Will the Current Serious Economic Recession Evolve into a Full-fledged Global Economic Depression?

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Theme: Global Economy
Global Research, May 12, 2020

"I was 21 and looking for work in 1932, one of the worst years of the Great Depression, and I can remember one bleak night in the Thirties when my father learned on Christmas Eve that he'd lost his job. To be young in my generation was to feel that your future had been mortgaged out from under you – and that's a tragic mistake we must never allow our leaders to make again. Today's young people must never be held hostage to the mistakes of the past." —***Ronald Reagan*** *(1911-2004), American actor and politician, former Governor of California and 40th U.S. President, 1981-1989, (in an address to the Nation, on Oct. 13, 1982.)*

"In the Great Depression in which I grew up and remember vividly, unemployment was over 25 percent, and over 35 percent where I lived. A grown man would work all day, 16 hours, for a dollar. I remember hundreds of people walking by, people who had come down from the North just to get warm. They would come to our house as beggars even though they might have a college education. People didn't have money. They bartered; they'd trade eggs or pigs. It was just completely different." —***Jimmy Carter*** *(1924-), 39th U.S. president (1977-1981), (in an interview with the St. Louis Post-Dispatch, on Feb. 4, 2009, talking about his book 'An Hour Before Daylight: Memories Of A Rural Boyhood', published in 2001.)*

"The 1929 [Great] Depression was so wide, so deep, and so long because the international economic system was rendered unstable by British inability and U.S. unwillingness to assume responsibility for stabilizing it by discharging five functions: (1) Maintaining a relatively open market for distress goods; (2) providing countercyclical, or at least stable, long term lending; (3) policing a relatively stable system of exchange rates; (4) ensuring the coordination of macroeconomic policies; (5) acting as a lender of last resort by discounting or otherwise providing liquidity in financial crisis." —***Charles Kindleberger*** *(1910-2003), American economic historian, and author of The Great Depression 1929-1939, 1973, revised and enlarged in 1986. (Quote in, The World in Depression, 1929-1939 (2nd ed., 1986), Ch. 14: 'An Explanation of the 1929 Depression'.)*

So far, it can be said that central banks and governments in most advanced economies have acted correctly to prevent the economic lockdown of large segments of the economy from turning into a total economic disaster. They have, at least, saved the day.

At the microeconomic level, nevertheless, there has been costly inefficiency when wage replacement programs had the unintended consequences of creating labor shortages in the very essential sector of health care centers and nursing homes.

Indeed, many deaths caused by the virulent coronavirus occurred in under-staffed institutions, where the contagion remained unchecked for months as some workers quit their job to qualify for a government wage stipend. In the haste to inject money into the economy, funds were dished out to unqualified corporations, which should not have received them. —On the whole, however, the main macroeconomic objectives seem to have been attained and the worse case scenario seems to have been avoided.

It has been estimated, according to a compilation made by Bloomberg, that governments around the world have committed themselves to spending some $ 8 trillion in fiscal measures, excluding central banks' intervention, to prevent their economies from collapsing. The question now is to know if such a large injection of purchasing power has been enough to prevent a severe recession from turning into a long lasting economic depression.

5 to 10 percent decline in GDP, and possibly more, is not out of the question for 2020 in total

In the United States, preliminary figures for the decline in the real Gross Domestic Product (GDP) during the first quarter of 2020 are not giving a complete assessment of the total economic damage caused by social distancing measures and the closure of many businesses. Indeed, it is estimated that the economic decline during the first quarter of 2020 was 4.8% of GDP, at an annual rate. It is reasonable to expect that the second quarter, which runs to the end of June, will likely show a more important decline.

That is why an economic decline of 5 to 10 percent for all of 2020 can be expected in the United States, and possibly even more, if there is a second and a third wave of coronavirus infections in the fall and next winter, as some experts have been predicting.

What to expect in Canada? The International Monetary Fund (IMF) estimates that Canada's real GDP could decline 6.2 per cent in 2020. This assumes that most of the decline would have occurred during the first half of the year, with a rebound during the second half, as the economic lockdown is progressively lifted. —That figure could be too optimistic. As a matter of fact, the Canadian economy is expected to suffer somewhat more from the economic lockdown than the U.S. economy because of the collapse of the relatively important oil sector.

The relative importance of the service sector

It is important to realize that today's advanced economies have a larger share of production of services than of goods or products (primary sector: agriculture, forestry, fishing, mining; secondary sector: construction, manufacturing, energy, etc.). For example, the tertiary service sector (consumer personal services, health care, education, retail and wholesale commerce, financial services, tourism, transportation, media, culture, etc.) accounts for 80 percent of GDP in the United States, and it is also where 80 percent of the jobs are.

In Canada, because of the importance of the resource sector, the service sector accounts for only 70 percent of GDP, but it employs about three quarters of Canadians.

All this to say is that the decline in production during the current economic lockdown is really a loss. This will not be fully recovered when the economy rebounds. There cannot be an inventory of services.

As a preliminary conclusion, we can say that even with an important economic bounce back in the second half of 2020 and in 2021, as many economists expect, this would far from erasing the economic damage already done by the lockdown, during the first half of this year.

In the U.S., a 5 percent decline in real GDP for 2020 as a whole would mean a loss of output of some $1.1 trillion US. However, in the event of a more pessimistic scenario of a 10 percent decline in GDP, this could translate into a loss of output of some $2.1 trillion US.

