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How bad is the economic damage looking—and what are the prospects for recovery?

There are things policymakers can do to minimise the permanent scarring

by Jagjit S Chadha / May 13, 2020 / Leave a comment

The Bank of England. Photo: Dominic Lipinski/PA Wire/PA Images

Covid-19 has transformed economic prospects as rapidly as it has comprehensively. And in the main this is because lockdowns have been the tool by which governments have chosen to control the virus. World growth is not only going to stall this year but move significantly into reverse. Year-on-year growth in world income has hovered in the range of 3 to 4 per cent for three decades, and even in the worst year of the financial crisis barely crossed the zero line. Yet we at the institute now expect output to contract by some 3-4 per cent this year and that is the best-case scenario. Any return to our pre-Covid world will have to be staggered and will require a comprehensive rethink of economic practice, in respect of more active and supportive government policies than we have typically deployed for the past four decades.

To say that these are highly uncertain times is a truism. The most reassuring scenario assumes that the measures to control movement and social contact will be eased gradually, permitting a wider range of economic activities to be undertaken as 2021 dawns. That leads to the projection that global GDP will fall by some 3-4 per cent this year, which is an unprecedented downward revision of around 6-7 percentage points from what was broadly expected in February. The fall is substantially larger than that during the great financial crisis. The closest global parallel is the great depression of the 1930s, when there was a multi-year fall in output in many countries, but the comparison is a very rough and ready one and does not really stretch very well to the UK's situation today.

Once lockdowns are lifted, higher output could lead to marked year-on-year rises in GDP next year. But in many countries, even by 2022, GDP will still be significantly lower than had the pandemic not occurred as economies will be scarred.

Unemployment trends in light of the lockdowns have been shocking. The unemployment rate in the US may have been as much as 20 per cent in April. And some findings show that a third of workers in Canada and the US report that they have lost at least half of their income due to the Covid-19 crisis. The proportion is a quarter in the UK and 45 per cent in China. The Covid-19 shocks tend to interact with poverty and make it worse, as well as widening the income distribution at the national and global level.

The economic outlook for the UK depends critically on the effectiveness of policies used to manage the economy while limiting the spread of the virus. It is almost certain that UK GDP will fall in 2020 and there is a material risk of a further fall in 2021. The government's announced measures to limit the long-term economic effect have a direct cost to the exchequer of about £75bn. Borrowing is likely to rise above £200bn in 2020–21, with the national debt jumping to over 90 per cent of output. Where it is safe to do so, the government could circumvent some of the trade-off between saving lives and saving the economy by easing the lockdown in key "upstream" sectors of the economy such as the public sector, manufacturing and construction. The most significant challenges are likely to come when the lockdown is eased and the government's supportive measures withdrawn, with demand yet to return. Government schemes will then need to be adapted to prevent unnecessary business failures as the economy recovers.

In all this, international co-ordination will be crucial. Trade linkages amplify the economic shocks but also bolster the case for such co-ordination. Countries are connected through deep and extensive trade links, and are prone to international contagion, given participation in complex multi-country production networks which increase indirect exposure. We estimate that global spillovers through trade linkages amplify the domestic economic impacts of the Covid-19 shock by roughly 60 per cent on average. The average amplification would fall to approximately 35 per cent if global trade were to contract back to the levels of the 1990s. But for some of the smaller, very open economies and in the Euro Area, the spillover effects from the rest of the world could dominate the impact of the domestic shock on their own.

Even in this dark hour, there is hope. We have examined how the UK recovered very quickly from a rapid decline in output in 1921, thanks to a combination of support from overseas demand, some relaxation in monetary policy and the resumption of employment in a key industry with large positive spillovers. Co-ordinated action between fiscal and monetary policy can help, particularly if deployed when the lockdowns start to unwind. Monetary policy can create some fiscal space in those economies that have independent choice over the deployment of their macroeconomic tools. But given that the crisis may return as an echo in some form later, it is important that monetary support does not undermine hard-won monetary and financial stability.

If we try to open sectors that have strong links across the economy that will also help, as will giving some thought to kick-starting public investment projects in low-risk areas as soon as possible. International policy co-ordination can also support economies by helping to offset the downward momentum of globally-synchronised lockdowns.

The Covid-19 economic crisis has created a major challenge for governments. Somewhat against the tide of economic liberalisation, which has characterised the last 40 years, they need to move away from passive responses to market failures and grasp the opportunity to build a resilient set of economic structures. Many economic weaknesses in health, education and infrastructure are not new but have been exposed in all their fragility by this tragic, sharp downturn. Do our leaders have the imagination and vision required?

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Jagjit S Chadha

Jagjit S Chadha is the director of the National Institute of Economic and Social Research

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