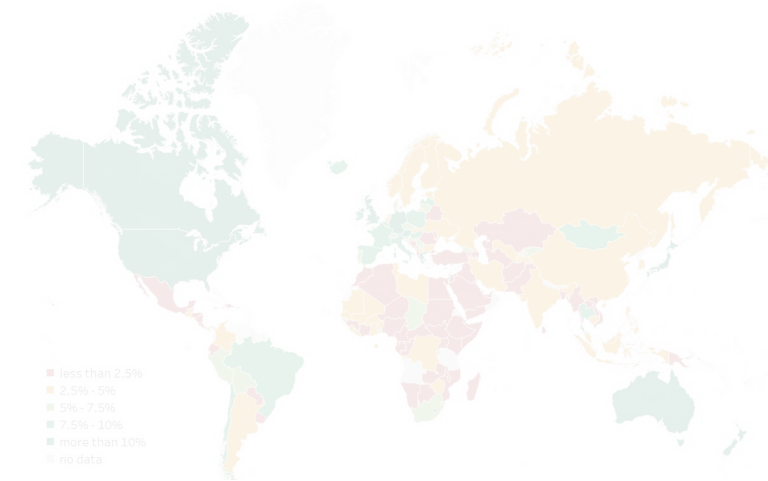


# The COVID-19 Recession and Recovery: What's Next?



**Karen Dynan**

Harvard Kennedy School

HKS Executive Education Faculty Webcast  
May 20, 2021

# The COVID-19 pandemic led to the second devastating economic crisis of the 21st century



The [International Labour Organization](#) estimates that working hours fell by the equivalent of 255 million full-time jobs in 2020—**four times greater than during the financial crisis of 2009**

# This talk will focus on the COVID-19 economic crisis, as well as the policies used to mitigate it

Key features of the COVID-19 recession

Insights shaping the economic policy response

Economic policy steps taken

What lies ahead

# Outline

**Key features of the COVID-19 recession**

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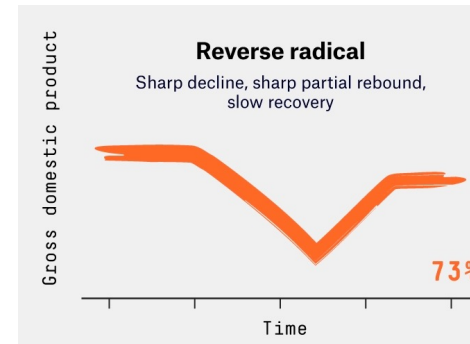
What lies ahead

# There have been similarities across countries

**Deep plunge** in economic activity as countries shut down in spring 2020

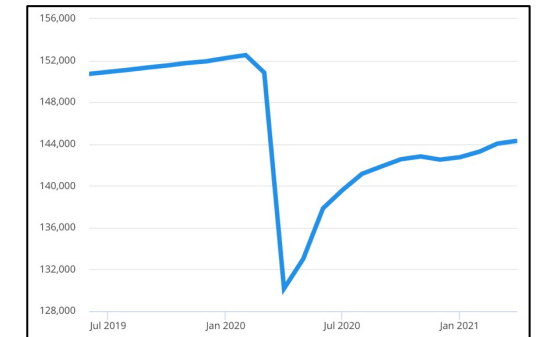
**Sharp partial economy recovery** as businesses that could safely reopen did so

**Sub-normal pace** of economic activity thereafter (weakness concentrated in high-contact services industries)



Screenshot from [fivethirtyeight.com](https://www.fivethirtyeight.com)

US Employment (thousands)



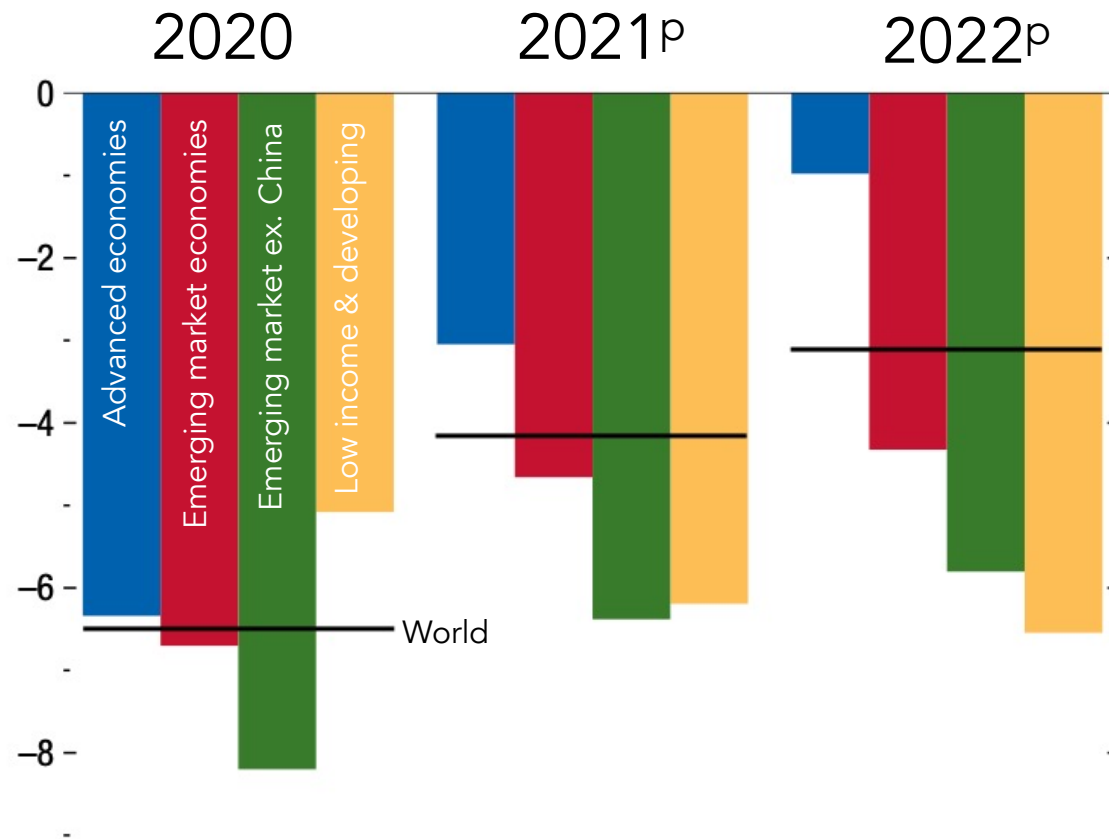
Screenshot from [FRED](https://fred.stlouisfed.org/)

*Robust recovery only after a large share of population vaccinated*

# There have also been important differences across countries

Revisions to IMF  
Forecasts of the  
Level of Per Capita  
GDP\*

\*April 2021 forecast relative to  
January 2020 forecast



<sup>p</sup> Projected

Screenshot from the [IMF](#)

