The Global Fiscal Response to COVID-19

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Photo: Kanawa Studio

Abstract

Globally, the fiscal policy response to the COVID-19 crisis has been the largest and fastest in peacetime. Governments have prioritised direct fiscal support for private incomes and employment, which has limited economic scarring and established a solid foundation for the recovery. The size and composition of the fiscal response has varied across countries, reflecting differences in automatic stabilisers, pre-pandemic fiscal space, the severity of infections and policy preferences. Fiscal policy is likely to remain supportive for some time after the pandemic subsides, and in many countries is expected to focus increasingly on boosting investment. For as long as governments anchor spending decisions in a sound medium-term fiscal framework and interest rates remain lower than the rate of economic growth, ongoing fiscal support need not pose problems for government debt sustainability.

The COVID-19 pandemic sharply disrupted economic activity and, in most countries, triggered the largest economic contraction since at least the Second World War. As the severity of the pandemic became apparent early in 2020, authorities across the world began implementing a large and multifaceted policy response. This included the largest fiscal policy response in decades, which substantially limited the decline in economic activity.[1] The subsequent recovery has also been stronger than expected in large part due to unprecedented policy support. This fiscal response can be characterised as having two phases:

1. In the *acute phase*, which is still ongoing in many economies, the response has focused on supporting private incomes, preserving employment relationships and shoring up health systems. This has mainly been achieved through large direct transfers to households, enhanced unemployment benefits, wage subsidies and increased healthcare funding.
2. In the *recovery phase*, when infections have been brought under control, fiscal support will

pivot toward boosting investment. This includes public infrastructure, 'green' investment and, to a lesser extent, incentives to support private investment and consumption. These support measures will be spread over a longer period than the acute phase.

This article focuses on the fiscal response during the acute phase and measures that affect government spending and revenue (i.e. the direct fiscal response), as opposed to indirect (off-budget) measures that do not have an immediate effect on the budget (such as loan guarantees). The first section examines the size and composition of fiscal responses around the world. This is followed by a discussion of its effects on labour markets, private incomes, economic activity and governments' fiscal sustainability. The article concludes with a brief outline of policy measures largely intended for the recovery phase.[2]

The fiscal response to the COVID-19 pandemic was the largest in peacetime

Most economies have yet to move beyond the acute phase of the fiscal response. These direct measures, including those that are expected to persist into early 2022, have ranged from 5 to 24 per cent of 2019 GDP in advanced economies. Authorities in emerging market economies have provided smaller, yet still significant, direct fiscal support which has been equivalent to between 1 and 9 per cent of GDP (IMF 2021). For many economies, this has contributed to the largest single-year increase in the government debt-to-GDP ratio during peacetime (Graph 1).

Fiscal support in the acute phase of the downturn was initially delivered rapidly, and in large part was a response to the effects of public health measures (such as mobility restrictions) on economic activity. The first wave of fiscal measures was delivered between February and April 2020 (Graph 2). As the first country to be affected by the COVID-19 outbreak, China was the first to announce significant fiscal support measures (in February). This was followed shortly thereafter by other economies in Asia, and then economies in the rest of the world as the pandemic spread and strict public health measures were imposed. Fiscal measures were expanded and enhanced rapidly throughout April as the severity of the pandemic, and the extent of the economic damage it was causing, became more apparent.

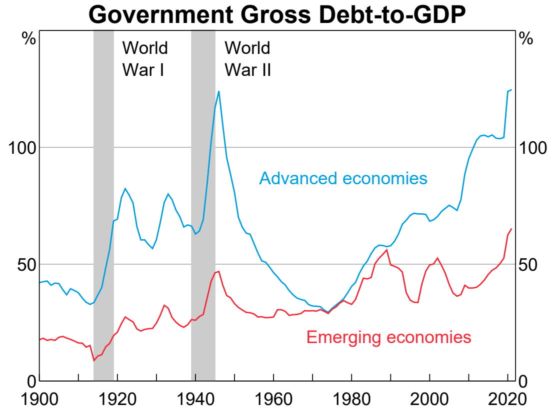
Governments in advanced economies have demonstrated flexibility in their fiscal response. The majority of fiscal measures had been designed to be short lived, often just a few months in duration, but repeated infection outbreaks, and associated public health controls, prompted fiscal authorities to extend measures further than originally envisaged. Many programs are still providing significant support to the economy. In emerging economies, fiscal support was frontloaded in the first half of 2020, but despite significant subsequent resurgences of infections, authorities were (or at least felt) constrained in their ability to continue extending large scale fiscal support.

