Commentary
Markets

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Policy Response: Where's the Way Out?

Elliot Hentov, PhD
Head of Policy Research, Global Macro Research

The COVID-19 pandemic has brought about a severe and unprecedented global economic shock. However, we believe that the economic rebound in developed markets will be robust as public health data start to improve and social distancing measures are lifted. In particular, the US, Europe and Japan have implemented swift and decisive policy action to alleviate the economic damage arising from the pandemic.

Emerging markets will likely experience a much greater public health and economic impact and many countries will require lending assistance on the road to recovery.

We forecast that the COVID-19 pandemic will reduce global GDP growth significantly in 2020 to levels associated with a global recession and the third-worst performance in about half a century, even if it remains above growth performance in 2009. However, we expect to return to a healthy, normalised growth rate by the end of 2021.

Recession Followed by Rebound

Recessions typically arise from economic shocks, but this recession is rare in that it has resulted from a public health crisis. We are seeing an unprecedented supply and demand shock, as witnessed by the huge global fall in the Markit Composite PMI index, an indicator of purchasing managers' confidence in the economic outlook. Global trade and industrial production are also on a downward trend, while US unemployment claims are at record levels.

Data will undoubtedly worsen before we see any sign of improvement. We have not reached the peaks of the infection rates and deaths from COVID-19 in Europe and the US, and ongoing economic fragility is almost a certainty.

However, the broad and robust response by central banks and governments is very encouraging. Central banks globally have acted swiftly to lower rates and inject liquidity into markets, while governments have introduced unprecedented fiscal measures. We expect these interventions will result in a relatively swift rebound in the services sector, consumer spending and other areas of global economic activity, once social distancing measures are lifted.

How can we achieve a swift recovery? First, we hope to see an improvement in public health data, specifically, the number of new COVID-19 cases and mortality, resulting from social distancing and improvements in testing availability and contact tracing. This, in turn, should lead to a faster relaxation of social distancing measures.

Our core assumption for a swift global economic recovery is that the social distancing measures will, on average, last around three months, and will not be followed by waves of re-imposed restrictions in the months ahead. However, if lockdowns are imposed for longer periods there will be a risk that liquidity challenges turn into a more serious solvency crisis, threatening the rebound.

While the number of new infections and deaths from COVID-19 has followed a typical exponential curve, we must remember that human innovation has also shown exponential growth. We see this in the significant growth of testing, diagnostics, personal protective equipment, healthcare capacity, social behavioural changes and medical treatments. The non-linear healthcare response will help to speed up the recovery.

In most of the US and Europe, we expect to see a gradual resumption of economic activity towards the latter end of the second quarter of this year, supporting a stronger rebound in the third quarter.

