BOX 3.1 Global economy: A lost decade ahead?

Past global recessions were associated with highly persistent output losses. The pandemic-induced global recession has already reversed a decade or more of per capita income gains in roughly 30 percent of emerging market and developing economies (EMDEs). By 2025, global output is still expected to be 5 percent below the pre-pandemic trend—a cumulative output loss that is equivalent to 36 percent of the world's 2019 output. Policy makers need to undertake comprehensive and credible reform programs to set the stage for stronger long-term growth.

Introduction

After experiencing its worst recession in 2020 since World War II, the global economy is expected to recover in 2021 (figure B3.1.1). However, the pandemic-induced global recession has already turned the 2010s into a lost decade for many emerging market and developing economies (EMDEs; Kose and Sugawara, forthcoming). In about 30 percent of EMDEs, per capita income losses in 2020 reversed ten years or more of gains; in more than half of these economies, at least half a decade of income gains has been reversed. In Latin America and the Caribbean and in the Middle East and North Africa, income gains of at least half a decade were reversed in 80 percent of countries. As a result, the number of people living in poverty, globally, is estimated to rise by more than a hundred million by 2021 compared to pre-pandemic trends, reversing several years of poverty reduction (World Bank 2020b; Lakner et al., forthcoming).

Against this backdrop, this box examines the following questions.

- What were the consequences of past recessions for output?
- How much larger could output losses be in a downside scenario?
- How large have output losses been after previous global recessions?

Consequences of recessions: Large output losses

Past country-specific recessions were associated with persistent output losses. A wide range of factors led to these losses: depressed capacity utilization discouraged investment and led to a legacy of obsolete capacity; elevated uncertainty and expectations of weak growth depressed investment; weak investment delayed the adoption of capital-embodied productivity-enhancing technologies; and protracted unemployment caused losses of human capital and reduced job-search activity.

Five years after the average country-specific recession, potential output was still about 6 percent below baseline in EMDEs (World Bank 2020a). Recessions in EMDEs that were accompanied by financial crises were associated with even larger potential output losses in EMDEs, of 8 percent relative to baseline after five years. The pandemic is likely to exacerbate the trend slowdown in growth of potential output and productivity that had been underway for a decade, particularly by increasing uncertainty about growth prospects, disrupting human capital accumulation, and raising concerns about the viability of global value chains (Dieppe 2020; Kilic Celik, Kose, and Ohnsorge 2020).

Looming danger: Even larger income losses

Output losses in the baseline scenario. Even after the recovery gets underway, there is expected to be a protracted period of below-trend global output, with substantial per capita income losses. In the baseline scenario, global output in 2025 would be about 5 percent below the pre-pandemic trend and there would be a cumulative output loss during 2020-25 equivalent to 36 percent of 2019 global GDP.

