Comments on the OECD Economic Outlook, June 2020

Finding the right policy measures to avoid scars in the economy
Introduction

Business at OECD (BIAC) shares the view of the OECD that necessary containment and other measures were key in slowing the spread of infections and saving lives, but resulted in significant economic disruption and job losses, alongside stark falls in economic sentiment and tighter financial conditions. As our 2020 Economic Policy Survey released in May shows, the share of business federations which perceive the business climate as weak or very weak increased from 16% in 2019 to a staggering 95%, a level never seen before.

The deterioration of the overall business climate is amplified by a collapse of international trade and investment. Insufficient global demand is regarded as key factor behind the collapse of the trade and investment outlook in our survey. At the same time, supply side restrictions including tariff and non-tariff barriers, policy and regulatory uncertainty and enduring trade tensions significantly weigh in on trade performance. Most alarmingly, 3 out of 4 respondents expect the current crisis to be more severe than the financial crisis. A swift rebound to pre-crisis output levels appears unlikely.

When it comes to government support measures, about half of business federations surveyed consider these as largely appropriate in the short-term, while the other half regards the adopted measures as either too small or somewhat small. We believe that effective recovery plans and international coordination and cooperation are vital to preserve our economies and societies, and ensure an open global market environment. Extraordinary fiscal, monetary and economic policy responses are required to support companies, household incomes and employment, as well as to minimise the risk of longer-lasting scars for the economy. Finally, building resilience must not be misused as a vehicle for protectionism and unilateral action, but should be based on structural reforms, more productive investments, improved public governance, reduced red tape and more effective international cooperation.

1. Economic Situation

- Acknowledging that the economic outlook is exceptionally uncertain, the OECD’s June 2020 Outlook projects the deepest recession seen in peacetime over the past century. Notably, the OECD stresses that the recovery is likely to be hesitant, and could be interrupted by another coronavirus outbreak in the absence of targeted instruments such as testing, tracking and tracing and isolating (TTTI).
  - In its “double-hit scenario”, global GDP growth is expected to decline by -7.6% in 2020 and to then increase by only 2.8% in 2021 and thus to fall well short of its pre-crisis level.
  - In an alternative scenario where a second outbreak is avoided (“single-hit scenario”), global GDP growth is projected to decline by -6.0% in 2020 and to then increase by 5.2% in 2021 (helped by strong carryover effects from a gradual resumption of activity during the second half of 2020), but still falling short of its pre-crisis level. This does not capture the lost output from deviating from pre-crisis trend growth.
  - While there are sizeable differences in growth prospects across the major economies, in most of them output levels at the end of 2021 are expected to be below those at the end of 2019, and considerably weaker than what past projections would have suggested. In particular the Euro area is expected to be severely hit across both scenarios (growth could fall at a double digit rate in 2020 and at still a sizable -9.1% in the single-hit scenario) given the implementation of stringent containment measures over a comparatively long period, while in Japan and the US output is expected to fall by slightly less but by still very sizable single digit rates, with South Korea being the notable outlier were GDP is expected to decline by ‘only’ -1.2 to -2.5% in 2020.

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1 In this scenario a second outbreak is expected in most countries later in 2020. Further outbreaks in 2021 are assumed to be avoided due to pharmaceutical breakthroughs, but remain a significant downside risk.
The effects of the crisis are expected to leave long-lasting scars in many economies: Even with some recovery, by the end of 2021 the median OECD country will have lost more than 5 years of income per capita growth, with a potentially permanent decline in potential output due to bankruptcies, weakening net investment, labour market hysteresis (unemployment levels are expected to rise for a sustained period) and permanently diminished supply chains harming global efficiency and income.

- The OECD notes that these falls come despite the fact that governments and monetary authorities acted remarkably quickly and thereby preventing an even larger negative economic and financial downturn. Yet, it also highlights that these measures lead to exceptional challenges, including extraordinarily high public budget deficits and debt, very low interest rates, and dramatically expanded central bank balance sheets. Considerable uncertainty is likely to prevail for an extended period, with a negative impact on investment spending. Moreover, pre-existing vulnerabilities, including high corporate debt and its declining quality as well as trade tensions could deepen the downturn and slow any subsequent recovery.

- World trade, already weak before the pandemic outbreak, is contracting sharply, with the OECD noting that additional trade and investment restrictions have sprung up, thus calling the international community for a constructive dialogue on trade which would lift business confidence and the appetite for investment.

