The Coronavirus Economy and Response

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Dr Tom McDonnell

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Global economic output collapsed in the first half of 2020

1. World economy

Most of the advanced economies were performing reasonably well prior to the onset of the Covid-19 related lockdowns, albeit with some evidence of slowdown in the euro area. Unemployment rates were close to record lows in a number of countries including the United States and Germany.

The coronavirus pandemic has caused unprecedented disruption to societies and economies throughout the world. Global economic output collapsed in the first half of 2020 with large declines in each of the Republic of Ireland's main trading partners. Every major economy experienced severely declining output in the second quarter of this year with the sole exception of China where the pandemic peaked earlier.

Table 1 Seasonally adjusted growth rates of GDP in Volume (annual change), %

	2019 Q4	2020 Q1	2020 Q2
Euro area	1.0	-3.2	-14.7
United Kingdom	1.1	-1.7	-21.7
United States	2.3	0.3	-9.1
China	6.0	-6.8	3.2
Ireland	5.9	5.7	-3.0
Ireland (modified domestic demand)	2.9	-0.9	-15.7

Sources: Eurostat: GDP main aggregates, CSO: Quarterly National Accounts, Trading Economics: GDP data.

Ireland's headline GDP decline was smaller than the decline in most other countries. However, Irish GDP is distorted by the impact of a small number of heavily globalised multinationals and the multinational sector has performed much better than the domestic sector. Table 1 shows that the drop in underlying domestic economic activity in Ireland (-15.7 per cent) was comparable to that of other European countries. Spain (-22.1 per cent) and the United Kingdom (-21.7 per cent) experienced particularly severe drops in their output. The unprecedented drop in domestic demand in March and April has been followed by a modest, tentative and partial recovery in the majority of countries since May.

Household savings jumped sharply in most advanced economies in the second quarter including in Ireland. This was partially enforced as the lockdowns imposed constraints on certain types of spending but the increase in savings was also precautionary reflecting the deteriorating labour market conditions and income expectations.

Overall household spending and manufacturing activity recovered somewhat in the third quarter as businesses have reopened. However, demand for services has remained weak in many countries as a consequence of the need for social distancing and fear of the virus. Consumer confidence is well below its pre-pandemic level in the euro area. Any recovery in the short-run is likely to require significant fiscal support.

Table 2 Annual inflation rate (HICP or consumer prices),

	June	July	August
Euro area	0.3	0.4	-0.2
United Kingdom	0.6	1.0	0.2
United States	0.6	1.0	1.3
China	2.5	2.7	2.4
Ireland	-0.6	-0.6	-1.1

Sources: Eurostat: Inflation, CSO: Consumer Price Index, Trading Economics: Inflation rates.

Prices in the Euro area turned negative year-on-year in August (-0.2 per cent) and were just 0.2 per cent in the UK and in Japan. Negative price pressure is coming from low energy prices and from weak consumer demand – itself a function of dampened consumer confidence and deteriorating labour market conditions.

Labour market

Cross-country labour market comparisons are somewhat difficult. This is due to divergent policy responses and different classifications of labour market status. It is clear however that labour markets everywhere have been severely affected. The US unemployment rate swiftly transitioned from full employment in March (3.5 per cent unemployment) to a peak unemployment rate of 14.7 per cent by May on account of almost 20 million jobs lost in April. Less than half of US job losses had been recovered by August.

The ECB estimates that euro area employment fell 5.1 million between the final quarter of 2019 and the second quarter of 2020 – a 0.3 per cent decline in the first quarter and further 2.9 per cent decline in the second quarter. The smaller decline in euro area employment relative to the decline in economic activity is largely attributable to the use of job retention and related schemes aimed at preventing redundancies and at supporting the self-employed. In Ireland's case these policies manifested as the Temporary Wage Subsidy Scheme (TWSS) and the Pandemic Unemployment Payment (PUP) respectively.

