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Three goals for fiscal policy

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On the Fiscal policy response to the Covid-19 crisis.

Need to rewrite the fiscal guidebook

A totally different shock.

Typical recession: demand shock. This time: supply shock
The shock is the lockdown: closing of non-essential activities, distancing
Policy induced (to fight virus), brutal, sharp, binding

Two phases (in advanced economies. More on middle income and poor economies later)
Phase 1. Getting infection rate down. Baked in. End by early summer.

Phase 2. Keeping infection rate down. Large uncertainty.
Uncertainty about virus (immunity?), about drugs, vaccines, tests
about scaling up potential of tests production.
Will determine path of lockdown. Could last 6-18 months.

Three goals for fiscal policy

Infection fighting. Not so much now (capacity constraints), but for later.

- Scaling up of tests. Moonshot?
- Development of vaccines. Need for state intervention/allocation
- Expensive, but small in macro terms: <1% of GDP

Disaster relief.

- Funds to liquidity constrained households, firms, local authorities
- Speed versus targeting
  - Different approaches. France/US
- Grants versus loans/credit. Backstop of banks, contingent liabilities.
- Very (too?) generous. Will have to be refined. And give incentives to reopen
- Price tag: Potentially 10% or more of GDP for 2020.

Aggregate demand? Cannot go above potential. (35% lower under full lockdown)

- Could disaster relief increase demand too much?
- In Phase 2, will demand go up or down? Need to be nimble.

Debt sustainability

From ``whatever it takes'' to ``Gosh, what have we done?''

Debt ratio will go up. Reasonable upper bound: 30%.
Will it be sustainable?

Depends very much on r* (the neutral safe rate) and g. (the growth rate)

- Before the crisis, r* was expected to be low for a very long time
- Every reason to think this will be even more the case
  - Precautionary saving
  - Investment under uncertainty
- Then, debt service burden very small. No need for large primary surpluses

The essential assist of central banks

- What if investors worry? Multiple equilibria.
- Role of central banks to maintain the "good equilibrium." Yield curve control?
- Not zero risk. If r* increases, tough choice.

Middle income and poor countries.

Perfect storm.

Virus, and weak health system. Herd immunity dynamics?
Commodity prices. Tourism
Capital outflows
FX denominated debt, and steep supply curves.
Limited ``fiscal space''

Existing debt may have become unsustainable
Additional borrowing from private creditors may not be available

Absolute need to provide funds to fight the virus. Grants or concessionary loans
Need for a large number of programs

Widespread debt restructurings on the way
Start with debt standstills.

Implications for AE financial system? And, by implication, fiscal implications