The Macro-Economic Implications of COVID-19 in developing countries

Ricardo Hausmann

Harvard Kennedy School

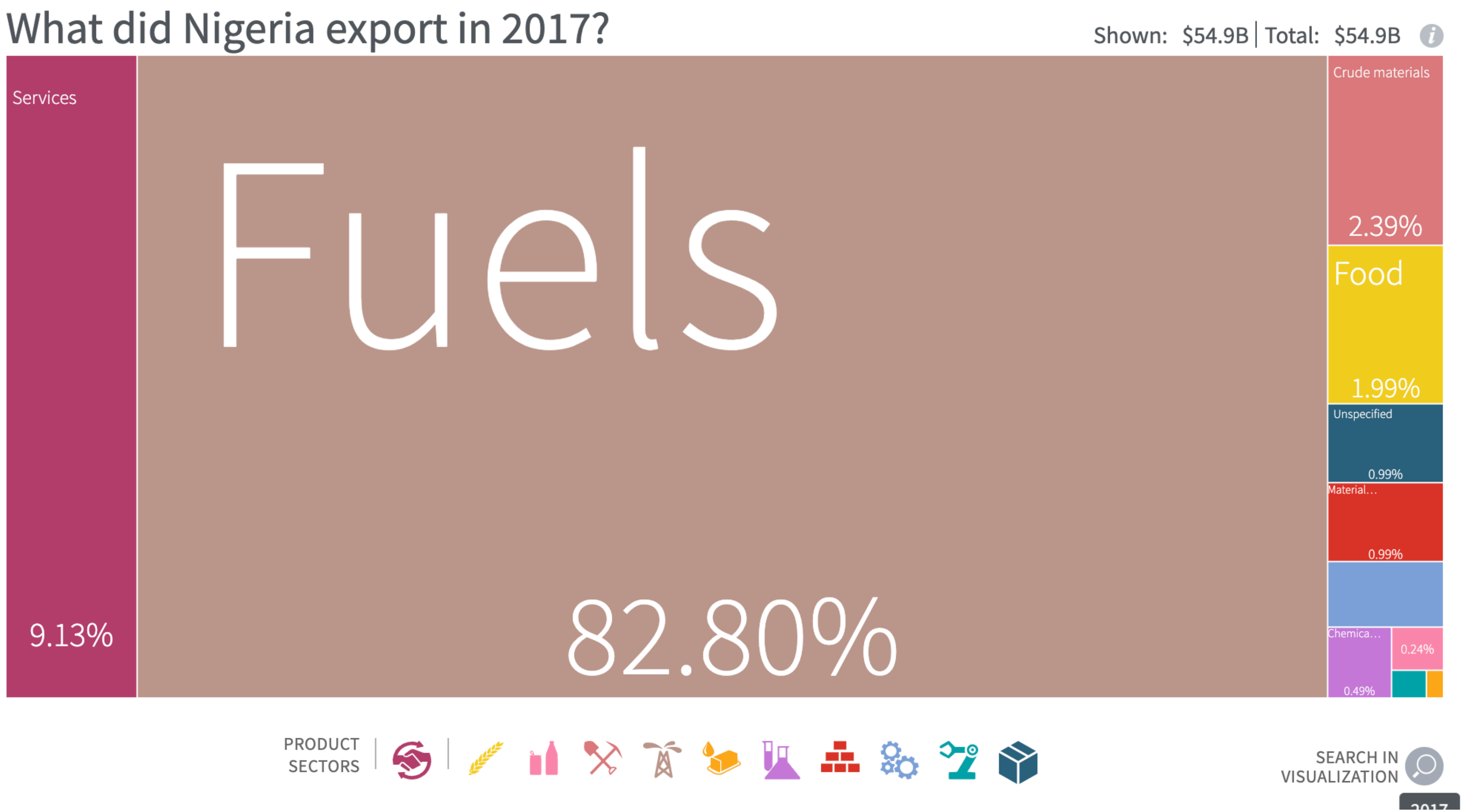
Caveats

- First time I give this talk
  - Hoping to learn from your comments
- It covers topics I know little about
  - Ignorance is daring
- It deals with horrible moral trade-offs
  - Do no shoot the messenger
- It focuses on developing countries
  - Too much of the discussion in the US has been inward looking
  - Growth Lab projects in Ethiopia, Albania, El Salvador, Venezuela

What is happening?

