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Article

Crises and Policy: COVID-19 Truly is Different

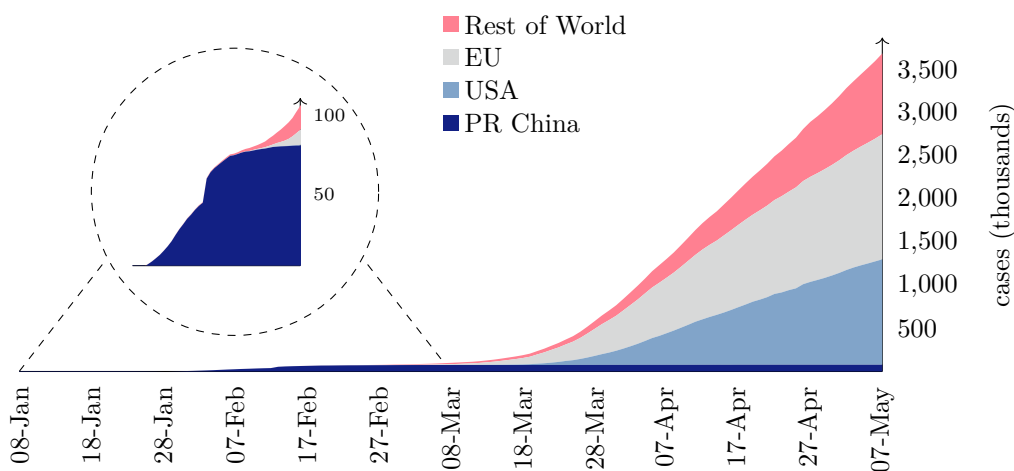
by Suah Jing Lian

Highlights

- COVID-19 is unprecedented - a supply shock which induced a demand shock.
- Policy during a pandemic must prioritise incomes and ensure liquidity without compromising public health prioritised.
- Policies should meet three criteria - directness, timeliness, and adequacy.

When news of the first COVID-19 outbreak in PR China broke in early January, the initial expectation was that it was temporary and most of the global economy would be insulated. Many of the initial downward revisions to global growth projections were largely well under 1 percentage point. The situation has since changed dramatically. COVID-19 is now a pandemic of unprecedented scale in this generation, infecting well over 3.6 million people as at 7 May (figure 1). Governments have mobilised resources for the healthcare sector and deployed strict containment measures such as restrictions in travel, movement and business activities to contain the pandemic. Amidst the lives lost to COVID-19, livelihoods have been significantly affected. This is a necessary, but heavy, price to pay, with the global economy now expected to enter a severe recession in 2020.

Figure 1: Cumulative confirmed COVID-19 cases by location



Source: World Health Organisation

This article addresses two main questions: Firstly, how different is the economic crisis caused by the COVID-19 pandemic? Secondly, how should economic policy respond to the ongoing crisis?

How should we view economic downturns and crises?

To address the ongoing crisis, we should first understand the cause of the downturn. Key guiding questions are: (i) what is the nature of these shocks, and (ii) what is the predicted response of output, employment, and prices? Broadly, macroeconomic shocks fall into three categories – supply, demand and financial.

1) Supply-side shocks

These are driven by constraints on production, total factor productivity (TFP), input prices and the labour force. The depth and duration of the resultant economic downturn depend on whether the shock is transitory or permanent. Notable episodes include the 1973 OPEC Crisis and the recent 2014-16 Oil Price Shock. Shapiro (1987) notes that the magnitude of output, employment and price responses depends on the persistence of the shock. Growth will moderate if production or price constraints remain and will normalise when they dissipate or are relieved by policy intervention. Production and prices tend to move in opposite directions.

