

Perspectives on Macroeconomic Policy Issues in the Post-Covid-19 Era

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Abstract At the onset of the COVID-19 crisis, most major economies could conduct large-scale expansionary fiscal policies thanks to the ultra-low interest rate environment. As such, the prospect of sustained expansionary fiscal policy to help economic recover after the COVID-19 critically depends on the movements of global interest rates going forward. This paper overviews the extent to which major economies increased debt levels in fighting against the COVID-19, and discusses the implications of the recent steep rise in US CPI inflation rate and the likely US monetary policy normalization.

Keywords COVID-19 · fiscal policy · government debt · borrowing costs · US inflation · US monetary policy

Introduction

In fighting against the COVID-19 pandemic, almost all the monetary authorities in the advanced countries have conducted unconventional monetary policies to stabilize the financial market by actively purchasing government as well as corporate bonds on top of lowering policy rates to ultra-low levels. At the same time, the fiscal policy authorities of most countries increased fiscal spending substantially to minimize economic damage as well as to assist the victims of the pandemic, such as through the universal cash transfer programs or extended unemployment benefits.

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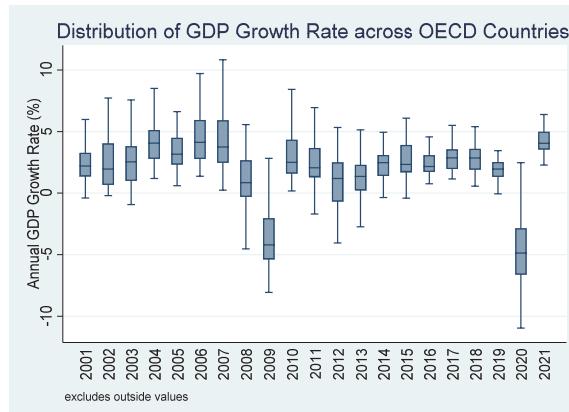
One question that arises at this point is whether such aggressive expansionary economic policies can last under the heightened uncertainties surrounding the relentless pandemic, and whether the economic recovery we just began to see would continue in the future. As an effort to answer those questions, this report will overview the expansionary fiscal policies of major developed countries in the midst of the global response against the pandemic, and discuss the impact and policy implications of the latest concern over rising US inflation and hence, those of the US monetary policy normalization.

Possibility of maintaining economic policy responses to the COVID-19 crisis

The economic impact of the COVID-19 pandemic

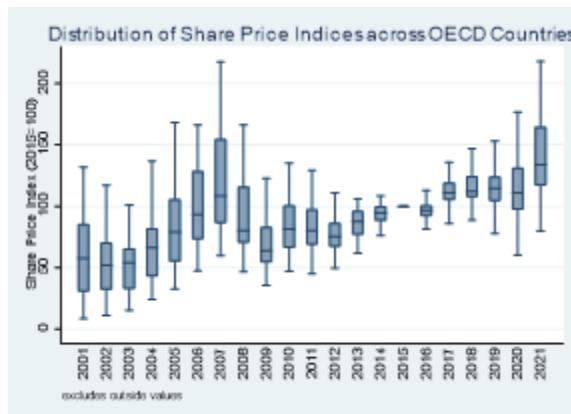
The COVID-19 pandemic struck the world economy in 2020, marking the largest economic contraction ever since the modern statistical system had been implemented (Figure 1). Major advanced economies were fortunately able to rebound quickly in 2021, although they were severely crippled to the extent of the levels of the 2008-9 Global Financial Crisis, labelled as the largest financial crisis since the Great Depression in 1929. This swift recovery can be seen through the projected growth rates from the IMF World Economic Outlook of 2021, as well as the share price indices across major countries (Figure 2). Unlike the slow and gradual recovery that occurred after the depression of the Global Financial Crisis, the current stock market continues to rise despite the COVID-19 pandemic, allowing us to expect a rather bright future in the post-pandemic era.

