the coronavirus labour market crisis</u>, Resolution Foundation, June 2020.

⁶⁸ TUC, <u>Rebuilding after recession: A plan for jobs</u>, June 2020.

⁶⁹ CBI, Priorities for a green recovery following the coronavirus pandemic, June 2020.

Section 6

Policy in a second wave

The risk that the health crisis re-intensifies is a key source of uncertainty in the recovery phase. Policy makers should not just choose policies that as far as possible are robust to that uncertainty, but also prepare for what more would need to be done if a second wave were to take place.

Our starting point is that, confronted by a second wave, the Government should put in place similar emergency support measures to those that have been in place over the past few months, but that these should not simply be a repeat of the approach during the first lockdown. The additional policy development time now available should be used to overcome some of the shortcomings of that approach, and to recognise that the experience of the crisis means that the appropriate policy will change over time.

When it comes to support for households we should aim for broader, and more equitable, coverage of support schemes. For firms, policy makers will need to recognise that the impact of the crisis to date in weakening balance sheets will mean that simply providing more liquidity support will be insufficient. Taking steps to prepare these measures ahead of a second wave would mean they are timelier and more effective if this risk crystallises.

Although the risk of a second wave plays a key role in shaping the policy response in the reopening phase, it is also a scenario that policy makers should prepare for in its own right. Indeed, the experiences of a number of countries, and the continued proximity of *R* to one, suggest a significant weight should be attached to such a scenario.

It is important to stress that what we mean here is a very substantial increase in the virus' caseload that necessitates a broad reintroduction of severe social distancing restrictions. More localised lockdowns for smaller flare-ups would be consistent with our main, more optimistic scenario. Our view is that any such return to full lockdown would likely be for a shorter period, and would impose fewer restrictions on the economy, given the experience gained through the crisis so far.

Objectives in the second wave would be similar to those during the initial lockdown

In such a second wave, the key objective for policy relating to households would be the same as in the initial lockdown. We want to prevent big income hits and retain matches between workers and firms so that the economy can recovery rapidly once we emerge. The success of the JRS and the relatively efficient functioning of the UC system to date vindicate holding onto these goals.⁷⁰

Looking ahead, then, there are three key reasons why policy should be different second time around:

- With more time to prepare, policy makers should do a better job of avoiding big gaps in generosity between support schemes, and minimising the numbers falling through the cracks.
- 2. If a second wave occurs, then it suggests the risks of subsequent waves of the virus are greater, too. So, we will need a system that can last.
- 3 The world will be different a second time around precisely because there was a first wave, and firms' and households' balance sheets changed as a response to it.

Income support policies should be recalibrated in a second wave

These considerations necessitate a greater focus on horizontal inequities between schemes, eligibility, and value for money. Here we focus on the three major components of income support policy: the Job Retention Scheme, the Self-Employment Income Support Scheme (SEISS) and Universal Credit.

Starting with the JRS, the first priority would be to reactivate the scheme, allowing full furlough, including for new starters not previously furloughed, and with employers once again not expected to meet any furloughing costs.

However, the terms of furlough payments should be adjusted to reflect the very unequal treatment of otherwise identical workers who are furloughed onto the JRS or lose their jobs and have to rely on UC. The current approach means that the former have average 'replacement rates' of 91 per cent, while the latter have an average of only 53 per cent of their previous income protected.⁷¹ To help close this gap and ensure the scheme can be maintained if multiple lockdowns are necessary, the scheme should evolve. We recommend replacing 80 per cent of the first £10,000 of gross annual earnings (as the

⁷⁰ For a discussion of the successful operation of UC, see: M Brewer & K Handscomb, <u>This time is different – Universal Credit's first</u> recession: Assessing the welfare system and its effect on living standards during the coronavirus epidemic, Resolution Foundation, May 2020.

⁷¹ M Brewer & K Handscomb, <u>This time is different – Universal Credit's first recession: Assessing the welfare system and its effect on living standards during the coronavirus epidemic</u>, Resolution Foundation, May 2020.

initial JRS did), but only 60 per cent of earnings between £10,000 and £20,000, and 50 per cent above that figure. A cap of £22,750 annually (£1,896 monthly) would limit support at the same level of pre-coronavirus earnings as in the initial JRS.

If a second national lockdown were to last three months (but ease through this period), and, as discussed in Section 2 entail a smaller hit to the economy, we estimate that this revival of the JRS would cost an additional £12 billion.⁷²

Recommendation

In a second wave, the Job Retention Scheme should be re-instated, but with lower replacement rates for higher earners.

Second, the SEISS should be brought back, and calibrated to match the new JRS in terms of the replacement rates at different earnings levels, and the cap. It would also be desirable to spread these grants out as monthly payments, to avoid what are effectively overpayments of UC in months when no grant is received.⁷³ But, more importantly, the availability of the SEISS should be simultaneously expanded and restricted in a second wave to end the current situation where many miss out on support entirely, while others draw down large grants despite having had very little or no hit to their incomes. We know that self-employed people have been disproportionately negatively affected during this crisis, so with more time to prepare it is highly desirable that policy does a better job of supporting them in the face of another lockdown.⁷⁴

The SEISS should therefore be expanded to the newly self-employed via the admission of those with 2019-20 tax returns; extended to higher earners through a cap on support rather than removing eligibility entirely above £50,000 of earnings; and via the inclusion in the scheme of dividend income drawn by company directors (which should be limited to those with dividends and earnings from the same company, or proscribed in other ways, to avoid those with wider, non-labour-related, dividend income from benefiting).⁷⁵

⁷² This costing is based on OBR costings for the JRS during the initial lockdown. Employer costs are tapered up over these three months, as is happening over a longer period for the initial JRS. We do this by taking three representative months of the OBR's costings for the JRS during the initial lockdown (June, August and September), the latter two of which require employer contributions. We assume that furloughing is at 70 per cent of the levels seen during the initial lockdown.

⁷³ For details of how the lumpy nature of SEISS grants to date can interact with UC, see: S Adam, H Miller & T Waters, <u>Income</u> protection for the self-employed and employees during the coronavirus crisis, Institute for Fiscal Studies, April 2020.

