1 Macroeconomic background

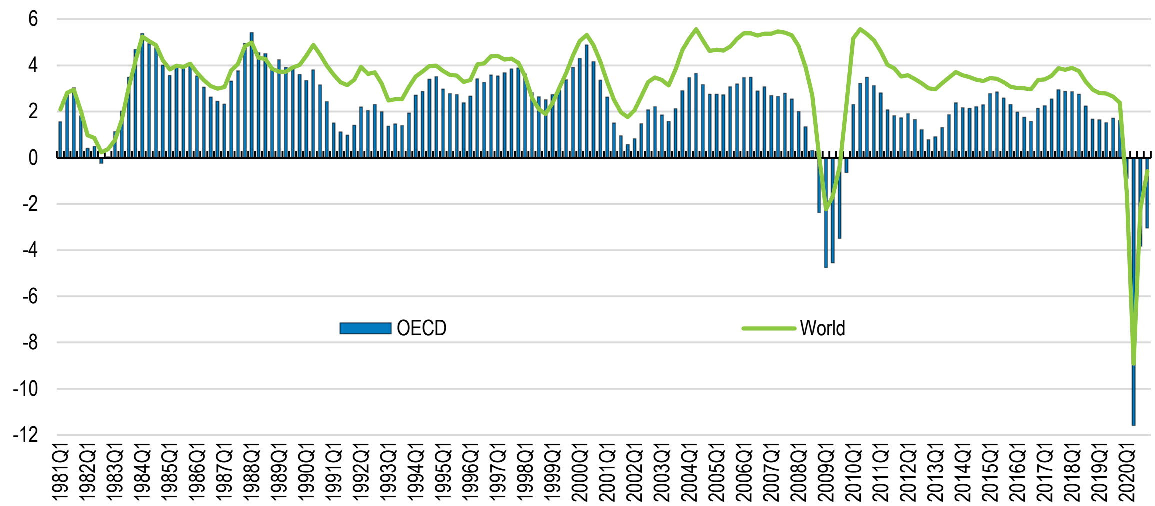
This Chapter provides a general assessment of the macroeconomic situation and outlook. It covers trends in growth, industrial activity, trade, investment, the labour market, public finances and inflation, based on the *OECD Economic Outlook, Interim Report March 2021*. This background is useful to understand the context in which the tax measures discussed in the report were adopted (Chapter 2), but also to identify how tax policy responses may need to evolve in the future (Chapter 3).

1.1. The COVID-19 crisis has been large and widespread

The COVID-19 pandemic continues to have widespread effects on economies and societies. The onset of the crisis saw sharp declines in output in all economies, with the virus spreading around the world. Global output declined by almost 10% in the first half of 2020, a much more rapid and deeper hit than in the global financial crisis (Figure 1.1). The subsequent rebound in output has been stronger than expected, but is far from complete. Output in all countries remained well below the levels expected prior to the pandemic at the end of 2020 (Figure 1.2), with shortfalls of 4¾ and 4¼ per cent in OECD and global GDP, respectively. Without the prompt and effective policy support introduced in all economies to cushion the impact of the shock on household incomes and companies, output and employment would have been substantially weaker.

Figure 1.1. The COVID-19 crisis was deeper than the global financial crisis

Real GDP growth, year-on-year



Note: Aggregates are computed using moving weights in PPP.
Source: OECD Economic Outlook database.