2) Demand-driven shocks

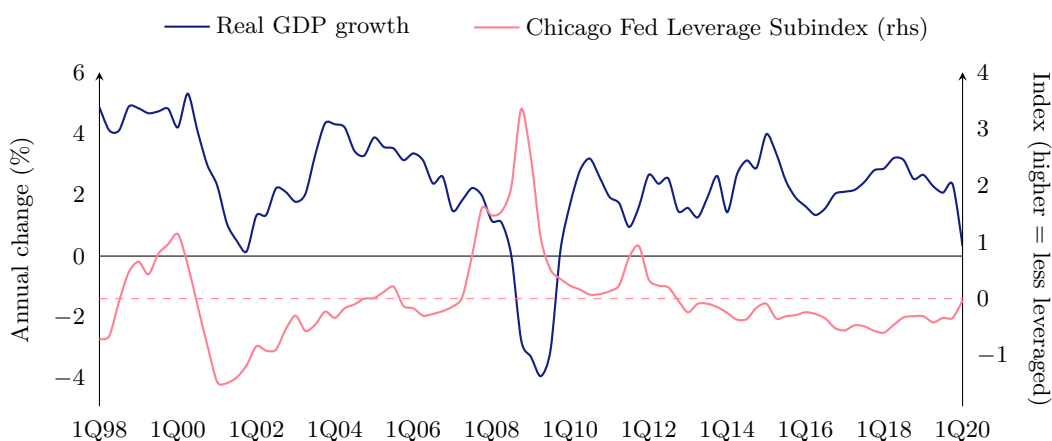
These are due to changes in demand-side factors, such as economic uncertainty, risk aversion, monetary shocks, or a shift in the strength of domestic expenditure or exports. For instance, the US-PR China trade war in 2018-2019 constitutes an external demand shock for small open economies. Inflation and growth often move in the same direction in crises originating from demand shocks.

3) Financial crises

Financial crises behave akin to a demand-driven crisis, except that the depth and duration of the downturn is usually larger due to the procyclical behaviour of the financial sector. Figure 2 illustrates this procyclical tendency with an indicator of leverage in the US financial sector and US real GDP growth. Leading to the 2008-09 Global Financial Crisis (GFC), rising leverage assisted the economic expansion. Loose credit conditions boosted asset prices, especially in the US housing and mortgage securities markets, which was sustained by widespread over-optimism and speculative risk-taking behaviour that became increasingly detached from economic fundamentals. As mortgage delinquencies rose amid slower household income growth, deteriorating sentiments and risk appetite led to the re-evaluation of risk asset prices. This led to the unwinding of financial imbalances that built-up prior to 2007. Growth weakened substantially and was accompanied by steep deleveraging, especially amongst banks, resulting in a credit crunch. This amplified the degree of financial tightness, loss of wealth and income and, subsequently, even weaker economic growth. Here, procyclical financial sector frictions amplified the

economic downturn on a global scale. While the source of financial crises is the financial sector, its procyclicality with economic activity exerted large adverse demand effects.

Figure 2: US Leverage Index and Real GDP Growth



Source: Federal Reserve Economic Database (FRED)

Despite the separate classifications, crises can morph into one another, eventually exhibiting cross-crises features. For example, the 1980s Latin American debt crisis originated from a supply-side shock in the global oil market, which led to slower demand as monetary policy tightened to address accelerating inflation in the US, a key source of external demand for the region. Consequently, scepticisms on reserve adequacy also triggered currency runs, such as in Mexico. Therefore, it is key to monitor signs that a crisis is broadening in nature.

Why is the ongoing COVID-19 pandemic causing an economic crisis?

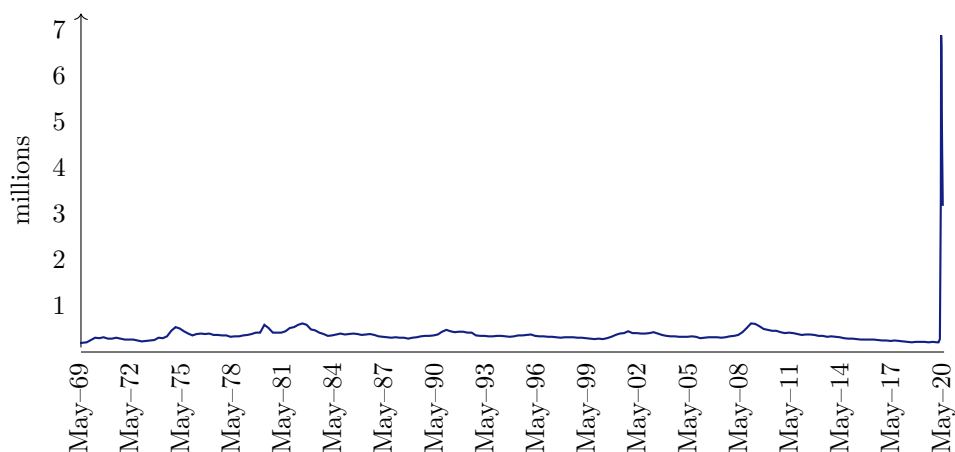
The economic crisis certainly originated as a *supply shock*; stay-at-home orders, lockdown measures and social distancing, both enforced and voluntary, have brought economic activity to a sudden stop, with production disruptions also affecting global supply chains. The supply shock subsequently triggered a large adverse *demand response*, as the decline in production caused businesses and households to sustain large income losses. In the early stages, for trade-dependent economies such as Malaysia, the pandemic constituted an adverse *external demand shock* originating from PR China. This has since broadened amid steep output contractions globally.

