OECD Economic Outlook, Interim Report

Coronavirus (COVID-19): Living with uncertainty

SEPTEMBER 2020

OECD

CORONAVIRUS: LIVING WITH UNCERTAINTY

Summary

Global output collapsed in the first half of 2020 as the COVID-19 pandemic took hold, with declines of more than one-fifth in some advanced and emerging-market economies. Without the prompt and effective policy support introduced in all economies, the contraction in output would have been substantially larger.

Output picked up swiftly following the easing of confinement measures and the initial re-opening of businesses, but the pace of the global recovery has lost some momentum over the summer months.

- Household spending on many durable goods has bounced back relatively quickly, but spending on services, especially those requiring close proximity between workers and consumers or international travel, has remained subdued.
- Hours worked have fallen significantly everywhere, but government support schemes have helped to maintain household incomes.
- Corporate investment and international trade remain weak, holding back the pick-up in manufacturing production in many export-oriented economies.

The outlook is subject to considerable uncertainty and projections are dependent on assumptions about the spread of the COVID-19 virus and policy developments.

- The projections assume that sporadic local outbreaks will continue, with these being addressed by targeted local interventions rather than national lockdowns; a vaccination is assumed not to become widely available until late in 2021.
- Global GDP is projected to decline by 4½ per cent this year, before picking up by 5% in 2021. The drop in global output in 2020 is smaller than expected, though still unprecedented in recent history, but this masks considerable differences across countries, with upward revisions in China, the United States and Europe, but weaker-than-expected outcomes in India, Mexico and South Africa.
- In most economies, the level of output at the end of 2021 is projected to remain below that at the end of 2019, and considerably weaker than projected prior to the pandemic, highlighting the risk of long-lasting costs from the pandemic.
- If the threat from the coronavirus fades more quickly than expected, improved confidence could boost global activity significantly in 2021. However, a stronger resurgence of the virus, or more stringent containment measures, could cut 2-3 percentage points from global growth in 2021, with higher unemployment and a prolonged period of weak investment.

Fiscal, monetary and structural policy support needs to be maintained to preserve confidence and limit uncertainty, but evolve with underlying economic conditions.

- Many central banks have appropriately announced further policy easing in the past three months and changes in policy frameworks are being rightly introduced to convince investors that policy rates will be kept low for a long time.
- Fiscal policy support needs to be pursued in 2021 and recent announcements in many countries of additional fiscal measures are welcome; the aim must be to avoid premature budgetary tightening at a time when economies are still fragile.
- The maintenance of strong fiscal support should not prevent necessary adjustments to key emergency programmes – including job retention schemes, and income support measures - to limit long-lasting costs from the crisis and encourage the needed reallocation of resources towards expanding sectors.
- Enhanced global co-operation to maintain open borders and the free flow of trade, investment and medical equipment is essential to mitigate and suppress the virus in all parts of the world and speed up the economic recovery.

OECD Interim Economic Outlook Forecasts September 2020

Real GDP growth

Year-on-year % change

	2019	2020		2021	
		Interim EO projections	Difference from June EO single-hit scenario	Interim EO projections	Difference from June EO single-hit scenario
World[1]	2.6	-4.5	1.5	5.0	-0.2
G20[1,2]	2.9	-4.1	1.6	5.7	0.2
Australia	1.8	-4.1	0.9	2.5	-1.6
Canada	1.7	-5.8	2.2	4.0	0.1
Euro area	1.3	-7.9	1.2	5.1	-1.4
Germany	0.6	-5.4	1.2	4.6	-1.2
France	1.5	-9.5	1.9	5.8	-1.9
Italy	0.3	-10.5	0.8	5.4	-2.3
Japan	0.7	-5.8	0.2	1.5	-0.6
Korea	2.0	-1.0	0.2	3.1	0.0
Mexico	-0.3	-10.2	-2.7	3.0	0.0
Turkey	0.9	-2.9	1.9	3.9	-0.4
United Kingdom	1.5	-10.1	1.4	7.6	-1.4
United States	2.2	-3.8	3.5	4.0	-0.1
Argentina	-2.1	-11.2	-2.9	3.2	-0.9
Brazil	1.1	-6.5	0.9	3.6	-0.6
China	6.1	1.8	4.4	8.0	1.2
India[3]	4.2	-10.2	-6.5	10.7	2.8
Indonesia	5.0	-3.3	-0.5	5.3	0.1
Russia	1.4	-7.3	0.7	5.0	-1.0
Saudi Arabia	0.4	-6.8	-0.2	3.2	-0.6
South Africa	0.1	-11.5	-4.0	1.4	-1.1

Note: Difference from June 2020 Economic Outlook in percentage points, based on rounded figures.

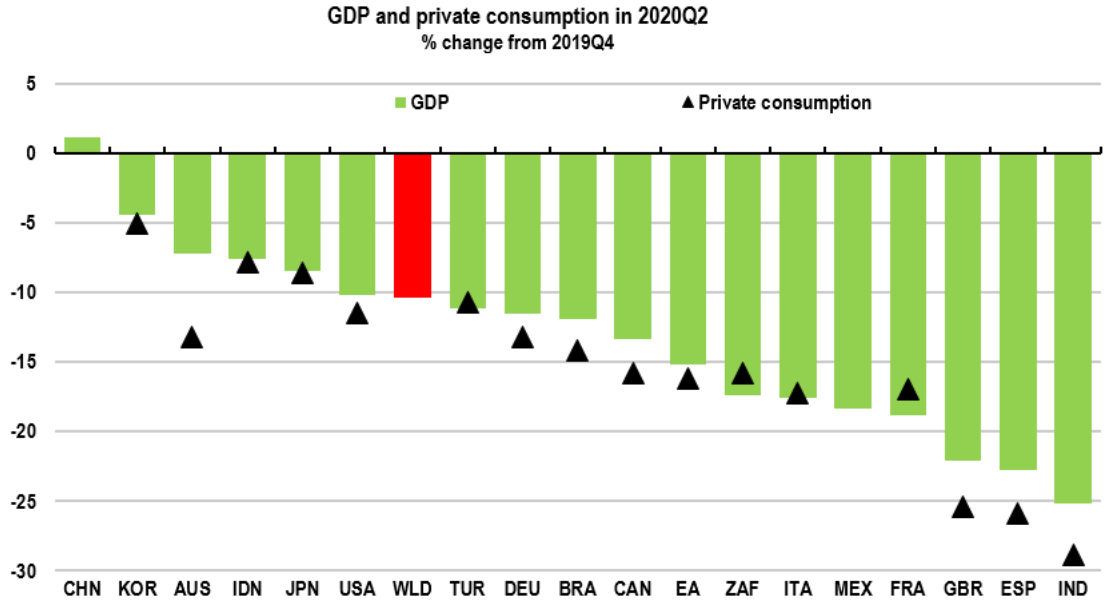
1. Aggregate using moving nominal GDP weights at purchasing power parities.
2. The European Union is a full member of the G20, but the G20 aggregate only includes countries that are also members in their own right.
3. Fiscal years, starting in April.

A gradual recovery is underway after an unprecedented shock

The economic outlook remains exceptionally uncertain, with the COVID-19 pandemic continuing to exert a substantial toll on economies and societies. Global output in the second quarter of 2020 was over 10% lower than at the end of 2019, an unprecedented sudden shock in modern times. The extent and timing of the pandemic shock differed across the major economies, but all experienced a sharp contraction in activity as necessary containment measures were implemented. Global trade collapsed, declining by over 15% in the first half of 2020, and labour markets were severely disrupted by reductions in working hours, job losses and the enforced shutdown of businesses. Without the prompt and effective policy support introduced in all economies to cushion the impact of the shock on household incomes and companies, the contraction in output and employment would have been substantially larger.

