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HOW THE PANDEMIC CHANGED THE GLOBAL ECONOMY

WHAT NEXT FOR ECONOMICS AND POLITICS IN A WORLD OF HIGH DEBT AND LOW GROWTH?

The coronavirus (Covid-19) pandemic has had a devastating impact on the global economy. To tackle the outbreak, developed countries have unleashed record-high amounts of fiscal stimulus, pushing public-debt ratios to unprecedented levels. Meanwhile, long-term growth prospects are grim, raising questions about the sustainability of such high debt levels and the implications of the current situation for economies around the world.

Executive summary

What next for firms, industrial policy and labour markets?

- Governments have offered unprecedented levels of support to otherwise non-viable, unproductive firms. Withdrawing these mechanisms would be politically problematic.
→ Consequently, most governments will prefer a scenario of low productivity growth, high debt overhang and underinvestment.
- A revival of industrial policy has been another feature of the economic responses to the pandemic in developed countries.
→ In most cases, industrial policies have taken the form of “mission-oriented” investment for the green recovery, but also protection of national champions.
- The risk of a large section of the population being subject to prolonged unemployment will pressure governments to reform labour markets.
→ Governments will likely bring forward measures to enhance social welfare and job security for permanent employees and temporary contract workers.

What next for taxes and fiscal sustainability?

- The pandemic has increased fiscal deficits to record-high levels, raising questions about how current taxation systems may have to change.
→ To replenish their coffers, governments are likely to adopt capital gains tax or property taxes, which could also address the growing issue of inequality.
→ Taxing polluting industries is another option; this could help governments to reach their goal of reducing carbon emissions and boost their political-approval ratings.
- Tackling the public-debt pile-ups post-pandemic will be a daunting task across the developed world.
→ In developed economies, the debate around debt sustainability will increasingly focus on servicing costs, rather than debt stocks.

What next for monetary policy?

- For many developed countries, a “new mediocre” of low growth and low inflation will probably become the norm.

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→ **Unconventional monetary policies, including quantitative easing (QE), will remain a feature of advanced economies for several years, at least.**

- Central banks are shifting focus from independent inflation-targeting strategies to implicit, and sometimes explicit, support for fiscal policy.

→ **This new interpretation of central bank mandates will lead to greater scrutiny of central banks and, potentially, provoke a political backlash.**

What next for long-term growth and key risks?

- If monetary stimulus is unwound early, for instance in response to a spike in inflation, and interest rates were to rise, then worrying public-debt pile ups would result.
- In coming decades, rich countries will witness a decline in their populations and, consequently, in GDP; they will consequently focus on maintaining high GDP per head.

Firms, industrial policy and labour markets

Will Covid-19 zombify OECD firms?

In advanced economies, the coronavirus (Covid-19) pandemic has delivered a major shock to corporate balance sheets. Lockdowns and social distancing measures have drained corporate cashflows, while government assistance to struggling firms has come mainly in the form of cheap loans. Debt overhang in the current environment of low interest rates presents a challenge to policymakers.

On the one hand, the corporate sector needs to undergo a deleveraging process to restore a sound balance-sheet position; on the other hand, the firms most in need of restructuring are the least likely to be able to adjust. Ultra-loose monetary policy also allows unproductive firms to roll over their debt, preventing the exit of unviable businesses.

→ **Withdrawing support to otherwise unproductive and unviable firms would come at a high political cost, as these businesses are vulnerable to failure, resulting in significant short-term upheaval of the labour market. As a result, most governments will prefer a scenario of low productivity growth, high debt overhang and underinvestment.**

Is an industrial-policy boom coming?

The pandemic and its aftermath have led to greater state intervention in the economy via industrial policy. This has taken the form of subsidisation of sectors forced to close or reduce activities because of the outbreak, such as air travel and hospitality; intervention in strategic sectors crucial to tackling the pandemic, such as pharmaceutical and medical-supply manufacturing; and plans to spur investment—especially green investment—to restart the economy once the pandemic is under control globally.

