

The Macroeconomics of COVID-19

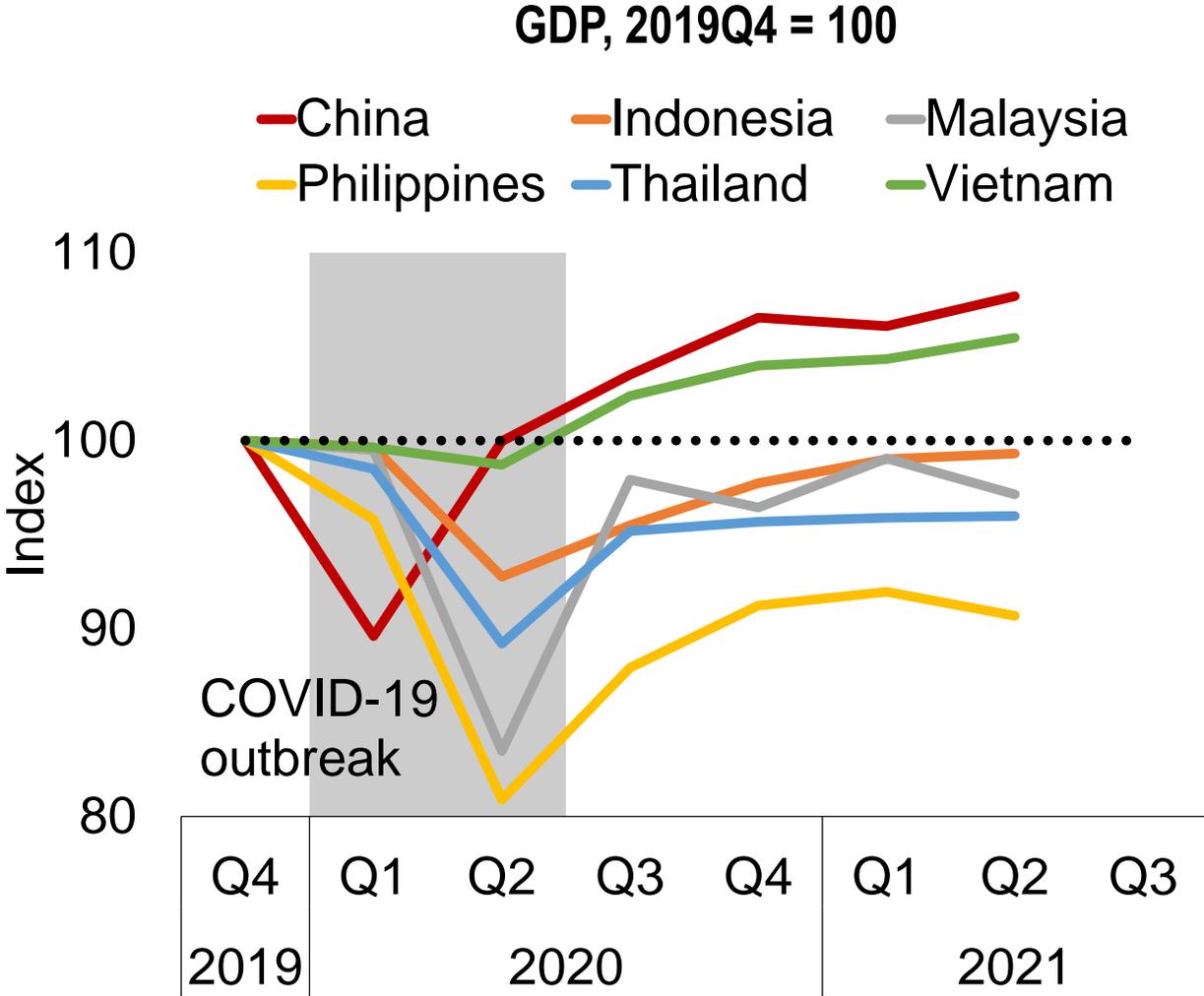


**Introductory course:
The Economics of COVID-19 in Developing East Asia and the Pacific
November 2021**

Roadmap of the Presentation

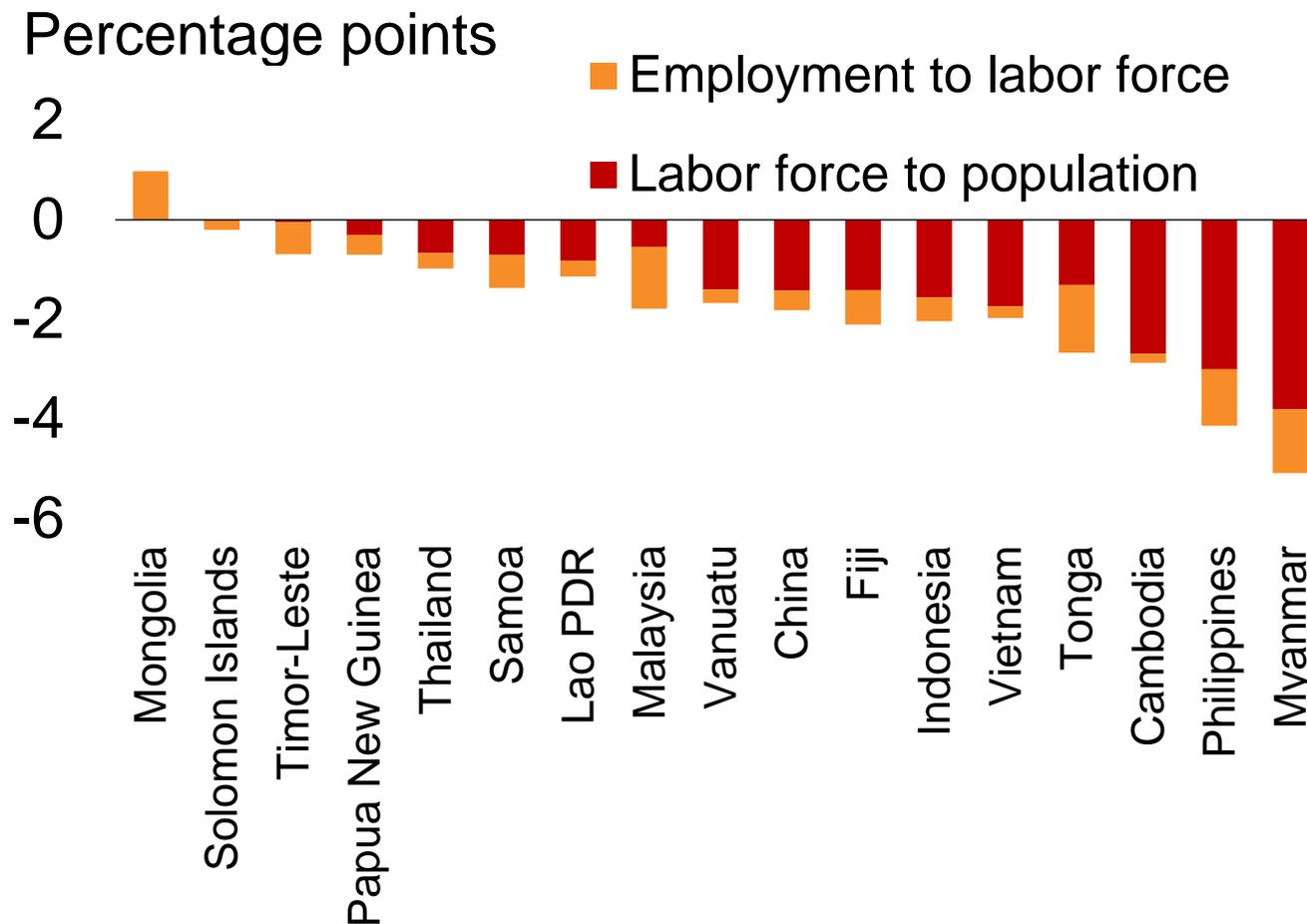
- The COVID-19 shock
- Monetary and fiscal policy response.