The size of fiscal support has varied across economies

The size of direct fiscal support has varied across economies because of differences in automatic stabilisers, pre-pandemic fiscal space and decisions by some countries to implement sizeable indirect fiscal measures instead. Automatic stabilisers are government policies that automatically adjust government spending and revenue to support economic activity through different stages of the business cycle. For example, during economic downturns, government outlays naturally increase as more people receive unemployment benefits (which support household incomes and consump-

Graph 1

Government Gross Debt-to-GDP



Sources: IMF; RBA

tion), while at the same time government revenues derived from taxes on household and business incomes and consumption tend to fall, especially where tax rates are progressive, which results in a smaller share of income going into taxes at lower levels of income.

Advanced economies with strong automatic stabilisers, including those with more generous unemployment benefits and pre-funded wage subsidy schemes designed to maintain employment relationships, required smaller additional fiscal measures in order to provide the same support to private incomes as other economies with weaker automatic stabilisers. European economies tend to have strong automatic stabilisers that provide relatively high levels of support to a larger share of their populations, which is one reason why their direct fiscal support has been smaller. In contrast, the United States has weaker automatic stabilisers, and this was one reason why US authorities provided the largest additional direct fiscal support in the first year of the pandemic.

Advanced economies that initially provided large direct fiscal responses also tended to be those with lower pre-pandemic government debt and smaller fiscal deficits. This group included Australia, Germany, New Zealand and Singapore. As the pandemic wore on, other governments became increasingly willing to extend and increase their fiscal support given its effectiveness earlier in the crisis and the low cost of funding this support through government bond issuance.

In emerging market economies, the direct fiscal support measures were, on average, smaller in scale compared to advanced economies. This reflected greater financing constraints experienced by some governments, including the high cost of new bond issuance (Alberola *et al* 2020). These financing constraints have made it more difficult for many emerging market economies to support their health systems and economically vulnerable segments of their populations.

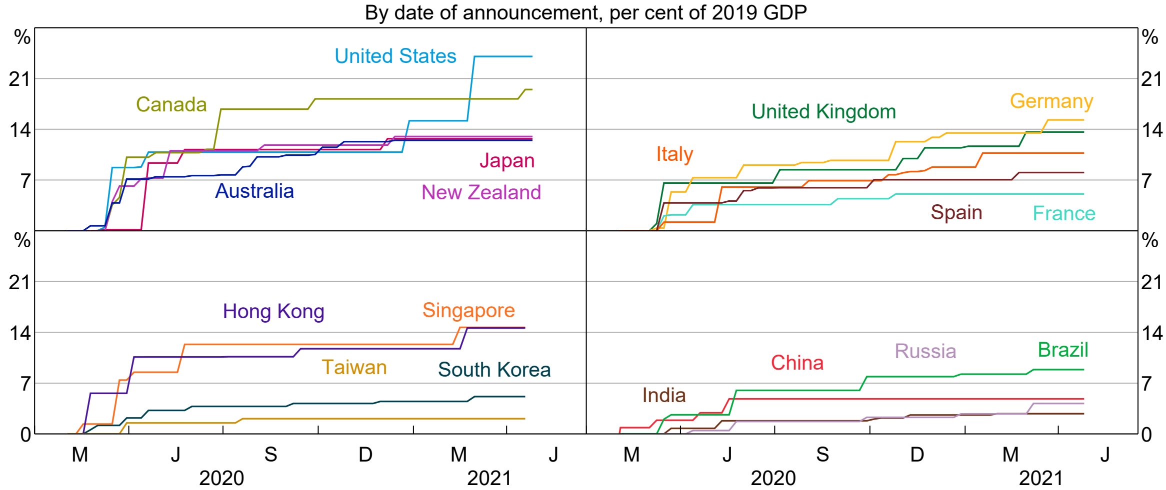
In the case of China, where government debt is relatively low, the early control of domestic infections and strong global demand for goods helped economic activity return quickly to its pre-pandemic trajectory. As a result, Chinese policymakers did not need to provide as much direct fiscal support as other economies, though support from other state-affiliated agents (such as state-owned enterprises and banks) has continued to play an important stabilising role in the economy.

