Business at OECD Economic Policy Committee Bureau

Comments on the OECD Economic Outlook, December 2020

Policies to bridge the gap until vaccination is well advanced

Introduction

The global economy has a long ascent back to reach pre-pandemic levels of activity. In the coming quarters, the recovery will primarily depend on countries' ability to contain the virus and keep our socio-economic fabric intact and on the scale and speed at which vaccines can be employed. Even though the recent news on vaccines looks encouraging, repeated cycles of accelerating viral contagion and tightening restrictions cannot be ruled out until widespread immunity is achieved.

Strong multilateral efforts are essential to fight the health and economic consequences given the shock's global nature, including mutual learnings on both test, track and trace and working vaccination strategies, with a key role for the OECD to play. Expansionary monetary, fiscal and economic policies will still be required in most countries well into the future to counteract long-term structural risks (i.e. scarring effects). This will continue to be the case at least until vaccination is well advanced and the recovery can build its own momentum. Notably, in our recent member survey respondents largely regard the current support to firms, workers and the unemployed, as well as monetary policy action by central banks, as adequate, while about half of the respondents see room for improvement in economic stimulus focusing on longer-term policy objectives such as investment, decarbonisation, and digitalization.

Throughout the recovery phase, financing conditions must remain favourable to support economic activity. A premature and sudden withdrawal of support must be avoided. A gradual phase out will instead allow borrowers and lenders the necessary time to adapt. In order to ensure that financing does not become the bottleneck for recovery, access to private capital via capital markets and financial institutions is necessary but must be facilitated through an extraordinary effort at collaboration between the public and private sector. To ensure the sustainability of public finances and not to pass on an unsustainable debt burden to future generations, strong economic growth led by the private sector is key.

1. Economic Situation – OECD December 2020 projections

- The OECD highlights that the economic outlook is looking brighter, with vaccines in sight and strong and continuous policy support playing a crucial role. At the same time, the OECD warns that considerable uncertainty remains and its analysis shows that the recovery in 2021 is largely driven by strong growth in China, whilst economic output is expected to remain below 2019 levels in 35 out of 47 countries assessed at the end of 2021.

- While global economic output picked up strongly following the easing of confinement measures and re-openings of some businesses, the recovery remains uneven, fragile, and incomplete after the strong declines in output in the first half of 2020. The OECD notes that thanks to unprecedented government and central bank support most of the economic fabric has been preserved and could revive quickly, while the situation remains precarious for many vulnerable people, firms and countries. Until widespread vaccination or some breakthrough in treatment, the pandemic will still impose strains on the economy.

- The OECD expects a gradual but hesitant economic recovery over the coming quarters and global output to only return to pre-crisis levels by the end of 2021, helped by the strong rebound of China, but highly uneven across countries.

    - After a strong decline this year (-4.2%), the OECD expects global GDP to rise by 4.2% in 2021, and a further 3.7% in 2022.

- However, there are marked differences across countries. As a general pattern, the OECD notes that the few countries and regions with effective test, track and isolate systems are likely to perform relatively well – a pattern which already emerged since the onset of the pandemic, even though these countries will still be held back by the overall weakness of global demand. At the same time, there is a substantial share of countries, where output is projected to remain around 5% below pre-crisis expectations in 2022, increasing the likelihood for substantial permanent costs from the pandemic.

  - China, where the recovery started earlier, is expected to grow strongly at 8.0% in 2021, accounting for over one-third of world annual economic growth. This follows growth of 1.8% in 2020, with China being the only G20 country to see positive economic growth this year.
  - OECD economies are forecast to grow at 3.3% in 2021, and thereby to recover only partially from the deep 2020 recession. The OECD notes that a striking feature is the shrinking contribution of Europe and North America to global growth. Notably, the United States is projected to grow at 3.2% in 2021, following -3.7% this year, while the Euro Area is forecast to see growth of 3.6% in 2021 after a relatively sharp downturn in 2020 (-7.5%). Japan's output will also still be well below pre-crisis levels at the end of 2021 (-5.3% in 2020, followed by 2.3% in 2021).
  - Divergences within major emerging markets are stark, too. In contrast with China and other East Asian economies such as South Korea, India has struggled to contain the outbreak and is expected to see its economy shrink by -9.9% in 2020, followed by 7.9% growth in 2021. In Latin America, the outlook for Mexico is particularly bleak (-9.2% in 2020 and 3.6% in 2021), while Brazil is expected to see output declines of -6.0% this year and a tepid recovery of 2.6% in 2021.

- The OECD acknowledges that the outlook remains exceptionally uncertain and dependent on the virus, policies and people's behaviour. While efficient vaccination campaigns and better international co-operation could speed up the global distribution of the vaccine, the current resurgence of the virus in many places shows that governments may well be forced again to tighten restrictions on economic activity, in particular if effective vaccine distribution proceeds slowly. The latter is likely to have severe consequences for the global economy and financial markets. Even in an upside scenario and despite the strong policy support, the OECD warns that the pandemic will have damaged the socio economic fabric of countries worldwide, with the most vulnerable likely to suffer disproportionally.

