## Asia-Pacific Financial Forum Virtual Roundtable on Economic Recovery

# The Road to Sustained Growth in the Post-COVID Era

25/26 March 2021

## ROUNDTABLE REPORT

With its wide-ranging economic impact, the COVID-19 pandemic posed an unprecedented challenge to governments and businesses all over the world. Vigorous responses from governments and central banks have succeeded in averting a major global crisis. As vaccination progresses and emergency measures are phased out, economies are expected to rebound over the short term. However, the COVID pandemic and the responses to it have left various medium and long-term challenges in their wake, which need to be addressed if economies are to achieve sustained recovery and growth. The most important of these are:

- how to reverse the deterioration of fiscal balances and huge increases in public sector debt;
- how to restore sustainable fiscal structures while promoting growth and recovery and keeping under control any resulting inflationary pressures;
- how to unwind the large balance sheets of central banks that have ballooned with their massive purchases of government bonds; and
- what growth strategies and structural reforms are needed to raise economies' potential growth rates, which is critical for central banks to be able to bring back interest rates to more normal levels.

This Virtual Roundtable was convened to assist the APEC Business Advisory Council (ABAC) in developing recommendations to APEC Leaders and Finance Ministers on how to address these challenges from the perspective of the Asia-Pacific business sector, with a special focus on micro-, small and medium enterprises (MSMEs). Special attention was paid to emerging markets, where the large build-up of debt, including non-financial private sector debt, poses important concerns about their possible impact on global financial stability.

### The Global Economic Landscape in the COVID and Post COVID Era

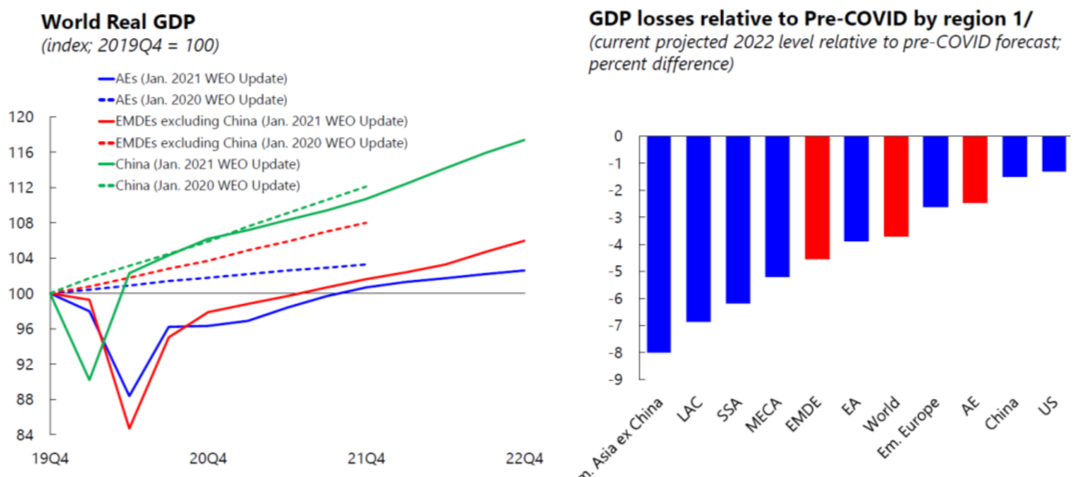
As of March 2021, many economies have started on the path to recovery, though this remains at early stages and subject to significant uncertainty. On the positive side, vaccines have been successfully developed. The increase in bankruptcies that immediately resulted from the Global Financial Crisis and other recessions has been more limited in this case, as governments ramped up support to households and businesses. Economies are adapting to social distancing. Merchandise trade is recovering and inflation remains subdued. However, there remain risks of delays in vaccination, virus mutation, stronger lockdowns and tighter financial conditions. There are also geopolitical tensions and social unrest that could escalate. Although employment numbers have recovered, the labor market remains vulnerable. Finally, the prolonged decline in economic activity is likely to leave scars in the economy.