Some governments have attempted to support their economy with a larger emphasis on indirect fiscal measures such as loans and loan guarantees (Graph 3). This has typically reflected policy preferences of the authorities and a more limited

Graph 2

Cumulative Acute Phase Direct Fiscal Response*

By date of announcement, per cent of 2019 GDP



* Includes fiscal measures announced by April 2021 and state government stimulus for Australia, Canada, Germany. Excludes loan guarantees and unallocated funds. China is based on announced changes in budget deficit for all levels of government, excludes state-owned enterprises; all other countries are based on announcements from national sources

Sources: IMF; national sources; RBA; Refinitiv ability to increase direct fiscal spending. Indirect fiscal measures were used extensively in the European Union because of concerns early in the pandemic about the ability of some member countries to raise funds at favourable interest rates and in a manner compliant with their EU treaty obligations.[3] Indirect fiscal measures comprised a large proportion of the fiscal response in some emerging market economies, including India and Brazil, due to their more limited fiscal space. These indirect fiscal measures were still much smaller than in advanced economies.

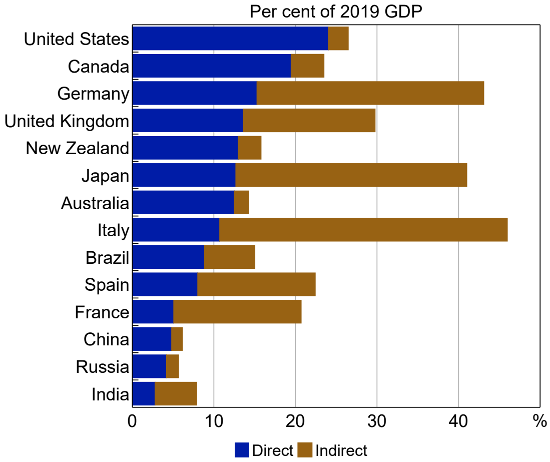
Governments prioritised support for private incomes, employment and the health response

Without decisive policy interventions, the pandemic would have sharply reduced household and business incomes, caused greater labour market disruption and prolonged economic scarring through business and personal bankruptcies and higher long-term unemployment. Indeed, in the early days of the pandemic, there were widespread concerns that it may lead to another Great Depression (Gumede 2020). Fiscal policy was swiftly recognised as the best tool to address these risks because it could be targeted at directly supporting incomes on a large scale (Baldwin and Weder di Mauro 2020).

Graph 3

Acute Phase Direct and Indirect Fiscal Support*

Per cent of 2019 GDP



* Includes fiscal measures announced by April 2021. China is based on announced changes in budget deficit

Sources: IMF; national sources; RBA; Refinitiv

The direct fiscal response in the acute phase has mainly consisted of direct transfers to households and businesses, wage subsidies and tax deferrals (Graph 4). Private sector cash flows were also supported by measures such as low cost (often government-guaranteed) loans and the temporary pausing of some debt and other contractual obligations, such as rent and mortgage payments. Most of the acute phase direct fiscal support has been disbursed in 2020 and early 2021.

As part of this support, wage subsidy schemes were deployed in almost all advanced economies to preserve pre-pandemic employment relationships and to provide replacement income to workers in affected businesses. The use of wage subsidies was motivated by a range of considerations: expectations that the pandemic disruptions would be short lived; the limited need for structural adjustment given the nature of the shock; and the perceived success of Germany's wage subsidy scheme during the Global Financial Crisis.[4] In the United States, the *Paycheck Protection Program* served a similar function through government-guaranteed loans that were forgiven when they were used to support employment and wages.