As a result, average hours worked declined much faster in the euro area (3.8 per cent in quarter one and then a further 10.2 per cent in quarter two) than did total employment. Similarly, hours worked in the UK declined over 18 per cent between the first and second quarters despite the official unemployment rate remaining below 4 per cent.

The ECB notes that survey-based data is indicative of further job losses in the third quarter. A second surge in the pandemic over the Autumn/Winter period, as seems likely, would lead to further job losses and potentially to a cascade of business failures.

Outlook

Measures of industrial production and business confidence are generally weak. International trade also remains subdued while the extremely high levels of uncertainty have depressed global business investment. The prospect and then reality of a hard Brexit in January 2021 will further depress investment and will deepen the scale of the economic crisis in the UK and in Ireland in early 2021.

Almost all countries have experienced sharp deteriorations in their public finances. This is on account of the collapse in hours worked combined with the various policy measures taken to contain the virus and to provide business, employment and income supports. Thus far the enormous fiscal supports and resulting deficits have yet to prompt increases in the cost of government borrowing in the euro area.

There are a number of reasons why the cost of borrowing for euro area governments has remained low. Most significantly, the ECB has become a de facto lender of last resort for euro area governments. This has given government bonds a form of safe haven status.

In addition, the European Council has agreed to coordinate its joint fiscal response through the creation in May of the temporary Next Generation EU instrument. This instrument will make €750 billion of funding available for EU governments from 2021-2024. There is also a general market understanding that the deficits are temporary crisis responses and not reflective of policy mistakes and profligacy. Finally, the depressed economic outlook and pandemic related uncertainty has meant that alternatives to government bonds have become less attractive as sources of returns.

The OECD's September assessment was that global output will decline by 4.5 per cent in 2020 but then grow by 5 per cent in 2021. This implies cumulative global growth of close to zero per cent over the two years. The OECD's 2020 outlook is particularly bleak for Italy (-10.5 per cent), the UK (-10.1 per cent) and France (-9.5). China (+1.8 per cent) is the only major economy expected to avoid negative growth this year.

The latest ECB staff projections foresee euro area real GDP falling 8 per cent in 2020 before increasing by 5 per cent in 2021 and then 3.2 per cent in 2022 – equivalent to virtually zero growth over the three years. The short-run outlook is especially uncertain for the UK economy given the like of clarity around the final shape of Brexit and the potentially disruptive impact on trade.

The baseline outlook is therefore very weak. However, the economic outlook is extremely uncertain given the wide range of possibilities about the future spread of Covid-19, and about the evolving health protection and other policy responses of governments. In particular, there is significant uncertainty related to the timing and widespread availability of a vaccine. An early vaccine would likely unlock significant pent up demand as consumer and business confidence returns. On the other hand, prolonged cycles of opening up and locking down will lead to more widespread bankruptcies, higher unemployment, loss of confidence, and a gradual deterioration of labour market skills and human capital.

Policy

Swift and decisive emergency policy responses from governments and central banks prevented even larger declines in output and employment. Crucially, there should be no cliff-edge removal of these supports. Central banks will need to make 'whatever it takes' commitments to ensure that governments are able to continue to act as income and liquidity sources of last resort well into 2021. In particular, central banks should continue to underpin support for government borrowing by guaranteeing that policy rates will be kept low out to the medium-term and maintaining asset purchases.

Governments in turn will need to maintain fiscal supports until well into 2021 and beyond and remain ready to reintroduce emergency income and business supports if and when incidence of the virus requires further lockdowns on economic activity. Governments should also delay budgetary tightening measures such as tax increases and the roll back of income supports and stimulus until at least 2022 and at minimum until a vaccine is widely available and deployed.

A final point is that the Covid-19 crisis may compound the medium-term decline in productivity growth that took hold in advanced economies in the 1990s and that accelerated in the aftermath of the financial crash. Sectors involving social interaction will experience increased costs per unit output in at least the short-term. Prolonged higher levels of unemployment will likely lead to some degree of skills erosion. The higher levels of uncertainty will depress levels of business investment. At the same time, ageing demographics will put increasing downward pressure on hours worked leaving productivity gains as the remaining lever for economic growth.