The impact of COVID and the Great Lockdown across economies has been uneven, with the USA, China and advanced economies being the least affected, and emerging Asia ex China and Latin America at the other end of the spectrum as the regions projected to post the largest GDP losses compared to pre-COVID forecasts *[Figure 1]*.[1] This gap between advanced and less developed economies is likely to widen

[1] For further details, see the IMF's April 2021 World Economic Outlook (https://www.imf.org/en/Publications/WEO/Issues/2021/03/23/world-economic-outlook-april-2021).

due to factors such as the downturn in certain industries like tourism (on which many developing economies have a high level of dependence), the difference in their governments' capacity to provide income support to households, and the significantly higher level of school closures in developing economies.

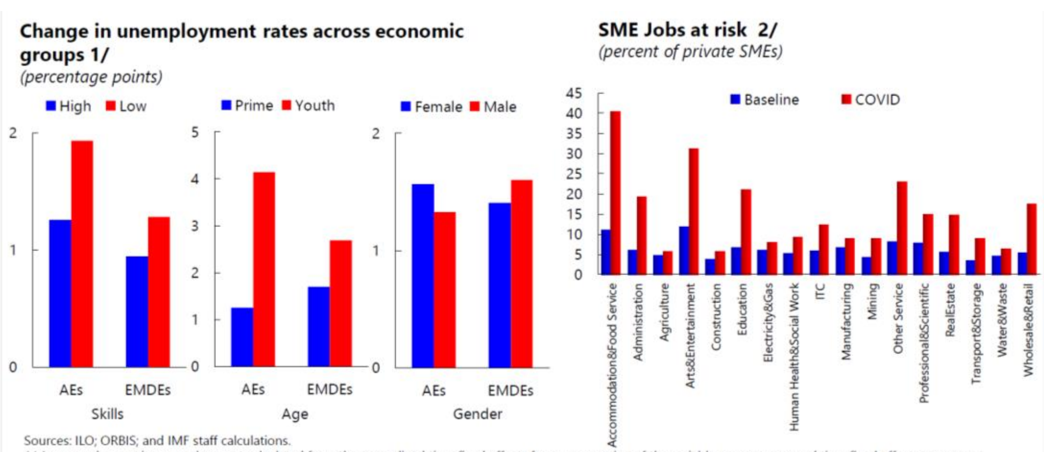
**Figure 1: Divergent Recoveries across Economies**




Sources: IMF, *World Economic Outlook*; and IMF staff calculations.
1/ AE = advanced economies; Em. Asia ex China = emerging and developing Asia ex. China; Em. Eur. = emerging and developing Europe; EMDE = emerging market and developing economies; LAC = Latin America and the Caribbean; MECA = Middle East and Central Asia; SSA = sub-Saharan Africa.

The impact of COVID and lockdowns has also been uneven within economies. Economic and social gaps have widened. In both advanced and developing economies, unemployment has disproportionately affected the less skilled and younger workers. This is also true for women in advanced economies. Those working for SMEs face higher risks of being unemployed, as these enterprises' financial conditions deteriorate. In particular, SMEs in the hotel and food, arts and entertainment, education and retail industries are projected to shed the most jobs [*Figure 2*].

**Figure 2: Uneven Impact within Economies**




Sources: ILO; ORBIS; and IMF staff calculations.
1/ Average changes in unemployment calculated from the normalized time fixed effects from a regression of the variable on economy and time fixed effects to account for sample coverage changes.
2/ The share of SME jobs-at-risk are computed using the employment information firms with less than 250 employees from ORBIS database which covers 21 economies that are projected to face negative cash or negative equity at the end of 2020. The projections use the methodology developed by Gourinchas et al (2020).

Surveys of financial institutions and fintech firms indicate that SMEs in general are facing significant financial distress. While the situation has improved since the second quarter of 2020 when an overwhelming majority of lenders expected roughly more than half of their SME clients to be in imminent financial distress, still by the fourth quarter more than half of lenders expected significant percentages of their SME clients (around 20-60 percent) to face challenges. To assist SMEs, a growing percentage of lenders and governments over the course of 2020 have decided to introduce blanket moratoria on payments of both interest and principal for their SME clients, and are investing in digitizing and upskilling them.