- When it rain, it pours
- Coronavirus COVID-19
  - How to think about it from an economics perspective?
- Collapse in access to foreign income
  - Collapse in commodity prices
  - Collapse in tourism
  - Expected collapse in remittances
- Collapse in access to capital markets

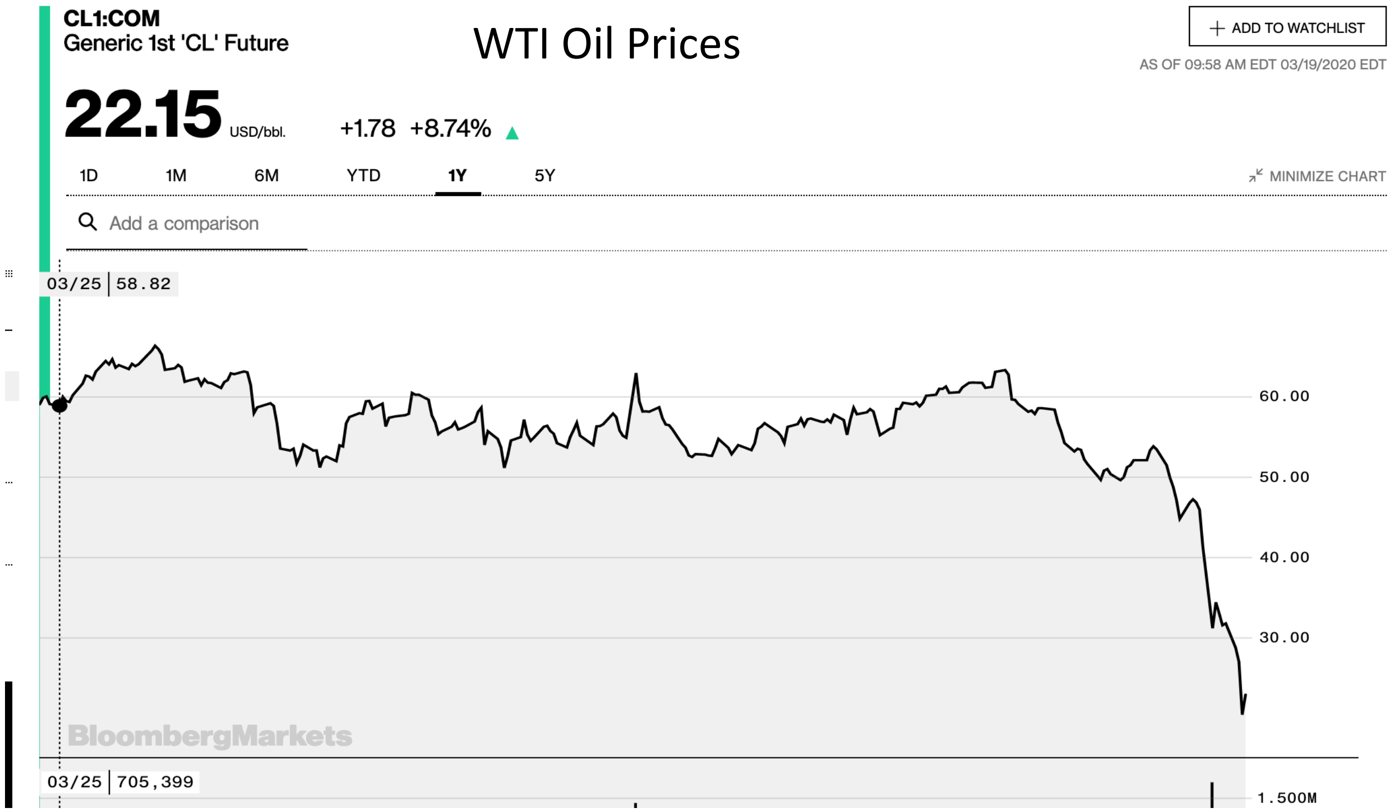
Some countries rely on very few commodities



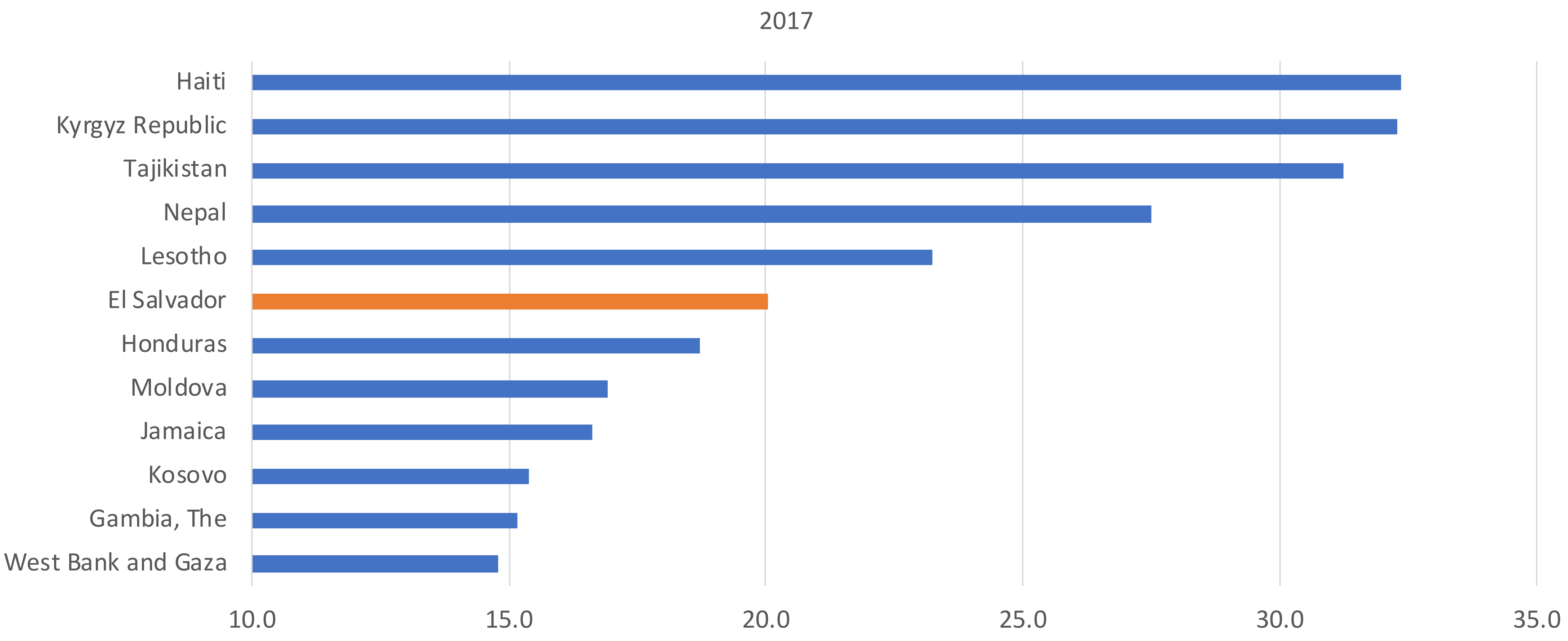
Different countries, different combinations

