PRESS RELEASE
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Governor Martin Galstyan's Opening Speech for 2020 Armenian Economic Association Annual Meetings

COVID-19 and its Economic Implications

Good morning. Let me first start with thanking the organizers for inviting me to this wonderful event. The program of the Armenian Economic Association annual meetings is impressive, and I congratulate all the organizers for putting together this conference despite all the difficulties at this time.

The topic of my talk today is, not surprisingly, the Covid-19 and its economic implications. I will start with laying out the global context with particular emphasis on comparison with the Global Financial Crisis (GFC) of 2009. I will stress uncertainty, which, will drive the economic activity taking its toll on aggregate demand at least in the short-run. After describing fiscal and monetary policy response around the world and zooming in on emerging markets, I will present our economic outlook for Armenia.

The overarching message is that despite the very aggressive fiscal and monetary policy response, macroeconomic policy cannot fundamentally address the health crisis, which is the key unknown in all our scenarios. The role of macroeconomic policy, though, is to preserve macroeconomic stability in these difficult times, so that macroeconomic and financial aberrations do not derail the recovery. In this respect, I would like to stress that the Central Bank of Armenia has the necessary policy space to preserve the price and financial stability in Armenia.

https://www.youtube.com/watch?v=nEcDDFpkBoE

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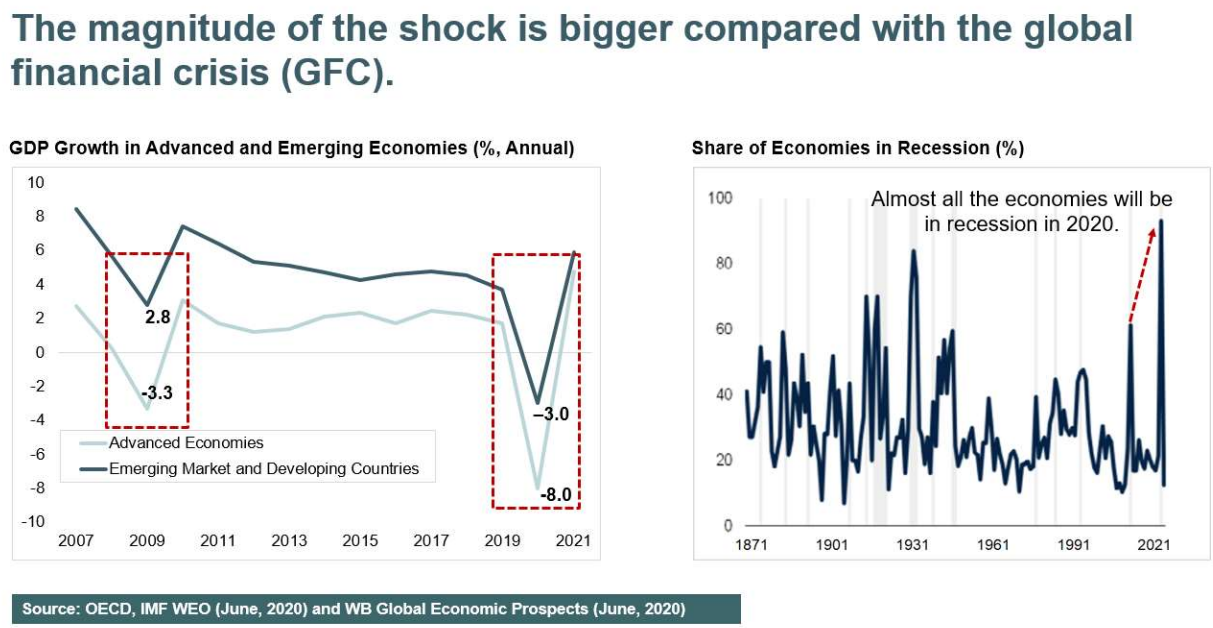
CBA Public Relations Service
Tel/Fax: (374-10) 56 37 61
E-mail: mcba@cba.am
www.cba.am