⁷⁴ See: N Cominetti, L Gardiner & H Slaughter, <u>The Full Monty: Facing up to the challenge of the coronavirus labour market crisis</u>, Resolution Foundation, June 2020.

⁷⁵ The Association of Independent Professionals and the Self Employed (ISPE) estimates that around 715,000 limited company directors missed out on the initial SEISS, only able to claim JRS support for the (usually small) proportion of their income drawn as PAYE earnings (although there are complications in owner-managers furloughing themselves that may prevent this). IPSE's recent letter to the Chair of the Treasury Select Committee suggests that this group could be included in SEISS support via a 'pay now, claw back later' principle, which would ensure the scheme only provides replacement income for dividends that form company director's profits (with validation e.g. via company accounts), not dividends coming from wider share portfolios. Other approaches might include restricting eligibility to those who also have PAYE earnings from the same source as dividend payments, or to those who draw a very high proportion of all dividend income from a single source.

The flipside would be that support should be proportionate not just to pre-crisis selfemployed profits, but also to the scale of the hit to these that self-employed people have suffered during the crisis. In other words, further SEISS grants should be restricted to those who expect their 2020-21 income (including self-employed earnings and previous SEISS grants) to fall below a given proportion of income in previous tax years (e.g. 80 per cent, matching the initial JRS), with any overpayments recouped via future tax returns.⁷⁶ The costs of such a scheme are difficult to gauge, but might be expected to come in at around half those of the initial SEISS over its first three months, i.e. £3 billion.⁷⁷

These proposals are, of course, complex to operationalise in practice. For example, the approach of scaling further grants to the degree of income hit people have actually suffered would increase the incentive to underreport incomes in future tax returns. We do not attempt to iron out all these complexities here, other than by suggesting that clear 'clawback' mechanisms and an active fraud prevention system will be necessary, as they are in relation to other aspects of the taxation and regulation of the self-employed.

Recommendation

In a second wave of the virus, the Self-Employment Income Support Scheme should be reinstated with lower replacement rates for higher earners; with eligibility expanded to the newly self-employed, high earners and those with dividend income; and eligibility restricted to those who have actually suffered income hits.

Third, the Government should boost UC further to narrow the gaps in income protection with the SEISS and the JRS. On top of the social security changes we recommended in the previous chapter (which focused on expanding eligibility and directing more support to children, to boost wider consumption), the Government should go further still on basic allowances in a second wave. For example, for the duration of a further lockdown, the basic element in UC could be increased by a further £15 per week, with £10 per week on top of that for couples. We estimate that these increases would cost the Government £2-3 billion over a three-month lockdown, on top of the £10 billion of additional (annual) investment in social security we suggested in the previous section.⁷⁸

⁷⁶ We do not suggest that this test be applied to previous SEISS grants; in other words, only second-wave SEISS payments would be in scope for retrospective claw back. One improvement on the initial SEISS in light of this tweak could be that the income level that SEISS grants (and any clawback) are predicated on is based on the highest two or three tax returns across 2016-17 to 2019-20. This would allow self-employed adults to discount years in which they were only partially trading, or had time away from work.

⁷⁷ The first SEISS grant is estimated to have cost £7.6 billion.

⁷⁸ Our modelling suggests that such increases would cost £8.5 billion annually on the basis of 2018-19 employment and earnings patterns. As in the previous section, we estimate the cost to be somewhat higher (£10 billion annually) on the basis of the hit to jobs and wages experienced in the current crisis.

Operationalising such explicitly temporary UC increases may be challenging. However, one of the advantages of UC over the legacy benefits it replaces is the relative ease and speed with which adjustments can be made.⁷⁹ The Department for Work and Pensions should explore the feasibility of such an approach as soon as possible.

Recommendation

In a second wave of the virus, the Government should temporarily increase the basic and couples elements in UC further.

These amendments would address the needs of some of those who fell through the cracks of the three core income support schemes during the initial lockdown. But to what extent would they narrow inequities in generosity? Figure 20 starts to explore this by considering a hypothetical family – a home-owning, single-earning couple without children. It shows this family's 'replacement rate' at different earnings levels. The replacement rate represents the proportion of pre-coronavirus net family incomes that the family receives when one adult is not working,⁸⁰ under both initial lockdown policies and our proposed second wave versions. Although it would not be eliminated, the gap in income replacement between those furloughed and those relying on UC is clearly narrowed along the earnings scale, and more than halved for those on higher earnings.

Figure 21 shifts focus from a hypothetical family to the actual UK population. Building on previous Resolution Foundation analysis,⁸¹ it shows typical family replacement rates when earners fall out of work onto our proposed second-wave versions of either UC or the JRS / SEISS (and the range of outcomes around these), compared to typical replacement rates on the original versions of these policies. The clear picture is one of both a greater cushion from UC – the average replacement rate rises from 53 per cent to 56 per cent – and a narrowed gap between UC and the JRS / SEISS (falling from 38 percentage points to 30 percentage points). The fact that replacement rates in some groups – single parents, for example – do not differ more between the initial lockdown and second wave versions of the JRS and SEISS is due to the greater generosity of UC countering lower gross income from these schemes for many lower-income families.

⁷⁹ It would also be desirable to mirror these increases in contributory benefits, but this is unlikely to be possible on the timescales involved, given it takes at least around five months from decision to implementation to do this.

⁸⁰ Higher replacement rates (closer to one) mean that a worker has a greater degree of protection from the financial consequences of unemployment. See Box 5 in: M Brewer & K Handscomb, <u>This time is different – Universal Credit's first recession: Assessing the</u> welfare system and its effect on living standards during the coronavirus epidemic, Resolution Foundation, May 2020.

⁸¹ M Brewer & K Handscomb, <u>This time is different – Universal Credit's first recession: Assessing the welfare system and its effect on living standards during the coronavirus epidemic</u>, Resolution Foundation, May 2020.