Industrial policy has the potential to spur productivity and combat the “zombification” of firms. Governments can invest at a loss for longer than firms are able to and can foster the development of innovative sectors that may become profitable over time, such as those that make up the green economy. However, badly designed policy may distort the market and entrench unprofitable incumbents, exacerbating the zombification process.

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→ Looking at Europe, there appear to be examples of both “mission-oriented” investment around the green recovery and indiscriminate protection of national champions (notably in Germany and other large states).

How will labour markets be affected?

The pandemic has accelerated the trends of automation and digitalisation. This will create disruption to the labour market, as machines replace workers in certain industries and new jobs are likely to be less labour-intensive. Jobs that mainly involve routine tasks that can be standardised—those at the low-to-medium skill level in the manufacturing, hospitality and catering and retail sectors—are particularly at risk of being filled by robots and artificial intelligence (AI). Meanwhile, skills required by newly created jobs take time and financial resources to acquire, and these new positions may not be suitable for—or desired by—people who were laid off in sunset industries.

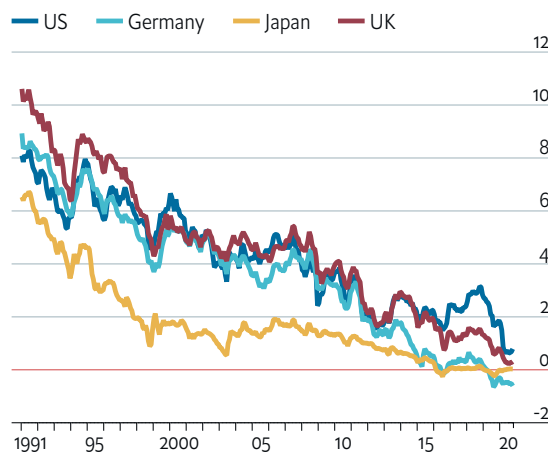
→ The risk of a large section of the population being stranded in prolonged unemployment will pressure governments to reform labour markets. Governments will likely bring forward measures to enhance social welfare and job security for permanent employees and contract workers.

Taxes and fiscal sustainability

Fiscal-stimulus measures adopted by governments during the pandemic have led to a deterioration in fiscal indicators and a surge in public debt. Debt-servicing costs are likely to remain low but governments will need to address imbalances in the public finances in the coming years. Looking ahead, politically, cuts in public expenses would be difficult to impose.

The pandemic has highlighted the need for increased public spending in many sectors, such as healthcare. It may, therefore, be politically easier to change corporate-tax structures; however, such

10-year nominal interest rates
(%)



Source: The Economist Intelligence Unit.

changes will affect countries’ global attractiveness as business locations. Any rise in corporate taxes could deter future investment and, potentially, lead to multinationals shifting operations to countries with more favourable tax regimes. As a result, most developed countries are likely to explore new measures in order to refill their coffers.

→ Governments are likely to adopt capital gains tax or property taxes, which could also address the growing issue of inequality. Taxing highly polluting industries is another option; this could help governments to reach their goal of reducing carbon emissions and boost their approval ratings.

Monetary policy

Will the pandemic lead to a new era of “secular stagnation”?

The pandemic-induced recession has occurred under unusual macroeconomic conditions: long-term interest rates were already at record-low levels across all advanced economies before the crisis. As a result, the standard adjustment process in a recession—a reduction in real interest rates—was unavailable, opening the door to the risk of “secular stagnation”: a persistent shortfall in demand, leading to a protracted phase of low growth and low inflation.

The only way to escape secular stagnation and restore acceptable rates of economic growth and inflation is for policymakers to adopt aggressive stimulus measures. However, such measures come with the risk of widening macroeconomic imbalances. In the US, for instance, the government has set aside concerns about fiscal discipline and is reviving the economy with massive fiscal stimulus. However, the US is an exception.