However, there are voices of concern over whether such recovery can continue for the coming years, given that the signs of rapid economic recovery could be simply temporary boosts from the unprecedented level of large-scale monetary and fiscal policies. A more negative outlook on the economic recovery suggests that the rising share price indices could reflect a potential



Source: IMF World Economic Outlook (April, 2021)

Fig. 1 Distribution of GDP Growth Rate across OECD Countries

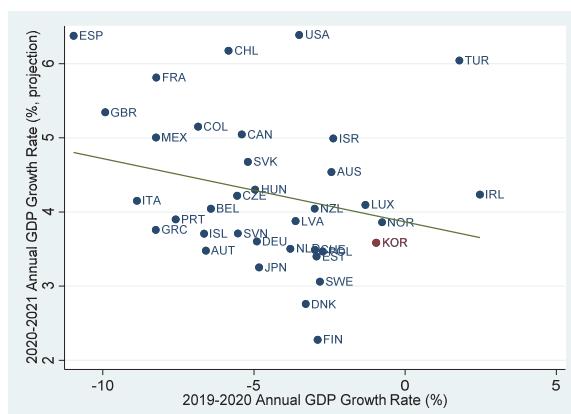


Source: OECD Statistics

Fig. 2 Distribution of Share Price Indices across OECD Countries

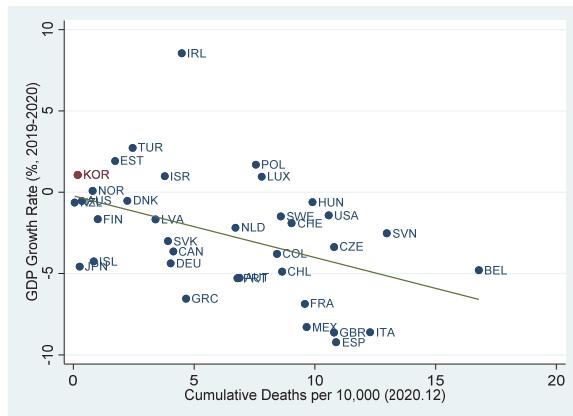
bubble, created by the excessive liquidity supply into the stock market, thereby widening the gap between the real economy and the financial market. It also conjectures that the quick rebound of world GDP growth rate may be driven by the base effect arising from the 2020 contraction due to the large-scale lockdown policies across countries. It hence expects the strong recovery trend to gradually disappear as large-scale monetary and fiscal policies are normalized and the base effect dissipates.

In fact, a quick contrast between the GDP growth rate of 2020 to the projected GDP growth rates of 2021 reveals a relatively strong negative (-) relationship between the two (Figure 3). Whereas countries that faced severe economic contractions in 2020 are expected to experience a higher range of rebound, countries that faced lower levels of economic contraction are expected to go through a lower range of rebound, thus confirming the point that the strong recovery is partially due to the base effect.



Source: IMF World Economic Outlook (April, 2021)

Fig. 3 2020 GDP Growth Rate and projected 2021 GDP Growth Rate of OECD Countries



Source: IMF World Economic Outlook (April, 2021); Our World in Data

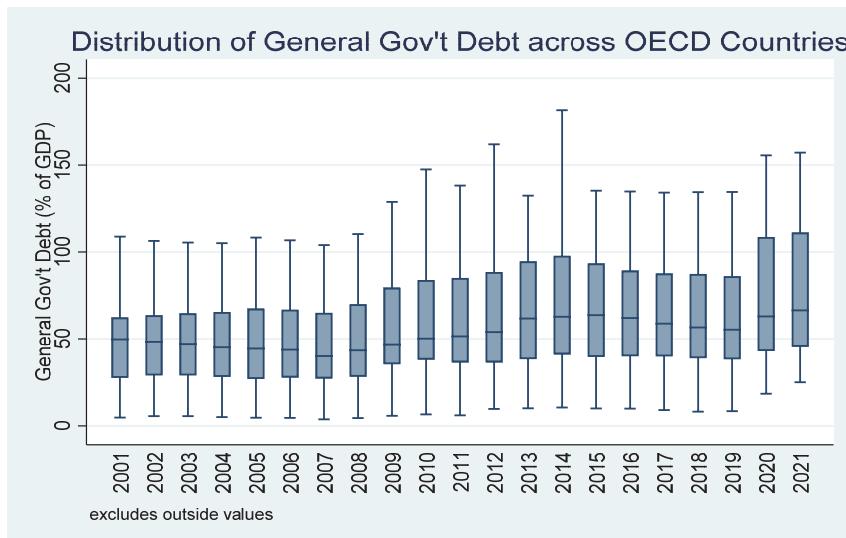
Fig. 4 2020 GDP Growth Rate and COVID-19 Cumulative Deaths in OECD Countries

