ECONOMIC VIEWPOINT

Economic Crisis Tied to the COVID-19 Pandemic

Despite Many Risks, We Can Remain Rather Optimistic about the Recovery

Everything is going to be all right! This mantra that has now permeated our everyday life brings hope of a happy ending to this crisis. That life will get back to normal. That workers forced into unemployment will be earning their livelihood again. While this may seem like a rosy scenario to some, it is nonetheless likely! We could, in fact, see a swift economic rebound in the months following the crisis. After mass business closures, we should see many doors reopen in the following months, which will make a strong positive contribution to the economy. Our basic economic forecast scenario reflects this line of thought. Some businesses and activity sectors, however, might take longer to return to normal.

At the same time, all economic forecasts are shrouded in uncertainty. This was true before the COVID-19 pandemic and is even more so now. The recovery could be more robust if better knowledge about the virus and the quick discovery of treatments lead to the lifting of more measures that are restrictive for the economy. Conversely, many health and containment measures might have to be maintained longer, which would muddy economic forecasts. This is not counting other risk factors that could worsen the situation.

How the Pandemic and the Lifting of Containment Measures Will Change Remains Highly Uncertain

Many governments rightly introduced health and containment measures in March to stop the spread of COVID-19 and limit the number of deaths. This resulted in a considerable slowdown in economic activity in March, with April being even more painful. A number of scenarios are possible for what comes next.

The scenario we feel is most likely for the time being is the reopening of a number of businesses in the spring, including daycares and schools. This is the signal sends by many governments around the world. This would lead to a rebound in economic activity that would limit the decline in real GDP in many countries for the second quarter. Taking advantage of this momentum, the third quarter would be fairly robust, and the results could be boosted if more businesses reopen in the summer. The rest of the catch-up would likely extend over a longer period. For example, the airline and tourism industries could take more time to get back on their feet. A complete reopening of borders seems unlikely until a vaccine or an effective treatment is discovered and can be widely distributed. Most activities involving large gatherings of people may also continue to be banned for now.

This scenario does, of course, depend on the pandemic staying well controlled. If it does not, plans of reopening could quickly be abandoned. Without a strong rebound in May and June, the decline in real GDP in the second quarter would be steeper. A slight improvement could be observed in the third and fourth quarter, assuming that some businesses would still reopen slowly. The economy could speed up more as soon as a vaccine or treatment is discovered and made available to a broad public.

In another scenario, the pandemic may stay under control for some time, but then produce a second wave later. Therefore, many businesses could resume their activities in the short term, perhaps even faster than expected in our current forecasts. The third quarter would still be robust, but things could get tougher towards the end of the summer. A second wave with a high number of COVID-19 cases could force governments to introduce new health and containment measures. Economic activity would slow down again in the fall, before gradually picking up in subsequent quarters.

Therefore, the pace and degree of severity of the crisis may vary substantially depending on how the pandemic develops and how quickly businesses reopen. In the favoured scenario, real GDP growth would be shaped more like a "V." This scenario is less severe than ones in which the pandemic would not be as well

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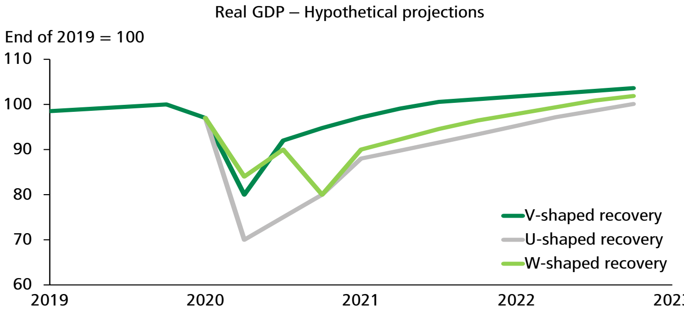
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

controlled and in which real GDP growth would be shaped more like a "U" or "W" (graph 1). In the end, however, the reality may not be as clear cut. We could have a more deformed "V", a "U" of varying severity or a "W" distributed differently over time and more or less symmetrical. This is economics after all, not an exercise in penmanship!

GRAPH 1
The pace of recovery will be highly dependent on the duration of health and containment measures



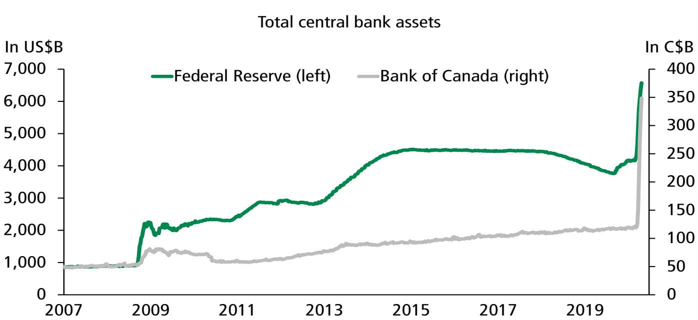
Source: Desjardins, Economic Studies

Governments and Central Banks Have Opened the Taps

Many actions have been taken by governments and central banks to support businesses, households and financial markets. This should help limit the damage in the short term and leads us to believe in a relatively optimistic scenario for the future recovery.