# The economic fallout from the pandemic has (and will) differ across countries for various reasons

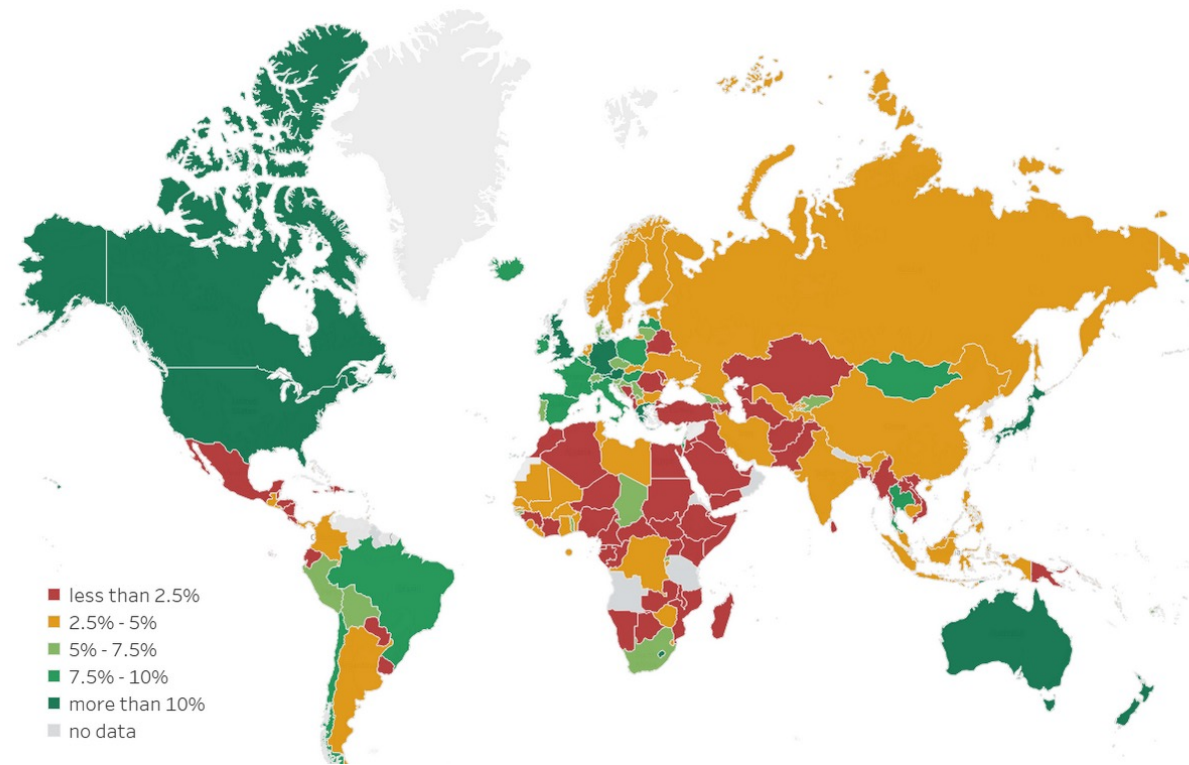
**Virus prevalence and vaccine rates**—recent estimates suggest that only about 50 percent of the world's population will be vaccinated by the end of 2021

**Idiosyncratic factors**—importance of virus-sensitive sectors (tourism), importance of sectors that suffered because of the global collapse in activity (oil, commodities), importance of SMEs to economic activity, underlying structural weaknesses

**A country's fiscal response**—enacted support varies from 20+ percent of GDP in the United States to very little in the lowest income countries

# Enacted Fiscal Policy Response

Percent of 2020 GDP

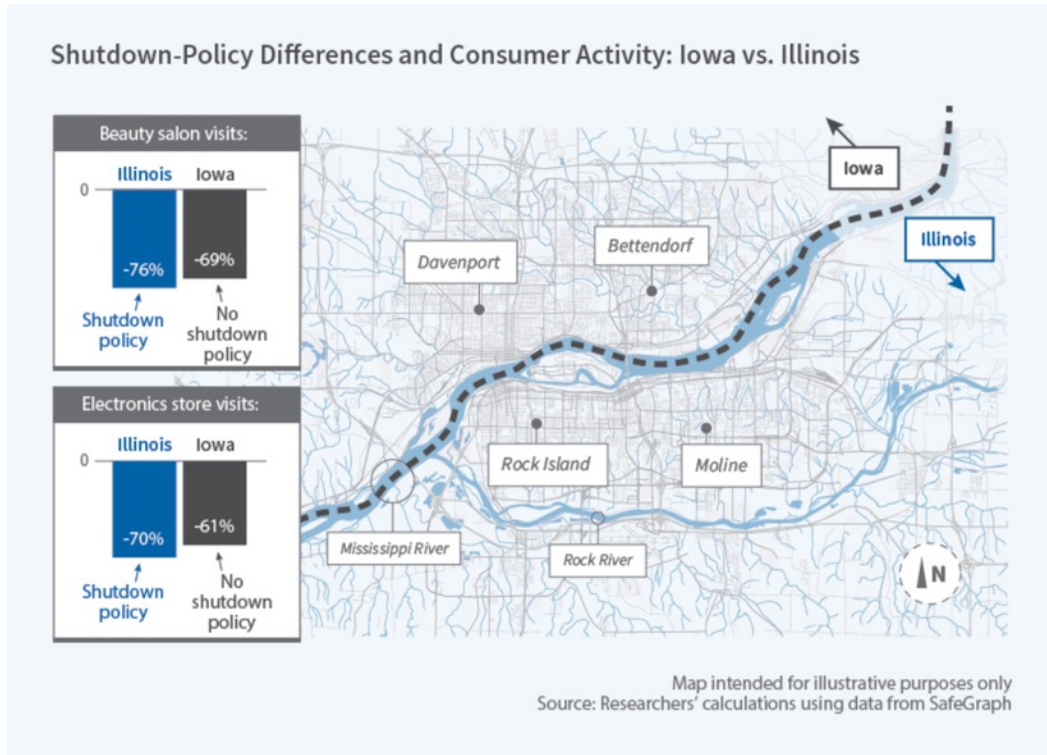


Countries spent different amounts because of different needs and, importantly, different ability to borrow to finance spending

Screenshot from [IMF](#)



