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A CAUTIOUS LOOK AT ECONOMIC PROSPECTS BEYOND THE COVID-19 DISASTER

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Abstract

COVID-19 has delivered a powerful double punch to the chin of the global economy, combining a terrifying pandemic with a collapse in production because of the withdrawal into their homes of half the world's workers. The uncertainty generated by the medical and economic shock is paralyzing consumers and investors, and the dispersion of short-term economic forecasts is far wider than at any time in modern history, about six times greater than during the Great Financial Crisis. This brief reviews the recent evidence on the epidemic and on the economy and assesses the prospects in 2021 and beyond. Is the pessimism overdone?

The GDP of industrialized countries is expected to plummet by between 5% and 10% this year, and U.S. unemployment is projected to exceed 20% in coming months, reaching levels not seen since the Great Depression. In an interview earlier this month, former International Monetary Fund Chief Economist Ken Rogoff likened the effects of COVID-19 to the worst financial crises, leading him to doubt that incomes would regain their 2019 level before five years. Stock markets have largely ignored these dire warnings. They have already clawed back about two-thirds of the decline from their mid-February peak. The S&P 500 Index at time of writing is down just 13% from that level, a decline smaller than a routine correction. Emerging markets, which many had given up for dead on account of their medical and economic vulnerabilities, have performed less well but have also rallied in the last month.

As an economic forecaster for much of my adult life, I think I have a good sense of when to reach for my calculator, and when to eschew false precision. I feel that a qualitative assessment is about as far as one can honestly go at present. The devastating effect of COVID-19 on global economic activity over most of 2020 is evident and does not need much elaboration. The U.S. economy, the world's largest, may well shrink at an annual rate of 40% in the second quarter.

Yet, the pessimism about the pandemic's durable effect on the global economy in 2021 and beyond can be overdone. This brief tries to redress the balance, not—one hopes—with a Panglossian assessment, but with a dispassionate look at some positive features which may be overlooked. We begin by noting an important fact, namely that the mortality rate of people of working age who are infected by COVID-19 is extremely low.

The Epidemic and the Opening

When the epidemic spreads exponentially and overwhelms the medical system, the economy cannot function, even less recover. Tragically, that scenario has played out in

locations across the world, from Wuhan to Bergamo. Exponential growth of cases is still occurring, at time of writing, in Brazil, India, South Africa and in several other countries in Latin America and the Arabian Gulf. However, about two-thirds of countries appear to have passed their peak weeks ago. The global number of COVID-19 deaths, though undercounted and especially so in developing countries, has been on a declining path over the last several weeks. In many countries lockdown and social distancing policies have been shown to be highly effective in stabilizing and then reducing the numbers of cases and deaths. Contrary to expectations, the epidemic has so far left African countries relatively untouched.

The COVID-19 case fatality rate (proportion of those infected who die of the disease) is now widely estimated to be somewhere between 0.2% and 1%, including the large numbers of infected individuals who are asymptomatic and rarely tested. These estimates are far lower than originally feared. Moreover, the higher range of mortality estimates is found in countries such as Spain and Italy, where hospitals were overrun. Where the medical system copes well, as for example in California, which suffered high rates of contagion, the mortality rate is much lower.

Young people are far less likely to become severely sick or die than the old. About half of all deaths in many advanced countries occur in nursing homes. A dramatic demonstration of the effect of age was provided by the virus outbreak on the French aircraft carrier Charles De Gaulle. Over 1000 of the 1700 crew (some 70% under the age of 35) tested positive for the virus without a single fatality. A comprehensive British study (May 7, 2020) concluded that the chance of a person below the age of 50 dying in hospital of COVID-19 is statistically almost zero, is very low in the 50-70 age bracket, and is high only among people over 70, especially men. The clear implication is that if one can protect the elderly and sick in nursing homes, hospitals, and at home, the young can go to work and to school without running significant risks.