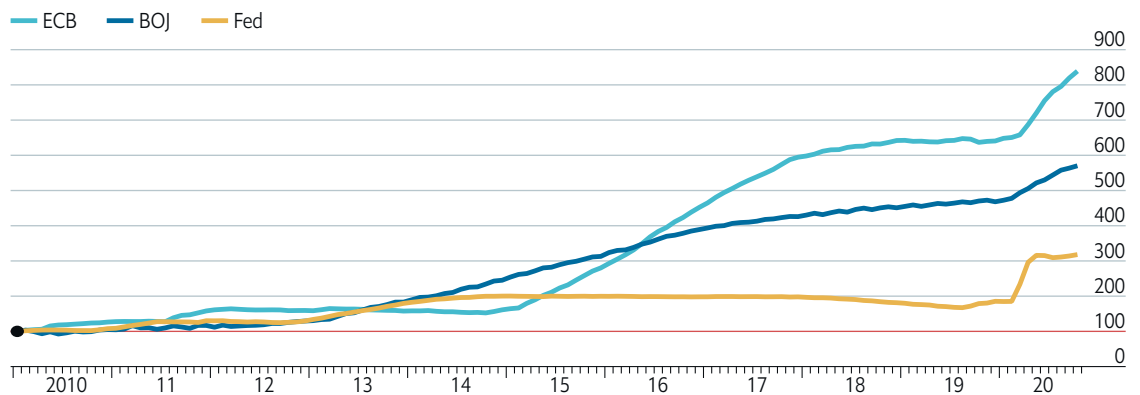
→ For many developed countries, a “new mediocre” of low growth and low inflation will probably become the norm.

How will monetary policy be affected in Japan, the US and the EU?

Central banks in Japan, Europe and North America have doubled down on their QE policies in response to the coronavirus-induced recession. Policy rates in these economies are at or near zero, with central banks pouring massive amounts of liquidity into markets. The Bank of Japan (BOJ) appears to be permanently locked into its loose monetary approach. For the European Central Bank (ECB) and the Federal Reserve (Fed, the US central bank), unconventional monetary policies, including QE, are likely to remain a feature for several years to come.

Central bank asset purchases have ramped up

(indexed central bank assets, January 2010=100)



Sources: ECB; BOJ; US Federal Reserve; The Economist Intelligence Unit.

For now, it appears that US economic growth will remain sufficiently firm in 2021-22 (owing in part to massive fiscal stimulus from the federal government) to allow the Fed to begin to rein in QE from 2022 and raise interest rates from 2023. In Europe, the ECB will focus on keeping policy accommodative relative to economic performance and boosting growth capacity. The ECB’s targeted longer-term repo

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operations (TLTROs) will play a role here, while the official policy rate is set to remain at zero for at least several years.

→ **Unconventional monetary policies, including QE, will remain a feature of advanced economies for several years, at least.**

How has the pandemic changed the work of central bankers?

Following the coronavirus outbreak, authorities quickly deployed a wide set of powerful crisis-management monetary-policy tools, avoiding some of their past mistakes and thereby preventing the coronavirus-induced economic recession from turning into a full-blown financial crisis. Beyond well-known tools such as QE, a key feature of central banks' responses has been the use of direct instruments to facilitate the flow of credit to households and businesses.

Central banks have interpreted their mandate for price stability broadly, encompassing actions that have allowed their national governments to borrow at ultra-low rates, blurring the distinction between monetary and fiscal policies. They have also undertaken policy interventions in individual sectors through targeted lending and corporate-bond purchases.

→ **With inflation near zero, central banks are shifting focus from inflation-targeting strategies to implicit—and sometimes explicit—support for government fiscal policy. This new interpretation of central bank mandates will lead to greater scrutiny of central banks, and potentially provoke a backlash.**

Long-term growth and key risks

Are public debt stocks sustainable?