- Monetary and fiscal policy challenges.

Slow recovery and a reversal of fortune



Declining employment and exit from the labor force

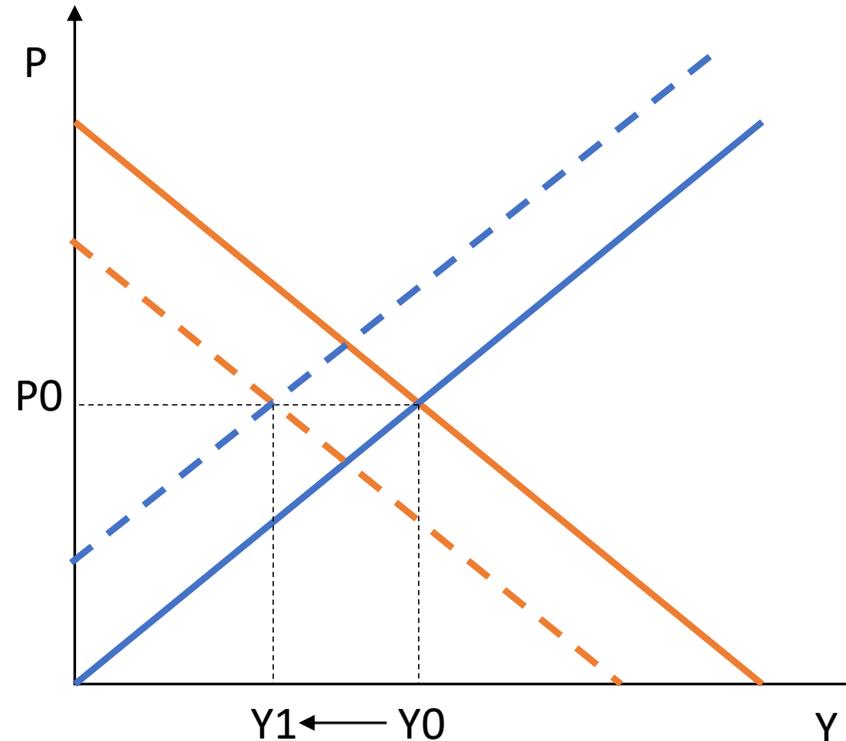
Employment to population and Labor Force Participation



COVID-19 is both a supply and demand shock

Businesses closed
(shock to supply)