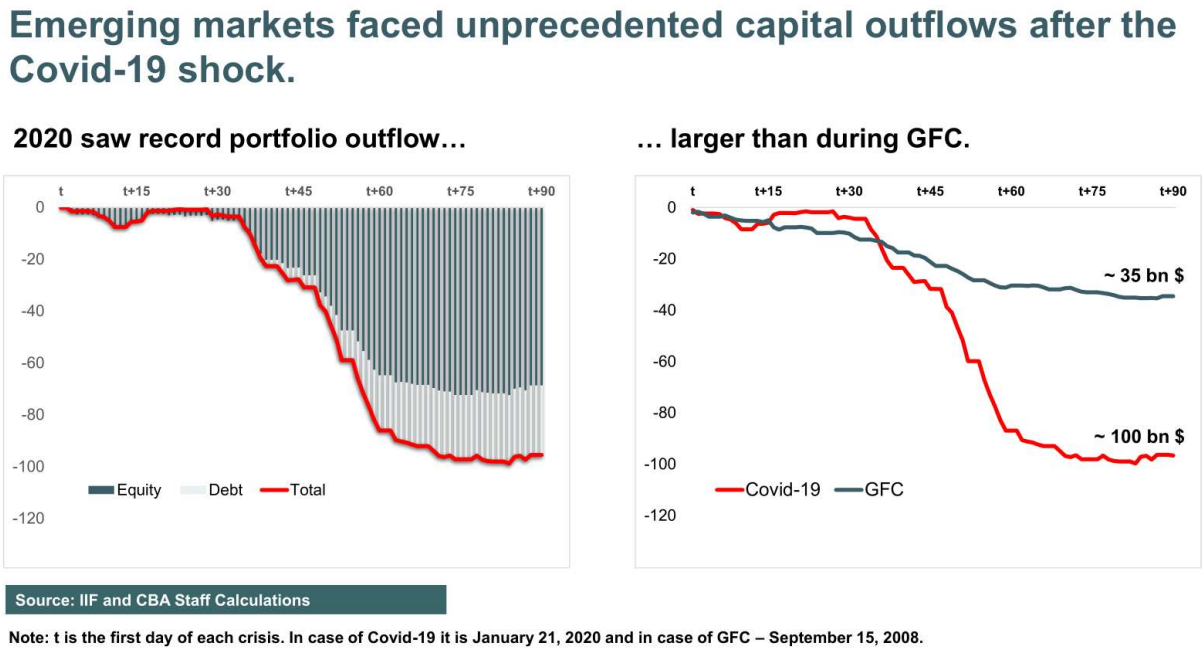
Let me start with the magnitude of the shock. Figure 1 shows the expected growth slowdown in advanced and emerging markets in 2020. Both advanced and emerging markets will face much bigger slump compared to the GFC. The left-hand-side graph shows that according to the latest WEO update of June 24[i], advanced economies will contract by 8.0% in 2020 compared to 3.3% in 2009. Emerging markets will contract by 3.0% in contrast to positive 2.8% growth in 2009. The right-hand side chart in turn depicts the share of economies, which will be in recession in 2020. Strikingly, almost all the countries will be in recession this year surpassing the GFC by a wide margin and exceeding even the Great Depression.[ii] It is worth noting that these forecasts are likely to be revised quite a bit over the next two quarters as the fundamental uncertainty around the resolution of the health crisis is out of sight as of now.

Figure 1



Let us zoom in on emerging markets for a moment. Emerging markets faced unprecedented capital outflows both by speed and magnitude after the Covid shock. Indeed, as the left-hand-side chart in Figure 2 illustrates, during the first three months after the outbreak of Covid-19 100bln USD left emerging markets. The right-hand-side chart shows that this episode belittles the GFC capital outflows, which stood at 35bln USD. Of course, it is too soon to judge the developments for Q2 as there is no data available, however some preliminary estimates indicate that the capital outflows have somewhat reversed since April.