- Commodity exporters vs. commodity importers

  - Oil prices declined to the lowest levels since 2003!!!
  - Bad news for Nigeria, Colombia, Venezuela
  - Good news for Ethiopia, Albania and El Salvador

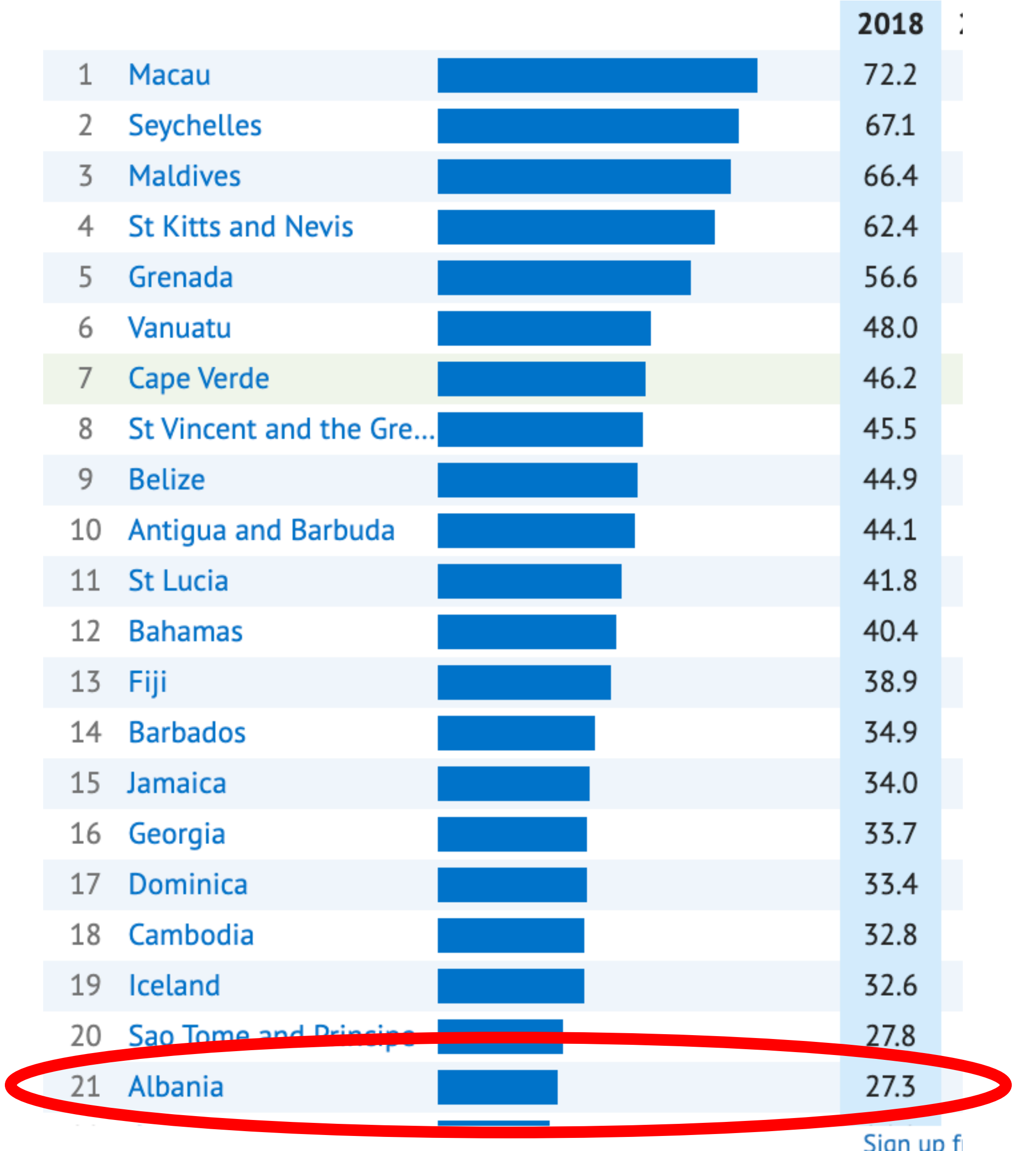


Some countries are highly dependent on remittances