Figure 3: How the COVID-19 Supply Shock Induced Amplified Demand Shocks



In the emerging pandemic-macro literature, Guerrieri et al. (2020) describes the ongoing COVID-19 pandemic as a Keynesian Supply Shock, which is a supply-side shock that produces an amplified demand shock. Guerrieri et al. (2020) explains that while income losses initially occurred only in directly affected sectors, such as non-essential services and food and beverages segments, other sectors subsequently experienced weaker demand, such as in essential services and manufacturing, causing labour demand to weaken further (figure 3). Restrictions on business operations and movements, a typical feature of lockdown measures globally, lead to a sudden shortfall of revenue, resulting in significant cash flow deficiencies. To stay afloat, businesses inevitably retrench or furlough workers. In the US, this caused the unprecedented rise in job losses since mid-March (figure 4). Overall, a vicious cycle is created where more income is lost, further depressing overall consumer demand, and amplifying output losses.

Figure 4: Weekly Initial Jobless Claims in the US



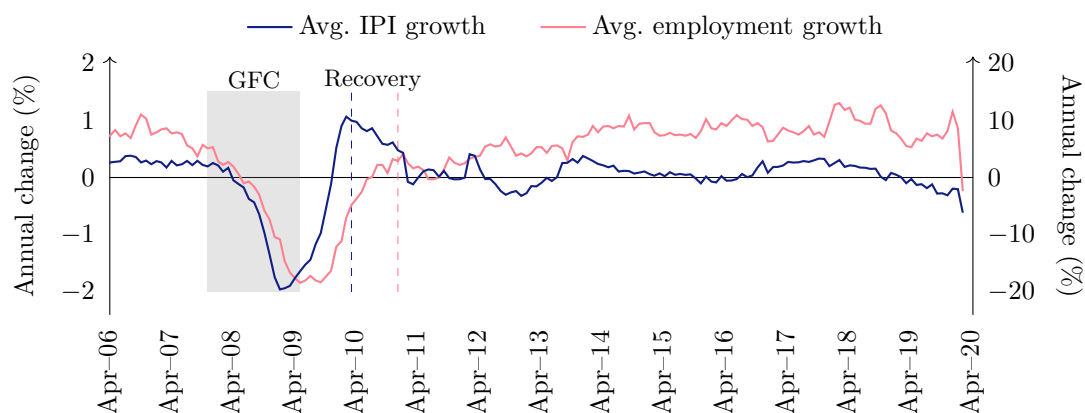
Source: Federal Reserve Economic Database

The dislocation of labour markets poses a concern for two reasons. Firstly, labour market strength anchor private sector expenditure, and subsequently overall economic growth. Weak labour markets limit the strength and pace of economic recovery. Secondly, this may lead to unemployment hysteresis, especially if people leave the labour force entirely, or if the loss of work experience result in skills mismatches. This explains Ball's (2014) finding that the OECD advanced economies af-

ected by the GFC experienced severe potential output losses. While labour market hysteresis may stem from a transitory shock, the output losses may be permanent. This stresses the importance of appropriate and adequate policy responses in addressing labour market weaknesses during the downturn.

Additionally, labour markets recover slowly. Search and matching frictions limit the pace at which employment recovers, constraining the pace of any normalisation, a view from the literature underpinned by Mortensen and Pissarides (1994). Amongst the G4 economies, the first post-recession peak in employment growth was observed two years after the trough of the GFC, while the rebound in output growth was observed a year earlier (figure 5).

