ECONOMIC RECOVERY IN THE ADVANCED COUNTRIES: LESSONS FROM THE PAST

The Covid-19 crisis has deeply affected our economies. Although the rebound observed in recent months seems to have been confirmed, uncertainty persists over their capacity to fully recover. This article will look at how the G7 economies reacted during post-recession phases in the past, in terms of GDP, private consumption and investment. How quickly did GDP in these economies catch up with pre-crisis levels and trends? What were the most dynamic components of aggregated demand during recovery phases? Given the specific characteristics of the Covid-19 crisis, can it really be compared with previous shocks? These are some of the questions that we will discuss in this article while highlighting current sector disparities.

The Covid-19 crisis is different from past crises. It combines a triple shock – a supply shock, a demand shock and an uncertainty shock – and its long-term consequences are still partly unknown. In the G7 countries (United States, Japan, Germany, UK, France, Italy and Canada), GDP in volume plummeted by nearly 6% in 2020, a much sharper contraction than the 3.6% decline reported during the 2009 recession. The gradual lifting of health restrictions, the acceleration of vaccination campaigns in most countries, and public policy support – both fiscal and monetary – should bolster the economic rebound in the second half of 2021.

We are still left with the question of whether the crisis will leave any lasting scars on these economies. The size of any scars will depend on several factors, especially public policy decisions. So far, the governments of the advanced economies have opted to intervene rapidly and massively to support economic agents, with measures geared towards households and companies. These interventions were mainly designed to limit the destruction of productive capital that may have occurred through a wave of bankruptcies or a significant surge in unemployment, especially long-term unemployment. So far, the gamble seems to have paid off fairly well, although some disparities can be seen between countries. In the European Union, for example, most of the negative shock of the Covid-19 crisis was absorbed through short-time working schemes and similar furlough measures, which significantly softened the impact on the labour market. The unemployment rate rose from 6.4% in March 2020 to 7.8% in August, before slipping back to 7.3% in March 2021. In the United States, in contrast, the fluctuations were much more abrupt. After reaching a pre-crisis low of about 3.5%, the US unemployment rate reached a peak to nearly 15% at the height of the pandemic. Since then, it has fallen back to about 6% of the active population.

One of the main questions now facing analysts and decision makers is the rebound capacity of these economies once all the health restrictions have been lifted. When will GDP, private consumption and investment return to pre-Covid levels in the advanced economies? When will they return to the levels they would have reached if the Covid crisis had never occurred (see box 1)? Has the crisis eroded the long-term growth potential of these economies? If yes, then by how much? Although we present these questions here in macroeconomic terms, they also raise numerous questions about changes in labour market conditions, the effectiveness of public policy support measures, and the sustainability of public finances in the different countries. If an economy rapidly closes the gap created by the crisis, then the consequences for the real economy will be smaller and not as lasting. Inversely, if the economy is slow to recover and remains weak, it will take longer for the labour market to return to normal. In this case, public support would still be necessary, raising the question of the sustainability of public debt.

In the second part of this article, we will try to get an idea of post-Covid macroeconomic trends in the months ahead by analysing the behaviour of the G7 economies during the exit phases of past recessions. We looked at recessions in which average growth was negative for a full year, which differs from the standard definition based on two consecutive quarters of contracting GDP. We observed the impact of these crises on

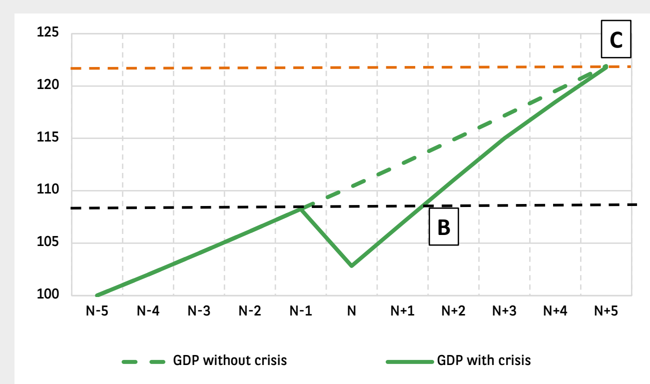
POTENTIAL POST-CRISIS SCENARIO

The big question is whether the negative shock of the Covid-19 crisis will have a lasting impact on the G7 economies. Has it eroded their long-term growth potential?