The take-up of wage subsidies has been substantial. Across advanced economies, the use of the subsidies peaked at between 15 to 60 per cent of the labour force. These peaks were generally reached in early 2020 when containment measures were most stringent and thus when activity was weakest. The value of wage subsidy programs has been difficult to compare across economies as some governments utilised existing schemes that were already funded (partly or in full) from past contributions.

Another key component of fiscal support during the acute phase has comprised unemployment benefits, which in some economies have been increased, extended and made easier to access. These changes were most consequential in the United States, where benefits were substantially increased as unemployment increased sharply; the income of many unemployment benefit recipients in the United States was higher than their earnings in the jobs they had before the pandemic (Ganong, Noel and Vavra 2020). Unemployment benefits were also increased in Australia but to a lesser degree. Meanwhile, Canada implemented a new and temporary unemployment benefit scheme, to better deal with the impact of the pandemic on incomes.

A few advanced economies also provided substantial direct transfers to households in the form of cash payments. These payments were largest in the United States, totalling 6 per cent of GDP or 11 per cent of median household income. Hong Kong, Japan and Singapore also made large direct transfers to households.

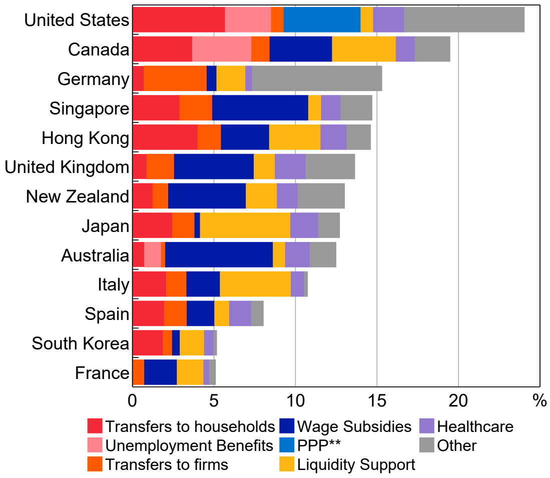
As a result of these fiscal policy measures, private incomes in advanced economies held up well during the pandemic despite the sharp drop in economic activity and hours worked (Graph 5). This outcome is in stark contrast to the experience during previous recessions when private incomes typically fell. In some economies, including Australia, Canada and the United States, household incomes increased sharply. In most European economies and Japan, wage subsidies only partially replaced wages, so household incomes declined. In addition to boosting household incomes, wage subsidies supported business viability by helping firms meet their major expense, labour costs; this helped reduce bankruptcies.

Household income support schemes helped to cushion the fall in household consumption. By providing households with more income certainty, they supported households in maintaining a higher level of consumption than otherwise; restrictions on services consumption meant that this boost to consumption was most evident in spending on goods. These schemes also contributed to a significant increase in household savings during 2020 and early 2021.

Graph 4

Type of Acute Phase Direct Fiscal Support*

Per cent of 2019 GDP



* Includes fiscal measures announced by April 2021 and state government stimulus for Australia, Canada, Germany. Excludes loan guarantees and unallocated funds

