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Global Monthly

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Global Economy - Impact, recovery potential and long-term effects

- **The global economy is expected to shrink by 4,4% in 2020, assuming that nationwide lockdowns to combat a second wave of Covid-19 are unnecessary.**
- **Recovery from summer reopenings has ground to a halt due to second-round effects and second (virus) wave effects. The latter are causing damage even without lockdowns.**
- **Official unemployment figures are not telling the whole story. In the US, the rise in permanent layoffs is much more fundamental than headlines of furloughed workers losing and then returning to their jobs. In Europe, if about one-fifth of people in short-time work arrangements eventually become unemployed, joblessness could move to around 12% in 2021.**
- **Another hidden threat to growth is the zombification of businesses that remain afloat without demand for their offerings. Letting the economy adjust could be welfare increasing, but at the cost of a large social divide.**
- **In the long run, Covid- 19 is likely to increase ongoing trends such as lower rates, deglobalisation, and tech dominance. Tech dominance could become a threat to the social contract that holds our society together.**

At the end of 2020, world output is expected to be 7,6% lower than it would have been without the pandemic. Instead of growing 3% in 2020, it is likely to shrink 4,4% (the IMF is scheduled to present its update on 13 October). To put this in perspective, the great recession of 2009 led the world economy to shrink by 0.1%.

These forecasts are to be read with extreme caution, as they assume that another round of nationwide lockdowns will not be necessary. However, we are currently fast approaching a second wave of the virus that may prove this assumption wrong.

The run-up to Q4

Q1: The economic crisis that followed the outbreak of the pandemic entailed a supply shock to the global economy when the core manufacturing region of Wuhan came to a near complete standstill, causing a severe disruption to global supply chains of manufacturing goods.

Q2: As the virus reached the rest of the global economy, lockdowns and fears of getting infected caused a demand shock to the individual economies, which then went into lockdown. The sectors where contact is hard to avoid, such as travel and hospitality, saw a particular deterioration in economic activity of about 70%. As all this happened largely simultaneously in many western economies; the fallout of demand was synchronized. It led to a fall in consumption, employment, trade and dealt a severe blow to business and investor confidence.

> *In the Netherlands specifically ,we find that the economic contraction (-9.9% in Q2 compared to Q4 2019) was relatively mild in comparison with the Eurozone (-15.5% in Q2 compared to Q4 2019). In addition to a strong digital infrastructure, which caused a large shift from offline to online consumption, other drivers of the relatively mild contraction in the Netherlands can be found on the supply side of the economy: construction, corporate investments and exports remained much more robust than the Eurozone average. The above-average support from the government, compared to other EU members, could, in part, have driven this response.*

Although the impact of the virus on people's lives is pervasive, the response from monetary and fiscal authorities has been extraordinary and prevented a worse outcome. Public debt to GDP among advanced economies is expected to rise from 105% in 2019 to 132% in 2021.

Q3: The recovery we saw in Q3 was partly statistical and partly from the reopening of economies. At the end of the summer, the recovery came to a halt in many Eurozone countries and the UK (where recovery is lagging in general). In the US, recovery kept its pace. China is leading the global recovery. This is not just because it went into lockdown earlier but also because manufacturing output has again reached pre-pandemic levels and the services sector is also slowly closing the gap. Confidence among businesses and consumers has bounced back in China on the strength of a well-functioning system of surveillance and highly localized restrictions.

In general, we find that economies that rely relatively heavily on manufacturing are showing a stronger recovery. Also, economies that experienced a deeper dip also recovered more strongly (statistical rebound).

Q4: In the coming quarter, second-round effects are mixing with damage from the second wave. Even without the currently emerging second wave of infections, our expectation was that unemployment, corporate retrenchment and loss of confidence among businesses and investors would start to impede recovery, and even cause a double dip in the Eurozone around the fourth quarter.