Governments should therefore focus their stimulus packages on reversing the persistently low levels of investment in the productive capital stock. Investments in infrastructure can be targeted to support the necessary transition to a zero carbon economy while increased investments in education, retraining, public R&D, public childcare supports and child poverty reduction can all help improve labour productivity over the long-run.

Governments and Central Banks will need to do 'whatever it takes'; to buttress employment, incomes and liquidity

2. Republic of Ireland

The Republic of Ireland's economy was undergoing a robust cyclical upswing prior to the onset of the pandemic. Annual employment growth averaged over 3 per cent between 2013 and 2019 while annual growth in modified domestic demand averaged over 4 per cent between 2014 and 2019. By the end of 2019 the labour market was approaching full employment with an unemployment rate below 5 per cent. Average nominal wage growth (hourly and weekly) was in excess of 3 per cent and wage growth was in excess of 2.5 per cent in real terms.

Table 3 Dashboard of Macroeconomic Indicators, Republic of Ireland

	2016	2017	2018	2019	2020' Q1	Latest
Percentage volume change over previous year						
Gross Domestic Product	2.0	9.1	8.5	5.6	5.7	-3.0 (Q2'20)
Modified Domestic Demand	5.8	3.5	4.3	3.3	-0.9	-15.7 (Q2'20)
Personal Consumption	5.0	2.4	2.8	3.2	-2.5	-22.1 (Q2'20)
Retail Sales	7.9	3.9	3.8	2.1	-2.1	-21.7 (Q2'20)
Modified GNI (GNI*)	5.9	4.6	6.8	1.7	-	1.7 (2019)
Percentage annual average rate of change						
Employment	3.6	2.9	2.9	2.9	2.2	-22.0 (Q2'20)
Labour Productivity	1.4	3.1	4.2	-	-	4.2 (2018)
Average Hourly Earnings	0.8	1.6	2.9	3.5	3.0	7.9 (Q2'20)
Average Weekly Earnings	1.3	1.9	3.3	3.6	3.7	6.2 (Q2'20)
Inflation (CPI)	0.0	0.4	0.5	0.9	1.0	-1.0 (M8'20)
Percentage of annual GDP or quarterly GDP						
Mod. Investment (% GNI*)	19.3	20.0	20.9	20.5	-	20.5 (2019)
Current Account Balance	-4.2	0.5	6.0	-11.3	-15.9	14.1 (Q2'20)
Government Balance (GGB)	-0.7	-0.3	0.1	0.4	-3.7	-3.7 (Q1'20)
Gov. Gross Debt (end year)	74.1	67.0	63.0	57.3	60.7	60.7 (Q1'20)
Percentage of labour force						
Unemployment (SA)	8.4	6.7	5.7	5.0	4.6	15.4 (M8'20)
Long-term Unemployment	4.2	3.0	2.1	1.6	1.3	1.1 (Q2'20)
Percentage of households						
Deprivation	21.0	18.8	15.1	17,8	-	17.8 (2019)
At Risk of Poverty	16.2	15.7	14.0	-	-	14.0 (2018)
Percentage						
Gini Coefficient	30.7	31.5	29.7	-	-	29.7 (2018)

Notes: Half-year, ('H'), Quarterly ('Q'), monthly ('M') and other data is compared to same period of the previous year. Modified domestic demand is non-seasonally adjusted modified final domestic demand, which we define as 'Total domestic demand less the effects of the trade in aircraft by aircraft leasing companies and the imports of intellectual property'. Modified GNI is GNI adjusted for factor income of redomicilied companies, and depreciation of aircraft leasing, R&D service imports and trade in IP and depreciation on aircraft leasing. Modified investment is the investment component of modified domestic demand. GGB is end-year figure as a % of annualised GDP or latest six monthly figure as % of six monthly GDP. Unemployment is average for four quarters or latest quarter/month seasonally adjusted. The 'latest' figures for employment/ unemployment are the Covid-19 adjusted estimates.