# The degree to which formal restrictions contributed to country or regional disparities is unclear



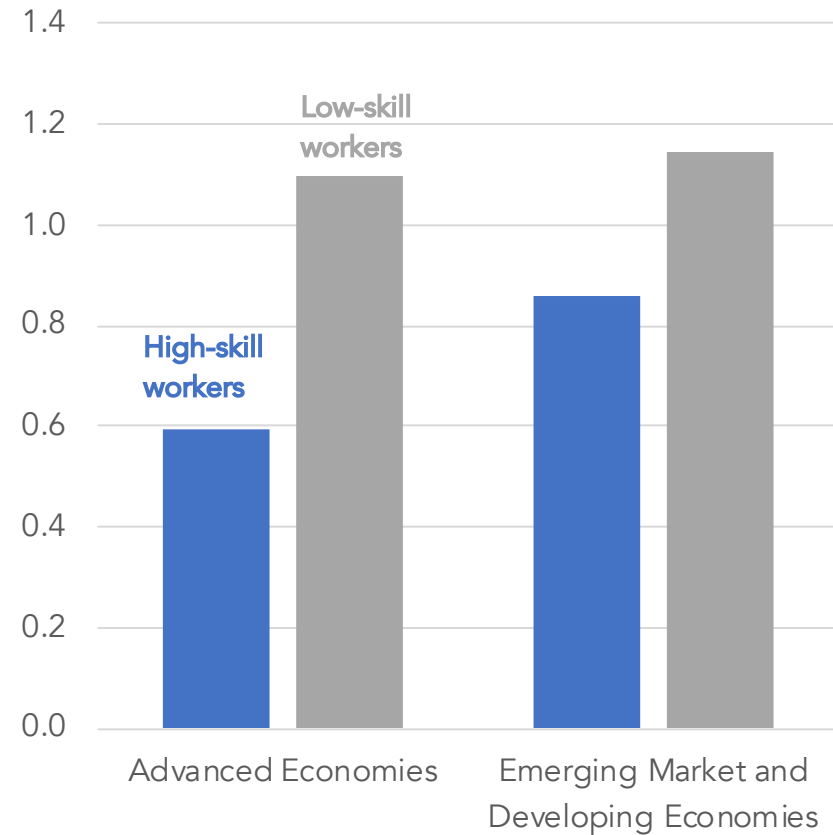
Some studies, like [Goolsbee and Syverson \(2020\)](#), have compared neighboring areas with different lockdown policies and found very similar declines in economic activity

Screenshot from [NBER \(2020\)](#)

# The economic fallout has also varied by population

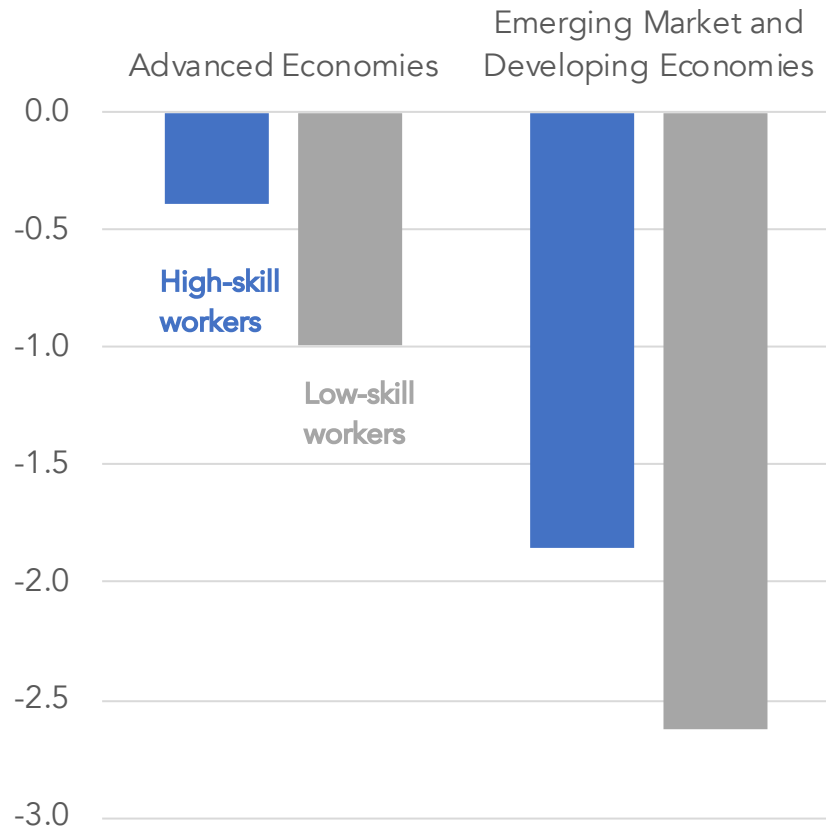
Change in Unemployment Rate, 2020

Percentage points



Change in Labor Force Participation Rate, 2020

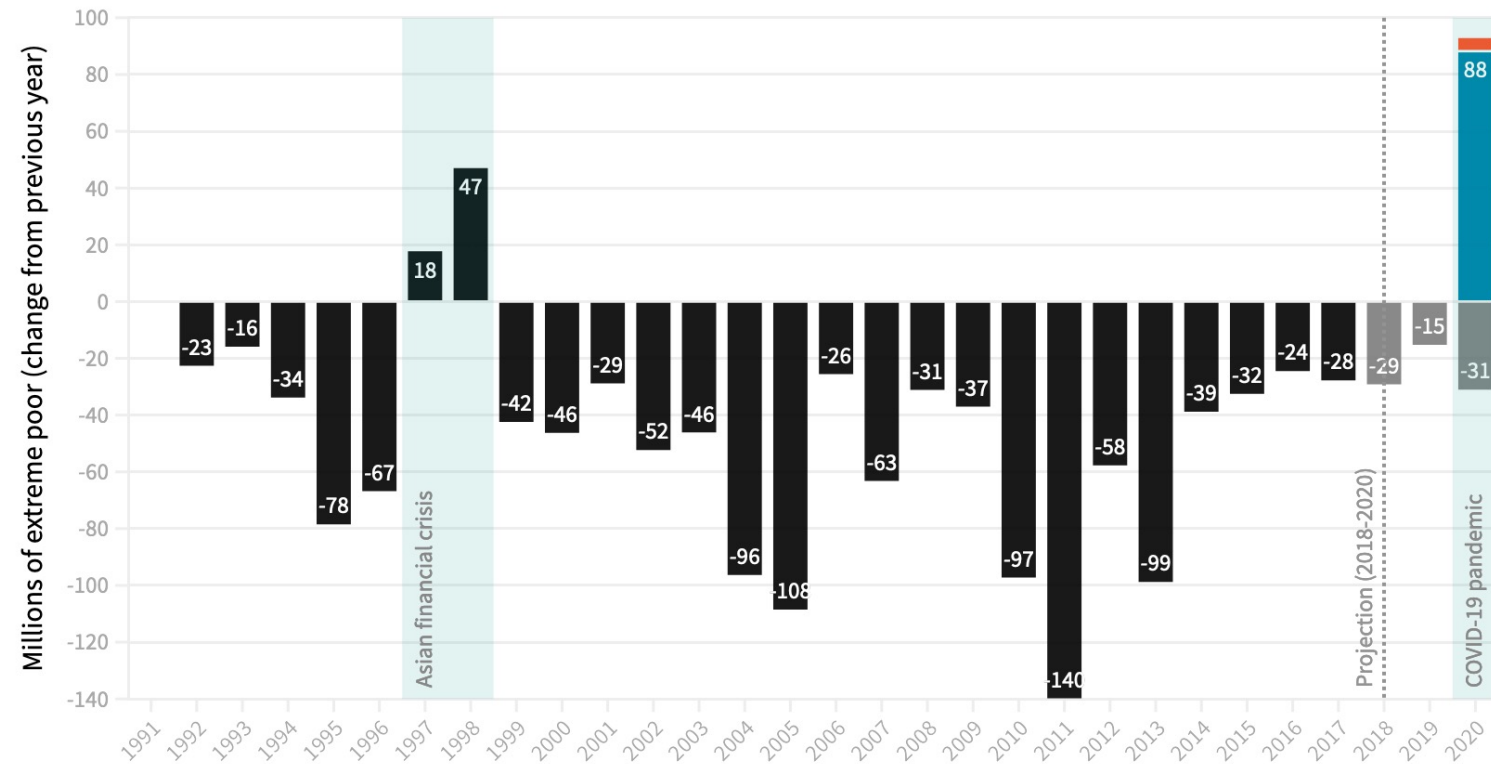
Percentage points



Data from IMF [World Economic Outlook](#) (2021)

# The fiscal constraints on poorer countries and the greater impact on low-skill workers has meant a big setback in progress toward reducing extreme poverty

Annual Change in the Number of Extreme Poor Millions



Screenshot from [World Bank](#) (2021)

# Outline

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# In the years leading up to the pandemic, macroeconomic thinking started to shift ...