Nonetheless, there remains the difficult question of how to manage the transition from relief to recovery, and how to determine which SMEs will prove resilient, and which will not survive. Institutions that have stronger, real-time digital data relationships with their customers are in far better positions to answer these questions. Institutions relying on more conventional, backward-looking credit information and "classical" scoring, will be in trouble.

## Achieving Fiscal Sustainability and Economic Recovery

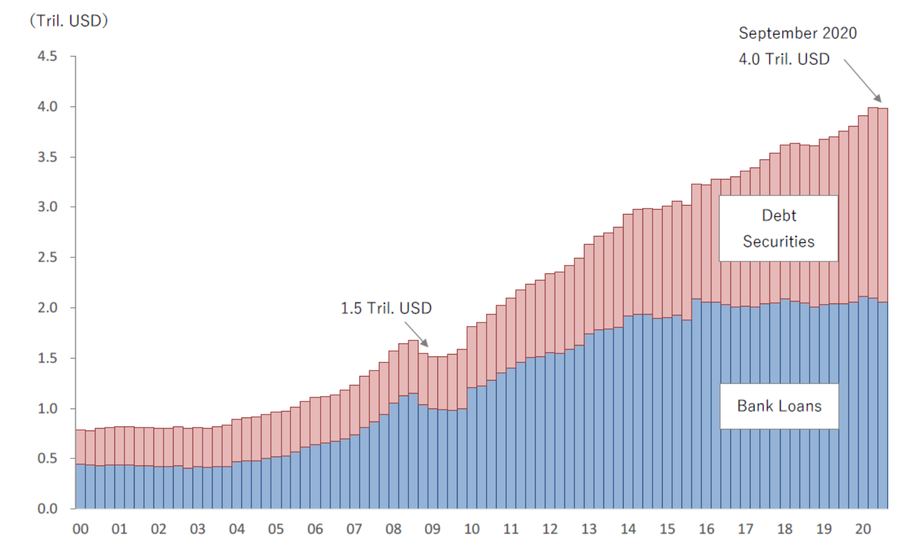
Strong fiscal and monetary responses by governments have prevented a severe economic downturn. In many economies, central bank asset purchase programs have helped to cushion pressures from capital outflow and the higher financing needs of governments. This has facilitated the recovery of foreign direct and portfolio investment to pre-COVID levels in Asian advanced and developing economies as a group. However, performance varies widely across the region, with most economies expected to post positive real GDP growth this year compared to their 2019 level, but with still a significant number where real GDP is expected to remain at or below 2019 levels.

In the USA, which has been a major engine of the global economy due to its high level of consumption, generous provision of cash payments and unemployment compensation has been reflected in a dramatic increase in total commercial bank deposits. The government's latest stimulus package promises to inject an additional USD500 billion into the economy, a significant portion of which is expected to translate into consumer demand as consumer confidence grows with success of vaccination. This is expected to lead eventually into inflationary pressure. A rise in US inflation from the current level of around 1.5% to beyond 2.5% would put strong upward pressure on US long-term interest rates, which will have implications for other economies.

This could prove problematic for a number of more vulnerable emerging markets, especially those in Asia that have higher exposure to various long-term economic risks. As a group, emerging markets have seen their aggregate dollar-denominated debt outstanding balloon to USD4 trillion by September 2020 [*Figure 3]*. Those most vulnerable among them face the prospects of potential significant capital outflows, which could make refinancing difficult for those firms that are over-leveraged. The ratio of emerging market non-financial private sector debt to GDP has reached levels that already in at least one case exceeded the corresponding ratio in Japan prior to the bursting of its asset bubble in the early 1990s and in other economies that have experienced financial and economic crises.