Some countries are highly reliant on tourism

- COVID-19 may represent a huge shock to tourism



Bond prices have collapsed

Albania

Peru

Colombia

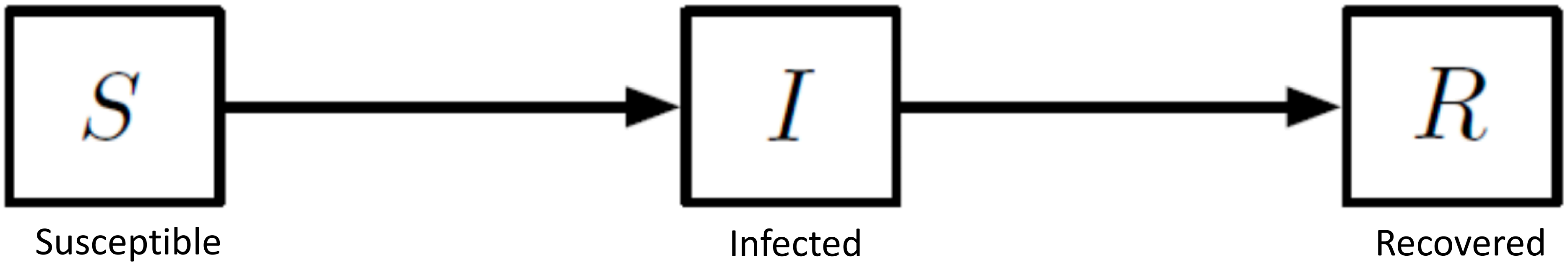
El Salvador

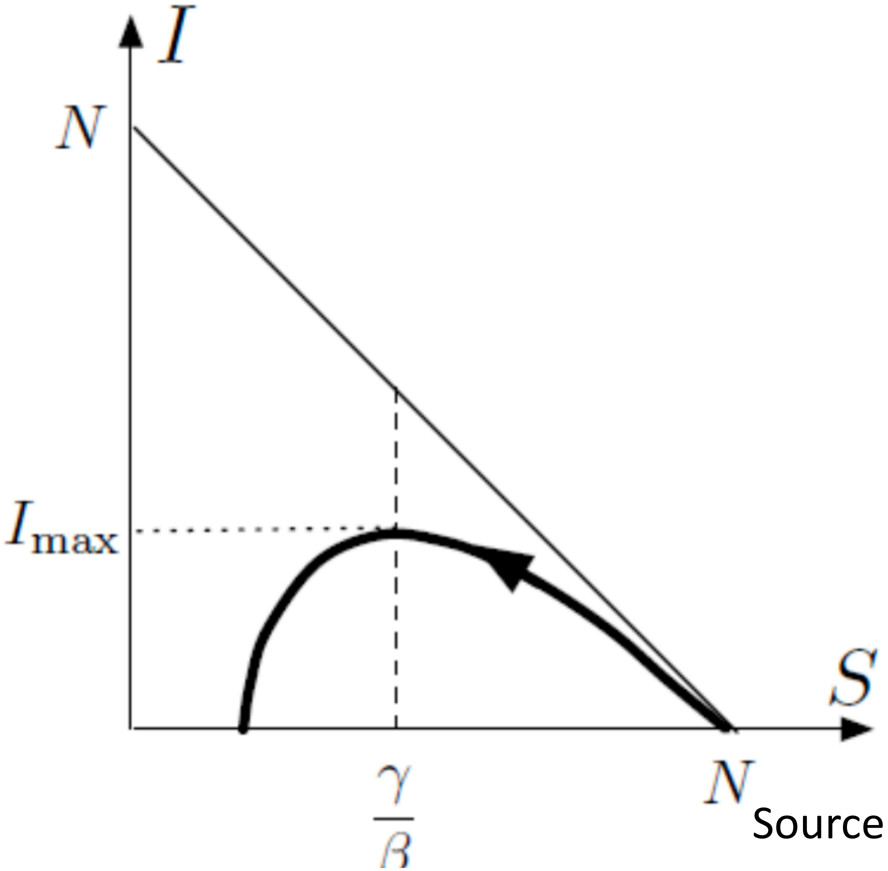
All of these are shocks we have seen before

