1 So far, so good: And now don't be afraid of moral hazard

Charles Wyplosz
Graduate Institute Geneva and CEPR

The previous COVID-19 eBook (Baldwin and Weder di Mauro 2020) showed an impressive convergence of analyses amongst the various authors – a rare situation in the economics profession.

For a few days, the messages from the authorities sounded lame. Then, over just two days, they came up with a raft of decisions that were coherent with the economists' analyses – an even rarer occurrence, especially as the numbers seem reasonable. These plans will have to be adapted as we understand better the situation, but we are on to a reasonable path. However, clarity of view and willingness to act are just necessary conditions. Implementation details will matter a great deal. Because most measures create some moral hazard, they can be criticised. The risk is that moral hazard considerations derail the policy responses. This is the wrong thing to worry about.

Focus on bottlenecks, not on moral hazard

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The widely agreed, key analytical issue is simple. Targeted support is needed to face the economic dislocation provoked by the combination of the epidemic, health containment efforts and anguished reactions of individuals, firms and financial institutions. But indiscriminately throwing large amounts of money – be it from the infamous helicopter or by cutting labour taxes – is not an effective way to deal with the myriad of bottlenecks that stand to grip the economic machinery.

Lists of bottlenecks have been produced, more stand to be uncovered, and the required policy responses are usually straightforward. Dealing with many, even most, bottlenecks is not enough, we must try to identify and treat all bottlenecks. Over time, we should uncover all the bottlenecks, but we may face resistance to dealing with all of them.

The decisions unveiled so far generally focus on such measures, but what are the potential pitfalls?

I can imagine five.

- First a bottleneck is like the weak link of a chain – the one that breaks when you pull hard.

A good (and well identified) example is health insurance in the US. If most of the 27 million or so uninsured people cannot afford to not go to work and to be treated, the epidemic and its economic consequences stand to be much worse (Mankel 2020). Moral hazard considerations explain why the US is the only developed country that does not have universal medical coverage. Individual responsibility is a fine concept, but it ignores the externalities from a lack of medical coverage for 'irresponsible' individuals who will infect the 'responsible' ones.

- Second, removing all bottlenecks will be enormously expensive.

The various plans announced by many governments could cost 5% of GDP, possibly much more. This means that we have to carefully craft the policy measures with a watchful eye on effectiveness.

Public spending effectiveness is always challenging, some would say hopeless. It is even more so when emergency measures are taken. It also means that explicit or implicit budget rules, or simply principles of prudent management, will have to be ignored. To make matters worse, we don't really know how much will be needed, and the bill could grow as we uncover more and more bottlenecks. Implicit or explicit budget rules, even regular management and planning, will have to be set aside. This sounds like a recipe for disaster. It is another example of moral hazard – a huge one in fact. Policymakers who have been brave enough to make bold announcements these last few days will face strong pushback.

- Third, the crisis has arrived at the wrong time, as crises often do.

Over the last decade, countless reports have described, in minute detail, corporate – and sometimes household – over-indebtedness, excessive leveraging among financial institutions and unsustainable public debts. The policy answer has generally been that we will deal with these vulnerabilities gradually over time – in effect assuming that we have plenty of time ahead of us.

This wise approach was predicated on the absence of shocks. Well, shocks occur unexpectedly, and we are caught in a most uncomfortable position. Many of the announced policy measures correctly rest on loans to households and firms, through the financial system and the public purse. This means that over-indebted firms and households will have to accumulate more debt, and that financial institutions will have to become more leveraged and more strained as they accept collateral that is about to melt away. For that to happen, public guarantees will have to be extended, backed by equally dubious collateral, or governments will have to lend directly, and possibly even make outright transfers. Here again, we face a moral hazard of enormous proportions. No doubt, wise and prudent objections will be raised, including from the same quarters that rejected dealing with the debt problem when times were good.

- Fourth, so far we face an economic crisis, not a financial crisis.