Output declines of over 20% occurred in some European economies and India, where containment measures were particularly restrictive (Figure 1). Economies relatively dependent on tourism, and other service sector activities requiring social interactions, were also strongly affected. In contrast, a sharper-than-expected recovery took place in China, with activity returning quickly to pre-pandemic levels by the end of the second quarter, fuelled by strong infrastructure investment. Direct comparison of the impact of shutdowns across countries is hampered by differences in the timing and extent of containment measures and the statistical methods used to estimate changes in non-market services, such as education and healthcare, during shutdowns. Nonetheless, with a few exceptions, those countries that saw the largest cutbacks in private consumption also experienced the greatest declines in GDP in the second quarter of 2020, highlighting that the drop in output was due largely to weaker household consumption.

Figure 1. Global output contracted sharply in the first half of 2020



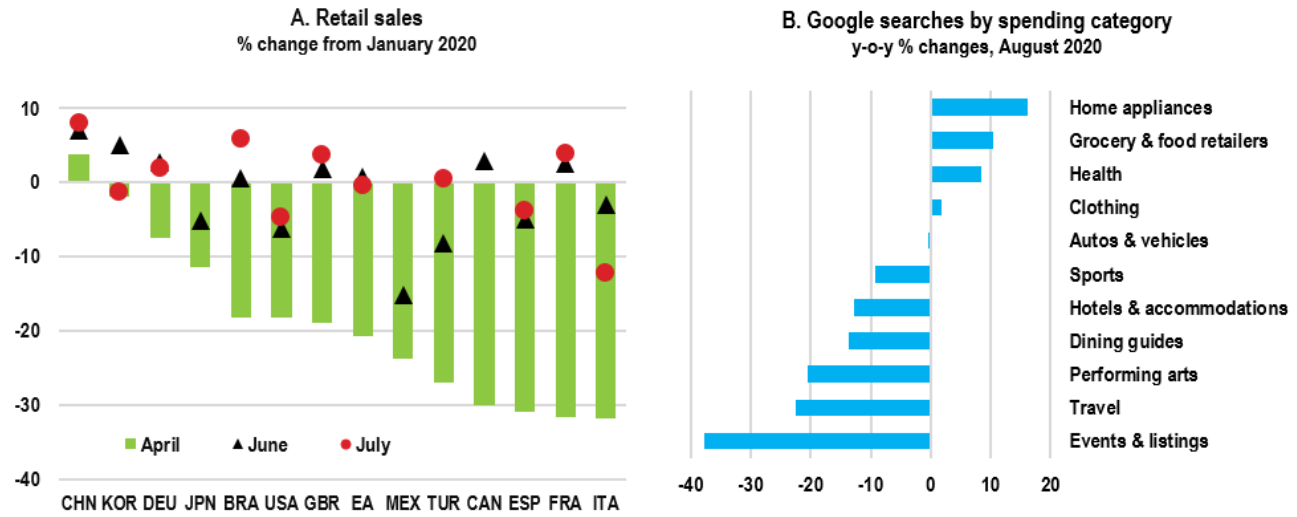
Note: Based on available countries with published quarterly national accounts. Private consumption is unavailable for China. Global growth is a PPP-weighted aggregate.
Source: OECD Economic Outlook database.

A recovery is now under way following the easing of strict confinement measures and the re-opening of businesses, but uncertainty remains high and confidence is still fragile. Amongst the countries with monthly economy-wide estimates of economic activity, a little over one-half of the decline in output between January and April had been restored by July, but with marked differences across countries and sectors. The pick-up in demand, particularly in China, has helped commodity prices to strengthen and improve risk appetite in financial markets.

Some categories of spending have bounced back relatively quickly, particularly household spending on many durable goods, including cars, where pent-up demand accumulated whilst strict confinement measures were in force (Figure 2, Panel A). Temporary fiscal incentives have also boosted demand in some countries. Household spending on services, especially ones requiring high levels of social interaction or international travel, has remained more subdued, reflecting changes in consumer behaviour and continued public health restrictions (Figure 2, Panel B). In the United States and Japan, two countries with monthly estimates of aggregate consumers' expenditure, total spending remains between 4 and 5 per cent below the immediate pre-pandemic level.

With incomes holding up thanks to government emergency measures and subdued consumer spending, household saving rates rose sharply during the second quarter in many countries, by between 10 to 20 percentage points in the major advanced economies with available data. Household bank deposit holdings have also soared in many European economies. While these suggest there is plenty of scope to finance additional spending, subdued confidence and high uncertainty about the evolution of the virus and labour market developments are likely to keep precautionary saving elevated. Corporate bank deposit holdings have also risen substantially since the onset of the pandemic in many countries, giving scope for stronger spending if demand and confidence improve quickly. However, investment intentions have weakened, suggesting that elevated uncertainty is likely to keep business investment at low levels for some time.

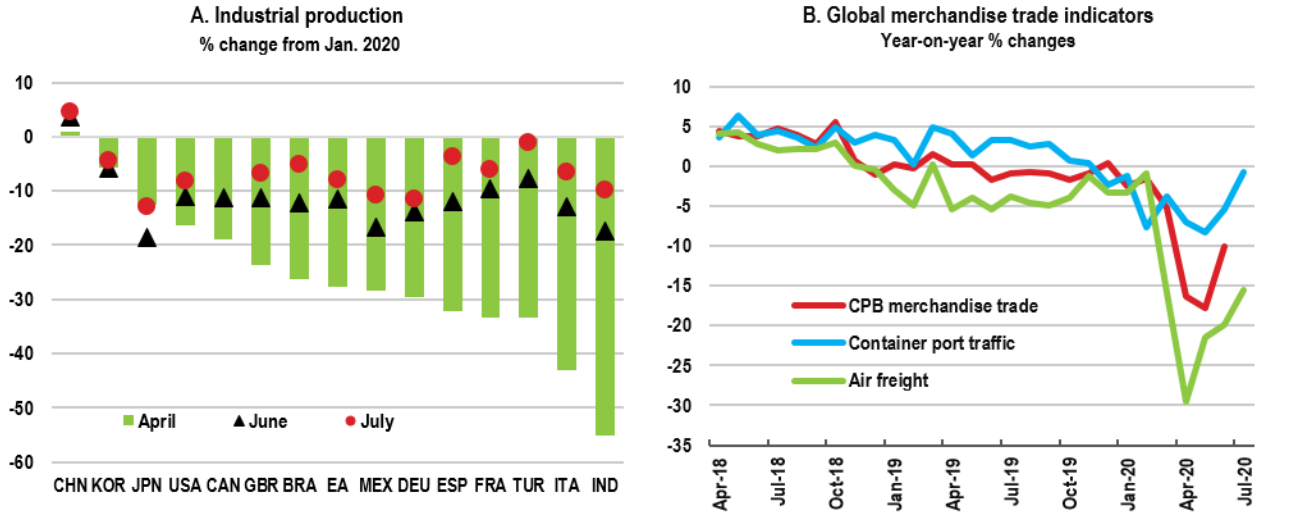
Figure 2. Household spending on goods has picked up quickly but services spending remains softer



Note: Retail sales for all countries apart from the United States and Japan, where monthly consumers' expenditure is used. Google searches are a median of OECD and non-OECD G20 countries.
Source: OECD Economic Outlook database; Google Trends; and OECD calculations.