- The OECD further notes that financial market conditions remain fragile despite some recent normalization following the massive declines in financial asset prices and spikes in volatility to levels above that were observed during the financial crisis. In particular, it notes that likely rises in corporate insolvencies and bankruptcies may lead to negative feedback effects in corporate bond markets, adding to existing challenges for the banking sector. Rising non-performing loans alongside weaker bank earnings in the low-growth and low-interest environment could, in turn, constrain banks’ willingness to lend despite the monetary policy support we are witnessing.

2. Policy responses

- Extraordinary expansionary monetary, fiscal and economic policies will be required from now well into 2022 in most countries to counteract the hysteresis risks stemming from the immediate fallout from containment measures. At the same time, we acknowledge the particular difficulties in stimulating demand while some supply-side restrictions based on health policies continue to apply.

- Despite the strong public efforts to support businesses and workers during the crisis, we will see higher unemployment, increased rates of business bankruptcies, weaker public and private balance sheets, reduced investment spending, and increased calls for protectionism, compared to the period before the virus outbreak. In this context, effective recovery plans and international coordination and cooperation are vital to preserve our economies and societies and ensure that an open global market environment can continue to leverage growth and development.

- During the recovery phase, it remains critical to ensure that companies, and in particular SMEs who frequently hold cash buffers of just less than one month, have easy access to sufficient liquidity at adequate terms. In some countries, short-term additional measures are needed to address challenges related to liquidity, solvency, employment and governance. The OECD can play an important role in evaluating the different types of measures taken in different countries, including an evaluation of the benefits of loan versus direct support, with early evidence from business organizations that certain risks can be mitigated better with direct support programs rather than credits as companies are reluctant to borrow in times of significant uncertainty.

- The 2008 financial crisis illustrated the risk that weak balance sheets and persistent uncertainty
translate into sub-par investment. It is now key to use all available levers to strengthen public and support private investment, especially with a view on R&D and innovation, digitalization, infrastructure and transportation, education and health, which can not only play an important role in the recovery phase but can also help economies improve their ‘preparedness’ going forward. Related to this, considerations should be paid to how governments can help in reducing unusually high market uncertainties, which may include the need to better communicate public policy strategies with relevant stakeholders.

• Next, exit strategies must be carefully evaluated. For instance in the area of finance, regulators and policy makers should take a gradual, phased approach to any decision to scale back or eliminate economic support programs. A key concern from members is the prospect that support programs could cease at a single point in time, which could create a sudden economic shock with ripple effects through the economy and across the financial sector. A gradual phase out will instead allow borrowers and lenders the necessary time to adapt. Next, a phased exit also applies to government fiscal measures that assist business. A phased approach needs to allow for continued targeted support for sectors that are unduly disadvantaged by containment measures.

• Regarding labor markets, reducing the tax wedge on labor, improving incentives for companies to hire and keep employees in work, as well as re-training the unemployed are key. Clearly, competition for investment and jobs is likely to be fiercer in the future as all countries strive to reduce high unemployment, which means that measures are needed to create stronger incentives to take a job, as well as to start and run a business.

• As the OECD Outlook highlights, government budget deficits will be very high and public and private sector debt is set to rise to exceptionally high levels in many countries as a result of the crisis. While the exceptional additional monetary policy support measures are key for economic stabilization and limit debt servicing costs, risks for over-indebted countries and companies will have to be carefully monitored and addressed, possibly through revisions of existing legal frameworks and new and creative macroeconomic policy approaches.

• Next, the need for restructuring and reallocation will be even greater after the crises. A key question is how to improve flexibility and manage the growing need for security at the same time. A related issue is the need for policy makers to achieve both resilience and efficiency through evidence-based policy making and best practice.

• Finally, building resilience must not be misused as a vehicle for protectionism and unilateral action, but should be based on structural reforms, improved public governance, reduced red tape and fostering greater international cooperation. Considering the importance of structural reforms to build resilience and trigger long-term growth, it is concerning to see that four out of five respondents in our recent survey regard policy reform intensity as only moderate or slow in their countries over the past 12 months. The digital transition, public infrastructure, public sector efficiency, innovation policies and raising the effectiveness of R&D policies, as well as investments to maintain and create jobs and foster sustainable growth, while addressing global challenges such as climate change, should be top reform priorities for 2020.
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