Sources: CSO: Labour Productivity, National Income and Expenditure, Quarterly National Accounts, Retail Sales Index, Labour Force Survey, Earnings and Labour Cost, Consumer Price Index, Balance of International Payments, Government Finance Statistics, Monthly Unemployment, Survey on Income and Living Conditions.

Personal consumption and retail sales were both growing strongly on the back of the strengthening labour market and while demand was growing strongly there was little evidence of overheating.

Traditional indicators such as GDP growth and the current account balance have been extremely volatile in recent years due to various multinational activities such as movements of intellectual property assets, and these indicators had become unreliable guides to overheating. However, inflation remained well below the ECB target while the household savings rate was comfortably above its long-run average. New dwelling completions, while growing quickly year-on-year, were just over 21,000 units in 2019 and less than 70 per cent of medium-term projected demand.

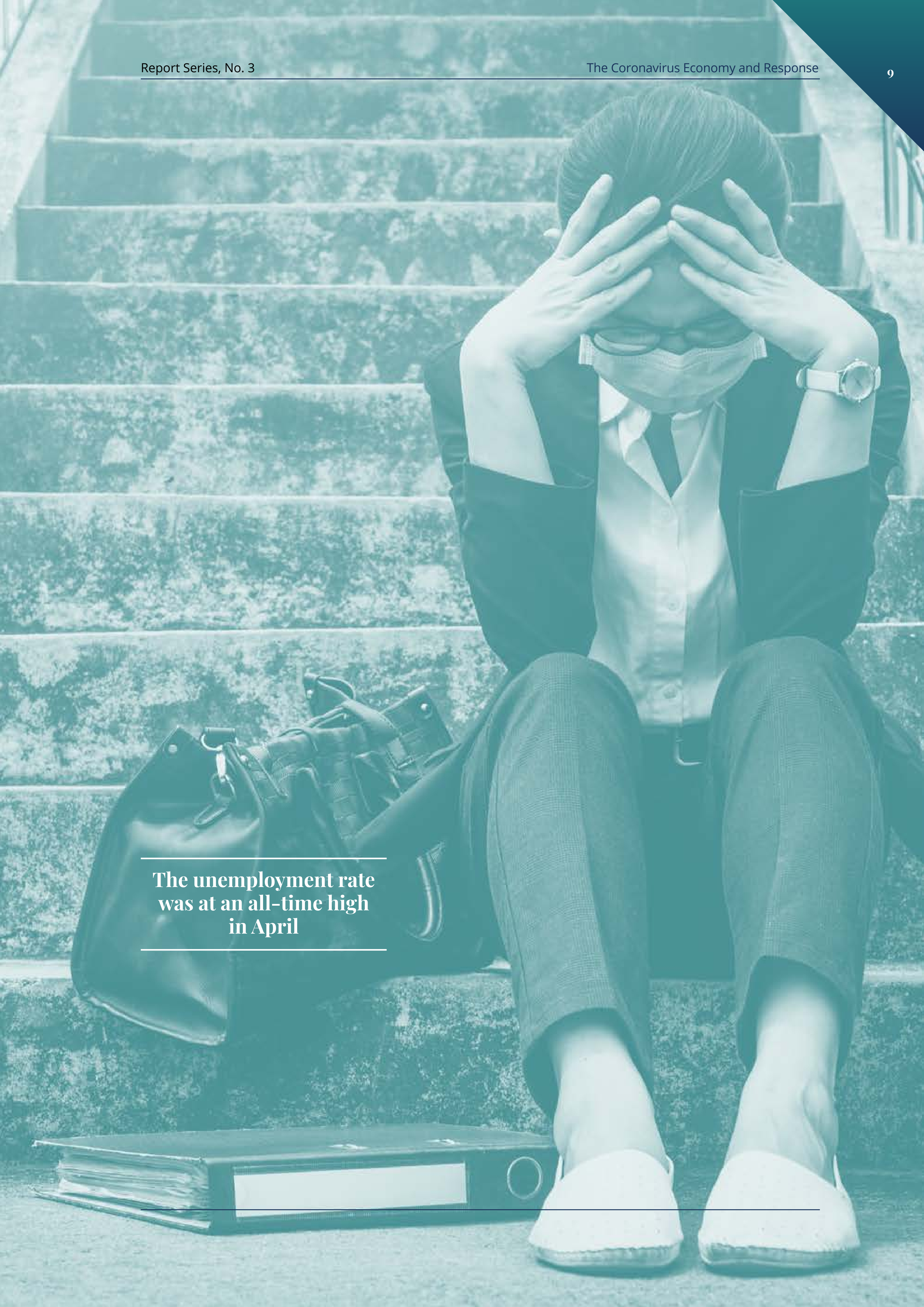
Despite the cyclical recovery there were a number of socio-economic concerns. For example, the undersupply of housing stock was leading to rapid increases in the cost of renting. In addition, the rate of material deprivation at 17.8 per cent in 2019 was well above the pre-financial crisis rate and had increased since the previous year.

