DESIGNING FISCAL POLICY FOR A POST-COVID WORLD

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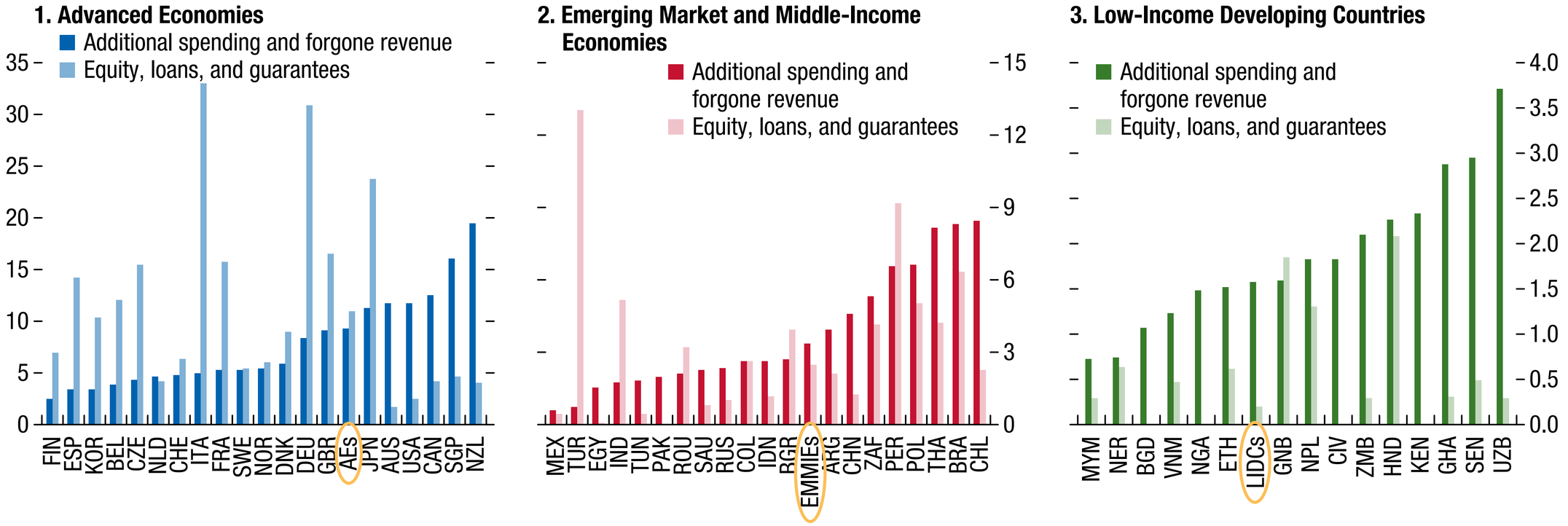
World Bank Group East Asia and Pacific Chief Economist seminar

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)



Sources: *Fiscal Monitor* Database of Country Fiscal Measures in Response to the COVID-19 Pandemic (https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19); and IMF staff estimates.
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.

Source: IMF Fiscal Monitor

Covid fiscal policy: debt/monetary financed

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

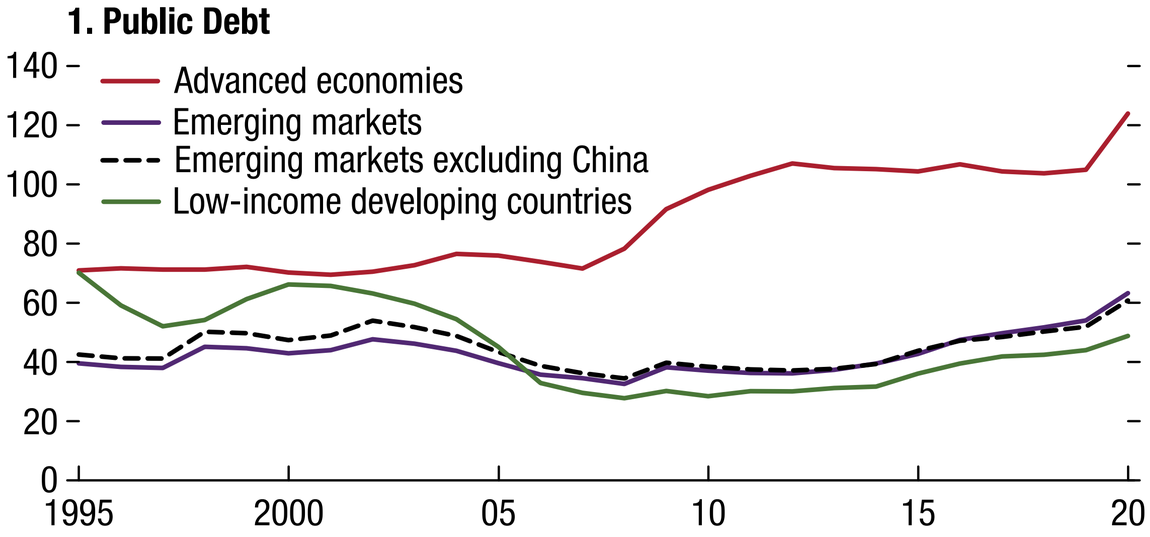
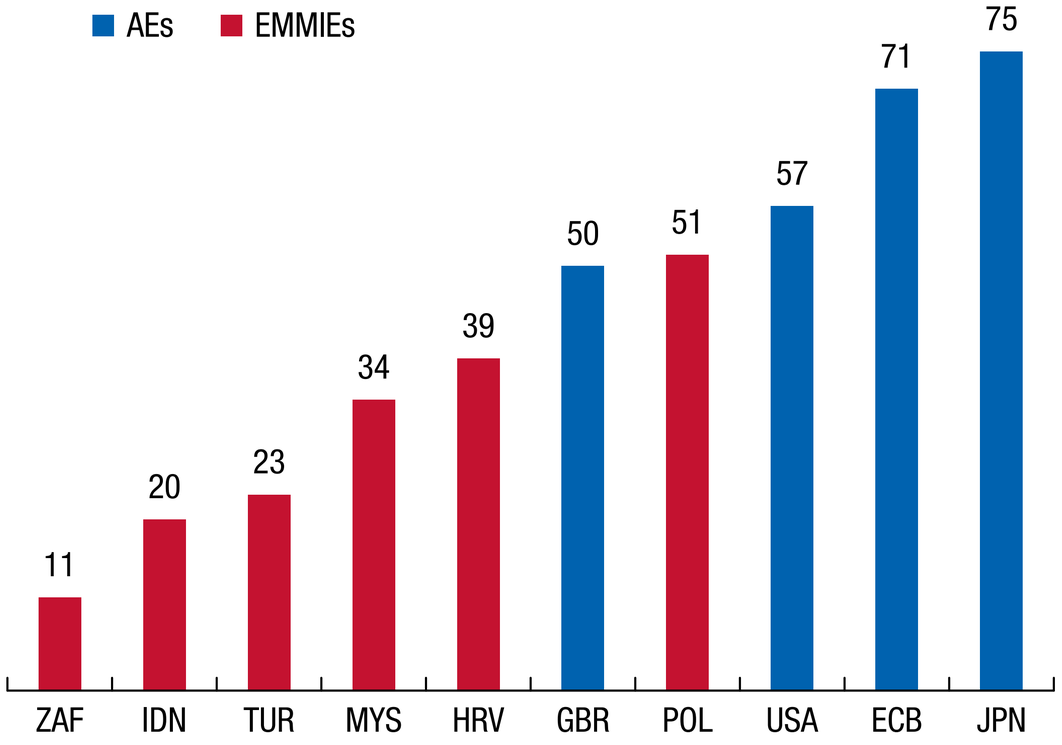


