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The Global Economy after COVID-19: Challenges and Policy Resolutions

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The COVID-19 pandemic disrupted the world economy in 2020. As of December 23, 2020 the World Health Organization (WHO) reports more than 76 million confirmed cases of COVID-19 and over 1.7 million deaths worldwide. Even more concerning is that these numbers are still growing fast. "The Great Lockdown" due to the pandemic has persisted throughout the year and caused the worst economic downturn since the Great Depression. The World Trade Organization (WTO) projects a 9.2 percent decrease in the volume of world merchandise trade in 2020 followed by a 7.2 percent increase in 2021, according to the WTO's trade forecast released in October. This revised projection shows a much less severe decline than its previous forecast, which ranged from 13 percent (optimistic scenario) to 32 percent (pessimistic scenario). Swift and enormous policy responses to COVID-19 by many governments with fiscal stimulus supported by expansionary monetary policy might have mitigated the disastrous effects on world trade. Nevertheless, tremendous uncertainty still remains about the strength of the recovery.

This special issue of the East Asian Economic Review (EAER) published by the Korea Institute for International Economic Policy (KIEP) was designed to address fundamental challenges to the global economy due to the COVID-19 pandemic and to

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contribute to policy debates. Contributions were made by distinguished economists across the world on the theme of "The Global Economy after COVID-19: Challenges and Policy Resolutions." The EAER special issue also celebrates the 30th anniversary of KIEP beginning operation.

At the intersection of the COVID-19 pandemic and the global economy, numerous issues pose challenges to scholars and policy makers. The de-globalization phenomenon coupled with trade slowdown has been an issue even before the pandemic broke out. There are several outstanding issues in international trade such as disruptions of global value chains, the multilateral trading system in crisis and WTO reform, the US-China trade war, and accelerating digital transformation of the world economy (rapid development and growth of digital technology and digital trade) among others. In international macroeconomics and finance, some of the important issues that are interconnected with the current pandemic and need to be addressed include the global financial crisis and its aftermath, crisis management, capital flow management, exchange rates, and financial globalization.

Trade and financial globalization have marched hand-in-hand continuously for several decades before the global financial crisis. However, the de-globalization of international trade was initiated by the global financial crisis, and it continued with a series of events such as Brexit and the US-China trade war that came after the global financial crisis. International trade has fallen sharply under COVID-19, and many people predict that de-globalization of international trade is likely to continue even after COVID-19 ends.

Under such circumstances, some people expect that the trend toward financial globalization will also be reversed. First, some emerging and developing countries experienced reversals in capital flows under COVID-19, and this may continue after COVID-19 ends. Second, trade and financial integration/globalization tend to have a positive correlation, as documented in some past studies. There are various reasons for the positive relationship. Trade openness may motivate cross-border financial transactions. International trade naturally evolves with corresponding international financial transactions, and therefore a fall in international trade would lead to reduction in international financial transactions.

However, there are some reasons that financial globalization may likely continue even after COVID-19 ends. First, capital inflows to some economies were reversed during the 2008 global financial crisis, but they recovered and capital inflows to those economies continued soon after the global financial crisis. Like the global financial crisis, reversals in capital inflows to some economies may end and capital inflows may continue soon after the COVID-19 ends. In addition, the size of outstanding cross-border assets and liabilities is huge, as a result of financial transactions made in past decades. Thus some reversals in capital flows seen during COVID-19 will not affect the size of cross-border assets and liabilities in a major way.

More importantly, under COVID-19, the service industries, especially those that need face-to-face interaction, suffered hardship, but contract-free service sectors equipped with information technology have had even more opportunities than usual. Financial transactions, especially international financial transactions, can be easily performed without direct contacts. In addition, a new trend in financial industry is led by FinTech. This may suggest that financial globalization can even be accelerated with the help of information technology and the developments of FinTech.

As a result, financial globalization may help to slow down the de-globalization of trade after COVID-19. As international financial transactions can be easily implemented, international trade transactions would be facilitated. In addition, financial openness may motivate international trade.

This special issue of the EAER features seven papers on important topics in both international trade and international macroeconomics and finance. Some observations and further thoughts for these contributions are provided below.

