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Macroeconomic response to COVID-19

INTRODUCTION

This brief argues that government needs a large response to the COVID-19 crisis, with a package that approaches R1 trillion. A stimulus that large cannot be financed using the conventional mechanisms. Instead, government must use quantitative easing, both to offset the collapse in demand and to finance government expenditure. Interest rate cuts will help but the response to this crisis has to be driven by fiscal policy, because only fiscal policy can replace lost wages and revenue. An inadequate stimulus risks turning a recession into a depression.

DESIGN PRINCIPLES

What should a package aim to achieve? The first principle is that government must reduce the negative long-term impact of the crisis. A catastrophe this large will reduce the growth rate of the economy in the future, possibly for decades. A response that does not mitigate this damage sufficiently will lead to a worse negative impact, via the effect on balance sheets. If households lose wealth because they miss salaries or lose employment, they will have less to spend in the future. If businesses become insolvent, they will not exist to produce goods and services in the economic upswing. This will cast a shadow, known as hysteresis,[1] from the current downturn onto lower growth in future decades.

This is not a normal fiscal stimulus because it is an economic crisis that was created by government to deal with a health crisis. That imposes some responsibilities on government. It means that government should ensure that households and companies do not suffer losses for the cost of complying with the lockdown.

The second design principle is that:

- Households need to be made whole: they should not have to miss salaries or increase debt because of lockdown.
- Businesses must be made whole: they should not have more debt or become bankrupt because of complying with lockdown.

The Human Sciences Research Council (HSRC) conducted a survey of 19 330 South Africans in April 2020 and found that 24% have no money for food and between 45% and 63% said the lockdown had made it harder to pay bills and keep jobs. A Statistics South Africa survey of 707 businesses found that only half could survive more than three months without revenue and 65% said they anticipate the impact of COVID-19 will be worse than the global financial crisis. Willis Towers Watson surveyed 412 South African companies and found that a quarter will be retrenching workers and three-quarters will be cutting costs.[2] If the stimulus package does not stop these trends, the damage to the economy will be severe.

The third principle is that government needs to fill the output gap, which is the difference between what gross domestic product (GDP) would have been without a crisis and what it is now. Government needs to fill in that gap because private companies will be trying to reduce their expenditure as much as possible because their balance sheets have suffered. Households will also be spending as little as possible because they are unsure of how long they will be employed, or they may have already lost their jobs. Only government can spend in this environment. Government expenditure needs to act as the impetus, to get spending restarted in the economy, and jump start household and company spending.

HOW BIG SHOULD THE PACKAGE BE?

Government should have a package that offsets most of the output gap. It should not be the whole output gap because spending by government will induce some extra spending by the private sector. The exact amount of further private spending is measured by the fiscal multiplier.

[1] Hysteresis is when the effect of a shock persists, even after the shock itself has dissipated.
[2] https://fm.pressreader.com/financial-mail/20200430/textview

If the package is too small the economy could remain demand-constrained for years to come because only government can offset the output gap.

The size of the multiplier is a matter of much debate but, in the current crisis, it would range somewhere between and 1 and 1.5. In other words, a government stimulus of R100 billion should increase GDP by somewhere between R100 billion and R150 billion.

The size of the output gap is unknown. The current government plan is based on an output gap of about R300 billion. The data reported in recent days would suggest that this is an underestimate of the impact. For instance, US GDP declined by 5% in the first quarter of 2020, when the full impact of the COVID lockdown only occurred in two weeks of that quarter. Forecasts for the second quarter are for an annualised decline of 20% to 40%. The European Central Bank is forecasting that European Union GDP will decline by 9% in 2020, with a worst-case scenario drop of 15%.

In South Africa, early forecasts were for a 6% decline. More recent forecasts have been for a decline of 10% of GDP or more in 2020. There is still a lot of uncertainty around any GDP forecast because there is no clarity on how long the lockdown will last, or whether a second wave of the virus might lead to further lockdowns.[3] Business for South Africa forecast a decline of between 10.7% and 16.7% in 2020. Brian Kantor of Investec projects an output gap of 24% of GDP (R1.07 trillion) into the second quarter of 2021.[4]

It is difficult to know which of these forecasts are correct ahead of time but there is a trend emerging that the scale of the contraction is so large that the current government package is insufficient.[5] If the package is too small the economy could remain demand-constrained for years to come because only government can offset the output gap. If the output gap is as large as R1 trillion, then government's current package is only a third of what is required.