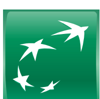
This question is illustrated in chart 1, which simulates the dynamics of GDP growth before and after a crisis. In the chart, GDP is represented by the green line. The dotted green line represents GDP growth if the crisis had not occurred (scenario 1). Under this scenario, GDP would continue to grow without interruption at a pace close to its long-term potential.

In our second scenario, the crisis intervenes in year N, at point A on the chart. Thanks to the automatic post-crisis rebound, GDP returns to the pre-crisis level (represented by the horizontal black dotted line), at point B on our chart. GDP returns to point B more or less rapidly depending on the size of the post-crisis rebound. At point B, GDP has returned to the pre-crisis level, but it is still far below point C, which is the point it would have reached without the crisis. In our example, growth does not return to point C until 5 years after the shock (N+5 on our chart). As we will see later in this article, if the crisis structurally weakens the economy, it is also possible that GDP will never return to point C.

ILLUSTRATION OF A POST-CRISIS ECONOMIC REBOUND:



BOX 1 CHART 1 SOURCE: BNP PARIBAS



the G7 economies and the speed at which they recovered based on the analysis of traditional macroeconomic variables: GDP, potential GDP, private consumption, total investment and exports of goods & services. Our sample comprises the G7 countries (US, Japan, Germany, UK, France, Italy and Canada) and we analysed about past 25 recessions. We looked not only at recessions that hit all of the G7 economies, but also took into account more localised recessions. We examined the oil shocks of 1974 and 1980; the subprime crisis of 2008-2009; the recessions of the early 1990s in the US, the UK and Canada, at a time of rising interest rates; the European Monetary System crisis of 1992-1993, which impacted several Eurozone member countries; the 1980 recession in the UK; the 2002-2003 recession in Germany due to the euro's appreciation and the slowdown in world trade; and the recessions in Japan in the late 1980s (bursting of the equity and housing market bubbles) and late 1990s (Asian crisis).

A crisis can have lasting consequences

In the vast majority of cases, economic and/or financial crises have a lasting impact on a country's growth momentum. The immediate impact of the crisis and the scars it leaves on the economy largely depend on three factors: the nature of the shock, the differentiated impact on sectors, and whether or not it includes a banking and financial crisis. The key factor is the nature of the shock, i.e. whether it comprises a supply shock, a demand shock or a combination of the two. A supply shock without a demand shock is likely to have a smaller economic impact that does not last as long. In terms of sector disparities, a shock can be concentrated more in the manufacturing sector (through the collapse of global trade, for example) or in the services sector (as was the case during the Covid crisis, which we will return to later in this article). Lastly, destabilisation of the banking and financial sector can have lasting effects at the macroeconomic level, notably by undermining the dynamics of bank lending, which in turn strains aggregated demand.

Recessions and slower growth

Table 1 shows the average GDP growth rates for the G7 countries that prevailed during the five years before and after recessions.

Based on our sample and methodology (using the average growth rates 5 years before and after the crisis), table 1 shows that average growth declined in 80% of the cases after a recession (see charts 2-5). For our selection, average growth (unweighted) contracted by about 1 point. In only certain cases, this post-recession economic slowdown can be seen as the normal reaction of an economy after a period of sharp acceleration in growth and major risk taking. In this case, the recession corrects the excesses that had built up before the outbreak of the crisis. Yet an economic and financial crisis can also have a negative impact on growth and/or on the level of productivity, notably via the destruction of productive capital, which in turn reduces medium-term growth. Note that independently of the negative effects of a crisis, most mature economies are experiencing a structural slowdown in productivity gains. Among recent recessions, one of the most striking examples is the subprime crisis of 2008-2009, which had an especially lasting impact on the dynamics of the G7 economies. Economic literature is filled with documentation on the long-term effects of financial and banking crises, and the 2009 crisis in particular[1]. Most of these crises are associated with a sharp drop-off in production and employment. They can have a lasting impact on the dynamics of productivity gains, inequalities and

