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Maintaining Fiscal Sustainability During the Pandemic Crisis

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Key Messages:

- **Plummeting demand for goods and services,** caused by the sudden disruption in major economic activities, has set the stage for a worldwide economic downturn. As production facilities remain intact, we need a bold fiscal and monetary intervention to revive demand.
- **Policies have focused initially on keeping people healthy,** then on minimising economic loss and restoring growth as soon as possible. This requires huge amounts of funds, which many countries have obtained by borrowing. Hence, such policies need to be accompanied by plans to repay the debt without jeopardising future growth.
- **Future fiscal risks include public budgets with low tax revenues, high social spending, and huge debts.** Thus, the principles guiding fiscal policies during the pandemic crisis should be cautious borrowing and wise spending.
- **As a regional cooperation mechanism, ASEAN can use its economic network and connectivity** to explore new goods and services for trading and improving people's welfare. A concerted regional effort would multiply regional demand.

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Managing a novel but highly contagious virus that rapidly evolved into a pandemic is the hardest job faced by world leaders in recent years. At first, most countries did not recognise the magnitude of the catastrophe created by coronavirus disease (COVID-19), so responses differed widely. Since the world was last hit by a pandemic more than 100 years ago, current world leaders were inexperienced in managing such a calamity. Indeed, the whole modern system – driven by technology, creativity, wealth, and interconnected people – appears to be unprepared. COVID-19 has disrupted almost all aspects of our lives. Even in the health sector, the almost exclusive focus on the pandemic has affected non-COVID-19 patients. In fragile and conflict-affected areas, disruptions in assistance and support have affected millions of people in vulnerable groups. In other areas, the world has paused temporarily.

Economic Impact of COVID-19 Pandemic

The serious and damaging effects of COVID-19 cannot be ignored. The pandemic has caused massive job losses due to sudden disruptions in trade and economic activities – especially in tourism, hospitality, transport, and events (e.g. sports, exhibitions, and shows). The impact has spilled over to other areas such as the retail, automotive, and construction sectors. Income levels have fallen below production capacity, creating excess resources from idle production factors, including labour, machine capacity, and capital. The world, including Southeast Asian economies, is experiencing decreasing producer and consumer price indexes, accompanied by low inflation – indicating shrinking demand.

If the demand shocks only have a small impact on the output deviation from production capacity, it will be adjusted in the near term through the market mechanism. If the shocks are significant, they will create a process of adjustment of the equilibrium level of income. If the process is prolonged and happens worldwide, it could lead to a great recession. When the market mechanism fails to function properly, the situation demands appropriate fiscal and monetary policies to prevent decreasing national income levels.

What kind of fiscal policies can offer the best response to the pandemic shock? There have been various proposals from prominent economists around the world, but no consensus has been reached. At this time, nobody is certain about the depth of the pandemic impact or the length of the crisis. Expansionary fiscal and monetary policies come with expensive costs, especially if the economies are not particularly healthy, e.g. with a high debt burden, high current account deficit, high unemployment, or low tax revenue. Romer (2012: 1) highlighted two important lessons from fiscal policies during crises: 'fiscal changes have large effects on output and employment in the near term, and unsustainable budget deficits over the long term eventually lead to ruin'.

Another worrying potential consequence of a prolonged recession is its hysteresis effect – the lingering effect of recession, typically on unemployment, after the economy has begun recovering. Several economies (Singapore and Malaysia in Southeast Asia) used public funds to partially cover private sector workers' wages under furlough or job retention schemes. These schemes aim to put workers in stand-by mode, ready to work again once the peak of the pandemic has passed, thus avoiding the hysteresis effect of rising unemployment. The hysteresis effect can also occur in other economic indicators, including altered production factors: human, institutional, knowledge and technology, and capital. We do not know if these production factors will be restored to their previous state after the pandemic. The 'new normal' equilibrium may extend beyond health protocols, leaving us with many questions: Where will investors put their money? Will the youth change their expectations of firms and entrepreneurship? What will happen to our social lives? Will we have altered levels of trust in our community, government, and global community?

The pandemic also raises questions about the role of cooperation and coordination. When resources are limited or exclusive (e.g. medical supplies, medical research technology, or technology to overcome the effects of disruption), competition to secure the coveted resources is fierce. The same happens when there is a perceived threat towards national interests, which countries prioritise above all else. The closing of borders has been a common news item since the pandemic began, but nobody expects this situation to last forever. Airlines need to get back in business, as do other affected industries.