Regarding differences in the extent of the 2020 economic contraction across countries, it appears that the fundamental cause stems from the extent to which a country succeeded (or failed) at its COVID-19 preventive measures (Figure 4). Countries that were unsuccessful with early preventive measures and faced high numbers of COVID-19 deaths were forced to implement harsh lockdown policies, thus unable to avoid large-scale economic contraction as the economic system froze. On the other hand, countries that were able to maintain COVID-19 cases at low levels through successful preventive measures did not need to implement sudden lockdown policies, and thus were able to experience relatively lower levels of economic contraction.

Fiscal policy responses against the COVID-19 crisis and its outlook

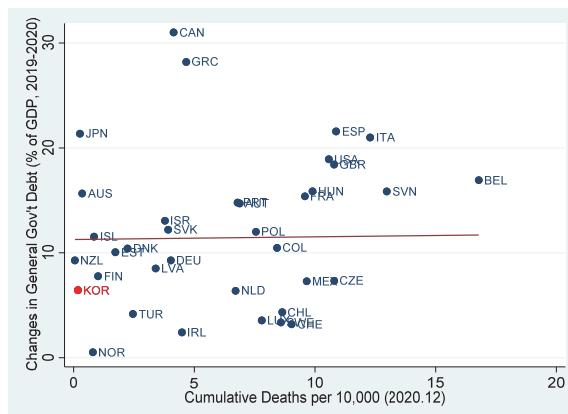
The performance of a country at its early preventive measures does not only affect the extent of its economic contraction, but may also determine the timing and scale of monetary and fiscal policies required to fight against the crisis in each country. It is well known that the government debt in major developed countries significantly increased through the active implementation of unprecedented levels of fiscal policies since last year (Figure 5).

However, there exists a substantial level of heterogeneity in the extent to which the government debt increased when it is measured in percent of GDP. Interestingly, it turns out to have little to do with how (un)successful early preventive measures were, as reflected by their weak correlation (Figure 6). For example, measuring the scale of fiscal policy responses by an increase in government debt-to-GDP ratio, it is shown that the most aggressive level of fiscal policy was implemented by Canada, a country with a relatively lower number of COVID-19 cases. On the other hand, countries with a much higher number of deaths, such as Mexico and Czech Republic, have been one of the countries that least increased the government debt.



Source: IMF World Economic Outlook (April, 2021)

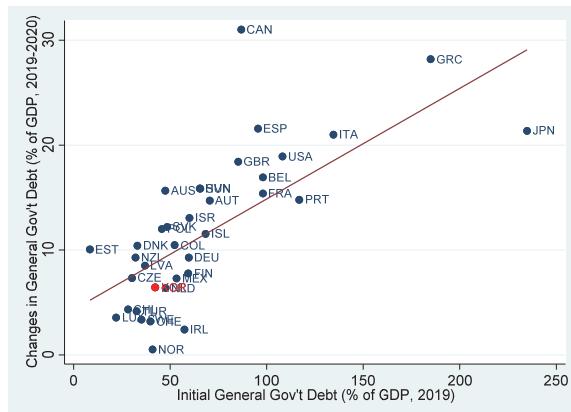
Fig. 5 Distribution of General Government Debt across OECD Countries



Source: IMF World Economic Outlook (April, 2021); Our World in Data

Fig. 6 Changes in Government Debt in 2020 and COVID-19 Cumulative Deaths, OECD Countries

What is more interesting is that the rise in government debt to GDP ratio over the period actually has strong positive correlation with the government debt level in the pre-COVID-19 period (Figure 7). In other words, countries that had high levels of government debt even before COVID-19 have run a higher level of additional fiscal deficit, thereby raising the government debt level relatively more in response to the pandemic.