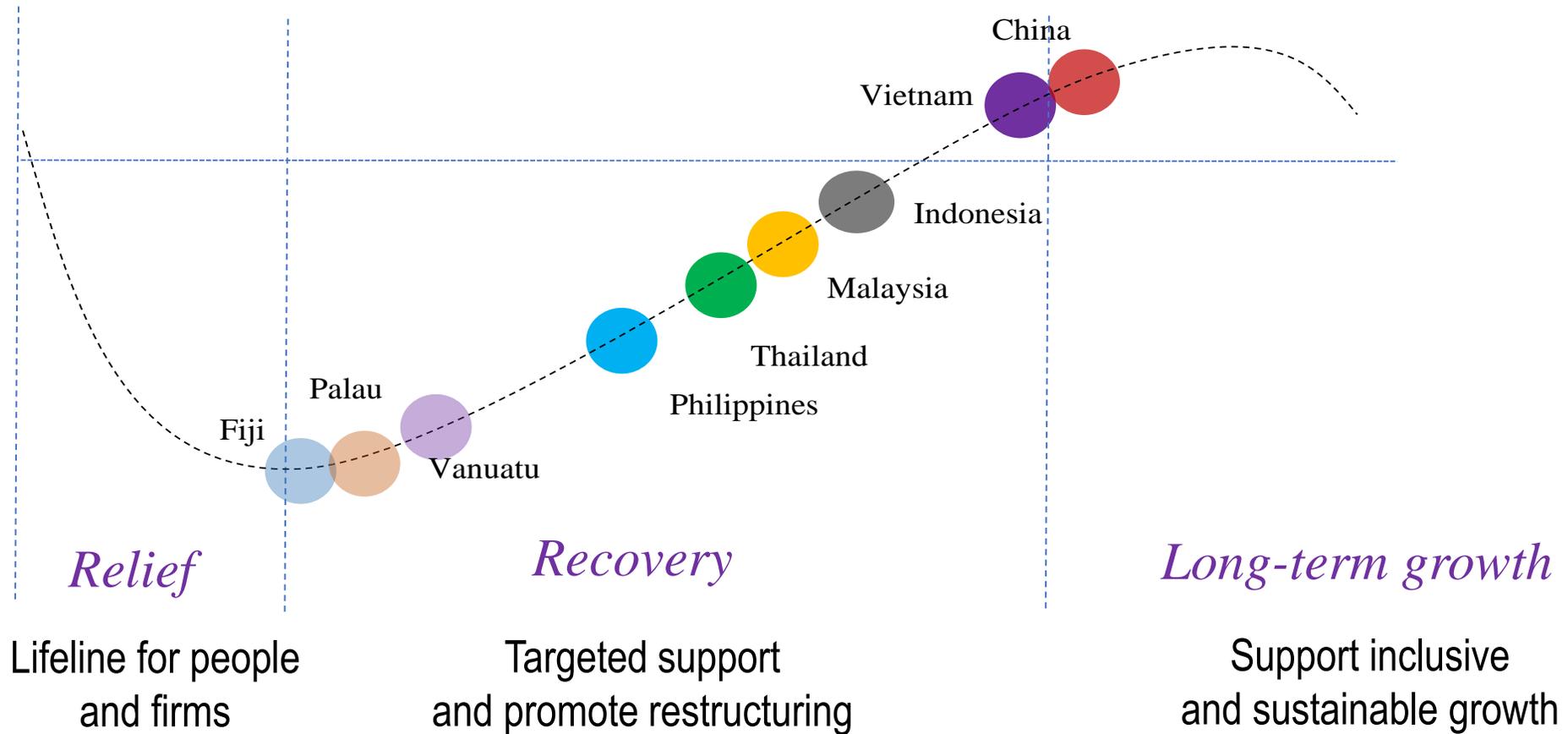
Households lost livelihoods
(shock to demand)



Keynesian stimulus
may be ineffective

Fiscal policy needed to help households (demand) and firms (supply).
Monetary policy needed to ensure flow of credit in the economy (supply).