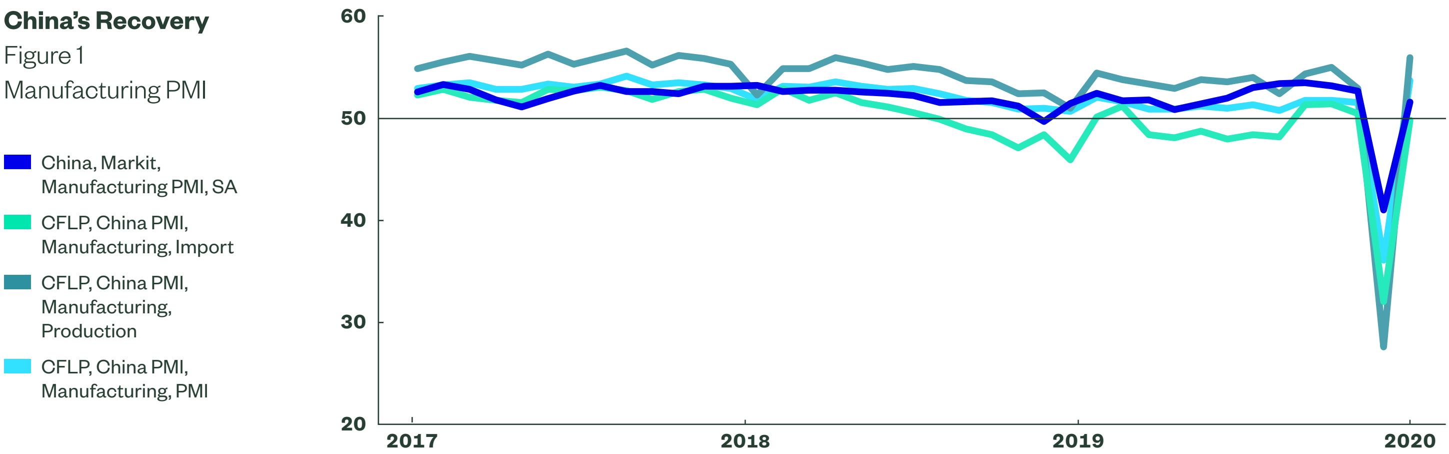
Perspectives from China

China managed to contain the spread of COVID-19 relatively quickly and has reopened parts of its economy. It therefore provides interesting perspectives for the rest of the world.

As the charts below show, China's manufacturing PMI has seen a V-shaped recovery, which is encouraging. However, manufacturing constitutes a relatively low share of developed market economies. Looking at non-manufacturing PMI in China, recovery has also been relatively swift and robust, although business activity hasn't returned to pre-crisis levels.

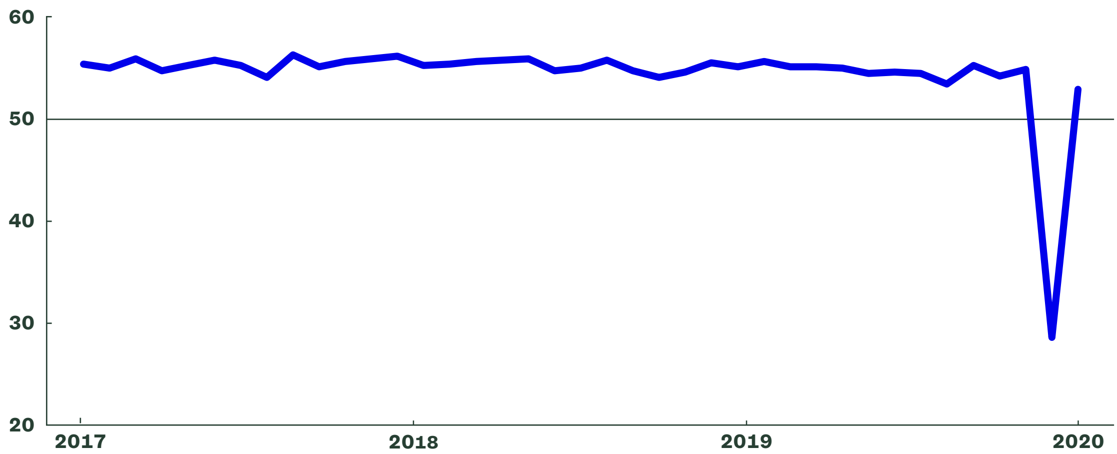
China's Recovery

Figure 1
Manufacturing PMI



Sources: China Federation of Logistics & Purchasing, IHS Markit. Updated as of 2 April 2020.

Figure 2
Non-Manufacturing PMI



Sources: China Federation of Logistics & Purchasing. Updated as of 2 April 2020.

The experience of developed markets may differ from China, however, this data give us confidence that we will see a strong rebound once economies start to reopen.

Monetary Support

The unprecedented monetary policy actions by central banks around the world can best be summarised in the words of Mario Draghi in 2012 — "whatever it takes". All the major central banks have reduced base rates to below 0.5%. The scale of lending has also ballooned.

This can be seen by looking at the balance sheets of the 'big-3' — the Federal Reserve, Bank of Japan and European Central Bank — which have each grown to a massive $5 trillion or more.

The Federal Reserve alone created 10 separate lending facilities in March for households, employers, financial markets, and state and local governments, in addition to its quantitative easing program. The Federal Reserve's existing >$2 trillion of lending support is expected to grow further in the coming weeks. If restrictions are in place for around three months, we think these measures will avoid a liquidity challenge turning into a solvency crisis.

