

The Future of the Global Economy
Public Talk at Fulbright University Vietnam
(via video conferencing)

by
Karen Dynan
May 6, 2020

I want to start by thanking you for inviting me, and thanks especially to Dean Tu Anh for hosting me. Visiting Fulbright University was a highlight of the trip that Harvard Kennedy School colleagues and I took to Vietnam in January. We were so impressed by the Fulbright students, faculty, and leadership team that we met. And, as we continued on our tour of Vietnam after our Fulbright meetings, we heard nothing but the highest praise for what Fulbright has accomplished in its short history. I look forward to hearing about Fulbright's successes in years to come, and I hope that I will have future opportunities to engage with Fulbright over those years.

January seems like a **very** long time ago. It is just incredible how the world has changed since then, and if someone had predicted in January that I would be speaking to the Fulbright community about the economic fallout from a global pandemic just a few months later, I would not have believed them.

But, here I am. What I plan to do today is to share what I think are the lessons so far about how the virus is affecting the economy and what we can do to limit the damage to economies.

I want make 8 points.

Point #1 is probably fairly obvious—shutdowns and voluntary social distancing measures are effective for containing the spread of the virus but they are causing grave challenges for the economies of the world.

You have probably all seen this data but, in country after country, shutdowns have been successful in “bending the curve” in terms of growth in virus-related deaths. That is unquestionably good news for society.

At the same time, these shutdowns are terrible news for the economy because they are causing a plunge in economic activity. Last week in the United States, for example, we received data about consumer spending in the first quarter. Consumer spending rose in January and February and then fell sharply in March. The decline in consumer spending seen during the Great Recession pales in comparison to the decline we experienced in March.

Looking at the individual categories of consumer spending, it is clear that the biggest declines were in spending categories that involved getting close to other people. For example, purchases of vehicles, spending on transportation (which would include air travel and taxi cabs), and outlays at restaurants and hotels were all down 25 percent or more. Interestingly, spending on health care was also way down—even though we know that many more people were seeing doctors because of COVID-19, people were avoiding other, more optional, types of health care.

And that was just the data for March when our economy began to shut down—the data for April will be much worse.

Point #2 is that from the point of view of forecasting the economy, the relatively easy question is how large a hole we are falling into; the much harder question is how quickly we'll be able to climb out of that hole.

Economists think that economic activity in the affected high-income countries is running 10 to 30 percent below normal. In the United States, for example, most forecasters think we will see a very sharp decline in real GDP in the second quarter, which builds on an already significant decline at the end of the first quarter. We will also see the unemployment rate skyrocket, perhaps to 20 percent or more, which would be the highest unemployment rate since the Great Depression in the 1930s.

But where we go from here is subject to huge uncertainty. The fact is that forecasters have no comparable episodes in recent history to inform us about what the recovery is going to look like.

One thing I *can* tell you is by far the most important factor shaping the recovery is the speed at which we can make it safe to open up the economy again. In most downturns, the recovery is determined by underlying economic conditions and policies put in place. But, in this case, the speed and magnitude of the recovery will be a function of the properties of the virus, which we still don't understand well, and also a function of how we build the capacity to do testing, tracking, and other means of limiting the spread and the deadliness of the virus. Different countries have made different degrees of progress in this regard, and I have to say that I have been disappointed by the progress in the United States. I am thus a fair bit more pessimistic about the U.S. outlook than I was a month ago.

Point #3 is that, beyond containing the virus, the next most important factor that will determine the shape of the recovery is the degree to which the economy suffers structural damage.

As a general matter, the longest recessions are the ones where the economy goes in with some sort of structural imbalance that can only be corrected with time. What made the U.S. recession that followed the financial crisis so bad was that we had overbuilt housing, households had taken on too much debt, and financial institutions had great exposure to problems in the housing market. It took a long time for all of these structural problems to unwind, which is why it took more than 5 years for the unemployment rate to return to anything even close to its normal range.

In the case of the current recession, most economies in the world did not go into the crisis with big structural imbalances—most economies were fairly strong on the whole. Some structural problems have been created—for example, we all know that it will be a long time before people will be going to movie theaters or crowding into restaurants like they did before the COVID crisis.

That said, I think these types of activities are not that large and will be replaced with other activities. The types of structural problem I am more worried about is damage to household and

business finances or to the financial system broadly. It is important to understand that this kind of structural damage can be limited by good policy and that is what I will turn to next.

Point #4 is that nimble and aggressive action by central banks has spared the world of a financial crisis that would have made the downturn much worse.