Figure 1.3. Central Bank Purchases of Government Debt
(Percent of central government marketable securities or debt issued since February 2020)

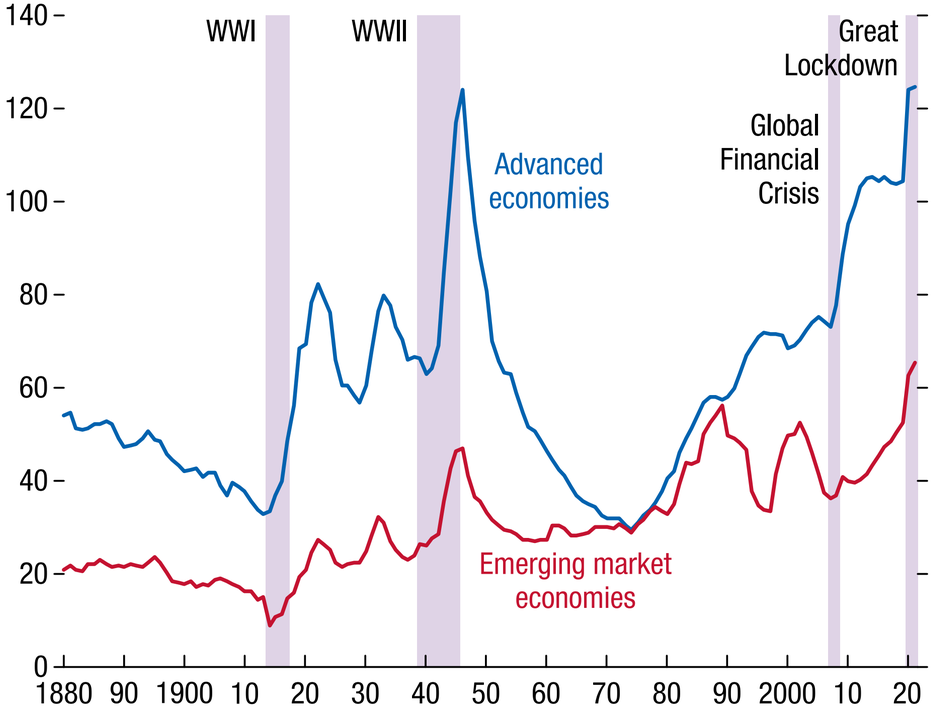


Sources: Country authorities; US Federal Reserve Economic Data; Haver Analytics; and IMF staff calculations.
Note: Data labels use International Organization for Standardization country codes. AEs = advanced economies; EMMIEs = emerging market and middle-income economies.

Source: IMF Fiscal Monitor

Pre-Covid context: rising debt, r<g

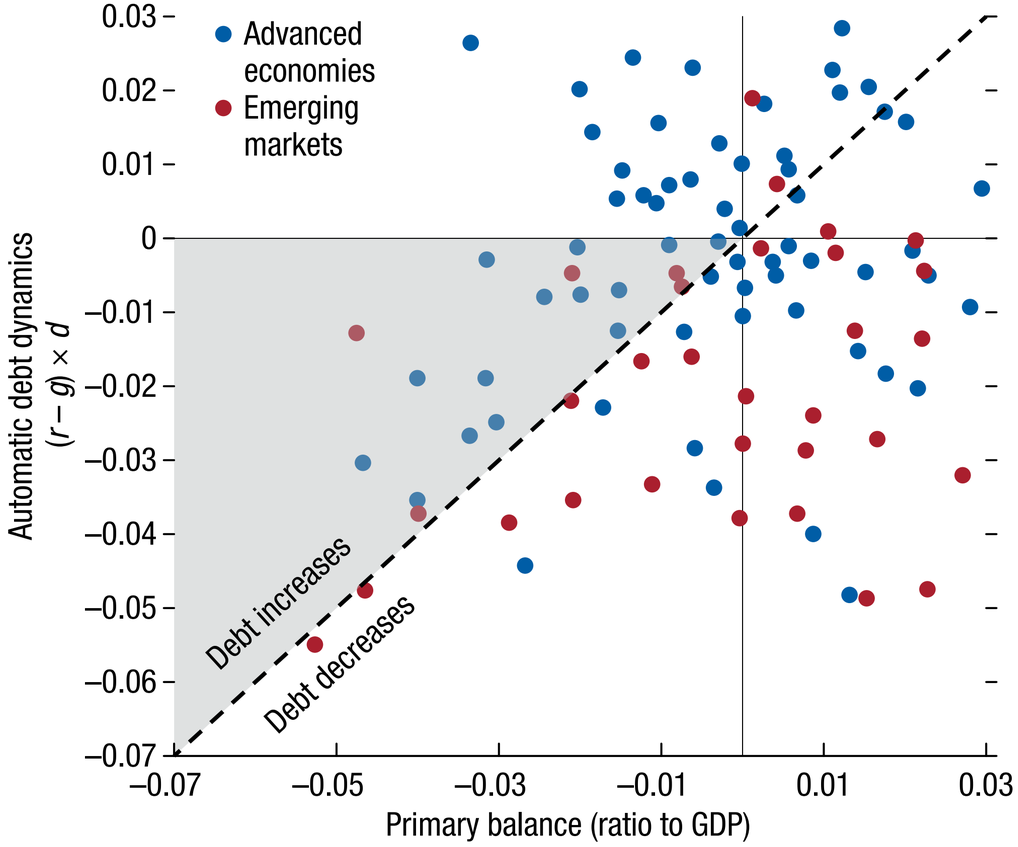
Figure 1.2. Historical Patterns of General Government Debt
(Percent of GDP)



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.