AVERAGE GDP GROWTH RATES 5 YEARS BEFORE AND AFTER A RECESSION

	Average growth of final private consumption 5 years before	Years of recession	Average growth of final private consumption 5 years after	Delta «after the recession» vs «before the recession»
Japan	7.7	1974	4.6	↘
	3.9	1993	1.4	↘
	1.9	1998/1999	1.3	↘
	1.0	2008/2009	1.1	↗
United Kingdom	5.0	1974/1975	2.5	↘
	2.5	1980/1981	3.6	↗
	4.8	1991	3.1	↘
	2.6	2008/2009	1.6	↘
United States	5.0	1974/1975	3.2	↘
	2.4	1982	4.7	↗
	3.2	2008/2009	1.9	↘
Italy	4.0	1975	4.6	↗
	2.9	1993	2.2	↘
	1.1	2008/2009	-1.0	↘
		2012/2013	1.1	↗
Germany	3.4	1975	3.4	↘
	2.4	1982	2.5	↗
	3.4	1993	1.3	↘
	1.5	2002/2003	0.6	↘
	0.6	2009	1.1	↗
France	4.7	1975	3.3	↘
	2.2	1993	2.0	↘
	1.9	2009	0.7	↘
Canada	2.2	1982	3.7	↗
	3.2	1991	2.3	↘
	3.7	2009	2.6	↘

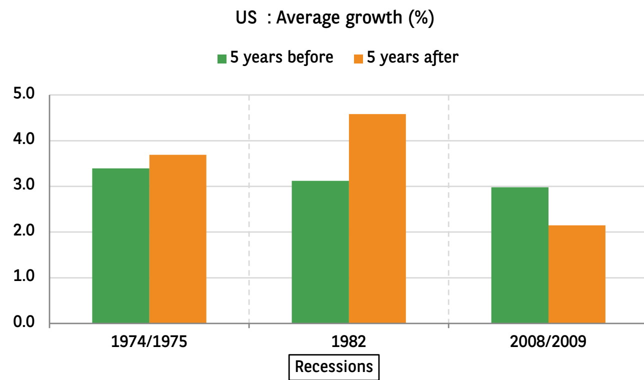
Note: For Italy, since the 2012 recession followed closely on the 2009 crisis, we compare Italy's 5-year average growth rate before the 2009 crisis with the 5-year average after the 2012 crisis.

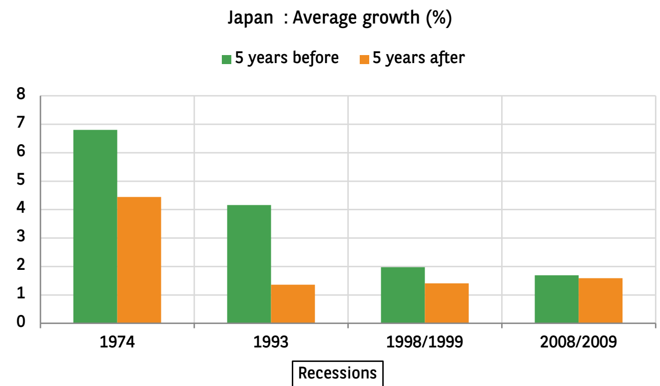
TABLE 1 SOURCE: WORLD BANK, BNP PARIBAS

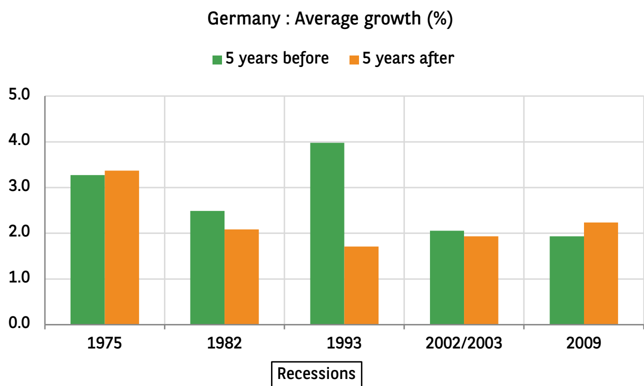
the public finance situation of a given country (we will come back to the 2009 crisis later in this article). They can also weaken potential growth rates and the standard of living of the local population. For Eurozone member states, the 2008-2009 crisis was rapidly followed by the sovereign debt crisis, which continued to have a severe impact on these economies. Some countries in our selection, like Italy, were hit