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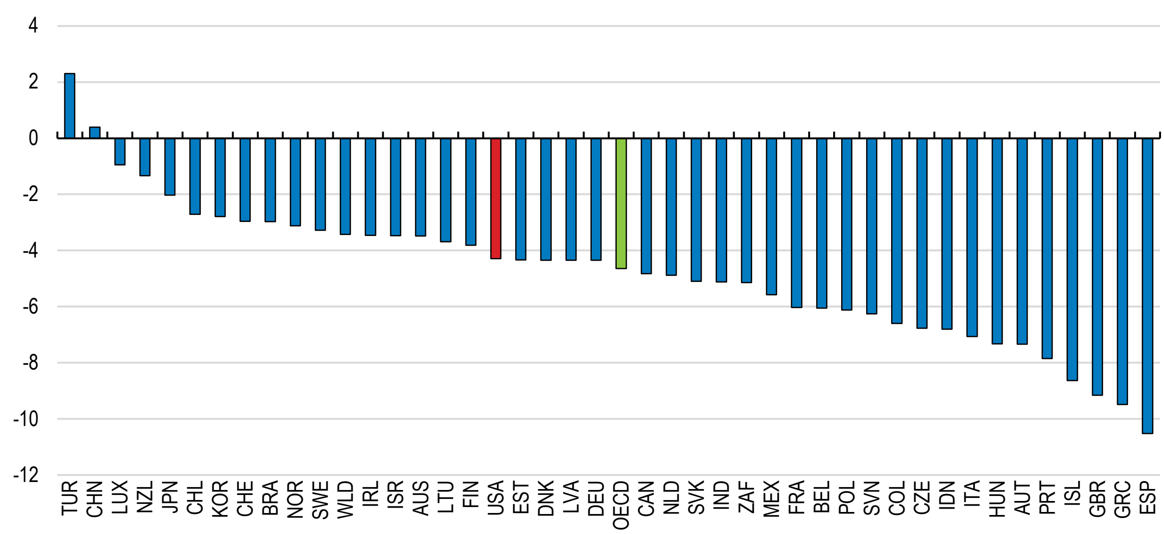
Figure 1.2. The estimated output loss from the COVID-19 crisis is large and widespread

Difference between GDP in 2020Q4 and pre-pandemic projections, per cent



Note: The value corresponds to the difference for the last quarter of 2020 between the latest data and the projection for GDP in the last quarter of 2020 made in the November 2019 OECD Economic Outlook.
Source: OECD Economic Outlook database.

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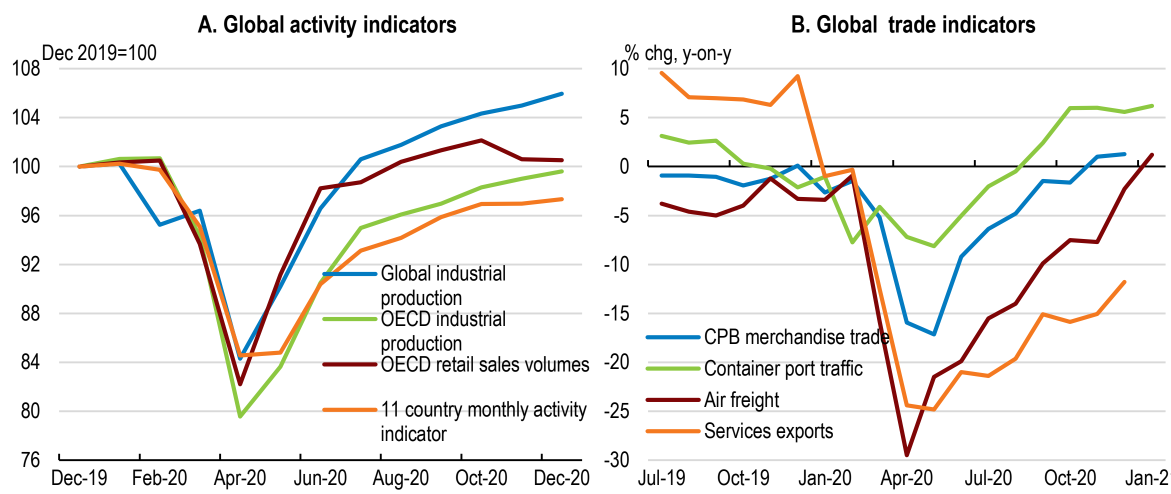
Almost all major countries experienced a year-on-year decline in GDP in 2020. Ireland, China and Turkey were exceptions, helped by lower restrictions on activity and strong fiscal or quasi-fiscal measures, and, for Ireland, strong IT and pharmaceutical exports from the multinational sector. The pandemic affected