2. Business policy recommendations

- The global economy has a long ascent back to reach pre-pandemic levels of activity and remains at high risk of setbacks, with partial lockdowns reinstated in several countries to protect citizens' health. While the recovery remains incomplete, the global economy steered clear of much greater damage thanks to generally strong fiscal and monetary policy action across countries.

- In the coming quarters, the recovery will primarily depend on countries' ability to contain the virus and keep our socio-economic fabric intact and ultimately on the scale and speed at which vaccines can be employed. Even though the recent news on vaccines looks encouraging, repeated cycles of accelerating viral contagion and tightening restrictions cannot be ruled out until widespread immunity is achieved. Strong multilateral efforts are essential to fight the health and economic consequences given the shock's global nature, including mutual learnings on both test, track and trace and working vaccination strategies, with a key role for the OECD to play.

- Despite the strong public efforts to support businesses and workers so far, we are and will be facing higher unemployment, increased rates of business bankruptcies, weaker public and private balance sheets, reduced investment spending, and increased calls for protectionism. Notably, in our recent member survey, participants regarded support to firms, as well as to workers and the unemployed as largely adequate, while only about half of respondents considered economic stimulus targeted at longer-term policy objectives related to investment, decarbonization and digitalization as adequate. This means that:

    - Expansionary monetary, fiscal and economic policies will still be required in most countries well into the future to counteract long-term structural risks (i.e. scarring effects). This will at least be the case until vaccination is well advanced and the recovery can build its own momentum.
    - Should in the meantime the health and economic situation deteriorate, existing programs may need to be scaled up, while keeping in mind that additional doses of expansion and safeguarding financial stability will become increasingly difficult to engineer.
    - All available levers must be used to strengthen public and support private investment, especially with a view to support innovation, digitalization, infrastructure, transportation, education, health and sustainability, including addressing climate change, which can not only play an important role in the recovery phase but also help build future resilience.
    - Similarly, working towards the recovery is an important opportunity to address pre-existing issues such as addressing longstanding weak productivity growth and maintaining business competitiveness. This includes policies ensuring the reallocation of capital to its most productive use.
    - The global pandemic has also underlined the importance of keeping markets open for trade and investment and highlighted the need for a competitive business environment. The OECD should emphasize that a reduction in tariff and non-tariff barriers is an effective tool in stimulating the economy and ensuring critical products reach consumers, and that it should be a key part of a holistic economic policy response to this pandemic. In this context, the OECD should continue to strongly emphasize the risks of global supply chain disruptions to the overall Covid-19 response and ensure timely roll-back of trade-restrictive measures to support economic recovery.

- Throughout the recovery phase, financing conditions must remain favorable to support economic activity. Firms remain dependent on new flows of credit and those who borrowed strongly need certainty that refinancing will remain available on adequate terms in order to avoid excessive deleveraging. In some countries, additional short-term 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 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.

- At the same time, support policies must be transitional and well targeted and exit strategies must be carefully managed. A key concern 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 particular threat relates to a sudden increase in business insolvencies, in particular in SMEs. A gradual phase out will instead allow borrowers and lenders the necessary time to adapt. Moreover, policymakers should also ensure good communication with the private sector on the phase-out and respective timelines.

- Given the risk that the enormity of the funds needed to recover will overwhelm the public sector's current capacity and thus to ensure that financing does not become the bottleneck for recovery, access to private capital via the capital markets and financial institutions is necessary but must be facilitated and coordinated through an extraordinary effort at collaboration between the public (e.g. IMF, Multilateral Development Banks, Paris Club, Export Credit Agencies, large bilateral government lenders) and private sector. These extraordinary efforts are essential in re-establishing capital market risk taking, liquidity, price stability and market functionality. In finance, we should explore actions such as reprieves, standstills, forbearance, public sector guarantees, and more blended finance. These would require regulators' and supervisors' continued flexibility in terms of accounting, loan-loss management and capital buffers.

- 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. In order to ensure the sustainability of public finances while avoiding passing on an unsustainable debt burden to future generations, strong economic growth led by the private sector is key.

- 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. Skilling, reskilling and upskilling are top priorities, with acquisition of future skills of relevance across age groups due to changing needs resulting from the digital transformation of our society.

- Finally, given the interconnectedness of the world economy, successfully combating and overcoming COVID-19 requires action on a global scale. A particular challenge relates to developing countries and emerging market economies, which typically have fewer fiscal capacities, less deep capital markets and more limited room for monetary policy action than advanced economies to mitigate the shock. The OECD's development mandate should be to ensure support, for instance by encouraging Development Assistance Committee (DAC) governments to live up to their official development assistance (ODA) commitments, by assisting policy makers on the ground with research, analysis and tailored guidance on effective policy action and by exploring approaches for levering the potential of the private sector for development, which could also help developing countries boost their resilience going forward. In our recent paper on "financing the economic recovery", we highlight additional financial mechanisms to support developing countries and note that for some a structured approach to over-indebtedness may appear increasingly necessary.

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