Outside China, the rebound in industrial production has been milder (Figure 3, Panel A), reflecting the weakness of investment demand amidst high uncertainty, and the sharp contraction that has occurred in international merchandise trade, particularly air freight (Figure 3, Panel B). Survey measures of global export orders have recovered from their trough in April, but remain soft. This is continuing to restrain the pace of the recovery in countries such as Germany, Japan and Korea, even though they were less affected initially by the pandemic. International tourism has also been exceptionally weak, with international passenger traffic revenue in July still over 90% lower than a year earlier. Total global commercial flight numbers in August remained around 40% below their pre-pandemic level.

Figure 3. Industrial production and trade are still subdued

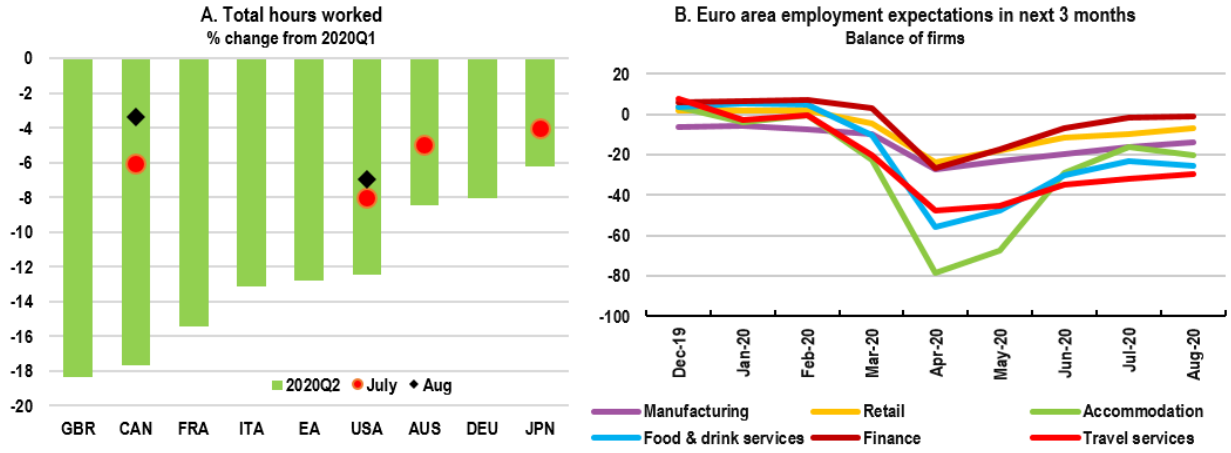


Source: OECD Economic Outlook database; CPB; IATA; RWI/ISL Container Throughput Index; and OECD calculations.

Labour market conditions have come under significant pressure during the pandemic, with sharp falls in hours worked (Figure 4, Panel A). In many countries, employment declines have been limited so far due to job retention measures, such as short-time work schemes or wage subsidies. By May 2020, job retention schemes supported about 50 million jobs across the OECD economies, about ten times as many as during the global financial crisis. Unemployment has edged up only gradually in the euro area and Japan, but has risen more sharply in the United States and Canada, with lower-wage employees and younger workers being relatively

hard hit. Survey measures of employment expectations remain relatively soft, especially in sectors that require close proximity between workers and customers (Figure 4, Panel B).

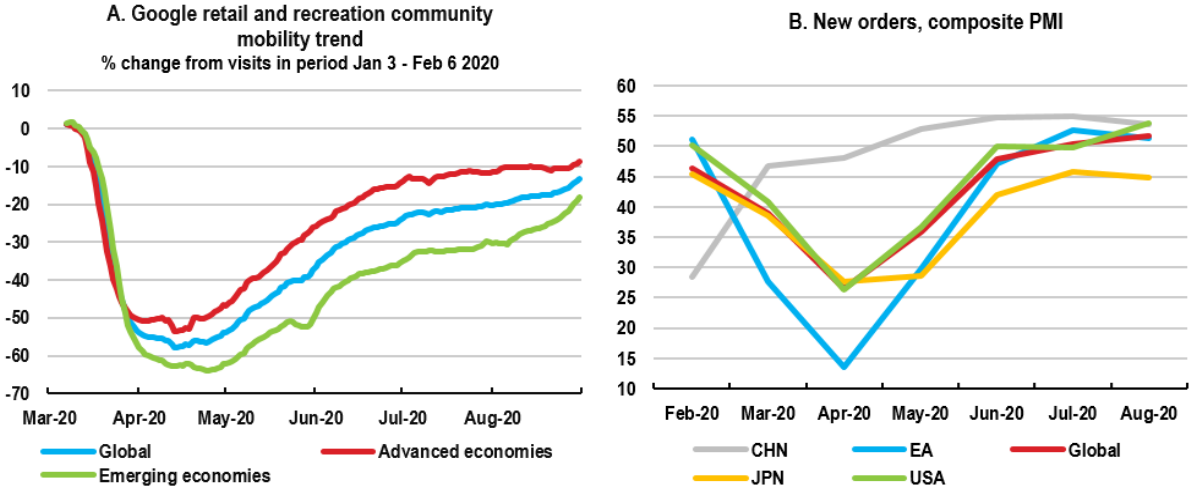
Figure 4. Labour market conditions remain under pressure



Note: Economy-wide data for hours worked in all economies apart from the United States, where the data refer to total hours worked by private non-farm employees. For Japan, data are based on total employment and average monthly hours worked by employed persons.
Source: Bureau of Economic Analysis; Statistics Canada; Australian Bureau of Statistics; Statistics Bureau, Japan; Eurostat; European Commission; and OECD calculations.

After the initial bounce-back in many activities following the easing of confinement measures, there are some signs from high-frequency indicators and business surveys that the pace of the global recovery has lost momentum since June, particularly in many advanced economies. Daily measures of mobility stabilised in July and August below pre-pandemic levels (Figure 5, Panel A), and the recovery in order books in many countries has settled at levels pointing to only modest improvements (Figure 5, Panel B). The localised lockdowns, border closures and new restrictions being imposed in some countries to tackle renewed virus outbreaks are likely to have contributed to the recent moderation of the recovery in some countries, such as Australia.

Figure 5. The recovery has lost some momentum in recent months



Note: Panel A: based on a PPP-weighted average of advanced and emerging-market economies. Data are not available for China.
Source: Google LLC "Google COVID-19 Community Mobility Reports", https://www.google.com/covid19/mobility/ accessed 05/09/2020; Markit; and OECD calculations.

Moderate growth is set to continue amidst persisting uncertainty

The global outlook remains highly uncertain. Growth prospects depend on many factors, including the magnitude and duration of new COVID-19 outbreaks, the degree to which current containment measures are maintained or reinforced and feed through to confidence, the time until an effective treatment or vaccine is deployed, and the extent to which significant fiscal and monetary policy actions support demand.