China initially, but its economy recovered quickly too, helped by stronger infrastructure spending and strong export growth. Many other Asia-Pacific economies also coped relatively well with the crisis due to spillovers from China and to more effective testing, tracking and tracing policies to reduce virus transmissions. Argentina, Mexico, South Africa, India and most European countries were relatively more affected than elsewhere. This reflects extended disruptions from renewed virus outbreaks and associated reductions in working hours in many service sectors. The different sector specialisation of economies also affected growth, with the economies most dependent on international travel and tourism generally experiencing a larger GDP decline in 2020. All in all, in 2020, global and OECD GDP are estimated to have declined by 3.4% and 4.8% respectively.

Despite further COVID-19 outbreaks in the latter part of 2020, activity was stronger than expected. Containment measures and the associated declines in mobility had a smaller adverse impact on activity than in the early stages of the pandemic. In part, this may reflect a more careful targeting of public health measures and income support. Recent restrictions have focused largely on service sectors with high levels of direct contact between consumers and producers, with manufacturing and construction activities generally affected only mildly. Global industrial production has thus continued to strengthen in recent months and global trade has now returned to pre-pandemic levels (Figure 1.3), supported by the strong demand in IT equipment and medical supplies. However, the impact of a new series of restrictions towards the end of 2020 and the beginning of 2021, affected service sector activities and household consumption in many countries, and slowed the momentum observed in the third quarter of 2020.

Figure 1.3. Industrial activity and trade are rebounding but service sectors have lost momentum



Note: Data in Panel A are PPP-weighted aggregates. The retail sales measure uses monthly household consumption for the United States and the monthly synthetic consumption indicator for Japan. The 11-country activity indicator uses GDP or economy-wide output data for Argentina, Brazil, Canada, Chile, Colombia, Finland, Japan, Korea, Mexico, Norway and the United Kingdom. Data in Panel B are all in volume terms apart from services exports, which are an aggregate of monthly nominal USD exports in 38 countries.
Source: OECD Economic Outlook database; CPB; IATA; RWI/ISL Container Throughput Index; WTO; and OECD calculations.

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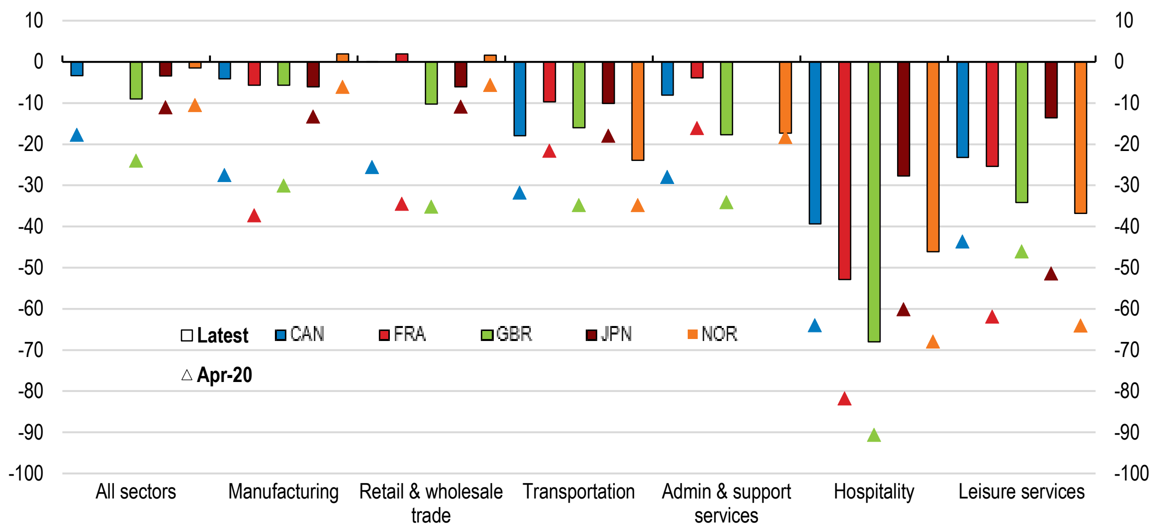
1.2. The recovery has been rapid in some sectors but lagged behind in others