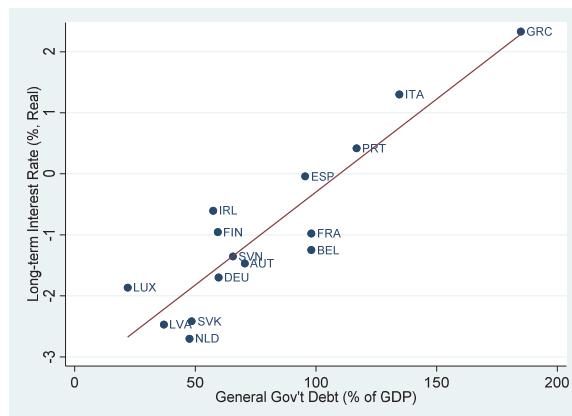
Source: IMF World Economic Outlook (April, 2021)

Fig. 7 Changes in Government Debt in 2020 and Initial Government Debt in 2019, OECD Countries

Moreover, one can notice that all countries that have had a government debt to GDP ratio higher than 100% as of 2019 are ‘reserve currency’ countries, all of which subsequently increased their government debt to GDP ratio by more than 15% in just one year. This is because reserve countries are able to issue government bonds relatively easily and maintain high levels of government debt because they face a relatively low cost of issuing government bonds, thanks to the strong demand for their government bonds by international investors. Would this mean that reserve currency countries can continue to increase government debt through expansionary fiscal policies? The answer to this question depends critically on the outlook for global interest rates.

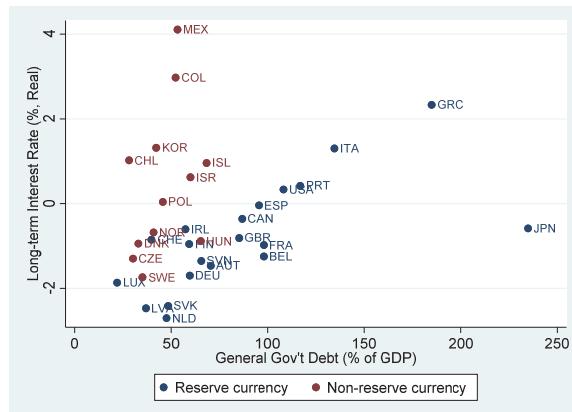
The cost of issuing government bonds is basically the interest on government debt, which is determined jointly by short-term policy rates, inflation rate, and default rate. Though it is impossible to distinguish between them without a sophisticated methodology, we can approximately estimate the respective role of these factors.

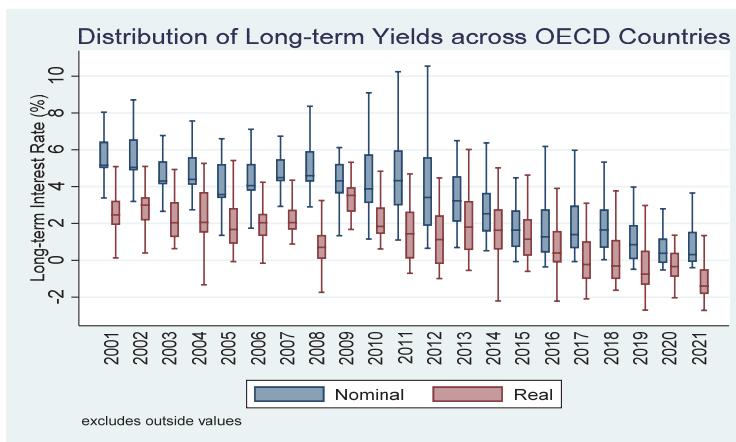
For instance, in the case of Eurozone countries, the part of differences in the government bond yields due to the different short-term policy rates can be effectively controlled because short term policy rates are equal for all Eurozone countries. Additionally, we can convert nominal interest rate to real interest rate to take into account the differences in inflation rate across countries. Consequently, the differences in real interest rates across Eurozone countries should mostly reflect default risks across countries. Figure 8 shows that there exists a positive correlation between the real interest rate and the government debt to GDP ratio for Eurozone countries as of 2019. This implies that even reserve currency countries face a higher risk of default rate as government debt to GDP ratio becomes higher, and hence are unable to avoid (relatively) high costs of issuing government bonds. For non-reserve currency countries, the increase in costs of issuing government bonds, caused by an increase in the risk of default rate, will be even steeper, which essentially suggests that they face stronger constraints against running large-scale fiscal deficits (Figure 8).