How should government proceed, given the uncertainty about how big the stimulus should be? The risks of getting the size of the package wrong are asymmetric, and this should inform the response.

There are much worse consequences from a package that is too small compared to a package that is too large. If the stimulus is too small it will result in large declines in household wealth and that of businesses. Put differently, a small package will lead to starvation, hundreds of thousands of job losses and thousands of company bankruptcies. These problems will persist during the crisis period and in the years afterwards when the companies that should be increasing production and hiring workers do not do so because they no longer exist.

If the package is too large, it would result in some inflation. This is a much smaller problem, and it is also a problem that South Africa, particularly the South African Reserve Bank (SARB), is adept at solving. All it would require is conventional monetary policy through interest rates and open market operations. Given the uncertainty about how large the package should be, it is wise to have a package that tends towards the too large rather than the too small.

FUNDING THE PACKAGE

The size of the package depends on government's ability to fund it. The current R500 billion package seems to include only a limited amount of new borrowing. The argument in this brief is that traditional methods of financing the relief package will result in a stimulus that is too small and thus South Africa needs to employ quantitative easing (QE).

Borrowing from the IMF

One of the key strengths of South Africa's debt portfolio over the last two decades has been that South Africa has borrowed little debt denominated in foreign currency, only 10% of the government's bond portfolio,[6] something few emerging markets could claim. This adds tremendous stability to the debt portfolio. If a country with a debt portfolio with a large share of foreign currency debt experiences a currency depreciation, debt sustainability is impaired and a vicious cycle can develop, when fears about debt sustainability lead to a weakening currency, which leads to further weakening. In the case of South Africa, a weaker currency leads to inflation and export growth, both of which improve fiscal sustainability. Government plans on borrowing US$5.2 billion from the World Bank, the International Monetary Fund (IMF) and the BRICS Bank. This would increase borrowing in dollars from US$7.2 billion to US$12.4 billion, a 72% increase. This would weaken South Africa's fiscal position, but it should be noted that South Africa's foreign exchange reserves were US$54 billion at the end of February 2020, so even this increase in dollar borrowing is still easily covered by forex reserves.

[3] The 1918 flu epidemic had three waves.
[4] http://www.zaeconomist.com/sa-economy/covid-19-and-the-economy-estimating-the-damage/
[5] Government has said their package is a R500 billion package. If R130 billion comes from reprioritisation and R70 billion from tax deferrals, the package is R300 billion at most.
[6] Foreign borrowing is R334 billion of total borrowing of R3.3 trillion.

Borrowing domestically

At the Budget in February, National Treasury planned to borrow R432 billion in 2020/21, which would have pushed total borrowing up to R3.3 trillion. Financing a stimulus package domestically would mean a doubling of an already very high level of borrowing. The other concern is that bond yields have increased dramatically since the beginning to the pandemic. The yield on a 10-year bond moved from 8.6% to over 12% in early March 2020. The yield has fallen back to 9.8%, but this would rise if South Africa announced a new stimulus based on domestic borrowing. Borrowing at the short end of the yield curve would be cheaper, especially if the South African Reserve Bank continues to cut the repo rate. But the larger point remains: government cannot borrow enough to finance a package large enough to counter the damage from the lockdown.

A COVID War Bond

World Wars I and II were financed to a large extent by special War Bonds, heavily promoted by war bond drives featuring celebrities and war heroes. The bonds differ from conventional bonds in that they might have a longer duration with their appeal to patriotism a source of demand. There is, however, little to recommend a War Bond aside from the marketing. Investors can already buy government bonds which are virtually the same product. The United States launched a Patriot Bond after the September 11 attacks but it did not attract much interest. A War Bond in South Africa would suffer from the same issues as normal domestic borrowing, namely that debt levels are elevated. South Africa already issues 30-year bonds, but investors have encouraged Treasury to issue more shorter term debt as demand for long term debt was waning, resulting in higher prices.

A wealth tax

Chatterjee, Gethin and Czajka (2020)[7] argue for the use of a wealth tax to finance the COVID stimulus. Given the vastly unequal distribution of wealth in South Africa – the richest 10% of the population own 86% of the wealth – a wealth tax is certainly an option that should be considered. The problem with any tax is that it will increase the size of the contraction as it withdraws demand from an already demand-constrained economy. The wealth tax has the virtue of only affecting a small number of taxpayers, so the impact on demand may not be severe. South Africa should probably have a wealth tax purely to reduce wealth inequality, but its introduction does not have to be tied to financing the crisis response.