Figure 2



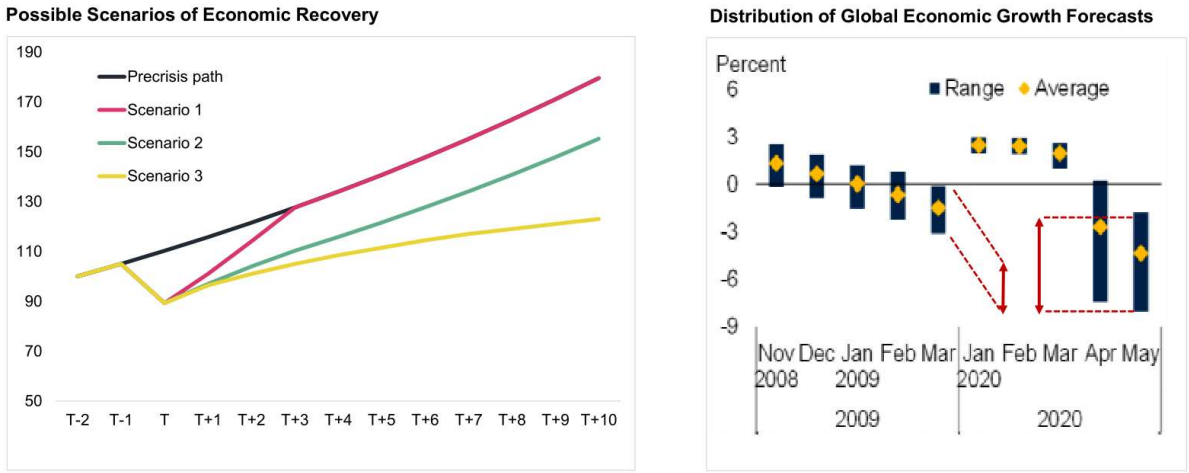
I stressed uncertainty in the beginning of my talk, because it contains a key judgment guiding our policy. Indeed, one of the main questions, given the unique type of the shock, is the relative speed of slowdown of supply and demand. The answer to this question has direct implications for monetary policy—a sharper decrease of demand versus supply will have deflationary implications in the short-to-medium run, whereas inflationary developments will prevail in case supply contraction is more severe. Our judgment is that in the near term the elevated uncertainty will lead to sharper decrease in demand compared to supply leading to deflationary pressures. A good example is the US personal saving rate, which jumped to 33% in April reflecting the precautionary savings in the face of uncertainty. Of course, this judgment is subject to continuous revisions given the possible effects of the pandemic on supply chains.

Uncertainty, in the current context has many facets. In Figure 3 the left-hand-side chart is a stylized illustration of uncertainty around the recovery. Indeed, the much-debated V-shape, L-shape or other shapes of recovery are pretty much on the table right now. The worst-case scenario is depicted by the yellow line on left, which is the case when the growth slows down persistently— possible stories behind this include hysteresis in labor markets and skill destruction, supply chain destructions, structural change in demand etc. Arguably, one of the main roles of macroeconomic stabilization policies at this stage is to pull economies further from this dangerous edge to avoid long-term damage.

To conclude on this point, the right-hand side chart shows the distribution of growth forecasts now and at the outset of the GFC—clearly, nowadays the shape of recovery is much less clear, as the distribution of forecasts is about twice wider.[ii] We will have a detailed box on this in our next Inflation Report to be published on June 30th, which I invite you to read.

Figure 3

The high uncertainty about recovery scenarios is reflected in forecast distribution.

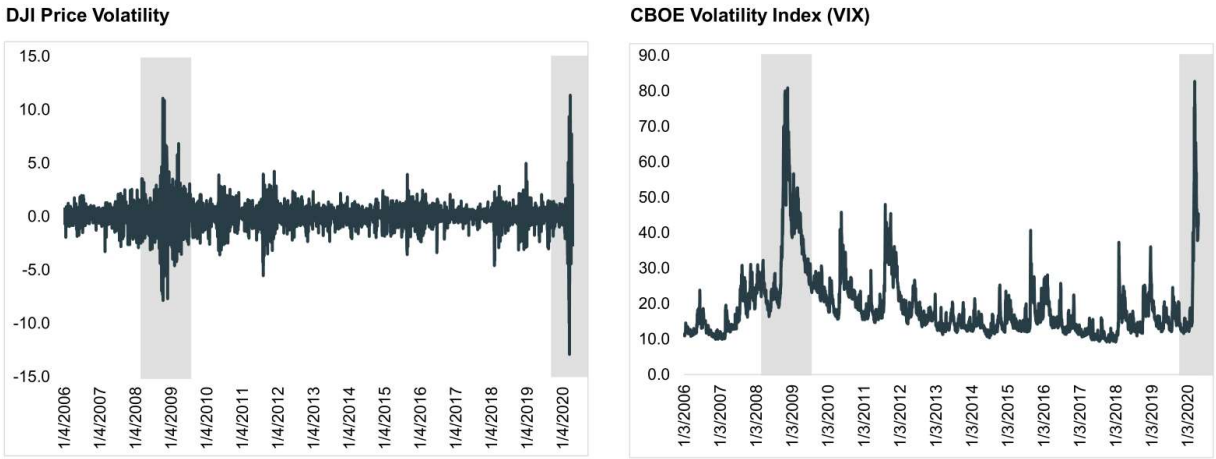


Source: CBA and WB Global Economic Prospects (June, 2020)

Of course, the uncertainty around the real sector of the economy is reflected in the financial markets as it is shown in Figure 4. Clearly, the volatility in the financial markets is similar to what we saw during the GFC.