Business survey indicators suggest that manufacturing activity has been particularly buoyant in recent months, including in the euro area and the United States. For services sectors, the situation is more varied with growth observed for some economies while restrictions continue to weigh on activity in other economies, notably in Europe. In particular, activity remains well below pre-crisis levels for hospitality and leisure services despite a significant improvement in other sectors since the trough in April 2020 (Figure 1.4).

Figure 1.4. Output remains depressed for sectors directly facing restrictions

Percentage difference from February 2020



Note: Monthly GDP in Canada, Norway and the United Kingdom, monthly output in Japan and France. Data based on national industrial classifications. Data on all sector output are not available for France, and data on administrative and support services are not available for Japan. Transportation data for Norway exclude ocean transport. Latest data are for January 2021 in Norway and the United Kingdom, and December 2020 in the other countries.
Source: Office of National Statistics, United Kingdom; Ministry of Economy, Trade and Industry, Japan; Insee, France; Statistics Canada; Statistics Norway; and OECD calculations.

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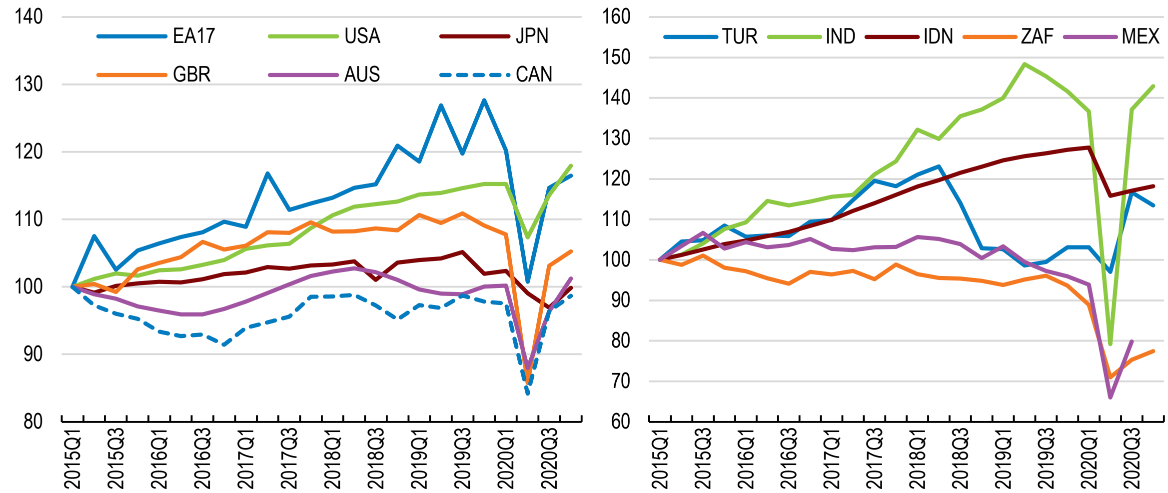
The crisis had a significant impact on gross fixed capital formation, with a large fall in the first half of 2020 across most countries (Figure 1.5). Despite continued uncertainty, investment has rebounded in several economies, for example in Australia, Canada and the United States, with volumes close to pre-crisis levels at the end of 2020. Equipment investment has been strong in several countries, helped by new investments in the IT equipment and systems needed for remote working. Housing investment has also picked up, helped by favourable financing conditions. Substantial government support has also helped many firms to stay in business and helped to ensure the continued availability of external finance. Nonetheless, this carries risks, as some supported firms may ultimately prove unviable, and higher leverage on corporate balance sheets could be a medium-term drag on firms' ability to operate and invest.