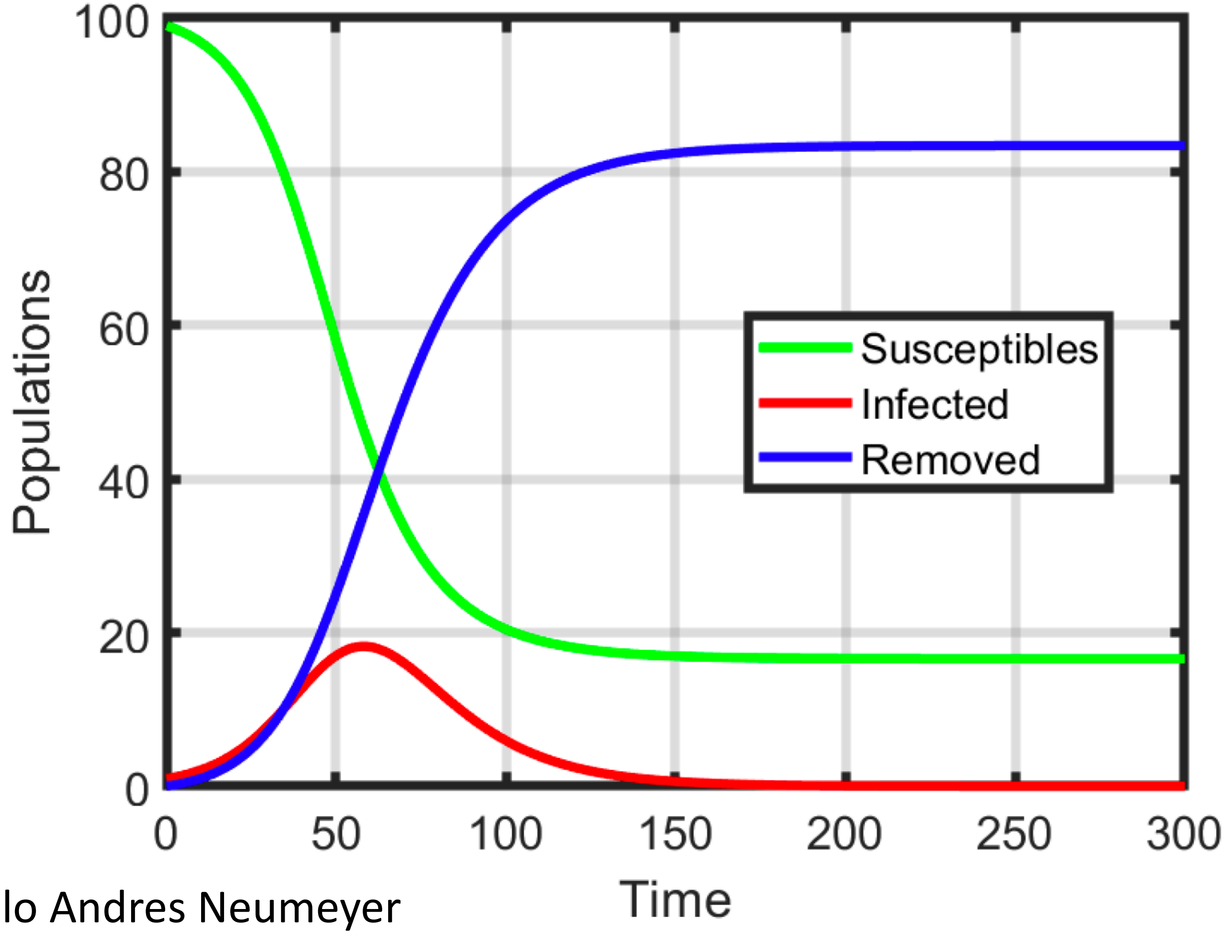
- We know, in principle, how to handle them
- Three ingredients
- Increased external (official) finance
  - To make adjustments more gradual
- Adopt expenditure reducing policies
  - Cuts to public and private deficits through fiscal and monetary contraction to bring spending in line with lower long-term income
- Expenditure switching policies
  - To make more of the spending go to local output through e.g. real exchange rate depreciation
- This approach works less well when many countries are in the same boat
  - Like now

But what about Coronavirus COVID-19?

What kind of a shock is this?