Policy emphasis depends on the state of the recovery

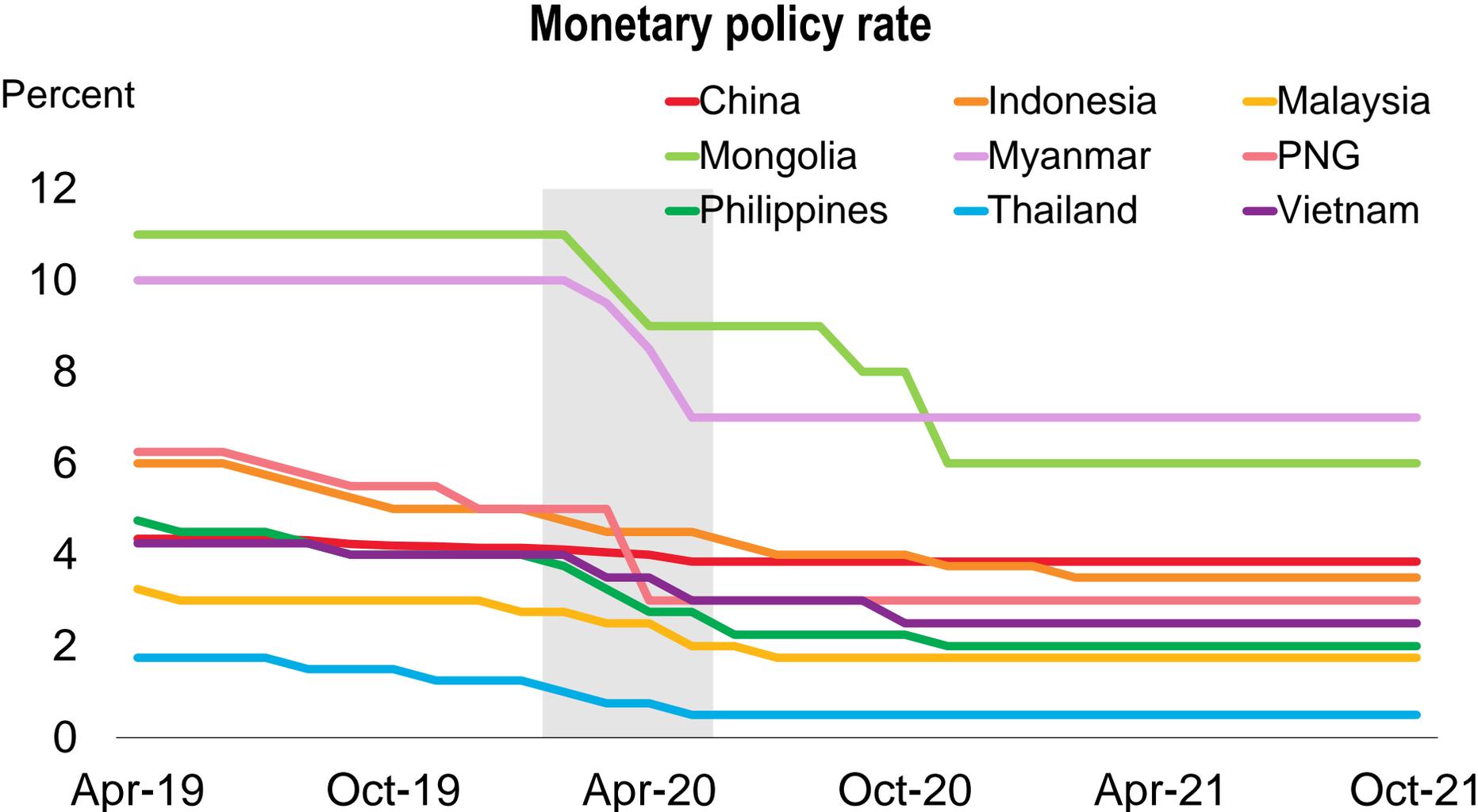


Note: The horizontal line indicates the level of GDP in December 2019..

Risk of inflation and unsustainable debt

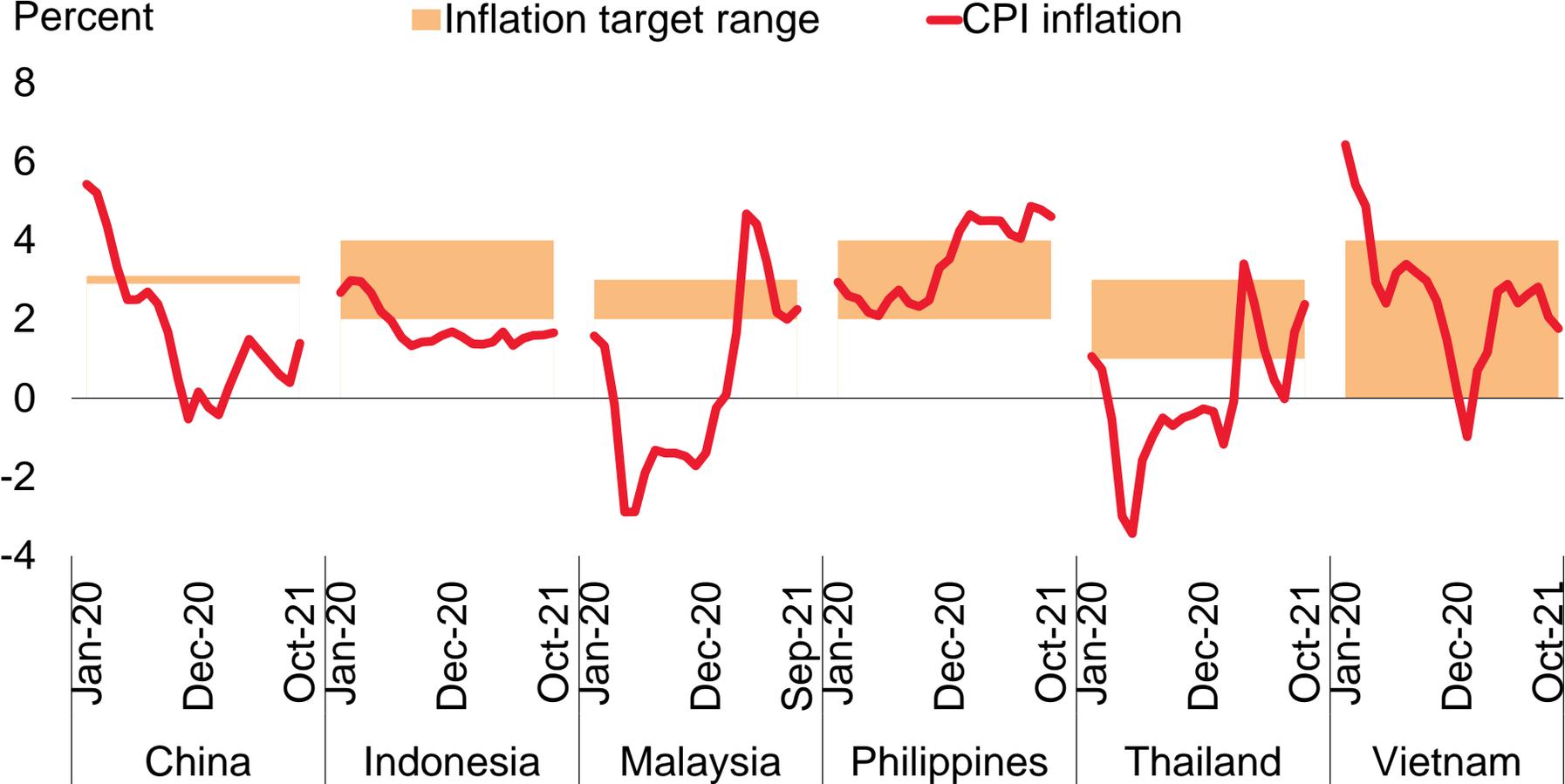
- Expansionary monetary policy can lead to higher inflation
- Increased borrowing to support fiscal expansion can lead to financial instability