Figure 5: Average Employment and Industrial Production Growth in G4 Economies

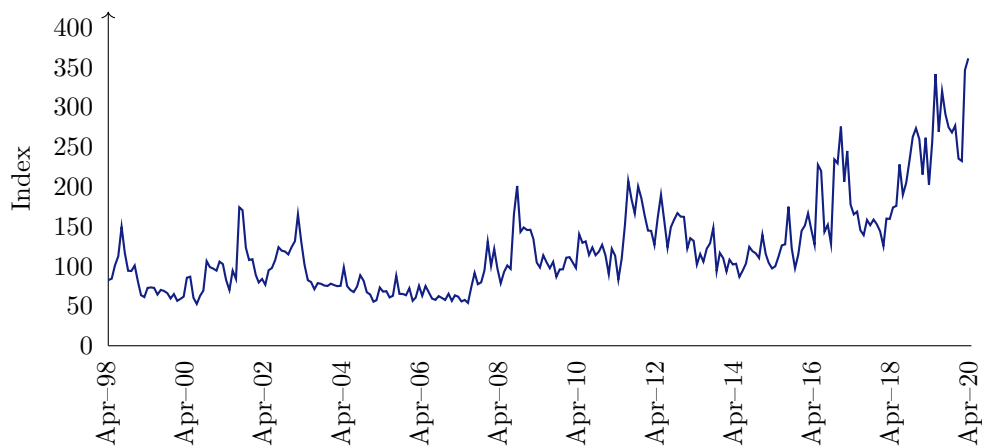


Source: CEIC, national authorities

Abstracting from labour markets, output hysteresis may also arise from business closures, driven by three factors. Firstly, firms face difficulties in immediately filling job vacancies as lockdown measures are lifted. Secondly, firms affected by cash flow mismatches and supply chain disruptions due to insolvencies or repurposing exercises may struggle to re-establish operations. Thirdly, with social distancing expected to continue even as lockdown measures are lifted, demand will be subdued. These frictions faced by firms will interact with those in the labour market, amplifying the initial shocks if left unaddressed.

The prevailing elevated levels of economic uncertainty could worsen the magnitude and pace of the recovery. Despite easing trade tensions in early January, economic policy uncertainty has returned to historical highs due to the unpredictability of the ongoing pandemic (figure 6). Baker et al. (2016) point out that repeated episodes of elevated economic uncertainty weigh on demand, further affecting prospects for an economic recovery. Additionally, Fajgelbaum et al. (2017) suggest that lower economic activity, in turn, generates an ‘uncertainty trap’ that persistently weighs on demand.

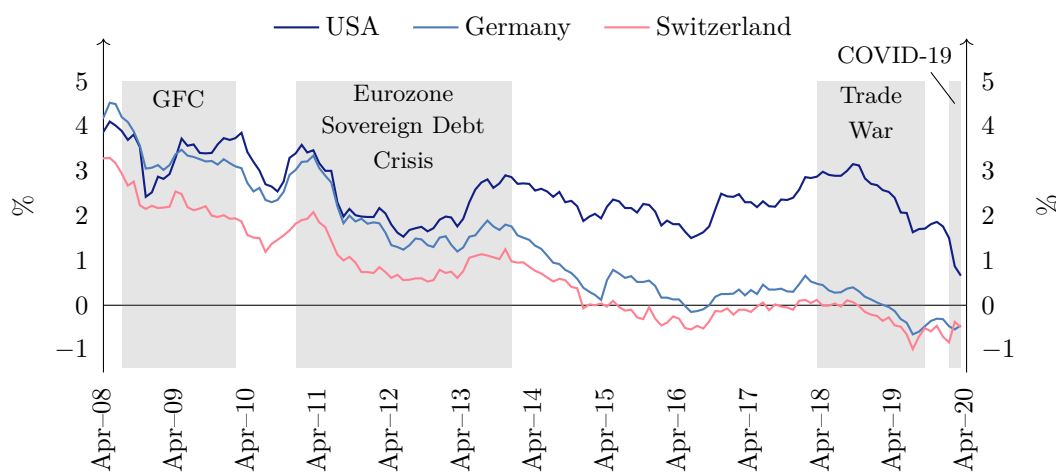
Figure 6: Global Economic Policy Uncertainty Index