Initially, the debate over reopening the economy was framed as a choice between livelihoods and lives. Across the political spectrum, the realization has now dawned that choosing to keep the economy closed for much longer implies an equally stark choice, that between widespread destitution and the bankruptcy of the nation. Clearly, the virus is not going away, but policymakers see that countries including China, South Korea, Singapore, Vietnam, Japan, and Sweden can keep the epidemic within manageable bounds without resorting to complete national lockdowns. Some countries (e.g. Austria and New Zealand) and states (e.g. the U.S. state of Georgia) have shown that they can exit lockdown without seeing surges in cases, although may be too soon to be sure.

Unfortunately, there is no sign at this point that we are on the verge of therapeutic breakthroughs. However, doctors have greatly improved understanding of the disease and are better able to anticipate its course and to apply appropriate protocols (a mix of pre-existing, anti-viral drugs, antibiotics, blood-thinners, etc.). They are also less inclined to use invasive ventilation techniques. Hospital and equipment capacity have increased. Several new anti-viral drugs are in clinical trial and one (Remdesivir) saw modest success and has been approved for use on an emergency basis by the Federal Drug Administration. Trials of convalescent plasma therapy on a small number of severely ill patients have shown modestly promising results, but the procedure's effectiveness is still to be confirmed.

Perhaps most encouraging is progress towards identifying vaccines. There are about 100 such efforts around the world and several have passed initial safety trials and at least two (Moderna and Oxford) has been shown to be effective in neutralizing the virus in animals. It now looks likely that a handful of vaccines will start larger-scale clinical trials in the coming months, and it is possible that one or more will be available to the most exposed groups, such as healthcare workers, within less than twelve months. Manufacturers are already building capacity to produce one or more of these candidate vaccines with the help of government funding, which is shouldering a large part of the risk. Still, there is no certainty that any of the vaccines under development will prove effective.

Also worth noting is the growing statistical evidence that warm temperatures and high humidity help reduce the spread of the virus. The arrival of summer in the Northern hemisphere is very unlikely to stop infections as happens with seasonal flu but may reduce COVID-19 transmission significantly. Equally, the arrival of Winter in the Southern hemisphere is likely to see worse outcomes in South America and in countries such as South Africa.

In summary, while the virus risk is unavoidable, the epidemic is controllable, even as the economy reopens. However, vigilance and precautions are essential, especially those precautions designed to protect the older population. The young can return to work without running unacceptably high risks. New medicines may come to the rescue, and they may come soon, but it is not sure that they will, and reopening the economy cannot wait much longer.

The Economic Outlook

It should be clear from the outset that the global economy is unlikely to return to operating at full capacity unless the virus disappears for good. This might magically occur if the virus mutates into a much milder form, it weakens with the changing season, a vaccine arrives, or if herd immunity is achieved—a distant prospect. Even with a large decline in the rate of infections—as is now observed across Europe and epicenters such as New York—and assuming that the decline is sustained, many, especially among the elderly population that are typically also the most affluent, will be reluctant to travel in crowded aircraft, trains, and cruise ships, or to visit restaurants as frequently. The depressing effect on the travel and tourism sector—a major employer—will be significant and sustained. It will also affect countries differently. In the United States, for example, the travel and tourism sector accounts for about 3.5% of total employment directly, while in Morocco and Greece, where it accounts directly for 7% and 12% of employment respectively, the effect will be far more severe. In the United States, the restaurant industry, which partly overlaps with the travel and tourism sector, accounts for 7% of total employment. The decline in demand in these sectors, which employ many lower-paid workers in the United States, will be disruptive but it will not be fully reflected in employment and GDP as spending is likely to be redirected to other sectors, from shopping for food to entertaining at home, cable subscriptions, and home improvement.

It is thus highly likely that even in the best scenario, a large and sustained decline in output and employment will occur in the travel, tourism, restaurant, and hospitality sectors because of the crisis. In most economies, this effect could turn out to be in the range of 1% to 3% of GDP and the impact on employment will be larger still. In small

economies most dependent on tourism, such as in the Caribbean, the effect will be much larger and sustained.