Further sporadic outbreaks of the virus are assumed to occur in all economies, or persist in the emerging-market economies where case numbers have yet to peak, necessitating continued containment measures and strategies that will differ across countries. Localised mobility or activity restrictions, rather than economy-wide lockdowns, are assumed to be used to address any new outbreaks, along with strict requirements on personal protective equipment in most countries, including the obligatory wearing of masks in some public places and employers' provision of such equipment. Limits on personal interactions are assumed to persist, such as physical distancing requirements and restrictions on the size of gatherings. Restrictions on people crossing national borders are also expected to remain in force, at least partially. Precautionary physical distancing may also continue to restrain household spending. All these factors raise business costs, particularly in services sectors heavily reliant on social interactions. The projections assume that it will take at least a year before widespread deployment of an effective vaccine, limiting its impact on the outlook for 2021.

On this basis, a gradual recovery of the global economy is projected to continue through the next eighteen months, but at a different pace across economies. Global GDP is projected to decline by 4½ per cent this year, before picking up by 5% in 2021. The upward revision to global growth in 2020 from the June 2020 *OECD Economic Outlook* projections (Figure 6, Panel A) masks considerable heterogeneity in developments across countries.

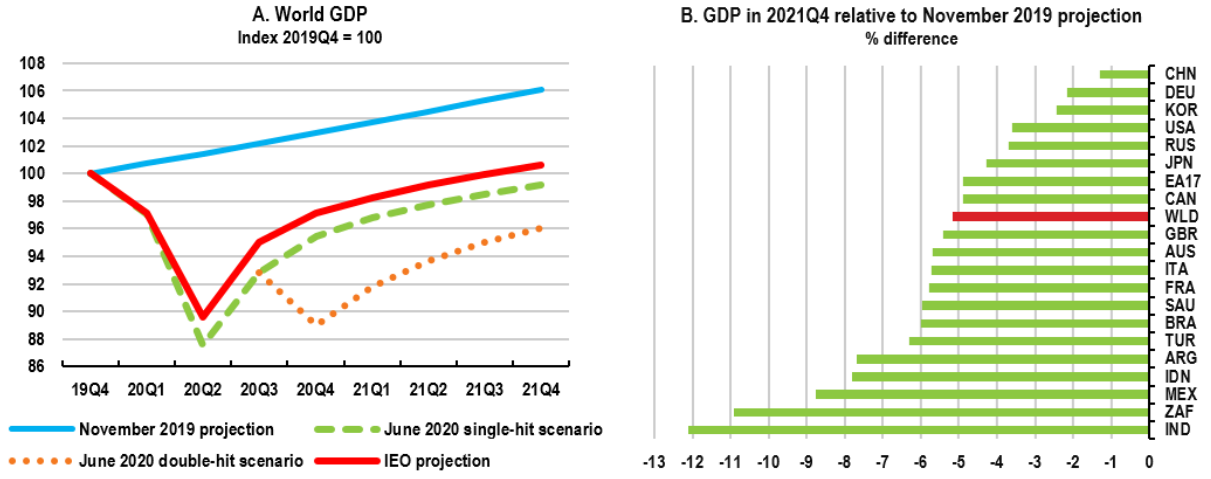
- Sizeable upward revisions in China and the United States, and smaller ones in the European economies, account for most of the adjustment to global growth.[1] China is the only G20 country in which output is projected to rise in 2020, helped by the earlier timing of the virus outbreak, rapid control of the virus, and the policy support provided to enable a quick rebound in activity.
- In contrast, the output declines in 2020 are projected to be even deeper than anticipated earlier in Argentina, India, Mexico and South Africa, reflecting the prolonged spread of the virus, high levels of poverty and informality, and stricter confinement measures for an extended period.
- In other countries where the virus continues to be contained effectively without economy-wide shutdowns, including Korea and Japan, little change is expected in the growth outlook, with fiscal support helping to sustain activity.
- For 2021, global growth prospects are little changed from the June 2020 *Economic Outlook* single-hit scenario, with the assumed intermittent virus outbreaks and the rising costs from a prolonged period of sub-par output constraining the momentum of the recovery.
- In most economies, the level of output at the end of 2021 is projected to remain at or below that at the end of 2019 and considerably weaker than projected prior to the pandemic (Figure 6, Panel B), suggesting that the risk of long-lasting costs from the pandemic is high. In effect, many major advanced economies could have lost the equivalent of 4-5 years of per capita real income growth by 2021. Many large emerging-market economies are also projected to experience large shortfalls.

High uncertainty, weak confidence and employment declines are likely to keep precautionary saving elevated for some time, but spending levels should pick up slowly provided outbreaks of the virus remain controlled. Considerable uncertainty is also likely to hold back investment for an extended period, particularly by companies with high debt. Many businesses in the service sectors most affected by shutdowns are likely to be insolvent if sufficient capacity cannot be restored and demand does not recover, with attendant job losses. Rising unemployment is also likely to worsen the risk of poverty and deprivation for millions of informal workers in emerging-market economies. Fiscal support measures should continue to underpin demand, provided fiscal consolidation is avoided in 2021. The exceptional additional monetary and financial policy measures introduced

[1] The projections include an assumption that a basic free trade agreement for goods between the European Union and the United Kingdom comes into force from the start of 2021.

since the start of the pandemic are also important for economic stabilisation, limiting debt service burdens and helping ensure financial stability, but are less likely to have strong effects on the pace at which domestic demand recovers.

Figure 6. A partial recovery is projected to continue



Source: OECD Economic Outlook database.

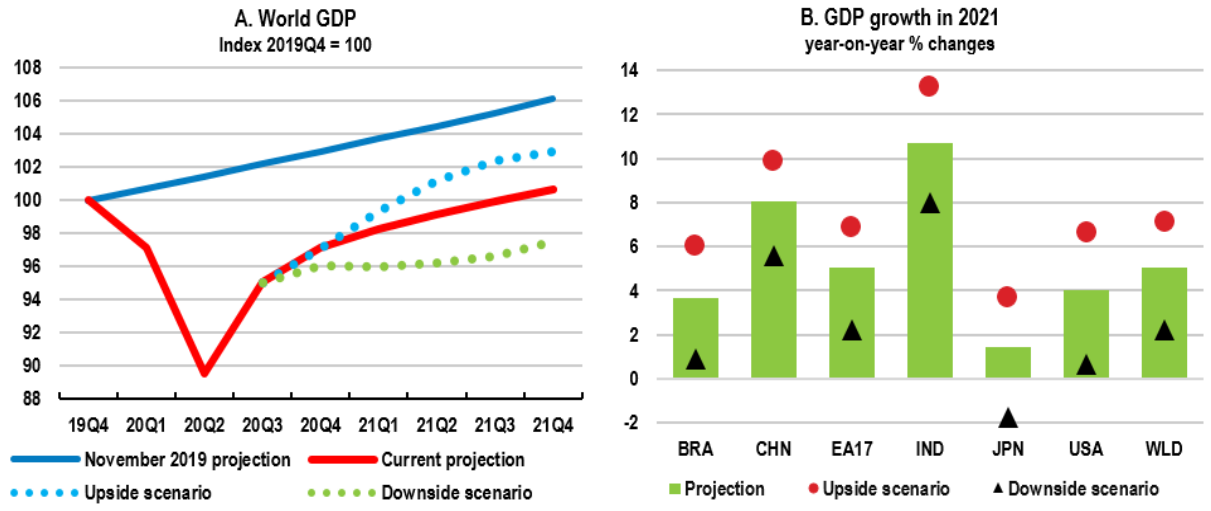
The projections are conditional on the evolution of the pandemic, assumptions about the actions required to contain the spread of the virus, and the extent to which a prolonged recovery weighs on consumers and businesses. A wide range of possible outcomes could occur over the next eighteen months. Two particular scenarios are explored in detail in Box 1 (see below):