Governments' unprecedented fiscal responses to the coronavirus pandemic over the past year have led to a sharp increase in public debt in both the US and the EU. Rising debt/GDP ratios have alarmed fiscal hawks on both sides of the Atlantic, but debt servicing remains modest, suggesting that the debt outlook is sustainable. Inflation will jump in 2021 as the global economic recovery gets underway but our core forecast assumes that annual price inflation will stabilise in 2022-25.

Debt interest payments have declined in Europe, despite a sharp rise in public debt

(public debt and debt interest payments as % of GDP in selected countries)



*2020 Economist Intelligence Unit estimates; 2021-22 Economist Intelligence Unit forecasts.
Sources: Eurostat; Economist Intelligence Unit forecasts.

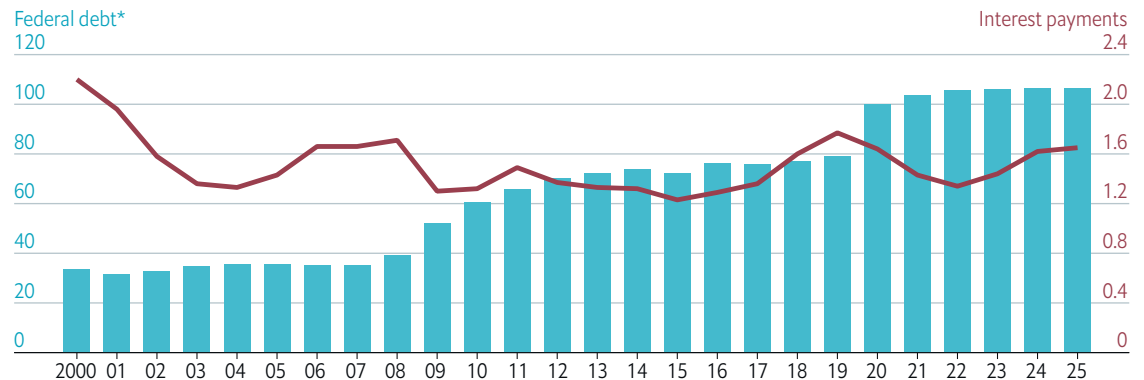
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As a result, we expect interest rates to remain low in 2021-25, maintaining debt servicing at manageable levels. However, there is a growing risk that central banks will respond to a potential spike in inflation by tightening monetary policy.

US federal debt servicing costs have eased, for now

(% GDP)



* Denotes federal debt held by the public.
Note. Values for 2021-25 are Economist Intelligence Unit forecasts.
Sources: US Treasury; The Economist Intelligence Unit.

→ **This situation has two key consequences: if monetary stimulus is unwound early (for instance, in response to a spike in inflation), this will put public debt on a worrying path and complicate debt servicing. Moreover, in developed economies, the debate around debt sustainability will increasingly focus on servicing costs, rather than debt stocks.**

Is an ageing population bad news for rich economies?