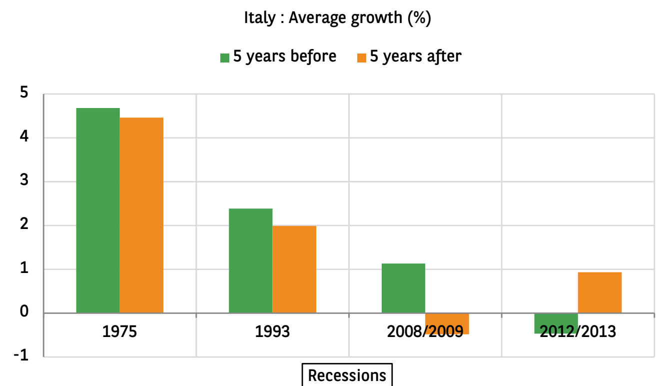
1 C.M. Reinhart & K.S. Rogoff, *The aftermath of financial crises*, NBER January 2009; W. Chen et al., *Lasting effects: The global economic recovery 10 years after the crisis*, IMF Blog, October 2018; E. Debauche & al., *The crisis: what lasting effects on growth, employment and public finances?*, Revue d'économie financière, 2011

AVERAGE GDP GROWTH RATES 5 YEARS BEFORE AND AFTER RECESSIONS









CHARTS 2-5

SOURCE: WORLD BANK, BNP PARIBAS

by two consecutive severe recessions that had a lasting impact on the country's productivity and public finances[2]. Inversely, Germany was the only big Eurozone economy in which growth increased after the 2009 crisis, fuelled by strong domestic demand.

In this environment, GDP can return more or less rapidly to the pre-crisis level, as well as to the level that it would have reached if the crisis had not occurred (for further explanation, see box 1 and chart 1). It all depends on the vigour of the post-crisis economic rebound and on the economic growth that prevails in the years thereafter. Except for specific cases, GDP in the countries in our selection returned relatively quickly to pre-crisis levels or higher, regardless of the size of the shock. This is an important point because it suggests that the shortfall in GDP due to a recession is rapidly erased in the years following the shock. Table 2 shows that GDP often returns to the pre-crisis level during the year following the crisis. The 2008-2009 crisis is a notable exception. For our selection of countries with the exception of Canada, it took longer for GDP to return to the pre-crisis level. As to Italy, two back-to-back crises – the subprime crisis and the eurozone sovereign debt crisis – had a long-lasting impact on economic growth, and it took 6 years before GDP returned to the pre-crisis level.

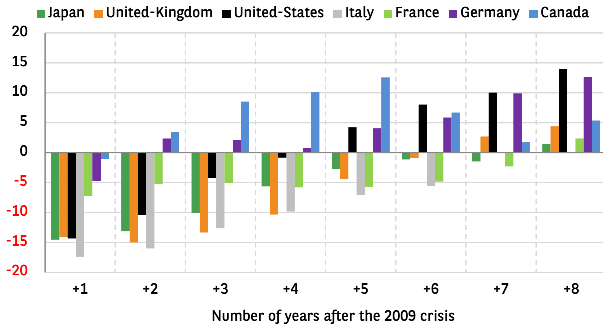
Investment: the weak link of economic recoveries

An economic crisis tends to have a more severe and lasting impact on total investment than on the other components of demand, namely private consumption and exports of goods and services. In post-crisis periods, consumption and exports do not slow down as much as investment (the 5-year unweighted average was down 1.5 points for consumption, 1.8 points for exports and about 2.5 points for investment). At the same time, it takes much longer for investment to catch up to pre-recession levels than consumption or exports. For the countries in our selection, chart 6 highlights the relatively slow pace of investment after the 2009 crisis.

Several factors explain these differences. In the midst of and following an economic or financial crisis, private investment is likely to be hampered by the high level of uncertainty, which delays its recovery and in turn hinders the economic rebound[3]. Over the longer term, these dynamics can erode the country's productive capital and growth potential. As to public investment, after recessions, governments are often determined to rapidly restore their public finances. An excessively sharp fiscal consolidation can further undermine growth momentum.

2 OFCE, *Italy: escaping the high-debt and low-growth trap, Policy Brief,* May 2019.
3 *"Business investment in EU countries", Occasional Paper Series*, ECB, October 2018

INVESTMENT SHORTFALL FOLLOWING THE 2009 CRISIS (%)



In Canada, 4 years after the 2008/2009 crisis, the level of overall investment was 10% higher than the pre-crisis level. In France, in contrast, 6 years after the crisis, investment was still about 5% short of the pre-crisis level.

CHART 6 SOURCE: WORLD BANK, BNP PARIBAS

This was the case in the aftermath of the Eurozone sovereign debt crisis[4]. Inversely, household consumption, which tends to return more rapidly to the pre-crisis level as we pointed out above, is supported by several factors, including automatic stabilisers (higher unemployment benefits, for example), the downward rigidity of nominal wages, and the big share of constraint expenditures.