The economy was also vulnerable to a number of risks and uncertainties. The most significant of these was Brexit but there were also concerns relating to protectionism and trade wars as well as fiscal concerns relating to potential reforms to international corporation tax policy. It now appears likely that a hard Brexit could indeed be realised at the end of 2020. This will be damaging for Irish trade and will create severe difficulties for businesses with cross border supply chains. The agri-food sector will be particularly hard hit and a Sterling depreciation would put further pressure on exporters.

Covid-19

Although labour market conditions were still improving on the eve of lockdown, the domestic Irish economy's long cyclical upswing appeared to be somewhat slowing down. The onset of the pandemic in March along with the ensuing policy response generated the greatest shock to the Irish economy and labour market in the history of the State.

Total employment in the second quarter of 2020, measured on a Covid-19 adjusted basis, fell by 22.5 per cent compared to the previous year. This closely matches the decline in actual hours worked which fell by 22.1 per cent compared to the previous



The unemployment rate was at an all-time high in April

year. Covid-19 adjusted unemployment (which includes PUP recipients) peaked at 29.1 per cent in April. This was its highest level ever and twice the peak of the great financial crisis. Even so, the unemployment rate had fallen back to 14.7 per cent as of September.

Table 4 Unemployment rate, lower and upper bounds, % or thousands, Republic Of Ireland

	Mar	Apr	May	Jun	Jul	Aug	Sep
Lower	4.8	4.8	5.1	5.4	5.8	5.8	5.4
Upper	16.5	29.1	28.5	24.5	17.6	15.4	14.7
No.	400	685	661	564	408	359	343

Sources: CSO: Monthly Unemployment

The collapse in hours worked was accompanied by a year-on-year decline of 15.7 per cent in modified final demand – representing an enormous contraction in the domestically focused section of the economy. Over the same period personal consumption fell by 22.1 per cent year-on-year, the volume of retail sales fell by 21.7 per cent and housing completions fell by 31.9 per cent.

Consumer price inflation turned negative year-on-year in April and has remained negative since then (the CPI was -1.0 per cent in August). Surprisingly, house prices were relatively unchanged over the period. This may reflect reduced supply expectations. Also counterintuitive was the sharp increase in nominal wages during the second quarter. The phenomenon is explained by the composition of working hours lost since the start of the crisis which have principally been in low paid service jobs.

The public finances will be sharply in deficit in 2020 with net-voted expenditure up 28 per cent year-on-year at the end of August. The Department of Finance was projecting a deficit of up to €30 billion in 2020 (10 per cent of GDP) although this is likely to be revised down somewhat. Ireland's debt-to-GNI* ratio is amongst the highest in the world.

Domestic demand started to recover in June along with the reopening of the economy. July and August saw retail sales volumes over 9 per cent larger than in the equivalent months in 2019 and at record levels. The jump in retail sales represents the release of pent-up demand after the end of the initial lockdown. High frequency data suggests the economy bounced back somewhat in the third quarter. However, the nascent recovery could be reversed in the fourth quarter if the spread of the virus prompts ongoing lockdowns.