While the most immediate task governments need to address is to stimulate demand to spur recovery and growth, it is important to bear in mind that this has not been sufficient to restore economic growth rates to their pre-crisis trajectories after the Lehman shock. Not only did it take more time for GDP growth to return to pre-crisis levels, GDP growth also deviated from long-term growth patterns or potential growth rates [*Figure 4*]. This is unusual compared to past downturns where GDP growth trajectories reverted back to the original trend once the crisis was over. Given that the capital stock and labor force have remained intact during and after the crisis, the most plausible explanation is that the shock of the GFC had a lingering and scarring effect on economies. This harks back to Japan's experience of its own home-grown financial crisis in the 1990s, in the aftermath of which the economy has since been unable to regain its previous potential growth rate,[2] which exceeded 4% before the crisis.

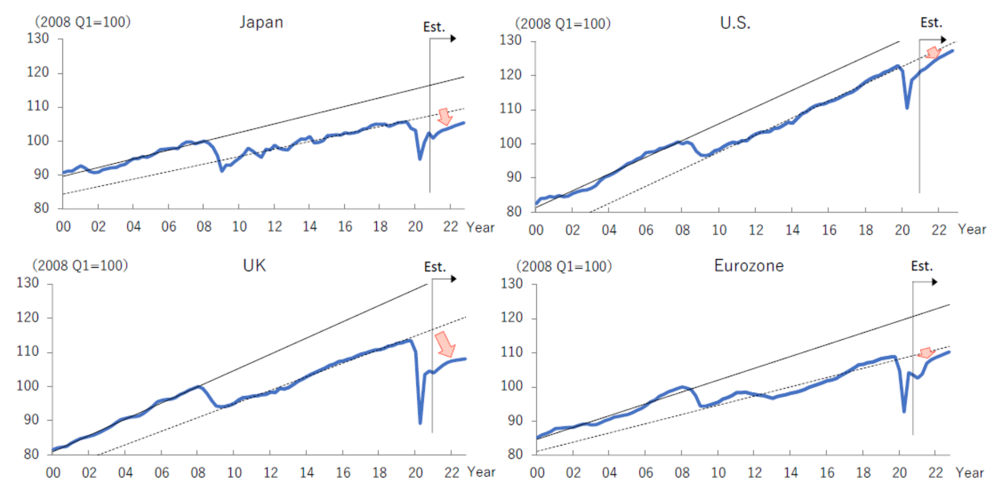
**Figure 3: US-Dollar Denominated Debt in Emerging Market Economies**




Source: BIS; compiled by DIR.
Note: Latest data as of end of September 2020.



**Figure 4: Real GDP Growth Trends**




Real GDP Growth Rates after 2000 Q1 (Annual Average Rate, %)

| | Japan | U.S. | UK | Eurozone |
|---|---|---|---|---|
| Before Global Financial Crisis: ~2008 Q1 | 1.2 | 2.4 | 2.6 | 2.0 |
| After Global Financial Crisis: ~2019 Q4 | 0.7 | 2.0 | 1.7 | 1.3 |
| After the Outbreak of COVID-19: ~2020 Q4 | 0.6 | 1.8 | 1.2 | 0.9 |

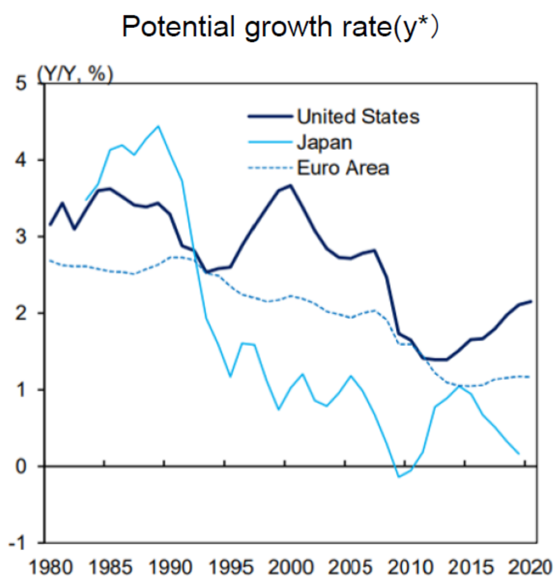
Source: Japan Cabinet Office, Japan Center for Economic Research, U.S. Department of Commerce, U.S. Congressional Budget Office, UK Office for National Statistics, European Commission; compiled by DIR.
Notes: 1 Solid lines indicate GDP trends from 2000 Q1 to 2008 Q1. Dotted lines indicate GDP trends from 2009 Q3 to 2019 Q4.
2 The prediction references the ESP Survey of the Japan Center for Economic Research in the case of Japan (16 Mar. 2021), and the U.S. Department of Commerce and U.S. Congressional Budget Office in the case of the U.S. (11 Feb. 2021). The European Commission is referenced for the UK (5 Nov. 2020) and the Eurozone (11 Feb. 2021).



