The Post-Pandemic Global Economy: A Framework for Navigating Choppy Waters

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Highlights

- Once the dust settles from this crisis, we will wake up a to a new and uncertain world.
- Since this pandemic is a historical novelty, forecasts cannot be made with much accuracy. Therefore, it is important to think about the post-pandemic economy within a clear framework that looks at different economic sectors and explores the interlinkages between them.
- The ongoing crisis will worsen some pre-existing conditions of the global economy (inequality, deglobalization, populism) while creating new ones (debt sustainability issues, labor market disruptions, more capital controls).
- We should brace ourselves for weaker growth potentials, massive debt burdens, less effective monetary policy, deglobalization, low for (even) longer interest rates and much more.

This pandemic is a historical novelty, which will drastically change all aspects of our lives. Once the dust settles from this crisis, we will wake up a to a new world (new business models, new regulations, new policymaking). The future is uncertain anyway, but the pandemic – which is unlike anything seen before – has exacerbated this uncertainty to unprecedented levels (Chart 1).[1]

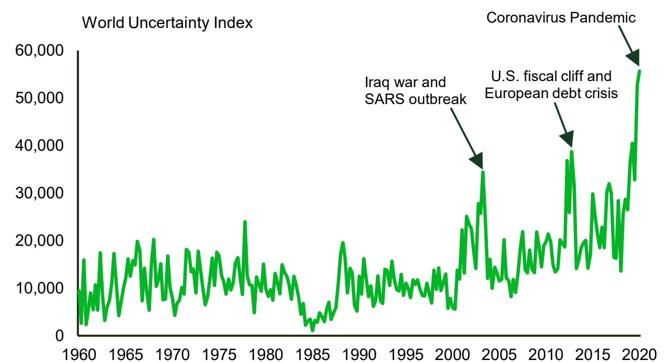
Given the uncertainty we will be living in over the next few months (and even years!), it is difficult for us – or anyone – to present the future with certainty. Economic forecasters have been humbled by these uncertain times.

Therefore, it is important to think about the post-pandemic world within a clear framework. This note presents such a framework for thinking about life after the pandemic by looking at different economic sectors and understanding the interlinkages between them (Chart 2). This note should serve as a guide for navigating the choppy waters ahead.

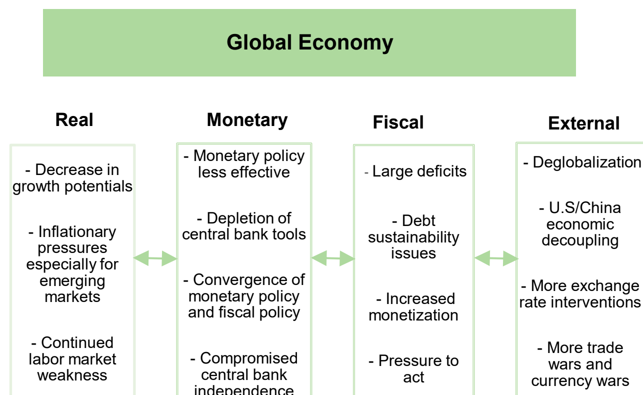
So far, government and central bank interventions have prevented an all-out financial crisis. However, the financial sector today is highly interlinked with the broader global macroeconomy. Therefore, the longer the weaknesses in the broader economy persist, the higher the likelihood we witness increasing vulnerabilities to and from the financial sector (Chart 3).

The ongoing crisis is unique in the sense that its health and economic ramifications are intertwined. The pandemic will shatter the old way of doing things and usher in a new era of economic policymaking. It will worsen certain pre-existing conditions of the global economy (inequality, deglobalization, populism) while creating new ones (debt sustainability issues, lower potential growth, capital controls).[2]

Chart 1: The Most Uncertain Time in 60 Years



Source: Ahir, H, N Bloom, and D Furceri (2018), TD Economics.
Note: A higher number means higher uncertainty and vice versa. The Index is constructed by counting the frequency of the word "uncertain" (or its variant) in Economist Intelligence Unit country reports. The Index is then normalized by total number of words and rescaled by multiplying by 1,000.



Real Sector: Weaker Growth Potentials Are Our Future

This crisis will leave deep scars on the global economy, which will take years to heal. Growth potentials will decline due to lasting impacts in capital and labor markets. The pandemic has already disrupted capital markets, but these disruptions will continue well after the pandemic fades away partly due lingering uncertainty and higher private-sector debt levels. For example, we expect total U.S. business investment to be 5% lower by 2026 than what it could have been without the pandemic.

Labor market disruptions will also keep growth potentials low. We expect continued pockets of weakness in the labor market, especially for countries that have not taken the necessary steps to support workers. Even countries that have provided ample labor market support will continue to witness reduced immigration, high unemployment levels, and permanent job losses. The younger workforce will face the brunt of these disruptions. These factors combined will keep growth potentials subdued.