Source: Baker, Bloom and David (2016), policyuncertainty.com

Sentiments also play a role as an amplifier of adverse shocks, as they tend to weaken as growth prospects become less favourable. Consumers and firms subsequently build up precautionary savings and defer consumption and investment, respectively. Where wealth losses are incurred through volatile asset price movements, expenditure may be reduced. For portfolio investors, risk aversion prompts flight-to-safety behaviour, tightening financing conditions and further amplifying the downturn. To corroborate, demand for safe-haven assets, such as long-term sovereign bonds of reserve currency economies, rises during economic crises, as reflected in dips in yields (figure 7).

Figure 7: 10-Year Government Bond Yields

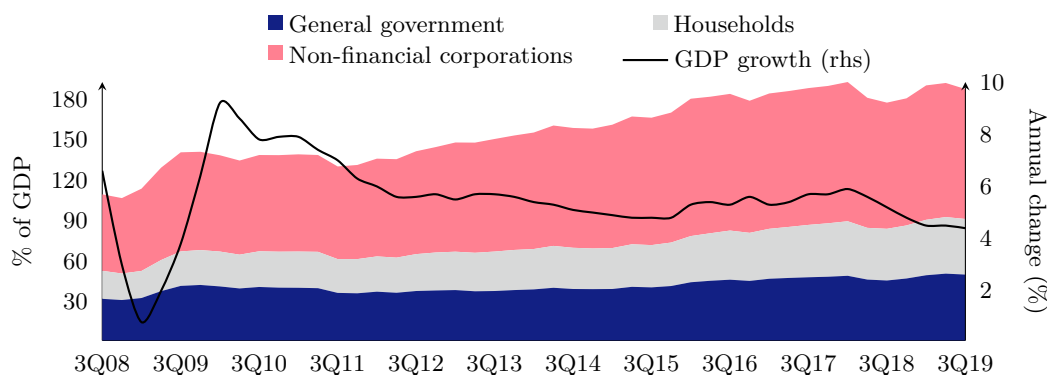


Source: CEIC, national authorities

COVID-19 is thus a temporary supply-side shock that has generated a large shortfall in demand. With significant effects on labour markets, business activity and sentiments, the recovery is likely to be weak.

Can the crisis deteriorate further?

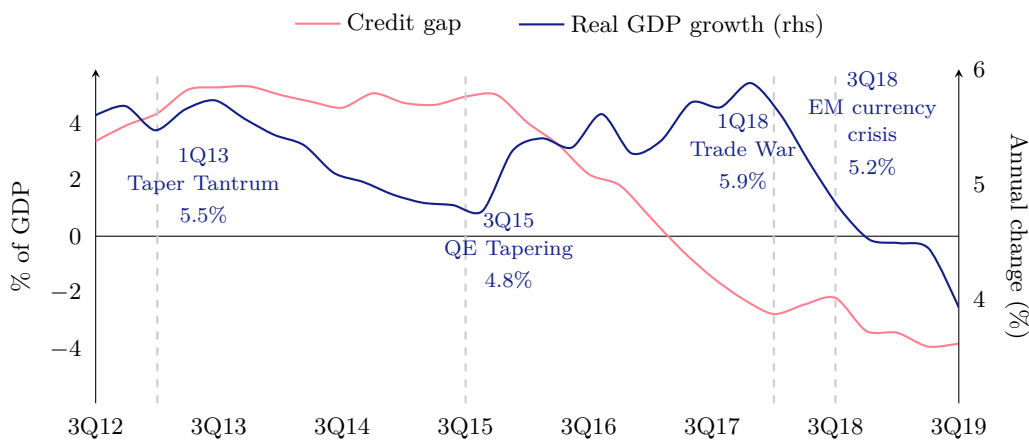
Figure 8: Credit to the Non-Financial Sector in Emerging Economies



Source: BIS

The potential unwinding of debt globally, especially in emerging economies, where there has been a steep build-up amid subdued growth since the GFC (figure 8), can worsen the ongoing crisis into becoming a financial crisis.