[2] The potential growth rate is defined as the annual change in the potential GDP—the highest aggregate output of goods and services an economy can sustain over the medium term using the factors of production at its disposal while keeping inflation stable.

This has an important bearing on monetary policy, because an economy's natural rate of interest (the real interest rate when the economy is at equilibrium and thus neutral to the economy) rises and declines in tandem with the potential growth rate. With most major economies' potential growth rates at 40-year lows today [*Figure 5*], their natural rates of interest are converging at around 0%. Using monetary policy to stimulate the economy involves keeping real interest rates well below the natural rates of interest. When the natural rate of interest is very low, as was the case of major economies after the GFC, central banks are forced to resort to unconventional monetary policies such as QE, negative interest rate policy or yield curve control to bring nominal interest rates to extremely low levels.

**Figure 5: Potential Growth Rates of the Euro Area, Japan and the USA, 1980-2020**




Source: Holston, K., T. Laubach, and J. C. Williams (2017): "Measuring the Natural rate of Interest: International Trends and Determinants, " *Journal of International Economics*, Fujiwara et al. (2016): "Supplementary Paper Series for the "Comprehensive Assessment" (2): Developments in the Natural Rate of Interest in Japan," Bank of Japan Review Series 16-E-12, Bank of Japan

Source: Toshitaka Sekine, Hitotsubashi University "Economic Crisis and Recovery with COVID-19" (September 9, 2020)



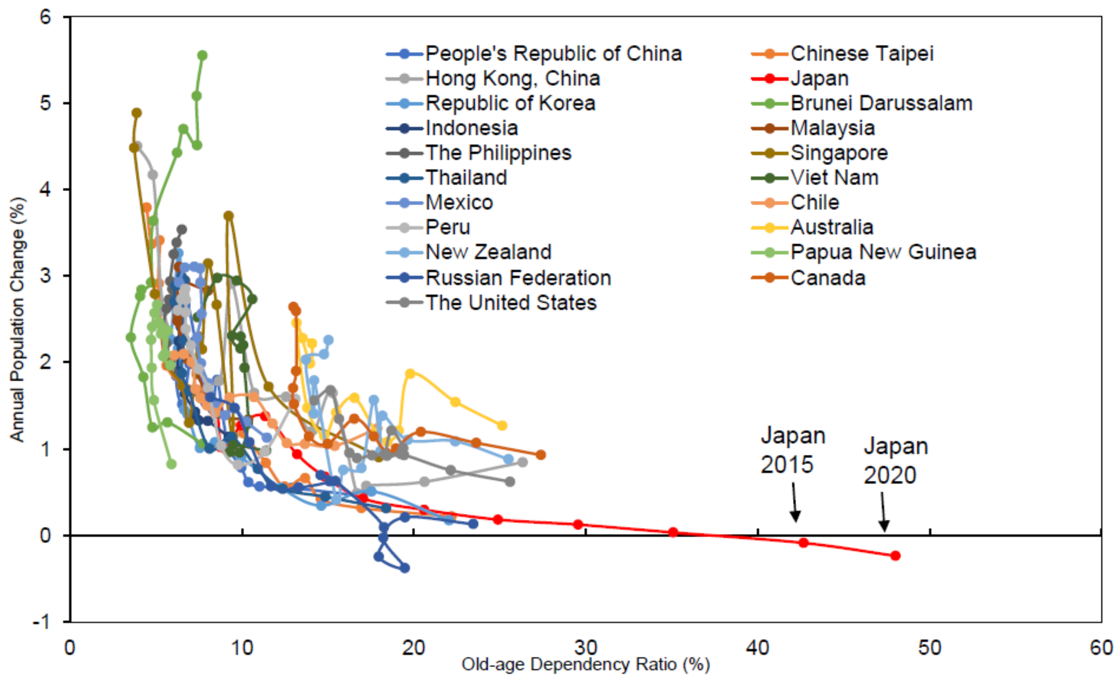
This means that unless potential growth rates are raised to higher levels, the natural rate of interest will remain very low, forcing central banks to continue implementing ultra-low interest rate policies. Only when natural rates of interest rise can nominal interest rates be brought back to normal levels, and monetary policy be more effectively used to stimulate the economy. Thus, what major economies need is a growth strategy that can raise their potential growth rates.