New “facts” or ones brought into sharper focus because of new research or recent experience

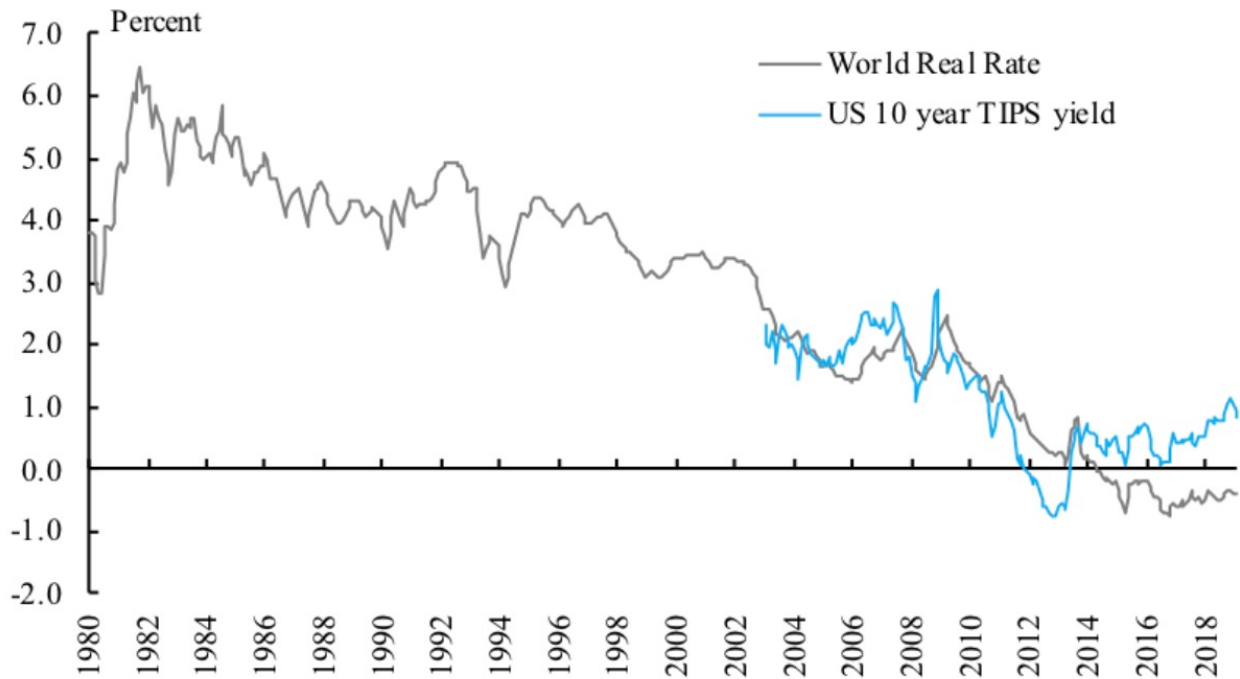
New thinking about the underlying economics

Reevaluation of concerns and risks

*I will highlight 4 insights but an important caveat for you is that there are different degrees of consensus around these items—they go from ideas that are being talked about by some prominent mainstream economists to facts that are fairly widely accepted*

# Insight 1: Real interest rates had fallen markedly since the early 1990s

Real Interest Rates on Government Bonds in Advanced Economies



Screenshot from [Rachel and Summers](#) (2019); rates implied by inflation-linked government securities

Perhaps it looks obvious, but economists did not really pay attention until interest rates failed to rise when the economy strengthened after the Great Recession

[Some details for those interested: the decline has stemmed from [trends related to the supply and demand for savings](#) (demographics, technology, income inequality, ...) that are not likely to reverse any time soon]

# Implications of lower interest rates

Monetary policy, which had been many governments' main tool for fighting recessions, was no longer as useful because the "jumping off point" for cutting interest rates when the economy weakens was much lower (the "zero lower bound" problem)

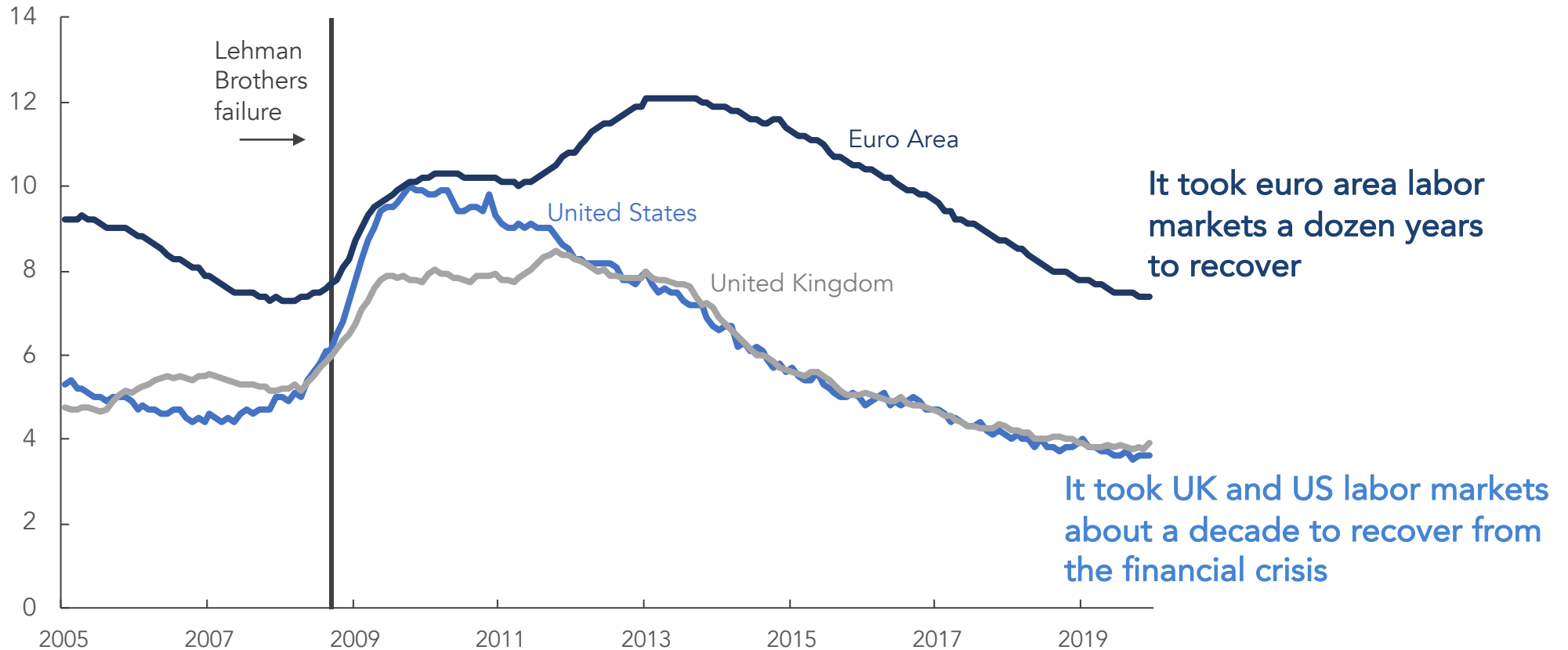
Fiscal policy was less costly as a tool for fighting recessions