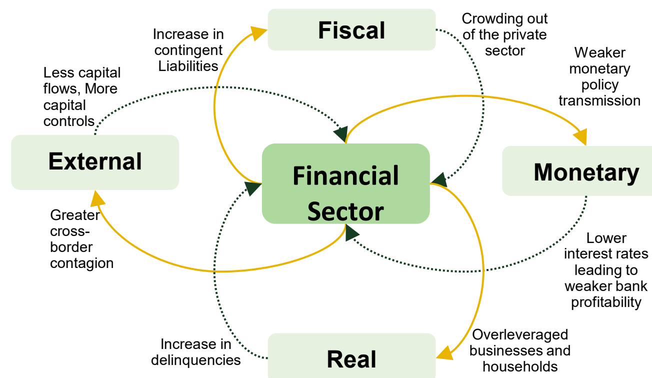
Many jobs may never return. This is especially true for in-person service jobs, particularly those requiring low-skills and paying low-wages. About 42% of job losses in the U.S. may be permanent, despite ongoing government support.[3] This means that out of the roughly 41 million Americans that have so far filed for jobless claims, at least 17 million will have no job to return to.[4]

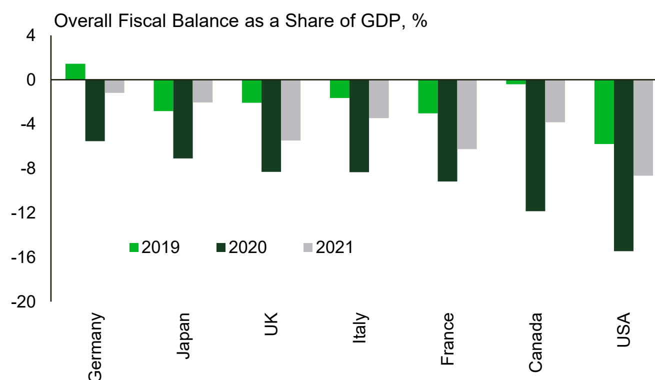
Widening income and wealth inequality will be exacerbated as the pandemic disproportionately impacts low-skilled workers. Previous major epidemics have shown a rise in subsequent inequality. This shock will hurt employment prospects of those with basic education while having a negligible impact on those with advanced degrees. The rise in inequality will give way to an increase in social unrest, populism and political polarization.

The economic disruptions caused by the pandemic will considerably slow down emerging markets' (EMs) "catch-up" to advanced economies (AEs) and lead to a greater divergence in per capita incomes. It will also push a large share of the EM population – especially that of low-income countries – into poverty.

Much like the Great Depression, deflation – negative growth in prices – caused by weak demand is the immediate short-term risk to prices. Some countries (Canada, Spain, Sweden) are already experiencing negative growth in prices. Deflation can raise the already high debt burdens in the near-term. It can also lead to a vicious cycle of weak demand as consumers postpone their non-essential purchases – after all, why buy today if one can buy for less tomorrow?

While deflation is a near-term risk, high inflation is a medium to long-run risk. The size of fiscal and monetary stimulus measures today could turn out to be inflationary a few years from now. This is especially true for countries with weak institutions or where there is a history of government intervention in central bank decision making (i.e., various EMs). Governments may be tempted to ask their central banks to keep interest rates low to reduce their burgeoning debt servicing costs, leading to overheating and inflation. While some inflation is desirable, the lack of central bank and government





separation is a recipe for (hyper)inflation. If this separation is not maintained, it may lead to a shift in central bank objectives away from inflation targeting, towards funding the government. This could cause inflation expectations to become unanchored, drive up bond yields and result in immense destruction to the economy.

Monetary Sector: Less Effective Monetary Policy

Central banks have already used up a lot of their ammunition since the global financial crisis (GFC). They have pulled out all the stops in response to the pandemic hit. Compared to the GFC, central banks are conducting quantitative easing (QE) at a much larger scale and buying a wider variety of assets. Some AEs – such as Canada – are experimenting with QE for the first time. Even EM central banks (Philippines, South Africa, Colombia) have joined in, with some (Brazil, Indonesia) directly purchasing government debt. Meanwhile, global interest rates are already at their lowest levels in recent years, so there is little room to ease further. Considering these factors, monetary policy could become less effective on the margin, as central banks would have little of their ammunition left.

Central banks may be forced to move away from targeting inflation. Discussions about moving away from existing inflation targeting frameworks – such as price-level targeting or average inflation targeting – had started well before the crisis.[5] However, this pandemic will provide a sense of urgency to those discussions. Given the scale of labor market disruptions around the world, central banks may be inclined to put more emphasis on keeping employment levels/rates stable rather than just prioritizing stable prices. Central banks may also target wage inflation rather than consumer price inflation as the former has a closer link to employment. They can also target nominal GDP which would allow them to bring price and employment stability into a single metric.

