Editorial

Sudden stop to be followed by a gradual, uneven recovery

The COVID-19 pandemic has caused a sudden stop in an increasing number of countries. This in turn had led to international spillovers via a decline in foreign trade and an increase in investor risk aversion triggering a global rush for dollar liquidity and a surge in capital outflows from developing economies. A forceful reaction has followed in major economies in terms of monetary and fiscal policy in an effort to attenuate the impact of the pandemic. The near-term dynamics of demand and activity will entirely depend on the length and severity of the lockdown. Once the lockdown has ended, the recovery is likely to be gradual and uneven and policy will have to shift from pandemic relief to growth-boosting measures, thereby putting additional pressure on public finances.

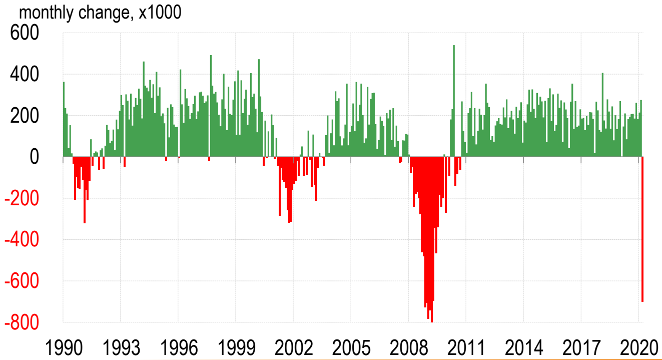
Sudden stop triggers swift and forceful policy reaction

The coronavirus pandemic has confronted major parts of the world economy with a sudden stop which is becoming more visible by the day. In the eurozone, several business surveys have seen record drops in March on a monthly basis. In the US, initial unemployment claims have skyrocketed to a degree never seen before and employment has fallen dramatically. The prospect of a big hit to GDP has triggered a swift and forceful policy reaction from central banks. The Federal Reserve has taken the federal funds rate down to zero, embarked on a programme of buying commercial paper as well as high-quality corporate bonds. It has also sent a message saying it would do 'whatever it takes' to stabilize the treasury market as well as the market for agencies' mortgage-backed securities. The ECB has introduced a EUR 750 bn Pandemic Emergency Purchase Programme and given itself the much-needed flexibility of deciding which bonds it would buy. The US administration and Congress have agreed on a fiscal stimulus plan corresponding to 10% of GDP. Several European countries have also taken measures to support households and companies. These measures should attenuate the impact of the crisis and limit the risk that a temporary health crisis ends up inflicting lasting damage to the economy, thereby weighing on the potential to recover swiftly.

Gradual and uneven recovery

The end of lockdowns will lead to a 'mechanical' rebound in activity and demand. Pent-up demand and inventory rebuilding are likely to give an additional short-term boost to growth. The key question is what happens to the growth outlook afterwards. The experience in China, in recent weeks, is a reminder that we cannot take a V-shaped recovery for granted, quite the contrary. It will probably be gradual because i/ not all countries move at the same pace towards normality (which will hinder exports, as we have already seen in China today) and ii/ the economic impact of the pandemic differs as well. This impact has a bearing on how fast demand and activity will get back to the pre-pandemic growth path. Several factors suggest that the process will likely be gradual and bumpy. By then, balance sheets of many companies will have deteriorated, causing a preference for deleveraging over increasing capital expenditures. It may even have an impact on hiring plans. These considerations are particularly important for small and mid-sized companies, where many tend to have less-diversified business models, which make them more sensitive to the economic shock. Certain households will adopt a precautionary savings attitude, seeking to re-establish some financial cushion. Lingering health risk concerns may also act as a drag on certain expenditures – e.g. international travel - without necessarily leading to an equivalent increase in other areas. More than anything, household spending will depend on how unemployment develops. In the US, where costs of laying off people are low, Federal Reserve officials expect the unemployment rate to increase significantly. Finally, international trade will probably remain sluggish for months to come, whereby exports from countries where the lockdown has ended up suffering from the drop in import demand from countries which have gone in lockdown at a later stage. Against this background, it is quite likely that fiscal policy, after having provided -- together with monetary policy -- a strong dose of pandemic relief, will need to also provide demand stimulus to ensure that the recovery gathers sufficient pace.

United Sates: Non Farm Payrolls



Source: US Bureau of Labor Statistics

William De Vijlder
william.devijlder@bnpparibas.com