Interview with Paul Sheard published in South Korean Edaily newspaper, 16 March 2020 (answers provided on 11-12 March to questions received)

- What impact do you think will be on the global economy following the coronavirus outbreak?

It is hard to say because much depends on how bad the spread of the virus becomes and how long it lasts. This is because an economic forecast in this case hinges largely on an epidemiological forecast, which is difficult for even medical experts to make. The impact on the global economy could range from being a mild slump in activity lasting a quarter or so to a much deeper and longer recession involving a negative feedback loop between the real economy and the financial markets. The former looks more likely, but the latter is a lurking risk.

The COVID-19 virus is a prime example of what economists call an "exogenous (negative) shock:" an unexpected event that pushes the economy off course, by disrupting supply or depressing demand. COVID-19 is hitting both the supply and the demand sides of the economy. It is disrupting production facilities and regional and global supply chains, but its bigger potential impact is on the demand side, as people either choose or are forced to curb consumption activities outside the home, such as eating out at restaurants, recreation, shopping, and travel, and businesses cancel events and delay investment decisions amid heightened uncertainty. Consumer and business sentiment may deteriorate more than the direct impacts would appear to warrant.

Forecasting the impact of an exogenous shock requires a three-step process, hinging on the answers to three questions: how big and sustained is the shock; what kind of policy response do governments and central banks deliver, and how quickly and forcefully; and how well does the economy respond?

There is a tendency, when a shock hits and its severity becomes clear, for people to become overly pessimistic, because its negative aspects tend to get amplified in the public's consciousness and blown out of proportion, whereas the scale and effectiveness of the policy response, which comes with a lag, tends to be underestimated. That will likely be the case again with COVID-19.

However, a pandemic has a special feature that limits the efficacy of demand-side policy responses. Monetary and fiscal policy usually aim to stimulate demand and offset the fall in demand caused by the exogenous shock. But, in a pandemic, a large part of the fall in demand may result from the public health policy response itself, which aims to keep people at home and away from other people. Monetary and fiscal policy aimed at encouraging people to spend is likely to be limited in its effectiveness, and partly run counter to the public hjealth measures implemented.

- Please pick countries vulnerable to the crisis caused by the coronavirus.

It is impossible to forecast which countries will be worst hit or hit next. After the outbreak in Hubei, China, who would have predicted that Iran and Italy would be the next countries to be hit at scale?

In general, countries with large dense population centers and with less sophisticated and less well-resourced public health-care systems are the most vulnerable. Fortunately, to date, there have been relatively few reported cases in Latin America, Africa, and Southeast and South Asia, much of which fits this bill, but this could change.

Given that Italy is part of the European Union, which allows freedom of movement for EU citizens, and a member of the border-free Schengen Area, other EU countries, particularly nearby ones, may be at particular risk of the virus spreading.

- How do you predict China's economy this year?

China's real GDP growth has been on a declining trend in the past decade, albeit off an ever-growing base, as the productivity gains from rural workers moving into the manufacturing sector and from closing the technology gap with the developed world taper off. After growth in 2019 being towards the lower end of the government's target range of 6-6.5%, real growth is almost certain to fall below 6%, for the first time in three decades, as a result of the hit from the corona virus.

- Some predict that the Chinese economy will recover quickly in the form of a "V" as it did in the SARS outbreak in 2003.

Given that efforts by the government to limit the spread of the virus from Hubei Province appear to have been successful, and assuming that this situation continues to prevail, it is likely that growth will pick up in the second half of the year. However, the recovery will likely be less sharply V-like than in the past, given that public health responses aimed at preventing the spread and further outbreaks of COVID-19 are likely to continue and have a lingering depressive effect on consumer demand.

There is also likely to be some permanent effect on China-centric global supply chains, as companies and countries reassess their reliance on China-sourced components and products, particularly ones deemed to be critical from a broadly defined national security perspective. Coming on top of their trade and technology "wars," further impetus may be given to decoupling of the US and China economies.

- Do you think the U.S. will overcome this crisis?