But the biggest uncertainties in the economic outlook lie elsewhere. They revolve essentially around the duration of the acute phase of the crisis and its effect on households and on vulnerable firms in many sectors of the economy. Not every firm is suffering during the crisis. The least affected include food retailers, utilities, online entertainment providers, defense, and medical industries. However, the longer the acute phase lasts, during which people stay home, revenues are depressed, and uncertainty is at the peak, the lower aggregate spending will be. With time, the likelihood of bankruptcies in sectors from retailing to automobiles—and of lasting unemployment—increases, inflicting permanent damage on the economy's productive and financial fabric. In the worst-case scenario, the crisis could eventually directly attack the banking system—which was well capitalized when the crisis hit—possibly causing a repeat of the 1930s or of the 2008-2009 global financial crisis. The global nature of the COVID-19 crisis means that the risk is severe of a vicious cycle that works through the collapse of world trade, its spillover onto the ability of firms and of some countries to service debt, and from there onto banks.

Having followed the unfolding sequence of crises and response in China, the rest of Asia, Europe, the United States, and the developing world, we now have a good sense of the duration of the most acute phase of the crisis in the most-affected countries, which is roughly four to five months. This is the amount of time, for example, that elapsed between late December, when the COVID-19 emergency became evident in Wuhan, and Wuhan's gradual reopening in April and May. Bergamo followed a similar cycle between mid-February and the planned full opening in June. New York's worst period began in early March and may extend to early July. Even in the most-vulnerable sectors, nearly all large firms and most medium-sized ones, will typically have sufficient cash at hand, cost-containment capacity, and credit lines to weather a sharp business decline and even a complete revenue interruption extending for four to five months. Many smaller firms will not, however, and most low-income families whose breadwinner becomes unemployed will not have the means to subsist for that long.

This takes us to the other crucial variable in determining the outcome, namely the size and reach of countercyclical policy measures, which include social relief measures and direct transfers to households. We now also have a good sense of these. The countercyclical policy response is not as well coordinated across the world as it was at the outset of the global financial crisis, but it is much larger and has been implemented faster. This is simply because the crisis affects each country directly and simultaneously, so all countries must respond in their own interests.

The Congressional Budget Office estimates that the increase in U.S. federal government spending under current legislation (with more to come) will amount to 11% of U.S. GDP in 2020 and 3% of GDP in 2021. By contrast, ex-post analysis concluded that from 2008Q3 to 2009Q3, increased federal spending accounted for less than 0.5% of US GDP and was largely offset by declines in spending by strapped local and state authorities. The Fed has also reacted more rapidly and more massively than during the global financial crisis, cutting its policy interest rate to near zero and initiating a large set of lending programs and asset purchases. The Fed's balance sheet has increased by almost $3 trillion since February (about 15% of GDP), with more to come, compared to about $1.5 trillion over the year up to March 2009 (about 10% of GDP). Stimulus measures in the

eurozone, Japan, and China have also been rapid, though not as large as in the United States. Many emerging markets have undertaken similar steps though at a much lower scale given their vulnerability to sudden stops in capital flows. Morocco, for example, has adopted a fiscal stimulus program amounting to 3% of GDP, cut policy interest rates, initiated emergency lending programs to vulnerable firms, and widened the exchange rate band.

How should the combined effect on economic activity of the lockdown and the countercyclical policy response be evaluated? In the case of the United States, a very rough way to think about the net effect is to evaluate the decline in economic activity on an annualized basis as 15% of 2020 GDP ((4.5 months/12) X (40%)), an extreme scenario, partly offset by fiscal stimulus of 11%, resulting in a fall of GDP of about 4%. This simple calculation assumes that increased demand in the second half of 2020 will largely offset reduced supply due to the lockdown and implies a strong rebound in activity in coming months. Low confidence, continued self-isolation by the older population, and lower global demand could lead to a worse outcome, while pent-up demand, low interest rates, and the coming on stream of fiscal stimulus and the Fed's new lending programs might improve on it.

Casting an eye across the world, China's economy is already largely open, industrial production has rebounded, retail sales are recovering, and GDP is likely to show modest growth again in the second quarter. The epidemic has been incomparably less deadly in Asia than in the West. Nearly all European countries began reopening in late April and early May. All states in the United States have begun a gradual reopening. There are already numerous signs that global economic activity is stabilizing and beginning to pick up. Among the most sensitive indicators are the prices of oil and of metals, which have seen steady increases over the last 30 days. Airline traffic in the United States hit bottom in April and is now picking up. A German investor survey revealed a big jump in confidence—pointing to modest expansion in May compared to sharp contraction in April.

