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# Changes, Challenges and Implications of Fiscal and Monetary Policy Directions in the Post-Pandemic Era

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## I. Introduction

COVID-19 has changed the way of our lives since it started emerging as a pandemic early 2020. The global public experience of masks and social distancing will leave a trauma, and eventually work as a main driver for us to reconsider and improve our system. The need for change becomes even bigger as the pandemic continues beyond initial expectations. With that, we are now entering the era of the great transformation.

In the *2021 World Economic Outlook* released by the Korea Institute for International Economic Policy (KIEP) in November 2020, "prevention and rehabilitation" were presented as keywords for the global economy under pandemic.

The first keyword "prevention" involves two aspects. From a medical and health perspective, this means to supply vaccines and continue social distancing. From an economic perspective, this means sustained policy support to contain damage to the economy. Without proper preventive measures, the economy would be severely hit by the pandemic and face devastating consequences.

The second keyword "rehabilitation" stands for mid- to long-term response measures for the post-pandemic world. Under the unprecedented situations people get used to a new way of life, such as work-from-home and delivered food, and become more conscious of environmental problems including climate change. Countries around the world are now investing in various physical and human infrastructure projects for the green and digital transformations. This great transformation has been hindered by high perceived cost for initial transition, but will now be made possible through huge investments initiated by the government.

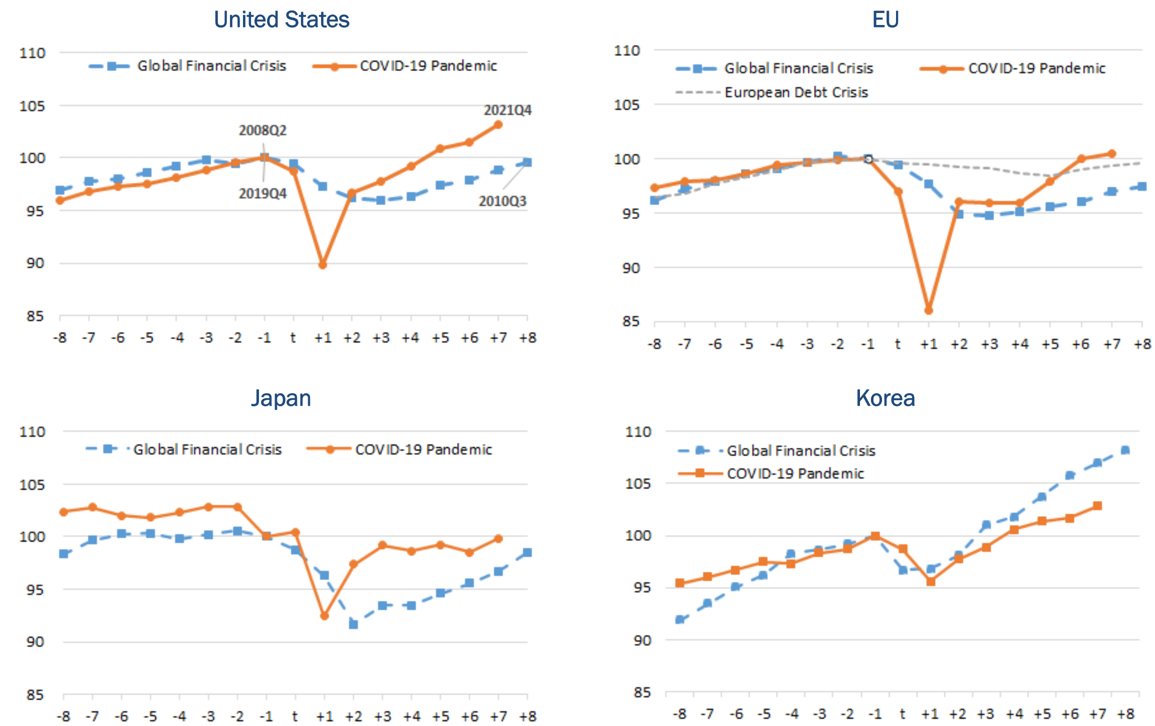
Against this backdrop, this brief focuses on examining the policy environment changed by the COVID-19 pandemic and analyzing the points to be considered when implementing future fiscal and monetary policies.