Source: IMF World Economic Outlook (April, 2021); OECD Statistics

Fig. 8 Long-Term Real Government Bond Yields and Government Debt Rate Across Eurozone Countries





Source: OECD Statistics

Fig. 10 Distribution of Nominal and Real Long-Term Yields across OECD Countries

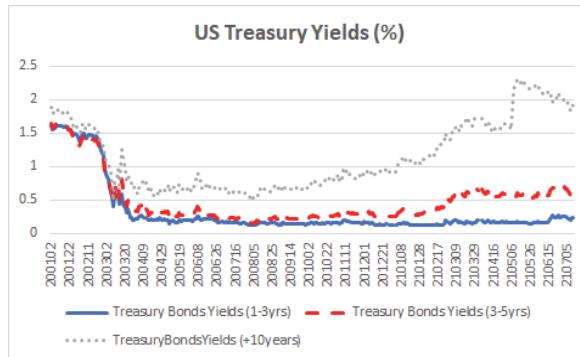
Concerns over US inflation and monetary policy normalization, and outlook

After the 2008-9 Global Financial Crisis, the Central Banks of major countries actively ran expansionary monetary policy with ultra-low interest rates, and ran unconventional monetary policies including Quantitative Easing in the US. Numerous countries also actively implemented various fiscal policies in face of the global economic depression. Despite such efforts, inflation remained low for ten years. The Central Banks across various countries believed a similarly persistently low inflation would continue after the COVID-19 crisis, and have taken immediate response against the COVID-19 crisis by decreasing policy rates and implementing unconventional monetary policies, which has received strong supports as a bold and decisive action by the market at the time.



Source: FRED Economic Data

Fig. 11 US 5-year Forward Inflation Expectation

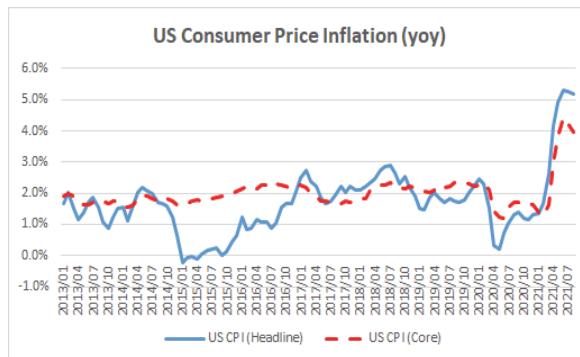


Source: FRED Economic Data

Fig. 12 Long- and Short-Term US Treasury Yields

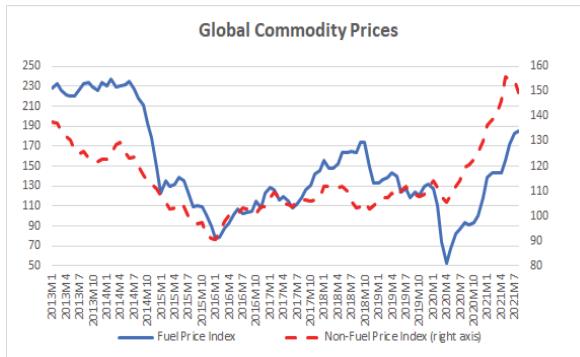
However, the problem at this moment is that the US, the world's largest economy, is showing signs of overheating, as it recovers rapidly through quicker-than-expected development and supply of vaccines. This had first been noticed through a steep increase in expected inflation since early 2021 as the 10-year long term government bond yield has just surpassed the pre-COVID-19 levels (Figure 11, Figure 12).