# Insight 2: It can take a LONG time to recover from a bad recession

Unemployment Rates, 2005-2019

Percent



Data from FRED ([here](#), [here](#), and [here](#))



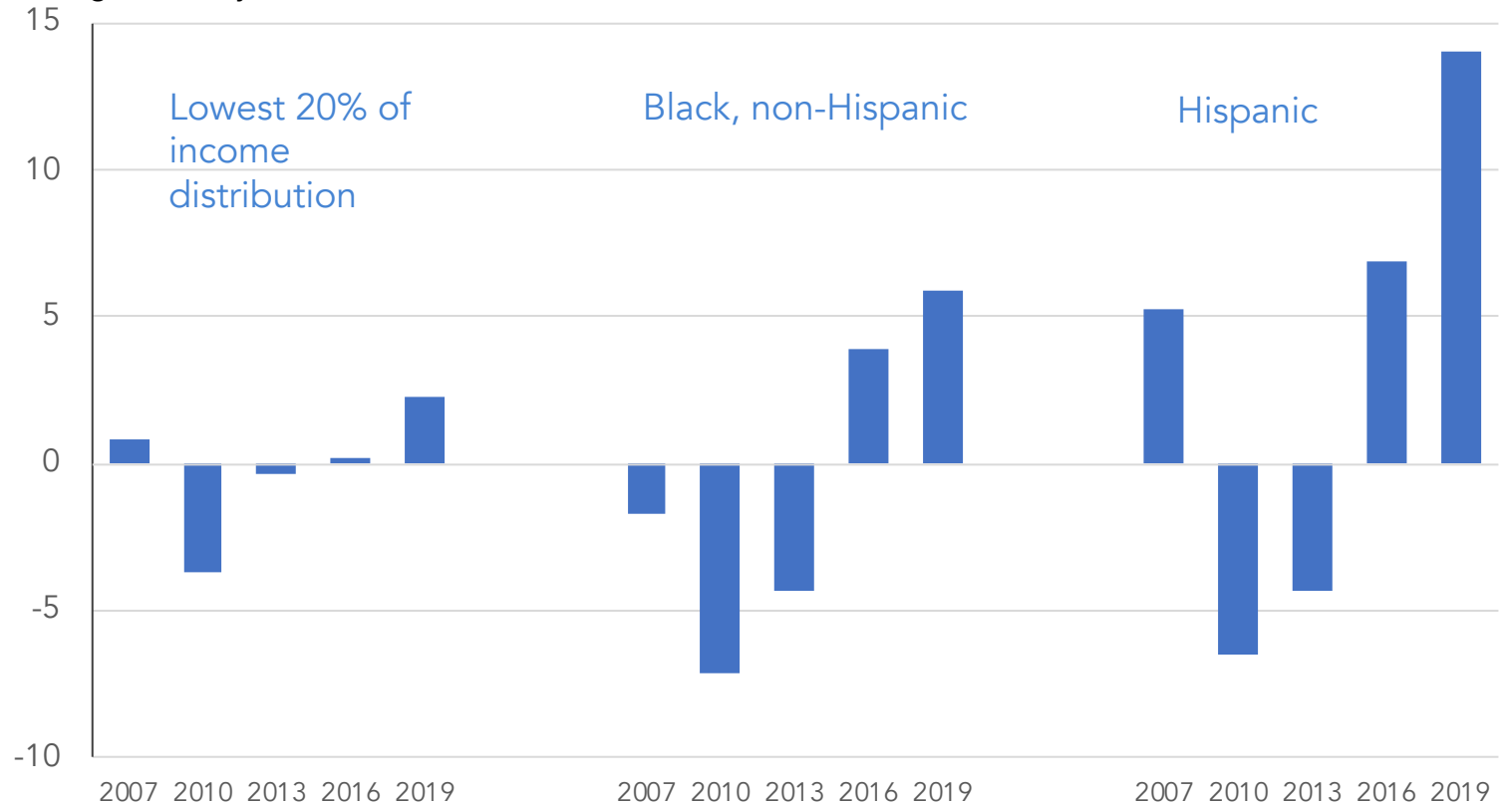
# Insight 3: “High pressure” (robust) economies have important distributional benefits

Distributional issues have long been viewed as microeconomist territory

But the late 2010s highlighted the role for macroeconomic conditions, with the robust US labor market leading to **measurably stronger family finances for traditionally low-wealth groups**