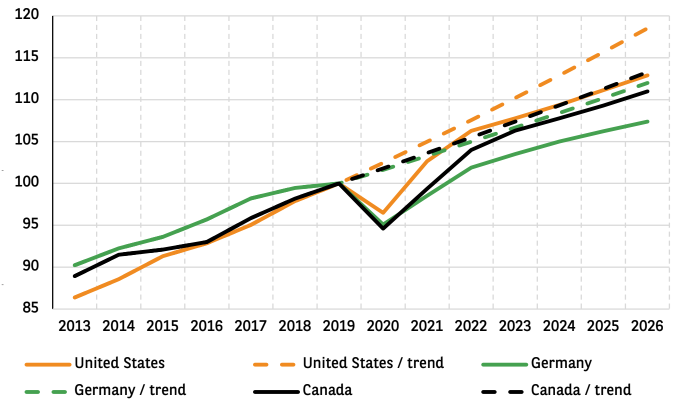
Covid-19: the specific characteristics of the health crisis

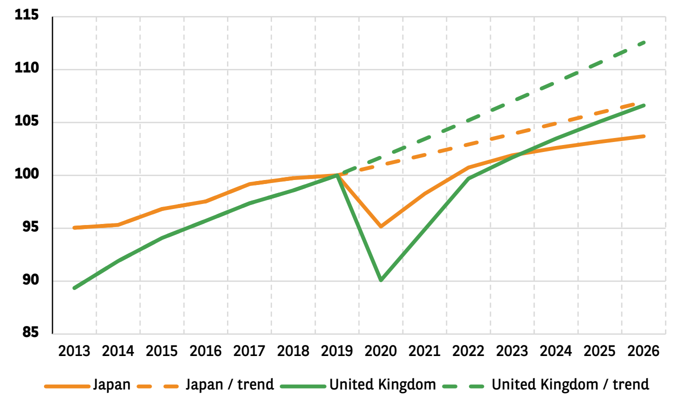
As we pointed out earlier in this article, the Covid-19 crisis, like many crises, should lead to a decline in the potential output of the G7 countries, notably those in the Eurozone. So far, the G7 have largely limited the destruction of productive capital (which occurs through corporate bankruptcies and surging unemployment) thanks to massive interventions by national governments. But their potential growth has eroded throughout the crisis due to the decline in the number of hours worked per employee. At the macroeconomic level, the Eurozone's potential output in 2022 is still likely to be about 3% below the trajectory expected in projections carried out prior to the crisis, according to the European Central Bank (ECB)[5].

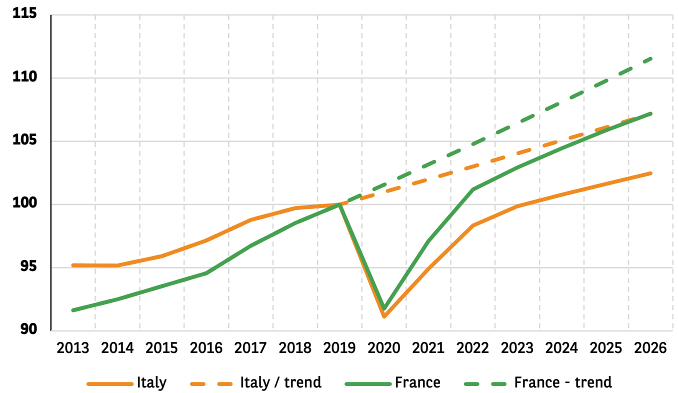
Yet the vigour of the economic recovery, which continues to surprise many observers, should enable GDP to rapidly return to pre-crisis levels in most of the G7 economies. By next year, the majority of G7 countries will have returned to the 2019 level. According to the latest projections by the International Monetary Fund (IMF), in contrast, GDP in the G7 countries is likely to remain far short of the pre-crisis trend (measured in this article as the average growth rate five years before the crisis) (see charts 7a-c). The United States stands apart on this point, since US GDP has virtually returned already to the pre-crisis trend, buoyed by the major fiscal impulse implemented, although growth should taper off again once the cyclical rebound is over.

Yet the pandemic's medium-term impact on the G7 economies is still uncertain. Key issues include the withdrawal of fiscal support and theNtargeting of the hardest hit sectors.