FIGURE 20: The difference in replacement rates for childless couples furloughed or losing jobs would be narrowed under our second wave policy package

Family income replacement rates for a single-earning, home-owning couple without children when one earner stops working, is furloughed or claims a self-employed grant, by pre-coronavirus earnings and policy scenario: 2020-21



NOTES: Modelled based on the Universal Credit system, assuming that the adult in question is eligible. Adults assumed to be aged 25+. SOURCE: RF analysis using the RF microsimulation model.

Of course, these three flagship income support schemes are not the only things we should be considering in relation to family incomes and living standards in the event of a further lockdown. There will be a strong case for reviving other family-focused policies, such as encouraging banks to provide mortgage holidays.

And when it comes to the related issue of rents, there may be a case for going further than policy makers did (or had the time to) go during the initial lockdown. For both business and residential rents, the core challenge is that these are in the end determined by income levels. But short-term rigidities prevent adjustments from taking place in the face of temporary income shocks. In a second-wave world (which would signal an elevated chance of further waves of the virus) that is a big problem, because incomes would be being suppressed for more than a few months.

For business rents, the Government should explore guidance around or regulation to support (at least temporary) revenue-contingent rents, or explicitly state that upwards-only clauses in rent reviews should be removed.

FIGURE 21: Across families, this second wave policy package would narrow gaps in support between those relying on different schemes

Family income replacement rates when one earner stops working, is furloughed or claims a self-employed grant, by selected characteristics and policy scenario: 2020-21



NOTES: Replacement rates shown for whole benefit unit income before housing costs, for adults aged 16-64 who stop working and then claim benefits as entitled. Job Retention and Self-Employment Income Support Schemes assume only full take-up of Government support, subject to cap. Second wave policy includes the benefit changes set out in the previous section as well as those detailed in this section. Support for self-employed assumed to be continuous. Partner income held constant. Full roll-out of UC and full take-up of benefits assumed.

SOURCE: RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model.

When it comes to households, during the initial lockdown the answer was that families either got almost all their income covered by the JRS or SEISS, or that UC existed to cover the cost of rents (up to the 30th percentile of local rents) when income did fall substantially through hours reductions or job loss.

The case for going further in a second lockdown is twofold. First, UC's rent coverage was always partial – many families are not eligible for UC, and this will become more of a problem if the benefit cap (which applies after the first nine months of a claim) is not suspended or raised (as we recommended in the previous section). Second, our own recommendation that replacement rates in the JRS and SEISS be reduced somewhat means there is a case for going further on rents.

This is not an easy challenge for the Government to solve. At a minimum, policy makers should reduce short-term rigidities by providing legal frameworks and clear guidance for tenants and landlords to negotiate temporarily lower rents without prejudicing longerterm rent levels. They could also go further by legislating that if a family has lost work in a second lockdown and their rent isn't covered by UC, then rents should fall by at least a given proportion for the period that lockdown restrictions are in place. Such an approach

would not be without significant challenges, not least in terms of risks to private investment in the rental sector (and therefore supply), and housing association finances. Given these challenges, it may be worth considering such action only in areas with very high rents relative to incomes (which could be linked to the risks of local second waves).

Recommendation

In a second wave of the virus, the Government should provide frameworks that allow for more businesses to move onto revenue-contingent leases, and for households to negotiate short-term rent reductions without prejudice to longer-term rent levels.

Finally, we note that the discussion in this section has largely been framed around a national second wave and further lockdown. Policy makers should also prepare to implement these policies on a localised basis, should local lockdowns occur. In such circumstances, JRS and SEISS availability could be based on business or residential postcodes (readily available to government via PAYE systems and company accounts). Local enhancements to UC will not be possible, so the Government should instead provide funding to local authorities to offer welfare support, as it did in the March Budget.

Recommendation

To support the health response in localised second waves of the virus, the Government should be prepared to operate local versions of the Job Retention and Self-Employment Income Support Schemes, and fund local welfare assistance.

Support for firms must adjust to reflect weakened balance sheets

Support provided to businesses also needs to build in flexibility and responsiveness in the event of a second wave of transmission or more localised outbreaks of the virus. Simply extending the existing CBILS, CLBILS, and BBLS schemes to allow firms to borrow additional amounts over a longer period would add to the debt burden of struggling firms that may already have taken out government-guaranteed loans equal to between 10 per cent (in the case of CBILS) and 25 per cent (in the case of CLBILS and BBLS) of their pre-outbreak annual turnover. Such firms are likely to be more averse to increasing their debts in the event of a second wave than during the initial outbreak, when many expected a single, short, sharp shock to their business. Moreover, simply doubling the size of the loans to 20-50 per cent of firms' pre-outbreak annual turnover is likely only to increase the number of firms that are unable to repay the debt (already estimated

at around one-third of total government-guaranteed borrowing⁸²) and are pushed into insolvency. This would trigger the embedded guarantees, push the outstanding cost of the loans onto the taxpayer, and require the Government to take control of the assets of thousands of small businesses. This is unlikely to be something the Government could manage effectively, and would result in the loss of considerable residual value in the firms.

As discussed in the previous section, our proposed Income-Contingent Loans Scheme would be a better way of extending support to troubled firms in a way that takes account of the performance of the business and avoids pushing them to the brink of insolvency. Further government-guaranteed credit would be extended nationwide, or to local firms in the event of more localised outbreaks. And firms would know that they would never have to pay back more than 5 per cent of their *actual* turnover in any future year. If they are unable to repay the loans after maintaining operations for the term of the loan, then the residual value would be written off to give them further balance sheet and cash-flow relief. Such an approach, therefore, provides the Government with the ability to provide additional equity-like investment in a large number of businesses without the burden of having to administer hundreds of thousands of equity stakes across a wide array of sectors in which the Government has little expertise.

Recommendation

The Government should transform all three of its lending schemes (CBILS, CLBILS and BBLS) into an Income-Contingent Loans Scheme limiting repayment to 5 per cent of turnover. If the loans are not repaid by the time they mature, the principal should be written off with the cost covered by the Government guarantee.

The Bank of England would need to pivot towards providing additional support to the financial sector

To date, the Bank of England has made substantial use of both monetary and macroprudential tools to ensure that the financial sector can continue to lend to the corporate sector. The Bank of England estimated in its coronavirus scenario, in which modelled GDP falls were larger than we expect but offset by a faster recovery, that the corporate sector would face a cash flow deficit of £140 billion in 2020-21.⁸³ In the case of a second wave and a more protracted period of economic contraction, funding requirements would rise further.