Median Net Worth for US Families

Change from 3 years earlier, thousands of 2019 dollars

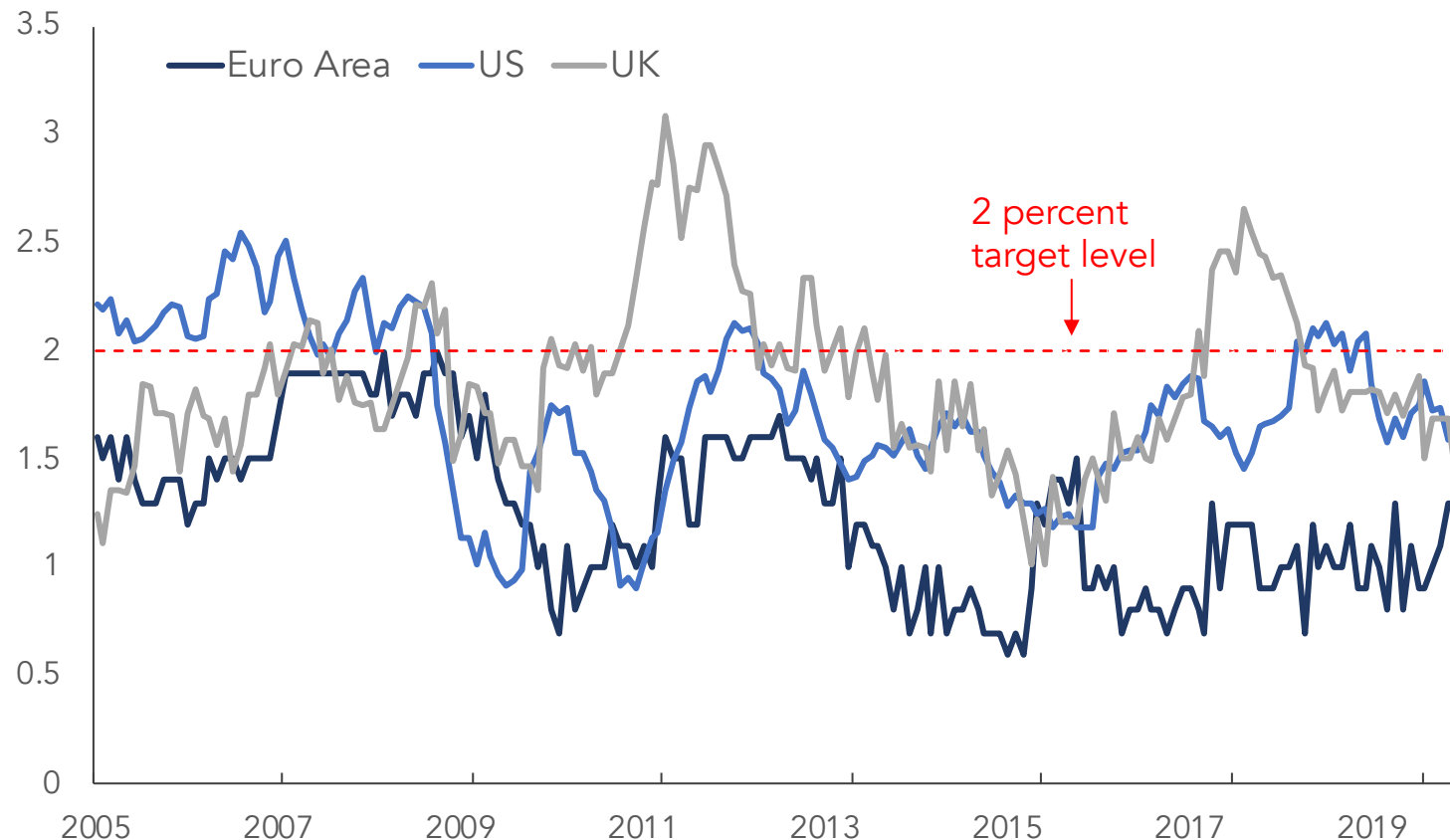


Data from [Survey of Consumer Finances](#)

# Insight 4: “High pressure” economies don’t have to have high inflation

## Core Consumer Prices, 2005-2019

Percent change from year earlier



Even as labor markets heated up in some economies in the late 2010s, inflation was mostly below central banks’ targets

That’s because inflation depends not only “slack” in the economy **but also importantly on inflation expectations**

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# Monetary policy may have been limited by low interest rates, but central banks played an important role

Do you remember the financial crisis of 2020?

(Hint: March 2020 saw severe financial market dysfunction around the world)

**Bloomberg**



Deals

## Dash for Cash On as Corporate Titans Draw Down Credit Lines

By [Sridhar Natarajan](#) and [Yalman Onaran](#)  
March 11, 2020, 9:47 PM EDT Updated on March 12, 2020, 9:24 AM EDT

- ▶ Blackstone, Carlyle advise portfolio companies to tap loans
- ▶ Wave of borrowers include businesses hit by virus, oil slump

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# Monetary policy may have been limited by low interest rates, but central banks played an important role

Most people don't remember the financial crisis of 2020 because central banks stepped in swiftly to provide **trillions of dollars of liquidity to markets** (including sending high-demand currencies to other countries through "[swap lines](#)")



Central banks also established **various lending programs** to make sure that credit continued to flow to key sectors of the economy

**In the absence of such steps, we might have seen a much more severe financial crisis that greatly amplified the pandemic economic crisis**

# Fiscal support has been more aggressive than after the financial crisis and taken different forms

Measures to **fight the virus** and **support the health care system**—e.g., money for PPE, testing, vaccine procurement, hospitals

Measures to **protect households**—e.g., “COVID checks,” payments to businesses to retain employees, household tax credits, expanded unemployment benefits, enhancements to other safety net programs, in-kind support

Measures to keep **businesses from failing**—e.g., tax breaks, grants, loan guarantees, subsidized loans

# What should the goals of fiscal policy in a pandemic?

1. **Fight the virus**—money to support the health care system, PPE, vaccine development and distribution
2. **Relieve hardship**—avoid huge cuts in consumption in the face of enormous job loss

# Did fiscal policy relieve hardship?

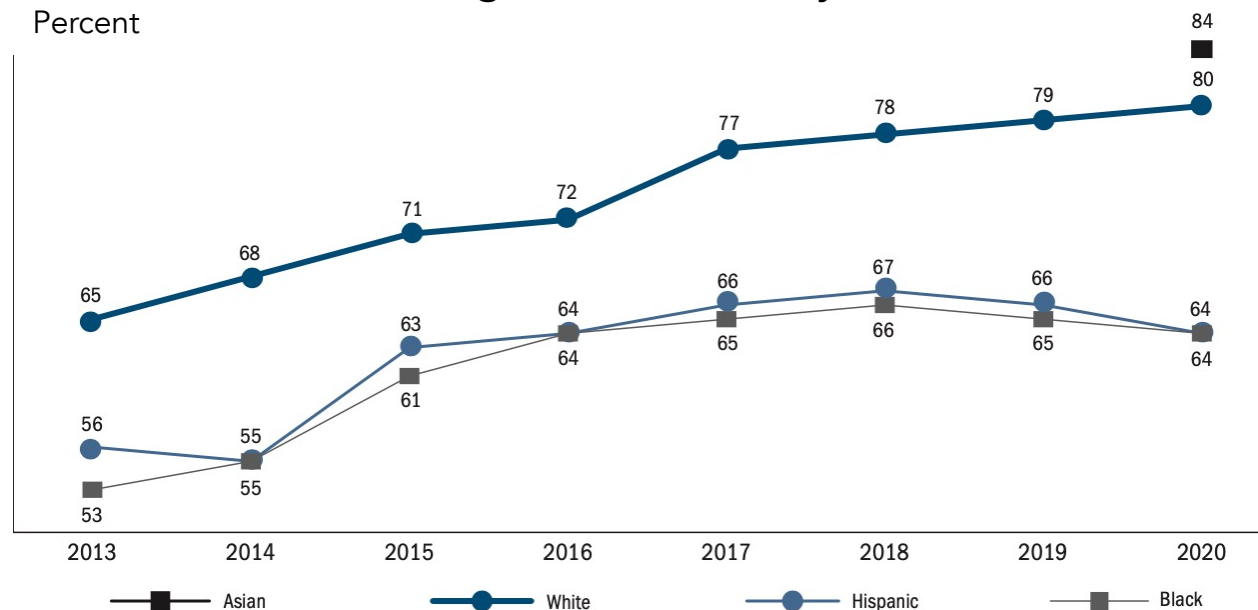
Hardship has occurred, and it will be years before we understand the full extent of it in countries around the world

However, it would appear that fiscal measures blunted the effects of the massive job and earnings losses, albeit for some groups more than others

[recent US evidence at right]

US Households Doing "At Least Okay"

Percent



[Screenshot from Federal Reserve](#) (2021)