## Strategies for Sustained Economic Growth in the Asia-Pacific Region

Raising Asia-Pacific economies' potential growth rates is a challenge that needs to take into account the evolution of both their economic and social structures as well as the global economic environment, which is increasingly being shaped by digital technology and sustainability concerns. The case of Japan provides valuable insights into challenges that a number of emerging markets in the region may face going forward. A rapidly growing economy during the first four decades of the post-war era, Japan experienced a major crisis that ushered in a new period characterized by deflationary pressures, persistently low interest rates and slower growth.

Japan has also been at the forefront of demographic change in the region, with a declining and increasingly aging population. In Japan, the elderly population above 60 years of age commands a growing share of financial assets, and net financial positions are rising with age. Statistics indicate that Japan's senior population is becoming healthier over time and life expectancy is getting longer. The economy's tight labor market has pushed the government to undertake tax, labor market and social security reform, with the aim of enabling its elderly population to continue working and of increasing women's participation in the workforce. While still far behind Japan in this development, most of the APEC members are following a similar trajectory [*Figure 6*], and will need to bear in mind the importance of maintaining adequate labor supply, which is one of the main factors that can raise potential growth rates, as their economies evolve.

**Figure 6: Demographic Changes in APEC Member Economies, 1955-2020**




Notes: 1. Old-age dependency ratio = elderly population (aged 65 and over) / working-age population (aged 15 to 64)
2. Annual population change is the average annual rate of population change in five-year intervals.

Source: United Nations statistics; Presentation at the Roundtable by Professor Toshitaka Sekine, *Sustained Economic Growth Strategy: The Experience of Japan*

Developing economies face a different set of challenges, centered on developing infrastructure and capital assets, promoting innovation and increasing efficiency. Also, in general, many Asian developing economies do not have diverse industrial structures, which are usually concentrated in tourism, natural resources, agriculture or certain services. Their export markets are largely concentrated in a small number of trading partners. To promote diversification, they need to expand trade by pursuing a policy of liberalization, including through regional trading arrangements, and promote efficiency through competition policy. At the same time, economies need to ensure a stable macroeconomic environment, which would require maintaining fiscal balance (including through domestic resource mobilization) and adequate regulation and supervision to prevent financial crises.

Finally, economies need to develop strategies to harness digital technology, especially through enabling policy and regulatory reforms, the development of digital infrastructure, and capacity building for the uptake of these technologies, while ensuring a level playing field for the digital economy and the prevention of a digital divide. They also need to undertake reforms to achieve sustainability, including the transition to a green and circular economy and the alignment of practices in the public and private sectors with environmental, social and governance (ESG) goals.

## Conclusion

Asia-Pacific economies have been able to avoid a major economic catastrophe arising from the COVID pandemic, thanks to vigorous fiscal and monetary responses from governments and central banks in the region. With the rollout of vaccines this year, economies are expected to rebound, although at different paces given the varying degrees to which they have been affected by the pandemic. However, these responses have also left challenges that need to be addressed, in particular huge fiscal imbalances and public sector debt, potential for inflation at a time of high emerging market debt levels, and large central bank balance sheets. In addition, COVID has left in its wake larger economic, social and gender gaps within economies, a larger gap between developed and more advanced developing economies on one hand, and the less developed economies on the other, and a financially weakened MSME sector.