Policy response prevents unemployment but slows recovery

Any government will aim to prevent unnecessary unemployment during and after a crisis. Some (EU) governments are doing this by compensating firms for their wage costs if they keep their workers employed (short-time work schemes), while others (US) are topping up unemployment benefits to generate additional consumer spending. Short-time work schemes prevent an economically damaging jump in unemployment, but they also tend to stall economic recovery. A third way (China) is to steer corporations directly toward economic activities in high demand. So far, the Chinese recovery path has been leading the global recovery. Manufacturing is already growing at pre-Covid levels, while the services sector is still catching up.

The US government did not introduce short- time work schemes. Instead, workers were furloughed on a large scale, meaning that they temporarily lost their jobs but will be rehired once demand returns. As a result, unemployment instantly increased when the pandemic reached the US: 14.7% in April, falling to 7.9% in September. More fundamental, however, is the rise in permanent layoffs, which is expected to slow down economic growth in the medium term.

We believe that some of this increase in permanent unemployment in the US is unnecessary. If the currently debated stimulus in the form of a top- up of unemployment benefits had not been stalled until after the election, people would have had more to spend, and hence some permanent unemployment could have been prevented.

In the Eurozone, unemployment was at 8.4% in august, but we expect it to peak around the end of 2021. We estimate that about one-fifth of the workers in short-time work schemes will eventually lose their job. These workers, together with a substantial number of people who are marginally attached to the labour market, could actually cause unemployment to rise to more like 12-13% of the labour force.

The EU recovery fund is expected to add 1.1% in additional growth to the Eurozone, which translates into merely 1 million additional jobs.

The policy dilemma between necessary adjustments and the social divide

Keeping firms in business without demand for their products and services (zombification) is usually a bad idea. It prevents people and capital from flowing to the more productive areas of the economy and thus stalls recovery.

Still, in some circumstances, keeping businesses alive is not such a bad idea. As long as the fallout of demand is temporary, keeping businesses alive can prevent a long-term loss of production capacity that would occur if investments were no longer made in skills, technology and capital goods during a temporary fall in demand (hysteresis).

The best recipe for the economy in these times is not yet certain. This crisis consists not only of a downturn followed by a recovery path, but in between the two there is a considerable space during which, in principle, healthy businesses have no possibility of generating revenues. This holds especially true for businesses in the hospitality and travel sectors, which are incidentally also the sectors where the most vulnerable people work under contracts that provide the least job security.

If businesses are to self-adjust, as we mostly see in the US, the adjustments will be highly unequal. In April, low-income workers (< USD 27,000) had lost 35% of employment since January while high-income workers (> USD 60,000) lost only 12% of employment over the same period. From the perspective of economic growth, the argument in favour of adjustment of the hard-hit sectors seems to outweigh the potential long-term loss of production capacity. The travel and hospitality sectors have relatively less complex commodity chains, less specific skill requirements and lower restart costs. These arguments weigh in favour of economic adjustments.

A signal of zombification of the economy is the number of bankruptcies. There has indeed been a substantial decrease in bankruptcies in the second quarter of 2020 (y-o-y). According to a recent study from the University of Amsterdam, countries like Belgium, France, Spain and the US report a high proportion of firms (30-70%) that were protected from bankruptcy with Covid-19 support measures that were in trouble for reasons unrelated to Covid-19. In the Netherlands, practically all companies that were kept afloat were in trouble due to Covid-19.

Sustainable growth is likely to return only when a vaccine or effective treatment is fully operational on a global scale. While this is expected at the end of 2021, large uncertainties loom.

In addition, the projections above are mainly based on the assumption that the worst is behind us. Meanwhile, advanced countries fear or are already experiencing a second wave of infections, which can make current projections substantially more negative.

Monetary policymakers willing to do more

Although the September meeting of ECB policymakers did not lead to any policy adjustments, recent speeches by the central bank's chief economist Philip Lane and ECB director Christine Lagarde have clearly signalled a willingness to ease. They have observed that the recovery is incomplete, insecure and unbalanced. The second waves of infections are posing downside risks to the outlook and inflationary pressures have come down further. Long-term rates have gone lower as new infections have increased uncertainty about a second round of lockdowns.

These observations, together with the growth setback we expect from second-round effects and weak inflation expectations, lead us to believe we may soon lower our long-term rates forecast for the end of the year.