OBSERVED AND EXPECTED GDP AND THE PRE-CRISIS TREND (100 = 2019)







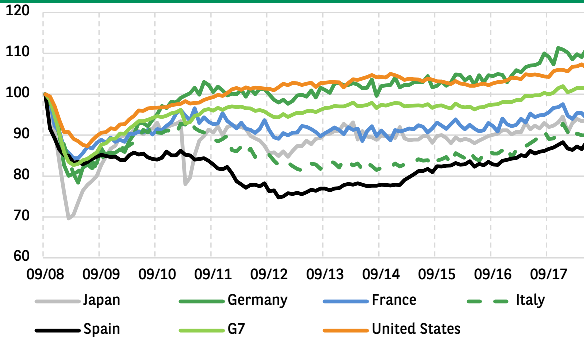
CHARTS 7A, 7B & 7C SOURCE: WEO FMI, BNP PARIBAS

From a macroeconomic perspective, the G7 economies are rebounding strongly, but sectoral situations are much more mixed.

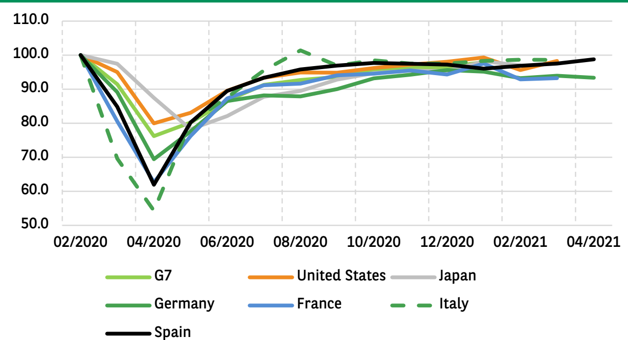
4 A.Bénassy-Quéré et al., *Which fiscal union for the euro area?*, CAE, February 2016

5 P. Lopez-Garcia, *The impact of Covid-19 on potential output in the euro area*, ECB Economic Bulletin, Box 2, November 2020

MANUFACTURING OUTPUT DURING THE COVID-19 CRISIS
(100 = FEBRUARY 2020)



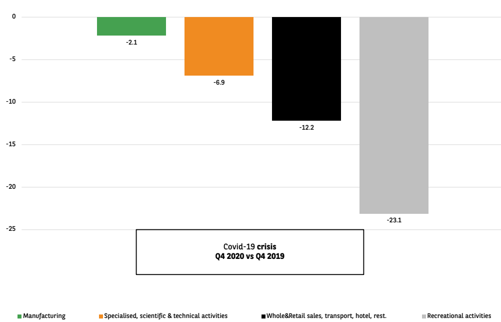
MANUFACTURING OUTPUT DURING THE SUBPRIME CRISIS
(100 = SEPT. 2008)



CHARTS 8A & 8B

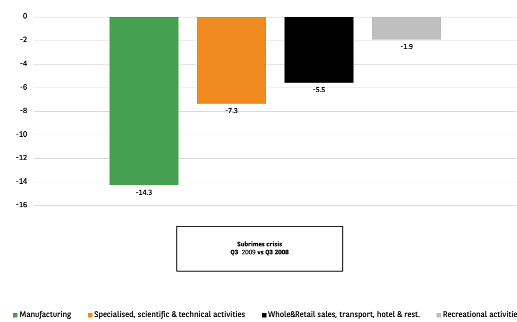
SOURCE: NATIONAL SOURCES, REFINITIV, BNP PARIBAS

EUROZONE: LOSS OF BUSINESS BY SECTOR ONE YEAR AFTER THE COVID-19 CRISIS (%)



During the Covid-19 crisis, manufacturing value added in the eurozone was only about 2% below the pre-crisis level of Q4 2019.

EUROZONE: LOSS OF BUSINESS BY SECTOR ONE YEAR AFTER THE SUBPRIME CRISIS (%)



Following the subprime crisis, manufacturing value added in the eurozone in Q3 2009 was about 14% below the level of Q3 2008.

CHARTS 9 & 10

SOURCE: EUROSTAT, BNP PARIBAS

Covid-19: a massive shock on the tradeable services sector

We must begin by pointing out that the manufacturing and services sectors are not two distinct entities. Corporate activities are becoming increasingly complex and diversified. Industrial companies also have own account services production[6]. The industrial production process implies a large number of services activities, such as R&D, marketing and accounting. For simplicity's sake, this article will maintain the traditional distinction between the two sectors in the database that we use. All countries have implemented health measures to curb the pandemic, and these measures have impacted all segments of the economy. Yet this macroeconomic picture tends to mask major sector disparities. Business was especially hard hit in tradeable services. Moreover, these services will only gradually recover from the loss of business.