Figure 4

Financial markets were experiencing dramatic uncertainty.

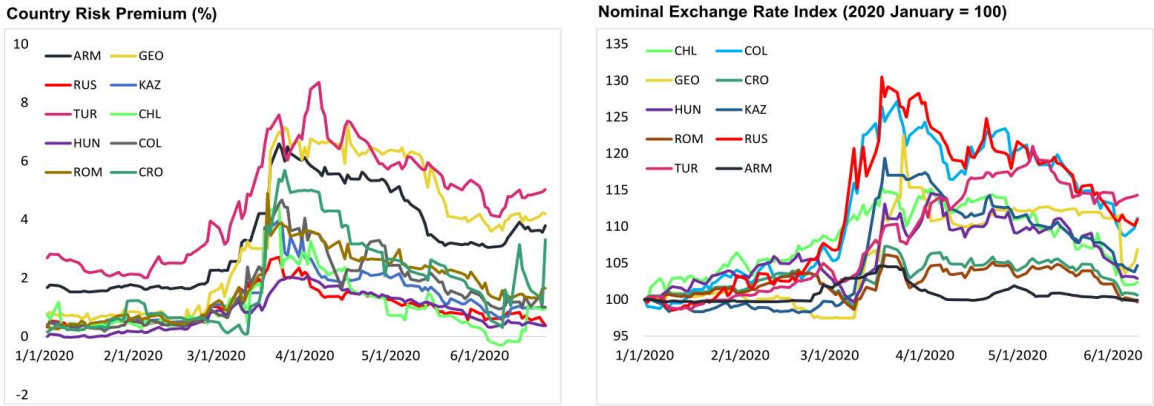


Source: St. Louis Fed Economic Data

Zooming in on emerging markets again, we can see from Figure 5 that investor risk aversion jumped abruptly since March. The left-hand-side chart shows a proxy for country risk premium for selected emerging markets including Armenia—in some countries the risk premium tripled in a matter of a month. In case of Armenia, the risk premium shot up from below 2pps to above 6pps. These premia, however, have mostly recovered, which is consistent with the earlier observation that capital outflows have somewhat eased during last two months.

Figure 5

Emerging-markets risk premia spiked and exchange rates depreciated drastically.



Source: Reuters and CBA Staff Estimates

Country risk premium is defined as Eurobond spread over the US government bonds with the same maturity.

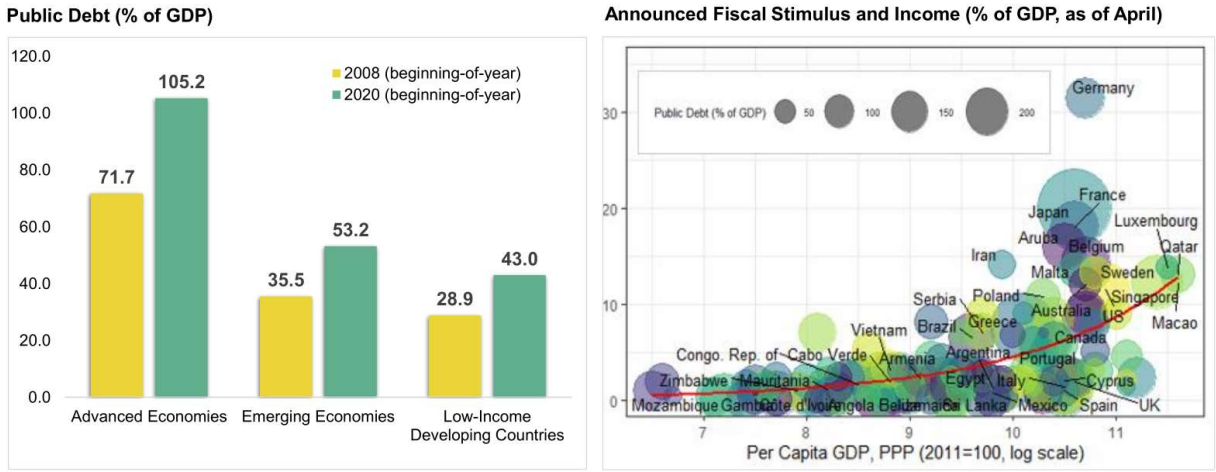
Moving to policy, I would like to discuss fiscal policy in the face of Covid-19 shock first. My first observation is that countries entered the current recession with much higher levels of public debt compared to the GFC. As the left-hand-side chart in Figure 6 shows, this is true irrespective of level of income. Advanced economies, for example, had 105.2% of public-debt-to-gdp ratio, in the beginning of 2020, as opposed to 71.7% in 2008.

