°232

Economic Consequences of the Covid-19 Pandemic and Lessons for Future Crises: Results from Economic Research

In addition to the damage to health, the Covid-19 pandemic caused tremendous economic costs. What can be learned from an analysis of the economic consequences and of crisis management in politics and in society? Extensive research is now available on this, although it mainly relates to the earlier phase of the pandemic: essentially experience and data from 2020. Various lessons emerge for dealing with future pandemics. The most important concerns the question of whether there is a trade-off between protecting health on the one hand and limiting economic costs on the other.

Health and Economy in Conflict?

The answer is an unequivocal No. The idea that one can limit economic damage from a dangerous pandemic by forgoing government-imposed contact restrictions and accepting that the pathogen will spread is misleading. There are two main reasons for this. First, such a policy prolongs and exacerbates waves of infection. Second, regardless of government action, people respond to the risk of becoming infected by refraining from certain forms of consumption. This is especially true for older people with high incomes, whose spending carries a lot of weight in economic development. This is shown by studies comparing consumer behavior in US states with different lockdown policies. US states that enacted lockdowns later or opened the economy earlier with similar levels of infectious disease do not exhibit significantly higher levels of social consumption, i.e., visits to restaurants, hair salons, or events. In Europe, Sweden in particular followed a special path in the early phase of the pandemic and initially refrained from lockdown measures. Comparisons of labor market developments in Sweden and other Scandinavian countries show that the crisis-induced decline in employment in Sweden came somewhat later, but was similar to that in neighboring countries that took lockdown measures earlier. In 2020, Sweden ultimately experienced much the same slump in growth as the other Scandinavian countries, but suffered significantly more fatalities, even around ten times as many as Norway.

Costs Arise Mainly from the Pandemic Itself

The overall picture of the available empirical evidence shows that at least 80 percent of the costs arising from loss of value added are caused by the presence of the virus and the risk of infection itself, not by government lockdown measures with a bearing on social consumption.

Here one could argue that lockdown measures are superfluous if people voluntarily avoid contact. However, that would be going too far. It is well documented that restrictions on social contact reduce infections. First and foremost, contact restrictions reduce transmission of the virus by people who would not otherwise avoid contact, either voluntarily or for fear of infection, and by those who cannot avoid contact, such as children who need to go to school. Not only do government policies that reduce infections do no more than minor economic damage. To the extent that they contain and shorten waves of infection and thus make social consumption possible again sooner, they even reduce the economic costs of the pandemic. In Germany in particular, it has become clear that digitalization in schools and public administration is an important prerequisite for proactive action of this kind. This is an important task for the coming years.

Lockdown Has Long-Term Consequences That Are Difficult to Measure

However, this does not mean that lockdown measures in any form pose no problems for economic development. In the early phase of the pandemic, national borders were closed not only to tourists and business travelers but also to freight traffic. The latter move did little to contain infections, but it did lead to a collapse in industrial production as intermediate products were no longer delivered and industrial value chains collapsed. Another problem is that political action was often limited to lockdown measures, whereas proactive action, especially more testing and faster tracking of infections, would have been possible and necessary. For one thing, this would have significantly curbed the spread of the virus. For another, more testing and hygiene measures would have made it possible to reopen important sectors of social and economic life sooner. The economic and social consequences of the school closures during the pandemic are particularly serious. Studies in education economics show that one-third of a year of lost schooling can reduce the lifetime income of affected students by 3–4 percent. While a significant amount of teaching moved to the internet during the pandemic, this cannot truly replace face-to-face instruction, especially for children from families where parents cannot assist with learning. This leads to a second important lesson from the pandemic: policies that are limited to lockdown measures and do not proactively address the pandemic through extensive testing and tracking of infections exacerbate not only the health implications but also the economic costs of the pandemic.

Clever Stabilization Policy Dampens Economic Slump

Another important lesson for economic policy is that targeted and decisive economic policy is of great importance for stabilizing macroeconomic development during the pandemic. However, traditional economic policy measures that aim to support demand do not make sense here. After all, in a pandemic situation, economic activity is impaired not because there is too little purchasing power, but because economic activity that brings people together is not possible. Economic policy must therefore concentrate on bridging the duration of the pandemic and ensuring that as little irreparable damage as possible occurs during this time. Moreover, in crises, especially in financial markets, there is a danger of confidence collapsing and banks having to restrict lending to companies or private households to such an extent that a self-deepening crisis results. Governments and central banks have prevented this from happening during the crisis by providing extensive state loans and guarantees, and in some cases also equity capital. In addition, high spending on short-time allowances and financial aid, especially for smaller companies, helped to contain insolvencies and social hardship during the crisis. As a result of these government interventions, the public debt ratio in Germany has risen by around 15 percentage points. Without this stabilization, however, the economic slump would have been much sharper. The debt ratio might even have ended up higher because the denominator of this ratio, gross domestic product, would have fallen even more sharply.

Clemens Fuest
Professor of Public Economics and Finance
President of the ifo Institute

Published in Forschung und Lehre, 12/2021