The threat of long economic Covid looms

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Governments need to focus on the cost of inaction, not the cost of supporting economies

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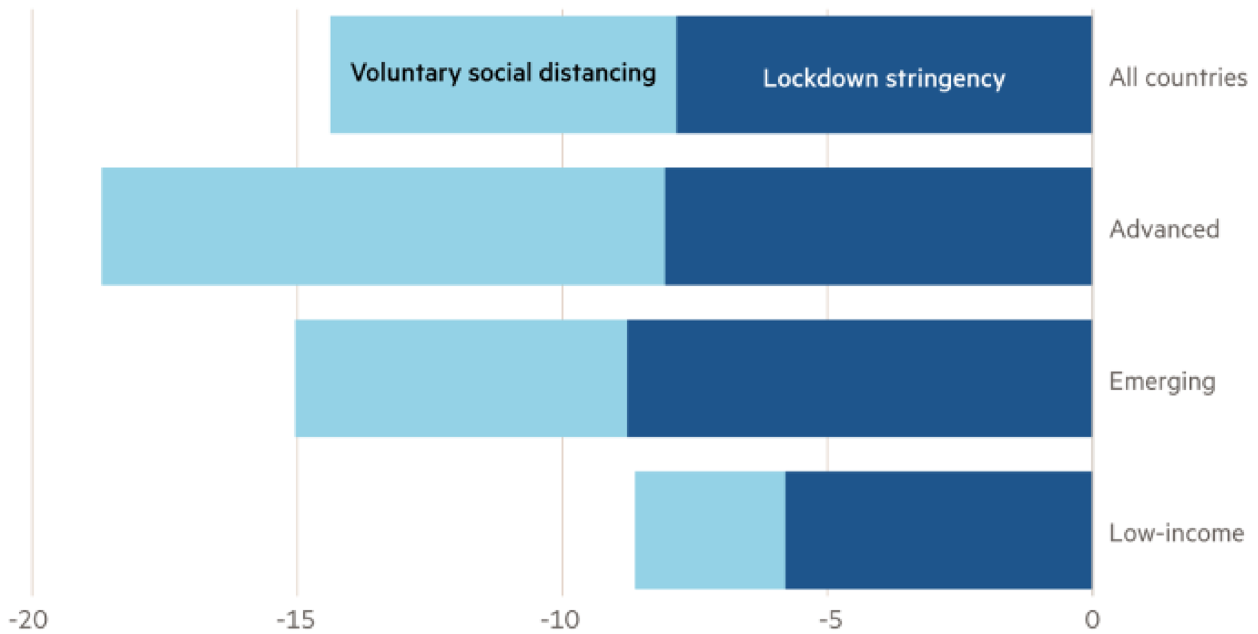
Covid-19 has left many patients with debilitating symptoms after the initial infection has cleared. This is "long Covid". What is true of health risks being true of the economy, too. The pandemic is likely to give the world not just a deep recession, but years of debility. To meet the threat of a "long economic Covid", policymakers must avoid repeating the mistake of withdrawing support too soon, as they did after the 2008 financial crisis.

This danger is real, even if there remains much uncertainty about how the crisis will unfold. Not least, we do not know how soon or completely Covid-19 will be brought under control.

Yet we do already know many things about the economic impact of the pandemic. We know it has inflicted a huge global recession; that the economic costs have been greater for the young, the unskilled, minorities and working mothers; and that it has badly disrupted education. We know, too, that "close to 90m people could fall below the $1.90 a day income threshold of extreme deprivation this year", as the IMF has put it.

Both lockdowns and social distancing had a big impact on mobility

Impact on mobility in first 90 days of each country's epidemic* (%)