## II. The Great Transformation

By examining the similarities and differences in fiscal and monetary policies compared to the 2008 global financial crisis, the path of recovery after COVID-19 can be understood. The characteristics of major countries' policy responses to this crisis are that short-term responses were quickly introduced, and mid-to-long-term responses for economic structural change are being made in various ways.

**Figure 1. Recovery Paths after Crises**

(Unit: *t-1*=100)




Notes: Seasonally adjusted real GDPs are normalized at one quarter before the crisis. The crisis quarter *t* refers to Q4 2008 for the global financial crisis, Q4 2011 for the European debt crisis, and Q1 2020 for the COVID-19 pandemic.
Sources: Author's calculation based on the data retrieved from Federal Reserve Economic Data (United States), Eurostat (EU), Cabinet Office (Japan), and Bank of Korea (Korea).

The initial economic downturn caused by the COVID-19 pandemic did not stem from the frictions in demand, but rather the impact on the supply side, such as labor supply restrictions due to regional blockades. Responding to supply shocks with only accommodative monetary policy can lead to stagflation. Meanwhile, as the demand for services such as tourism sharply decreased due to the local lockdown, the economic damage was aggravated. Fiscal expenditures to relieve the economic damage followed in this situation. Disaster subsidies and selective support for small and medium-sized businesses were quickly implemented.

**Table 1. Long-term Investment Schemes**

| Country | Description |
|---|---|
| United States | • American Jobs Plan ($2.25 trillion) → [Senate] Infrastructure Investment and Jobs Act ($1 trillion)<br>• American Families Plan ($1.8 trillion) → House of Representatives approves budget resolution of $3.5 trillion (strengthening childcare support, expanding educational opportunities, climate response, etc.) |
| EU | • Recovery Fund NGEU (Next Generation EU) of 750 billion euros established<br>• 90% of NGEU is assigned to the RRF (Recovery and Resilience Fund).<br>• Restrictions on the use of funds due to long-term structural reforms such as green transformation and digitalization |
| Japan | • Comprehensive Economic Measures (Dec 2020 Ministerial Meeting) stipulate infrastructure investment policies (maintenance of old facilities, digitalization, and recovery from natural disasters).<br>• Reinforcement of digital administration (establishment of digital government, expansion of digital transformation in the private sector, fostering digital talent)<br>• Green Transformation |
| China | • Focus on large SOC investments to induce economic revitalization after the global financial crisis<br>• Investment in *new infrastructures* after COVID-19 (5G, AI, Big Data, new energy vehicle infrastructures) |

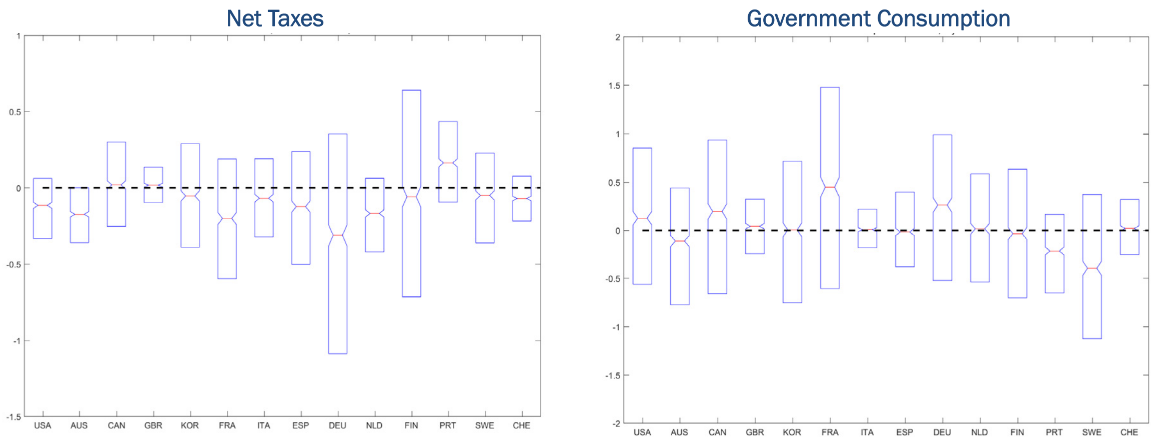
The mid- to long-term response in major countries is focused on investment in physical and human infrastructure for digital transformation and green transformation. A large-scale long-term investment plan of a decade is being drawn up among concerns over financial soundness. Thus, the political controversy can be expected to continue until public investment schemes are confirmed.