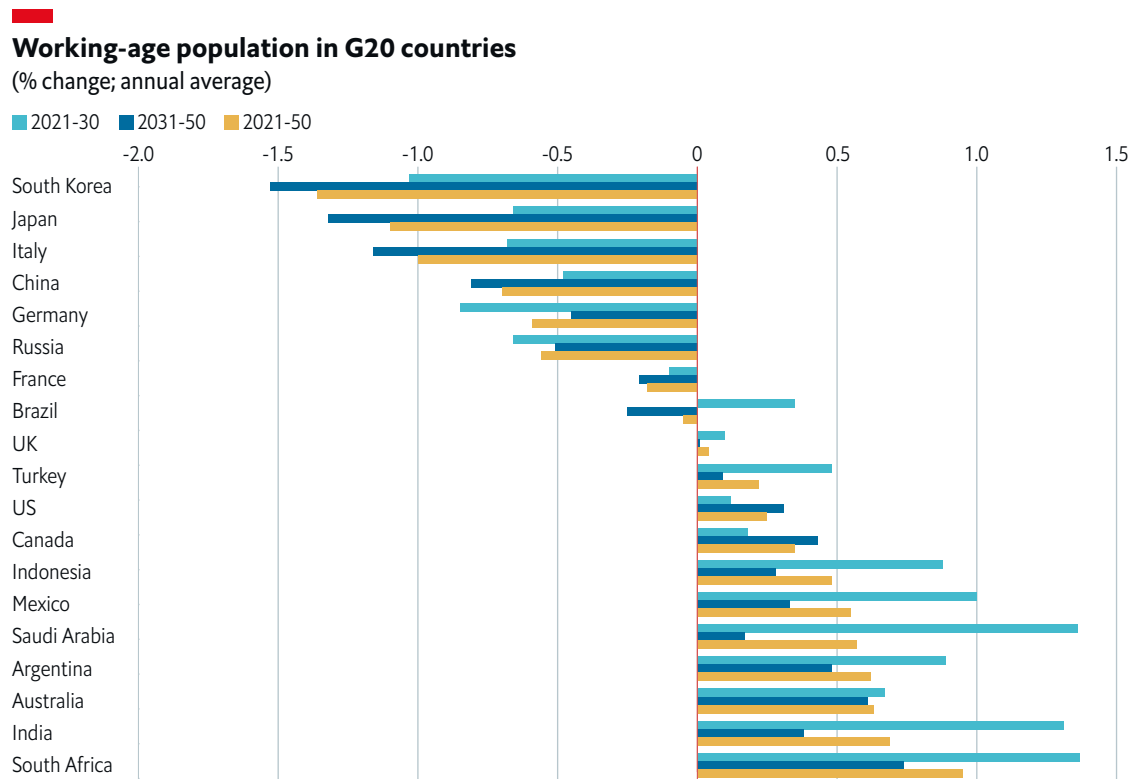
Population ageing is one of the most important demographic trends in the developed world. A shrinking, ageing population affects long-term growth through various channels: a smaller workforce; a decline in productivity; higher public spending on pensions and healthcare; and an impact on savings decisions. However, such demographic trends are not set in stone. Governments have at their disposal multiple ways in which they can address demographic challenges, including increasing immigration; initiating labour-market reforms; and boosting research and development (R&D) to foster a rise in productivity.

Nonetheless, these options entail policy choices that can come with a high political cost. If they do not manage to reverse the ongoing trends of declining investment and productivity growth, developed countries with poor demographic outlooks will have bleak long-term growth prospects. Conversely, countries where the population is projected to grow are likely to be the economic winners of tomorrow, reshaping the global landscape.

→ **Ultimately, most developed countries will accept a decline in their population and, consequently, in GDP growth, but focus on maintaining high levels of GDP per head.**

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Source: The Economist Intelligence Unit forecasts.

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LONDON

The Economist Intelligence Unit
20 Cabot Square
London E14 4QW
United Kingdom
Tel: + 44 (0) 20 7576 8181
Email: london@eiu.com

GURGAON

The Economist Intelligence Unit
Skootr Spaces, Unit No. 1,
12th Floor, Tower B, Building No. 9
DLF Cyber City,
Phase – III
Gurgaon – 122002
Haryana
India
Tel: + 91 124 6409486
Email: asia@eiu.com

NEW YORK

The Economist Intelligence Unit
The Economist Group
750 Third Avenue 5th Floor
New York, NY 10017,
United States
Tel: + 1 212 698 9717
Email: americas@eiu.com

HONG KONG

The Economist Intelligence Unit
1301 Cityplaza Four
12 Taikoo Wan Road
Taikoo Shing
Hong Kong
Tel: + 852 2802 7288
Email: asia@eiu.com

DUBAI

The Economist Intelligence Unit
PO Box No - 450056
Office No - 1301A
Aurora Tower
Dubai Media City
Dubai
United Arab Emirates
Tel +971 4 4463 147
email: mea@eiu.com