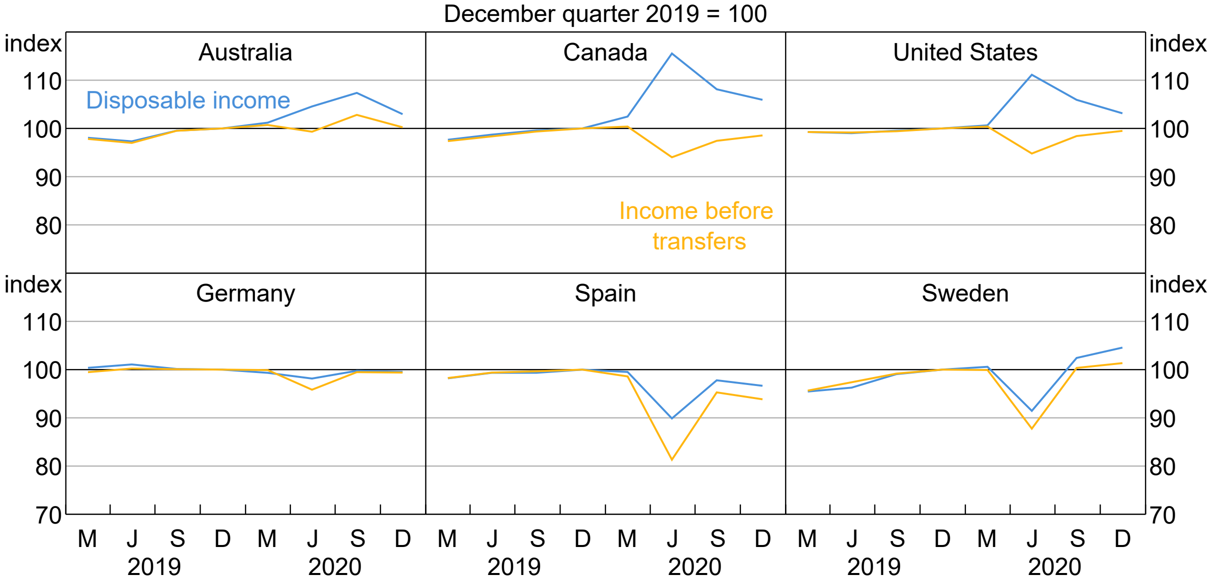
** Paycheck Protection Program

Sources: IMF; national sources; RBA; Refinitiv

Graph 5

Real Household Income

December quarter 2019 = 100



Sources: National sources; OECD; RBA; Refinitiv

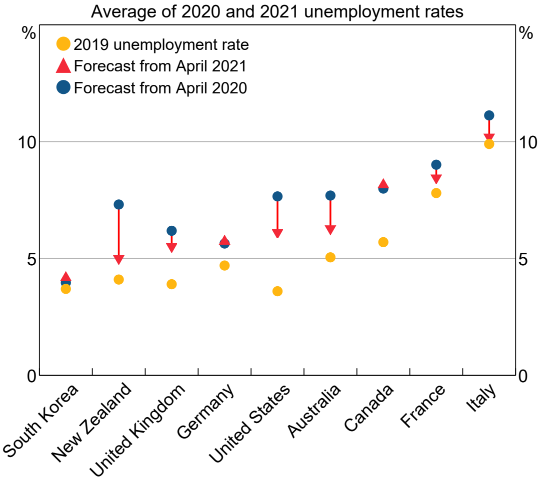
Economic scarring effects, which can be caused by extended periods of unemployment (resulting in discouraged workers), firm closures and weak investment, have been smaller than was feared in the early stages of the pandemic. They have also been smaller than observed following past recessions, as unemployment rate forecasts made early in the pandemic have turned out to be too pessimistic in most advanced economies (Graph 6).[5] This was in part due to the substantial and growing fiscal and monetary support that limited the effect of the pandemic on the level of unemployment (IMF 2021). Participation rates and hours worked declined sharply early in the pandemic, but started to recover later in 2020 and, in some economies such as Australia, have recently returned to pre-pandemic levels. In supporting firms' balance sheets and employment, the fiscal response in many economies has helped to provide a foundation for strengthening labour market conditions.

In some of the large emerging market economies, including Brazil, India and Russia, the direct fiscal response prioritised income support for the most vulnerable parts of their populations through direct transfers and subsidies for essential consumption; these measures were smaller than in advanced economies. By contrast, China's support measures were mostly targeted to small businesses and stimulating aggregate demand directly, including through infrastructure investment. The Chinese

Graph 6

Unemployment Rate Forecasts

Average of 2020 and 2021 unemployment rates



Sources: Consensus Economics; RBA; Refinitiv

Government also encouraged state-owned enterprises and banks to support employment and financing conditions, as is often the case in global and regional downturns.

All economies provided additional funding for their healthcare systems to increase hospital resources, COVID-19 testing and contact tracing. Governments have also expanded funding since late 2020 in support of the procurement and rollout of vaccine programs. Although the additional healthcare spending has been a small share of the direct fiscal support, it has led to a 20 per cent increase in healthcare spending in advanced economies.