Does this imply less fiscal space to act? We have to be careful here, as the levels of public debt are not straightforward to interpret. Indeed, this is a topic of fierce debate nowadays. On one hand, some economists claim that given the ultra-low interest rates, which are likely to stay with us for a long time, sustainable levels of public debt are much higher. Moreover, as long as g>r it makes sense to borrow cheap and invest in public capital with high return. Even though g will be low this year, but in the medium run it will most probably exceed r. On the other extreme, the argument is that public debt increase cannot go on forever and markets at some point will impose fiscal discipline by pricing in non-linear increase in borrowing costs. On this question jury is still out and I expect it to stay as a topic for fierce debate for coming years, but one thing is clear—developed and developing countries face very different constraints.

To illustrate this last point, let us look at announced fiscal stimulus package around the world in response to the pandemic. The right-hand chart in Figure 6 depicts the size of fiscal stimulus in terms of percent of GDP against the per capita income. The pattern is unmistakable, poorer countries even with lower levels of debt announced much less counter-cyclical fiscal policy compared to their richer peers. Moreover, the pattern is non-linear. More generally, a more formal analysis, which I do not show here due to time constraint, clearly shows that the level of country risk derived from rating-agency assessments explains much of the variation in fiscal stimulus.[iii] Of course, the caveat is that these are announced packages, which may differ from actual implemented ones.

Figure 6

Countries entered the Covid-19 period with much higher public debt burden compared with the GFC.



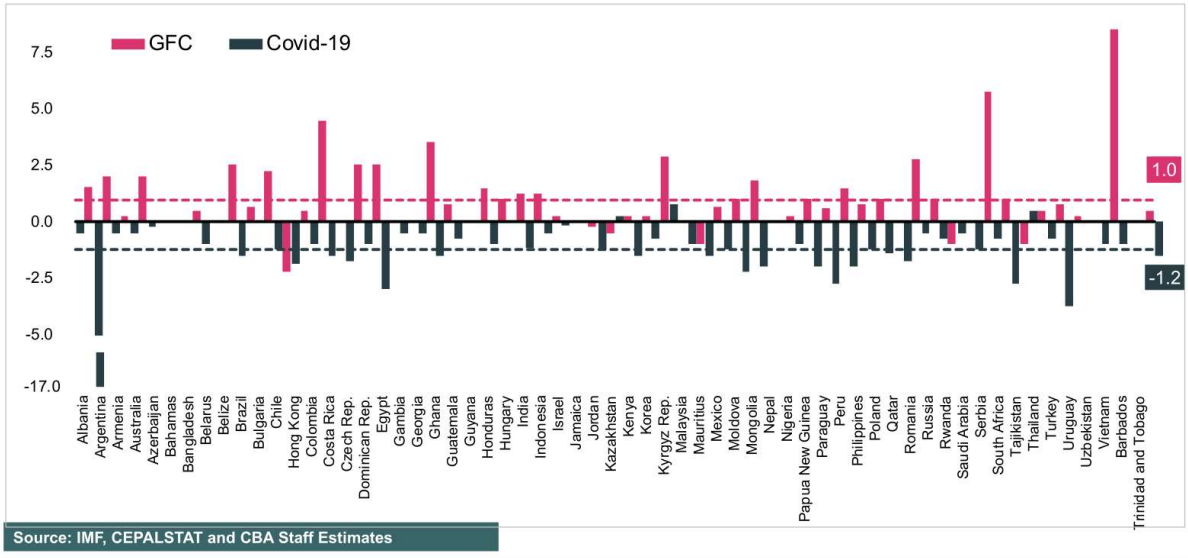
Source: The World Bank, IMF Global Debt Database, IMF Coronavirus Government Response Tracker and CBA Staff Calculations

Let us turn now to monetary policy concentrating on emerging markets. It is quite striking that there is a dramatic shift in monetary policy response since the GFC. Indeed, as the Figure 7 shows, after the GFC, at least in the short-run, the majority of emerging markets had to tighten their policy, whereas after the Covid-19 shock the picture is completely reversed—the majority of countries substantially eased their monetary policy.

What is driving this shift? One of the possible explanations is that inflation is much lower and better anchored now in emerging markets creating policy space to react.

