DESIGNING FISCAL POLICY FOR A POST-COVID WORLD

Ricardo Reis
LSE

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Covid fiscal policy: large responses

Figure 1.1. Discretionary Fiscal Response to the COVID-19 Crisis in Selected Economies
(Announced measures as of September 11, 2020, in percent of GDP)


Note: The timeframe for the announced measures is country specific, but the bulk of the measures announced so far are short-term crisis-response measures to be implemented in 2020–21. Country group averages are weighted by GDP in US dollars adjusted by purchasing power parity. Data labels use International Organization for Standardization country codes. AEs = advanced economies; COVID-19 = coronavirus disease 2019; EMMIEs = emerging market and middle-income economies; LIDCs = low-income developing countries.
Covid fiscal policy: debt/monetary financed

Figure 1.1. Global Public and Private Debt, 1995–2020
(Percent of GDP)

Figure 1.2. Historical Patterns of General Government Debt

Figure 1.3. Central Bank Purchases of Government Debt
(Percent of central government marketable securities or debt issued since February 2020)

Sources: Country authorities; US Federal Reserve Economic Data; Haver Analytics; and IMF staff calculations.
Note: Data labels use International Organization for Standardization country codes.
AEs = advanced economies; EMMIEs = emerging market and middle-income economies.
Pre-Covid context: rising debt, \( r < g \)

**Figure 1.2. Historical Patterns of General Government Debt**

(Percent of GDP)

![Graph showing historical patterns of general government debt](image)

Sources: IMF, Historical Public Debt Database; IMF, World Economic Outlook database; Maddison Database Project; and IMF staff calculations.

Note: The aggregate public-debt-to-GDP series for advanced economies and emerging market economies is based on a constant sample of 25 and 27 countries, respectively, weighted by GDP in purchasing-power-parity terms. WWI = World War I; WWII = World War II.

**Figure 2.2. Contributions of the Interest Rate–Growth Differential and Primary Balance to Debt Dynamics**

Even where \( (r - g) \) is negative, the debt-to-GDP ratio can rise if primary balances are sufficiently negative.
Changes on the horizon
1. Fiscal policy as ex post social insurance

- After financial crisis: large support to financial institutions
- During Covid: large support to households, use of transfers
- When untargeted: come with rises in savings, speeds recovery
I. Fiscal policy as ex post social insurance

- Again in reaction to 2022-23 energy and food crises
- Normative argument: macro shocks
- Positive argument: automatic stabilizers, and precautionary savings as Keynes’ animal spirits
- Modern theory: MPC heterogeneity, and countercyclical pre-transfer inequality
- Danger: moral hazard
2. Fiscal policy and monetary coordination

• Keynesian analysis justified by ZLB and view of insufficient aggregate demand
• Worry about stagnation and deflation, welcome joint stimulus
2. Fiscal policy and monetary coordination

- More nuanced view of ZLB
- \( r^* \): when investment = savings and output is at potential
- Government bond \( r^* \): tells you constraint on monetary policy, wherein ZLB is binding
- Private investment \( r^* \) tells you transmission of monetary policy
- Is wedge up/down with policy?

Source: Reis (2022) "Which \( r^* \) star, public bonds of private investment" Gurkaynak Swanson Sack zero coupon TIPS data set
3. Fiscal policy and investment: crowding in/out

- Still on the wedge between r*’s
- Focus on improving efficiency of allocation of capital (or factors more generally)
- Focus on private investment
- Fiscal policy crowds it in? ZLB argument may not apply
- Fiscal policy crowds it in? Public infrastructure, collateral/store of value, social insurance, may be new arguments
3. Fiscal policy and investment: crowding in/out

- Refocus on supply side, on allocation of capital and barriers to it
- Energy production is an example.
4. Debt management: revenue and adjustment

Figure 2.1. Debt, Interest Expense, and Gross Financing Needs across Countries, 2007, 2019, 2021
(Ratio to GDP)

Even though debt and gross financing needs have risen, the interest burden has been unchanged since 2019.

Debt/GDP = EPV_{m-g}(PrimaryBalance/GDP) + EPV_{m-g}((m-r)Debt/GDP)

- Amazing achievement: borrow more, pay less.
- Debt revenue: what governments earn from supplying the service flow that makes public debt special (store of value, liquidity, collateral, safety)
4. Debt management: revenue and adjustment

Maximize debt revenue by coerced government borrowing (reserve requirements too)

Present bias: benefit from low cost of government financing, but this hurts tax base in the future.

Unpleasant fiscal arithmetics: fiscal problems cause financial crisis, justify financial repression

Note: This chart plots the average of financial repression indexes across years. The financial indexes include interest rate controls, credit controls, capital controls, and an overall financial reform index. The shaded area is the 95% confidence band calculated by normal kernel smoothing. For all the indexes, the higher the value, the less regulated.
5. Public debt and inflation: inflating debt

- Inflation lowered debt in 2022
- But compromises safety premium debt will earn in 2023 and onwards
- Public debt stress in UK, Germany, EU...
- Short-run bias
5. Public debt and inflation: central bank losses

- Central banks long-short portfolio implies losses.
- Credibility of currency requires fiscal backing.
- In EMs, large foreign holdings.
- As USD appreciates, have large gains instead.
- Fiscal temptations.
Conclusion: 5 features of post-Covid policy

• **Stronger use of ex post transfers**
  - Complete missing insurance markets, leverage automatic stabilizers. Danger: moral hazard

• **Less conflict between monetary and fiscal policy**
  - With supply shocks, and outside ZLB, where wedge between two r*’s crucial

• **More judicious choices to crowd in investment**
  - Less focus on deficits, more on project selection and on allocation of capital in economy

• **Debt crises in the horizon**
  - Debt revenue is shrinking, usage of financial repression/regulation is often short-sighted

• **Inflation is a risk and source of burden, not an opportunity**
  - Gains of 2022 are done, now come losses from risk premium and cost of central bank losses