- On the upside, consumer and business confidence could improve more quickly than assumed if only mild containment measures were required to control new virus outbreaks, or if there were signs that an effective treatment or vaccine could be widely deployed more rapidly than assumed. This would strengthen domestic demand and improve growth prospects. Illustrative simulations of this scenario suggest that a 1-2 percentage point decline in household saving rates starting in the first quarter of 2021 could strengthen global growth by around 2 percentage points in 2021, pushing it up to around 7% (Figure 7 and Box 1). Stronger household spending, and higher business investment as demand picks up, help to lower unemployment by around 1 percentage point in the major advanced economies, and by more in several large emerging-market economies. Monetary policy is assumed to remain unchanged in this scenario, implying an increasingly accommodative stance over time. This would help to limit the scarring effects from the pandemic and reduce the output shortfalls relative to expectations prior to the pandemic, but it would not close them completely (Figure 7).
- On the downside, confidence could remain weak for an extended period, and uncertainty deepen, if COVID-19 outbreaks were to intensify, or more stringent containment measures were required to control their spread. Many companies would be under greater stress for an extended period, particularly in sectors in which activity would be severely restricted again, raising the risk of substantial and rising bankruptcies and job losses. Precautionary saving by consumers would increase, business investment would weaken substantially and financial markets would become more risk averse. In many economies, monetary policy easing could also be constrained by interest rates at the zero-lower-bound. Illustrative simulations of this downside risk scenario suggest that it could reduce global growth by between 2-3 percentage points in 2021 (Figure 7 and Box 1), halving the global growth rate projected for 2021 in the baseline.

The balance of the shocks in these two possible scenarios are skewed to the downside, in part reflecting a judgement that a downside surprise (relative to the projections) would be more likely to induce repricing in financial markets and possible discontinuities from higher corporate bankruptcies. Monetary policy is also

assumed to be asymmetric, with policy rates lowered, to the extent possible, in event of weaker outcomes, but held unchanged in event of an upside improvement that helps to reduce the current levels of spare capacity in all economies.

Figure 7. Considerable uncertainty surrounds the baseline projection



Note: See Box 1 for full details of the shocks applied in the upside and downside scenarios.
Source: OECD Economic Outlook database; and OECD calculations using the NiGEM global macroeconomic model.

Policy support needs to be maintained to boost confidence and reduce uncertainty

The extensive policy actions undertaken as the pandemic developed have helped to prevent an even larger collapse and buffer the incomes of households and companies. With the recovery remaining hesitant, sporadic outbreaks of the virus still occurring, and many sectors still struggling to adjust, fiscal and monetary policy support needs to be maintained to preserve confidence and limit uncertainty.

At the same time, a delicate balance has to be struck between facilitating the immediate recovery by supporting viable jobs and companies and ensuring that policy allows sufficient flexibility for necessary reallocation across sectors to occur over time. This calls for flexible and state-contingent policy support that can evolve as the recovery progresses. Supportive macroeconomic policies need to be accompanied by a renewed drive to implement structural reforms that raise opportunities for displaced workers and strengthen economic dynamism, fostering the reallocation of labour and capital resources towards sectors and activities with the strongest growth potential.

Enhanced global co-operation and co-ordination is essential to mitigate and supress the virus, speed up the economic recovery, and keep trade and investment flowing freely. Preserving open borders, and providing the support necessary to enable emerging-market and developing countries to successfully cope with the consequences of the pandemic, will also help prevent long-lasting harm to their growth prospects.

Comprehensive public health interventions remain necessary

Considerable uncertainty remains about the evolution of the pandemic during the next few months. Comprehensive public health interventions remain necessary to limit and mitigate new outbreaks and reduce uncertainty for consumers and businesses. In particular, governments need to maintain sufficient resources to allow large-scale test, track, trace and isolate programmes to operate effectively, and ensure adequate healthcare capacity and stocks of personal protective equipment. Mitigation measures, such as physical distancing, personal hygiene campaigns, and the widespread use of masks, also help to limit the spread of the virus. Notwithstanding a recent pick-up in infections, hospitalisation and mortality rates remain low in most

advanced countries, reflecting advances in the ability to treat serious cases and the likely seasonal concentration of new outbreaks amongst younger age groups. However, building and maintaining higher levels of capacity remain important to allow the healthcare system to deal with a potential resurgence of infections without unduly delaying necessary interventions for other patients.

Such steps should allow a resurgence of infection rates to be dealt with through targeted localised measures, rather than the economy-wide confinement measures employed earlier in the year, limiting the overall economic and social costs. Nonetheless, the risks of becoming subject to localised measures are likely to sap confidence, and continued restrictions, particularly on cross-border mobility, point to an ongoing drag on the pace of the recovery.

Global co-operation and co-ordination are needed to tackle the severe health challenges all countries are facing. No country is able to obtain the range of products necessary to combat COVID-19 purely from domestic resources. Improved international co-ordination of border management would also help to reduce uncertainty and limit the costs of border closures. Greater funding and multilateral efforts are needed to ensure efficient production of medical products and allow affordable vaccines and treatments to be swiftly available everywhere, rather than being limited to particular countries. Co-operative agreements on regional stockpiling and health-emergency assistance in advanced economies should be designed in an inclusive way to take into account the needs of the most vulnerable emerging-market and developing countries, where healthcare capacity is limited and resources are not available for significant investment.

Macroeconomic policy support needs to be maintained

Monetary policy needs to remain supportive

As the pandemic took hold, monetary policy was eased quickly and substantially around the world. Policy interest rates were lowered, asset purchase programmes enhanced and targeted interventions undertaken in financial market segments under extreme stress. Financial market regulation was also eased to support credit provision by financial institutions. Many central banks have announced further policy easing since the start of June, reflecting low inflation and expectations that the ongoing economic recovery will be only slow and gradual. Asset purchase and funding programmes have been enhanced in Australia, the euro area and the United Kingdom, and interest rates lowered further in Brazil, Indonesia, Mexico, Russia and South Africa. In the United States, the Federal Reserve has adopted a new flexible average inflation-targeting framework and stressed that a robust job market can be sustained without causing an outbreak of inflation. These announcements imply that the Federal Reserve will tolerate inflation moderately above 2% for some time following periods of persistently low inflation. Against the background of subdued inflation since the global financial crisis, this has reinforced expectations that very accommodative monetary policy will be maintained for an extended period and weighed further on the US dollar. Temporary US dollar liquidity swap lines have also been extended into 2021.

These actions have helped to restore confidence, ease financial conditions, and raise asset valuations to new highs in some countries, particularly the United States. The US dollar has also depreciated significantly, declining by around 7% since May in effective terms, providing a boost to the US economy and easing pressures on many emerging-market economies, but weighing on activity in other advanced economies. The policy easing since the onset of the pandemic should also help to ensure sufficient credit supply and support the economic recovery. However, already low interest rates before the pandemic and high corporate debt could reduce the effectiveness of monetary policy compared with normal times. Complementary fiscal and structural policy actions will be needed to help restore confidence, demand and economic dynamism, and tackle the asymmetric impact of the pandemic across sectors and households.