Quantitative easing

Quantitative easing is the purchase of government bonds and other securities by the central bank, using money it has created for the purpose. There are two main mechanisms for QE. The United States is a proponent of the central bank buying bonds in the secondary market. The United Kingdom has used a different approach. HM Treasury has instructed the Bank of England to make deposits into the government account at the Bank of England. Both approaches are feasible in South Africa. The SARB could deposit funds into government's account, the Corporation for Public Deposits. Alternatively, the SARB could buy debt on the secondary market, though as Jannie Rossouw noted, law restricts the amount of debt the SARB can buy directly from government in the primary auction.[8] Central banks in the US, the European Union and Japan are also banned from buying securities directly from government, but they were nonetheless able to carry out QE.[9] Economically there is no difference between central banks buying directly from government or in the secondary market, the impact is the same.

QE is the cheapest method of financing a deficit as it is free. Moreover, QE has a positive impact on the rest of government's debt portfolio as it pushes bond yields down. This improves fiscal sustainability.

There are valid concerns about the use of QE, the primary one being that QE could result in higher inflation. Most examples of hyperinflation have involved monetisation of debt and recently QE has mostly been used to fight deflation.

The South African economy is suffering from two significant disinflationary shocks from the large impact of the lockdown on demand and the fall of the global oil price. QE would be a useful tool to counteract these shocks. It is difficult to see how hyperinflation occurs when there is such a large disinflationary shock.

Richard Koo examined the Japanese experience in his book *The Holy Grail of Macroeconomics*. Japan started QE in March 2001 and it had very little impact on inflation. Japan only exited deflation in 2006, after five years of QE. Koo argues that companies were still suffering the ill effects of the 1989 crash which reduced asset prices and impaired company balance sheets. Companies were profitable but over-indebted, so their main focus was on reducing debt. QE had little impact on inflation because companies were paying down debt, not taking new loans, so most of the QE funding stayed with the Bank of Japan as banks' excess reserves. South Africa will find itself in a similar position. The crisis will have a substantial

[7] https://www.moneyweb.co.za/news/economy/coronavirus-why-south-africa-needs-a-wealth-tax-now/
[8] https://www.businesslive.co.za/bd/opinion/2020-05-05-how-the-law-restricts-david-masondos-idea-of-reserve-bank-purchases/
[9] https://files.stlouisfed.org/files/htdocs/publications/es/10/ES1014.pdf

Table 1. Countries implementing quantitative easing

COUNTRY NAME	INFLATION RATE (2019)	POLICY RATE (CURRENT)
Australia	1.6	0.25
Brazil	3.7	3.0
Canada	1.9	0.25
Chile	2.3	0.5
Colombia	3.5	6.25
European Union	1.9	-0.5
Iceland	3.0	1.75
India	4.5	4.4
Israel	0.8	0.1
Japan	1.0	-0.1
New Zealand	1.6	1.0
Norway	2.2	0.25
Philippines	2.5	3.75
South Korea	0.4	0.75
Sweden	1.7	0
Thailand	0.7	0.75
Turkey	15.2	8.75
United Kingdom	1.8	0.1
United States	1.8	0-0.25

negative impact on companies' balance sheet because revenue has fallen. In the next few years, companies will be trying to pay down debt, much as Japanese companies were in the early 2000s. This should mean the inflationary impact of QE will be muted.

Many countries are not concerned about the inflationary impact of QE, as can be seen in Table 1. It is hard to think of a rationale for why QE would not be effective in South Africa, when it is being used in so many differing economies. In most cases, QE is being used because central banks have run out of policy space (i.e. policy interest rates are near zero), but there are examples of other economies such as India, Colombia and Iceland that are using QE despite having policy space and a positive inflation rate. Gali (2019) finds that QE is most effective when inflation rates are positive, resulting in a higher fiscal multiplier.[10]

The United States has bought US$2.3 trillion of assets since the beginning of March 2020. This is more than 10% of GDP, equivalent to the SARB purchasing R500 billion of assets in two months.