Figure 1.5. The recovery in gross fixed capital formation has been mixed

Index 2015 Q1 =100



Note: EA17: Euro area (17 OECD countries).
Source: OECD Economic Outlook database.

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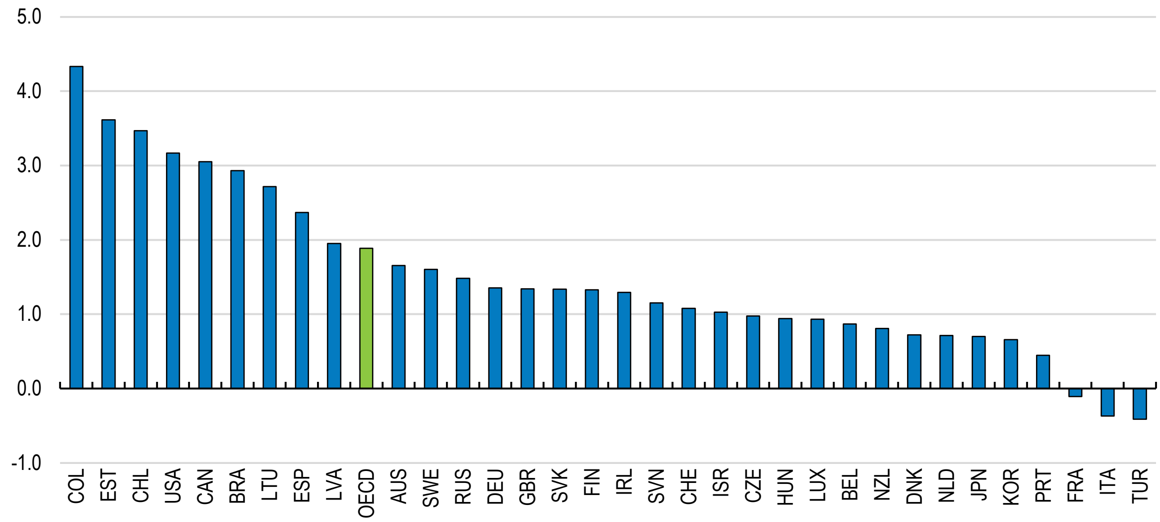
1.3. The labour market has shown some resilience but could be affected in the longer term

In the aftermath of the crisis labour markets remain weak, but the impact on unemployment has been relatively contained so far (Figure 1.6). Although activity at the end of 2020 was well below the pre-pandemic level in many countries, the OECD-wide unemployment rate was only 2 percentage points higher than at the end of 2019. Massive government support programmes helped to maintain jobs in many OECD countries, preventing workers from losing their jobs while their workplaces were shut. The United States did not implement particular employment-supporting programmes, and the US unemployment rate surged by nearly 10 percentage points in the second quarter of 2020 before falling quickly as the economy re-opened. In several OECD countries, notably in Europe, the claimant unemployment rate through 2020 barely changed and even decreased slightly in France and Italy. Nonetheless, the employment rate declined in almost all OECD countries over the year to the fourth quarter of 2020, dropping by 1¼-percentage points in the median economy.

The labour market crisis particularly affected women, who tend to work more in services such as hospitality and tourism that have been subject to strong containment measures. During 2020, the female unemployment rate increased more sharply than the male unemployment rate in many OECD countries (Figure 1.7). However, the situation changed during 2020: for example, in the United States, where unemployment surged in the second quarter, the female unemployment rate increased by an additional two percentage points compared to men, before it declined faster for women in the rest of the year.

Figure 1.6. The increase in unemployment has been contained

Change in the unemployment rate between 2020Q4 and 2019Q4, in percentage points of the labour force



Source: OECD Economic Outlook database.