Meanwhile, the Fed has made a much more significant change to its policy framework than might appear at first glance. The introduction of an average inflation target means rates are not likely to rise before 2025-2027 as a base case and if the Fed struggles, rates may stay low indefinitely. We do not expect the Fed to achieve the new goal through additional easing steps but rather a reliance on stronger forward guidance

A key uncertainty is therefore how the political landscape evolves and, specifically, the outcome of the November election. The best chance of generating some inflationary pressure is if the Democrats win both the House and Senate. This is because Democrats are generally less averse to deficit spending, and some prominent Democrats (such as Alexandria Ocasio-Cortez) are even advocates of an MMT framework.

Lockdown lessons for the second wave

The IMF global Outlook that was recently published pays considerable attention to the lessons learned about lockdown effects on economies. In line with our own research IMF concludes that a significant part of the economic impact from lockdowns arises from self-restrictions by individuals that are afraid of getting infected. There insights can be summarized as follows:

1) The first insight since the pandemic is that more stringent lockdowns lead to greater economic downturn s. However, an increasing body of evidence concludes that voluntary reductions of social interaction and movements can be as economically harmful as lockdowns, according to the IMF. The economic consequences from voluntary social distancing are highest in more advanced economies, where people have more scope to stay home while continuing to work.

In the US, Goolsby and Syverson used google mobility data to identify voluntary restrictions of movement by analysing people's movements around the borders of states in the US that had different lockdown measures but the same number of infections. Their research finds that 53% of the drop in consumption is explained by voluntary restrictions while 7% of the drop is explained by government regulations.

2) The tendency to voluntarily self-restrict to avoid getting infected implies that economies do not recover at the same pace when opening up. If the infection rate means that people do not feel comfortable to move around, a reopening will not cause a spectacular recovery.

3) Lockdowns create less economic damage if implemented at an early phase in the growth trajectory of new infections.

Long-term implications

Covid-19 and the attendant economic crisis are occurring in a world that is characterised by three large shifts that were already ongoing.

1) The lower-for-longer interest rate environment is on a trajectory to continue or even fall further in the medium term. In the past, low rates were driven by such thing as demographic trends, Chinese cheap goods flowing into wealthier countries and a global propensity to save. On the back of these trends, Covid-19 is set to continue this development due to two factors. The first is the global fallout of demand as economies were and may again go into lockdown. The second factor is rising inequality. The recovery from this crisis is likely to be very uneven between low and high-income families and economies. Also, lower interest rates are likely to boost asset prices, which tend to increase income and wealth disparities. As the rich have a higher propensity to save, this is likely to further push down the natural rate of interest. One factor that might partially work in the opposite direction is the supply of safe assets (high-quality government bonds), which have increased. The fall in their supply has pushed down interest rates. We do not believe the increase in the supply of safe assets will have a major impact, as most of it has been absorbed by central bank purchases.
2) *Deglobalisation* was already unfolding before Covid-19 emerged and it will continue regardless of the election outcome in the US. If Joe Biden becomes President, a less aggressive trade relationship with China is likely but decoupling will continue. The pandemic is adding speed to this development as firms have become more risk-aware when it comes to their supply chain. In response, firms can shorten their chain, search for more suppliers (horizontal flexibility) or reduce the variety of their offering. Furthermore, the intensification of great power blocks that we have seen during Covid-19 is likely to continue. This will especially apply to fields where governments have felt vulnerable, such as in medical equipment, but will also affect the current dominating competition between high-tech standards in the US and China.
3) The dominance of big tech is a third trend that is set to increase in the wake of Covid-19 as the fear of infections has made offline purchases substantially less attractive than online consumption. As technology platform companies grow on network effects (adding more value with every new member), there is a winner-take-all effect that is set to lead to reduced competition unless policymakers intervene. Moreover, the increasing pace of technological advancement is likely leaving knowledge workers behind, causing the infamous race between technology and labour. This is a race that, if won by technology, will increase wage inequalities to a level where the social contract becomes problematic.