A GLOBAL PERSPECTIVE ON COVID-19

The Economic Impact, Potential Recovery, and Longer-Term Outlook

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INTRODUCTION

The new coronavirus spread globally and largely invisibly in January and February, leaving countries with no choice but to put much of the world in lockdown mode. That is the status quo in most places. The mounting costs of remaining in this configuration are coming into sharp focus, and they are very large: huge increments to sovereign debt supported by accommodative central bank policy, sudden dramatic increases in unemployment and unemployment insurance claims, evidence of growing business distress in a variety of locked down sectors, and the beginnings of social unrest stemming from government restrictions, public health challenges, and economic duress.

In countries, states, or regions that have implemented fairly complete lockdowns, social distancing, and non-essential business closures where proximity is inevitable, the rate of virus spread appears to be declining so that confirmed cases may be nearing a peak. Governments are actively considering sequenced opening scenarios, and in some cases have already begun. May looks like the month in which this easing begins in many places in the United States and Europe. But there is tension. The medical and scientific community warn of uncontrolled growth in the virus that could result from premature or excessively rapid opening.

In reality, the costs and risks on both sides of the open/wait decision are potentially high. Trading them off involves difficult value judgments, and making these choices legitimately belongs to the people and their representatives. Experts on the scientific, medical, and economic sides are needed to provide informed predictions of the consequences of various policy choices. As the duration of the lockdown grows, the balance is shifting toward beginning the opening process.

In this note, we first explore what the opening process may entail, and how opening the economy with certain virus containment strategies supports a more rapid and effective restoration of economic activity. Then we turn to the extent and location of the economic damage, roughly which balance sheets are adversely affected, and how these distributional issues may relate to recovery.

IN THIS NOTE, WE WILL EXPLORE...

"Social distancing" means wearing a mask and staying away from other people. "Lockdown" means staying at home except for essential outings and business closures for non-essential businesses where proximity is required and remote working is not possible.

CONTAINING THE VIRUS

Attention has turned to the specifics of an exit, and planning for it is underway, across both Europe and the U.S. The EU, for example, outlined a roadmap on April 15 that includes some unspecific use of digital technology to boost the efficiency of the containment effort.

That said, the process is chaotic, involves multiple jurisdictions of varying competence, and thus far seems confused and relatively ineffective. The simple truth is that no Western country prepared properly for this in advance.

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Information is crucial in dealing with both the health and the economic challenges. Right now, in lockdown mode and in the absence of information that would differentiate risk across individuals, every encounter or contact is equally risky.

Preparation for a staged exit is at best incomplete. The exit from lockdown would ideally occur in the context of a regime change in which several conditions are met:

1. Medical facilities are adequate to handle realistic forecasts of critical cases,
2. Testing capacity is very large, including test kits, people trained to administer, and rapid reporting of results,
3. Very large numbers of people are trained and deployed to track and test contacts where potential infections may have occurred, and
4. There is a relatively low rate of infection in the relevant population.

It is unclear whether most jurisdictions are close to meeting these conditions. Testing for antibodies and potential immunity – which still needs to be determined medically – could be a powerful additional containment tool.

Digital technology has been used in several different ways to track cases across Asian countries[1], which appears to have made a material difference in containment, keeping people informed, and opening up the economy. The system that China adopted, in which the municipal government collaborated with platforms including Ant Financial and Tencent to create a color-coded QR system, helped restore the economy (and limit the spread of the virus) by directly reducing the risk of social contact.[2]

Whether these technologies will be considered and selectively used in the West remains to be seen. The answers will likely differ across countries, depending on design specifics, privacy protections, and trust – or its absence – in government and platforms. Leadership will be required – and tested – to make concrete decisions.

[1] World Economic Forum, "Here's how Asia is using tech to tackle COVID-19," 18 March 2020.

[2] Bloomberg, "People in China Need a Green Light From Alipay App to Move Around Country," 23 March 2020.

THE FRAMEWORK FOR RESTORING ECONOMIC ACTIVITY

In order to reawaken and restore economic activity, we have to allow more social contacts, and to do that safely, we have to lower the risk of infection associated with these contacts. This is the central quandary facing international governments and their scientific advisers as they map the path out of containment.

The principal focus of lockdown and social distancing measures deployed across the globe has been to reduce the effective reproduction rate of the virus, which is determined by the number of people with the infection and the number of susceptible individuals with whom infected people are in contact. Recent estimates of the reproduction rate in a setting with no controls run as high as 5.7, which was the reproduction rate in Wuhan, China before the government sought to contain the virus.[3] There is no right reproduction rate. It depends on density, geography and social habits. But the consensus is that the number is high.

