

Finland's economic strategy in the face of the coronavirus crisis

An executive summary

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An exceptional crisis

The coronavirus pandemic has brought the global economy to a standstill in an exceptional way. Before the crisis, the global economy was expected to grow by about 3% this year, whereas the current estimate is that it will contract by at least the same amount. This is a very exceptional situation. At the time of the global financial crisis (2007-2009), for example, the world economy did not contract in any year during this period.

In principle, the fact that the crisis comes from outside the economy makes a quick recovery possible, as long as the coronavirus can be contained. However, this is no longer likely for two reasons. Firstly, the available information indicates that the risk of the serious illness caused by the virus cannot be eliminated in the next few months in a manner that would enable a rapid return to normal economic life.

Secondly, the shock caused by the coronavirus has set in motion processes that will affect the economic development of vulnerable countries, in particular, for a long time to come. Poor raw material producing countries will be hit by a price collapse and major problems caused by their inadequate healthcare systems. In Europe, heavily indebted states are not well placed to prevent the multiplier effects of the shock, and there is a genuine risk of such phenomena as the Eurozone crisis recurring.

Restrictive measures and fear will slow down economic activity and cause many other challenges

Various restrictions aimed at reducing interactions between people, such as the prohibition of large meetings, reduced travel, cancellation of cultural, sporting and other events, closure of schools, restaurants as well as shops, even curfews have had a major impact on economic activity. Mere recommendations often have the same effect as prohibitions. In addition, people use services less because they fear becoming infected, which reduces private consumption and thus exacerbates the crisis.

The crisis has primarily weakened the service sector, leading to a record number of lay-offs and dismissals. Global supply chains have also been disrupted, which has hampered manufacturing to some extent. However, a decline in industrial activity is mainly to be expected later as the weakening demand takes effect.

In Finland, as elsewhere, the greatest losses in sales and jobs have been witnessed in the service industry, especially in the tourism and restaurant sectors. However, differences between companies are large. In all sectors, one can find companies whose turnover has grown despite the crisis, while other companies in the same sector have lost more than half of their sales.

In addition to lost production, income and jobs, the crisis has had many other harmful effects, most of which are directly due to the restrictions imposed by the authorities. Non-urgent illnesses go untreated, mental health, substance abuse and domestic violence problems increase, and older people suffer from loneliness and loss of functionality when left alone for long periods. Learning is hampered, as children have no access to early childhood education and care or school. Especially children who do not receive adequate support at home are at risk of serious harm. The long-term harm of school closures can be great.

Companies and employees alike may not survive without government support

The initial task of economic policy is to reduce the direct damage caused by the epidemic and the restrictions imposed to curb it. In many countries, this means securing the incomes of those who are out of work. In Finland and other countries with good safety nets, the unemployment security system provides a reasonable income for the unemployed.

Economic policy measures in Finland and comparable countries have thus focused on maintaining the operating conditions of the business sector. Without support from society, a significant proportion of previously profitable companies can be expected to go out of business, with loss of the 'organisational capital' associated with them. Companies which manage to stay in business but which lose a great deal of capital and are forced to let some of their employees go will also be less able to respond to improved demand and invest later.

Central banks have taken major steps to provide liquidity, while governments have created or expanded special funding arrangements. In Finland, liquidity support has mainly been channelled through the Bank of Finland and Finnvera. Companies have

also been granted extended time to make Social security payments and pay value added taxes.

Direct support has so far mainly been granted through Business Finland, the ELY Centres and the municipalities. In addition, Finnish Industry Investment has launched a capital investment programme, while the central government has announced its intention to recapitalise Finnair as its main shareholder. A decision has also been made on a specially designed support programme for restaurants.

While the government measures undertaken so far have been useful, we do not find them adequate. A system with wider coverage that can rapidly support the profitability of companies in all sectors is needed. The objective of this support is to prevent bankruptcies by allocating temporary direct aid to companies, which have suffered the most during the coronavirus epidemic.