The challenge that the region faces today is how to achieve sustained economic recovery. The answers we have received from the Roundtable are as follows:

First, economies need to continue undertaking stimulus measures in order to address the shortfall in demand and enable themselves to recover from the impact of the pandemic. They also need to introduce innovative reforms in personal insolvency regimes to accelerate fresh starts for entrepreneurs whose businesses failed or are failing as a result of the COVID pandemic.

Second, stimulus measures targeting demand, though necessary, are not sufficient. Economies need to address supply-side factors in order to raise their growth potential. This means developing a growth strategy that prioritizes structural reforms to harness digital technology to drive capital expenditure and innovation, align this process with sustainability principles, promote openness to trade and investment, expand the role of women in the work force, reform labor laws to encourage employment of healthy elderly people in economies with tight labor markets, and ensuring competition and a level playing field.

Third, there are risks to financial stability in the debt overhang in both developed and developing economies, as well as inflation in major economies, and so in the process of providing stimulus that is needed in the short-term, governments and central banks need to remain vigilant and act swiftly when required to prevent another financial crisis.

**ANNEX: ROUNDTABLE AGENDA** (*Times displayed are Japan Standard Time*)

| | |
|---|---|
| 1000-1005 | **OPENING SESSION** |
| | **Welcome and Opening Remarks**<br>Mr. Hiroshi Nakaso, Chair, Advisory Group on APEC Financial System Capacity Building; and Chairman, Daiwa Institute of Research |
| 1005-1050 | **SESSION 1**<br>**The Global Economic Landscape in the COVID and Post-COVID Era** |
| *1005-1010* | **Introduction** by Moderator |
| *1010-1020* | **The Macroeconomic Outlook in the Wake of the COVID Pandemic**<br>Mr. Chikahisa Sumi, Director, Regional Office for Asia and the Pacific (OAP), International Monetary Fund |
| *1020-1030* | **The Impact of the COVID Pandemic and Emergency Responses on SMEs**<br>Dr. Matthew Gamser, CEO, SME Finance Forum and Chief Operations Officer, International Finance Corporation/World Bank Group |
| *1030-1050* | **Open Discussion** |
| 1050-1135 | **SESSION 2**<br>**Achieving Fiscal Sustainability and Economic Recovery** |
| *1050-1055* | **Introduction** by Moderator |
| *1055-1110* | **Meeting the Medium- to Long-Term Challenges for Monetary and Fiscal Policy**<br>Mr. Hiroshi Nakaso, Chair, Advisory Group on APEC Financial System Capacity Building; and Chairman, Daiwa Institute of Research |
| *1110-1120* | **Post-COVID Monetary and Fiscal Policy: Impact on Credit Risks in Asian Emerging Markets**<br>Dr. Michael Taylor, Managing Director and Chief Credit Officer, Asia-Pacific, Moodys Investors Service |
| *1120-1135* | **Open Discussion** |
| 1135-1215 | **SESSION 3**<br>**Strategies for Sustained Economic Growth in the Asia-Pacific Region** |
| *1135-1140* | **Introduction** by Moderator |
| *1140-1155* | **Promoting Sustained Economic Growth in Developing Economies**<br>Dr. Tetsushi Sonobe, Dean and CEO, Asian Development Bank Institute |
| *1155-1210* | **Sustained Economic Growth Strategy: The Experience of Japan**<br>Prof. Toshitaka Sekine, Hitotsubashi University |
| *1210-1225* | **Open Discussion** |
| 1225-1230 | **CLOSING SESSION** |
| | **Concluding Remarks**<br>Mr. Hiroshi Nakaso, Chair, Advisory Group on APEC Financial System Capacity Building; and Chairman, Daiwa Institute of Research |

*Moderator: Dr. Julius Caesar Parreñas, APFF Coordinator and Senior Advisor, Daiwa Institute of Research*