Hanson, Gordon, “Who Will Fill China’s Shoes? The Global Evolution of Labor-Intensive Manufacturing”

Gordon Hanson points out that China’s expansion to dominate world trade in labor-intensive manufactured products has reached a peak and appears to be reversing. That raises the interesting and important question of how China’s domination of these products will be replaced. In his essay Hanson explores three alternatives that might potentially serve that purpose, evaluating the likelihood of each.

First, and perhaps most obvious, would be for another group of low-wage countries to replace China in this role. He identifies a plausible group of countries in Asia and Europe that might do this, but he is skeptical that they have adequate capacity. A second option would be for China itself to maintain its lead in these sectors by replacing labor with new labor-saving technologies embodied in capital. This seems unlikely, however, as the roles that labor continues to play in such industries as textiles and apparel seem to be the least able to be replaced by machines. Hanson's third option would also be for China to maintain its dominance in labor-intensive manufactures, but by replacing its current labor with lower-paid labor in China's interior. That makes sense, given the size of the country and the distribution of wages, but he sees no sign, as yet, of this happening.

Hanson seems skeptical, then, about aspects of each of these options, and he therefore does not conclude with any prediction of how this will play out. On that basis, it seems most likely that events will include a mix of all three of these options.

Hoekman, Bernard, "WTO Reform Priorities post-COVID-19"

Bernard Hoekman addresses several aspects of how the World Trade Organization needs to be reformed. None of these are new or specific to the COVID-19 pandemic, but the need for them has become even more evident during the pandemic, as many countries have taken actions that flouted either the rules or the underlying principles of the WTO. Hoekman discusses four areas of reform: transparency; support for deliberation; governance of plurilateral agreements; and fixing dispute settlement.

On transparency, Hoekman points out that the WTO falls regrettably short of having full information about member country trade measures, even though they are required to report them. Using the database now available from Global Trade Alert, he graphs those data against measures identified by or reported to the WTO, and finds that the WTO data fall far short of being complete. Just how the WTO is to correct this problem, he does not say.

His remarks on support for deliberation are less precise, the main point being that WTO efforts to study and provide information about issues of negotiation continue to be essential to their success.

On plurilateral agreements, Hoekman provides very specific recommendations. Recognizing that these are likely to be the major means by which WTO members will move forward, he lists some eight elements that he says should be formalized as governing these agreements, all of which would serve to assure that their benefits would not be confined to only those who subscribe to them.

Finally, on dispute resolution, Hoekman does not need to remind us of the current sad state of the Dispute Settlement Understanding, and his main suggestion here is that reforms not be limited to only fixing the Appellate Body, but rather should include improving the panel process, though he does not say how to do that.

Bown, Chad P., “How the United States Marched the Semiconductor Industry into Its Trade War with China”

Chad Bown gives us a detailed history of trade conflicts in the semiconductor industry. These stretch back to conflicts between the US and Japan in the 1980s, but they are now central to the trade war between the US and China. Driven, at least on the surface, by concerns about national security, these also are plausibly an effort by the US to prevent China from dominating an industry that is of critical importance to modern technological economies.

In contrast to the US-Japan conflict of the 1980s, the current conflict with China involves much more than just US imports. Semiconductors were just one of many products targeted by the tariffs levied against China in 2018. More important, as discussed clearly by Bown, were investment restrictions, anti-trust actions, and especially export controls that were intended to cripple the major Chinese company, Huawei.

Interestingly, the aim of the latter policy could not have been to support a US competitor, since Huawei’s major competitors are all non-US. Indeed, the implication may be that these actions have only hurt US suppliers without any compensating US economic gain. This is in marked contrast to the US-Japan conflict, which was intended to benefit US competing suppliers, and may have been understood only by economists to have hurt the larger US.

Bown concludes this discussion with his expectation that the semiconductor supply chain will respond to all of this by changing, but in “unexpected ways” that he does not attempt to predict.

Miroudot, Sébastien, “The Reorganization of Global Value Chains in East Asia before and after COVID-19”

Sébastien Miroudot documents the performance of global value chains in East Asia, and the role that trade costs may have played in their expansion beginning in the early 1990s and then especially in the halt and perhaps reversal of that expansion since the global financial crisis. The purpose is to guide expectations of how supply chains may respond after the COVID-19 pandemic.