Low interest rates have supported fiscal sustainability

The significant global fiscal policy response has been funded largely by debt issuance, with government debt-to-GDP ratios increasing to historically elevated levels in many economies. In advanced economies, the higher government debt levels have not called into question the sustainability of government finances. This partly reflects low interest rates on government debt. The prevailing combination of low long-term interest rates that are lower than expected economic growth means that many governments can stabilise their debt-to-GDP ratios even while running primary fiscal deficits (i.e. fiscal deficits before the payment of interest on their debt).

Broadly speaking, government debt is considered sustainable when governments can continue to service their debt (and avoid default or debasing the currency) without having to significantly adjust fiscal policy settings, including by cutting spending or raising taxes which risks slowing the economy. The sustainability of debt is important for a couple of reasons. One is that it allows governments to pursue their public policy priorities without being forced to undertake significant unwanted fiscal adjustments. Another major reason is that governments with less sustainable debt may be limited in their ability to respond to future negative economic shocks by providing debt-funded fiscal stimulus.

In some economies, low levels of public debt has meant that fiscal deficits have been comfortably financed in the capital markets. The ability of governments to run a primary fiscal deficit without endangering debt sustainability also partly depends on the difference between the interest on the government's debt and the growth in GDP (the interest rate-growth differential; Furman and Summers 2020). If the interest rate on government debt is lower than the growth rate of the economy, then growth in the economy will lower government debt as a share of GDP as long as the primary deficit is not too big.

In advanced economies, the interest rate-growth differential has been negative since the early 2000s and has declined further during the pandemic, as interest rates on government debt have declined by more than expected longer-term GDP growth rates (Graph 7). As of April 2021, the International Monetary Fund (IMF) (IMF 2021) expects that in the years immediately after the pandemic, advanced economies with elevated government debt levels will have primary deficits that are small enough to stabilise or reduce their debt-to-GDP ratios (Graph 8). The IMF expects that some advanced economies with lower levels of government debt may take longer to reduce their debt-to-GDP ratios as they will be under less pressure from the financial markets to do so.

While the interest rate-growth differential has not been volatile over the past 30 years, it can rise rapidly if there is a sudden reassessment of a government's fiscal sustainability (Mauro and Zhou 2020). Therefore, were the currently supportive conditions to change, some governments may face difficulties stabilising debt-to-GDP ratios without a significant change in their fiscal settings.

Further fiscal support will contribute to a more complete recovery

Fiscal policy in advanced economies is expected to remain accommodative over the next few years as the support during the acute phase evolves into fiscal support for the recovery phase. This transition will necessarily involve a different set of longer-term priorities. Countries will make this transition at different times.

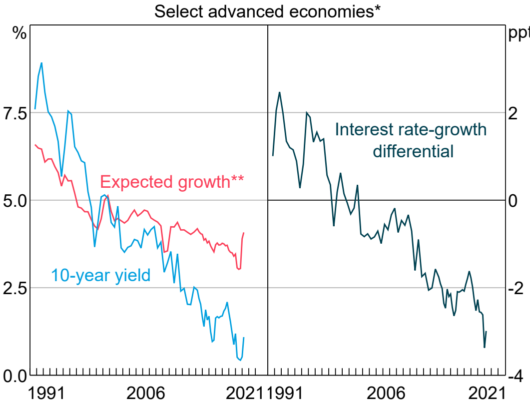
In most advanced economies, where economic activity remains constrained by containment measures, fiscal policy is expected to continue to focus on supporting incomes and preserving employment relationships for some time. But as infections are brought under control and vaccines are rolled out, the emphasis of fiscal support will shift. This will entail a greater focus on public investment, particularly in green and digital initiatives, incentives for more consumption and private investment, and retraining programs for workers in those sectors that are expected to have been severely impacted during the pandemic.