Source: IMF Fiscal Monitor

Changes on the horizon

1. Fiscal policy as ex post social insurance

Figure 1.5. Changes in Household Income, 2020
(Percent of 2019 disposable income per capita)

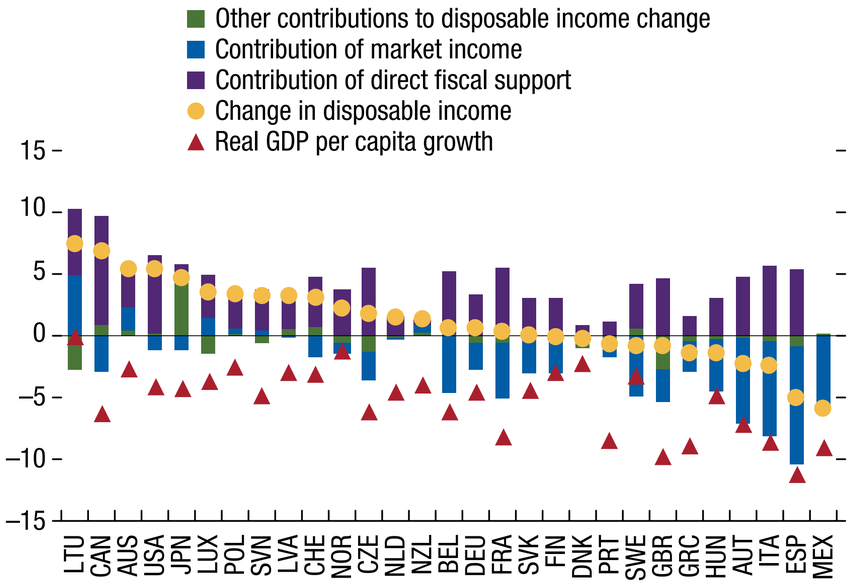
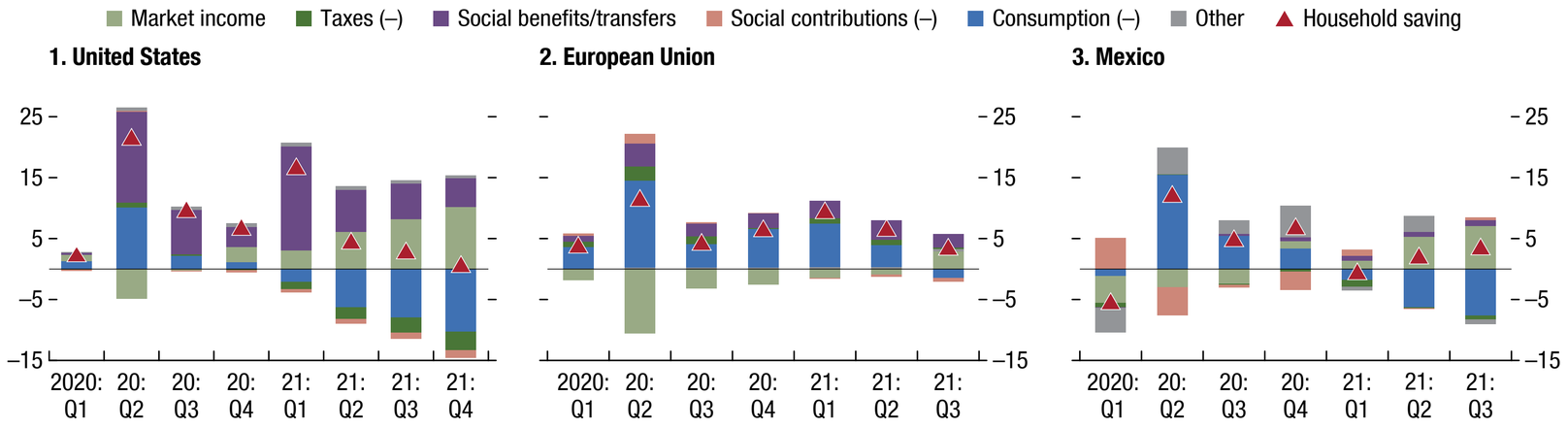


Figure 1.7. Contributions to Changes in Household Savings, 2019–21
(Percent of country-specific disposable income as of the fourth quarter of 2019)



- 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

Source: IMF Fiscal Monitor

1. Fiscal policy as ex post social insurance

Figure ES.4. Food and Energy Support Policies, by Income Group
(Percent of GDP, median, 20th and 80th percentiles)

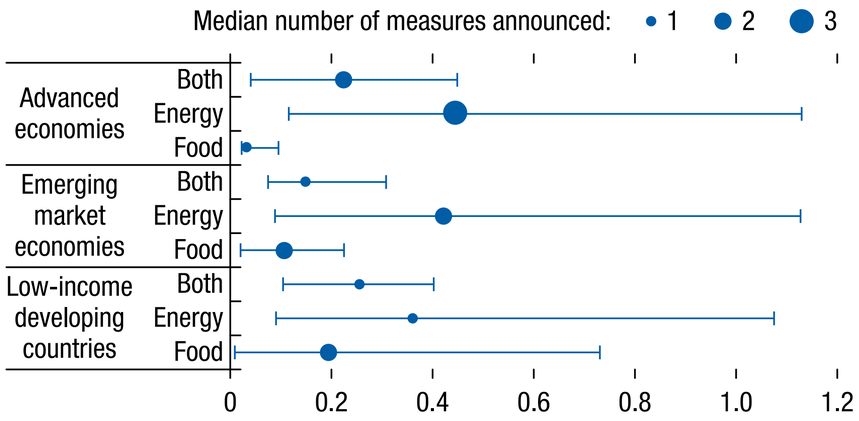
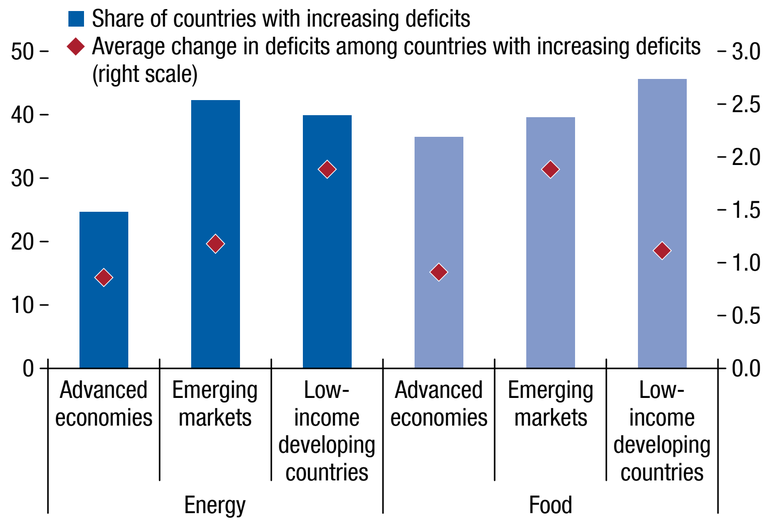