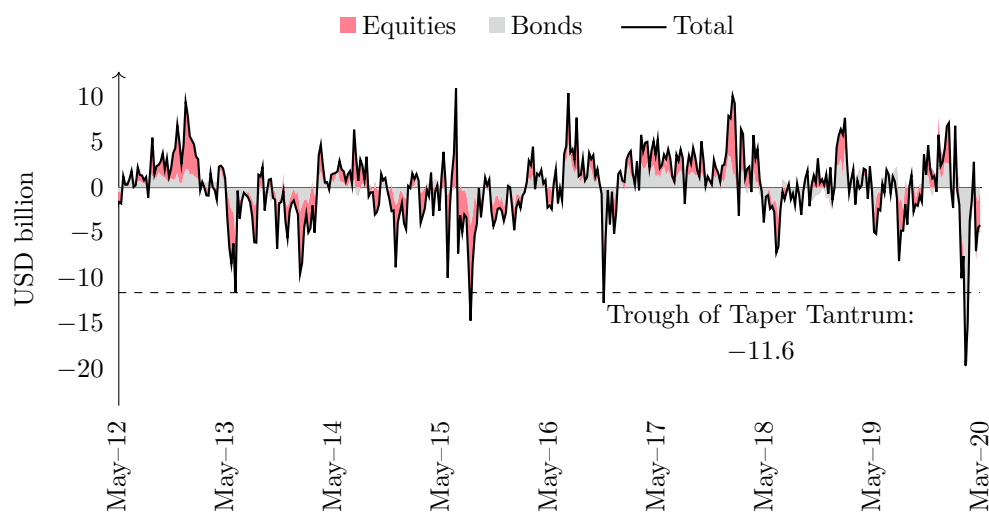
Figure 9: Real GDP Growth and Credit Gap in Emerging Economies



Source: BIS, IMF, CEIC, Haver, national authorities, BNM estimates

From a cyclical point of view, both credit and business cycles are at less favourable positions (figure 9), relative to previous episodes of downturns since the GFC. This limits the scope of some vulnerable emerging economies to withstand the shock from COVID-19. Regulatory improvements, such as the Basel III framework, partly mitigates this risk by increasing financial sector resilience since the GFC, especially amongst banking institutions. In Malaysia, this has enabled the financial sector to confront the ongoing crisis from a position of strength, with ample capital and liquidity buffers. Nevertheless, flight-to-safety behaviour can trigger sharp capital outflows and exacerbates external sector vulnerabilities in emerging economies (figure 10), thus increasing financial stability risks.

Figure 10: Net Capital Flows in Emerging Economies



Source: EPFR Global

Downturns can be limited without compromising public health priorities

Against the backdrop of the health crisis, economic policy has two roles. Firstly, it is to ensure that the pandemic is contained. Secondly, it is to support income levels without compromising on health priorities.

Achieving the first role is straightforward. Policy should lift resource constraints faced by the healthcare sector. This is broadly attained through the generous and swift provision of funding, equipment, infrastructure and human capital for healthcare services, including in Malaysia. The article will focus on the second role, which is more contentious, as it requires addressing deteriorating livelihoods without trading off health goals. To achieve this, measures must meet three criteria – (i) **directness**, (ii) **timeliness**, and (iii) **adequacy**.

1) **Directness**

Measures should address directly the immediate and binding constraint faced by households and firms – large cash flow shortages amid prevailing financial vulnerabilities. Policy responses introduced by many economies thus far have attempted to address this issue both directly, such as cash handouts and wage subsidies, and indirectly, via tax credits/deferments and loan guarantees. These measures attempt to minimise income losses and preserve cost conditions for firms and households, in the absence of work and production. Importantly, direct cash transfers to individuals or businesses alleviate immediate liquidity constraints. They decouple production and business activities from income flows, hence avoiding conflict with public health efforts to flatten the epidemic curve.

To prevent escalating into a financial crisis, policy also directly addressed balance sheet strains in the financial sector. Supervisory authorities and central banks have broadly encouraged the use of countercyclical capital and conservation buffers, beyond interest rate cuts and liquidity injections. The relaxation of macroprudential policies have also been pursued to support the economy. Additionally, central banks and governments have extended broad and targeted loan guarantees, and credit lines, to prevent credit crunches at the firm-level, which could generate adverse spillovers into financial institutions.