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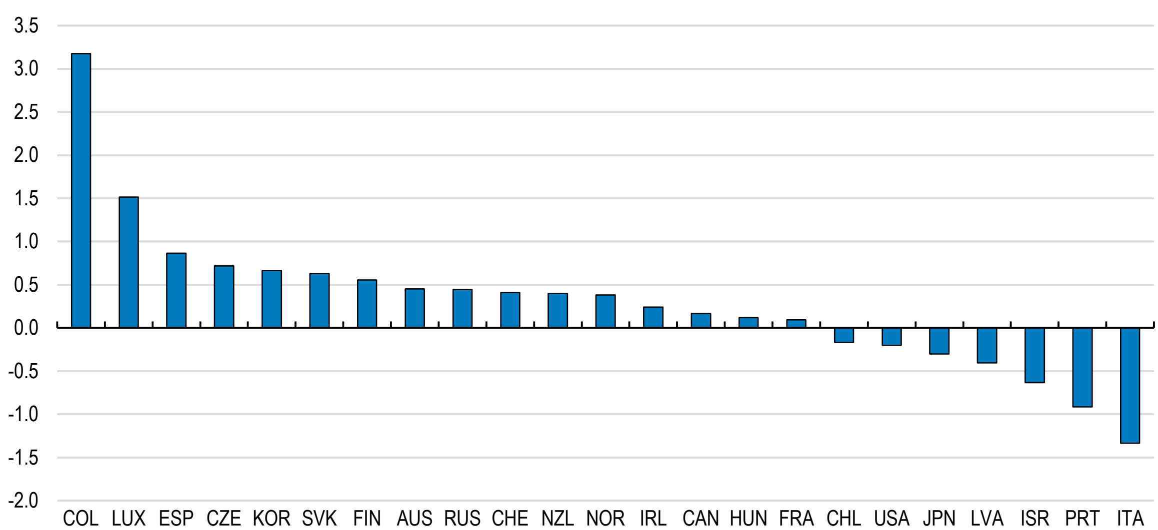
Figure 1.7. The increase in female unemployment has been relatively sharp

Difference in the year-on-year increase of the unemployment rate in 2020Q4 between women and men, in percentage points of the labour force



Source: OECD, Labour Market Statistics database.

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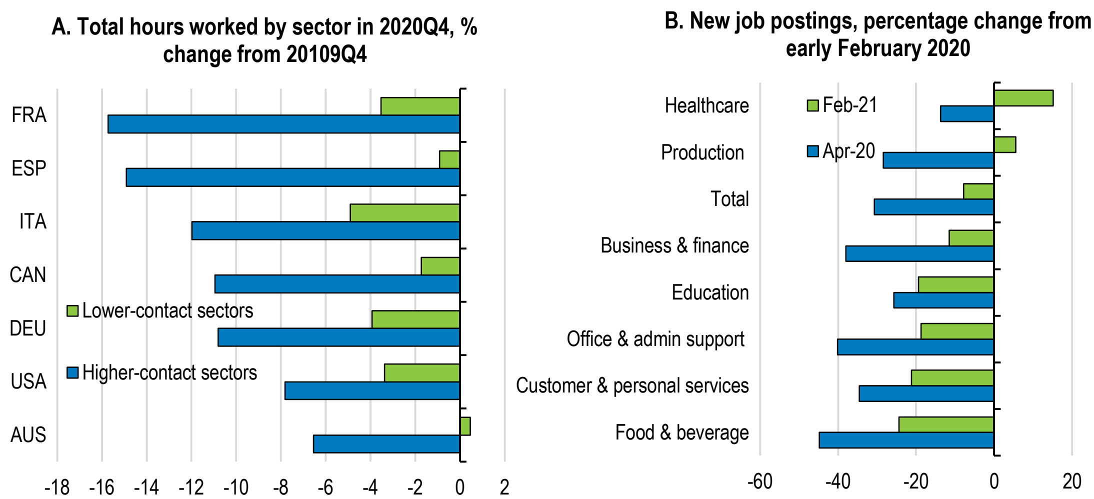
The employment situation remains particularly vulnerable in sectors with close contacts between consumers and producers, with total hours worked remaining significantly below pre-pandemic levels (Figure 1.8, Panel A). The crisis is likely to require some labour and capital reallocation from unviable businesses to growing ones, although the extent remains uncertain. Some sectors most affected by physical distancing requirements and associated changes in consumer preferences may be permanently smaller after the crisis. A lasting shift towards remote working, reductions in business travel and the increasing digital delivery of services, including e-commerce, could also change the mix of jobs available and the location of many workplaces (Figure 1.8, Panel B).