Given the depth of the decline in recent months, and the return to work in most sectors, it is entirely plausible to expect a sharp rebound of global economic activity in the third quarter. Barring an unmanageable second COVID-19 wave in one or more of the major economic centers, the expansion could continue at a rapid pace well into 2021. A possible breakthrough in a therapy or vaccine would have a major boosting effect on consumer and investor confidence, even if it does not become universally available until late 2021 or in 2022.

How real is the threat of a major second wave of the epidemic in coming months, or in winter when the cooler weather arrives? The threat is real, but in countries and regions that have achieved low infection numbers and plentiful hospital capacity, it is far more likely to be met by an early response that is geographically or cluster-directed, as one presently observes in China and South Korea, and in tougher social distancing rules, rather than by renewed national lockdowns. In continent-sized economies, including China, Europe and the United States, the response will almost certainly be region or city specific, mitigating the effect on national and global economies.

Innovations

The Second World War resulted in a large running-up of government debt and so will the war against COVID-19, reducing policy space in years to come. The Second World War also spawned or created a need to accelerate the application of major innovations, including radar, development of the jet engine, nuclear power, synthetic rubber, and the electronic computers. The present crisis is unlikely to be as prolific or original in innovations, but it will be remembered as marking major progress in many aspects of technology and social engineering. I point to four areas.

First, the pandemic has marked a big step forward in the application of biotechnology, showing how rapidly the genetic code of a deadly virus can be deciphered, new tests can be developed, and genetically engineered antibodies can provide promising vaccine candidates. The prospects of the biotechnology sector across a wider range of applications—from agriculture to materials and medicines—have been boosted by the pandemic.

Second, governments across the world have deployed systems to quickly target needy individuals with lump-sum transfers, and firms with emergency loans. These systems will be steadily improved and will serve in various contexts, including, hopefully, increased efforts to mitigate high- and rising-income inequality.

Third, central banks have developed an arsenal of new sector, market, and firm-specific loan facilities, as well as targeted asset purchase programs, greatly improving their capacity to intervene at the micro and macro levels. Though many would argue that independent central banks should ordinarily refrain from micro-level interventions, which are the competence of finance ministries, the fact remains that new instruments have been created that can be – for better or worse – deployed quickly and without waiting for the approval of parliaments. Such instruments may prove invaluable in future crises.

Fourth, and probably most importantly in terms of the effect on long-term productivity and welfare, the pandemic has shown that a vast array of activities that we normally carry out in person can be done virtually. Platforms including Skype, Webex, and Zoom will probably never replace personal contact completely. However, they have shown that there exist valid alternatives to billions of commuter hours spent in crowded trains, to expensive travel across time zones, to in-classroom instruction, and to the burning of fossil fuels that endangers our climate.

These innovations, or their acceleration, will in my view prove to be more significant outcomes of the crisis than the often-deplored fallout in international relations, including increased nationalism, protectionism, and great-power rivalry. To be sure, the latter developments carry serious risks and should not be underestimated. They are, however, mainly the result of changing ideological fashions and the vagaries of political leaders. In contrast, the innovations triggered by COVID-19 will last. Knowledge, once acquired, is not easily unlearnt.

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Uri Dadush is a Senior Fellow at the Policy Center for the New South, previously known as OCP Policy Center in Rabat, Morocco and a non-resident scholar at Bruegel. He is based in Washington, DC, and is Principal of Economic Policy International, LLC, providing consulting services to the World Bank and to other international organizations as well as corporations. He teaches courses on globalization and on international trade policy at the School of Public Policy at the University of Maryland. He was previously Director of the International Economics Program at Carnegie and, at the World Bank, Director of the International Trade, Economic Policy, and Development Prospects Departments. In the private sector, where he was President of the Economist Intelligence Unit, Group Vice President of Data Resources, Inc., and a consultant with Mc Kinsey and Co.

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