Number 56
March 2020

ECONOMIC VIEWPOINT

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The Economic Policy Response to the Coronavirus?

Considerable attention is focused, and rightly so, on the public health challenges posed by the Covid-19 spread; however, following the sharp collapse of the stock market, analysts are now also beginning to opine on the macroeconomic implications of the pandemic. Recent op-eds speak of the perhaps premature reduction in interest rates initiated by the Federal Reserve in the U. S., while other pundits are speculating as to whether the sharp drop in global GDP will be followed by a V-shaped more rapid recovery or a U-shaped longer one. The main instrument to deal with the consequences of this unforeseen event is fiscal policy and here is where attention should be directed.

Following the global financial crisis, we have seen tepid growth for almost a decade, exacerbated by the trade war between the two largest economies, major technological changes that affect global value chains, and most damaging of all, a spike in uncertainty that has negatively affected private investment. Therefore, the denominator in any debt-to-GDP calculation has been growing rather slowly, while the numerator, a reflection of persistent fiscal deficits in many countries, has continued to rise. More telling has been the sharp rise in corporate debt in the advanced economies as well as in emerging markets. Total global debt is now estimated to be roughly $250 trillion or three-times global GDP. For emerging markets, the World Bank recently noted the new wave of external debt reaching $55 trillion or 164 percent of GDP. These are not healthy numbers.

Looked at from a policy perspective, the world's central banks have exceeded their mandates to keep economic activity alive with excessive reliance on quantitative easing and provision of liquidity. Unfortunately, this has not had the desired effect of pushing up investment. At the same time, governments have increased spending and are running larger than usual deficits according to the IMF. This is only tolerable, even for advanced economies, because the cost of that debt is currently so low. This fact notwithstanding, there is very little fiscal space to fill the gap that will be the result of reduced consumption and lower output caused by Covid-19.

So the big policy question is are we stuck lacking the proper instruments to deal with this crisis, which will quickly move from a health crisis to a marked global slowdown?

Governments will in the first instance have to spend a lot to deal with Covid-19 and most have already allocated extra-budgetary funds. But the real problem will be factory closures, jobs that cannot be handled by telecommuting, reduced consumer spending while the health scare persists, and a reduction in global travel and in those related industries that can have a cascading negative effect. The net effect will be reduced global GDP—perhaps by as much a one percentage point or a third of global growth. This impact assumes that governments will be passive in their responses, which many will not be due to political and social pressures.

If governments decide that they need to provide large tax breaks to the airlines and the travel industry, or if they opt to provide additional income support to those who may be laid off in directly or indirectly affected sectors, or if they decide that with reduced consumption, exports and investment, the only sensible policy is a classic counter-cyclical Keynesian stimulus, we will see a spike in public debt levels. For some poorer countries, the IMF and World Bank have offered additional lending; however, the issue may not be purely cyclical in nature for many low-income countries. All this resonates with the IMF's classic admonition to create fiscal buffers, namely, to plan for rainy days. And this global pandemic will create a coordinated shock that will strain many rainy-day funds even where they do exist.

The irony is that for many countries already confronted by lower potential growth rates, the right interventions would have been greater public investment in infrastructure and improvements in efficiency that would promote improved productivity; however, the likely set of fiscal interventions will be more similar to those chosen in 2009, namely, shovel-ready projects with dubious returns, bailouts of affected sectors or transfers to favor more spending. This is the most probable set of responses for governments trying to create a V-shaped recovery rather than a more prolonged slow-down. Inevitable though this may be, it simply highlights the waste of years of extraordinarily low borrowing rates that were ignored when it came to areas such as new infrastructure spending,

Nowhere is this unfortunate turn of events more apparent than in the U. S., where the National Infrastructure Bank has languished in Congress for decades. Eminent economists, such as Olivier Blanchard, American Economic Association president and former chief economist at the IMF, among others, have argued that with historically low interest rates, many public projects were viable and financeable. This would of course have consumed some fiscal space, but also created more solid foundations for future growth. The excessive savers of Europe have also missed the boat in terms of smart spending, and those rightly concerned with climate change can also see a decade of opportune investing slipping away.

Fiscal policy requires a radical rethink in many economies. The balance between spending on the current generation, whose pension and health needs can drain increasing amounts of resources, and the needs of future generations requires re-examination. Equally troublesome is the tax avoidance of major corporations, a market failure that the OECD has tried to address with global taxation ideas. The additional casualty of Covid-19 and its fiscal effects will be that these important issues will continue to be sidelined.

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