## III. Fiscal Multipliers during the COVID-19 Pandemic

The effects of fiscal spending by major countries are analyzed using the time-varying structural vector autoregressive (TVSVAR) model. Using quarterly data from 14 countries since 2000, we examined how the multiplier effect of net tax and government consumption on gross national product changed over time, comparing before and after the COVID-19 crisis.

The effectiveness of fiscal policy was found to vary by country and by means of fiscal policy. This means that careful consideration of national characteristics and policy measures is necessary for efficient fiscal execution. When examining the additional effects of fiscal policies during the COVID-19 crisis, an additional stimulus effect of net taxes, that is, a relatively low crowding out effect, was found in most countries. On the other hand, there was no additional stimulus effect evident in government consumption. It seems that the transfer payments as part of net taxes such as disaster relief funds have been effective. On the other hand, it was also found that the multiplier effect of fiscal expenditure decreases when a quarantine-type policy that restricts face-to-face economic activities is implemented. Therefore, when introducing a policy that strengthens the quarantine level, it is necessary to consider a more active fiscal policy.

**Figure 2. Fiscal Multipliers before and after the COVID-19 Pandemic**




Notes: 1) Difference of 3-year accumulated fiscal multipliers between the pandemic period (Q1 2020 – Q4 2020) and the normal period (Q1 2015 – Q4 2017).

2) Inter-quartile range with median

Source: Author's calculation

## IV. Unconventional Monetary Policy in the Post-Pandemic Era

Unconventional monetary policy has been introduced following the global financial crisis. The policy goal of economic stimulation could not be attained despite continual policy rate cuts, which were eventually limited by the zero lower bound. In such a situation, an alternative measure to tuning the short-term interest rate was introduced. Managing quantity variables rather than a price variable became more popular. Such measures include asset purchase, simultaneous engagement of long- and short-term markets, the preemptive announcement of future rate targets without spot market intervention, and direct interventions on targeted markets. More specifically, these non-traditional monetary policy measures were implemented as negative interest rates, forward guidance, yield curve management, quantitative easing and credit policies. These policies implemented after the global financial crisis turned out to be effective and significant.