Central banks were the quickest to act through interest rate cuts and various asset buying programs. The central banks of major advanced countries now all have key rates near or below zero. The size of their balance sheet is also growing considerably. For example, the Federal Reserve's (Fed) balance sheet grew from approximately US$4,000B to over US$6,000B in the space of a single month (graph 2). Many expect it to cross the US$10,000B mark by the end of the year. That would be close to 50% of the size of the U.S. economy.

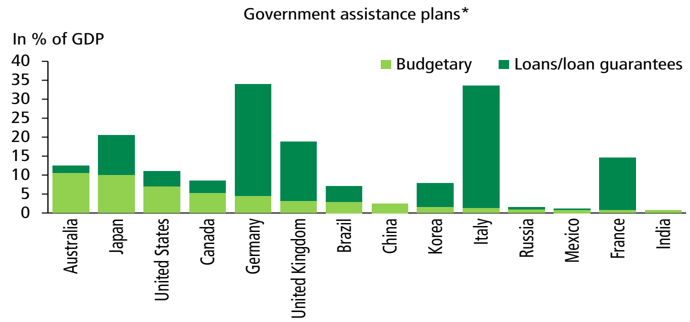
GRAPH 2
The size of central bank balance sheets is growing very quickly



Sources: Datastream, Bank of Canada and Desjardins, Economic Studies

Government assistance comes in the form of various programs aimed essentially at limiting the shock on the income of workers forced to stop working and at supporting businesses financially. The programs are a mix of transfers and loans or loan guarantees often totalling more than 10% of GDP (graph 3). Further measures could be introduced to prop up the economy, particularly once the loosening of containment measures is well underway.

GRAPH 3
Government assistance plans have multiplied



* Data as of April 8, 2020.
Sources: International Monetary Fund and Desjardins, Economic Studies

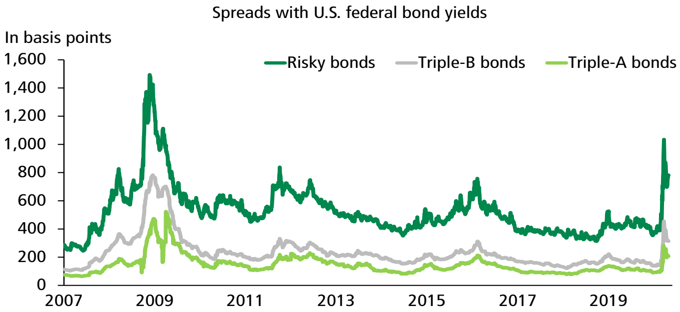
The Effectiveness of All These Measures Could Still Be in Doubt

Before the current crisis, questions already swirled about the effectiveness of monetary policies in some countries, especially in Europe where negative interest rates have been in effect for close to six years and appear to be having only a minor effect on the economy and inflation. Government debt may also spark concerns. That bill will have to be paid sooner or later.

In the short term, these issues should not undermine economic recovery. It seems clear that central bank actions have helped, particularly by reducing the risk of a financial crisis. The financial system is now flooded with cash, and the fact that central banks have extended their purchases to a wider range of assets, including corporate bonds, is helping to reduce the many risk premiums that had increased substantially (graph 4 on page 3). The decreases in key interest rates were also needed to ensure that consumers and businesses can benefit from financing terms appropriate for this difficult period.

The actions taken by central banks also reduce the cost of debt for governments. In Europe, since many bond yields are in negative territory, governments' ability to pay can hardly take a dramatic turn for the worse. This may nevertheless seem like a lot of money spent in a short amount of time, but we also have to bear in mind the consequences of taking no action. Workers and businesses would experience more persistent adverse effects, and that could prove to be more costly for governments at the end of the day.

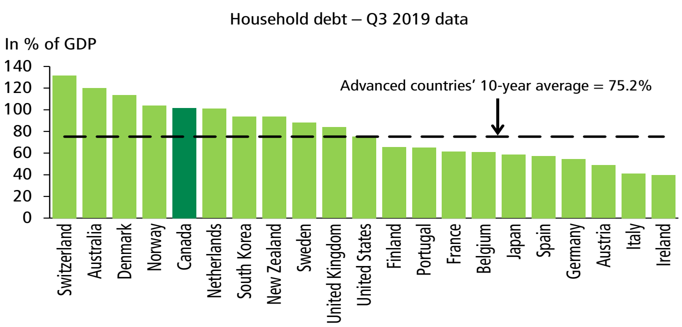
GRAPH 4
Interest rate spreads soared in March



Sources: Datastream and Desjardins, Economic Studies

However, government and central bank actions could also have negative long-term effects, especially if the crisis lasts longer than expected and is more severe. For example, massive central bank purchases could lead to distortions in the value of asset classes, which could result in bubbles and increase volatility on financial markets. This could also result in a less effective allocation of capital and weaker economic growth in the longer term. Accommodative monetary policies could also cause a problem with household debt. In many countries, including Canada, household debt was already high before the crisis (graph 5). Macroprudential measures could, however, curb any potential frenzy in that respect.