Uncertainty about the pandemic brought private consumption to a standstill as certain businesses were shut down and borders were closed, social distancing measures were introduced, and consumers were afraid to enter enclosed spaces. Consequently, it will take some time before activity fully recovers in tradeable services. Of course, manufacturing industry was also hard hit by the health crisis, but to a much lesser extent. Industry has benefited from the very strong rebound in global trade in recent months, and volumes already rose last winter above pre-crisis levels[7].

Looking at sector disparities, a striking comparison can be made between the current Covid-19 crisis and the subprime crisis of 2008-2009. The Covid-19 shock has had a bigger impact on services, while the great financial crisis had a much bigger impact on manufacturing. During the earlier crisis, it took three years for global merchandise trade to return to pre-crisis levels. Charts 8a and 8b show manufacturing output in the G7 countries during the Covid-19 crisis and 2008 subprime crisis, respectively. Despite differences in momentum between countries, on the whole we can see that there was a much more abrupt drop-off in manufacturing output during the Covid-19 shock than during the 2008 crisis. The rebound was also much stronger, and production rapidly returned to pre-crisis levels. Following the 2008 crisis, in contrast, the rebound in manufacturing output was much more gradual. Some eurozone members, especially the southern countries like Italy and Spain, were hit by a double shock as the sovereign debt crisis followed

6 M. Crozet & E. Milet, *Is industry becoming less industrial?*, CEPII letter, February 2014
7 G. Derrien, *World trade in goods reaches new heights*, EcoFlash, BNP Paribas, May 2021

close on the heels of the 2008 crisis. Inversely, certain G7 countries like the United States and Germany pulled through much better.

In charts 9 and 10, the shortfall in activity one year after the onset of the crisis (measured by the value added in real terms) highlights the differences in the sector impact between the Covid-19 crisis and the subprime crisis, respectively. In the manufacturing sector, activity rebounded rapidly after spring 2020 and has almost completely closed the gap, whereas in 2009, there was still a big shortfall a year after the crisis began. Inversely, recreational activities were relatively spared by the subprime crisis, whereas they are largely bearing the brunt of the Covid-19 crisis.

The speed at which this service category recovers will depend on the savings behaviour of consumers. Households have accumulated additional savings during the crisis. In the end, renewed confidence and a decline in household savings, notably precautionary savings, will drive the recovery of the services hit hardest by the pandemic.

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Given the very specific nature of the Covid-19 shock, it is not easy to draw comparisons between the current crisis and past economic and financial crises. Nonetheless, an analysis of past shocks provides some answers to questions raised by the Covid-19 crisis. Although it did not trigger a banking sector crisis, the belated rebound in the confidence of economic agents, especially companies in the sectors hit hardest by the crisis, could strain investment momentum and thus the overall economic recovery. Today there are still many uncertainties concerning the evolution of the pandemic, given the growing alarm about the Delta variant and the surge in new cases despite the acceleration in vaccination campaigns. Yet the G7 economies have shown proof of a strong capacity to adapt in the face of health restrictions. The digitalisation process has even accelerated in certain segments of the economy, notably via online sales, which suggests that the loss of productivity could be limited. In the end, we cannot grasp the overall consequences of this crisis until the pandemic has been brought fully under control.

Completed on 15 July 2021

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HOW MANY YEARS DOES THE GDP NEED TO RETURN TO ITS PRE-CRISIS LEVEL?

Country	Year	GDP level
Japan	1974	+1
	1993	+1
	1998/1999	+1
	2008/2009	+4
United States	1974/1975	+1
	1982	+1
	2008/2009	+2
Germany	1975	+1
	1982	+1
	1993	+1
	2002/2003	+1
	2009	+2
United Kingdom	1974/1975	+2
	1980/1981	+2
	1991	+2
	2008/2009	+3
Italy	1975	+1
	1993	+1
	2008/2009	-
	2012/2013	+6
France	1975	+1
	1993	+1
	2009	+2
Canada	1982	+2
	1991	+2
	2009	+1

TABLE 2 SOURCE: WORLD BANK, BNP PARIBAS

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