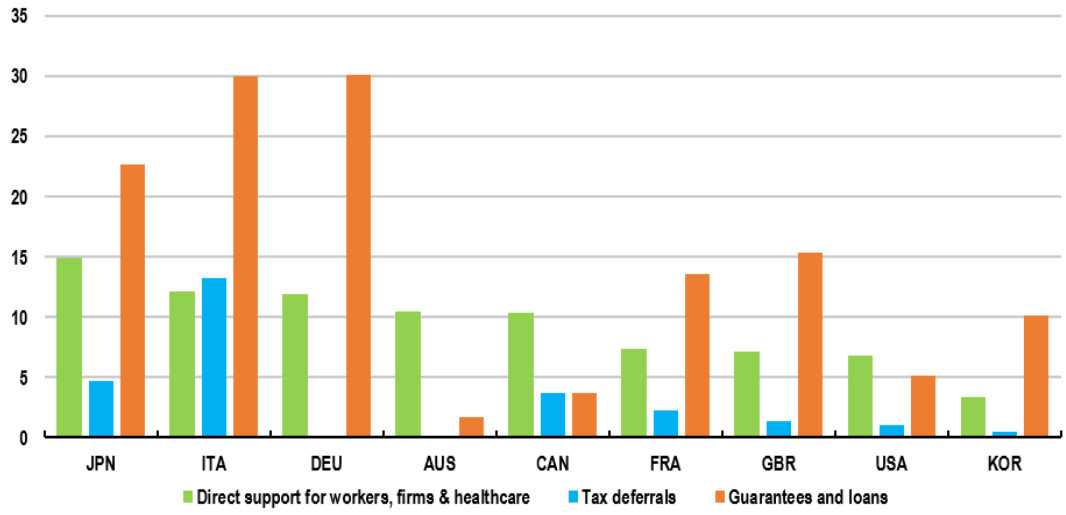
Fiscal policy support needs to be continued and become better targeted

The rapid and extensive fiscal support provided since the pandemic began has proved very effective, helping to prevent an even larger economic contraction (Figure 8). Emergency measures expanded healthcare capacity, preserved the incomes of workers and companies, and guaranteed private debt on a large scale in some countries. Specific measures were also implemented by several governments to help firms in the hardest-hit sectors, such as tourism and hospitality. With confidence still fragile, continued fiscal support remains necessary

to support incomes, minimise scarring effects from the pandemic, and ensure a full and durable recovery. Support is particularly needed for vulnerable groups heavily affected by the crisis and the slow recovery, such as youth, non-permanent employees, informal workers, lower-income households, and small businesses.

Figure 8. Substantial fiscal support has been announced since the pandemic began

Official estimates of fiscal support, % of 2019 GDP



Note: Countries are ordered by the scale of support with a direct budget impact. The figure shows official estimates, when available, of financial help included in emergency packages announced in selected advanced economies in response to the COVID-19 crisis, as of 14 September. In many cases, they are highly uncertain due to an unknown duration of the crisis and take-up of various programmes by the private sector, and may not be fully comparable across countries.
Source: OECD calculations based on official estimates.

Premature withdrawal of fiscal support in 2021 would stifle growth, as occurred in the aftermath of the global financial crisis in many countries. At the same time, governments need to re-assess and adapt the design and balance of support measures, ensuring that they are well targeted, closely monitored, and reduced gradually as the recovery progresses to facilitate the necessary reallocation of labour and capital towards sectors with better long-term prospects.

Prospects for a sustainable recovery could also be strengthened if governments move beyond income support and stimulate aggregate demand directly through public investment. With long-term interest rates close to zero in many advanced economies, the social rate of return on public investment is likely to exceed the financing costs for many projects. Investment is particularly needed in areas that have large positive externalities for the rest of the economy and where under-investment might otherwise occur due to market failures, including in health care, education, and digital and environmental infrastructure.

- Many governments have recently announced extensions to crisis-related programmes providing income support to workers via job-retention or furlough schemes well into 2021. As the recovery progresses, a key requirement of such programmes will be to ensure that support remains focused on jobs and companies that are temporarily unviable, rather than helping to maintain ones that are ultimately unviable (see below).
- New stimulus measures to strengthen aggregate demand and improve the prospects for a stronger recovery are also being implemented in several advanced economies, including France, Germany and Italy. In Europe, the Next Generation EU Recovery Plan of EUR 750 billion (about 5.5% of EU27 2019 GDP), financed through the issuance of common debt, will also provide welcome support to investment, though mainly after 2021, through a mixture of grants and loans. Emergency income support measures

have been reduced in the United States since the summer, but the projections assume that a further stimulus package, worth up to USD 1.5 trillion (nearly 8% of 2019 GDP), will be agreed this autumn.

Very accommodative monetary policy, with low interest rates and increased central bank holdings of government bonds, has reduced government debt servicing costs significantly in the advanced economies, increasing near-term fiscal space. Even so, emergency fiscal actions, the impact of the automatic fiscal stabilisers, and a lower output level are acting to raise budget deficits and debt burdens significantly in all economies. In the advanced economies, the government debt ratio could rise by around 15 percentage points of GDP by 2021, in many cases to a record high. Debt sustainability is not an immediate risk, at least in advanced economies, but debt burdens will need to be lowered eventually through higher growth and discretionary fiscal measures.

Undertaking fiscal consolidation measures now would be premature, but the health of the public finances will have to be restored eventually in ways that do not undermine long-term sustainable economic growth, as has sometimes been the case in the past. Well-designed fiscal rules, and budgetary frameworks that strengthen the incentives and information necessary for prudent long-term planning, would help to lower fiscal vulnerabilities. An early start on thorough reviews of government expenditure to detect efficiency savings and opportunities for cutting low-priority and ineffective expenditures would also help to create space for new spending on high-priority areas with positive impacts on the economy and well-being, such as health, skills, childcare, climate change mitigation and digital infrastructure.

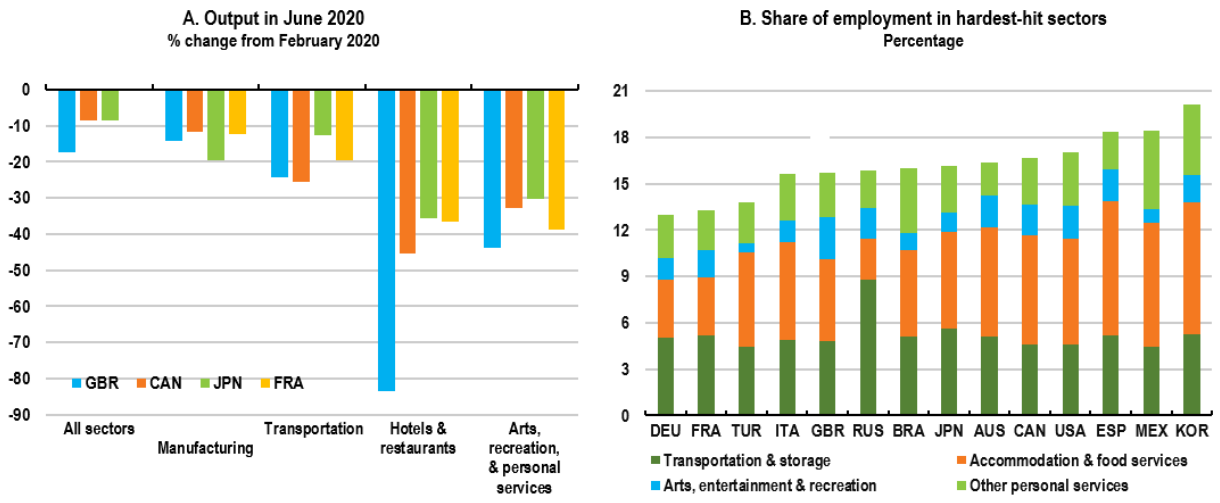
Many emerging-market economies and developing countries face particularly acute macroeconomic policy challenges, with substantial declines in export revenues, particularly from international tourism, compounding the domestic impact of the COVID-19 shock. In addition, many of these economies have become vulnerable to changes in market sentiment due to the build-up of high private and public debt in recent years, leaving them with daunting debt challenges. The G20 has taken action to freeze bilateral government loan-interest payments for many low-income countries this year, offering a temporary respite for some vulnerable countries. However, further actions may be required, given persistent declines in the main sources of income and the ongoing spread of the pandemic.