In Canada, similar percentages would entail a loss of $117 billion CAN, in the first scenario, but a loss of $234 billion CAN, in the second scenario.

A paramount objective: To stop the advent of a persistent structural deflation

The need for central banks and governments to intervene massively in such a time of viral and economic crisis is to prevent the economic downturn from turning into a structural deflation.

A structural or malignant deflation is the result of insufficient demand in an environment of excess capacity, and that may be the consequence of an aging population. The result is a persistent downward pressure on prices and wages. Such an economic condition happens when numerous sectors (ex. financial markets, agriculture, energy, mining, etc.) experience falling prices when firms are forced to reduce prices to move their inventories in an environment of stagnant demand. This results in a drop in profits and in the demand for labor. With a high level of unemployment, wages fall with prices, and a dangerous downward wage-price spiral can be set in motion.

Indeed, when an economy faces declining asset prices, business closings and massive unemployment, banks, companies and consumers with the most debt suffer great financial losses under a crushing debt burden. This could lead to bank closures, loan delinquencies, business defaults and bankruptcies and house mortgage foreclosures… and also to lower prices and wages, and less demand. This could transform an ordinary economic recession into a full-ledged economic depression, with unemployment rates above 20 percent and lasting many years.

Deflation can bring on a destructive debt deflation

In an economy loaded with debts, as is the case presently in many economies, the advent of a structural deflation can signify a death knell for any sustainable future economic growth. Indeed, the Achilles heel of the current economic environment is the historically high level of debt as compared to Gross Domestic Product (GDP).

Here is a quick look at the level of the U.S. total debt picture in mid-2019:

1. Total U.S. corporate debt (nonfinancial corporate debt of large companies, debt of small medium sized enterprises, family businesses, and other business debt) was $15.5 trillion or 72% of American GDP.
2. Total U.S. consumer debt (credit cards, auto loans, student loans, home mortgages and other household debt) was $13.95 trillion or 65.2% of GDP.
3. Total U.S. government debt (outstanding debt owed by the federal government) was $22.7 trillion or 106.1% of GDP.

All together, the total nonfinancial U.S. debt level in 2019 was about $52 trillion or 243% of GDP, for an economy that produces around $22 trillion annually of goods and services. It's like having a 500-pound man riding a pony.

With soaring budget deficits of some $3.7 trillion in 2020-21 and of about $2.0 trillion in 2021-22, the total U.S. government debt alone could reach $27.7 trillion next year.

When there is no expected inflation, governments may rely on the central bank to purchase newly issued treasury bonds and let the money supply increase. This is not an option, however, that is open to heavily indebted private companies and consumers. The latter may have no other choice but to default on their debt, or severely curtail their expenses.

For the immediate future, the economic consequences of such a debt deflation could put an important brake on the strong recovery that many observers expect, once the pandemic crisis has run its course and the economy returns to normal.

The leveraged loan market

To add to all public and private debts, policy makers and regulators should keep an eye on the largely unregulated $1.2 trillion leveraged loans market, which is a market for speculative or low-grade high-yield corporate loans.

These relatively new debt instruments are somewhat reminiscent of the 2007-2008 subprime mortgage fiasco, which led to the 2007-2009 Great recession. They could be the first category of debts to collapse if the current recession were to deepen.

Conclusion

It is very unusual that a major public health issue is intertwined with a major economic decline. In the current double-crisis world, nobody can predict with certainty what will happen in the coming years.

That is why I submit three possible scenarios of things to come: A short-term optimistic scenario in which everything goes as wished; a mid-term stagflation scenario when both inflationary pressure and slow economic growth go side by side; and, a more pessimistic scenario, in which widespread deflation and wrong responses and bad policies combine to push the economy into a prolonged economic depression.

1. An *optimistic scenario*: Everything turns out just right, public bailouts are enough to prevent the onset of a structural deflation, and the unfolding of a dangerous debt deflation spiral is avoided. Unemployment returns to its historical levers. —It is based on the assumption that the threat of a virus contagion fades away permanently, and does not linger on for months, if not for years. Moreover, it is expected that disturbed commercial supply chains are easily reestablished without destructive trade wars.
2. A *mid-term stagflation scenario*: The current state of affairs gives rise to important shortages in certain lines of production; prices jump and there are calls for some form of rationing; and stagflation sets in. Unemployment remains high.
3. A more *pessimistic scenario*: After years of fiscal irresponsibility and the piling on more and more debt, the current economic recession turns into a full-fledged global economic depression and the economy struggles under a process of debt

> deflation. Policy mistakes are made and are a repeat of the 1930's errors, i.e. rising interest rates, a contracting money supply, beggar-thy-neighbor trade policies, which combine to precipitate a worldwide economic depression where every country loses. Unemployment remains stubbornly above 20 percent for many years.

Geopolitically speaking, as judging by some repetitive aggressive rhetoric, again and again, the Trump administration (Trump himself, Pompeo, Kushner, Miller, etc.) seems to be tempted to start a war, commercial or otherwise, with China and/or with Iran. Such an occurrence could throw gasoline onto the fire and turn a bad situation into an economic disaster, with a galloping inflation, even possibly hyperinflation on the horizon. This does not happen often, but such events did occur in the past.

Therefore, there are many reasons why it would seem to be too early to declare victory on the economic front and think that everything will go back to normal, once the viral crisis subsides and the economic lockdown is completely lifted.

—Only time will tell.

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