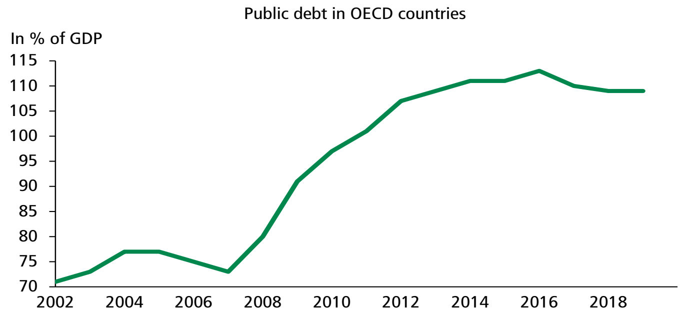
GRAPH 5
Household debt is already high in many countries



Sources: Bank for International Settlements and Desjardins, Economic Studies

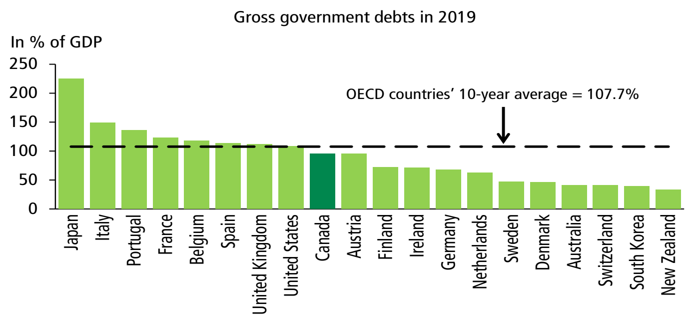
As for governments, it is difficult to know how far into debt they can fall before causing the economy more harm than good. That said, during the 2008–2009 Great Recession, the government debt load had increased significantly, and a sovereign debt crisis then affected many European countries deemed to be in fragile financial health. A spike in government debt may give rise to a new crisis of confidence in the ability of some governments to repay their loans. What is not helping is that the weigh of public debt in advanced countries has not been reduced after growing considerably ten years ago (graph 6). The average public debt ratio of advanced countries was still over 100% GDP in 2019. Some countries, such as Canada and Germany, are in a more enviable financial position than others, however (graph 7).

GRAPH 6
Public debt spiked because of the 2008–2009 crisis and has not really come down since



OECD: Organisation for Economic Co-operation and Development
Sources: OECD and Desjardins, Economic Studies

GRAPH 7
Governments did not all have the same leeway



OECD: Organisation for Economic Co-operation and Development
Sources: OECD and Desjardins, Economic Studies

It is also worth noting that unless there is a spike in inflation, which does not seem very likely, interest rates are expected to remain low for a number of years. This should help governments manage their debt loads. This is not to mention that central banks should maintain large government bond holdings, even after the crisis. The Fed, the European Central Bank (ECB) and the Bank of Japan (BoJ) have been doing so for the past decade, and inflation has never run away. The fact remains that central banks will have to stay quite vigilant in managing their various intervention measures. In the event of over-stimulated demand relative to supply, inflation could become problematic and require a change in strategy.

Many Businesses Could Emerge Weakened from This Crisis

Regardless of the scenario, it will be difficult to save every business. Obviously, the longer and more severe the crisis, the greater the potential number of businesses struggling financially. Moreover, even though borrowing costs have dropped with the help of central bank and government programs, credit terms are still far from what they were before the crisis. This could still complicate some refinancing. It is also likely that businesses will see their credit ratings downgraded, which will compound the challenges.

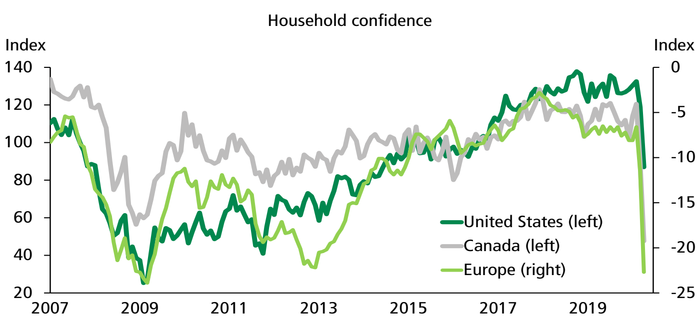
Assistance plans could nevertheless be adjusted as necessary to contain the potential fallout. The Fed has quickly amended its corporate bond buying program to include lower-quality bonds. Conversely, increasing their risky asset holdings could mean potential losses for central banks. At the end of the day, governments are likely to get stuck with the bill. This would add to the costs of various support measures. In the United States, the government gave the Fed close to US$200B in capital to implement the lower-quality bond buying program. Absorbing losses by creating money would be riskier from an inflation standpoint.