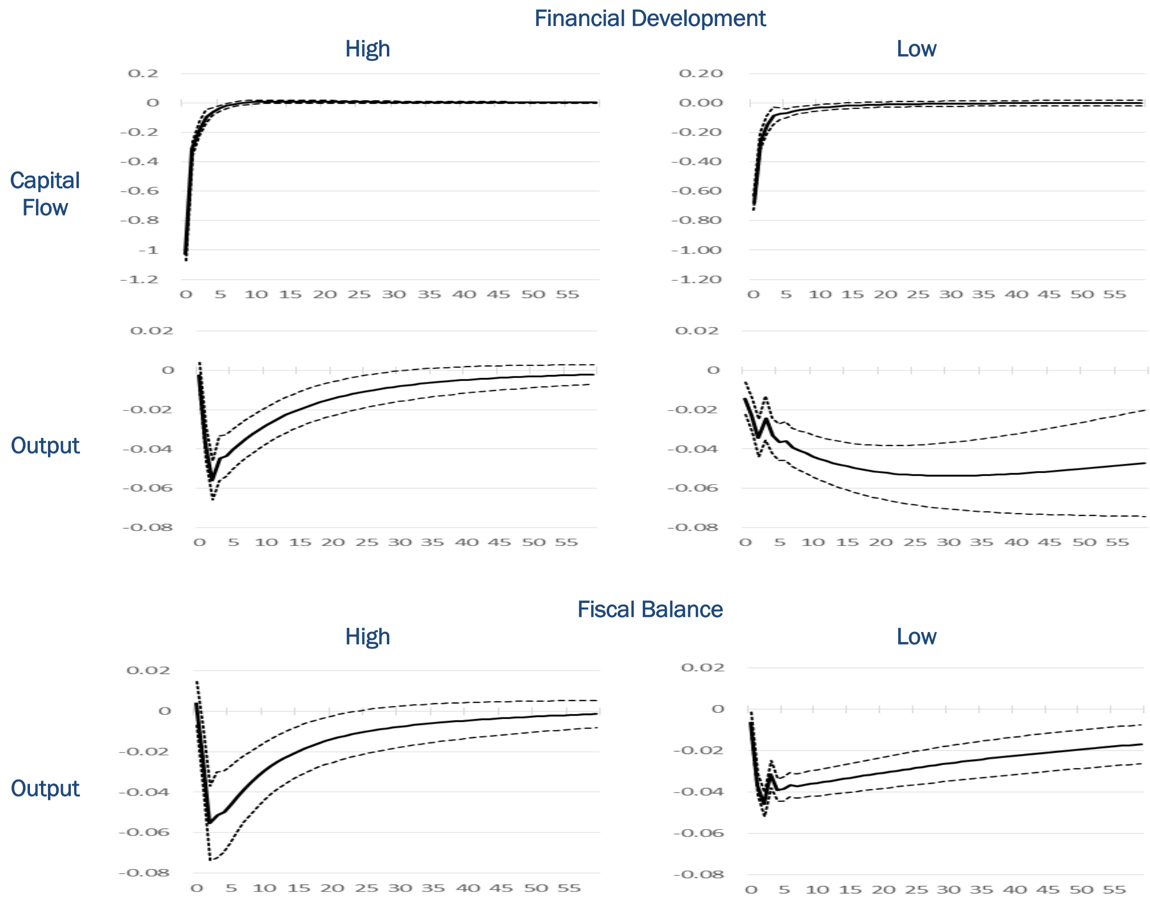
As the pandemic shock involves both supply-side and demand-side elements and an unprecedented scale of fiscal expenditure has been implemented, assertions are raised that the central bank should consider more aggressive policies such as helicopter money schemes or monetary financing. The United States is expected to achieve a fast recovery through vaccination and large-scale fiscal spending, and then take a path to normalize its differentiated monetary policy in order to respond to inflation. On the other hand, there still remains a possibility that additional policy measures will be required with limited policy space due to the prolonged pandemic.

Changes in the monetary policy framework, such as the introduction of the average inflation target (AIT), have a long-term effect on the expectation formation of market participants and are reflected in economic activities, so it is necessary to understand and forecast these trends.

## V. Transmission of Uncertainty Shock to Peripheral Economies

When uncertainties increase in major advanced countries such as the United States, capital flows and macroeconomic variables of neighboring countries are affected. In a situation where omni-directional policies are implemented in response to the spread of COVID-19 and economic slowdown, expectation shocks such as elevation of policy and financial uncertainty are highly likely to intensify and generate a riffle effect on capital flows.