In this proposal, the aid would be targeted at small and medium-sized enterprises to cover fixed costs, which companies struggle with during the downturn. The aid is also partly based on companies' wage costs to support employment during the crisis. A proposal to this effect is discussed in more detail in Chapter 3 and Annex 10.

The need to relax restrictions and the difficulty of choosing a wise strategy

In order to control the pandemic, it has been necessary to introduce strict restrictions on citizens' freedoms. These restrictions have been successful in halting the spread of the epidemic. In the meantime, the restrictions hamper significantly people's daily lives and business activities. This is why an effort should be made to lift the restrictions as quickly as possible.

In the effort to control the pandemic, countries have a choice between two main strategies. One of them is based on so-called herd immunity. If preventing the spread of the virus among the population at large is not possible, the best strategy is simply to slow down the epidemic just enough to ensure that the capacity of the health system is not exceeded. This was the initial strategy of the United Kingdom, for example. At the moment, it is followed by few countries besides Sweden.

In the second approach, strict restrictions are used to reduce the speed of transmission (reproduction number R_0) so much ($R_0 \ll 1$) that the epidemic is suppressed and the restrictions can be dropped. However, maintaining strict restrictions in an

open society for a longer time is unrealistic. Unless the virus can be suppressed globally, the preconditions for its complete suppression in Finland would include permanent restrictions on entry.

The strategy selected by the Finnish Government is based on restrictions that prevent an exponential spread of the epidemic ($R_0 \approx 1$). However, the restrictions create significant obstacles to the economy and people's daily lives. This is why it makes sense to try to replace the strictest restrictions with less damaging protection measures and adopt a strategy based on testing, tracing, isolation and treatment.

We find that the last strategy, named the hybrid strategy, is justified in the Finnish circumstances. The strategy should be further complemented with effective protection measures enabling a safe return to work and normal life as well as by increasing the testing and tracing capacity further. The option chosen by Finland can be expected to lead to a significantly lower mortality rate than the Swedish strategy, provided that effective treatments and/or a vaccine become available before the Swedish strategy produces sufficient herd immunity.

When lifting individual restrictions, both the health risks associated with their removal and the economic and other benefits gained from dropping them must be assessed. We are forced to make such assessments based on very incomplete information. There is little actual research evidence either on the effects of the restrictions on the spread of the epidemic or their economic significance.

This crisis will continue for an extended period. Even in the most optimistic scenario, vaccine development will take at least one year. Current scenarios indicate that the time available will not allow us to develop the required immunity, and some degree of restrictions and protection measures will have to be kept in place for quite some time.

The Finnish economy will be hit hard

The coronavirus shock will cause a severe recession in Finland, though there is great uncertainty about its depth and duration. Keeping some restrictive measures in force will be necessary for a relatively long time in Finland and elsewhere. The uncertainty related to the epidemic and its impact on economic development will not disappear quickly. No policy measures, however extensive, will be able to prevent the multiplier effects caused by the shock completely.

In terms of the Finnish economy, the direction taken by the economic developments in the Eurozone will be crucial. In light of the information currently available, economic growth will remain weak in many countries for an extended period.

Whereas we do not expect Europe to end up in a situation similar to the Eurozone crisis, the risk is nevertheless there.

While the details are as yet unknown, the coronavirus crisis will bring about changes in consumption and production structures. The tourist industry, especially cruise lines, will be weak. On the other hand, the crisis will boost digital services. The demand for technological solutions important in terms of climate policy may also increase significantly.

We estimate that production and employment will drop off the previous growth track for a longer period of time. The duration and severity of this downturn remains uncertain. The drawn-out recession, which began in 2008, shows that production and employment can depart from trend for years. We cannot trust the employment and productivity rates to return to their earlier trend in the foreseeable future. To avoid development leading to another 'lost decade' of this type, we need policy that will significantly strengthen economic growth.