This is certainly true for Armenia—we were the first in the region to react, when other countries were not able to ease in the face of capital outflows. Our assessment is that our disinflationary policy since 2014 shock created this policy space for us. Of course, any developments are possible, since there is no clarity about the resolution of the health crisis, however my main message is that we have room to adjust our policy on both sides as forcefully as needed.

Figure 7



Without going into much details, I would like to point out yet another interesting development—many countries, including emerging markets, resorted to variety of QEs much more forcefully and quickly compared to the GFC.[iv] Of course, advanced economies, like US, had experience in doing this, so to some extent the sizes of their packages, even though unprecedented, were not surprising.

As it is shown in Figure 8 what is new is that emerging markets, which have conventional monetary policy space, chose to implement QEs. The most common explanation behind this is the nature of the shock, which involved major liquidity shock caused by the crisis. According to this story, the liquidity shock prompted emerging markets to intervene to stabilize the markets. Here again, the jury is still out and time will show, if some of these actions were opportunistic.

Figure 8

…and was accompanied by a variety of asset purchase programs.

QE Programs of Emerging Countries

Country	Date	Size	Type of Asset
Israel	23-Mar	50 billion ILS	Sovereign
Korea	25-Mar	Unlimited repos for 3 months	Repos
Colombia	24-Mar	12 trillion COP	Sovereign
South Africa	25-Mar	Unspecified amount	Sovereign
Poland	08-Apr	Unspecified amount	Sovereign, State-Guaranteed Bonds
Romania	20-Mar	Unspecified amount	Repos, Local Government Bonds
Hungary	28-Apr	1.3 trillion HUF	Sovereign, MBS
Croatia	13-Mar	Unspecified amount	Sovereign
Philippines	24-Mar	300 billion PHP	Sovereign
Mexico	21-Apr	100 billion MXN	Sovereign, Corporate Bonds
Turkey	31-Mar	Unspecified amount	Sovereign
India	20-Mar	400 billion INR	Sovereign
Indonesia	01-Apr	Unspecified amount	Sovereign

QE Programs of Advanced Economies

Country	Date	Size	Type of Asset
U.S.	16-Mar	700 billion USD	Sovereign, MBS
U.S.	23-Mar	Unlimited	Sovereign, MBS, Corporate Bonds
U.K.	19-Mar	200 billion GBP	Sovereign, Corporate Bonds
Europe	18-Mar	750 billion EUR	Sovereign
Japan	26-Apr	Unlimited JGBs	Sovereign, Corporate Bonds
Canada	27-Mar	3.5 billion CAD per week	Sovereign
Australia	19-Mar	Unlimited	Sovereign
New Zealand	23-Mar	30 billion NZD	Sovereign
Sweden	16-Mar	300 billion SEK	Sovereign

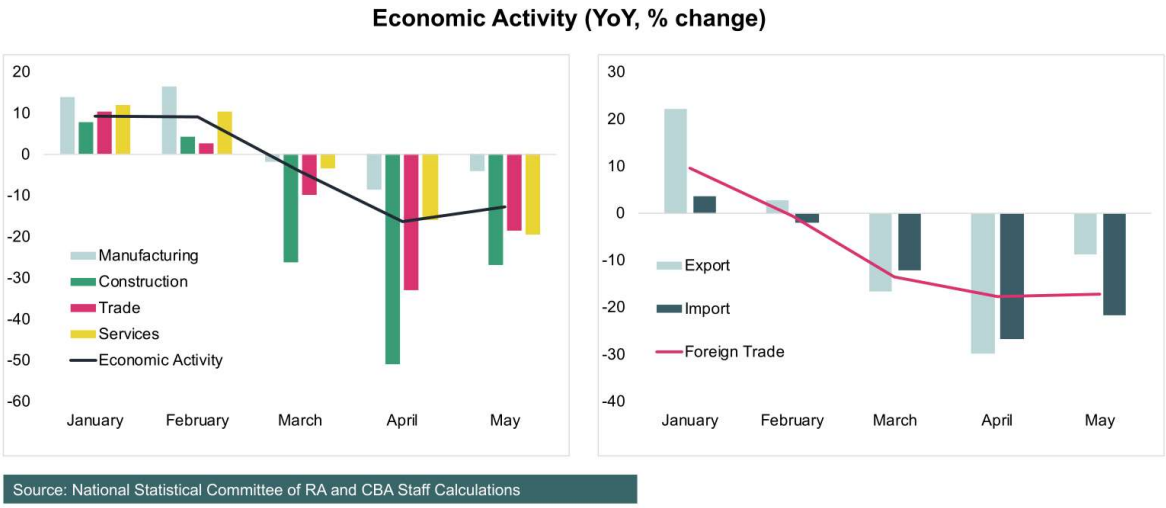
Source: Hartley J. and Rebucci A. (June, 2020)

Countries at Zero (Effective) Lower Bound (ZLB)

Having laid out the global context, we can now move to the economic outlook for Armenia. The Figure 9 shows that slowdown in economic activity most probably hit the bottom in April following the strict lockdown. In May the YoY decline of economic activity stood at 12.8% and was broad-based. Both import and export compressed, which is consistent with demand slowdown.