Figure 1.14. Fiscal Performance during Energy and Food Price Booms, 1991–2018
(Percent and percentage points of GDP)

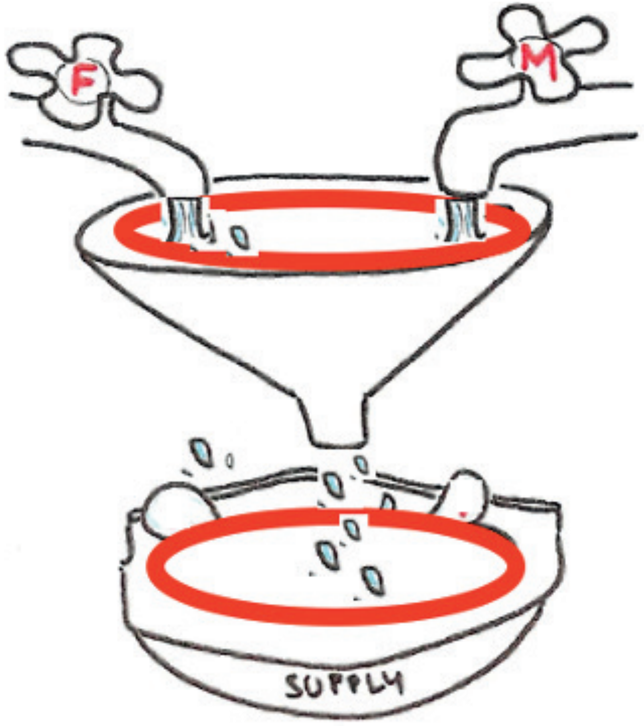


- Again inreaction to 2022-23 energy and food crises
- Normative argument: macro shocks
- Positive argument: automatic stabilizers, and precautionary savings as Keynes' animal spirits
- Modern theory: MPC heterogeneity, and countercyclical pre-transfer inequality
- Danger: moral hazard

Source: IMF Fiscal Monitor

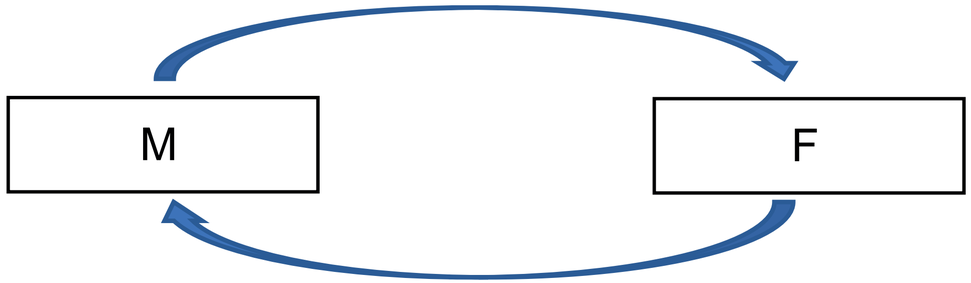
2. Fiscal policy and monetary coordination