Even if the governments manage to brush aside the kind of resistance described above, their pockets may be deep, but they are not infinite. They can, and should, suspend the budget constraint, even though they cannot eliminate it and will eventually have to deal with the consequences. But as they ramp up borrowing from the financial markets, those that were already highly indebted stand to face major financial difficulties.

Much the same applies to a whole range of financial institutions. The prudential reforms applied to banks after 2008 were meant to make them more resilient. Resilience, however, is a relative concept. It has been appraised by a great many stress tests, but were the tests stressful enough to encompass the unfolding situation?

Financial jolts are on their way, the markets have already started to panic. In this situation, investors do not just attempt to protect themselves by selling, many also seek to profit from the meltdown by taking short positions, which are potentially infinite. At that stage (much earlier in fact), all eyes will turn to the only institutions that have infinitely deep pockets – central banks, which can lend potentially infinite amounts in last resort.

The earlier central banks let it be known that they are ready to lend in last resort to their governments, to banks and other financial institutions, the more they will stabilise the markets and, therefore, the less it is likely that they will need to intervene. This is particularly relevant for the ECB, as explained below. The argument against such explicit statement is, guess what, that it may create a moral hazard.

- Fifth, assume that all policy announcements are implemented, that all bottlenecks are identified and dealt with, and that central banks manage to nip a financial crisis in the bud, the production system will be ready to promptly resume its functions as soon as the epidemic ends.

With bankruptcies kept to a minimum and workers still attached to firms thanks to temporary suspension of their contracts, demand should also resume as people draw on whatever savings they had put aside during the epidemic and as firms carry out postponed investment.

Avoiding a double-dip recession

Governments should be very careful not to undermine the resumption of growth as they feel the urge to wind down the deficits that they opened up during the crisis. The now-classic example is the euro area's double dip after the Great Recession. Suspending the budget constraint, even for good reason, creates a moral hazard. The response is not premature austerity, nor is it ever lasting laxity. Finding the right balance will be challenging.

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The euro area faces a number of specific challenges. We hear many calls for coordination. There is no doubt that some coordination would help, but not in every dimension. Targeted fiscal measures, which imply transfers to erase the bottlenecks, are ill-suited for coordination. Most measures must target well-identified bottlenecks. In the absence of a fiscal union, providing support to firms and households is a national competence for the obvious reason that it is financed by national taxpayers. In addition, these targets are probably better understood and more effectively dealt with at the local level. However, there is a risk that some governments cannot borrow what they need because they are already overindebted. Given the amounts likely to be required, the

risk of another debt crisis is serious because, as we now know, the euro is a foreign currency because member countries do not own their central bank, the ECB. This is where coordination is required.

One solution would be a mutual guarantee for new national borrowings. An alternative is that the borrowing be undertaken collectively through jointly issued Eurobonds. This is a function that could be entrusted to the European Stability Mechanism (ESM), but its resources (3.5% of GDP) are too limited, the conditions too drastic and the decision-making process, which requires unanimity, too inefficient.

Unfortunately, both mutual guarantees and Eurobonds have been rejected repeatedly in the recent past because of moral hazard considerations. Indeed, countries that managed to attain low public indebtedness are unwilling to protect those that did not. Under the current exceptional circumstances, it would make sense to set the moral hazard concern aside but, given the urgency of the situation, it seems unlikely that an agreement can be worked out after so many years of heated discussions.

Conclusion

The only solution to avoiding a potential debt crisis is for the ECB to offer the same potentially infinite guarantee that national central banks offer their respective governments. It already did so with its "whatever it takes" announcement, but then it was subject to conditionality (pre-existing adjustment programmes focused on deficit reductions) that is incompatible with the current situation. Removing conditionality from the Outright Monetary Transactions (OMT) programme is the most needed form of coordination.

Obviously, this solution involves substantial moral hazard. Casting moral hazard aside will be the acid test of the ability of member countries to coordinate in a meaningful way when needed.

References

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About the author

Charles Wyplosz is Emeritus Professor of International Economics at the Graduate Institute Geneva, where he was Director of the International Centre for Money and Banking Studies, and a CEPR Research Fellow.