Figure 1.8. Part of changes in the labour market could become permanent



Note: In Panel A, high-contact sectors are ones with high social interactions between consumers and producers. These include retail and wholesale trade, accommodation and food services, transportation and storage, arts and entertainment, and other personal services. Data in panel B are seasonally-adjusted online job postings by type of occupation and aggregated over 20 countries. April 2020 and February 2021 respectively refer to the weeks 24-30 April 2020 and 21-27 February 2021.
Source: OECD Economic Outlook database; Bureau of Economic Analysis; Statistics Canada; Australian Bureau of Statistics; Statistics Bureau, Japan; Eurostat; Office for National Statistics; Indeed; and OECD calculations.

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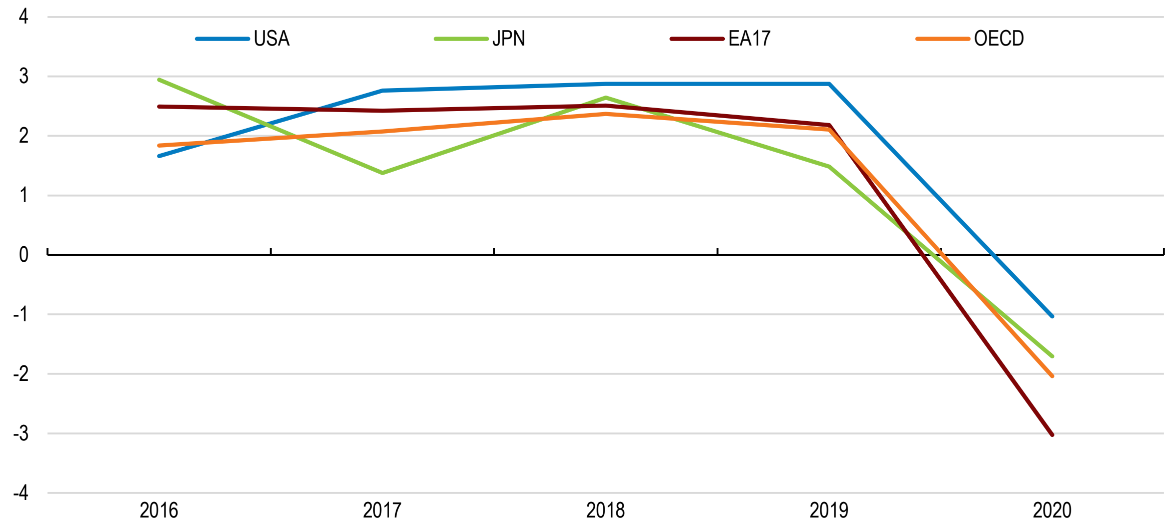
With the fall in activity and higher unemployment, real labour compensation declined by around 2% for the OECD as a whole in 2020 (with a fall of 0.7% in nominal compensation) (Figure 1.9). The fall was particularly large in the euro area (above 3%), and smaller in the United States (about 1%). This reflects lower employment in 2020 and a composition effect that varies according to the size and the degree of protection of jobs in low-wage sectors. For example, in the United States, the increase in unemployment was higher, and more low-wage workers lost their jobs, giving a positive compositional effect on economy-wide compensation per employee.