2) **Timeliness**

There is a limited duration before people are overwhelmed by financing and expenditure needs amid a loss of income. Policy must quickly ease liquidity constraints faced by households and businesses to avert insolvencies and, consequently, job losses. Timely policy requires data and some automaticity. One way to ascertain this is through fast-moving coincident indicators that unambiguously indicates if the economy is in a recession. The Federal Reserve's Sahm Rule is one such indicator. Sahm (2019) suggest the direct linking of the indicator to the release of large-scale direct stimulus, while Chodorow-Reich and Coglianesse (2019) suggests the automatic extension of unemployment insurance by liberalising eligibility and financing during times of economic distress. Haughwout (2019) further recommends the automatic kickstart of public infrastructure projects, as and when the economy is believed to have entered a recession. While recessions are often defined in terms of GDP, such measurables carry considerable lag, hence resulting in delayed diagnosis of economic conditions.

Early detection of the recession allows for more effective measures, and hence limiting more significantly the economic fallout, in the form of elevated bankruptcies, sharp rise in job losses and the likelihood of a permanent increase in unemployment.

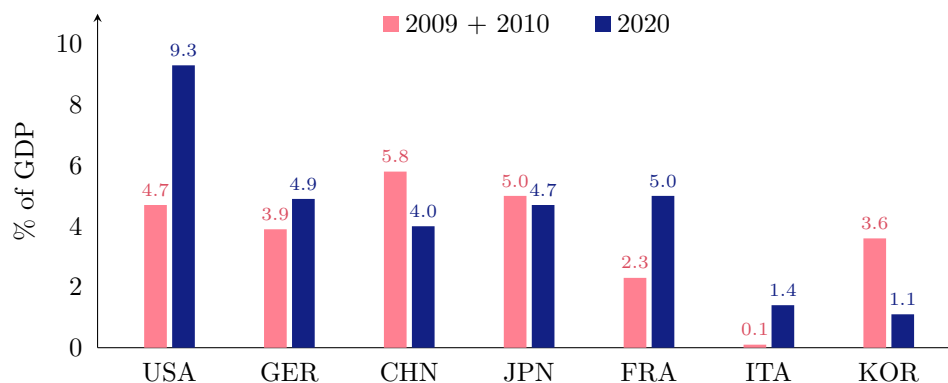
This highlights the importance of timely interventions. Coordinated and swift monetary policy actions eased financial market conditions, especially in emerging markets. US Dollar swap lines were offered by the Federal Reserve to central banks of major emerging markets, including Brazil and Mexico, and selected regional economies. This partially offsets the shortage of US dollar and limited the degree of sharp and sudden tightening of financial conditions, thus preventing the ongoing crisis from becoming a financial crisis.

3) Adequacy

The magnitude of the policy response must be adequate, corresponding to the unprecedented nature of the economic crisis caused by the COVID-19 pandemic.

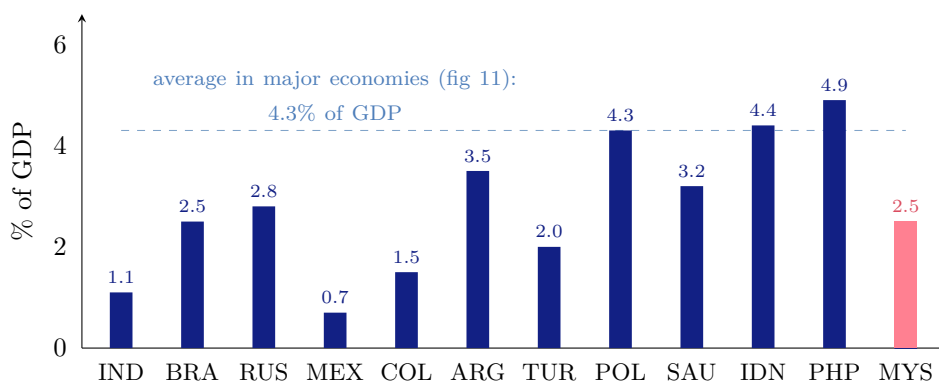
Abstracting from economics, as we view COVID-19 from a humanitarian standpoint, stimulus is about maintaining livelihoods and keeping people dignified during a challenging period. Guerrieri et al. (2020) suggests that even though policy stimulus has rightfully a reduced impact on growth, as continued social distancing and containment restricts economic activity, it is still the appropriate response. By providing ample assistance to vulnerable groups in the economy, the core aim of sustaining well-being in a humane manner can be achieved.