Public finances heading towards an unsustainable level of debt

The economic outlook described above means that general government finances will weaken significantly, not only in the current year but for a long time ahead. Public debt will grow rapidly and, even in the best-case scenario, we expect it to reach 90% of GDP by the end of the decade unless corrective action is taken. Without policy measures, however, a debt-to-GDP ratio in excess of 100% is perfectly possible.

As such, a debt-to-GDP ratio of up to 90% is not an unsurmountable problem if interest rates can be expected to remain low. This assumption is strongly justified, given the economic outlook of the Eurozone as a whole. Despite the low interest rates over the next few years, however, a 90% debt rate will leave Finland more vulnerable to new shocks; at this rate, contracting additional debt may not be easy in the future, and debt management may turn out to be costly.

However, an even more serious problem is that without policy measures, no end to the growth of debt will be in sight even by the 2030s. This means not only increased vulnerability but also further growth in Finland's long-term sustainability gap in public finances, which already is large.

For these reasons, it is clear to us that the debt surge on the horizon is unacceptable. The minimum requirement is that the debt-to-GDP ratio can be stabilised during the current decade.

Three elements of economic strategy

The economic policy in the face of the coronavirus crisis can be divided into three phases: (1) damage limitation while the epidemic is brought under control, especially by supporting companies, (2) fiscal policy that will support demand after the restrictions have been lifted, and (3) repairing the economic damage and stabilising public finances once the economy has returned to a growth track.

The hardest one of these will be the third phase, as it will require 'sharing scarcity' by cutting expenditure and increasing taxes as well as making structural reforms, some of which will be unpopular. The scale of this strategy is demanding but not overwhelming, and the experience of the crisis may help to reach consensus on carrying out the necessary measures.

The need for new types of business support

There are solid grounds for supporting business sector liquidity and profitability at the current stage of the crisis. In the long run, however, business activity cannot be based on continuing the current support measures. In addition to being impossible in terms of public finances, it would seriously distort economic activity.

If the crisis recedes in the next few months, fixed-term support measures can be dropped by the autumn, at least for the most part, without the need for new measures. As part of the future fiscal adjustment, it would be preferable to find ways of reducing business aid.

If the crisis is prolonged, on the other hand, a more thorough review of the support strategy will be required. In this situation, the original plan of maintaining the operating capacity of as many companies as possible during the acute crisis, will founder.

Even in this situation, however, it will be important to ensure the survival of the most valuable parts of the business sector, such as high-tech export companies with a great deal of organisational capital. With some exceptions, the direct aid instruments currently in place are unsuitable for this. A new strategy and instruments selected in line with it will be needed.

The key question will be selecting the companies which would be rescued with society's support, if the crisis is prolonged. At the same time, other forms of support should be considered. These could offer the government a share of the future revenue of the rescued companies or induce the companies to repay the investments in other ways. We propose that a new expert group be appointed to consider both the continuation of

the current aids and, in particular, the needs to develop the financial support strategy for companies.

Stimuli are needed to support a reboot of the economy

Lifting restrictions will not automatically trigger an increase in economic activity. In the likely case of weak domestic demand and poor export prospects, fiscal stimulus measures will be needed to ensure that domestic demand will grow, thus supporting business activity. The first requirement to be set for fiscal policy is that the so-called automatic stabilisers will be allowed to operate after the acute epidemic stage. As the crisis eases, there will also be a need to complement the action of automatic stabilisers with policy underpinned by decisions.

It currently appears that the budget for 2021 should have a strong focus on recovery. Some fiscal measures may already be considered in late summer if sufficient progress in lifting the restrictions has been achieved. In any case, central government support to the municipalities will be already needed this year due to both a reduction in the municipalities' tax revenue and the pressures on their services.

It is vital that the economic policy aims to strengthen economic performance. This is not an argument in favour of general tax cuts or an increase in income transfers and benefits. Instead, efforts must be made to invest in increasing the economy's production capacity and encouraging growth orientation.