Central banks cut interest rates to support their economies

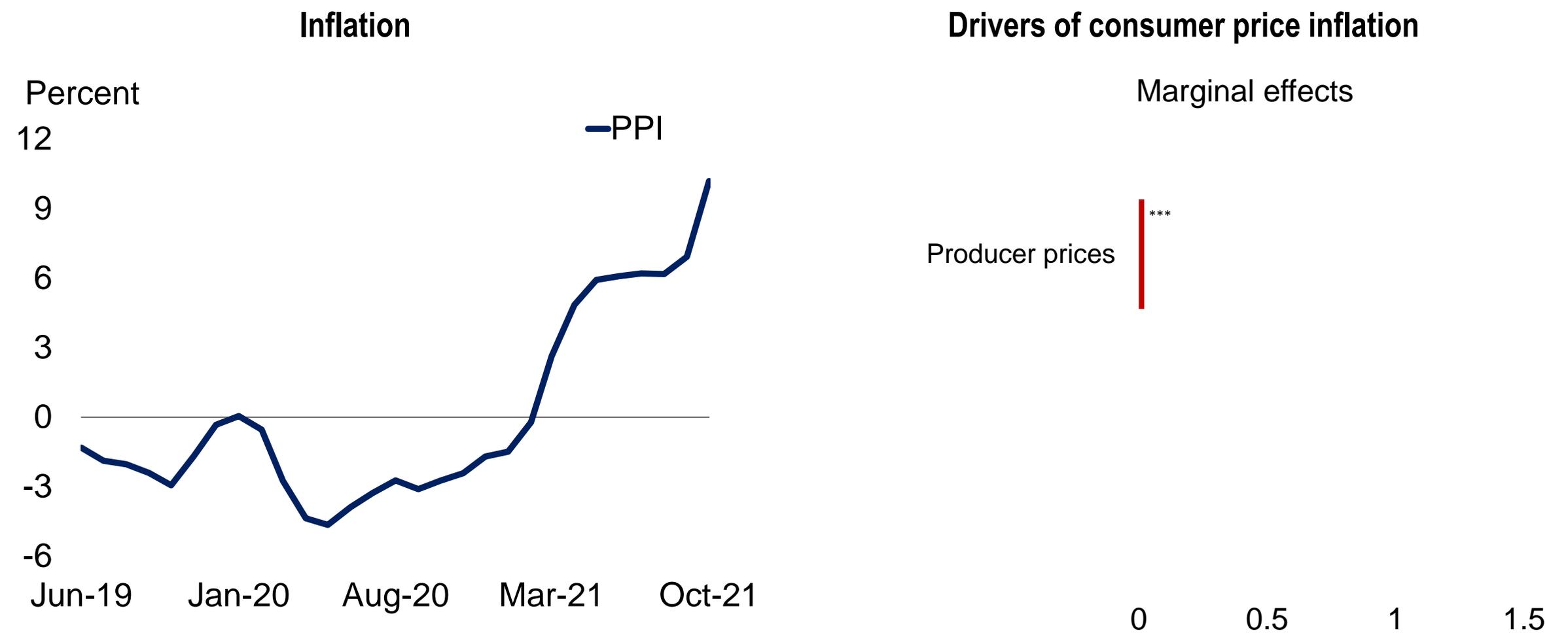


Source: East Asia and Pacific Economic Update, October 2021.

Supportive monetary stance has not yet provoked inflation



The increase in producer prices hasn't been passed to consumers, in part because of well-anchored expectations



Source: EAP Economic Update October 2021. *Left:* Unweighted averages. *Right:* dependent variable: CPI inflation. Other explanatory variable: lagged inflation, nominal USD exchange rate and output gap. Results similar for nominal effective exchange rate, import prices, oil prices and food prices.