Source: Pablo Andres Neumeyer

The logic of flattening the curve

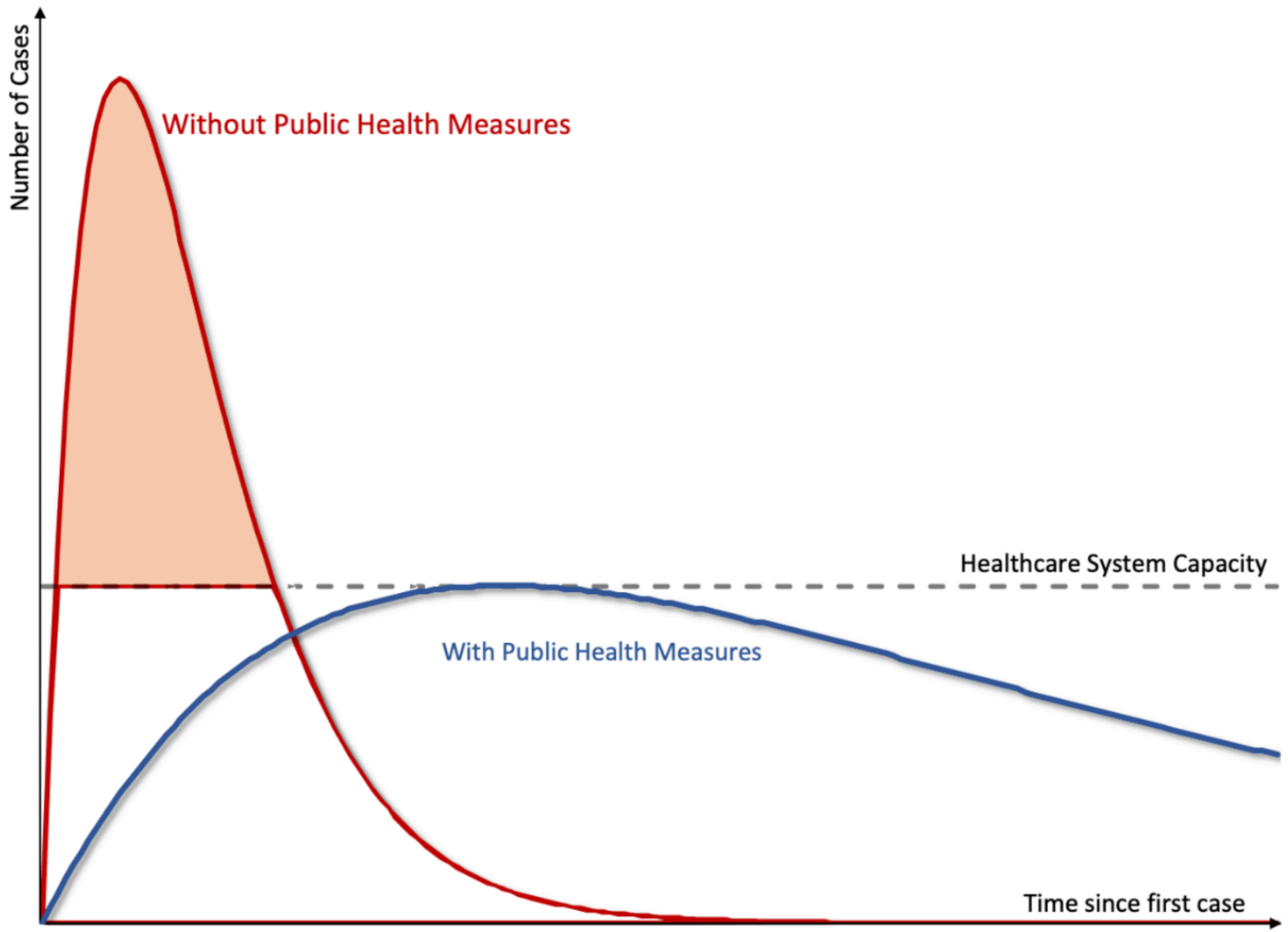


Figure 1: Flattening the Pandemic Curve

Source: Pierre-Olivier Gourinchas

Things to notice

- Flattening the curve means that there will be fewer cases at any point in time
- …but it does not directly affect the total number of people who eventually get the disease
  - Unless it gives time to develop a vaccine
- Prevents the health care system from being overwhelmed
  - This should lower the death rate, as patients would have ventilators and ICUs
- It delays the peak of the crisis
  - Makes the process longer
- Increases the chances that by then we would have better treatment and/or a vaccine

But how do you flatten the curve?

- By restricting human activity
- But this restricts GDP
  - Harvard (especially Exec Ed)
  - Broadway
  - Airlines
  - Bars, restaurants, gyms
- Lockdown impacts all activities
- But these decisions percolate through the economy amplifying the initial effect
  - Lay-offs
  - Bankruptcies
  - Non-performing loans in the banking system