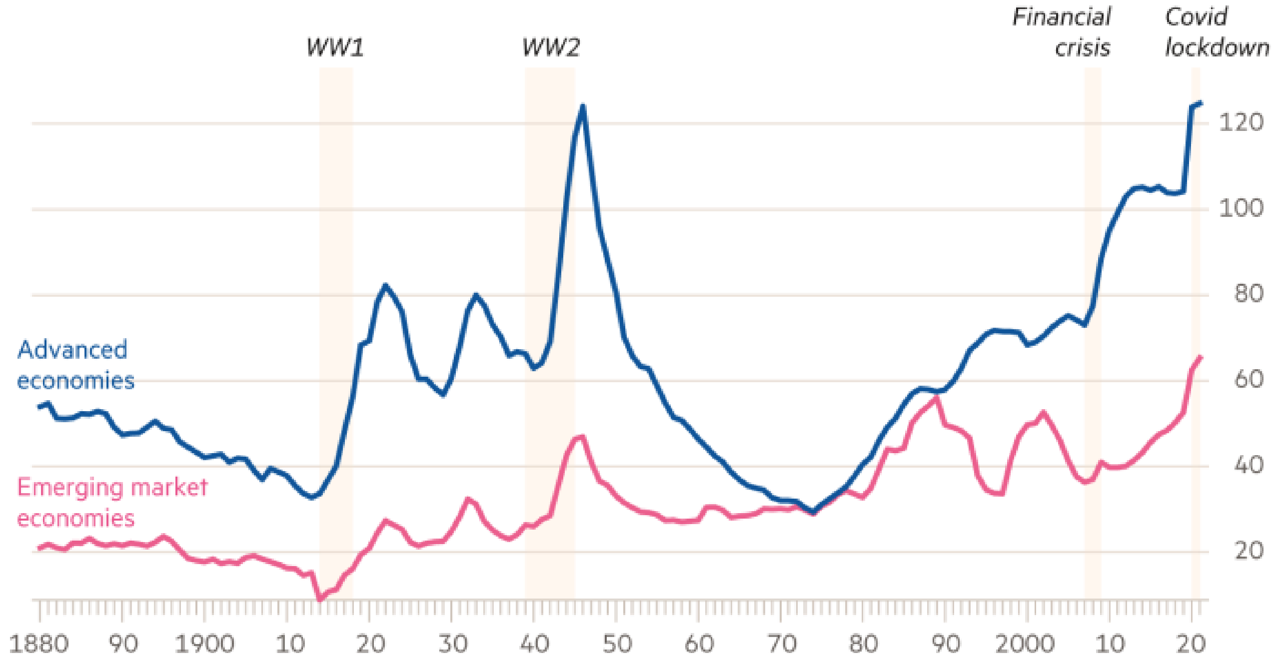
* Counted from first Covid case in each country, then averaged for country groups
Source: IMF

We know that many businesses have been hurt, as demand for their output collapsed or they were locked down. The second waves of the disease now crashing on to many economies will make this worse. As the IMF's Global Financial Stability Report shows, financial fragility is increasing in already highly indebted sectors of high-income economies, as well as in emerging and developing countries.

But we also know that things could have been far worse. The world economy has benefited from extraordinary support from central banks and governments. According to the IMF's Fiscal Monitor, fiscal support has amounted to "$11.7tn, or close to 12 per cent of global GDP, as of September 11 2020". This is vastly more than the support offered after the global financial crisis.