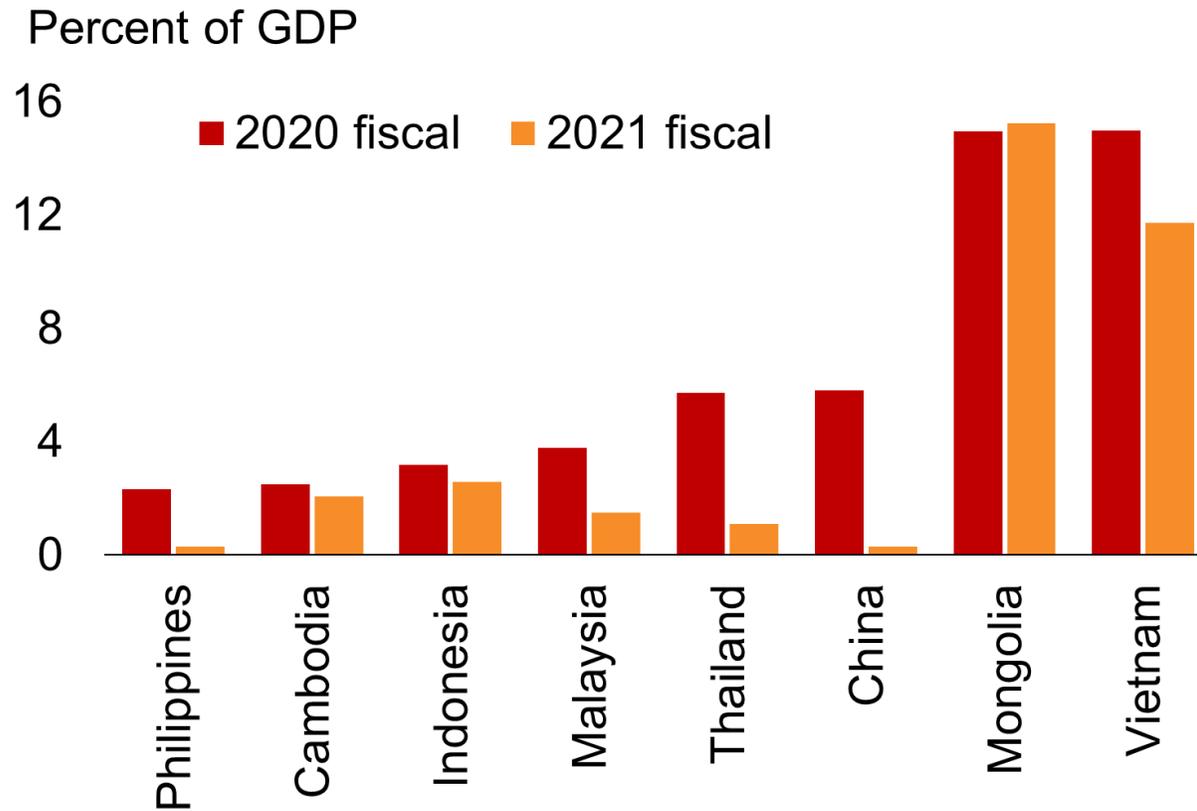
Risk of inflation and unsustainable debt

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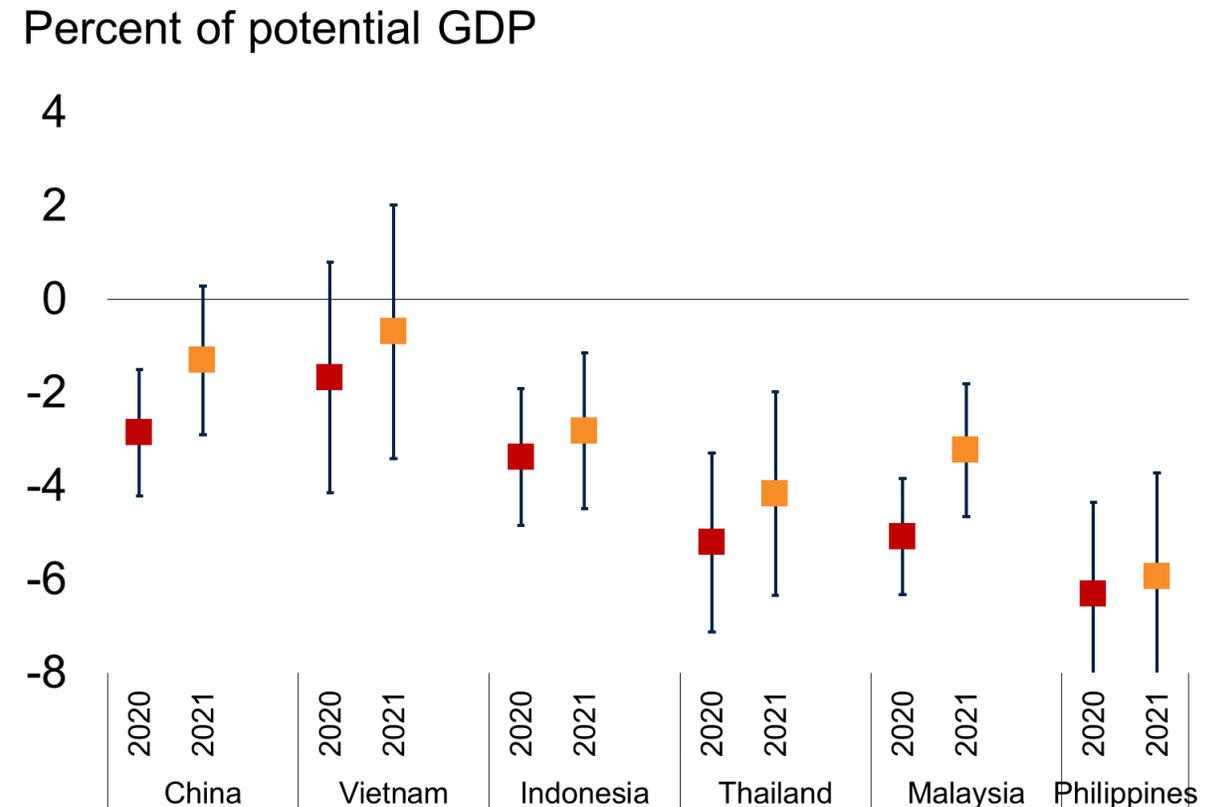
Fiscal support increased significantly in response to COVID-19