Obvious targets include investments in infrastructure, which will boost the economy by increasing demand in the short term and strengthening economic performance and productivity in the long term. They may comprise road or rail projects or, for example, increasing housing construction to alleviate housing shortages in growth centres. Investments in promoting environmental and climate policy and increasing energy efficiency are also worth considering. It is essential that the selected 'green recovery' measures are effective and can be launched in a way that supports economic activity reasonably quickly.

Bringing forward investments in measures regarded as necessary in any case, or strengthening competence levels, research, and promoting innovation, will also be justified. However, such solutions must be compatible with a tight rein on spending limits over the longer term.

A major adjustment package required for fiscal consolidation

The crisis will divest Finland of resources and weaken our public finance significantly in the medium term. The fiscal sustainability gap, the main driver of which is the ageing of the population, continues to grow. This is why a more forceful fiscal adjustment to the potential production capacity of the economy will be needed than what was expected before the crisis. In practice, this adjustment will mean cutting expenditure and/or increasing taxation.

The extent of the adjustment required is uncertain. With no changes in economic structures, however, it is justified to set its minimum range from 3% to 4% of GDP. This would probably be sufficient to stabilise the debt-to-GDP ratio at less than 90% in the 2020s and possibly even bring about a slight decrease in indebtedness. While this adjustment would reduce the long-term sustainability gap by a similar amount, it would not be enough to eliminate it. Even after adjustments of this level, public finances would be clearly more vulnerable to future shocks than before.

The need for adjustment will be reduced if the potential production capacity of the economy can be improved by means of structural policy, in other words if the employment rate increases and the labour productivity goes up. From the public finance perspective, the employment rate and efficiency of publicly funded service provision will be particularly important. This type of structural policy will be needed in any case to avoid the prospect of weak economic growth over the longer term.

The challenge of such policy is that its impacts will materialise slowly at best. This also entails the problem that unrealistic structural policy plans can be used as an excuse to avoid unpopular cuts in expenditure or tax increases. For these reasons, it is important that measures aimed at improving the potential production capacity of the economy, including public sector efficiency, will be clearly defined and implemented at a brisk pace.

The requisite set of policies means preparing a large adjustment package. Decisions on expenditure and taxation or structural policy are never easy.

Plans must be mainly based on what we know now

The crisis has not changed the means available for increasing the employment rate or productivity. The uncertainty about their effects also persists. Additionally, there has been no change in our understanding of how spending cuts and tax increases affect different groups of people.

On the other hand, the need to balance public finances in a way compatible with the potential of the economy has grown significantly. This also means that the ability to make, rather than postpone, policy decisions is needed more urgently than ever. When faced with a problem that is large and becomes worse over time, we must be able to make decisions with the understanding that we may have to change them quite soon as new information comes to light.

There is no shortage of suggested measures aiming to improve economic efficiency and the sustainability of public finances. Such stakeholders as the Ministry of Finance, the Bank of Finland, the OECD, the IMF, the European Commission and the Economic Policy Council have repeatedly presented various proposals aimed at increasing the employment rate, improving productivity and, in particular, boosting public sector efficiency.

Careful preparation is required to achieve good results, and in this context, economic efficiency is only one element. Achieving a set of policies that are considered fair will be at least equally important.

Finland will prevail

In international comparisons, Finland has been identified as one of the best-functioning societies in the world. The citizens trust each other and central government institutions. The administration works efficiently and equitably. Finland is highly appreciated as an innovative information society.

We have proof of our ability to survive major shocks. While the Civil War, the Second World War and the recession of the 1990s were serious crises, we ultimately coped with them surprisingly well.

The coronavirus crisis is a dramatic deviation from the normal. Policy-makers have been forced to resort to exceptional measures to control the epidemic and protect businesses and citizens. Individuals, businesses and other communities have shown initiative and demonstrated great innovativeness in solving problems. As far as bringing the epidemic under control is concerned, the results are excellent. The next steps will not be easy. In the light of our previous achievements, however, we should be well able to cope.