Thus, we face the following situation:

- We do not know much about the exact behaviour of COVID-19 and how best to handle it.
- We do not know how deeply this pandemic will affect the economy in the medium and long term, but some level of economic damage is inevitable. Should we throw all our efforts into overcoming the economic collapse now, despite future costs?
- The supply side will most likely remain intact or have insignificant deviation in the short run, amid declining demand (Kimura, 2020).
- One country's decision may affect and be affected by other countries, and a non-cooperative game may lead to unintended and unexpected consequences.
- We are dealing with trade-offs – overcoming short-term vs. long-term effects, market vs. public approaches, domestic vs. global interests, etc.

What Options Do We Have for Fiscal Policy?

Assuming that fiscal policy is effective, it will affect output, especially in the near term, so we need to make sure that it helps to achieve the objectives. The first priority is to prevent people from dying. Governments have allocated huge amounts of funding to handle the pandemic – supplying extra medical equipment, hospital beds, medical workers, and medicines; covering the treatment costs of infected people; and compensating for the closure of certain areas and the banning of economic activities, etc. Despite these huge efforts, it is important to note that this is not aimed at eradicating the disease, but instead at flattening the curve and reducing the number of infected people and fatalities until a vaccine is found. Thus, there is a long road ahead until the economies return to a productive state.

The second priority is to minimise production capacity losses during the pandemic and to restore production as soon as possible, perhaps when a vaccine is found. This calls for policies on job retention schemes, unemployment benefits, or extended social protection. Since the recession will most likely be caused by shrinking demand (especially for commodities), fiscal policy can be directed towards raising such demand. If unemployed people still have the ability to consume, they will make the production sector active and workers will earn income from industries that have reignited production. In this case, pouring money into the market will not increase inflation, particularly in the near term, as the additional money will be matched by the idle output. However, making money 'cheap' by disbursing it without careful consideration of the expected response will lead to an insignificant output effect in the near term and ruin fiscal sustainability in the long term.

Goverments should pay attention to the allocation and mechanism of spending policies. During a deep recession, multiple entities request government support. Retailers lose revenue, transport and construction experience disrupted demand, banks worry about non-performing loans, state-owned enterprises collapse, small and medium-sized enterprises perish, and people lose their jobs. All these parties request help from public funds – directly and indirectly. Since government budgets are limited, priorities should be defined based on the expected distributional impact. We also know that moral hazard, which is very likely where loopholes exist, must also be taken into account.

Tax cuts (or deferrals) and subsidies are common instruments to help economic agents. Tax cuts do not require cash from the state budget, but they cut government revenue; and if hysteresis occurs the state of low tax revenue can last longer than the recovery time. Meanwhile, subsidies require cash from state budgets, which create debatable options: loans, bonds, or printing money. At the same time, countries may need to pay attention to currency depreciation, particularly for volatile currencies, as they need to import medical supplies.

Some countries (Indonesia, Singapore, and Thailand in Southeast Asia) take dual actions, as they apply tax cuts and subsidies simultaneously. In this case, the government expects to help the affected entities by easing their obligations to the country and helping them for the lost income. Consequently, the state budget will experience dual hardship: low tax revenue and high social spending. Almost all economies issue bonds to finance their fiscal burdens. The amount of bonds issued for managing the COVID-19 pandemic has broken records.[1] This means shifting current costs to long-term burden. With a contracted economy, the debt–gross domestic product (GDP) ratio rises. Then, dual hardships become triple hardships, with low tax revenue, high social spending, and huge debt. A tight budget has narrow fiscal space. This is not to judge the policy, only to state the consequences, and we fully realise that such policies are inevitable in this situation. Hence, it is crucial to spend wisely because we do not want the triple hardships to drag the economy down in the future.

Third, governments should start planning to maintain fiscal sustainability. Increased government borrowing should be accompanied by a structured repayment schedule. Thus, spending wisely also means projecting future resources for debt repayment. It also includes continuous evaluation of current policies and takes the necessary actions to fix glitches, without diverting from the near- and long-term objectives of the fiscal policies.

The state of debt status across the ASEAN Member States (AMS) varies. The International Monetary Fund (2020) forecast global gross public debt as a percentage of GDP to reach more than 96% this year from 83% the previous year, with different rates across country groups. Based on current debt levels and additional deficits, public debt in Malaysia and Thailand could reach more than 60% and 50% of GDP, respectively, while Indonesia maintains a ratio of less than 40%. However, these figures alone do not reflect the ability to service debt sustainably without jeopardising potential growth. Hence, we would like to reiterate the rule of thumb – taking on debt cautiously and spending it wisely.