The fiscal measures that have already been announced for the recovery phase are substantial

Graph 7

Interest Rate-Growth Differential

Select advanced economies*



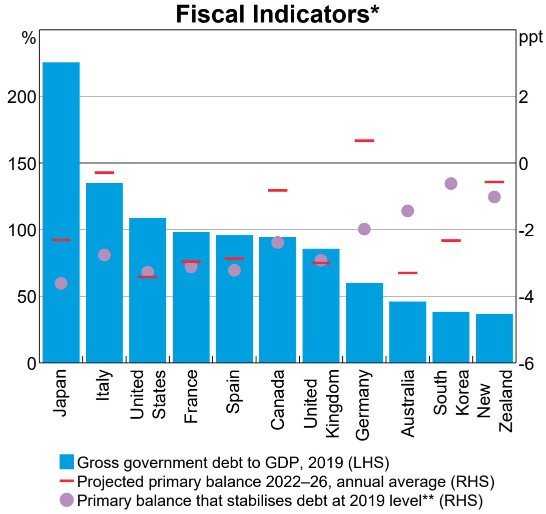
* PPP GDP-weighted average of Australia, Canada, France, Germany, Italy, Japan, New Zealand, South Korea, Spain, United Kingdom and United States

** Expected average annual nominal GDP growth over following 10-years

Sources: Bloomberg; Consensus Economics; IMF; RBA

Graph 8

Fiscal Indicators*



* Countries with dashed lines above their dot are expected to stabilise debt below 2019 levels, and vice versa

** Assumes interest rate-growth differentials remain at current levels

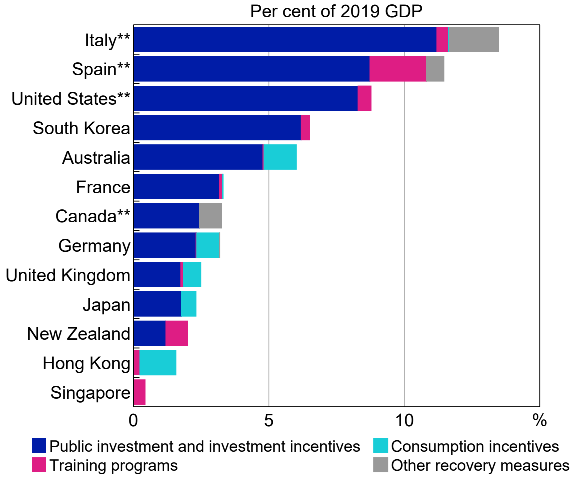
Sources: Consensus Economics; IMF; OECD; RBA but in most economies are smaller than for the acute phase and will be spread over a longer period. With significant spare capacity in most advanced economies, these measures can reduce the long-term economic 'scarring effects' of the pandemic without generating high inflation. The size and design of the recovery phase fiscal support varies across countries (Graph 9). The United States is expected to provide very large recovery phase fiscal support, equivalent to 9 per cent of GDP, which will be focused on infrastructure investment and spread over a decade. European Union members will deploy a combination of grants and loans that are expected to be spent between 2021 and 2026. These measures will be funded by EU-issued debt that will provide recovery fiscal support equal to 5 per cent of EU GDP.[6] The distribution of these funds will be tilted to EU members more heavily affected by the pandemic and those who began the pandemic with weaker economic fundamentals. In a few other smaller economies, fiscal support for the recovery phase will likely be as large as 6 per cent of pre-pandemic GDP.

The announced recovery phase measures should help avoid a repeat of the post-Global Financial Crisis experience in some advanced economies, where fiscal austerity was adopted before the

Graph 9

Recovery Phase Direct Fiscal Support*

Per cent of 2019 GDP



* Fiscal measures aimed for the recovery phase, i.e. after the pandemic has passed; includes fiscal measures announced by April 2021 and state governments for Australia, Canada and Germany; includes EU Recovery and Resilience Facility funds for EU countries where spending plans are available; expected to be spent over multiple years