# What should the goals of fiscal policy be under these circumstances?

1. **Fight the virus**—money to support the health care system, PPE, vaccine development and distribution
2. **Relieve hardship**—avoid huge cuts in consumption in the face of enormous job loss
3. **Avoid scarring**—minimize damage to economic structures that will weigh on the recovery or cause a permanently lower level of output over the longer run

# Potential channels of economic scarring

Households	Businesses	Governments	Financial System
<p>Erosion of skills, loss of labor market attachment due to prolonged unemployment</p> <p>Foregone skill development because of closed schools</p> <p>Household debt overhang because of limited income</p>	<p>Loss of organizational capital when businesses fail</p> <p>Business debt overhang because of limited revenues</p>	<p>Sub-national budget strains because of higher spending + reduced tax revenues + balanced budget requirements</p> <p>Unsustainable debt positions for countries hit especially hard</p>	<p>Weakened or failed financial institutions leading to credit crunch</p>

# What should the goals of fiscal policy be under these circumstances?

1. **Fight the virus**—money to support the health care system, PPE, vaccine development and distribution
2. **Relieve hardship**—avoid huge cuts in consumption in the face of enormous job loss
3. **Avoid scarring**—minimize damage to economic structures that will weigh on the recovery or cause a permanently lower level of output over the longer run
4. **Fiscal stimulus**—the traditional goal; restore aggregate demand to its pre-pandemic levels



*Do we really want this while supply is pandemic-constrained? I will return to this question in a minute*

# Outline

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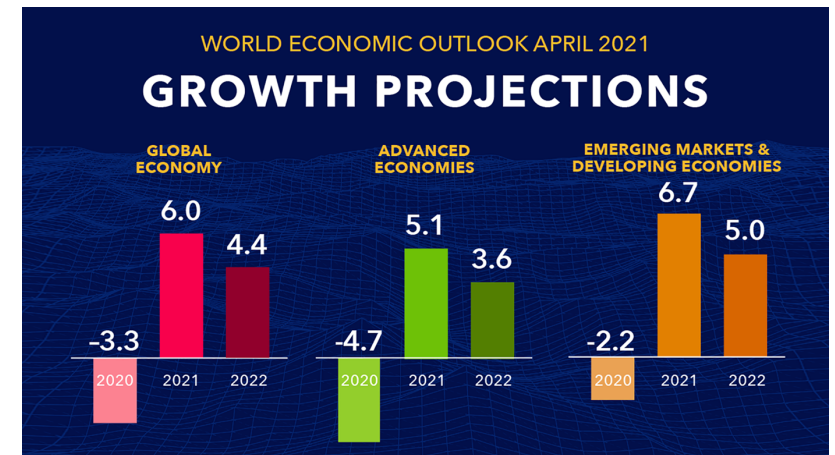
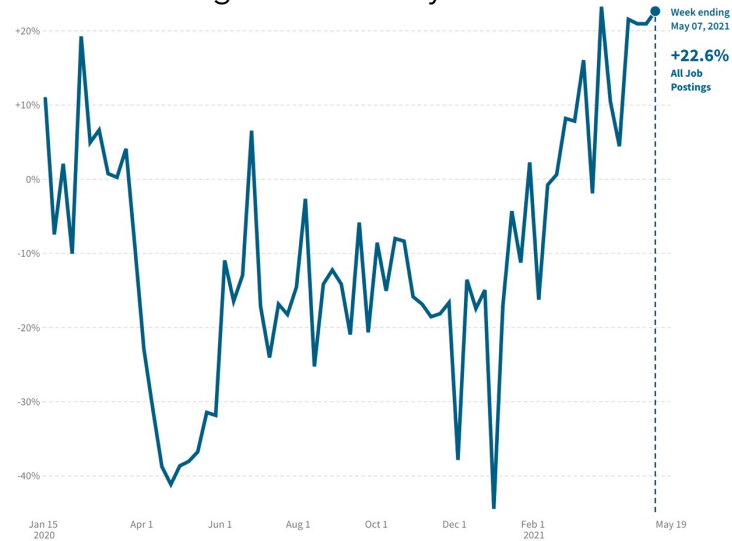
Economic policy steps taken

**What lies ahead**

The recovery appears to be shifting into high gear for countries where the population is being rapidly vaccinated—with the much of the rest of the world expected to follow

## US Job Postings

Percent change from January 2020



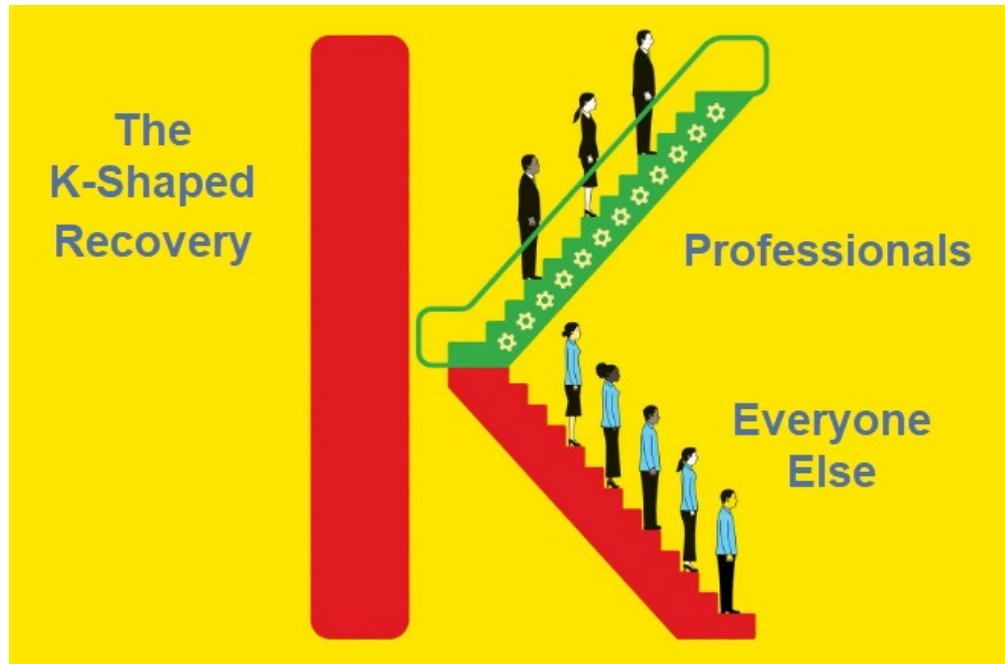
# But there are challenges and risks ahead

The potential for an ongoing K-shaped recovery

The possibility of a rise in inflation to undesirable levels

Government debt sustainability issues in emerging market economies and low-income developing countries

# The potential for an ongoing K-shaped recovery



Screenshot from thestreet.com

Prospects are looking brighter for lower-income workers, but **how long will it take to put tens of millions of them back in jobs**—particularly as surviving businesses emerge leaner and with more automation?