The outlook for 2021 is highly contingent on the progress of the virus, the development of a vaccine, and the level of consumer and business confidence. The Services (52.5) and Manufacturing PMIs (52.3) were both consistent with modest growth expectations although the Construction PMI (44.0) implied a decline in economic activity. All three indices are negative with regard to employment expectations. Accurate forecasting in the current context of radical uncertainty is extremely difficult. The NERI's baseline is that growth will be modest throughout 2021 and that the economy will be smaller at the end of 2021 than it was at the end of 2019.

Table 5 Institutional forecasts and scenarios, GDP, %, Republic of Ireland

	2020 (Base)	Severe	Benign	2021 (Base)	Severe	Benign
EC	-8.5			6.3		
CBI	-9.0	-13.8		5.0	4.9	
ESRI	-12.0	-17.0	-9.0			
OECD		-8.7	-6.8		-0.2	4.8
IMF	-6.8					
DoF	-2.5			1.4		

Notes: European Commission and Central Bank (CBI) scenarios are from July. ESRI scenarios from May. OECD scenarios are from June. IMF and Department of Finance scenarios are from September.

Sources: European Commission (EC): Economic Forecast, Central Bank of Ireland (CBI): Quarterly Bulletin, ESRI: Quarterly Economic Commentary, OECD: Economic Outlook. IMF: Country data, Department of Finance: Stability Programme Update.

Policy

The government has thus far taken the correct approach to the economic fallout. The wage subsidy scheme will help preserve productive capacity while income supports will help preserve demand. The economic and fiscal costs of the pandemic will likely be added to by a disorderly Brexit at the end of December. The government will need to show ambition and engage in a multi-year stimulus programme as we move beyond the early phases of the crisis over the coming months. This is notwithstanding the significant deficit in the public finances in 2021. The stimulus should be based primarily on green infrastructure investment and on human capital development.

The government's stated intent to prioritise investments in health, housing and a green recovery is welcome. Greater investment in healthcare will be needed to bring the virus under control. Enhanced social protection measures should remain in place in some form in 2021 in order to preserve incomes and protect vulnerable households. Similarly, the government should retain a short-time work scheme in some form that maintains employment relationships in the event of significant shocks, for example through a reformed Employment Wage Subsidy Scheme (EWSS).

In addition, governments should invest in people by increasing spending on supports for retraining, upskilling, higher education and apprenticeships in order to assist workers to transition between sectors and between types of work. Such investments will be needed in any event in order to transition to a zero carbon economy. Investments in human capital will also produce long-term benefits in the form of higher productivity growth as human capital is a necessary ingredient of and complement to creativity, innovation and technology diffusion.

The government should pursue a multi-annual stimulus based on green investment and on human capital development

The Irish government is not yet experiencing budgetary constraints. The average interest rate on Irish debt was just 2.2 per cent in 2019. There is no evidence of the debt burden becoming unsustainable with yields remaining very low in 2020. The Irish economy has the potential to grow by 4 per cent to 5 per cent annually in normal times. As such, interest rates of 1 per cent or 2 per cent are very much affordable over the medium-term. The public finances were in surplus prior to the crisis – suggesting the underlying position was sound - and the perception is that Ireland will not be disproportionately affected economically by the Covid-19 crisis relative to other EU countries.

As such, the Irish government can and should seek to avail of the low interest environment in order to support the economy through the crisis and in order to fund a multi-billion stimulus programme based on investment in infrastructure. The Irish state's revenue base will eventually need to be broadened to ensure fiscal sustainability but this process of reform should be delayed until 2022 so as not to hamper the economic recovery.

NEVIN ECONOMIC RESEARCH INSTITUTE

31/32 Parnell Square, Dublin 1, Ireland
Phone: +353 1 8897722

45-47 Donegall Street, Belfast BT1 2FG, Northern Ireland
Phone: +44 (0)28 9024 6214

info@NERInstitute.net

www.NERInstitute.net

@NERI_research