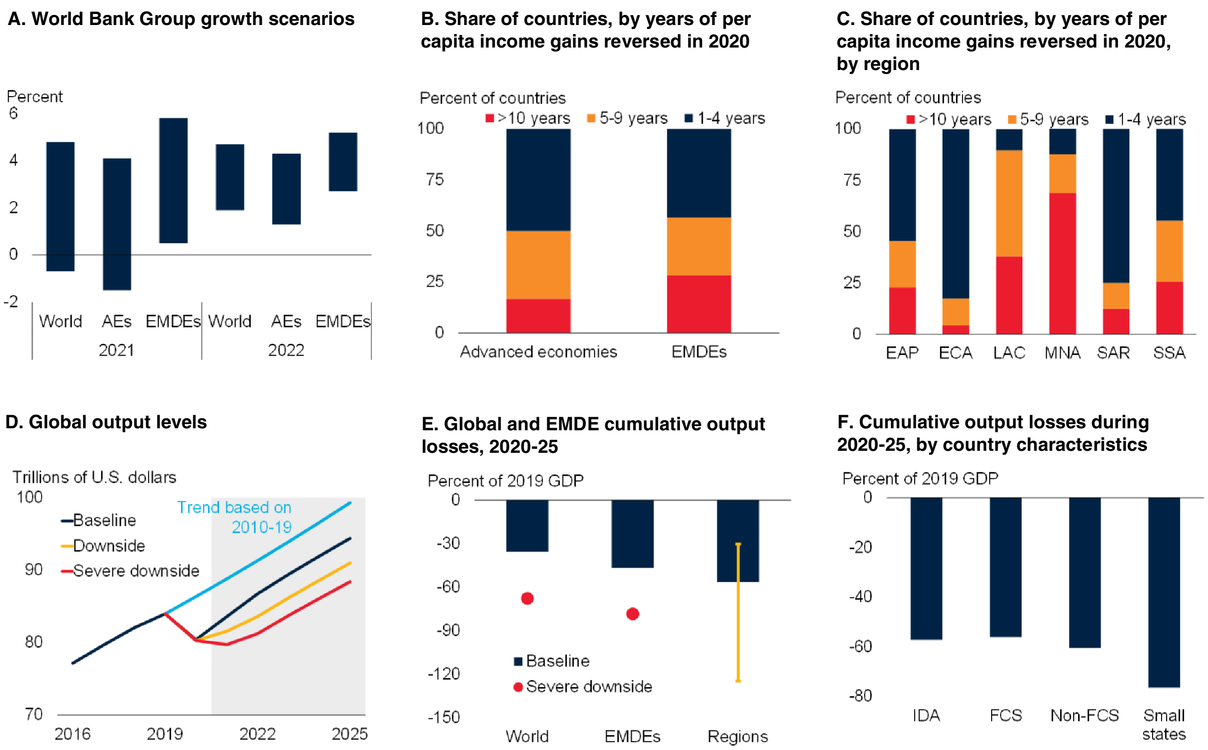
Output losses in risk scenario. A more protracted pandemic than expected could lead to even larger income losses (box 1.4). In a downside scenario of persistently higher caseloads and delayed vaccination, global output in 2025 would be about 8 percent below earlier expectations and there would be a cumulative loss equivalent to 54 percent of 2019 global output. Delays in vaccine deployment could disappoint financial markets and trigger a repricing of risks. Amid record-high debt, higher borrowing costs could tip many firms into bankruptcy, weakening bank balance sheets, possibly to an extent that could trigger a financial crisis. In such a severe downside scenario, global output could contract by another 0.7 percent in 2021. Cumulative output losses over 2020-25 could amount to 68 percent of 2019 output globally and 78 percent of 2019 output for EMDEs, with wide variation across EMDE regions. Small-state IDA countries

Note: This box was prepared by Naotaka Sugawara.

BOX 3.1 Global economy: A lost decade ahead? *(continued)*

FIGURE B3.1.1 Repercussions of the COVID-19 pandemic

The pandemic has already reversed a decade of income gains in a considerable share of countries. It is expected to cause lasting output losses over the next half-decade.



Sources: Consensus Economics; World Bank.

Note: AEs = advanced economies, EMDEs = emerging market and developing economies, EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, SSA = Sub-Saharan Africa.

A. Bars show ranges of growth scenarios for 2021 and 2022, depending on rollout of vaccines and financial stress, as discussed in box 1.4. Aggregate growth calculated using GDP at 2010 prices and market exchange rates as weights.

B.C. The share of countries with per capita income gains reversed in 2020, by the number of years indicated.

D.-F. Data are in U.S. dollars at 2010 prices and market exchange rates. Shaded area indicates forecasts. Trend is assumed to grow at the regression-estimated trend growth rate of 2010-19. For global and EMDE output, baseline output is based on the baseline estimates and forecasts in chapter 1 over 2020-22 and, for 2023-25, is assumed to grow at the rates computed with long-term consensus forecasts surveyed n October 2020. The downside and severe downside scenarios are described in the main text of the chapter and box 1.4. For regions and IDA aggregates, baseline output is assumed to grow at the baseline estimates and forecasts in chapter 1 over 2020-22 and, for 2023-25, is assumed to grow at the same rates as in the trend. Samples for IDA include 70 IDA-eligible countries, including 31 FCS, 39 non-FCS, and 23 small states.

E.F. Bars show cumulative output losses over 2020-25, based on baseline growth forecasts, and, for regions, an average of six EMDE regions is presented. Red circles are based on growth forecasts under the severe downside scenario. A vertical yellow line for regions shows the minimum-maximum range among the six regions. Cumulative losses are computed as deviations from trend in U.S. dollars, expressed as a share of GDP in 2019.

F. "FCS" refers to economies in fragile and conflict-affected situations. "IDA" refers to countries that are eligible to borrow from the International Development Association, the part of the World Bank Group that helps the world's poorest countries.

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generally face larger losses than other IDA countries or EMDEs.