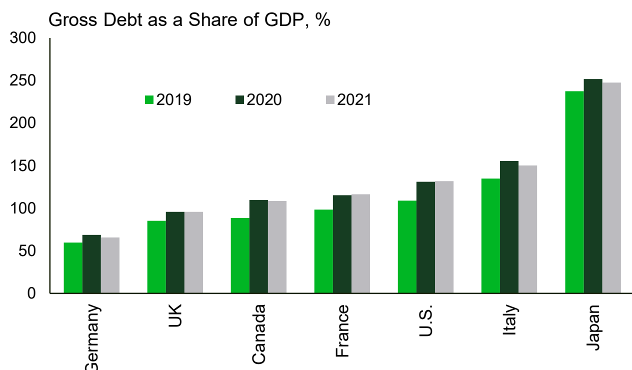
The neutral interest rate – the rate at which employment and inflation are stable – has important implications for post-pandemic monetary policy. The pandemic may further exacerbate the decline in neutral interest rates. Greater risk aversion will increase precautionary savings and large-scale government spending will crowd out the private sector. Increased risk-off behavior will lead to flight-to-safety and lower potential growth, which will also put downward pressure on neutral interest rates. Although less likely, the neutral interest rate may eventually rise if government debt continues to grow rapidly. An increase in the debt-to-GDP ratio by say 60 percent might increase the neutral interest rate by 120 to 140 basis points.[6]

We expect interest rates to stay low for (even) longer, due to recent moves by central banks and the slow expected global recovery. As a result, banks will see their net interest margins – difference between interest paid on assets and interest paid on liabilities – further compressed. Persistently low interest rates may continue to put pressure on banks' profitability. When unable to generate profits, banks are less likely to provide loans and other financial services to businesses and households. Withholding loans to the private sector may further hamper growth.

This crisis will be a watershed moment for how fiscal and monetary policy interact going forward. Policy measures announced by central banks and governments have led to a convergence of fiscal and monetary policy, putting central bank independence at risk. Such coordination will be standard practice going forward, as the world tackles the unprecedented rise in public debt.

Fiscal Sector: Unprecedently High Debt Burdens

Given weaker monetary policy, there will be more pressure on fiscal authorities to act. Large open-ended fiscal programs announced to counter the pandemic have already resulted in large fiscal deficits and debt burdens (Chart 4 and 5). The increase in fiscal deficits is likely to be outpaced by the rise in public debt as tax revenues tend to fall even faster than economic activity during deep recessions. High public debt levels also threaten to crowd-out private sector spending, creating a drag on growth.



High debt levels may be unsustainable, depending on countries' growth prospects and future debt servicing costs. Low interest rates could help achieve fiscal sustainability in some countries, but governments should not count on real interest rates remaining persistently below real GDP growth. If interest rates on borrowing exceeds GDP growth, debt servicing will become difficult. A lot would depend on how long it takes for the economic wounds caused by this crisis to heal – the longer it takes, the lower the growth going forward, and greater the difficulty to service debt.

Governments will have a few options to reduce debt. They can count on inflation, debt restructuring, financial repression, higher taxes, austerity, or wealth expropriation.[7] While these measures can reduce the debt burden – as financial repression and inflation did in the postwar era – the negative growth consequences can easily outweigh the benefits. For instance, Japan increased consumption taxes twice (2014 and 2019) in the last decade. Both instances drove the economy into a recession. These measures also have political consequences. There is no easy way out.

Given high debt burdens, central banks may increasingly monetize government debt. However, there are limits to government deficits being monetized by central banks without resulting in inflation. The upside of higher inflation is that it can decrease government's debt burden.

As the popular adage goes, there is no such thing as a free lunch. To make up for lost revenue today, governments may have to impose higher taxes when the crisis is over. For example, the European Union (EU) is already calling for new environmental taxes and corporate levies as it looks for innovative ways to finance $829 billion (5% of GDP) in debt as part of its recovery plan. However, if a central bank monetizes its government debt, the increase in taxes will not have to take place. This way, the government can have its cake and eat it too.

Governments' guarantees to banks on loans extended to the private sector have increased substantially during this crisis. Such guarantees are contingent liabilities – potential obligations that do not arise until a banks' loan is defaulted on – that can expose the issuing government to considerable risk. British banks have already warned that they expect about 50% of the businesses to default on their pandemic support loans. If bank are not repaid, contingent liabilities become activated, increasing fiscal costs. Given that several governments already have high fiscal deficits and debt levels, such an increase in fiscal costs may further push up sovereign bond yields. And since banks – especially in Europe – hold large amounts of sovereign bonds, it may lead to investors charging a higher interest rate to banks as well.