Countries may see higher income inequality in the post-pandemic world

# To avoid an ongoing K-shaped recovery

A policy priority should be **worker reallocation measures**—“active labor market policies” such as training and assistance with job search

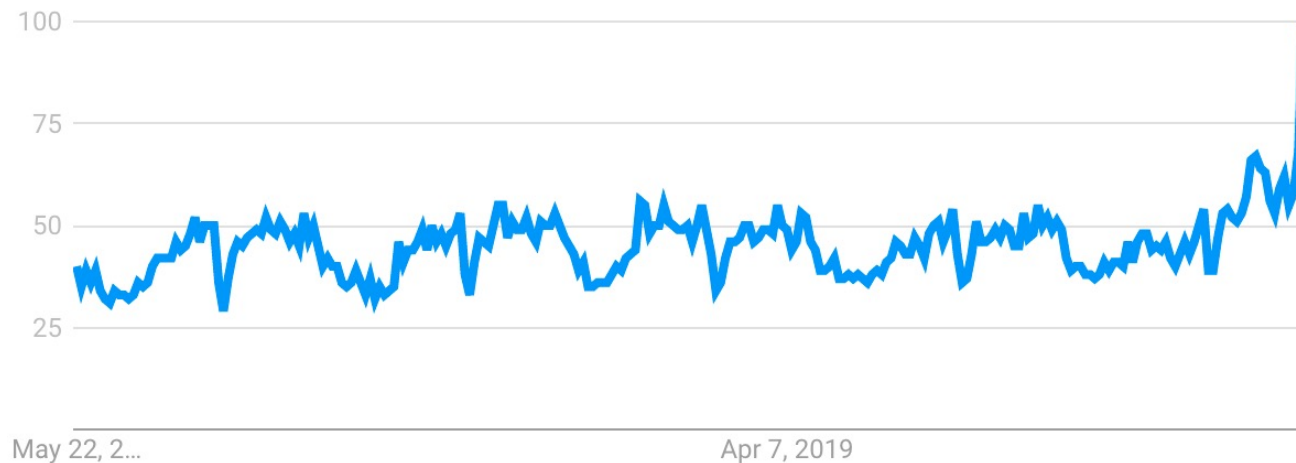
(Countries still focused on worker retention policies need to pivot)

For the longer-term, countries need to **strengthen social safety nets if they are weak** and countries with high inequality need to make **more “investments” in poor children and their families**



# The possibility of a rise in inflation to undesirable levels

Google Searches for "Inflation"



Everyone is suddenly talking about this

Screenshot from [Google Trends](https://trends.google.com/trends/)

# Recall—the determinants of inflation are “slack” in the economy and inflation expectations

It’s not hard to understand why people think **slack is diminishing rapidly in countries like the United States**—there is huge pent-up demand, most people have the money to finance it, and there are limits to how quickly economies can open up

What about **inflation expectations**? They have risen in recent weeks, but **the level is not particularly high**

US Long-term Inflation Expectations  
Percent



# What to think about inflation

The odds of a 1970s-style upward spiral in inflation seem low under these circumstances

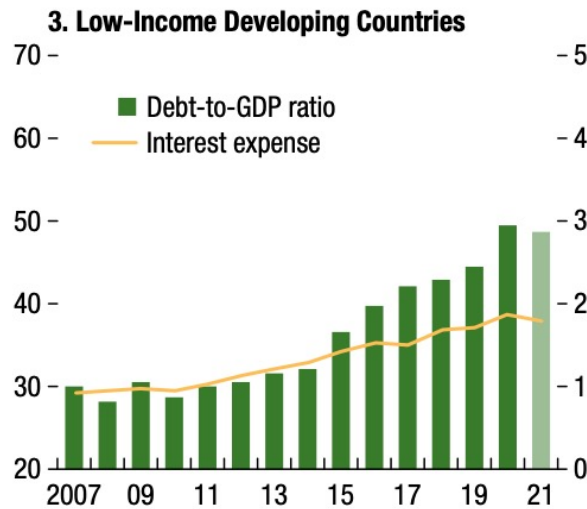
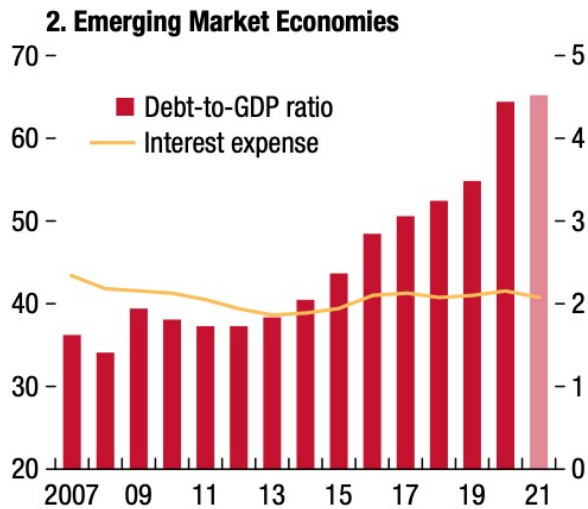
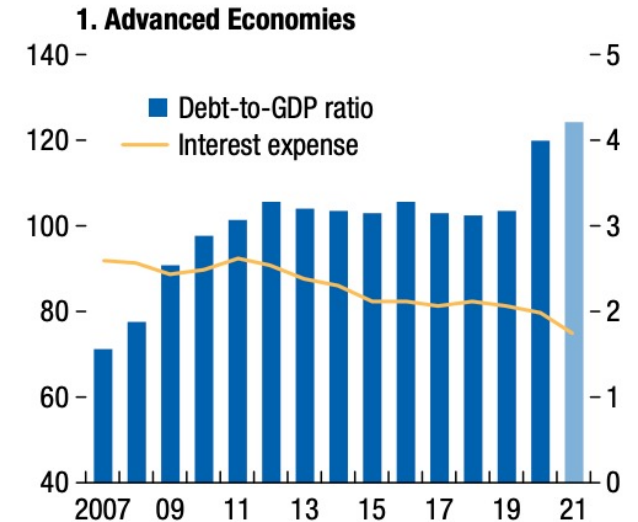
But we may see **central banks having to tighten sooner than expected** if inflation rises significantly above their targets on a sustained basis

The hope would be for a “**soft landing**”—markets aren’t surprised, economic growth subsides, and inflation retreats

The real risk is that of a “**hard landing**” with the tightening leading to various types of fallout in global financial markets and (potentially) recession

# Government debt sustainability

The expectation that interest rates will remain low by historical standards is why people are not so concerned about the pandemic-driven rise in debt in richer countries—interest expenses have been flat despite a jump in debt



Interest expenses have also remained flat in lower-income countries (so far, so good)

BUT ...

# Lower-income countries cannot take it for granted that their rates will remain low

This is **why they are fiscally constrained** in their efforts to mitigate the economic fallout from the pandemic—if they borrowed more, investors would want more compensation because of fears they may be unable to service so much debt

Even without more borrowing, investors could become nervous about countries' ability to pay, raising the rates they pay and **potentially leading to debt crises** that would be devastating for them and have spillovers to the global financial system

For both humanitarian reasons and to head off potential debt crises, richer countries and international institutions (the IMF, the G20, ...) need to be thinking about what sorts of **liquidity measures, grants, and restructurings** are needed

**Thank you!**