Clearly, liberalization of current containment measures will increase the probability of infection due to increased contact. Liberalization strategies must therefore be premised on:

1. Retaining and requiring continued social distancing, which in many nations will include mandating face masks in public.
2. Strict control of the rate of increased social contacts. We would anticipate this to include a continued ban on large gatherings like sporting events and concerts, alongside restrictions on the demographics involved in smaller gatherings, e.g., implementing age restrictions in bars and restaurants. The reopening of schools presents a particular challenge in this dimension, given the risks of wider community transmission beyond the school gates.

Reducing the rate of infection among the population in circulation will require mass testing and contact tracing:

1. Even if this process is far from perfect, enhanced visibility of the presence of the virus is required to both mitigate and control future outbreaks. Mandatory self-isolation in the case of positive tests is a critical aspect of this approach.
2. In scenarios in which the population comes into close contact or proximity to one another, it will be necessary to monitor symptoms. Measures may include taking the temperature of people congregating for work, on transport, in supermarkets, restaurants, and preventing entrance for those with fever.
3. Asymptomatic cases will remain a key challenge. To date, studies have indicated that these represent a significant fraction of the total. International efforts to develop a valid serology test, which measures levels of antibodies in blood plasma, will be critical to improving visibility of asymptomatic cases and carriers. While these tests have been positioned at the center of some governments' "return to work" strategies, the WHO has warned that there is limited evidence to indicate thus far that the use of a serological test can show that an individual has immunity or is protected from reinfection.

Another major unknown in the outlook for economic recovery is the extent to which individual and consumer behavior will differ once containment measures are relaxed. Behavior will be determined in part by regulation, but also will depend on the perceived risks of partaking in "normal" social and consumption activity. Speaking in London recently, Bank of England Deputy Governor Ben Broadbent said that Britain's economy might be slow to recover once the government relaxes its coronavirus lockdown if people remain cautious about resuming their everyday lives as before.[4]

Of course, behavioral responses will vary widely. Some groups are inevitably more willing to take risks and are less sensitive to the negative externalities associated with activities than others. But the majority of the population may be more risk averse. Economic activity is only expected to expand relative to declines in perceived risks, even if restrictions are lifted. Effective communication that enables informed assessment of risk is therefore critically important.

[3] Centers for Disease Control and Prevention, "High Contagiousness and Rapid Spread of Severe Acute Respiratory Syndrome Coronavirus 2," 7 April 2020.

[4] Reuters, "UK recovery after lockdown may be slowed by caution: BoE's Broadbent," 20 April 2020.

FACTORING SUPPLY AND DEMAND INTO THE SPEED OF THE ECONOMIC RECOVERY

The virus and the subsequent lockdowns have together produced exogenous supply and demand shocks. The result is a deep recession of unknown duration at this point. There is no disagreement about this: the only question is how deep and how long.

Both demand and supply are important in gauging the speed of recovery.

On the supply side, we have observed a rolling disruption of global supply chains as the virus spread from China to other emerging markets and to the developed economies. If the virus can be beaten back relatively quickly, the supply shock can, in principle, be short lived. This is premised on two important qualifications: (a) not without a restoration of demand in hard hit sectors, and (b) not if many businesses fail before demand materializes.

In China and other Asian economies, it was reasonable to expect relatively rapid recoveries, in part because of robust and very aggressive containment programs. That was before the huge shock in the developed economies materialized. Because of the interconnected structure of the global economy, a more plausible base case now is a deep negative shock and a slow recovery – something like a very flat U that could collapse toward an L.

There is the issue of whether businesses survive to live another day. A portion of the "stimulus" across a range of countries is directed at helping businesses avoid failure, in the hope that they can reemerge as restrictions are relaxed and demand picks up. The channels for delivery of support vary, but most involve the central bank and the financial system (banks), sometimes with government guarantees.

The challenge here is implementation and speed. In Italy, for example, business support programs implemented through the banking system are bogged down in bureaucracy.[5] The support may arrive too late for some businesses. These are self-inflicted wounds. In much of the West, there is no well-developed AI-driven online credit provisions system which can respond quickly.[6]

On the employment side, the picture is mixed internationally. In the U.S., where the unemployment numbers are staggering, there is heavy reliance on unemployment insurance. In a number of European countries, including France, Italy, and Germany, there are subsidies to businesses to retain and pay employees. In the EU and U.S., there are also direct payments to households to replace lost income. Some of these differences are reminiscent of the GFC responses. There are no right answers here. Values, cultures, and institutions differ, but the key is rapid, effective implementation.

The hard part is the demand side. Demand and employment have been hammered by the mandated lockdowns. Households have suffered. There are at least three things that will constrain spending and the restoration of demand, even when employment is restored:

1. Risk aversion with respect to health,
2. A heightened sense of risk with respect to income and employment, and
3. Diminished balance sheets by reduction of assets or increases in debt.

[5] Bloomberg, "Italy's Crisis Funds May Come Too Late for Desperate Firms," 14 April 2020.

[6] Washington Post, "Federal officials scramble to ensure tech glitches, bureaucracy don't delay $1,200 coronavirus checks," 1 April 2020.

