OECD report points to pandemic’s long-term impact

Nick Beams
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Any claims that major economies and the world economy as whole will experience a miraculous V-shaped recovery as restrictions imposed as a result of the COVID-19 pandemic are lifted should be laid to rest by a report issued by the Organisation for Economic Cooperation and Development (OECD) earlier this month.

The report makes clear that the pandemic has led to the most severe contraction since the Great Depression and that its effects will be long-lasting. It notes that in a number of key areas of the global economy, notably trade, investment and corporate debt, the pandemic has exacerbated trends that were already clearly evident before it struck.

In a comment on the report, OECD chief economist Laurence Boone said that “economic activity has collapsed across the OECD during shutdown by as much as 20 to 30 percent in some countries, an extraordinary shock.”

In framing its outlook, the OECD, which covers 33 major economies, considers two scenarios: one in which the virus recedes and remains under control, and one where a second wave erupts later this year.

“Both scenarios are sobering,” Boone writes, “as economic activity does not and cannot return to normal under these circumstances.”

The report says that the economic outlook is “exceptionally uncertain.” It states that any recovery will be “hesitant” and could be interrupted by another outbreak “if targeted containment measures, notably test, track and trace” were not put in place or did not prove effective.”

In a “double-hit” scenario, global GDP is projected to decline by 7.1 percent this year, while in a “single-hit,” the contraction will be 6 percent this year, returning to almost pre-crisis levels by the end of 2021.

But even under this latter, relatively optimistic, scenario, “in many advanced economies, the equivalent of five years or more of per capita real income growth could be lost by 2021.”

“The crisis will cast a long shadow over the world and OECD economies,” the report states. “By 2021 it will have taken real income per capita in the majority of OECD economies back to 2013 levels in the double-hit scenario and to 2016 levels in the single-hit scenario.”

Moreover, it may “permanently reduce potential output due to the premature scrapping of capital that is likely to accompany higher bankruptcies” and the adverse long-term effects of high unemployment levels.

The report notes that “stronger international cooperation” is needed to help end the spread of the pandemic more quickly and speed up global economic recovery, as well as to avoid harm to emerging market economies.

“The sharing of knowledge, medical and financial resources, and reducing harmful bans to trade, especially in health care products, are essential to address the challenges brought by the pandemic,” it states.

But the opposite is taking place. Boone notes that the pandemic has accelerated the shift from the “great integration” to the “great fragmentation,” with additional trade and investment restrictions taking place.

This process is not confined to the economic sphere, as the Trump administration and other major powers step up their anti-China campaign, seeking to blame it for the global spread of the virus.

The report notes that the hardest hit areas in terms of employment have been in leisure, entertainment and tourism. But equally significant has been the decline in spending on consumer durables. Global car sales in

March and April were down by 37 percent compared to the monthly average for 2019.

Investment spending, one of the crucial drivers for economic growth over the longer term, has also fallen sharply. Production of capital goods in the major advanced economies fell by around 12 percent in the first quarter of 2020. In this case, the pandemic accelerated a trend clearly visible in the latter half of 2019, as investment began to fall.

Another longer-term indicator is the fall in global trade. The OECD reports that it is now “contracting sharply,” with a fall of almost 4 percent in the first three months of 2020—that is, prior to the full impact of lockdown measures. International freight traffic by air dropped by 30 percent in April compared to a year earlier.

“Global export orders fell to their lowest levels on record in April and remained exceptionally weak in May, with all countries reporting sizeable declines,” the OECD notes.

As with investment, the pandemic has severely exacerbated what was already an underlying trend that began in the wake of the global financial crisis. In recent years, world trade has risen only marginally faster than the increase in global output, whereas in the years preceding 2008 it was rising at twice the rate of growth in global GDP.

The OECD forecasts that global trade will fall by 11.5 percent in 2020 under a double-hit scenario and by 9.5 percent if there is a single hit.

Its forecast for unemployment also points to the long-lasting effects of the pandemic, with unemployment in the OECD area projected to rise to the highest levels in a quarter of a century and ease only slowly in 2021.

The report states: “The scarring effects from job losses are likely to be felt particularly by younger workers and lower-skilled workers, with attendant risks of many people becoming entrapped in joblessness for an extended period.”

On the financial front, the OECD notes that the pandemic sparked “massive declines in financial asset prices and a spike in volatility, with some markets ceasing to function properly.” There was a collapse in stock markets in many countries of between 30 and 50 percent in the biggest plunge since the 1987 crash.

The market turmoil eased only as a result of the massive intervention by the US and other central banks around the world. But this intervention will have to continue. The OECD asserts that central banks may have to opt for yield curve control in order to keep interest rates down. This is the policy already pursued in Japan, where the central bank essentially buys up government debt in order to maintain a low-interest-regime.

While such a regime boosts stocks, it creates problems in other areas of the economy because a prolonged period of low interest rates will “challenge the solvency of pension funds and insurance companies.”

The OECD adds that while it does not have comprehensive data on the position of non-financial corporations, “the evidence for selected large companies suggests that the negative impact of the collapse in output will be very large.”

Here again, the pandemic struck as underlying weaknesses were starting to emerge, with the OECD noting that at the end of 2019, some 25 percent of firms “did not have enough cash to cover all debt obligations in 2020.”

It states that the “likely rise in corporate insolvencies and bankruptcies” may lead to “negative feedback effects in corporate bond markets,” and notes that a “record amount of [corporate] debt has fallen to junk status in recent months,” that is, rated at below investment-grade.

This could add to “challenges for banks,” especially in Europe, where companies depend more on banks for their financing than in the US. While banks were not the origin of the crisis and have higher liquidity buffers than in 2008, the report says, “they are likely to be affected negatively by increased corporate and household defaults as well as weak demand.”