Sovereign debt has reached historic levels

General government debt as a % of GDP

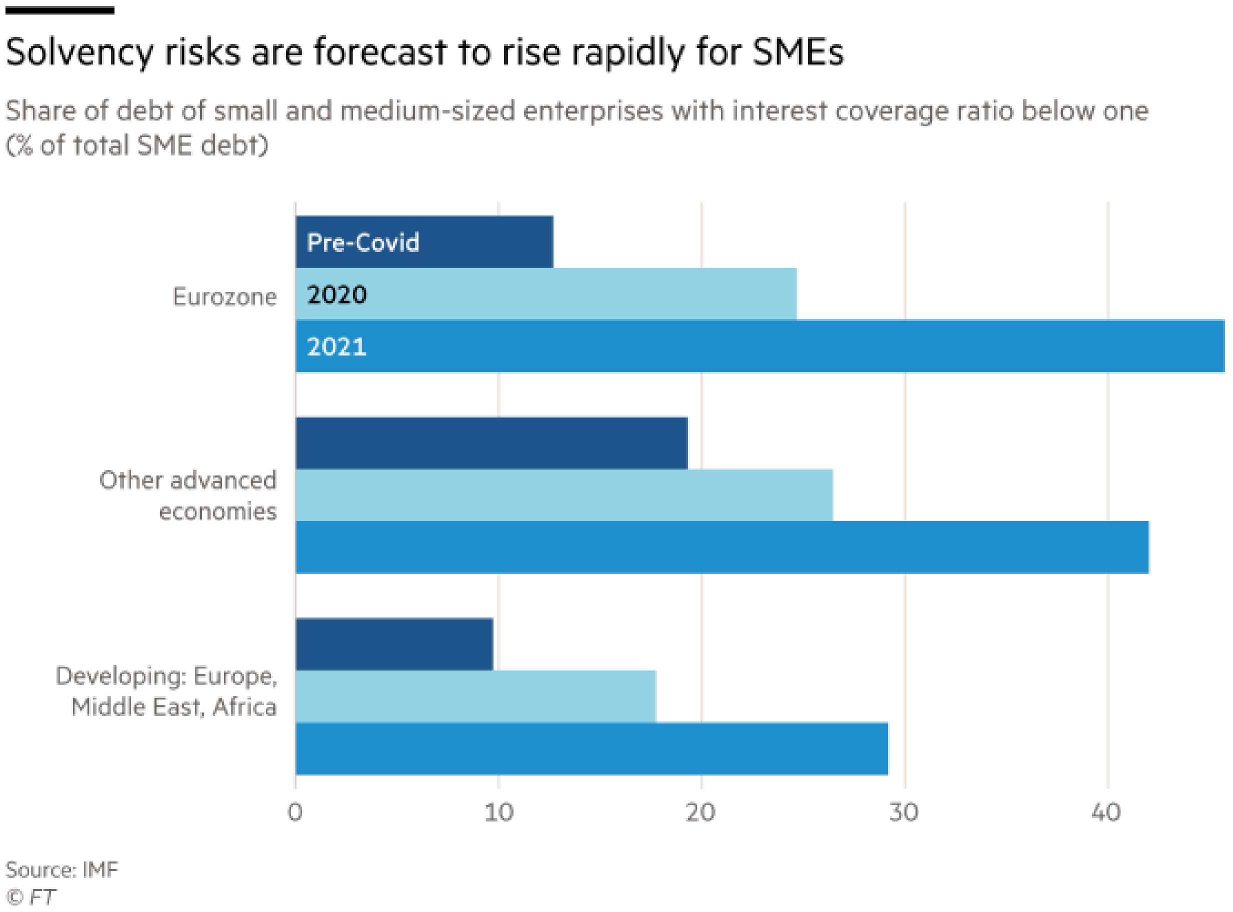


Aggregate series based on constant sample of 25 advanced and 27 emerging economies, weighted by GDP in purchasing power parity terms Source: IMF

We know, nevertheless, that what has already happened is going to leave deep scars. The longer the pandemic continues, the bigger those scars will be. The IMF is already forecasting a big shortfall in economic activity relative to potential in 2022-23. That is sure to keep private investment subdued. Not surprisingly, the fund also now forecasts significantly lower growth of real gross domestic product per head between 2019 and 2025 than it forecast in January.

In a crisis of this scale, there is only one entity able to act as both insurer and supporter of demand. Unfortunately, the capacity of governments to act varies hugely. But those with globally accepted currencies have enormous room for manoeuvre. They have used it already; they will need to go on doing so.

Fiscal policy has to play a central role, as it alone can provide the necessary targeted support. Central bankers have been clear about this. The Fiscal Monitor helpfully divides the needed support into three phases: lockdown; gradual reopening; and post-Covid recovery.



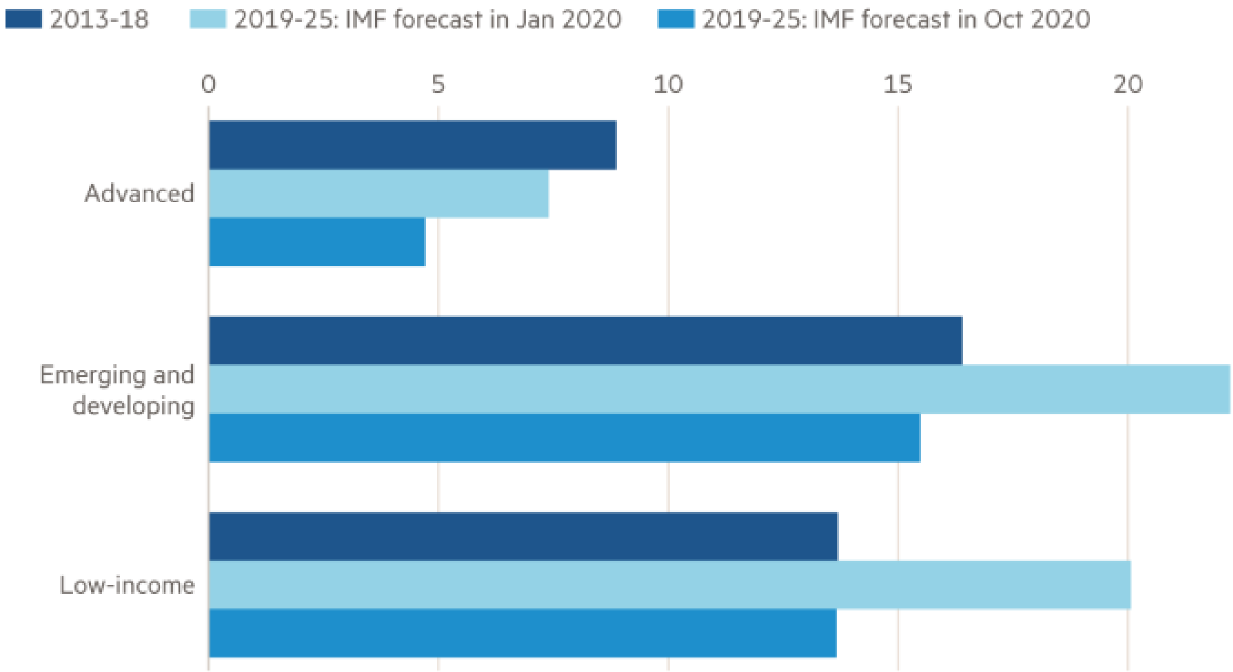
During lockdown, the onus has to be on cash transfers, unemployment benefits, support for short-time work, temporary deferral of taxes and social security payments, and liquidity support for businesses.