Figure 9

In Armenia the slowdown of the economy is likely to be broad-based.



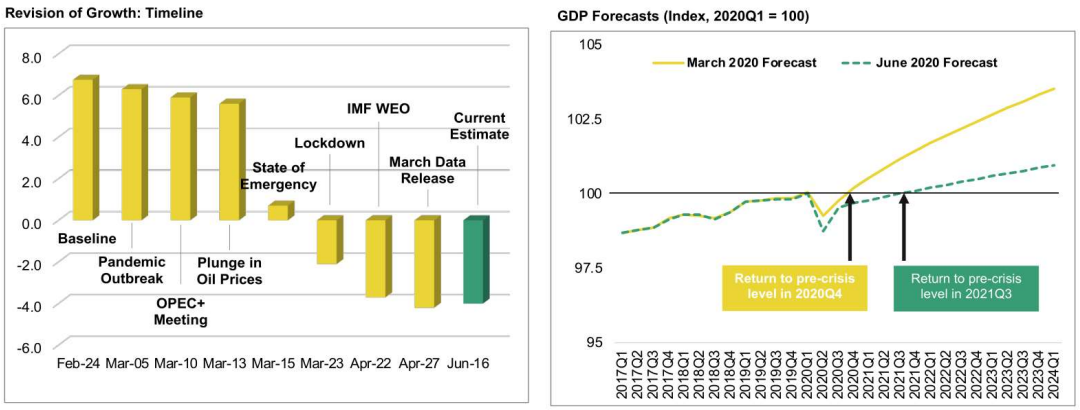
Source: National Statistical Committee of RA and CBA Staff Calculations

We will publish our updated forecasts next week, but I will show here the timeline of our previous forecast revisions. The left-hand chart in Figure 10 shows that our growth forecast for 2020 was revised down from above 6% in February to the negative territory. The two biggest forecast revision took place in the middle of March, when state of emergency was declared and then strict lockdown followed.

The right-hand chart shows that we see the recovery much protracted as compared to our last published forecast. This revision was one of the main reasons we decided to decrease the policy rate by 0.5pps during our last interest-rate-setting meeting.

Figure 10

Growth forecasts were revised down since the beginning of the year.

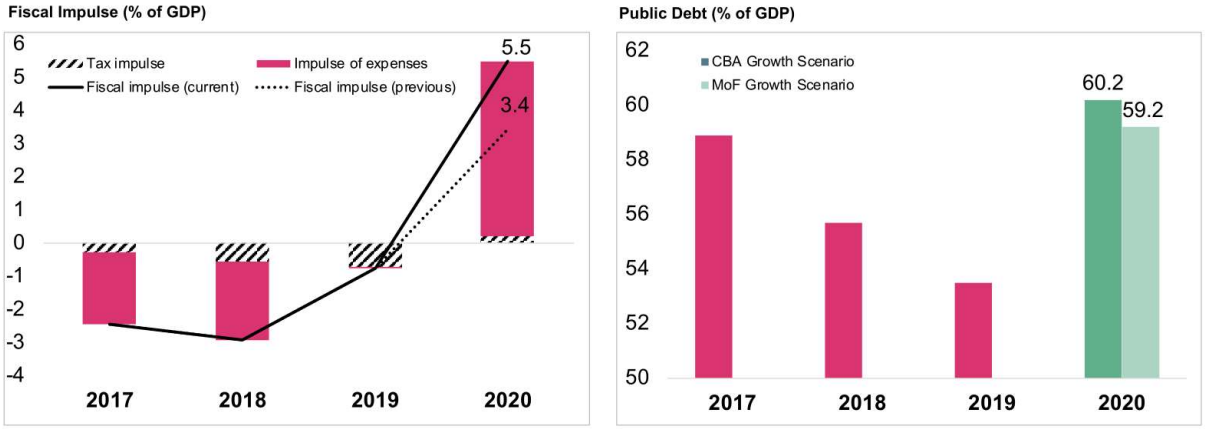


Source: CBA Staff Estimates

Fiscal policy in 2020 will be more expansionary compared to the original budget with 5.5% fiscal impulse (Figure 11). The latest change of corporate tax administration will likely add another 0.9 pps. Notably, fiscal policy, rightly used the escape clause in the fiscal rule to implement a countercyclical policy. The debt is expected to exceed 60% at the end of 2020.
Given the nature of the shock, fiscal policy is the first line of defense with its broad base of instruments. Moreover, in contrast to monetary policy, the expansionary fiscal policy is well-placed irrespective of relative strengths of demand and supply slowdown.