TOBIN'S FUNNEL WITH INSUFFICIENT STIMULUS



TWO-WAY POLICY SPACE CREATION

M creates space for F: monetary backstop and low borrowing costs

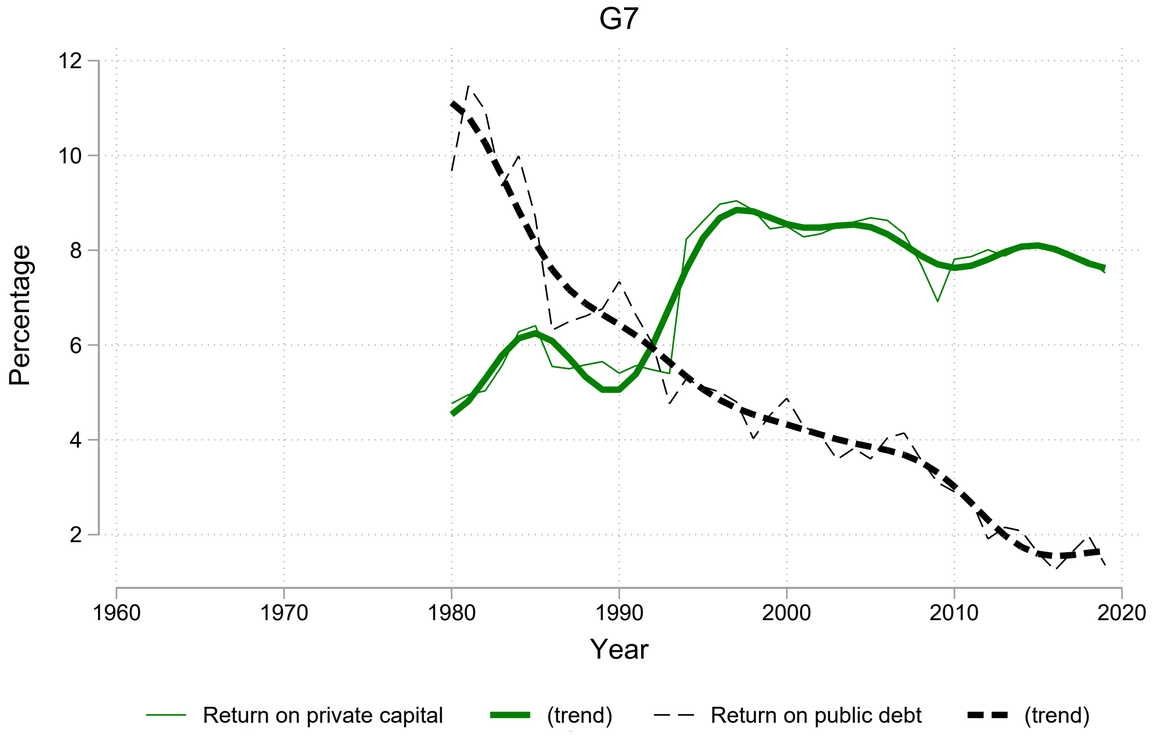


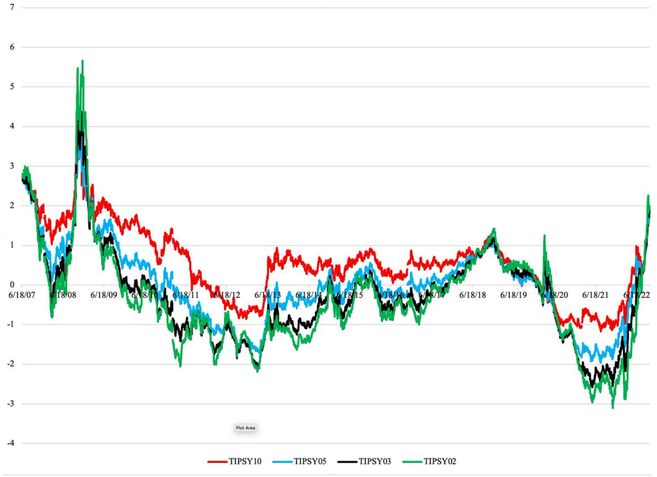
F creates space for M: fiscal backstop, internalizing the risks and costs of ultra-low R*

- Keynesian analysis justified by ZLB and view of insufficient aggregate demand
- Worry about stagnation and deflation, welcome joint stimulus

Source: Bartsch, Bénassy-Quéré, Corsetti, Debrun (2020) It's All in the Mix

2. Fiscal policy and monetary coordination

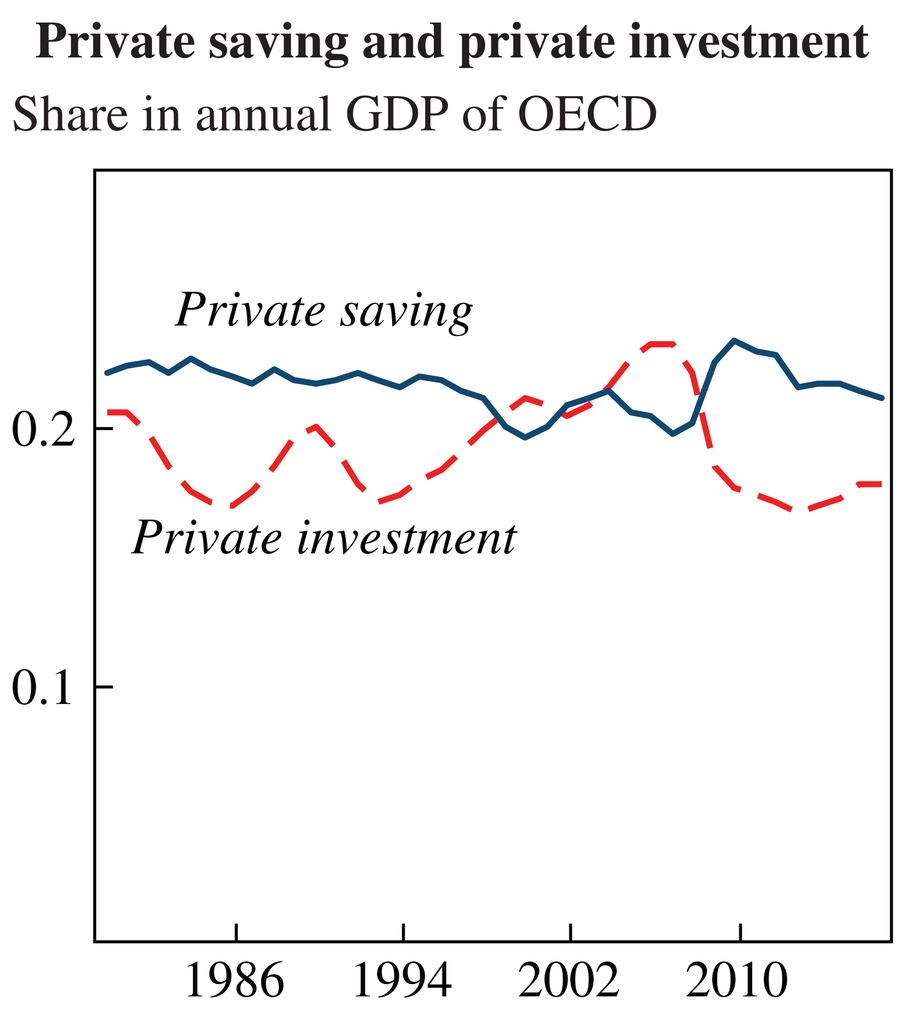




- More nuanced view of ZLB
- r*: when investment = savings and output is at potential
- Government bond r*: tells you <u>constraint</u> on monetary policy, wherein ZLB is binding
- Private investment r* tells you <u>transmission</u> of monetary policy
- Is wedge up/down with policy?

Source: Reis (2022) "Which r-star, public bonds of private investment"
Gurkaynak Swanson Sack zero coupon TIPS rates dataset