Large emerging-market economies with a credible macroeconomic policy framework, including flexible exchange rate arrangements, strong foreign asset positions and manageable exposures to foreign-currency-denominated debt, can continue to accommodate the current shocks through a combination of monetary and fiscal policy easing. However, high public debt and contingent liabilities, or a low tax base, constrain the further use of fiscal policy to support growth and incomes of vulnerable groups in some large emerging-market economies, including Brazil, India, Mexico and South Africa. This shifts the burden of economic stabilisation to monetary policy, but rising inflationary pressures and concerns about financial stability in some of these economies, particularly India, limit central banks' room to cushion economic activity from the COVID-19 shock.

Support schemes for workers and companies need to be refocused and accompanied by structural reforms

The disruption resulting from the pandemic is likely to leave long-lasting scars in many economies, magnifying existing challenges from a decade of weak investment and sub-par productivity growth in the aftermath of the global financial crisis. Living standards have been reduced significantly, longer unemployment spells may result in higher structural unemployment or withdrawal from the labour force, and investment is set to remain very weak for an extended period amidst high uncertainty and impaired corporate profitability. Many sectors most affected by physical distancing requirements and associated changes in consumer preferences are employment-intensive (Figure 9), but may be permanently smaller after the crisis. A lasting shift to remote working and the increasing digital delivery of services, including e-commerce, could also change the mix of jobs available and the location of some workplaces. Adjusting to these changes is likely to require substantial labour and capital reallocation.

Figure 9. Jobs in the hardest-hit sectors represent a sizeable share of total employment



Note: Data in Panel A are based on national industrial classifications. Data in Panel B are based on a common industrial classification and for the latest year available (2019 for all countries apart from Australia (2018), Canada (2016) and the United States (2018)).
Source: Office of National Statistics; Ministry of Economy, Trade and Industry, Japan; Insee; Statistics Canada; OECD Annual Labour Force Statistics; OECD STAN database; OECD Annual National Accounts; and OECD calculations.

This leaves policymakers facing exceptional challenges to sustain growth and reduce inequalities, emphasising the urgent need for renewed and well-targeted structural policy reforms in all economies. The measures put in place at the height of the pandemic to support jobs, incomes and companies need to be refocused as the recovery progresses. Failure to do so could hinder aggregate productivity and the economic recovery by trapping resources in non-productive "zombie" firms and jobs, and reduce the prospects for job switching to more productive and higher-paid positions. Young people are particularly exposed to these risks. Studies spanning many OECD countries show that labour market entry during a recession imparts scarring effects on earnings for up to ten years post-graduation.

- Job retention schemes, such as short-time work programmes or wage subsidies, are effective in preserving existing jobs but may hinder desirable post-crisis adjustment across sectors, especially if the recovery is slower than expected. Over time, their focus needs to be adjusted gradually to support workers rather than jobs. Raising the financial contributions from employers to the cost of unworked hours in these schemes, and reassessing the eligibility of companies claiming support, could help to identify businesses who expect to remain viable for an extended period and encourage companies to increase working hours as soon as possible. Greater flexibility may also be required to allow differentiated support for companies, with resources temporarily targeted on sectors and companies most affected by containment measures.
- In countries where unemployment benefits have been raised to support incomes at the height of the pandemic, such as the United States, there is less risk of preserving non-viable jobs. However, some pre-crisis job matches that have become viable again as activity recovers may be difficult to restore. Along with a gradual return to pre-pandemic unemployment benefit systems this could require financial incentives for firms to re-hire former employees, although careful design would be needed to reduce the risk of subsidising re-hires that would have occurred even without incentives.
- Alongside this, substantial additional investments in active labour market programmes, including employment services to help jobseekers find a job, and enhanced vocational education and training are needed to create new opportunities for displaced workers, lower-skilled workers, and those on reduced working hours. Reforms to reduce barriers to labour mobility, such as occupational licensing restrictions and housing market rigidities, would also help to facilitate job reallocation and reduce the chances of persistent scarring effects. Enhanced childcare provision and adequate income protection for vulnerable

groups also need to be an integral part of well-designed policy packages to enhance participation, foster reallocation and make the labour market more inclusive.

- Participation in training while on reduced working hours can help workers improve the viability of their current job or improve the prospect of finding a new job. One option is to make participation in training a requirement for receiving short-time work subsidies, potentially by providing financial incentives to firms or workers. The main challenge is to organise training in such a way that it can be combined with part-time work and irregular work schedules. This is easier when training courses are targeted at individuals rather than groups, delivered in a flexible manner through online teaching tools and their duration is relatively short.
- Government support for companies through wage subsidies, tax deferrals and guarantees will also need to be phased out gradually as the recovery progresses to ensure that unviable firms are not supported for an extended period. To the extent that support measures encourage firms to take on additional debt, there is a risk that higher debt service burdens will reduce the internal resources available to finance new investment and employment as the recovery progresses. Possible approaches could include extending the maturity of loan guarantees, or converting pandemic-related public support into public equity stakes, although care should be taken to ensure this does not distort competition and that there are transparent and clearly defined conditional exit strategies for such investments. Reforms to streamline insolvency procedures and enhance economic dynamism by reducing barriers to market entry would also help to spur productivity-enhancing capital reallocation in the course of the recovery. The dispensations from normal insolvency and banking regulations used by many countries to limit corporate bankruptcies this year will also have to be phased out gradually as the recovery progresses.

Government efforts to support the economic recovery also need to take advantage of the opportunity to incorporate the necessary actions required to limit the long-term threat from climate change. Sector-specific financial support measures should be conditional on environmental improvements where possible, such as stronger environmental commitments and performance in pollution-intensive sectors that are particularly affected by the crisis. The potential for an extended period of substantially lower fossil-fuel prices than previously expected further raises the urgent need to introduce effective incentives for firms to invest in energy-efficient technologies. Governments can also help directly by implementing well-designed investments in low-carbon infrastructure and making use of opportunities to support behavioural changes that may help a low-carbon transition, such as facilitating teleworking and enhancing widespread availability of high-speed broadband in rural areas.

Box 1. Scenarios highlight the uncertainty around the main projections

The scenarios set out below use the NiGEM global macroeconomic model to illustrate the potential uncertainty around the main projections. Economic outcomes remain strongly intertwined with the evolution of the pandemic and the measures required to mitigate it. On the downside, stronger and more persistent effects from the COVID-19 virus would weigh on confidence, heighten uncertainty and tighten global financial conditions at a time when the scope to further ease monetary policy is limited. On the upside, faster progress in preventing the spread of the virus would boost the confidence of consumers and companies to spend and invest, with a positive impact on economic activity.

The upside scenario: a resurgence in confidence

This illustrative scenario considers the potential effects if renewed outbreaks of the virus prove milder and more easily controlled than assumed in the main economic projections, enhancing the confidence of consumers and companies and raising the prospects of a stronger rebound in spending and output.