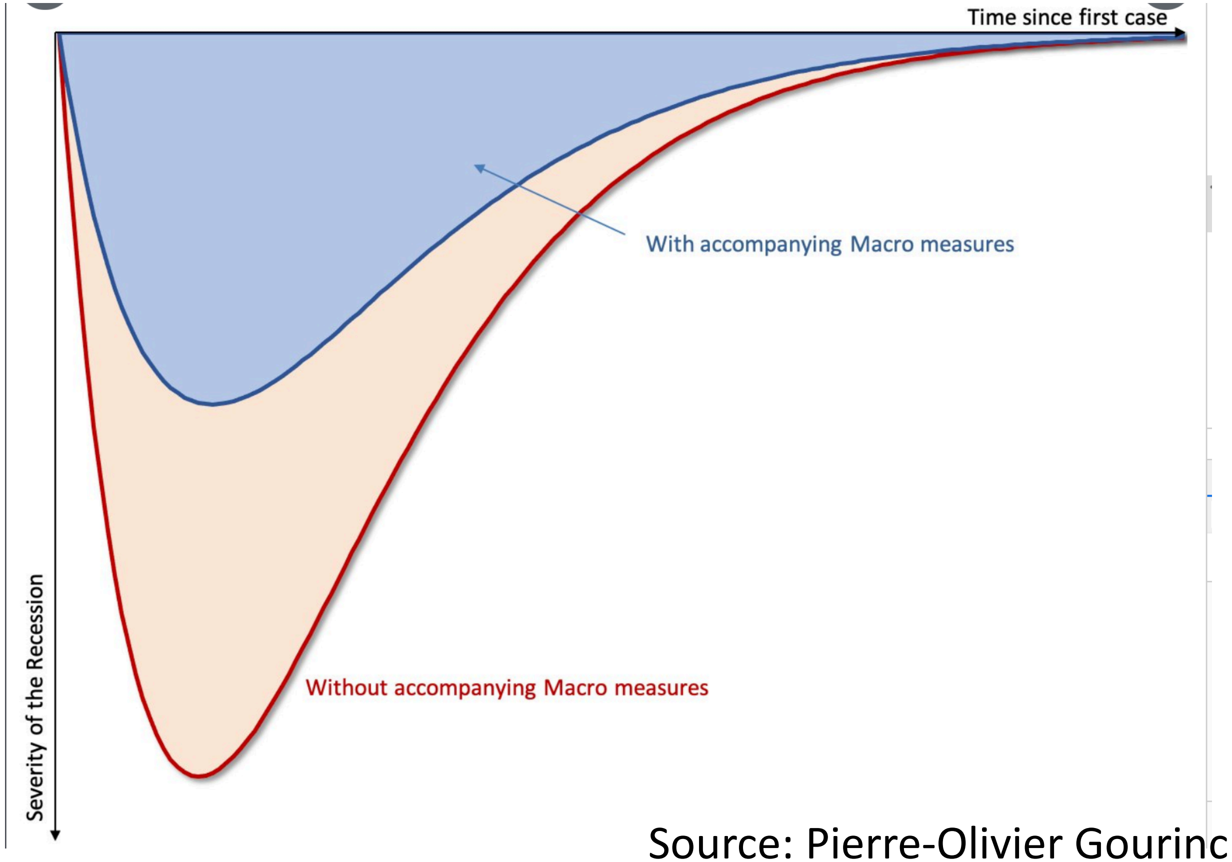
What does this mean?

- The fight against COVID-19 starts as a supply shock
  - You cannot produce
- But as it percolates through the economy, some are hit by supply shocks
  - You cannot make X because somebody did not make input Y
- Others are hit by negative demand shocks
  - Laid-off workers spend less
  - Bankrupt firms will not invest and will not be there when the crisis is over
- This amplifies the initial contraction
- While the initial shock may be hard to avoid, this amplification could be addressed
  - Protect workers, firms, banks
- …using fiscal (i.e. public resources, capacity to borrow)

This is different from a garden-variety recession

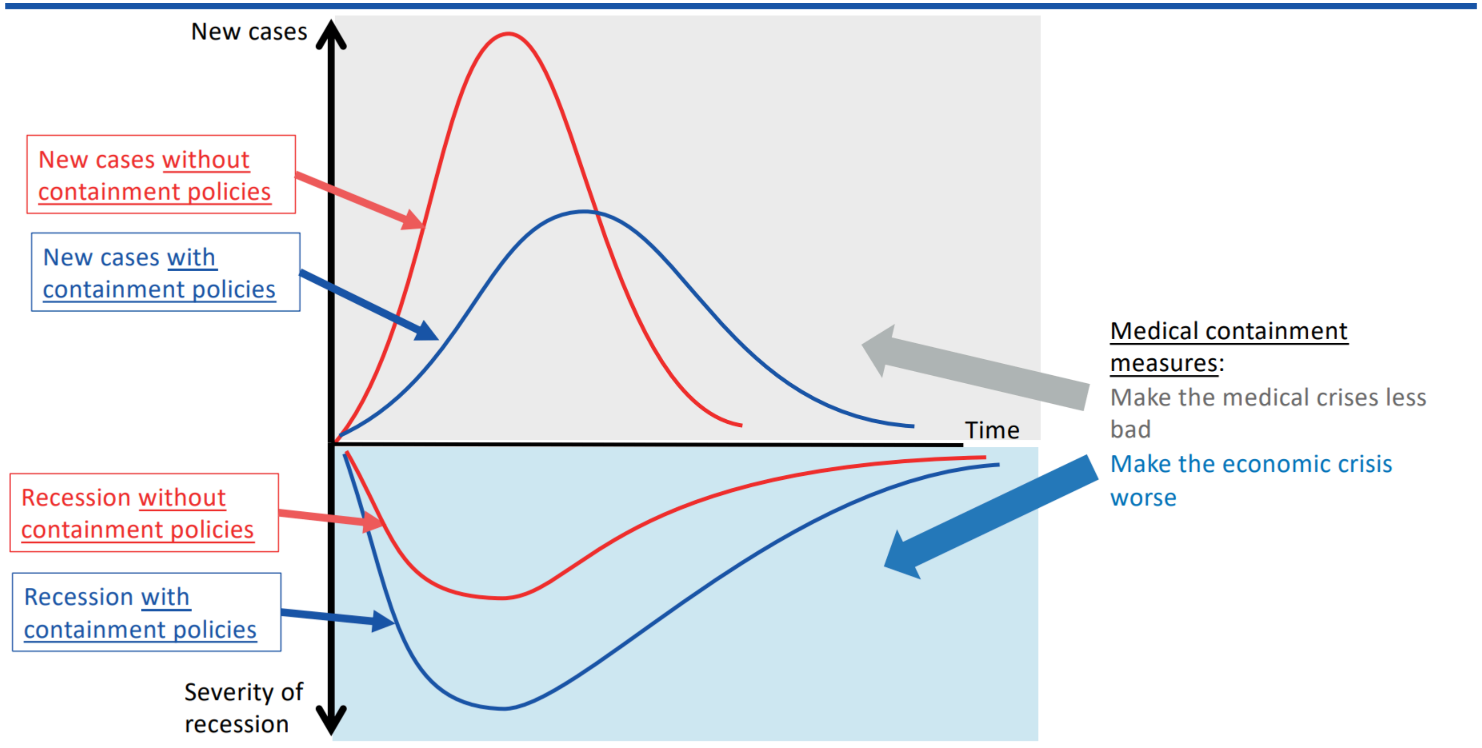
- It is a supply shock, not a demand shock
- It percolates through both supply and demand channels
- Traditional Keynesian policies have limited effectiveness
  - More demand for Broadway plays does not cause more plays in a lockdown
- Lay-offs and bankruptcies make the recovery much slower
  - Hard to hire, hard to form new ventures
- So fiscal policy can help but not through the standard channels
  - By helping people and firms withstand the shock