The spread of the corona virus in the US to date has been quite limited relative to the geographic, population and economic size of the country, and the public policy response has been quite quick and targeted. There is likely to be a negative impact on economic growth, particularly in the second quarter (more so than the first quarter), given the timing of the mitigation effects.

- *Will the Trump administration's stimulus plan work?*

It is not so much a stimulus plan as a plan to contain the spread of the corona virus, and eradicate the virus or the threat of it, and to mitigate some of the adverse economic and social impacts from taking those actions. As explained above, in a pandemic such as the current COVID-19 one, the primary public policy focus should be on the public health aspects and this will necessarily have a negative effect on economic activity. Rather than a traditional stimulus package aimed at directly countering the decline in demand, it makes more sense for fiscal, monetary and other measures to be focused on directly attacking the underlying problem - the virus causing the pandemic - and on alleviating the collateral damage on impacted individual and businesses. This seems to be broadly the approach being adopted by the Trump Administration.

- *Do you think the U.S. Federal Reserve will cut its key interest rate and resume quantitative easing?*

The Fed has already cut the federal funds target range by 50 basis points in response to the corona virus and had started to expand its balance sheet again from October in order to provide additional liquidity to money markets after they experienced some dislocation last September. Given the potential for the corona virus shock to have a negative impact on overall economic activity, beyond the disruptions directly associated with the public health measures taken, and for a negative feedback loop to develop between the real economy and financial markets, the Fed is likely ease monetary policy quite aggressively. Specifically, the Fed is likely to cut the target range for the federal funds rate at the next FOMC meeting on March 18, possibly by another 50 basis points (to 50-75bp) and to introduce liquidity-providing measures, particularly tailored to ensure that liquidity keeps flowing to sectors impacted by the corona virus shock.

- *How do you think South Korea, which relies heavily on China for its economy, will be affected?*

South Korea is in a tough spot, facing the double-whammy of its economy being highly geared to China's economy, including via interconnected supply chains, and facing the challenge of managing its own corona virus outbreak. It may be hard for South Korea to skirt recession. It will need a comprehensive policy response, centering on strong public health measures to contain the spread of the virus and fiscal and monetary policy measures aimed at supporting impacted sectors and individuals and at buoying the macro economy.

-*Ultimately, is there a possibility that the Fed could return to zero-interest policy?*

It is very possible that the Fed will cut the federal funds rate to the "effective lower bound," which the Fed takes to be zero percent (the Fed has all but ruled out implementing negative interest rate policy). It depends on whether the Fed judges the economy to be heading into recession or at significant risk of doing so, due to a significant and generalized demand shock coming from the corona virus. In that case, the Fed will not hesitate to cut interest rates to zero and resume quantitative easing in order to head off a recession or minimize its impact if one occurs.

- Since November 2008, the Fed has purchased $3.955 trillion worth of long-term government bonds and mortgage securities (MBS) on three occasions between QE1 and QE3. This time, observers say that the Fed may buy stocks and corporate bonds, which are rather risky assets in addition to state bonds and MBS. Do you agree with that?

Some central banks have bought or are buying private sector risk assets, most notably the Bank of Japan, and in theory a central bank's quantitative easing should be more potent if it buys risk assets rather than government bonds. However, it is very unlikely that the Fed would buy stocks and corporate bonds at the current juncture because it is not authorized to do so under the Federal Reserve Act and it would require a change in legislation.

- Do you think the U.S. is likely to experience a recession this year in the aftermath of the coronavirus spread?

- The economic crisis caused by the coronavirus is likely to lead to a complex crisis that will shock the domestic and manufacturing industries and financial sectors. Therefore, some analysts say that the economic downturn will be deep. What do you think?

It is looking increasingly likely that the US will experience at least a mild recession, given the dampening effect on consumption of the "social distancing" measures being widely implemented and the worrying recent financial market moves. The recession will probably be short-lived, because it will likely elicit a strong fiscal and monetary policy response and the precautionary public health measures being implemented will likely bear fruit. Unless the spread of the virus gets out of hand, the economy will probably not fall into a deep recession, along the lines of what happened in the financial crisis.

There is also the possibility of a "positive shock" happening such as the spread of the virus tapering off of its own accord or a vaccine being developed and deployed much faster than in the past.