** Proposed support not yet approved

Sources: IMF; national sources; RBA; Refinitiv

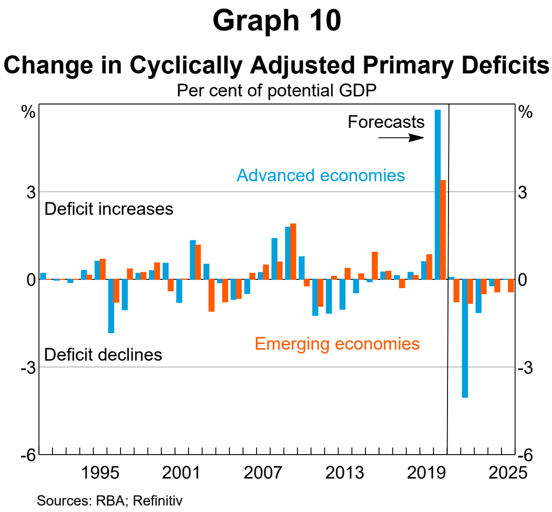
economic recovery was entrenched. The premature winding back of fiscal support, before private demand was able to sustain the recovery, created unnecessary headwinds for many economies (House, Proebsting and Tesar 2017).

Fiscal support during the acute phase of the pandemic has been so large that, even with the transition to the sizeable recovery phase support, there will be a tightening of fiscal settings in 2022. In advanced economies, cyclically adjusted fiscal deficits, which represent the deficit after accounting for the role of automatic stabilisers, are expected to decline from 2022; this will result in what is known as 'fiscal drag' (Graph 10). The projected decline in deficits largely reflects expectations that reduced fiscal support, such as wage subsidies or unemployment benefits, will be needed as economic activity normalises. On current expectations the reduction in the direct fiscal support will occur when the economic recovery is more progressed than it was during the Global Financial Crisis and it should be less disruptive to the recovery from the COVID-19 pandemic.

In emerging markets, where fiscal space is often more limited, some governments with pre-existing macroeconomic or financial imbalances have faced more pressure to reduce fiscal deficits. But this experience has varied considerably across countries. Some large emerging market economies in Asia have had few issues in announcing fiscal measures to support activity during their recovery phase. For instance, India announced fiscal stimulus measures after the initial lockdown ended in October 2020, including consumption incentives and increased infrastructure spending, while China started transitioning to its recovery phase measures in the middle of 2020. But most emerging economies are yet to announce substantial support for the recovery phase, partly because their priority is still on bolstering health systems to deal with elevated infections and to support the rollout of vaccination programs.

Conclusion

The COVID-19 pandemic caused the largest fall in economic activity since at least the Second World War. Along with substantial monetary policy easing,



this has been met with a significant fiscal policy response in most economies. Governments have prioritised direct fiscal support for private incomes and employment, which has limited economic scarring and given the recovery a solid basis. Fortunately, a repeat of the premature shift to fiscal austerity as seen in a number of economies after the Global Financial Crisis appears unlikely, with fiscal settings likely to evolve but remain supportive for some time after the pandemic subsides. ✵

Footnotes

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[1] Significant fiscal responses were estimated to limited the peak-to-trough decline in activity in advanced economies to 11½ per cent, some 5 percentage points lower than otherwise (Chudik, Mohaddes and Raissi 2021)

[2] The article discusses fiscal support announced by April 2021. While policies and the context in which they are implemented differ across economies, best efforts have been made to draw high-level comparisons to illustrate key commonalities and differences.

[3] These constraints were eased with the European Commission temporarily relaxing the EU's fiscal rules in March 2020 (European Commission 2020) and the ECB acting forcefully to reduce differences in government funding rates across the euro area (European Central Bank 2021).

[4] For a discussion of Germany's experience with wage subsidies schemes during the Global Financial Crisis, see (Cooper, Meyer and Schott 2017).

[5] For further detail on the economic effects of fiscal policy during the COVID-19 crisis, see (IMF 2021)

[6] The funding is from the Next Generation EU Recovery and Resilience Facility. The grants effectively allow for increased fiscal transfers within the EU to its members that are less developed and that entered the crisis in worse economic positions. The lending is designed to subsidise borrowing costs for the EU's member economies with more elevated government debt levels and sovereign bond yields. For further details see (RBA 2020).

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