The persistence of a COVID-induced global recession

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As many countries enter deep economic downturns, many wonder about the shape and length of the recession, as well as the steepness of the recovery. Past recessions have left permanent scars on long-term growth, known as hysteresis. This column reviews the hysteresis academic literature to gain insights on the current crisis and the policies that should be put in place to minimise its long-term effects. Continued macroeconomic stimulus, where policy space exists, is needed using an array of instruments. Now is not the time to err on the side of caution when it comes to expansionary economic policies.

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The COVID-19 pandemic has resulted in a tragic loss of human life. As of end-April 2020, worldwide cases of coronavirus exceed three million and nearly 200 thousand deaths. To contain the spread of the virus, countries around the world have been implementing social distancing practices including lockdowns on all non-essential businesses. As a result of these measures and the fear about the disease, global economic activity has come to a halt. For many countries, this is likely to be the deepest recession since the Great Depression and, as a result, there are many voices calling for aggressive and even never-used policies to contain the economic damage of the pandemic (Gourinchas 2020, Gali 2020, Krugman, 2020).

How long will the recession last? How strong and fast will the recovery be? While it is not easy to find historical episodes that are a good guide to the current one, it is not new to wonder about the shape and persistence of recessions. We recently wrote a review of the academic literature on the persistence of business cycles with a focus on the fact that deep recessions have typically led to economic scarring in the long term, what we call hysteresis (Cerra et al. 2020).

The current crisis, as it stems from a health crisis, is likely to be somewhat different from many past episodes (Baldwin 2020). There could certainly be some features of the current crisis that could allow for a quick recovery: part of the depressed economic activity can be considered a temporary supply shock—a period of lockdown requires a disruption of supply of some services, even if demand for them exists. When businesses are permitted to reopen, some of the supply could return to satisfy pent-up demand. However, other forces are likely to push in the opposite direction: the health crisis could linger for months or years and any activity that involves person to person engagement—especially such as restaurants, retail, tourism, and travel—is likely to be depressed for a long period of time.

Hysteresis in a historical context

This academic literature on the persistence of business cycles has developed over the last 25 years emphasising that fluctuations can either affect long-term performance in labour markets or the drivers of long-term economic growth. In these models, GDP is history-dependent and shocks can have permanent effects on output, what we refer to as hysteresis. This represents a change from the traditional models, going back decades, where economic growth and business cycles had been treated independently. In the early days of the business cycle literature, fluctuations were seen as deviations from a "normal state of trade or a position of economic equilibrium" (Burns and Mitchell 1946). This tradition was later developed into formal models of the business cycle that thought of long-term growth as exogenous (Solow 1956) and fluctuations were typically driven by small, frequent, and typically symmetric shocks, as in the real business cycles literature or the new Keynesian models.

The persistence of European unemployment in Europe in the 1970s already hinted to the possibility that the negative effects of cycles could be highly persistent (Blanchard and Summers 1986). But, more fundamentally, the emergence of endogenous growth models in the late 1980s led to models where growth is not independent of cycles. If the forces driving long-term growth are affected during a recession, there will be permanent scars left to the economy during a crisis and GDP will never return to its pre-crisis trend (Stadler 1990, Fatas 2000).

Our paper reviews the many channels by which temporary shocks can produce persistent effects. Job losses can lead to hysteresis in employment, including from the erosion of skills or job matches. Those entering the labour market during a downturn experience persistently lower wages. If human capital accumulation slows, either from a disruption of schooling or from disruption to the process of learning-by-doing from the lower volume of economic activity, it can adversely impact the growth rate of the economy's supply potential. Rising debt and weak demand lead to deterioration of balance sheets and financial sector weaknesses. Increasing financial fragility and higher debt are likely to increase the probability of financial distress and reduce availability of credit for R&D and business investment, as well as consumption. Expectations of lower future demand and productivity could further dampen business investment. All of these generate potential scarring effects and are likely to be relevant during the current crisis.

From a statistical point of view these models predict that the time series of GDP should be very persistent or even display a unit root, something that is true for both advanced and emerging markets (Nelson and Plosser 1982, Cogley 1990). While the evidence on unit roots in GDP was initially used as an argument in favour of technology shocks as a driving force of fluctuations, a growing empirical literature has later shown that all kind of fluctuations are persistent, including those associated with demand shocks, providing evidence that strongly supports models with hysteresis (Blanchard et al. 2015).

While the argument of hysteresis can apply to models with symmetric shocks, its insights can be more powerful in models with asymmetric shocks, in particular models where output only deviates downward from a growing trend as in the Friedman plucking model of cycles or even the commonly used NBER narrative of business cycles phases (Friedman 1993). If we add hysteresis to these models, the costs of recessions become substantially larger. Recessions are not just periods where we temporarily lose GDP, we are also creating permanent scars. This is what we observe empirically when we look at large crises. After financial, banking or currency crises, output remains clearly below its pre-crisis trends (Cerra and Saxena 2008). And this evidence was confirmed by the GDP path that most economies followed during the Global Crisis (Ball 2014).

Economic policies in a world with hysteresis

What are the policy lessons of hysteresis? Our research review finds considerable recent evidence that policies that dampen fluctuations can also affect the supply side (Fatas and Summers 2018, Jordà et al. 2020). The costs of cyclical shocks or the lack of action of policymakers are much larger because of the permanent scars they can leave on GDP through their interactions with the endogenous forces that drive long-term growth or the dynamics of labour markets. Therefore, more aggressive and faster actions during recessions become optimal policy. Policymakers should understand the likely large supply costs of not being as close as possible to potential output by running a 'high-pressure' economy. Moreover, the increase in supply reduces the fear of generating inflation.

In today's crisis, these insights are relevant. If the health crisis is mismanaged, it could linger for years and lead to a more persistent crisis. If our economic policies are not aggressive enough, they could make the economic effects of the crisis even larger. Continued macroeconomic stimulus, where policy space exists, is needed using an array of policy instruments. While these are standard recipes for any crisis, our research highlights that, in the presence of hysteresis and in the case of a large and persistent event like the one we are witnessing, the costs of policy mistakes are very large. Now is not the time to doubt or err on the side of caution when it comes to expansionary economic policies.

Authors' Note: The views expressed in this blog are those of the authors and do not necessarily represent the views of the IMF, its Executive Board, or IMF management or carry the endorsement of the United Nations.

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