Figure 11: Crisis-Related Fiscal Stimuli in Major Economies (as of 6 May 2020)



Source: National authorities

Figure 12: Crisis-Related Fiscal Stimuli in Emerging Economies (as of 6 May 2020)



Source: National authorities, IMF, and BNM estimates

In response to the significant shortfall in economic activity, major economies have introduced large fiscal and monetary policy responses. Figure 11 summarises the magnitude of the fiscal measures, benchmarked against the 2008-09 GFC. Table 1 shows the monetary policy measures, both policy rate cuts and quantitative easing as at 6 May 2020. Within the first months of the pandemic, fiscal and monetary policy responses have exceeded levels in the GFC, especially in the US and Japan. Additionally, figure 12 shows the fiscal stimulus sizes of select emerging economies, benchmarked against the average of several major and regional advanced economies.

Table 1: Monetary Policy Responses of Selected Economies (as of 6 May 2020)

	Cut to Policy Rate (basis pts)		Quantitative Easing (LCY bil)	
	GFC	2020	GFC	2020
USA	425	150	1,750	unlimited
EUR	325	0	60	870
GBR	475	65	200	200
JPN	45	0	6,000	25,180
KOR	325	50	-	10,000
IND	525	75	-	2,000
ZAF	650	100	-	unspecified
CHL	775	125	-	6,600
MYS	150	100	-	-

From a financial sector perspective, maintaining ample access to liquidity is vital during crises, where deleveraging and risk aversion are elevated, to prevent self-fulfilling banking sector, debt and currency crises. Central banks and supervisory authorities have enabled banks to draw on prudential buffers to provide countercyclical response to the ongoing crisis. Securing financial sector stability not only limits the economic fallout, but also enables a sustained recovery by ensuring strong financial intermediation during and after the crisis.

Malaysia's policy responses have met these criteria

Policies have been centred on alleviating cash flow challenges faced by firms and households since the onset of the COVID-19 pandemic, fulfilling the directness criterion. In end-February, prior to the global escalation, direct transfers and credit guarantees were introduced for affected sectors, mainly the tourism-related industries. In March and April, widespread direct transfers, the loan moratorium and special credit lines, such as the BNM Special Relief Facility, recognised that directness in addressing liquidity needs of households and firms was critical.

Additionally, the swift operationalisation of measures was responsive to global and domestic economic developments, which had deteriorated significantly since mid-March. Notably, with extensions of the Movement Control Order (MCO), sizeable relief for SMEs and households were announced incrementally, commensurate with the degree of disruption in economic activity. From the monetary and financial policy fronts, the Overnight Policy Rate (OPR) and Statutory Reserve Requirements (SRR) were lowered, while allowing banks to draw on prudential buffers, in advance of the full escalation of COVID-19.

To limit the economic fallout without compromising public health goals, sizeable economic assistance was provided. Recognising the severity of the economic fallout if left insufficiently addressed, Malaysia's stimulus package ranks as one of the largest across emerging economies and the region, totalling 17% of GDP accounting for both direct and indirect measures. Broad-based monetary easing further bolstered financial stability, enabling a smooth recovery as the pandemic dissipates. Indeed, during a truly different crisis without historical precedence, the economic response has been equally unprecedented, in line with the urgency exemplified by these criteria.

Conclusion

This article contextualises the economic nature of the public health crisis caused by the COVID-19 pandemic. It is an unprecedented supply-side shock that prompted an amplified demand response. We analysed the global fiscal, monetary and financial policy responses. We noted that the policy priority during COVID-19 is to view the economy from a humanitarian standpoint – to sustain livelihoods and keeping liquidity needs met without compromising public health priorities. For this aim, the article identified three characteristics in which policy considerations should meet – directness, timeliness, and adequacy.

COVID-19 truly is different – an unprecedented health crisis, that has generated a paradigm-shifting economic crisis. As such, the economic front, reflective of the downturn, requires policy responses of a similarly unprecedented nature.

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