⁸² See: The City UK, <u>Recapitalisation Group – Interim Update</u>, June 2020.

⁸³ Bank of England, Interim Financial Stability Report, May 2020.

There are two concrete actions the Bank of England should consider to ensure that the financial sector does not restrict credit provision, exacerbating the economic contraction. First, as financial institutions are required to predict losses under accounting and capital regulations (in contrast to simply recognising losses which have already materialised), if losses are overestimated this will lead to cuts in lending. The Bank of England has already issued guidance for firms to ensure that losses are not overestimated, and this should be kept under review – particularly to ensure that financial institutions fully take into account the impact of government-support measures.⁸⁴ Of course, it is also important that financial institutions do not underestimate losses, as this could mean that the post-crisis recovery is impeded by regulatory forbearance and inefficient private-sector capital allocations.⁸⁵

The second concrete action that the Bank of England should consider is whether there are macroprudential tools that directly encourage additional corporate lending if credit conditions tighten. The primary macroprudential tool used so far – cutting the countercyclical capital buffer for banks – removes regulatory constraints for additional lending, but has no impact if banks choose not to lend due to reduced risk appetite or increasing uncertainty. The Bank of England has directly encouraged lending through the new Term Funding Scheme (TFSME) by incentivising additional lending with lowcost bank funding. This may need to be extended if banks unduly restrict lending to the corporate sector.

Stepping back, even if the Bank of England undertook these actions to support the economy through the financial system, its role in this crisis is different to those in the past. As discussed in Section 3, with policy interest rates constrained, the Bank is playing only a supporting role in this crisis.⁸⁶ Instead, fiscal policy must be the main provider of stimulus. A key concern in undertaking the sort of large-scale fiscal stimulus discussed in this section and the previous one surrounds its affordability, particularly given the legacy of the persistent rise in debt levels following the financial crisis. So, in the next section we provide a detailed costing for the measures discussed above, and discuss the risk that the Government may have trouble funding such a large stimulus.

⁸⁴ The Bank of England has issued a series of guidance documents, for example: Bank of England, <u>Statement re guidance on the</u> <u>application of regulatory capital and IFRS 9 requirements to payment holidays granted or extended to address the challenges of</u> <u>Covid-19</u>, May 2020.

⁸⁵ The impact of accounting standards and the timeliness of recognition of losses by financial institutions has been a topic of much research since the financial crisis. For example, see: C Laux & C Leuz, Did Fair-Value Accounting Contribute to the Financial Crisis?, Journal of Economic Perspectives 24(1), 2010; B Cohen & G Edwards, <u>The New Era of Expected Credit Loss Provisioning</u>, BIS Quarterly Review, March 2017.

⁸⁶ For more on this supporting role, see: J Smith & T Yates, <u>Helicopters on standby? With rates at all-time lows, the Bank of England</u> needs a different playbook for this crisis, Resolution Foundation, March 2020.

Section 7

The impact of policy on the public finances

The cost of the necessary measures taken to socialise the initial impact of the coronavirus crisis on the UK economy have been significant, with the Job Retention Scheme alone projected to cost around £54 billion this year. Equally necessary is government spending to implement a stimulus package in order to support the UK economy through the reopening phase of the pandemic. The cost of implementing the policy package set out in Section 5 stands at £209 billion, and £240 billion in a second-wave scenario which includes the policies set out in Section 6. This additional spending will have significant impacts on the public finances over the next five years. Stimulus spending on this scale could push public sector borrowing to 16 per cent of GDP, and debt to 105 per cent of GDP. Borrowing would rise even more significantly in a second wave scenario, with its greater economic impact and extended support schemes, reaching 19 per cent of GDP, with debt reaching 115 per cent of GDP.

But financing pressures remain manageable in the near term, and a low interest rate environment means higher debt stocks are sustainable over the medium term. Elevated debt does increase the vulnerability of the UK's public finances to rising interest rates, or inflation shocks in the years ahead. That said, there are strong arguments for thinking that downward pressure on longer-term interest rates will continue. If rates do rise, however, the Bank of England – acting within its remit – may have a role to play in ensuring that the Government can continue to provide support to the economy. To help reduce such risks, there is a strong case for strengthening the fiscal framework.

The economic impact of the pandemic drives down revenues and increases expenditure in both scenarios

In both our Government exit strategy and second wave scenarios, tax revenues fall and public spending rises as a direct result of the economic shock (shown in Figure 6) even before we consider the impact new policy measures. However, given that these scenarios
assume the implementation of a successful policy package that stimulates economic activity, the near-term impact on borrowing is less severe than some similar scenarios, such as those published by the Institute for Fiscal Studies,⁸⁷ and the OBR.⁸⁸

As shown in Figure 22, the macroeconomic impact on borrowing peaks at 5 per cent of GDP in 2020-21 in the Government exit strategy scenario, with a 2 per cent of GDP impact on borrowing by the end of the forecast period. This is due primarily to falling income tax and NICs revenues, as earnings fall and unemployment remains elevated. Falls in inflation and gilt yields have the effect of reducing debt interest payments, providing some limited downward pressure on borrowing. The impact of the economic shock modelled in the second wave scenario is more persistent on public sector borrowing, peaking at 7 per cent of GDP in 2020-21, and remaining elevated at 3 per cent of GDP by 2024-25. This is largely the result of the assumption that unemployment will continue to rise across the forecast period.

FIGURE 22: Falling revenues and rising expenditure drive up borrowing in both scenarios



Impact on public sector net borrowing of the economic scenarios (excluding policy costs)

SOURCE: RF analysis of OBR, various.

⁸⁷ C Emmerson, B Nabarro & I Stockton, <u>The outlook for the public finances under the long shadow of COVID-19</u>, Institute for Fiscal Studies, June 2020.

⁸⁸ Office for Budget Responsibility, <u>Coronavirus reference scenario</u>, May 2020.