To measure both the import-intensity of production and trade as well as the costs of trade, Miroudot draws on the OECD Inter-country input-output tables released in December 2018. From this he constructs measures of global import intensity and then uses a gravity model to measure trade costs. From these he shows that for his sample of East Asian countries (China, Hong Kong, Japan, Korea, and Taipei), one cannot explain slowed growth of import intensity from trade costs.

That of course leaves open what may happen both during and after the pandemic, which we cannot know. But the implication is that if indeed the pandemic causes supply chains to be shortened, the reason will not likely be an increase in trade costs.

Uribe, Martin, "Financing COVID-19 Deficits in Fiscally Dominant Economies: Is the Monetarist Arithmetic Unpleasant?"

Martin Uribe addresses optimal monetary policy when the path of fiscal policy is exogenous. While his direct aim is to counter the negative implication of the word "unpleasant" in a contribution of Sargent and Wallace from 1981 – "Some Unpleasant Monetarist Arithmetic" – his message may be very much of current relevance. It is that, when circumstances present for large but declining fiscal deficits, the optimal monetary policy is likely to be to finance them early on with borrowing rather than with the seigniorage that accrues to money creation. Sargent and Wallace are correct that this does not avoid inflation but only postpones it, but they are incorrect in implying that this is undesirable. In the model here, which captures the essence of the "monetarist arithmetic" of Sargent and Wallace, variation over time in the rate of inflation is distortionary, and therefore the optimal path of policy is to smooth the path of inflation over time. This is done in the presence of a declining deficit by early borrowing.

Uribe delivers this message by first constructing a simple monetarist model of a static endowment economy with utility deriving from both consumption and the holding of money. He solves this for the optimal path of monetary policy given an exogenous path for the fiscal deficit – what he calls fiscal dominance. The result is as just described, and is then extended also to a growing economy.

He illustrates his result with a numerical example based on the experience of Argentina beginning in 2015 under Macri, who was saddled with an initial debt and deficit by the prior administration, and undertook to reduce the deficit gradually over time. Uribe gives him eight years to do that and derives what would have been optimal to do, though of course in reality Macri did not last that long in office.

For our purposes here, this paper may be of considerable relevance, as the pandemic has imposed on countries the need for even larger fiscal deficits than they were accustomed to, and the hope is that as the world emerges from the pandemic, these deficits will be able to decline. The model here suggests that even though these deficits may ultimately need to be financed by printing money, the inflationary impact of that should be postponed by greater borrowing in the present and near future.

Gao, Xiang, Zhenhua Gu and Kees G. Koedijk, "On the Role of Projected FDI Inflows in Shaping Institutions: The Longer-Term Plan for Post-Pandemic Investment Reboot"

Xiang Gao, Zhenhua Gu, and Kees G. Koedijk address the prospects for recovering from the pandemic through a combination of FDI and improvements in institutions. Specifically, they hypothesize two linkages between FDI and institutions that may operate, and they find evidence in support of both. The first linkage is that firms that have previously engaged in FDI exert their own influence on their host government to improve institutions that matter to them. The second is that, knowing the importance of institutions for attracting FDI, interested domestic parties will lobby their governments to make these improvements. Using data on FDI and institutional quality for a large number of countries and years, the authors find support for both hypotheses, with the greatest effect being the second.

In order to distinguish the two effects, they first use a gravity equation to predict FDI based on exogenous country characteristics, and they then use the results of this estimation to construct levels of predicted FDI. By then regressing several separate measures of institutional quality both on actual FDI and on this predicted FDI, they are able to distinguish their two hypotheses.

Aizenman, Joshua and Hiro Ito, "U.S. Macro Policies and Global Economic Challenges"

Joshua Aizenman and Hiro Ito address how the United States should respond with macroeconomic policy after the pandemic ends, leaving it with the huge debt that has been run up during the crisis. They identify two alternatives that might be followed, the first being to return to the policies that were in place before the pandemic, and the second being to use fiscal policies with "high social payoffs" in a strategy that will only gradually reduce deficits. They discuss these alternatives in the context of several earlier macroeconomic responses to crises, including after World War II, after the high inflation of the 1970s, and after the global financial crisis of 2008-9. They discuss these historical episodes in the context of theoretical "snowball effects" that can be positive or negative depending on whether the economy's rate of growth exceeds or falls short of the rate of interest. Their main point is that the first of the alternatives would be likely to cause great harm for emerging markets and global stability.

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