3. Fiscal policy and investment: crowding in/out

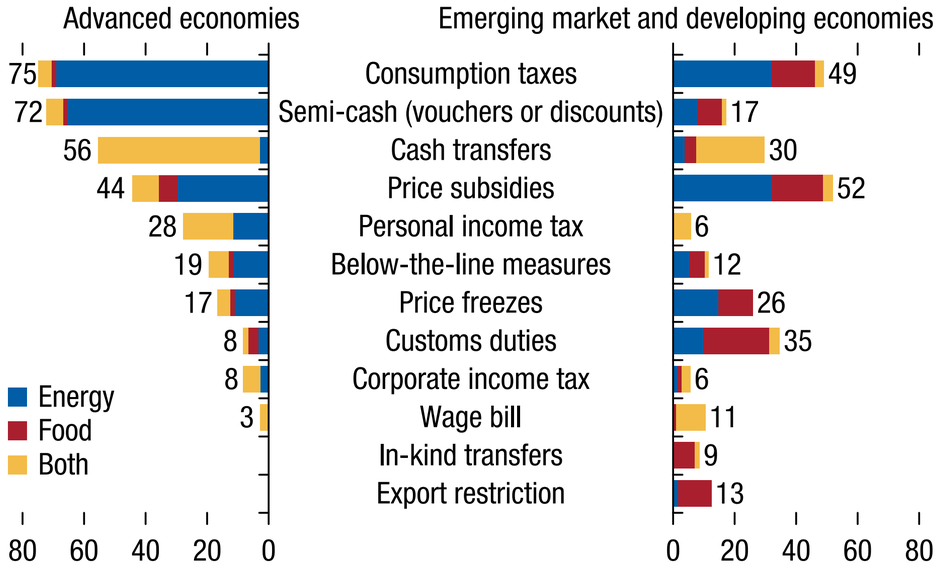


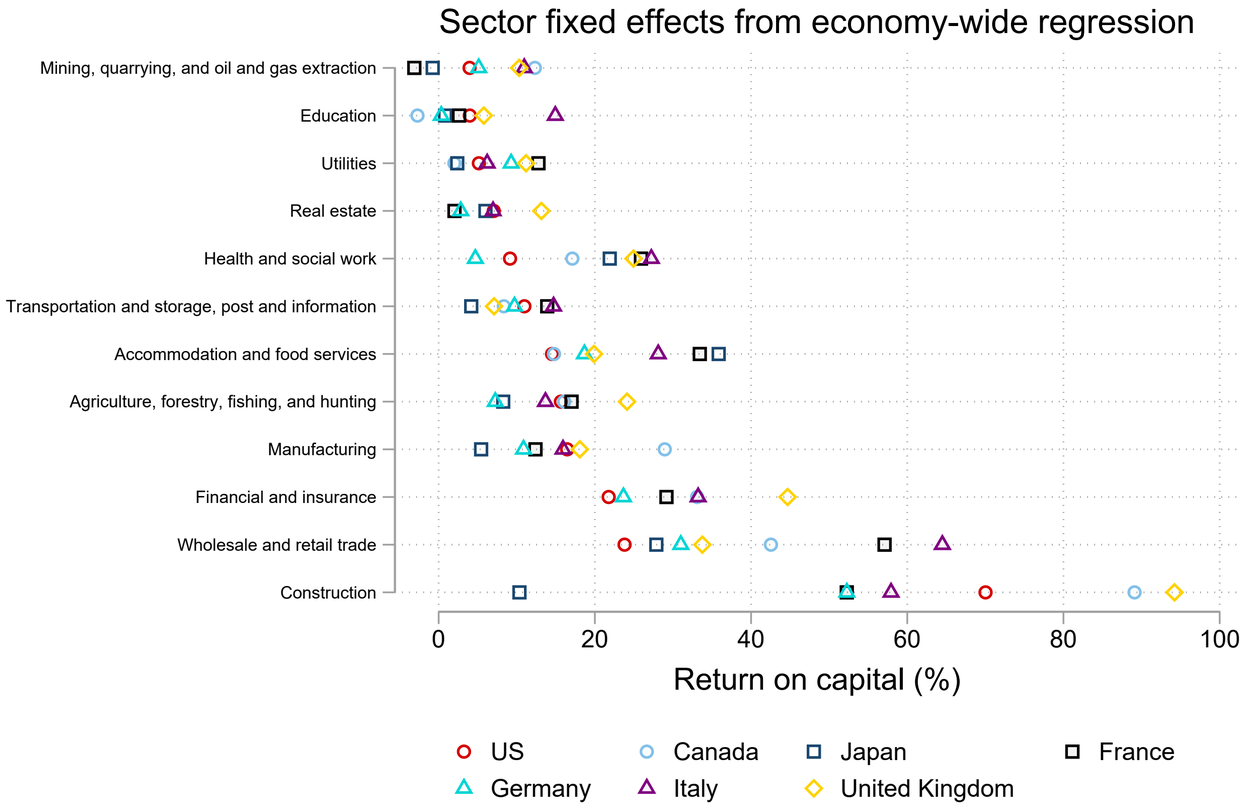
- Still on the wedge between r*'s
- Focus on improving efficiency of allocation of capital (or factors more generally)
- Focus on private investment
- Fiscal policy crowds it in? ZLB argument may not apply
- Fiscal policy crowds it in? Public infrastructure, collateral/store of value, social insurance,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

Source: Rachel Summers (2019) "On Secular Stagnation in the Industrialized World

3. Fiscal policy and investment: crowding in/out

Figure 1.9. Recently Announced Measures in Response to High Energy and Food Prices
(Share of surveyed countries, as of July 2022)





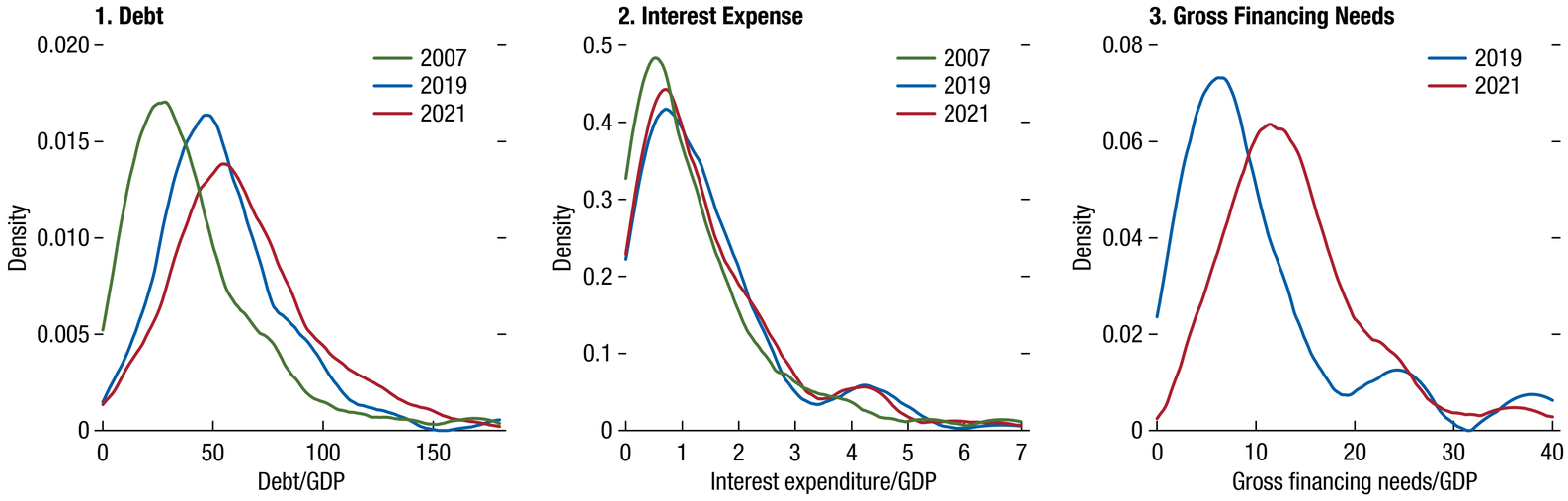
- Refocus on supply side, on allocation of capital and barriers to it
- Energy production is an example.