During reopening, support has to be more targeted, with incentives focused on getting people back to work. Plans should be made for higher public investment. Meanwhile, support for companies needs to be focused on those with decent prospects, but with controls over dividends and executive pay.

During the post-Covid period, systems of social protection that the pandemic has shown to be defective will need reform. Meanwhile, attention must shift towards active labour market policies and big boosts to public investment. This, argues the Fiscal Monitor, will strongly stimulate private investment. Mechanisms for accelerated debt restructuring will be needed, too.

Covid-19 is expected to leave big economic scars

Cumulative growth in GDP per head: actual and forecasts, by country group (%)



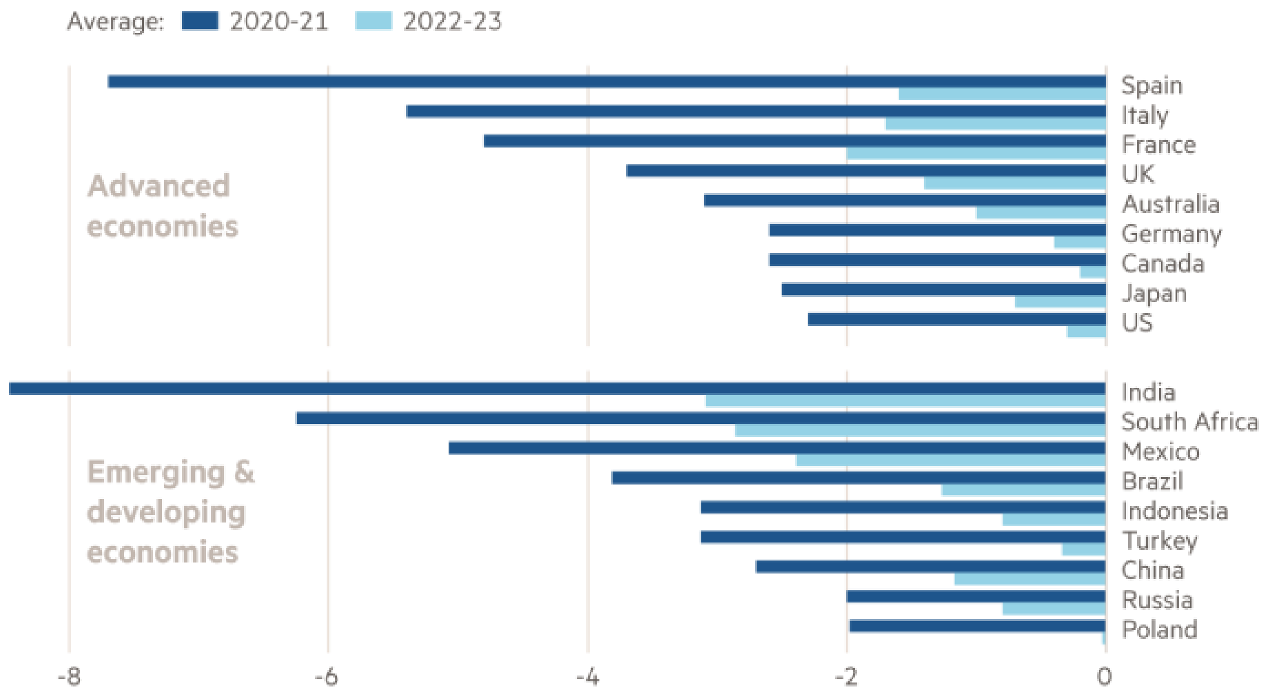
Source: IMF

Getting all this right, particularly as the timing of the transitions between the disease's various phases is uncertain and may not be in one direction, will be hard. Policymakers have to be flexible, but not frugal.