Hence, demand in key employment sectors will at best stage a partial return when lockdowns are lifted. As a result, my tentative conclusion is that the length/flatness of the U-shaped recovery will be determined in part by the success or failure of the post-lockdown regime to lower health risks. It will also be affected by the extent of balance sheet damage in all sectors other than government.

It is difficult to establish a clear picture of the extent to which the lockdown period is being used effectively to enable the phase two approach. Across jurisdictions, states, and countries, the answer seems to vary significantly; Germany and Italy (ex-Veneto) are in completely different places. But overall, the investments thus far seem, on average, to be short of what is needed to implement an effective and relatively safe phase two containment strategy that accelerates the return to normal business and economic activity. Hopefully this will change as phase two draws closer.

BALANCE SHEETS AND THE DISTRIBUTION OF BALANCE SHEET DETERIORATION

The deep recession we are in will eventually result in a recovery, but the output and income that was lost will be largely permanent. That economic damage will appear in the form of reduced assets and increased liabilities on balance sheets across all sectors: business, financial, household, and sovereign.

These diminished balance sheets will constitute a headwind to the speed of recovery, much as they did in the aftermath of the GFC, particularly in the household sector. To be clear, for households and businesses, coming out of this with more debt is better than not coming out of it at all. But the propensity to consume and invest will be adversely affected. That will affect the speed of recovery.

In my view, it is best for the economy if, to the extent possible, most of the damage eventually lands on the public sector (federal) balance sheet in the form of expanded sovereign debt. This outcome would effectively socialize the costs/losses across sectors, across segments of the population, and especially over time.

The pandemic will not land on everyone equally

That said, there is widespread and vocal sentiment on the center-left of the political spectrum that runs in the direction of wanting large businesses, the financial sector, and their shareholders to absorb some of the impact. In my view, if carried too far, this is a mistake. Unlike the GFC, where, arguably, parts of the financial system were complicit in creating the crisis, this is not the right occasion to sort out longstanding tensions around trends in income and wealth inequality. If financial sector balance sheets take the hit, credit will be constrained, impeding the speed of recovery. Household balance sheet deterioration impedes consumption and hence employment growth. On the other side, laying off workers and paying out large dividends would, if it occurred, be a display of political tone-deafness that is not helpful.

The bottom line here is that the pandemic will not land on everyone equally, and it will probably hit lower income populations harder. Undoubtedly, there are distributional and fairness issues that must be addressed in a forthright manner as the pandemic recedes, if we are to avoid coming out of the crisis with even more social and political polarization.

CONCLUDING THOUGHTS – LOOKING AHEAD

Looking ahead, we think in terms of the recovery period and patterns on the one hand, and the longer-term changes, accelerations, and shifts that may result from the pandemic. We will explore the latter in another note.

On the recovery and the immediate future, we think at this point in terms of two years, with lingering effects after that. Based on where we are, what we don't yet know, and all the factors discussed above, we expect a very deep (probably deeper than current macro forecasts) recession, followed by a slow recovery that will be under way by the end of 2020 but extend through 2021 and perhaps beyond. Slow means relatively flat, but there will be bumps along the road, associated with recurring virus outbreaks.

Predictions of lockdowns that extend out months are driven by health considerations, but they are not realistic. Individual economies and the global economy would not survive tight lockdowns for that long. The damage to incomes, businesses, and livelihoods would be too great, and resources to buffer the shock for that long are beyond the means of even rich economies.

Opening will occur in steps and be somewhat cautious. That is part of the reason for the flatness of the recovery in the initial stages. The roadmap for a well-executed exit is widely understood by policymakers and their expert advisers, evidenced by recent sensible guidelines from the EU and U.S. governments with respect to the opening up process. But the implementation will vary across countries, regions, and states. Initial conditions are not the same. The prevalence of the virus varies, and resources, competence, and political factors will also influence outcomes.

> **Creativity, innovation, empathy, and solidarity have not been in short supply**

On the upside from the base case, the only thing that could move the needle to a rapid recovery would be the early arrival of an effective vaccine. Expert estimates of vaccine arrival times vary but tend to run into the next 12 to 18 months.[7] That is consistent with the slow recovery base case but followed by a reasonably rapid recovery.

On the downside, the so-called L pattern, a lot of things would have to go wrong: excessively lengthy lockdowns; failures of implementation of programs to buffer the economy, companies, and sectors from semi-permanent damage; problems producing an effective vaccine; a mutation of the virus or the arrival of another one. At the moment, this scenario does not seem likely to us.

That said, crises and challenging times tend to bring out the best in us. We are seeing determined, steady, and effective leadership across the public, private, non-profit, and medical/science sectors. Creativity, innovation, empathy, and solidarity have not been in short supply. When we emerge, we will have learned a lot about this kind of shock and about preparedness and resilience, knowledge that one can hope will be used to guide policies and choices going forward.

[7] The Atlantic, "How the Pandemic Will End," 25 March 2020.

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