One of the important things that central banks do is act as “lenders of last resort.” In March, when it was clear that the economy was heading into big trouble, there was a rush to build up liquid funds. Companies wanted liquidity because they knew their revenues were going to decline but they would have ongoing expenses like payrolls and rent. Banks wanted liquidity so they could lend to companies. As a result, lots of companies and financial institutions were selling assets like stocks and bonds and that was creating big declines in asset prices and a lot of panic and volatility. In some ways, it was like the turmoil that precipitated the financial crisis and ultimately produced a big credit crunch that had devastating effects on the economy.

The important thing is that central banks stepped in at that point and said “you don’t need to sell all your assets; we are here to lend you money against your securities or buy your securities when you need cash.” And central banks have done so in a big way and stand ready to do much more if needed. The Federal Reserve, the U.S. central bank, for example, has announced nine different lending facilities that will provide businesses and different types of financial institutions with access to liquid funds; it has also announced it will purchase whatever amount of U.S. Treasury securities and government-backed mortgage securities is needed to stabilize financial markets. Of course, these actions are expected to result in a huge increase in the U.S. central bank’s balance. There are some risks associated with these activities that I can talk about later in this session, but the risks are small relative to the benefit of avoiding a financial crisis.

Point #5 is that fiscal policy has an enormous role to play when it comes to avoiding structural damage to the economy that would slow the recovery.

Often during a recession, governments cut taxes or raise their spending to increase demand and, in turn, raise production and employment.

In the COVID crisis, governments need to be focused more on providing the sort of “disaster relief” that they would supply in the face of a devastating earthquake or typhoon than on traditional fiscal stimulus. In particular, they need to target the aid to the people and businesses that have been hurt hard. In the United States, for example, we have increased the benefits we pay to people who have lost their jobs, and we have created a program that offers grants to small businesses that will provide them with the money they need to pay their employees and their rent for the next few months.

The whole idea is to prevent widescale bankruptcies among households and businesses, because that would be the type of structural damage that could really hold back economic recovery. If we can keep most businesses from failing and most households from being wiped out financially, the economy will be in a much better position to quickly return to normal once the issue of containing the virus is behind us.

Point #6 is that rich countries are in a much better position to fund their virus- and recession-fighting efforts than many lower-income countries.

The fiscal needs associated with the COVID crisis are huge. Countries will suffer large losses of tax revenues, they will need to spend much more on health care, and most need massive amounts of funding for the types of disaster relief I just discussed.

As a result, government borrowing will soar. In the United States, for example, the ratio of our federal debt to GDP is expected to exceed 100 percent by the end of September—a level we've only seen once before in our history, during World War II. But, this borrowing is not an immediate problem for the United States as the government is able to borrow at very low rates. Interest rates on 10-year U.S. Treasury bonds dropped sharply in March, reinforcing a decades-long downtrend in interest rates. These rates are now below 1 percent, indicating a great willingness of investors to fund our debt.

Many other rich countries will also be able to fund their needs by borrowing. While there is a lot of variation across emerging market countries and developing countries, many lower-income countries are in a much worse position. It varies depending on the debt they had going into the crisis as well as their dependence on hard hit sectors like tourism or oil production, but some are at risk of not being able to borrow more or setting themselves up for a future debt crisis.

Point #7 is that there is much more work to be done in terms of policy—both within countries and in terms of international cooperation.

Although many countries have already provided a lot of fiscal support, many will have to do considerably more. Most importantly, countries need to provide all the funding they can to keep their health care systems going and to fight the spread of the virus—both because doing so is critical to the welfare of their citizen and because it is critical to their ability to open their economies up again. And rich countries should be spending “whatever it takes” to develop a vaccine and better treatments that can be used to limit the harm around the world.

Countries also need to be cooperating with each other. The science around the disease will move forward more quickly if countries are working together. They should be working to see that equipment and medicine is getting to the countries that need it most—it's very clearly that the global economy is very integrated so having parts of the worlds that are falling apart would only drag on the recoveries of the countries that have fought off the virus.

Similarly, if debt crises occur in some lower-income countries, that could hurt the global financial system in ways that will adversely affect all countries. When I think about what risks might cause a double-dip global recession, the potential for a set of severe sovereign debt crises is second only to another wave of the virus. To reduce this risk, G20 is going to need to have a more serious conversation about debt standstills and debt forgiveness.

Point #8 is that the crisis is highlighting the importance of good leadership.

A running theme in this talk has been the critical role of good policy in limiting the economic fallout from the COVID—good financial policy, good fiscal policy, and especially good public health policy. Good policy does not happen by itself. We needed well-trained technical people to design effective measures, and we need leaders who are not afraid to act boldly in the best interests of their own countries and the global community.

In that regard, it has been an honor to be able to offer my thoughts at an institution like Fulbright University Vietnam that is training these types of leaders.

Thank you, and I look forward to the conversation with Dean Tu Anh.