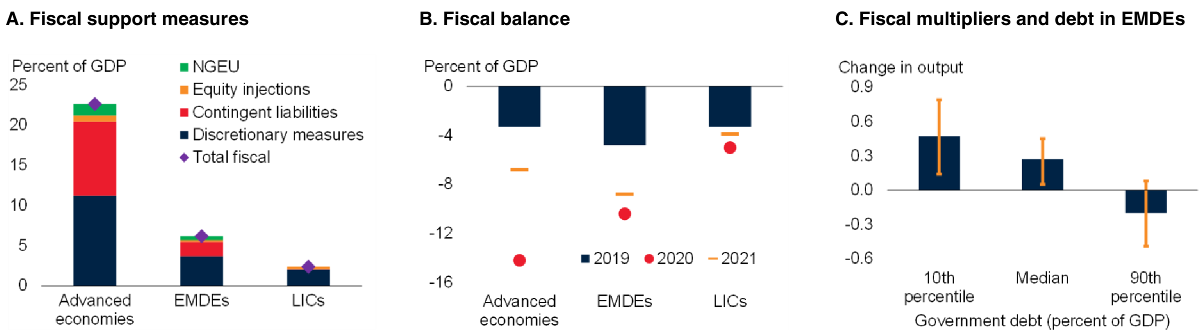
An outcome to avoid: Another lost decade

Large output losses. Like its predecessors, the pandemic-induced global recession will likely lead to highly protracted output losses. In the past, the losses from global recessions were associated with a wide range of factors: depressed capacity utilization; discouraged investment because of uncertainty and weak growth expectations; slower productivity-enhancing technology adoption; and loss of human capital due to persistent unemployment. The pandemic is expected to exacerbate the trend slowdown in potential growth and productivity growth in EMDEs that had already been underway for a decade.

BOX 3.1 Global economy: A lost decade ahead? *(continued)*

FIGURE B3.1.2 Increasing fiscal risks

Fiscal support and economic contractions have raised debt to record-high levels. Unless accompanied by credible commitments to return to sustainable fiscal positions, high debt and deficits can erode the effectiveness of fiscal policy.



Sources: Huidrom et al. (2020); International Monetary Fund; Kose et al. (2020a); World Bank.

Note: EMDEs = emerging market and developing economies, LICs = low-income countries.

A. Fiscal stimulus measures are derived from the October 2020 IMF Fiscal Monitor database and include measures planned or under consideration. Aggregates are the GDP-weighted average of the total fiscal package and its components. “Discretionary measures” includes revenue and expenditure measures; “Contingent liabilities” includes loan guarantee and other quasi-fiscal measures; and “Equity injections” includes equity injections, loans, and asset purchases. “NGEU” refers to Next Generation EU funds. Sample includes 35 advanced economies, 139 EMDEs, and 23 LICs.

B. Aggregates computed with current GDP in U.S. dollars as weights.

C. Bars are the median conditional fiscal multipliers after two years. Fiscal multipliers are the cumulative change in output relative to cumulative change in government consumption to a 1-unit government consumption shock. Orange lines are the 16-84 percent confidence bands.

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Intensifying fiscal risks. Record high debt levels may also weigh on output growth and investment in many EMDEs (box 1.1). In 2019, global total debt reached a historic record of 230 percent of GDP and global government debt rose to 83 percent of GDP (Kose et al. 2020a). Like advanced economies, EMDEs have implemented considerably larger fiscal stimulus programs than in 2009, equivalent to about 6 percent of GDP in 2020 (figure B3.1.2; World Bank 2020a). While appropriate to support aggregate demand and activity and to protect vulnerable groups and sectors during the downturn, such stimulus translated into record fiscal deficits. As a result, global government debt is expected to rise by 17 percentage points of GDP, to 100 percent of GDP in 2021 (IMF 2020b, 2020c). Current low interest rate reduce debt service cost. Nevertheless, unless accompanied by credible commitments to return to sustainable fiscal positions, record-high debt and deficits can erode the effectiveness of fiscal policy (World Bank 2015a, Huidrom et al. 2020). Past episodes of rapid debt accumulation often resulted in financial crises: about one-half of the more than 500 episodes of rapid debt accumulation in EMDEs since 1970 were associated with financial crises within two years of the debt peak, at considerable economic cost (Kose et al. 2020c, World Bank 2020c).

New risks from unconventional monetary policy. Recognizing the benefits of prompt policy action—one of the lessons of the 2009 global recession—many central banks and governments have implemented unprecedented monetary policy easing measures. While this was appropriate to cushion the recession, it may erode the hard-won distance of central banks from political pressures and fiscal authorities in EMDEs where inflation expectations tend to be more poorly anchored (Ha, Kose, and Ohnsorge 2019). If this leads to an upward reassessment of inflation expectations, it could trigger capital outflows, depreciation, and inflationary pressures.

Conclusion

The immediate policy priorities remain to save lives, protect vulnerable groups, and preserve functioning markets. However, increasingly, policy makers need to turn their attention to averting and reversing long-term economic damage from the pandemic by strengthening policies and institutions for a resilient recovery.