UBS

Chief economist's comment

Can GDP be saved?

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Paul Donovan, Chief Economist, UBS GWM, paul.donovan@ubs.com

- This is not a wartime economy. In war, governments try to maximize economic activity. Today governments deliberately want to lower economic activity. This creates two economic phases.
- Phase one is a policy-led demand drop. Phase two is a bounce back, once policy has stopped trying to lower GDP.
- It is nonsense to try and do economic stimulus in phase one (it would be opposing government policy). The sensible aim is to keep the demand drop as short as possible.
- The main risk is that unemployment rises as demand weakens, and this lengthens phase one. Keeping firms in business and people in jobs are the most important policy aims.
- This is about fiscal policy - but the right fiscal policy. Lending works for some firms, but not all. About 25% of consumer spending is potentially lost demand, and lending does not work as well there. Grants, support for wage bills and other cost reductions are more effective.
- Consumer cash handouts may help boost phase two. They do little or nothing to keep people in jobs in phase one.

The economic damage of the coronavirus is caused by fear. Consumers are fearful, and stop spending money. Companies are fearful, and change working patterns and investment. Policy makers are fearful and change policy.

This has led to a very unusual situation. In most major economies, the main objective of governments is to *lower* GDP. Governments want less economic activity. This is to achieve health policy aims. GDP forecasts change when health policies change. This also makes nonsense of talk of a "wartime economy". Wartime economies try to maximize economic activity. GDP was specifically created to help maximize wartime economic activity. What governments want to do now is to cut economic activity, to stop the spread of the virus.

This means that for every major economy, there are now two clear phases.

- In phase one demand will drop. Government led shutdowns and consumers who are afraid mean less demand.
- In phase two the economy will bounce back. The crisis does not last forever.

These phases require two different policies. *Economic stimulus is no use in phase one*. Governments want GDP to go down. There is no point trying to get GDP to go higher. It will not work. What is important is that phase one is as short as possible.

The biggest economic risk in phase one is that the fall in demand leads to significant job losses. Businesses, in particular small businesses, face weak demand or no demand. If these businesses lay off staff, then there is a clear risk of a double demand drop. After the peak of the virus (or fear of the virus) unemployment will mean a second wave of demand weakness. First the shutdown lowers demand. Then, people out of work cut demand. This will mean that phase one will last longer. Early data from the US suggest this may already be happening there.

Fiscal policy. But the right fiscal policy

How can policy shorten phase one? Firms need to stay in business. Firms need to keep employing people. Consumption can then fuel the bounce back in phase two.

Small firms are the biggest risk. They are the largest employers (at around 70% of private sector employment). They are the most at risk in an economic slowdown. Not all small firms will suffer, of course. Smaller food shops have presumably benefited from panic buying, for example. It is also worth remembering that many small business owners will have a strong emotional attachment to their firms. Family firms, or firms built from nothing, mean a great deal to their owners. Owners will do a great deal to keep their firms going.

It is fiscal policy that matters. Cutting interest rates will not raise demand in a lockdown. People are not going to decide to step aboard a cruise today just because interest rates have fallen. Cutting interest rates does little to help small firms. It is cash flow and help with bills that is needed.

Fiscal policy does need to be targeted. Giving $1,200 to an adult American in lockdown in San Francisco does not save the job of the worker in a local bar that has been forced to close. (It will, of course, help the bar worker pay for basics for a short period of time). In Europe governments are trying to prevent job losses by offering low cost loans, cutting taxes, offering help with wage bills, or just giving money as grants.These seem more likely to keep people in jobs.

Central banks can help elsewhere. Central banks can make sure that there is cash to meet liquidity preference. That prevents an unnecessary credit crisis. They can make sure bond markets are working. That lets governments raise the money needed for fiscal policy. They can try to make sure that banks help with (for instance) mortgage holidays. Central banks can fund and encourage low cost lending to companies.

In phase two the economy will bounce back. When fear of the virus has passed, things will return to normal. This is where traditional stimulus plays a role. If the government is no longer trying to lower GDP, then stimulus will help speed the recovery. Interest rate cuts already in place should boost demand. Less targeted tax cuts and cash handouts may be spent.

Loans help some. Not everyone

All major economies have launched government guaranteed loan programs for firms. These are on a huge scale in some cases. Whether government guaranteed loans will help a firm depends on which part of the economy you are in. Looking just at the effects of the virus on lockdowns and consumer behavior, there are three groups of consumer spending. Around 60% of spending will not change, and may rise. This can be broadly summarized as anything paid for by direct debit, plus essentials. Spending on home insurance does not go down. Spending on food at home will rise. (If people do not eat out, they eat at home instead). Spending on communication will rise with children off school and adults working from home. Firms in these areas have no problem.

Around 15% of spending is delayed spending. A person may not buy new furniture today, because of the lockdown. However, they are just delaying their purchase. When the lockdown ends, they will make the purchase anyway. It makes sense for firms facing with delayed spending to take out a government loan and stay in business. They can repay the loan when the delayed spending happens.

The final 25% of spending is lost spending. If a person does not have a meal at a restaurant today, they do not delay eating until the lockdown ends. If a person is not flying today, they do not fly twice when the lockdown ends. For firms facing lost spending, taking out a loan to stay in business is not so obvious. In the future demand will be normal, and they will be able to meet their normal bills. But it will be difficult to repay the loan if there is no delayed demand.

Those parts of the economy with lost demand will be better helped by direct payments. This could be grants. Targeted help that bring their day to day costs as low as possible would also increase the chance that these firms will stay in business. More importantly, it increases the chance that these firms keep people employed.

What is the cost?

What would it cost to save jobs? A reasonable range is somewhere between 1% and 2% of GDP for every month of lockdown. Not all businesses will need help – it depends on the sector. Help does not have to be 100% of wages (but it does have to be meaningful). To pay the 70% of the wages of half the small businesses in an advanced economy costs around 0.75% of GDP. To that should be added grants for businesses facing lost demand. Some industries may need larger bail outs. A 1% to 2% GDP figure each month is something governments should be able to manage for up to six months of a lockdown.

GDP cannot be saved (for now)

In the near term, GDP cannot be saved. GDP must go down because government policy will force it down. It is the length of the demand dip that matters. If governments avoid very large-scale unemployment, then the bounce back can happen as soon as governments stop trying to cut GDP. If governments fail to save jobs through badly focused policies, the demand drop will become a double demand drop. The economic downturn will then last beyond the virus.

Appendix

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