The line between the government sector and the private sector will also become fuzzy. An increasing number of governments are taking stake in private companies. For example, the German government has taken a 20% stake in its flagship airline Lufthansa in a $9.8 billion rescue deal. The U.S. and Canada have also indicated the possibility of taking equity stake for company aid. We expect this trend to continue across AEs.

External sector: Deglobalization and US-China Decoupling

Increased debt monetization and money creation would lead to weaker currencies. And since interest rates would already be low, countries would increasingly resort to exchange rate interventions to stimulate their economies. This in turn may lead to more currency wars, not just between the U.S. and China but also between other bilateral pairs.

Long before the pandemic hit, deglobalization was well on its way. However, the pandemic will act as a catalyst for deglobalization through an increase in protectionism and onshoring. The pandemic has exposed vulnerabilities of relying too much on long supply chains. This crisis will prompt countries to look inwards by domesticating supply chains, raising tariffs, and introducing other non-tariff barriers (bans, quotas, licenses). While doing so would keep jobs at home and compa-

nies self-reliant, it may reduce companies' profit margins and productivity.[8] Supply chain disruptions will also put upward pressure on inflation, as companies look for alternatives. More protectionist trade will allow AEs to subsidize their industries, keeping EMs – especially low-income countries – mired in recession for longer. These factors will combine to increase the frequency of trade wars.

Economic decoupling between the U.S. and China has accelerated due to the pandemic. This decoupling is seen across the board – in trade, technology and investment. This decoupling is also reflected in latest data – China's direct investment in the U.S. in the first quarter of this year fell to just $200 million, down from an average $2 billion last year. China has also become the new flagbearer of multilateral cooperation while the U.S. has stepped back. China's $2 billion donation to the World Health Organization (WHO) to fight the pandemic and U.S. threats to permanently withdraw funding from WHO are good cases in point. The post-pandemic world will become more polarized, not just politically but economically. The last time such a decoupling (between U.K., Germany and later the U.S.) took place, it brought an end to the first wave of globalization in 1914, contributed to two world wars and a global depression. [9]

Given the rapid reversal of capital flows seen in EMs, the pandemic will usher in a period where we are likely to see restrictions to the movement of capital, in the same way we are seeing restrictions to the movement of people and goods. These capital controls on outflows can be in the form of limits, taxes, differential exchange rates, and bans. Capital controls on inflows are a useful weapon during trade wars as they can depreciate currencies, making exports more competitive. However, there are several downsides to imposing capital controls on inflows. They can fan currency wars and trade wars when other countries retaliate. Domestically, they create credit constraints, reduce business investment and decrease potential growth. The permanent nature of capital controls also means that they are difficult to remove once implemented.

In this period of economic Darwinism, we expect only the fittest to survive. And the biggest – the Amazons, Apples and Huaweis of the world – to thrive. Small and medium enterprises (SMEs) will be disproportionately hit by deglobalization trends. Several SMEs may exit the market – some temporarily, and some for good. This will decrease competition, raise consumer prices and allow more room for anti-competitive behavior by large companies.

Bottom Line

The pandemic induced crisis has brought unprecedented uncertainty. Once the dust settles from this crisis, we will wake up a to a new world. Since this pandemic is a historical novelty, economic forecasts cannot be made with much certainty. Therefore, it is important to think about the post-pandemic economy within a clear framework. Looking at different economic sectors and understanding the interlinkages between them can serve as our guide for the uncertain future. The ongoing crisis will worsen some of the global economy's pre-existing conditions, while creating new ones. We should prepare ourselves for weaker growth potentials, massive debt burdens, less effective monetary policy, deglobalization and low for (even) longer interest rates. This will be a bumpy ride.

End Notes

1. Ahir, H, N Bloom, and D Furceri (2018), "World Uncertainty Index" Stanford mimeo.
2. Potential growth is the rate of growth that an economy can sustain over the medium-term without generating excess inflation.
3. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3592953
4. 17 million is the low-end number as jobless claims at the time of writing were 41 million. We expect jobless claims to continue to rise in the near-term, leading to the actual number of people with permanent job losses higher than 17 million.
5. Instead of stabilizing a one-period (yearly) inflation rate around the target (as in inflation targeting), a central bank doing average inflation targeting aims to stabilize the average inflation rate over multiple periods.
6. https://www.piie.com/blogs/realtime-economic-issues-watch/high-inflation-unlikely-not-impossible-advanced-economies#_ftn2
7. Financial repression describes a government's actions though which it can channels funds from the private sector to itself as a form of debt reduction. Examples include; ceilings on interest rates, a tighter connection between governments and banks or creation of a captive domestic market for government debt.
8. The pandemic will accentuate the trend towards digitization and automation which may increase productivity for certain industries.
9. The first wave of globalization took place between 1870 - 1914. The second wave was between 1944 and 1971. The third and current era began in 1989.

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