The difference between the shock with and without fiscal protection



Source: Pierre-Olivier Gourinchas

Flattening the epidemic curve worsens GDP



Source: Author's elaboration, inspired by illustrations in the chapter by Gourinchas.

Source: Richard Baldwin

So the solution seems to be clear

- Social distancing and lockdown to prevent infections
  - Bad for GDP
- Fiscal action (with monetary accommodation) to prevent the amplification and long term damage of the lockdown
  - Good for people short term
  - Good for the eventual recovery of the economy
- Typical instruments
  - Maintain payment of payroll or provide unemployment insurance
  - Provide special loans to business
  - Provide regulatory forbearance to banks so that they can reschedule loans

But what if countries have no fiscal space?

- Many countries are fiscally weak in good times
- With the COVID-19 shock, their fiscal space may disappear
  - tax revenues decline
  - Especially if they get a terms of trade, tourism or remittance shock
  - The crisis requires more health expenditures and ideally spending to cushion the blow
- None of this is good for the country’s creditworthiness
- But if, in addition, financial markets shut down, the government may not be even forced to cut back!
- So fiscal policy cannot play the same role as in the standard recommendation, say for the US

In other words

- Without fiscal space, flattening the epidemic curve is costlier
- So countries may be forced to / “choose” not to fight the virus by as much
- …leading to faster spread,
- more deaths because of lower capacity to treat
- … and a faster end to the epidemic, assuming no re-infection
- In other words, lack of fiscal space costs lives

But many countries are trying to avoid this

- Some countries without much fiscal space have nevertheless opted for lockdowns
  - Albania and El Salvador, in our network
- How should they manage it?
- How should they prioritize the use of their fiscal space?
  - Health system
  - Livelihoods
  - Firm survival

What to use the lockdown for?

- A lockdown promises to bring the trajectory of cases / deaths down, ***<u>relative to a counter-factual</u>***
- But a lockdown is not sustainable
  - Eventually, people will have to decide between dying of the virus and starving to death
- Unsustainable situations cannot last
- So you will eventually need to resume production, but how?
- How can the cost of the lockdown be lowered?
- … and how should it be shared?

How do you get out of a lockdown?

- Wait for a treatment or vaccine?
  - May be too long
- Wait for cases to go down and your testing and ICU capacity to go up
  - But then, use the lockdown time efficiently
  - Markets for medical inputs may become congested
- Re-open activities gradually
  - Starting with the most critical and least “networky” activities
  - Test frequently and quarantine only the affected as opposed to everybody
- Adjust speed of the re-start as more information is revealed
  - On cases, treatments, capabilities

What should the international financial community do?

Increase fiscal space by expanding the availability of official finance

- Recirculate the flight-to-safety money that is flowing to the US
  - And causing undesired US$ appreciation
- Quantitative Easing
  - Should Central Banks buy IFI bonds? Emerging Market bonds?
- Increase the number of countries with access to FED swap lines
  - The FED announced this policy this morning but it included only Australia, Brazil, Denmark, Korea, Mexico, Norway, New Zealand, Singapore and Sweden.
- Why only those?
  - If the concern is credit risk, maybe have those swap lines intermediated by the IMF
- Expand the use of existing credit facilities
  - IMF's Rapid Finance Instrument, Stand-by arrangements, other IFIs
- Support for dollarized economies
  - They do not have a lender of last resort
  - El Salvador, Panamá, Ecuador in my part of the world

Thank you!