Output gaps suggest that fiscal support remains critical

A. Government support



B. Output gaps

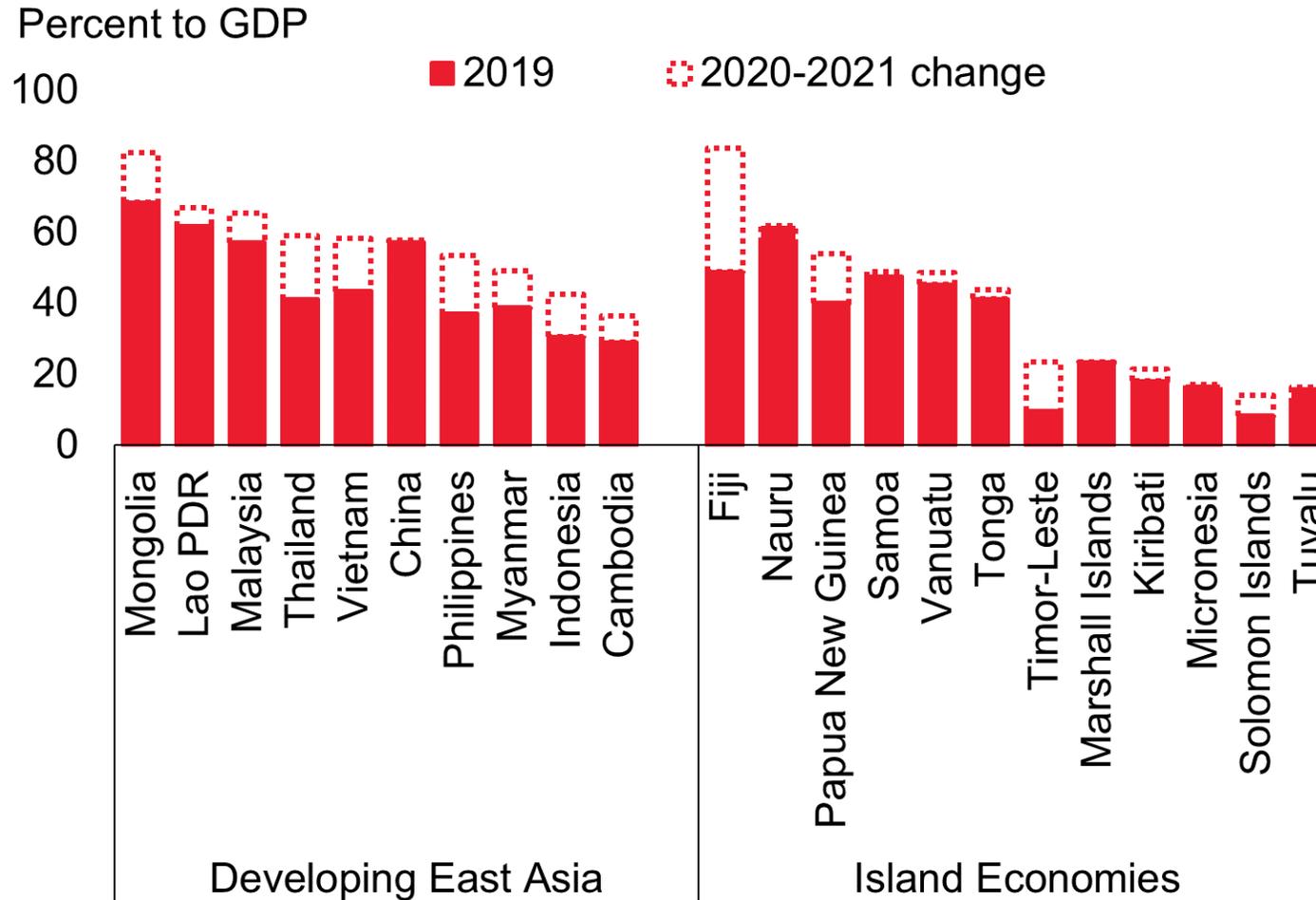


Source: World Bank staff estimates.

Notes: A. Figure shows fiscal support excluding health measures, below-the-line measures, and contingent liabilities.