Fiscal stimulus measures drive up government expenditure

Government policy measures in response to coronavirus have been on an unprecedented scale, and at an unprecedented cost in peacetime. Public sector net debt rose above 100 per cent of GDP for the first time since the 1960s in May.⁸⁹ However, as shown in Section 2, equally crucial to facilitating an economic recovery are fiscal stimulus measures on the same, if not a larger, scale. Illustrated below are the fiscal impacts for the package of policy measures set out in Sections 5 and 6 for the Government exit strategy scenario, as well as the second wave scenario.^{90,91} The main components of the fiscal stimulus package are costed as follows:

- Labour market support: Costings for the proposals set out in Section 5 are largely drawn from 'The Full Monty: Facing up to the challenge of the coronavirus labour market crisis', including: £5 billion per year to employ 180,000 workers in social care; £5 billion to fund a Job Protection Scheme, and £1.3 billion per year to raise the employer NICs threshold to £15,000 for additional workers in expanding firms for their first year.⁹² We include an additional £6 billion a year for training and activation policies (see Section 5 for details). Withdrawing the Job Retention Scheme more slowly in the hardest-hit sectors would add around £5 billion to borrowing this year, with extensions of the JRS and SEISS in a second wave scenario adding around a further £16 billion.
- Supporting the corporate sector: The adaptations proposed to the coronavirus business loan schemes (CBILS, CLBILS and BBLS) assume that, on top of the existing projection for defaults which have an impact on public sector borrowing, there will be a further proportion of loans that are not paid back within the new terms of the loan. In the Government exit strategy scenario, total loan take-up is based on the OBR's projected £50 billion for this year, and projected default rates are assumed to be 20 per cent, with a further 30 per cent of loans written off due to income-contingent repayments. The second wave scenario assumes a further £50 billion of loan take-up, with a 40 per cent default rate, and a further 10 per cent

⁸⁹ Office for National Statistics, Public sector finances, UK: May 2020, June 2020.

⁹⁰ The baseline used for both scenarios is the OBR's <u>March 2020 Economic and Fiscal Outlook</u> forecasts, stripping out current and capital policy decisions from the 2020 Budget on the basis that much of this spending will be re-prioritised. Existing support schemes are costed in line with the most recent version of the OBR's <u>Coronavirus policy monitoring database</u>, updated on 19 June 2020.

⁹¹ Existing support schemes in the second wave scenario are costed in line with the OBR's <u>Coronavirus policy monitoring database</u>, with business rates reliefs and small business grants extended for a further year and funding for LA support for the vulnerable, SSP costs and public spending on top of DEL increasing by 70% in 2020-21 (the relative size of the further macroeconomic shock to that modelled in the Government exit strategy). Costs relating to fiscal stimulus measures are generally assumed to be delayed by three months, as compared to the Government exit strategy scenario.

⁹² N Cominetti, L Gardiner & H Slaughter, <u>The Full Monty: Facing up to the challenge of the coronavirus labour market crisis</u>, Resolution Foundation, June 2020.

written off after five years.⁹³ Both scenarios include a further £1 billion of loan writeoffs in the form of business adaptation grants, assuming £1,000 is required per business currently using the loan scheme.⁹⁴

- Consumption support: The total support required to boost consumption is modelled based on work from the Washington Centre for Equitable Growth on the magnitude of direct payments in an average recession.⁹⁵ To offset half of the 3 and 4 per cent falls in consumption, respectively, £69 billion of consumption support is required in the Government exit strategy scenario, and a further £16 billion in a second wave scenario. Around £27 billion of this total is made up of consumption vouchers, based on 90 per cent use of vouchers worth £500 per adult and £250 per child.⁹⁶ The remainder comes in the form of the Universal Credit increases for 2020-21 to 2022-23 set out in Section 5, with further UC increases adding to the extension of the JRS and SEISS to make up the additional £16 billion in the second wave.
- Government investment: Public sector gross investment in 2020-21 is assumed to increase at half the real increase in gross investment spending in 2008-09, in the aftermath of the financial crisis, on the basis that a similar pace of investment spending increases could be realistically achieved this time. Investment then reaches the final value of the comprehensive investment package set out in 'Euston, we have a problem: Is Britain ready for an infrastructure revolution?' for the last four years of both scenarios, at a cost of around £40 billion per year.⁹⁷
- Bank of England schemes: A further £70 billion of quantitative easing is assumed in a second wave scenario, on the basis of a further macroeconomic shock (of around 70 per cent of the initial lockdown).⁹⁸

⁹³ For the Government exit strategy scenario, a 20 per cent default rate is calculated assuming the same proportion of write-offs projected in the OBR's <u>Coronavirus policy monitoring database</u>, with a Loss Given Default (LGD) ratio of 50 per cent. Half of businesses, based on projections of turnover for a typical business, are able to repay the loan in full, with these projections suggesting a remaining 30 per cent of loans repay around 93 per cent of their loan. For the second wave scenario, a 40 per cent default rate, based on the 12-month scenario in <u>Doing more of what it takes: Next steps in the economic response to coronavirus</u> is assumed, with a further 10 per cent of loans remaining unpaid in full following the same logic as above, at an average of 92 per cent repayment. Total costings assumed LGD to be 50%, and take into account the Government's 80 per cent guarantee over CBILS and CLBILS, and 100% guarantee over BBLS.

⁹⁴ Based on estimates that 60 per cent of businesses are set to spend up to £1000, and a quarter of businesses expect to spend more than £1000 to meet social distancing guidelines set out in: Federation of Small Businesses, <u>'Strong recovery possible with right</u> <u>support, small firms tell Chancellor, as majority face reopening costs</u>, 22 June 2020.

⁹⁵ C Sahm, '<u>Direct Stimulus Payments to Individuals</u>' in The Hamilton Project and Washington Center for Equitable Growth, <u>Recession</u> <u>Ready: Fiscal Policies to Stabilize the American Economy</u>, May 2019.

⁹⁶ This would equate to around a quarter of the fall in consumption, reflecting that the sectors in which vouchers can be used represent only part of total consumption falls, and many of these businesses will still be gradually re-opening over the course of the eligible period for spending of vouchers. Around 94 per cent take-up of consumption vouchers is assumed, in line with similar estimates relating to gift cards: Department for Business, Innovation and Skills, '<u>Millions wasted as people don't spend gift vouchers</u>', December 2014.Therefore, to achieve £30 billion in consumption support, a £27 billion cost is assumed.