What Can ASEAN Do as a Regional Cooperation Mechanism?

Countries have their own policies to cope with the pandemic. Given several options, decisions are made based on the capacity to execute the plan and manage the consequences in the future. Options for fiscal policies considered suitable in this situation are as follows:

- Pour liquidity into the market to increase demand. It is important to pay attention to the distributional impact (how to allocate) and capacity to absorb (how to implement). Apart from budget reallocation, funding can be sourced from printing money (debt monetisation or quantitative easing), issuing bonds, or making new loans. Beware of moral hazard and rent-seeking actions that can sabotage the objectives.
- Be prepared for the consequences of the policies, especially debt repayment, possible inflation (in the case of excessive liquidity pumping or money printing), increasing future taxes, and lower savings.
- While global demand is likely to be weak in the near future, production plants need to produce goods for domestic markets and possibly regional markets, perhaps through bilateral cooperation.

Despite remarkable progress in regional cooperation, particularly trade, cooperation in financial and fiscal policy in the Association of Southeast Asian Nations (ASEAN) seems to work slowly. Initiatives are in place to deepen financial integration for both the monetary and fiscal sectors, but implementation is sluggish. The financial crisis that has hit the European Union and the United States also hampers progress. Jumping into regional cooperation in the midst of a crisis is not a good option because individual members have their own challenges. However, loose fiscal and monetary cooperation is possible and may create mutual benefits.

Possible areas of cooperation include the following:

- Currency swap and repo line facilities. Advanced economies such as Australia, Japan, and the Republic of Korea may have the capacity to offer these to AMS.
- Taking indirect actions towards supporting effective fiscal policy, e.g. health cooperation to prevent the spread of COVID-19, facilitating intra-ASEAN trade in medical supplies, and simplifying non-tariff measures for regional medical cooperation.
- Data exchange to monitor the region's financial health status and potential market.

The modern world requires connectivity. We will not see any AMS detached from its counterparts in the region. The economy can absorb both the advantages and challenges of an interconnected world. Because of this, regional cooperation will have advantageous multiplier effects compared with individual efforts, including fiscal and monetary policies. Therefore, strengthening regional cooperation is a sine qua non for ASEAN.

As trade is one of the proven remedies for economic growth, the region can revisit and strengthen its capacity to increase demand. In 2018, intra-regional trade contributed about a quarter to one-third of the international trade of AMS. If the data are extended to China, Japan, and the Republic of Korea (ASEAN+3), they reached up to about half of the total AMS international trade, as shown in the table.

[1] The stimulus packages for these countries are as follows (as of 9 June 2020, GDP refers to FY2019): Indonesia, $48 billion (4.3% of GDP); Malaysia, $68.2 billion (19% of GDP); the Philippines, $30 billion (8.4% of GDP); Singapore, $66 billion (about 19.2% of GDP); and Thailand, $63.79 billion (about 12.3% of GDP).

We hope that the regional economy will extend itself to cover ASEAN+6 by the conclusion of the Regional Comprehensive Economic Partnership.

Trade recovery can be achieved by restoring existing export and import activities, plus exploring new tradable commodities, e.g. medical supplies, medicines, goods related to research, and trading between special economic zones. Apart from commodities, trade can be extended to various services such as educational services, healthcare services, and tourism activities between designated zones.

Adequate soft infrastructure should be in place to support those activities, particularly facilitation for digital trade, satellite and cyber optic backed connectivity for fast data transmission, a special agreement on regional cooperation in healthcare services, and agreed regional/international standards for the 'new normal'.

Table 1 : Share of International Trade of AMS, 2018

Country	Intra-ASEAN trade (% of total international trade)		ASEAN+3* (% of total international trade)	
	Export	Import	Export	Import
Indonesia	23.3	24.5	54.6	64.1
Malaysia	28.5	27.5	53.2	62.1
Philippines	16.5	26.2	48.4	58.2
Singapore	30.1	23.2	52.2	48.9
Thailand	25.8	18.2	49.8	57.9
Viet Nam	9.8	13.6	42.5	74.2

AMS = ASEAN Member States, ASEAN = Association of Southeast Asian Nations.
* China, Japan, and Republic of Korea.
Source: United Nations (2018), UN Comtrade Database. https://comtrade.un.org/data/ (accessed 4 June 2020).

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