Such trends have not only been spotted in the expected inflation, but have also been noted through a steep increase in CPI inflation rate, bringing our concerns to reality. In comparison to the same period in the previous year, CPI inflation rate had sharply increased from 2.6% in March to 4.2% in April, and remained at around 5% from June to August (Figure 13). This is analysed to be largely due to the surge in the global commodity prices, such as the global fuel price (Figure 14). Although this is partly due to a base effect from the steep fall in their prices at the beginning of the COVID-19 crisis in 2020 such that the CPI inflation rate is expected not to exceed, nor to be maintained at, current levels, it is sending too strong signal to be ignored by the US Fed.



Source: FRED Economic Data

Fig. 13 US 5-year Forward Inflation Expectation



Source: FRED Economic Data

Fig. 14 US 5-year Forward Inflation Expectation

Jerome Powell, the Chairman of the Federal Reserve Board, mentioned repeatedly that he considers tapering by the end of this year through the normalization of unconventional monetary policy, and has also reconfirmed his point after the Jackson Hole Symposium in late August. Furthermore, a decision to increase policy rates seems likely to follow in the near future.

US Fed's normalization of unconventional monetary policies, emphasized by the rising concerns over US inflation, as well as the likely increase in policy rates in the near future, will ultimately lead to an increase in the policy rates of major advanced and emerging market economies; it is expected to go further as to increasing the cost of issuing government bonds for each government as illustrated in Figure 15.

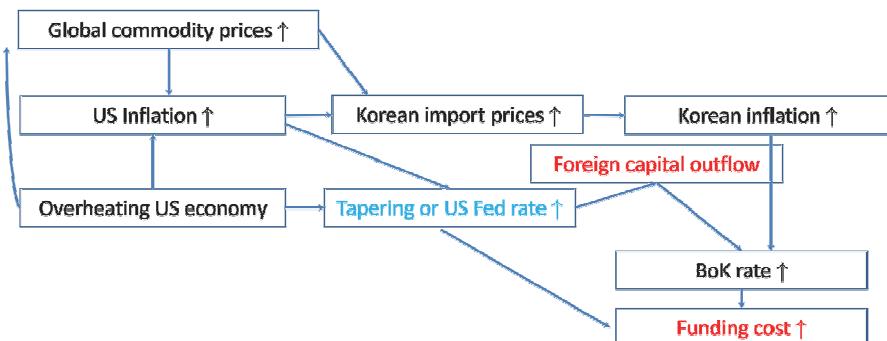


Fig. 15 International Repercussions from US Monetary Policy Normalization

In the short term, as was seen in the taper tantrum in 2013, the liquidity that has flowed into emerging market and major economies through US Quantitative Easing can flow back out, causing volatility in financial markets and foreign exchange markets of each country. Many countries may decide upon increasing policy rates in order to prevent foreign capital from flowing out, but this will force them to face higher domestic interest rates, thus increasing the debt burden on households and businesses. Furthermore, this upwards pressure will be passed onto each government's bond yield in the medium to long term and the persistent increase in

US policy rate will encourage the upwards pressure even further, ultimately leading to a vicious spiral of government debt increasing as government interest burden grows.

Conclusion

Major countries were able to minimize the damage of the COVID-19 crisis on their economies, as they were able to respond with large-scale fiscal deficits. Increasing their government debt through such policies was possible thanks to the low costs of paying interest, bringing about an economic recovery that was much quicker than was expected. Whether the rate at which the economy is currently recovering can be maintained at current levels depends on the fiscal space of each government, while the fiscal space of each government in turn depends on the costs of borrowing. Recently, the steep rise of US CPI inflation rate has led to pressures on accelerating the likelihood of the US monetary policy normalization, which also increased the possibility of interest rate rising more quickly than anticipated. Taking this into account, the expansionary fiscal policies cannot be sustained in the medium to long term, especially for non-reserve currency countries that tend to be weaker against increases in interests. In order to maintain the strong growth and economic recovery rates, there needs to be a transition in the economic strategies of achieving economic growth - namely, to one that avoids relying on expansionary fiscal policies.