 ⁹⁷ A Bailey, R Hughes, L Judge & C Pacitti, <u>Euston, we have a problem: Is Britain ready for an infrastructure revolution?</u>, Resolution Foundation, March 2020.

⁹⁸ Quantitative easing is reflected in the difference between market and nominal gilt values recorded in public sector net debt, and the far smaller effect of QE on debt interest, which impacts public sector net borrowing.

Policy assumptions, effect on public sector net borrowing from 2020-21 to 2022-23, and rationale

Rationale		9 - Modelled using OBR ready reckoners.	 OBR costings from Coronavirus policy monitoring database, 19 June. 	 OBR costings from Coronavirus policy monitoring database, 19 June.) - OBR costings from Coronavirus policy monitoring database, 19 June.	 Self-employed NICS increased by 3% to match employee rate from 2021-22.) $-$ £500 per person aged over 18, plus £250 per child, with costs split over 12 months.	 Includes £20 per week increase in UC couples elements, £10 per week in child elements, re-instatement of family element and removal of two-child limit, plus extension of increase in generosity announced for 2020-21 in Budget 2020. 	 Investment in 2020-21 at half the real increase in gross investment spending in 2008/09, increasing to total RF proposed investment package. 	 - Creation of 180,000 jobs in social care, which would bring the ratio of care workers to the over-70 population back to its 2014 level.) -Includes projected defaults andincome contingent loan write-offs, recorded in PSNB in year loans issued.	 £5 bn for slower withdrawal of JRS in hardest-hit sectors in 2020-21. Three month extensi of JRS and Self-Employment Income Support Scheme in second wave scenario. 	 Two-year scheme (delayed by 3-months in second wave scenario) providing a 10 per cent subsidy of all labour costs to eligible workers, capped at £2,500 per year. 	 Job guarantee scheme, based on the Future Jobs Fund, with costs split over two years in second wave scenario. Costings of education policy proposals from 'Class of 2020', split over two years in second wave scenario. 	-Raising the employer NICs threshold to £15,000 for additional workers for their first year, thus varies characteristics and the second workers of the second
Second wave	. 2022 23	£69	£6	£0	£0	-£1	£0	£13	£37	£5	£0	£0	£5	£3	£1
	2021- 22	£65	£18	£0	£0	-£1	£30	£18	£36	£5	£0	£0	£5	£6	£1
	2020- 21	£128	£80	£54	£15	£0	£0	£13	£14	£5	£20	£21	£0	E3	£0
Government exit strategy	2022- 23	£40	£4	£0	£0	-£1	£0	£13	£37	£5	£0	£0	£3	EO	£1
	2021- 22	£47	£4	£0	£0	-£1	£15	£18	£36	£5	£0	£0	£5	£6	£
	2020-21	£105	£58	£54	£15	£0	£15	£10	£14	£5	£6	£5	£3	£6	£
Policy measure		Impact of macro scenario	Existing policy - OBR	Job Retention Scheme	Scheme for self-employed	NICS payments from self-employed	Consumption vouchers	Increases to UC	Government investment	Social care job creation	CBILS/CLBILS write-offs	Extension to Job Retention Scheme and SEISS	Job Protection Scheme	Jobs guarantees and training	NICS cut for new hires
	Existing support					Fiscal stimulus									

Source: RF analysis of OBR, Coronavirus reference scenario; RF calculations.

Taken together, the costings above would imply total fiscal stimulus spending of £209 billion across the first three years of the Government exit strategy scenario, and £240 billion in a second wave scenario – roughly equating to the necessary magnitude of fiscal stimulus set out in Section 4. Around £60 billion per year is included in the final two years, assuming that spending on social care and higher levels of investment spending are continued, in order to maintain support for the labour market. As illustrated in Figure 23, this stimulus spending is at a lower rate but cumulatively amounts to more than the initial spending to socialise the costs of the lockdown – with cumulative stimulus spending over one and a half times higher than 'rescue spending' from 2020-21 to 2022-23 in the Government exit strategy scenario.

FIGURE 23: **Stimulus spending cumulatively amounts to more than the initial spending to socialise the costs of the lockdown**



Additional public sector net borrowing



Borrowing reaches double the peak of the financial crisis in a second wave scenario

Increases in government expenditure on this scale, coupled with falling revenues from the macroeconomic shock modelled, lead to borrowing rising to £330 billion this year, or 16 per cent of GDP, in the Government exit strategy scenario (Figure 24). This would be the highest public sector net borrowing since the immediate aftermath of the Second World War in 1944-45. However, as mentioned above, a smaller hit to the economy in Q2 means this is only just over £30 billion higher than the OBR's most recent estimates of borrowing this year that exclude further policy measures.⁹⁹ In a second wave scenario, borrowing is set to reach 19 per cent of GDP, nearly double the heights of borrowing during the financial crisis. Here, the additional stimulus spending set out in Section 6 largely elevates borrowing in 2021-22, as the economic recovery from the pandemic is delayed by around 3 months by renewed lockdown measures. Again, while these levels of borrowing are significant, they compare favourably with other estimates because we have a more positive macroeconomic forecast: for example, the Institute for Fiscal Studies' second wave scenario suggests borrowing will reach over 20 per cent of GDP without a fiscal stimulus package.¹⁰⁰



SOURCE: RF analysis of OBR, various.

Significant increases in government borrowing result in public sector net debt reaching 105 per cent of GDP this year in a Government exit strategy – returning to levels not seen since 1960-61. Debt stocks continue to rise compared to the baseline by the end of the forecasting period, largely as a result of continued expenditure on public investment. In a second wave scenario, public sector net debt rises more dramatically to peak later at 115 per cent of GDP in 2023-24, given the delayed profile of stimulus measures. This would

99 See OBR, Coronavirus reference scenario, 14 May 2020.

100 See C Emmerson, B Nabarro & I Stockton, <u>The outlook for the public finances under the long shadow of COVID-19</u>, IFS Briefing Note, June 2020.

be the highest debt stock seen since the mid-1950s. As illustrated in Figure 25, Bank of England operations represent a higher proportion of net debt in a second wave scenario, given a higher take-up of the Bank's Term Funding Scheme with incentives for SMEs (TFSME) is assumed.



