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Light at the end of a long tunnel?

By Thomas Lam

NOTWITHSTANDING the breadth and depth of policy responses thus far, the ongoing coronavirus pandemic has clearly emerged as the most dominant threat to the global economic landscape.

But any attempt to pin down the severity and duration of the fallout at this time is extremely challenging insofar as we continue to grapple with the dynamics of the outbreak.

Broadly, however, economists tend to assume that the negative economic imprint from a pandemic is likely to be appreciable but transitory followed by a sharp recovery thereafter.

One option to tease out the likely contours of the current business cycle is simply to analyse very long and varied historical episodes. The United States' inflation-adjusted GDP (gross domestic product) data, which can be extended all the way back to the 19th century on a quarterly basis, is a natural choice. Essentially, the data series reflects a fairly diverse environment, including multiple shocks, crises, wars, epidemics, pandemics, etc.

In light of the historical guidance, we find that the typical average decline in GDP in the preceding episodes, when measured over the initial two quarters, was in the vicinity of 4 per cent to 6 per cent, though the maximum drag was nearly 20 per cent (all in annualised terms).

But given the shockingly weak preliminary data releases thus far, it is probably not unreasonable to witness a GDP contraction of at least 20 per cent annualised on balance during the first two quarters of this year. Also, we find that the historical peak-to-trough duration was usually in a range of two to four quarters.

Therefore, it is plausible that the assumed downshift could endure more than two quarters, possibly at least a year.

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In view of the aforementioned recession assumptions, our econometric exercise – incorporating the rate of contraction, real interest rates and crisis episode identifiers – suggests a GDP recovery of roughly 9 per cent (two quarters from its trough), implying a whopping shortfall of around 10 percentage points.

The estimated underperformance in growth is slightly more than double the previous episode in 2009, which was deemed one of the weakest recoveries in post-war business cycle history. Moreover, if the current deterioration in the economy sparks a financial crisis, then the recovery will likely be even softer, potentially with a shortfall of almost three times the prior episode.

In short, if history is any guide, the current US recession can prospectively be longer, perhaps more dire, followed by a weaker-than-expected recovery. To end on a less-pessimistic note, however, as they say, "history may not repeat itself but it does rhyme".

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