Macroeconomic Policy in the Time of COVID-19

Andrés Velasco
LSE and CEPR
April 2020

The policy challenge

- Any benevolent government must have two goals in mind
  - To save lives
  - To save livelihoods

- That choice has to be made over 2 time periods
  - The SR, when urgent measures have to be put into place
  - The MR, when lockdown restrictions begin to ease and the economy begins to recover –whenever that is.

- First crucial question: is there a tradeoff between these two goals?

- Second crucial question: when there is a tradeoff, what can we do?

Is there always a tradeoff? Not necessarily

- A very restrictive lockdown policy
  - May save lives today
  - But may cause layoffs, destroy valuable organizational capital and delay the recovery

- A very restrictive lockdown policy
  - May save lives today
  - And may also ensure there are enough healthy workers to participate in the recovery tomorrow

- Flattening the infection curve need not always flatten the economy!

- It is crucial to ascertain over what range of which policies there is and there isn´t a tradeoff between health and economic objectives. The devil is in the details

- It depends crucially on what the post-lockdown period looks like, and about this we know little (as Roberto and Ricardo said).

When there is a tradeoff, what is to be done?

- Ameliorate the tradeoff!

- Health and containment policies!
  - Massive and early testing (Romer)
  - Insulating the elderly
  - Intelligent lockdowns: alternating?

- Labor policies
  - Facilitate working from home (teleworking and telecommuting)
  - Extending sick pay

- Macroeconomic policies
  - Prevent toxic multipliers from setting in!

The macroeconomics of a pandemic

- In SR, massive negative supply shock! Firms lose workers, sales and revenues
- Key challenge: to preserve organizational capital: if your hire specialized workers you cannot just hire them again in the future

- How to keep paying wages? Need credit! Not just rollovers of existing debts, but new resources for working capital
- Tax cuts alone will do the trick! Interest rate cuts alone will not to the trick!

- Catch 22: banks will lend if they expect the firm will be healthy in future. But firm will be healthy if and only if banks lend, so that valuable workers can be retained!
- Need not only cheap financing for banks (provided by either CB or Treasury), but active government role to rule out bad equilibria.
- Under bad outcome, health crisis will morph into output crisis and financial crisis!

Particularities of EMs and DCs

- Prevalence of self-employed and informal workers
  - Makes it hard to condition aid packages on maintenance of payroll and payments to suppliers
  - It also makes it hard to lend to finance slump
  - But informal firms may have little specialized employment and less organizational capital!

- Limited institutional capacity and credibility
  - In ACs, if government says you stay home, you do
  - In DCs, governments have less enforcement capabilities
  - But tradeoff is different: people may choose not to stay home if they expect the future will be no better than the present
  - Second area where bad equilibria may be a danger! (recall R. Chang´s point)

- Limited fiscal space
  - A handful of EM s have some capacity to borrow
  - Most do not –role of IFIs absolutely crucial!

Financing issues

- Resources for emergency health measures
  - Are not that large and pay for themselves (ameliorate tradeoff)!
  - WHO has estimated basic health spending in EMs and DCs at $40 billion
- Resources for support of households and firms
  - Headline figures are huge: AEs are spending 10% of GDP and more
  - But notice: this is gross spending, not net! It helps forestall an economic collapse that would also be hugely expensive
  - The US government made money bailing out the banks and AIG 12 years ago. And lost just $8 billion bailing out the auto companies
  - The ECB promised to do whatever it takes, and in the end it had to do very little!
- The alternative: let pandemic run until heard immunity is attained
  - That was the strategy the UK considered and discarded
  - Deaths could be in the millions
- Needed: a great deal more from the international community, especially the IMF
  - Swaps between Fed and IMF, which could in turn relend dollar resources
  - New SDR issues, lend bigger multiple of quota

Thank you!