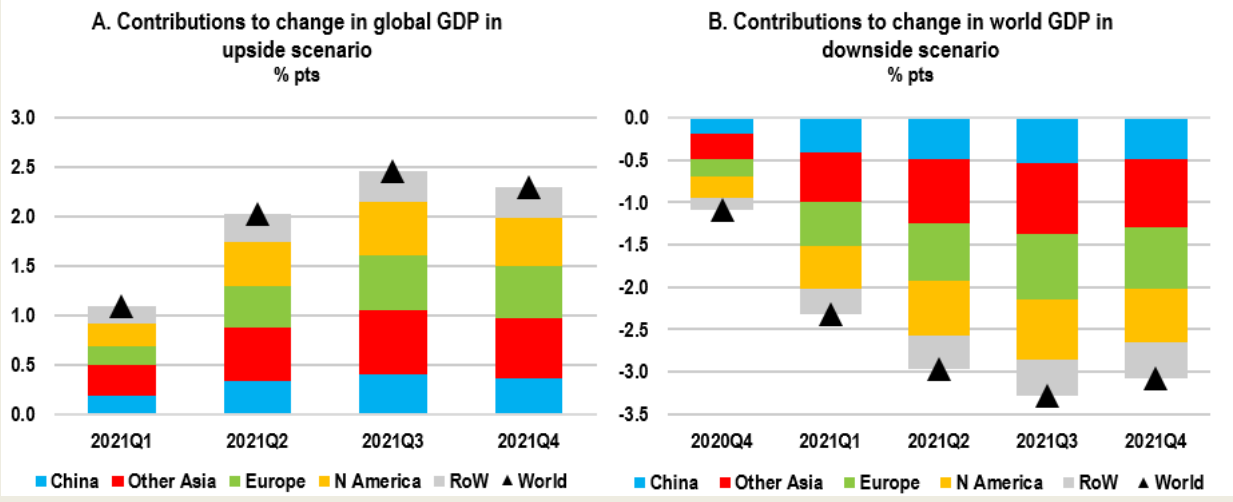
To illustrate this, an endogenous reduction in household saving rates of 1½ percentage points is applied in the first half of 2021 in the major advanced economies, with a proportionate shock to domestic demand in the smaller economies. These shocks are then assumed to decline gradually from then on. Policy interest rates are assumed to remain at their baseline levels, implying an increasingly accommodative monetary

policy stance as demand strengthens. The automatic fiscal stabilisers are allowed to operate fully in all countries, so that the fiscal balance improves as activity strengthens.

Key features of this scenario are:[1]

- Overall, the level of world GDP is raised by around 2½ per cent (relative to baseline) at the peak of the shock in 2021, with the full year impact on global GDP growth in 2021 being close to 2 percentage points (Figure 7 and Figure 10, Panel A). World trade is strengthened substantially, rising by around 6% on average in 2021, boosting exports in all economies.
- The initial decline in the saving rate and higher household incomes as activity picks up and unemployment declines result in a substantial boost to spending, with private consumption over 3% higher in the advanced economies. Business investment is also stimulated by stronger demand, rising by 2¾ per cent (relative to baseline) in the median advanced economy. This boosts the capital stock and the prospects for a sustained recovery.
- The shock is mildly inflationary, with consumer price inflation pushed up by around 0.5 percentage point in 2021 in the OECD economies. A smaller increase would be likely were monetary policy to be tightened.
- Stronger growth also helps to ease government debt burdens, with the government debt-to-GDP ratio declining by around 3¼ percentage points in the median advanced economy by the latter half of 2021.

Figure 10. Contributions to the change in global GDP in the downside and upside scenarios



Note: The panel shows the contributions of different regions and countries to the change in global GDP. See text for details of the shocks applied.
Source: OECD calculations using the NiGEM global macroeconomic model.

The downside scenario: heightened uncertainty and a widespread resurgence in infections

The shocks considered in this scenario are as follows:

- Consumer confidence is assumed to decline as the virus increases in intensity once again. Household saving rates are raised endogenously by 1 percentage point in the fourth quarter of 2020 and the first quarter of 2021 in the major economies, with a proportionate shock to domestic demand in the smaller economies.
- Heightened uncertainty and a longer period of weak demand result in the further closure of businesses and the scrapping of capital. The business sector capital stock is lowered by ¼ per cent by the first quarter of 2021, with proportionate shocks applied to the total capital stock, or potential output in the smaller economies.

- Global equity prices are lowered by 15% and non-food commodity prices by 10% in the first half of 2021.
- Higher uncertainty and shortfalls in output developments relative to expectations are assumed to result in weaker risk appetite, modelled via an increase of 50 basis points in the risk premia on corporate bonds and equities. This raises the cost of capital, further lowering investment.

All of these shocks are assumed to fade away gradually by early 2022, by which time a vaccine is assumed to have become available. Monetary policy is allowed to be endogenous. Policy interest rates can be lowered (relative to baseline), but for illustrative purposes there is assumed to be a binding zero lower bound. Thus, policy interest rates either cannot become negative or remain unchanged where they are already negative.[2] The automatic fiscal stabilisers are allowed to operate fully in all countries, implying that governments do not react to the shock by attempting to maintain a previously announced budget path.

Key features of this scenario are:

- Overall, the level of world GDP is reduced by over 3¼ per cent (relative to baseline) at the peak of the shock, with the full-year impact lowering global GDP growth in 2021 by between 2½ and 3 percentage point (Figure 7 and Figure 10, Panel B). Global trade is affected significantly by the drop in demand, declining by over 7% in 2021.
- All major regions and economies experience a significant output contraction due to weaker demand, with relatively strong declines occurring in the small open economies with high trade intensity in East and South-East Asia and Europe.
- Higher household saving, greater uncertainty and tighter financial conditions result in substantial cutbacks in private demand and higher unemployment. Business investment declines by around 13% in the median advanced economy in 2021.
- The overall impact of lower commodity prices is broadly neutral. Commodity exporters are hit by lower export revenues, but commodity-importing economies benefit from lower prices.
- The net effects of the combined shocks are deflationary, with consumer price inflation in the advanced economies pushed down by around 1 percentage point in 2021.
- The impact of the shock would be greater if monetary policy did not react where space is available and the automatic budgetary stabilisers did not operate. Reductions in policy interest rates in the economies that have policy space helps to cushion the negative effects on domestic activity and provides support for an eventual recovery. Even so, in the median advanced economy, government debt increases by over 6% of GDP by the latter half of 2021.

The current numerous monetary and financial policy programmes should offer sufficient flexibility to help deal with a widespread return of the pandemic, associated disruptions to the economy, and heightened financial market volatility. In this event, many of these programmes will need to be scaled up or extended, particularly liquidity and lending support. A further expansion of US dollar funding swap lines, potentially including more emerging-market economies, may also be necessary. Fiscal actions may be needed as well, including prolonged support for indebted companies and continuations of job protection and income support schemes.

1. The scenarios are undertaken on the NiGEM model in backward-looking mode. This means that consumers and companies do not make their current spending choices with certainty about the future evolution of the virus.
2. Central banks can also undertake additional steps to relax policy, including asset purchases, but these are not considered in the present analysis.

OECD Economic Outlook, Interim Report

Coronavirus (COVID-19): Living with uncertainty

This Interim Report provides updates for G20 country projections made in the June 2020 issue of *OECD Economic Outlook* (Number 107).

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