All EAP countries have experienced an increase in public debt

General government debt

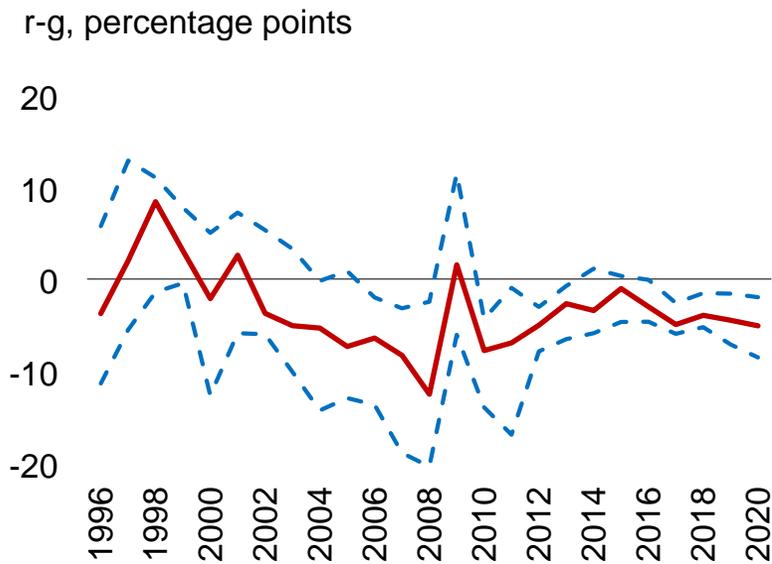


Source: World Bank.

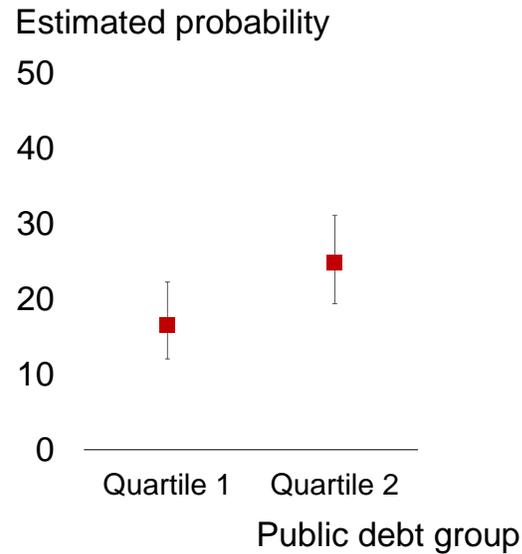
$r < g$ is not a license to spend

in part because high deficits and debt can raise r and lower g

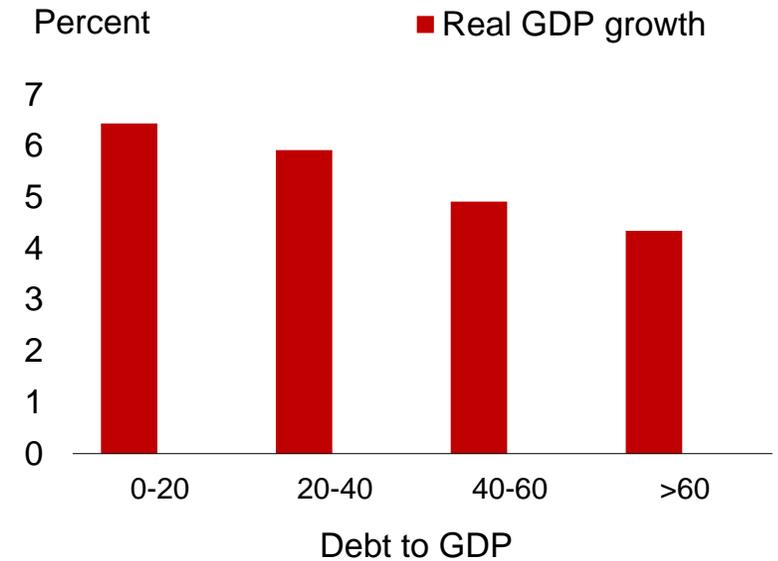
A. (r-g) differential



B. Probability of r-g reversals



C. Debt, growth and interest rates



Source: Consensus Economics; Haver Analytics; International Monetary Fund; J.P. Morgan; World Bank staff calculations.

Notes: A. Nominal interest rates minus nominal growth; China, Indonesia, Malaysia, Philippines, Thailand, Vietnam. Red line: median; dashed lines: min and max. B. Estimated using a logit model that regresses an indicator of positive future $r-g_{t+5}$ on an indicator of negative current $r-g$, indicators of debt groups based on the quartiles of the public debt-to-GDP distribution, and their interaction terms. Red squares denote point estimates and bars show 90 percent confidence intervals. C. Unweighted averages. The sample includes 50 developing (of which 10 EAP) countries with at least 10 observations on $r-g$ and public debt over GDP over the period 2000-2019

What can be done?

Fiscal support today without instability tomorrow

- Increase efficiency of expenditure and investment.
- Introduce fiscal rules.
- Credibly commit to future fiscal reforms.

Coping with the challenge from monetary policy actions abroad

- Central banks are likely to face trade-offs between continuing expansionary monetary policy, containing inflationary pressures, and maintaining exchange rate stability.
- Trade-offs can be softened if inflation expectations are well anchored, foreign reserve levels are significant, and there's limited foreign currency debt.

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