NOTES: Major financial asset sales delayed from 2020-21 are assumed to take place in 2021-22. Given the lack of information on which to base the likely profile of defaults and foregone repayments on government-guaranteed loans, we have recognized the full fiscal impact on both borrowing and debt in 2020-21. SOURCE: RF analysis of OBR, various.

However, the public finances appear robust to near-term and longerterm pressures

Despite debt stocks reaching historic peacetime highs, low interest rates together with assumed falls in inflation mean that debt interest costs in both scenarios are low and falling across the forecasting period. As illustrated in previous work,¹⁰¹ this means that debt interest as a share of public sector revenue, a key indicator of the sustainability of debt servicing costs remains significantly below the 6 per cent ceiling set out in the 2019 Conservative manifesto.¹⁰² Figure 26 illustrates that if interest rates were to return to Bank of England estimates of equilibrium rates (2.25 per cent), this would bring the debt

¹⁰¹ R Hughes, J Leslie, C McCurdy, C Pacitti, J Smith & D Tomlinson, <u>Doing more of what it takes: Next steps in the economic response</u> to coronavirus, Resolution Foundation, April 2020.

¹⁰² Conservative Party, <u>Conservative Manifesto 2019</u>, November 2019.

Easing does it | **Economic policy beyond the lockdown** The impact of policy on the public finances

interest to revenue ratio above this ceiling, albeit in line with ratios seen in the 1990s. However, given the long average maturity of the UK's debt stock (nearly 16 years¹⁰³), this upwards re-adjustment would occur gradually as debt was re-financed over many years. Given the current imperative to increase public sector debt through stimulus spending to avert further economic decline, these questions over longer-term sustainability are important but secondary concerns. And given the expansion of quantitative easing, as well as the effects of the crisis in increasing 'forced saving' and reducing private sector investment, downward pressure on interest rates remains significant, with the likelihood of interest rate risks crystallising remaining low.



NOTES: The underlying scenario forecasts are based on gross public sector net debt interest excluding the Bank of England; they have been transformed proportionally to be consistent with public sector net debt interest and so does not explicitly model the dynamics of net interest directly. SOURCE: RF analysis of OBR, various.

Perhaps a more pressing concern are the near-term financing requirements required for the fiscal stimulus spending of over £200 billion in the coming years. In the Government exit strategy scenario, gross financing requirements reach £438 billion, or 21 per cent of GDP this year, rising to £494 billion or 24 per cent of GDP in a second wave scenario. Demand for Debt Management Office (DMO) issuances has remained reassuringly

¹⁰³ HM Treasury, <u>Debt management report 2019-20</u>, March 2019.

strong, with cover ratios (the ratio of the volume of bids received to the volume of debt being auctioned) generally at 2 or more, and yield tails (a measure of the spread of prices bid) remaining low.¹⁰⁴

However, the Bank of England has indicated that its gilt purchases will slow, with the most recent expansion of quantitative easing (by £100 billion) taking place over the six months to end-December 2020. As Figure 27 shows, DMO issuance¹⁰⁵ is likely to outstrip Bank of England gilt purchases significantly over the months ahead, even without accounting for further fiscal stimulus. One reason not to worry about this is the additional downward pressure on longer-term interest rates as it increases incentives for saving relative to investment. But there is a risk that the yields on the Government's debt start to rise. If that happens abruptly, we would expect the Bank of England to step in and accelerate its purchases of debt as it did in March.¹⁰⁶ If rates start to rise more gradually, however, it is less obvious that the Bank would need to intervene. Even in that case, however, there is a strong rationale for MPC to act if the increase in borrowing costs would be sufficient to force a withdrawal of fiscal stimulus that could lead to a substantial tightening in fiscal policy and a likely undershoot of the inflation target. Crucially, that risk would be reduced - perhaps significantly - by the Government putting in place a fiscal framework that sets a credible plan for how it will return the public finances to a sustainable medium-term position.¹⁰⁷

¹⁰⁴ Debt Management Office, <u>Results of gilt operations</u>, June 2020.

Forecasts for Debt Management Office issuance are calculated using the OBR's monthly profiles for central government net cash requirement (CGNCR) set out in OBR, <u>Coronavirus reference scenario</u>, updated 14 May, plus gilt redemptions set out in DMO, <u>Gilts in issue</u>, June 2020. The profile of CGNCR projections has been higher than outturn gilt issuance for April – June 2020.
 See Box 2 on page 14 in <u>Monetary Policy Report</u>, Bank of England, May 2020.

¹⁰⁷ For more details on how that could be achieved, see: R Hughes, J Leslie, C McCurdy, C Pacitti, J Smith & D Tomlinson, <u>Doing</u> more of what it takes: Next steps in the economic response to coronavirus, Resolution Foundation, April 2020.

FIGURE 27: DMO issuance looks set to outstrip quantitative easing purchases

Bank of England gilt purchases and gross financing requirement: outturn and forecast



SOURCE: RF analysis of OBR, Coronavirus scenario; DMO, Gilts in issue; Bank of England, Results and usage data.

Overall, while the extended support measures and fiscal stimulus set out in Sections 5 and 6 increase existing pressures on the public finances, the crucial point is that these costs are manageable in both the near and medium-term. Although borrowing and debt both rise to peacetime highs in our scenarios, low debt-servicing costs keep the opportunity costs of debt financing low, and manageable. Over the longer term, high debt stocks mean greater vulnerability to interest rate and inflation shocks, but in a low interest-rate environment this does not appear to be a pressing risk. And the cost of failing to stimulate the economy effectively or attempting a premature fiscal consolidation would be far more severe, slowing or halting the economic recovery from coronavirus.