Source: Reis (2022) "Which r-star, public bonds of private investment" Fiscal Monitor

4. Debt management: revenue and adjustment

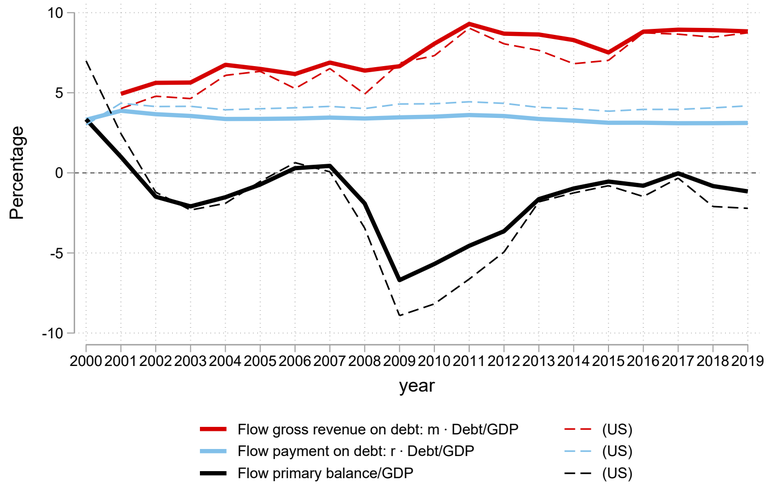
Figure 2.1. Debt, Interest Expense, and Gross Financing Needs across Countries, 2007, 2019, 2021
(Ratio to GDP)

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



G7 countries

Figure 1: The flow budget components as a ratio of GDP for the G-7 countries and the US



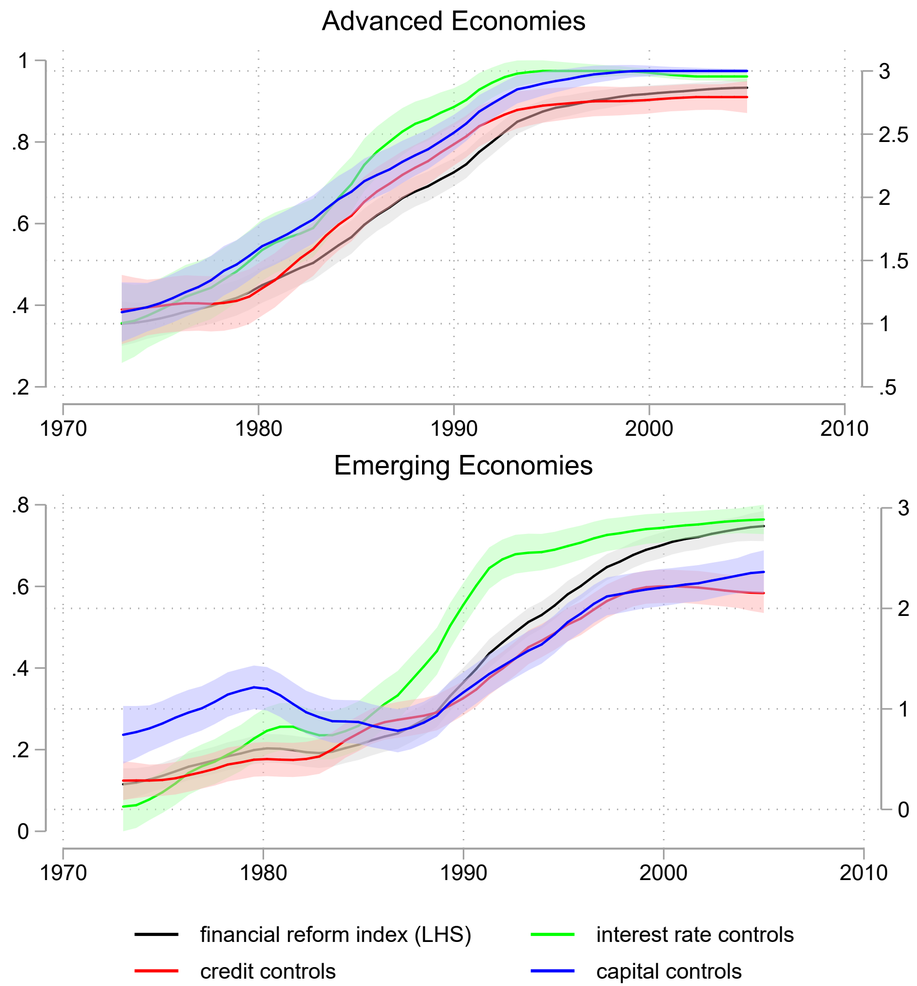
$$Debt/GDP = EPV_{m\text{-}g}(PrimaryBalance/GDP) + EPV_{m\text{-}g}\,((m\text{-}r)Debt/GDP)$$

- 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)

Source: Reis (2022) "Debt Revenue and the Sustainability of Public Debt" Fiscal Monitor

4. Debt management: revenue and adjustment

Figure 10: De jure measures of 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 kernal smoothing. For all the indexes, the higher the value, the less regulated.