Fiscal Support

Governments globally have massively boosted fiscal spending to support their economies. The table below shows the scope of the initiatives undertaken by the authorities of the major countries or regions, split by discretionary measures (including tax deferrals) and government guarantees:

Figure 3
Fiscal Policy Ramping Up Too

Country	Discretionary (% of GDP)	Guarantees (% of GDP)	Noteworthy Initiatives
China	2.5-3%	Limited	Infrastructure stimulus in the pipeline which should raise total to close to 5% of GDP
US	7.5%	4%	$500bn in corporate industry support $367bn in SME lending $600bn in household payments Support of $450bn Fed lending facility
UK	2.8%	15%	Demand support to labour market by funding lost income Higher spending to help the healthcare system £330bn in government guarantees & loans
Japan	7%	13%	Zero-interest loans and tax cuts for SMEs Direct payments to households and companies Compensation for companies w/ no job cuts
EU	3%	17%	**EU level:** Relaxation of budget rules; creation of ESM COVID-19-related credit lines of additional 2% of GDP; new EIB €200bn fund to leverage SME funding; SURE program of €100bn for unemployment **Italy:** only 1.5% of direct spending + 7% of guarantees **Germany:** 7% of fiscal stimulus + 36% of guarantees, much through KfW **France and Spain:** thus far still below 2% of stimulus with guarantees around 10% of GDP

SME — Small and medium-sized enterprises.
ESM — European Stability Mechanism.
EIB — European Investment Bank.
SURE — Support to mitigate Unemployment Risks in an Emergency.

Source: SSGA Macro Policy Research.

Discretionary spending is likely to increase further over time. For example, we believe China and the EU will increase discretionary spending to 5% of GDP by the end of 2020. We should bear this in mind when hearing the news that EU GDP will fall 7% in 2020.

Furthermore, the size of guarantees, particularly for the EU, UK and Japan is enormous. This will be critical in bridging the loss of demand, and transferring credit risk from creditors and banks to the sovereign as the backstop. Germany, for example, has implemented guarantees worth over a third of its GDP, in addition to a 7% fiscal stimulus.

These robust policy measures underpin our optimism of a swift recovery after social distancing measures are lifted.

Tougher Times for Emerging Markets

Regrettably, we believe emerging markets are unlikely to rebound as swiftly or strongly in the months ahead. Aside from the more serious public health implications of COVID-19 for emerging markets, the key reasons are the sudden stop to capital flows and the reduction in global trade, which will hurt emerging economies even harder than developed economies. It is notable that non-resident portfolio flows to emerging markets have fallen significantly since the start of the year.

The oversupply of oil and ongoing fall in oil process will also hurt emerging market oil exporters in the short-term. We expect that oil supply cuts in May will help emerging markets from the third quarter of 2020 onwards.

As a sign of the severity of the crisis, the International Monetary Fund (IMF) has already received requests for lending assistance from over 80 emerging market countries. It's possible that the IMF's funds will be insufficient and other lenders will have to assist those countries in need.

Encouragingly, emerging markets overall had stronger fiscal positions, larger foreign exchange reserves and lower borrowing prior to the crisis, compared to previous years. This will help them to maintain some level of economic resilience in the months ahead.

Global GDP: Slowdown then Reversion

We forecast that global GDP will still grow in 2020, but just barely. This would be the third-worst year for global growth in the last 50 years.

We don't think we will see an overshoot of growth in 2021, as has happened after previous crises, including the global financial crisis. Our forecasts suggest that growth in 2021 will return to its long-term average of roughly 3.6%.

Longer-term Impacts

We have discussed the short-term challenges of the COVID-19 pandemic but what about the medium and longer-term economic and geopolitical impact?

We predict this crisis will accelerate existing trends towards de-globalisation, reduced global coordination and heightened geopolitical confrontation. We may, for example, see evolving and shortening global supply chains as governments look to reduce economic dependence on other countries.

The concept of national security will likely extend far beyond military defence to include wider considerations of healthcare, artificial intelligence, automation, agriculture, textiles and other sectors.

Finally — and a phenomenon we are already witnessing — is a re-evaluation of the role of the state in the global and national economy.

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