Section 8

Conclusions: The importance of a bold recovery plan for Britain's economy

This report has focussed on policy for the reopening phase of the crisis. During the lockdown phase, the objectives for policy were clear – protect jobs, businesses and incomes – and did not involve policy makers weighing up substantial economic trade-offs in achieving them. By contrast, as the economy is reopening, those same objectives must be balanced against the need to stimulate a recovery amid severe uncertainty about the future path of this crisis, and the timetable for finding a long-term solution.

The stakes are high: push too aggressively for a rapid recovery and risk exacerbating the spread of the virus, spikes in inflation, wasting public funds and, damaging the public finances; go too slowly, and there is a wealth of evidence that this could lead to permanent economic damage and lower living standards.

Crucially, the fundamental uncertainty surrounding the future spread of the virus and the timetable for a long-term solution has implications for policy choices today. Our approach is to use scenario analysis to explore robust policies that will be effective even in an adverse situation in which the Government has to return to a nationwide lockdown.

We argue that, because some sectors – particularly those reliant on social interaction – will continue to face constraints on their output in the reopening phase, those sectors will be more adversely affected than others. This observation drives the design of our policy measures, with the proposed economic support skewed towards limiting the damage to both supply and demand in these hardest-hit sectors.

Lower-income families have been far less able to cut their spending in this crisis, meaning that income hits have seen them turn to higher debt. In contrast higherincome families have seen 'enforced' saving as they are unable to continue their normal consumption patterns. Demand support should take this distributional pattern into account, and it should also be focussed on reducing pressure on firms' balance sheets so they are better able to drive a rapid fall in unemployment. Table 5 summarises our policy package. There are three key features of this package that should be emphasised:

- It is big: unlike previous work on policy in the reopening phase, this policy package is designed explicitly to be quantitatively large enough to generate a rapid recovery in the face of an unprecedented shock to the economy and the constraints facing monetary policy, which has done most of the work supporting the economy in previous recessions;
- It is robust: the measures in this package are designed to be robust to the risk of a second wave of the virus the key source of policy makers' uncertainty; and
- It is targeted: these robust measures are designed to counteract the sectorallydifferentiated impact of the crisis and how that shock transmits to the rest of the economy, providing innovative new policy ideas rather than using the 'go to' tools of previous recessions.

	Robust policy measures (Effective if all goes to plan or if we return to lockdown)	Rationale	Cost in Gov't exit strategy scenario (£bn)	Cost in Second wave (£bn)	
	Protection against temporary supply shocks	Temp shocks will destroy productive capacity			
Labour market:	Extend JRS	Help for hardest hit sectors	£5	£21	
	Job subsidy scheme	Resist against labour market shakeout	£10	£10	
	Measures to boost hiring	Reduce inevitable rise in unemployment quickly	£30	£30	
Corporate sector support:	Income Contingent Loan Scheme	Boost job creation and investment by reducing headwinds from debt and uncertainty	£6	£20	
	Targeted demand stimulus:	Weak demand will reduce jobs and incomes			
Consumption:	High Street Voucher Scheme	High impact support to hardest-hit sectors	£30	£30	
	Increase UC	Boost incomes for those who have had spending constrained	£41	£44	
Investment:	Public sector investment package	Boost spending in key areas of the economy in ways which provide long-term stimulus	£87	£86	-
		Total cost:	£209	£240	

TABLE 5: Summary of stimulus policy measures designed to generate a broadbased and rapid recovery

NOTES: 'Extend JRS' includes additional support to self-employed; and 'hiring measures' includes social care job creation, NICS cut for new hires and job guarantees and training funding. SOURCE: RF analysis.

The impact of the policy measures in this paper

The package in Table 5 is bigger than those featured in the public discourse so far and uses a range of unfamiliar tools, raising concerns about the extent to which policy makers might be willing to implement such a package.

So, to illustrate its impact, we undertake a counterfactual exercise which unpacks the impact of the policy package in this paper. Because of the nature of our scenarios – which plot a course for the economy that is recovering in line with the easing of supply constraints – this exercise can only consider the marginal impact of policy relative to that scenario. Nonetheless, this exercise suggests that GDP would be up to around 10 per cent weaker relative to a case without such a stimulus package. These are big numbers in themselves and would imply, that absent a significant policy response, there would be much more widespread hardship. Moreover, because of the overwhelming evidence that weak recoveries lead to permanent scarring, it is likely that these estimates underplay the true long-term value of this package.



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NOTES: Fiscal stimulus measures are taken from the total package set out in Section 7 of this paper; monetary policy measures are our estimates for the impact of actual changes in monetary policy since the onset of the coronavirus crisis. The impact of stimulus measures is assumed to unwind gradually over a period of four years.

SOURCE: RF analysis of Bank of England and OBR.

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An alternative approach to one we outline in the report would be to postpone major easing measures now and put further measures in place once the impact of reducing social distancing restrictions became clear. Such an approach risks failing to provide families and particularly firms with confidence that the economy is going to recover rapidly. That risks exacerbating the impact of the crisis, necessitating even larger measures in future. A particular risk is that firms respond by reducing employment significantly, increasing the longer-term damage to the economy. Indeed, as discussed above, it would be far easier for policy makers to respond to the future impact of overstimulating the economy – for example by raising interest rates to reduce inflation – than it would be to address the longer-term scarring effects of failing to deliver a rapid recovery in the near term.

Finally, there are those who would say this is all too expensive and will lead to lasting damage to the public finances. The Government will certainly have to wrestle with the lasting impact on the public finances of this crisis, but that should not get in the way of the immediate first priority: delivering a rapid recovery. Measures to return the public finances to sustainability will be important, but they are second priority to delivering the recovery. Such measures will also largely be a response to the permanent supply hit the pandemic is likely to cause, rather than to the cost of the temporary fiscal stimulus itself. The analysis in this report makes it clear that – at ultra-low levels of interest rates – the Government *can* afford to deliver such a policy response. And if measures are taken to bolster the macroeconomic framework, then that will help minimise the risk that funding constraints mean the Government has to change course. More importantly, as this counterfactual makes clear, Britain needs bold policy action in order to avoid damaging living standards that have barely grown for a decade. In short, policy makers cannot afford *not* to put in place a bold package of measures to deliver a rapid recovery for Britain.



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