Macroeconomic Policy Responses to the COVID-19 Pandemic

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COVID-19, GLOBAL MARKETS & GLOBAL MACROECONOMIC POLICY RESPONSES
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Faculty from HBS's Business, Government, and the International Economy (BGIE) unit discussed the macroeconomic crisis resulting from COVID-19 and global policy responses.

Alberto Cavallo described the magnitude of the crisis and explained the need for urgent policy responses. Huw Pill discussed monetary policy, Matt Weinzierl described fiscal policy, and Dante Roscini looked at emerging markets.

Mother of All Crises

This unprecedented event has been termed the "mother of all crises" because it is simultaneously a health crisis, a massive financial and economic crisis, a crisis that is damaging aggregate demand, and a shock to aggregate supply due to labor lockdowns and supply chain disruptions. And, it is affecting all countries.

Neither the depth nor duration of the crisis is known.

- **Depth:** A GDP decline of 10%-15% is not out of the question. For comparison, in the Great Recession (2008-09), US GDP fell ~5%. In the Great Depression (1929-33), US GDP declined ~26%. The IMF has estimated world GDP will fall by 3% in 2020.
- **Duration:** The goal is for this crisis to be temporary; the longer it lasts, the more permanent damage that occurs. A longer crisis breaks firm-employee connections, disrupts supply chains, damages global trade, and collapses industries.

Comments from program participants indicate concerns include uncertainty about when the crisis will end, political instability, deglobalization, slowing long-term growth, the social impact, the impact on small and medium enterprises, and changes in consumer behavior.

Because of the potential for permanent damage, urgent policy action is required.

Policy Goals

The primary focus of policy is to ensure that when the lockdown ends, there is a quick, robust recovery, ideally to pre-crisis levels. However, this is a tall order and chances of a quick and complete rebound are slim.

Intermediate objectives of macroeconomic policy responses are:

- Keep financial markets functioning.
- Minimize the impact of temporary demand weakness on the supply side.
- Support efforts to increase healthcare system capacity.

MAIN IDEAS

- **The health crisis has caused an economic crisis that affects demand and supply.**
- **Monetary and fiscal policy responses aim to ensure functioning financial markets, minimize the impact of demand weakness, and enable a rapid economic recovery.**
- **This crisis is wreaking havoc in emerging markets, requiring a multilateral response.**

> "The longer it takes, the more likely we will experience a permanent loss in output."
>
> Alberto Cavallo

- Sustain confidence in the economy to avoid a collapse in spending that could trap the economy in a depression-like state.

The main tools are monetary, fiscal, and global policies.

Monetary Policy

Central banks set and implement monetary policy. This includes the US Federal Reserve Bank (the Fed), the European Central Bank (ECB), and central banks in Japan and elsewhere.

To keep financial markets functioning, the Fed has injected massive amounts of liquidity, reactivated special refinancing facilities, and acted as a "market maker" of last resort. The Fed has propped up credit markets by purchasing commercial paper and exchange-traded funds. Other central banks have intervened similarly. The Fed has also reactivated foreign exchange swaps with other countries' central banks to enable them to obtain dollars.

In addition, the Fed has focused on preventing permanent damage to the supply side by reducing interest rates to zero, guaranteeing some loans, and giving forbearance to banks so they can make loans.

Some wonder if the Fed is overstepping. There is an argument that it has, but the Fed saw a life and death crisis and knows that once markets seize up, it is difficult to restart them. While there are risks in actions by the Fed and other central banks, these actions were necessary. Debating the long-term role of the Fed and central banks must be taken up after the crisis.

"What we've seen from central banks, led by the Fed, is they've acted aggressively and promptly to sustain market functions and support continuous trading and pricing in financial markets."

Huw Pill

Fiscal Policy

Matt Weinzierl looked at the composition and scale of the fiscal response. Like the health system, fiscal policy can be thought of as: 1) urgently treating the infected; 2) limiting the spread; and 3) protecting us for the future. He looked at US and international policy along each step.

Step	Fiscal policy	US (CARES Act)	Internationally
1. Treat the infected	Direct transfers from the government, especially to the unemployed	~$1T for direct transfers, extended unemployment insurance, assistance to states	Direct transfers to households in Hong Kong and Singapore
2. Limit the spread	Payroll support and temporary loans	~$1T in loans to large firms and forgivable loans to small businesses	In Denmark, government paying salaries; in France, banks lending with government as a backstop; Australia has wage subsidies to sustain employment
3. Protect us for the future	Not much yet	Not much, though some funds for public health for tests and vaccines	

In considering the scale of the fiscal response, the goals are to enable the economy to quickly bounce back by: 1) minimizing damage to the supply side from the drop in demand; and 2) avoid a self-fulfilling collapse in confidence. Stimulus is not the goal.

Since the US economy is ~$21 trillion, countering a GDP decline of 10%-25% would entail a fiscal response of $2T-$5T. Therefore, the $2T CARES Act is an appropriate start. The US can afford this response because the country can borrow at interest rates near zero and paying back 10% of one year's GDP over the long term is manageable. Post crisis, paying this debt will likely require increased taxes, both at the top of the income scale and by those who benefitted. A value-added tax may also be appropriate, but increased corporate taxes are unlikely.

For countries lacking the trust and economic strength of the United States, borrowing will be more difficult and expensive, implying a role for the IMF.

Emerging Markets

The COVID-19 crisis is even more difficult for emerging markets. The IMF has projected that 170 countries will experience lower per capita income this year, after previously predicting that 160 would grow. Considerations for emerging markets include:

- **Commodity prices:** Prices of oil, gas, and metals have all collapsed, badly hurting many emerging markets.
- **Global trade:** For emerging markets that rely on export-led growth, plummeting trade is disastrous. Trade had already slowed in 2019 due to tensions. The World Trade Organization forecasts trade will fall this year by 13%-32%. The last time trade declined so drastically was the 1930s.
- **Capital flows:** Almost overnight, foreign investors became averse to risks in emerging markets resulting in immediate and extreme outflows, at a greater rate than in previous crises.
- **Weakened currencies:** Investors' race to safety has propelled the US dollar to new highs and has caused emerging markets' currencies to suffer extreme depreciation. Several currencies have lost ~25% of their value against the dollar.
- **Financial market dislocations:** Equities have plummeted and bond market yields have doubled.

These risks for emerging markets make it more difficult for countries and companies to finance their debt, which increases the risk of default, at just the time that the level of debt in emerging markets is at its highest ever. Emerging markets are also exposed to tail risks if the duration is long, if the recession is so deep that it creates long-lasting consequences, or if external assistance is insufficient.

To date, emerging markets have used monetary and policy responses, but these markets don't have the same ability to borrow as developed markets. Emerging markets will need debt relief and multilateral assistance from organizations such as the World Bank, IMF, and G20.

Additional Resources

- View the video and download the slides from this program
- See the HBS Global Policy Tracker, a website developed by HBS tracking global policy

"Foreign investors desperate to shed risk have been withdrawing cash from emerging markets at record speed . . . what investors have already withdrawn from emerging markets dwarfs any past capital outflows."

Dante Roscini

"All of the above significantly increases the risks for emerging markets."

Dante Roscini