The Macroeconomic Response to the COVID Crisis

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Overview

- The crisis is the worst this economy has every faced.
- Government’s response is a useful start -needs to be scaled up
- We cannot fund a stimulus big enough with conventional means – need to use quantitative easing.
- Government stimulus package has some good elements – more could be done.
- Monetary policy is useful –fiscal policy is more important because it can replace wages or provide grants to workers and companies.

What Should Policy Aim to Achieve?

1. Governments needs to spend to offset the output gap

    - Companies will spend less because balance sheets are weaker and they debt levels have increased.

    - Households might have lost jobs or worry that they will – will spend less and try to build up savings.

    - Only government has the ability to spend more.

What Should Policy Aim to Achieve?

2. Government needs to reduce long term impact of the crisis

- Crisis will have an impact on growth in future years – hysteresis.
- If companies go out of business, they will not exist to produce in the upswing.
- If household wealth falls, consumption will decrease.
- The worse the crisis is now, the larger the impact on future growth.

How Large Should a Package Be?

- Stimulus should offset the output gap but little idea how big that could be.
- Early forecasts for SA were for a 5-6% decline
- More recent forecasts are closer to 10%.
- Brian Kantor of Investec forecast an output gap of R1 trillion in 2021Q2.
- US GDP nowcasts are -53% (FRB Atlanta) and -35% (FRB New York)
  - Even after massive government support
- EU GDP forecast to fall by 9% in 2020, with a worst case scenario of 15%.

How Large Should a Package Be?

- If we don’t know how big the output gap is, how should we proceed?
- The costs of getting it wrong are asymmetric
  - If the package is too small, we lose hundreds of thousands of jobs and thousands of companies.
  - If it is too big, we get inflation.

  - Inflation is a small problem and we know how to solve it.

  - The opposite is happening – 34% of respondents in HSRC survey said they had missed meals – hunger is increasing.

Funding a Package

1. Borrowing from the IMF
   - SA entitled to borrow R80 billion from IMF – in ZAR
   - Interest rate of 1.1% - much lower than current borrowing rate of 7.2%
2. Borrowing domestically
   - Will already need to borrow R280 billion to offset tax shortfall.
   - Fiscal space is limited and the cost is high – 8.7%
   - Would need to double this year's borrowing to finance stimulus – rates would increase dramatically.

Quantitative Easing

- Cheapest, quickest and easiest method of financing stimulus – essentially free
- Improves fiscal sustainability because it reduces interest rates
  - Can push $r<g$

- Valid concern about inflation
  - QE has been part of all hyperinflation episodes
  - SA facing two disinflationary shocks – lockdown and oil price decline – both counteract impact of inflation
  - Inflation unlikely while demand is so weak – "too much money chasing too few goods" – can't occur
  - Koo – inflation won't occur while firms pay down debt
  - In 2008, many critics believed Fed and ECB policy would be inflationary

SARB Arguments Against QE

- Inflation – as before unlikely to occur
- Impedes functioning of debt markets
  - Is this principle worth higher unemployment and weaker growth?
  - The SARB already intervenes in markets, so why is long end of the market different from the short end?
- Could lead to investors dumping bonds and higher long rates
  - The exact opposite has occurred when the SARB intervened in markets.
- Reduces spending constraint on government
  - Is this principle worth higher unemployment and weaker growth?
- Impinges on SARB Independence
  - Is this principle worth higher unemployment and weaker growth?
  - Has not occurred where other countries used QE.

A Prudent QE

- How can we proceed so that inflation risk is reduced, while growth impact still maintained?
  - Buy discrete amounts of bonds – R20-R30 billion per week
  - If inflation picks up, stop purchases
  - Pursue normal OMO to mop up liquidity

  - Pay interest on excess reserves – Fed did this in 2009 – excess reserves increased from US$2 billion in 2008 to US$ 1.5 trillion in 2012
    - prevents excess money causing inflation.