Figure 11

Fiscal policy used escape clause to support the economy.

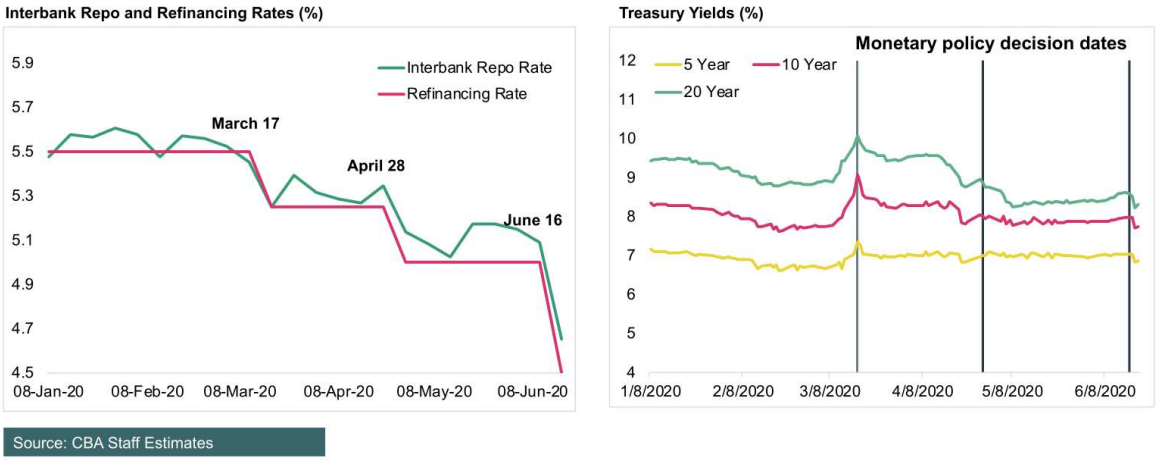


Source: 2020 Budget Law and CBA Staff Estimates

The Central bank of Armenia eased monetary conditions three times since March decreasing the key rate cumulatively by 1.0pp. This was accompanied by significant increase in our weekly refinancing operations: the weekly refinancing volumes quadrupled since March. The right-hand-side chart in Figure 12 shows that these monetary policy actions succeeded in stabilizing the government bond yield curve.
It is worth stressing again that the ability to ease policy, when facing significant uncertainty and volatility in financial markets, was a result of consistent policy after 2014 oil price shock. The disinflationary policy that the Central bank of Armenia followed since then clearly paid off. Nevertheless, it is too soon to judge the results of monetary and fiscal policies, as the health crisis is not over.

Figure12

Monetary policy actions resulted in stabilization of the financial market.



Source: CBA Staff Estimates

I will have a short conclusion.

- Despite the forceful monetary and fiscal response, there is still no clarity around the shape of recovery.
- Public debt will be a key question for years to come.
- In Armenia, economic outlook critically depends on health developments, which is a key uncertainty in all our forecast scenarios.

To finish my talk, I would like to emphasize the importance of research and this kind of conferences for the Central bank of Armenia. You will see today my colleagues presenting their models on Covid-19 and its policy implications, which was done literally in matter of weeks and fed into our actual decisions. There is no better proof of imporatance of evidence- and research-based policymaking.

With this, I would like to thank you all for your attention.

References

[i] IMF World Economic Outlook Updates (June 2020), “A Crisis Like No Other, An Uncertain Recovery”
[ii] See WB’s Global Economic Prospects (2020), “Pandemic, Recession: The Global Economy in Crisis”
[iii] See Nurbekyan, Minasyan, Hayruni (2020) “Emerging markets need fiscal stimulus too. The IMF must get more firepower”, LSE blog
[iv] See J. Hartley and A. Rebucci (June 2020), “An Event Study of COVID-19 Central Bank Quantitative Easing in Advanced and Emerging Economies”, NBER Working Paper No. w273395.