Even though economic conditions are so dire that inflation is unlikely to be a concern, it would be prudent to guard against any large increase in inflation. QE purchases need to be in discrete amounts and take place over a period of time to gauge the inflationary response. For instance, the SARB could purchase R20 billion-R30 billion of bonds per week. If inflationary pressures start rising then this amount could be reduced or stopped completely. In the worst-case scenario, purchases would be stopped and effectively reversed by the SARB selling bonds, which would reduce the amount of liquidity in the market. The SARB could also start paying interest on bank reserves. This would incentivise banks to hold excess reserves with the SARB rather than lending them out, reducing the growth in money supply. The Federal Reserve used a similar strategy during the global financial crisis to offset the inflationary impact of QE. This resulted in excess reserves held with the Fed increasing from just over US$2 billion in 2008 to nearly US$1.5 trillion in 2012.[11]

In conclusion, borrowing from the IMF is cheap, but it comes at the cost of increased foreign debt and, like any borrowing, it will erode fiscal sustainability. South Africa cannot borrow enough from the IMF to fund a big enough stimulus package. Similarly, borrowing domestically evades the problem of foreign borrowing, but there are limits on how much government can borrow in this environment and the closer Treasury gets to those limits, the more costly borrowing will become. The War Bond is almost exactly the same as normal domestic borrowing and

[10] https://www.nber.org/papers/w26249
[11] https://www.frbsf.org/education/publications/doctor-econ/2013/march/federal-reserve-interest-balances-reserves/

Table 2. Review of funding mechanisms

FUNDING MECHANISM	COST	IMPACT ON GROWTH	IMPACT ON FISCAL SUSTAINABILITY	IMPACT ON SIZE OF STIMULUS PACKAGE
Borrowing from the IMF	1%	Negative	Negative	Negative
Borrowing domestically	4%-10%	Negative	Negative	Negative
Covid War Bond	4%-10%	Negative	Negative	Negative
Wealth tax		Negative	Positive	Positive
Quantitative easing	0%	Positive	Positive	Positive

has the same drawbacks. A wealth tax could be useful, but a tax increase will work against the other elements of the stimulus package. A wealth tax will contribute to improved fiscal sustainability as it offers a new source of revenue. QE is the cheapest option, and it is the only option that allows a stimulus package big enough to counteract the fall in demand. QE will also improve fiscal sustainability by lowering long-term interest rates.

WHAT SHOULD BE IN A PACKAGE?

The current government package contains useful elements, but the size of the package is too small. A useful first step would be to upscale the size of the current package. This would include:

- Larger social grants: the current increase does not even meet the definition of food poverty, defined as R561 a month per person, the minimum needed to avoid malnutrition. Support to the poor could be upscaled dramatically. The introduction of a grant for those who are currently not receiving any other grant is useful, but the scale and duration of this grant need to be increased. This should be government's first priority.
- The R200 billion loan support scheme is very beneficial. The German scheme is similar but not limited in size as the German government has committed that any company that needs a loan will get it. Secondly, the grant component of the package should be larger. Companies have complied with government's request to shut down and government can assist companies by injecting capital, meaning that some portion of the loan effectively becomes a grant.
- Government should aim to make sure that no worker misses a salary because of the lockdown.
- Support packages to small businesses and the tourism industry have already been exhausted. These need to be much larger.

Support should be generous and available to all companies that existed in 2019. Limiting support to South African-owned companies discriminates against South Africans employed by foreign-owned companies and is counterproductive because the bankruptcy of any company that was healthy before the lockdown will result in a less productive economy.

Some other elements need to be considered but these are of secondary importance compared to the points above:

- Banks will be affected by companies and individuals being unable to afford loan repayments. Government may need to inject capital into the banks to ensure that banks remain stable and that they can absorb the losses without liquidating companies.
- State-owned enterprises will have incurred losses during the lockdown, and they will require bailouts.

CONCLUSION

In conclusion, this crisis is unprecedented and government's response also needs to break away from conventional thinking. Government runs the risk of having an inadequate response to the crisis, which could be disastrous, turning a deep recession into a depression. Government's stimulus package should be commended but it needs to be much bigger and the best way to do that is to use quantitative easing. As Willem Buiter has said in the case of Brazil: "The situation is dire. It requires the central bank to use its full expansionary toolkit to support the fiscal stimulus that the government is providing. They (central bankers) should just let go and buy both short- and long-term bonds ... and be ready to cover the government deficit this year."[12] Government cannot stand by and watch hundreds of thousands of jobs disappear and thousands of companies go bankrupt.

[12] https://www.reuters.com/article/us-brazil-economy-qe-analysis/brazil-set-to-start-qe-cautiously-but-may-need-to-bring-out-bazooka-idUSKBN2221G1