All this spending is going to raise public deficits and debt substantially. The global general government fiscal deficit is forecast to hit 12.7 per cent of GDP this year; in high-income economies, it will reach 14.4 per cent. The global ratio of general government debt to GDP is forecast to jump from 83 to 100 per cent of GDP between 2019 and 2022, with that for high-income countries going from 105 to 126 per cent.

Spare capacity is forecast to endure for a long time

Forecasts for output gap (% of potential GDP)



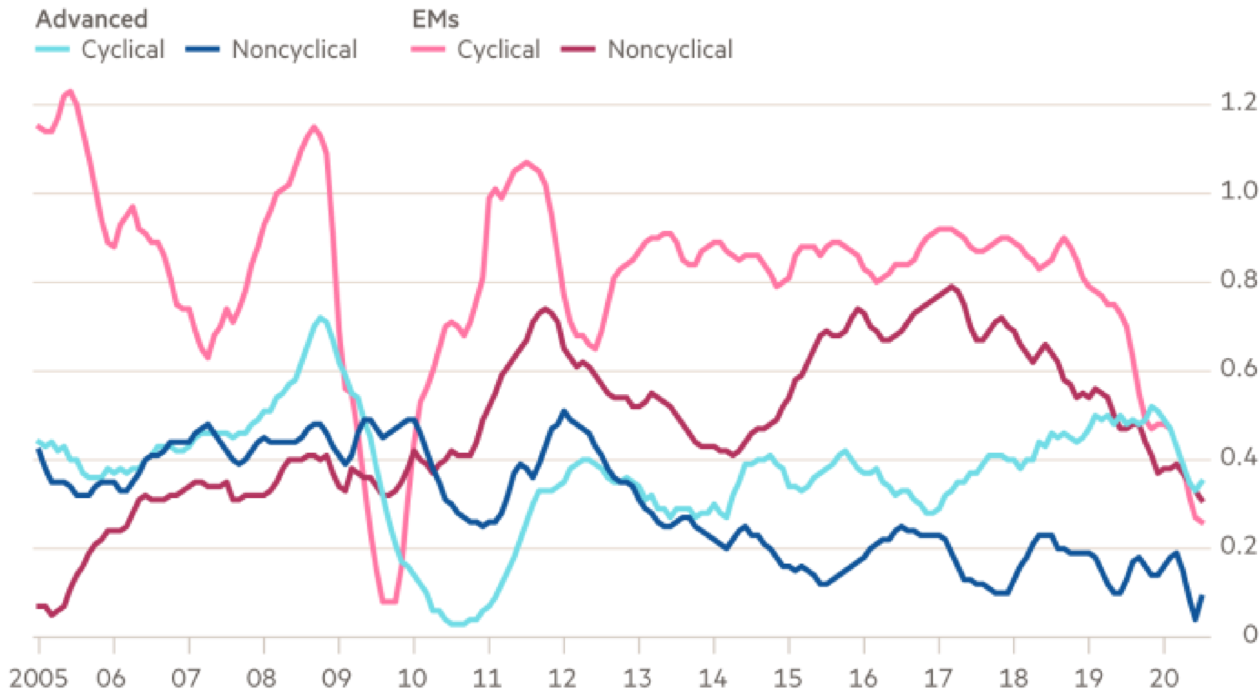
Source: IMF

Never mind. For high-income countries, real interest rates on long-term borrowing are zero, or less. Central banks are also credibly committed to maintaining very easy monetary policies. Governments can afford to spend. What they cannot afford is not to do so, leaving economies to falter, people to feel abandoned, economic scarring to worsen and economies to be caught in permanently lower growth.

Governments have to spend. But, over time, they must shift their focus from rescue to sustainable growth. If, ultimately, taxes have to rise, they must fall on the winners. This is a political necessity. It is also right.

Core inflation has fallen to very low levels

Contributions to headline inflation (% points) for advanced and emerging/developing economies



Source: IMF

We are still only at the beginning. We cannot know how this will end, not least because we do not know what people in power will do. But we do know that history will judge policymakers harshly if those with room to do so do not rise to the occasion.

A long economic Covid must be prevented. This does not mean abandoning efforts to control the disease, but rather the reverse. It will also require active, imaginative and bold economic policy for years ahead. Do not worry about what it will cost to do this. Worry far more about what it will cost not to.

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