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

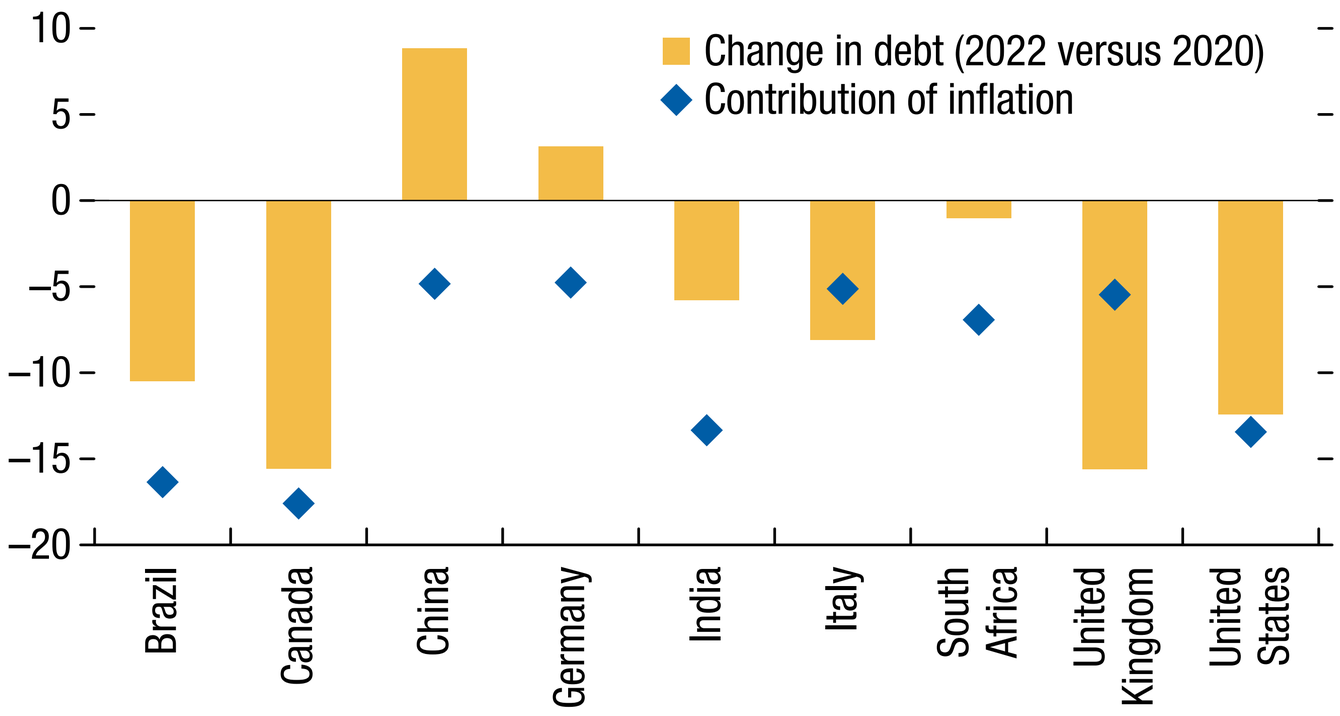
Present bias: benefit from low cost of government financing, but this hurts tax base in the future.

<u>Unpleasant fiscal arithmetics</u>: fiscal problems cause financial crisis, justify financial repression

Source: Mauro, Zhu (2020) "r-g<0: can we sleep more soundly"

5. Public debt and inflation: inflating debt

Figure ES.3. Effect of Inflation Shock on the Debt Ratio, Selected Countries, 2022 versus 2020
(Percent of GDP)

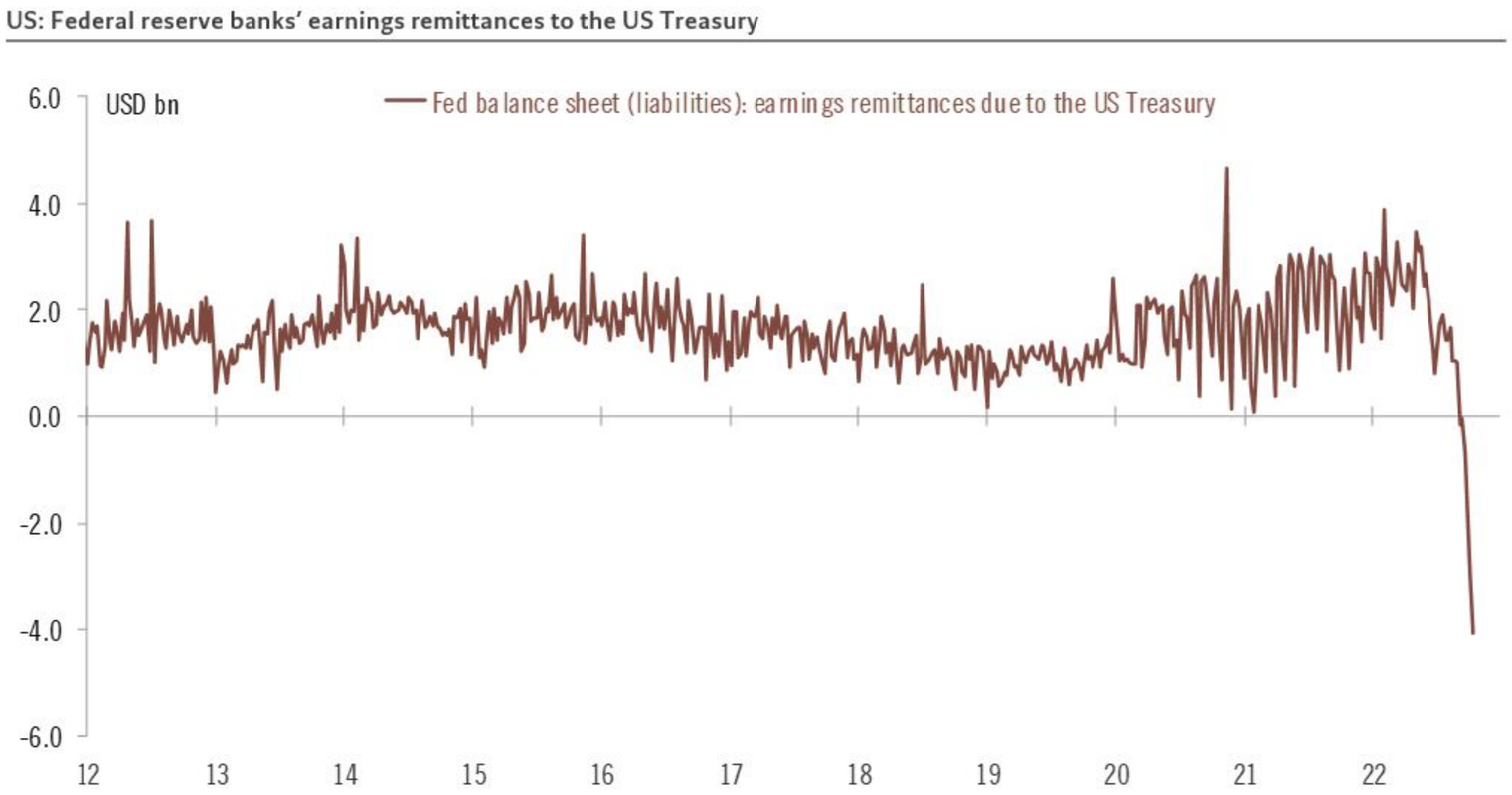


Sources: IMF, World Economic Outlook database; and IMF staff calculations.

- 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

Source: Fiscal Monitor

5. Public debt and inflation: central bank losses



Source: Pictet Wealth Management, Pictet Wealth Management, Fed, as of 13 October 2022

- 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