The bottom line is that we remain rather optimistic as to the capacity of governments and central banks to save many businesses. Most should be able to reopen as they are permitted to do so. In the longer term, their capacity to invest will have to be monitored nonetheless, whether it is in research and development, training or any other projects likely to generate long-term growth.

Confidence May Not Be Quick to Return

Confidence indicators all over the globe have crumbled (graph 8). This is fairly normal considering the number of businesses and workers affected by the current crisis. That said, will these indicators bounce back quickly? This is an important issue for economic forecasting.

GRAPH 8
Confidence crumbled quickly



Sources: Datastream, Conference Board and Desjardins, Economic Studies

Presumably, in a scenario in which the pandemic stays under control and the reopening of the economy stays the course, confidence could increase faster. Nevertheless, businesses and households could have doubts about the strength of the recovery and could fear longer-term effects of the crisis. The continuation of certain health and containment measures could be a reminder that the battle is not yet won and that the situation could quickly deteriorate again. Workers might see greater insecurity on the labour market. Businesses might take longer to rehire all their staff. Government debt might also be cause for concern and undermine confidence.

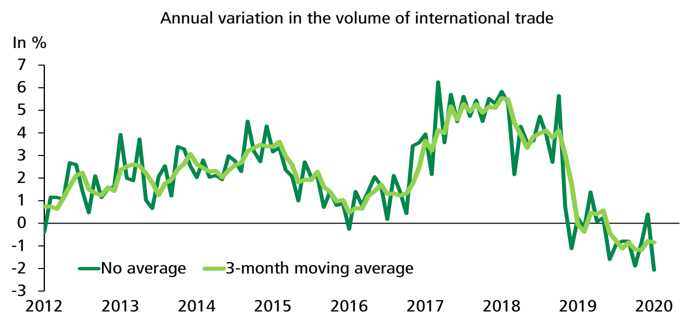
It therefore seems preferable to tread carefully in this aspect of economic recovery. For the time being, we are moderately optimistic about developments in confidence. In many countries, an acceleration in government spending, particularly on infrastructure, should help offset the hesitation in consumption and investment in the short term.

Increased Deglobalization

Many are wondering whether this crisis will change the way the global economy functions. Shortages of certain drugs and medical supplies could encourage many countries to repatriate production locally. The process seems to have already begun and could extend beyond the health sector. Other strategic products could be identified, particularly in the food sector. This is not to mention certain consumption habits that are likely to change. In short, we could see a sort of deglobalization in the coming years.

With the rise in U.S. protectionism, global trade has already weakened considerably since 2019 (graph 9). This trend could ultimately continue over the next few years with new protectionist measures. For example, government stimulus packages could give priority to local purchases, as was the case during the 2008–2009 crisis. Tensions between China and the United States may also resurface.

GRAPH 9
Global trade has been declining since 2019



Sources: CPB - Netherlands Bureau for Economic Policy Analysis and Desjardins, Economic Studies

Trade is generally recognized as a source of efficiency gains that sustain long-term economic growth and limit price increases. In the end, less trade could mean somewhat weaker world economic growth and a little more inflation. However, the effects would mainly be felt in the longer term. This therefore has less of an impact on our short-term forecasts. What is more, even before the pandemic, we were already cautious about the risk of renewed trade tensions.

The Coming Quarters Are Looking Very Uncertain

Economic forecasting is a particularly difficult exercise in the current context. Developments in the pandemic and the duration of containment measures should have a considerable effect on how quickly the economy recovers in the coming quarters. This should also influence a number of other risks. A longer pause imposed on businesses could make their financial challenges tougher and reduce their ability to invest afterwards. Government debt is expected to be higher if the shutdown lasts longer. Central banks could also be required to intervene for a longer amount of time, which would raise the risk of counterproductive effects in the longer term. The protectionist threat could also increase with the severity of the crisis. This is not to mention the uncertainty surrounding how consumer and business confidence will change going forward.

That said, the latest developments encourage us to remain rather optimistic. After a very difficult March and April, we should see a marked improvement. Many governments are beginning to allow businesses and schools to reopen. We must also stay hopeful that a better understanding of the virus will be gained through research and a treatment or vaccine will be found. If the pandemic remains under control, we could save both lives and the economy. Yes, everything could be all right!

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