**Figure 3. Responses on External Uncertainty Shock: Emerging Economies**




Note: Emerging economies' response on the U.S. financial uncertainty (VIX) shock
Source: Author's calculation

## VI. Policy Suggestions

First, it is necessary to consider strengthening inclusiveness in short-term policy measures. Major countries have introduced liquidity assistance programs that encourage selective lending to small and medium enterprises (SMEs). In Korea, a wide range of financial support for self-employed and SMEs has also been introduced, but the predetermined amount of funds is distributed through financial institutions whose incentives are vague. In the case of Japan and China, a price-based approach is employed so that individual financial institutions are given incentives, such as interest rate subsidies to secure funds through the market. In order to strengthen inclusiveness, it is necessary to consider introducing incentive-based policies reflecting market functions.

Second, the timeliness and effectiveness of investment for structural improvement should be considered. Globally, the mid- to long-term restructuring is focused on digital and green transformations. The Digital New Deal and Green New Deal, which are the focus areas of the Korean New Deal, are in line with global trends, and it is necessary to refer to the lessons learned from past policy experiences.

As expectations on digital transformation emerge, an asset price bubble forms, especially among major tech companies. Therefore, policy makers should be careful when sending out signals to the market on their evaluation of current market conditions and future policy directions. In addition, risk management for moral hazard related to government support on venture enterprises is also required.

Green transformation lies in the growing public interest in environmental issues and the growing awareness of the need to respond to climate change. The starting point is slightly different from digital transformation, which uses new technology to enhance convenience and productivity in life. Green transformation is motivated by the fear of a major disaster in the future. As such policies are unlikely to receive long-term attention, as is the case with awareness and response to crises in general, the policy authorities need to pay special attention to achieve apparent goals.

There is great uncertainty about government investment in a period of new technology transition, and at the same time, it is highly likely to cause moral hazard in the market. Rather than providing direct support to businesses and universities, the government R&D might be used to fund research infrastructure on a scale that the private sector cannot. In the case of direct investment and support in the private sector, it is necessary to evaluate the timeliness of projects and closely monitor effectiveness.

Third, a plan for medium-term fiscal consolidation should be prepared for sustainability. Although the pandemic is prolonged and uncertainty remains about the arrival of the post-coronavirus, the fiscal burden aggravated as a result of the short-term response may be normalized through fiscal consolidation in the future. However, it is worth noting that concerns about an increase in national debt have been raised in Korea even before the COVID-19 crisis. There is a structural effect where the proportion of the welfare budget increases due to increasing inequality and aging population. Of course, it would not be difficult for Korea to secure fiscal soundness as it has a low tax burden compared to major countries, and thus has sufficient fiscal space. However, in order to secure fiscal soundness, it is necessary to expand the tax base, which could invoke strong tax resistance and requires a political solution.

Fourth, it is necessary to pay attention to the path to normalization taken by U.S. monetary policy. The Federal Reserve is expected to actively use forward guidance in the process of normalization in the future. Moreover, policy uncertainty has increased due to the lack of details on operation plans for the newly introduced AIT. When implementing monetary policy in Korea, it is necessary to reflect the impact of the policy uncertainty of the United States on neighboring countries. Monetary policy normalization requires close monitoring, as the financial imbalance may increase through the asset market channel.

Meanwhile, asset prices have risen sharply due to abundant liquidity supplied globally during the pandemic. As the real estate market overheated in Korea, mortgage loans increased rapidly, which led to a sharp rise in household debt and regulations on total loan volume to limit the growth of household loans. Above all, it is necessary to prepare policy measures to maintain the soundness of the loan itself and, in particular, keep the volatility of collateral assets low.

Fifth, efforts for international cooperation are anticipated in relation to infectious diseases and the great transformation. At this point, the need for international cooperation on infectious diseases cannot be overemphasized. In particular, all parties must work together to prevent short circuits at nodes on the global supply chain by increasing vaccine penetration in emerging countries. Securing financial resources is not the problem of a single country, but a global one. While many agreements have been reached as the Biden administration returns to international cooperation, concerns remain about the continued leadership of the United States. In particular, as the pattern of the U.S.-China conflict has become more sophisticated and the embers of national priority remain, this can act as a negative risk. The Korean government should clearly recognize the uncertainty in international cooperation and prepare an external strategy. KIEP