Figure 1.9. Labour compensation fell across the OECD

Real labour compensation growth rate, in per cent



Note: EA17: Euro area (17 OECD countries). Total labour compensation (wages plus social security contributions) deflated by the private consumption deflator.
Source: OECD Economic Outlook database.

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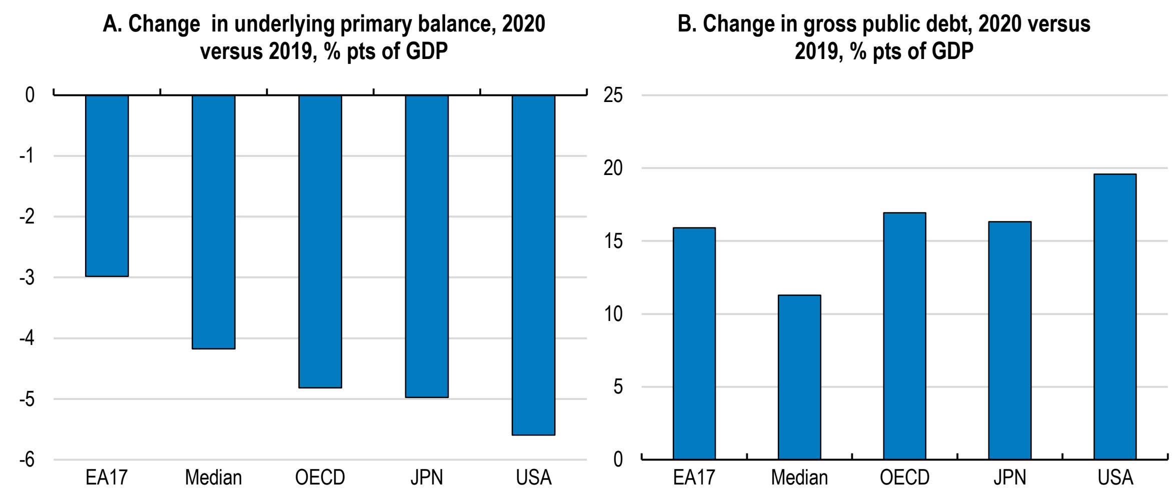
1.4. Fiscal policy has played a major role during the crisis

Strong and timely fiscal support since the onset of the pandemic has played a vital role in supporting incomes and preserving jobs and businesses. Estimates for the OECD as a whole in 2020 suggest an increase of 5 percentage points of GDP in the primary deficit adjusted for the economic cycle (a measure of the fiscal stance); and an increase of nearly 17 percentage points of GDP for gross public debt (Figure 1.10). These increases were particularly significant in the United States but smaller in the euro area.

Figure 1.10. Public finances deteriorated quickly in 2020

Estimates based on projections



Note: EA17: Euro area (17 OECD countries). Projections based on information available as of November 2020. Median refers to the median OECD country for the associated metric. Public debt refers to the Maastricht definition for the euro area.
Source: OECD Economic Outlook 108 database.

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Notwithstanding the substantial rise in government liabilities, debt-servicing costs remain low, helped by the space provided by very accommodative monetary policy. For example, in Canada, gross public debt increased by nearly 35 percentage points of GDP in 2020 while gross interest payments remained the same. Government bond yields declined in 2020 as the monetary policy stance became more accommodative (Figure 1.12), but have begun to edge up as prospects for a stronger global economic recovery have improved. Amongst major emerging-market economies, the fall in interest rates was also generalised during 2020. There has been a recent increase for China, which recovered earlier from the crisis.

The extent of fiscal support is likely to vary significantly across economies over the next two years, with substantial extra spending in the United States (Box 1.1), and to a lesser extent Japan and Canada, but limited discretionary measures in others. This is particularly so in Europe, unless already agreed spending plans at the level of the European Union are implemented earlier than anticipated. Nonetheless, budget deficits will remain large, as appropriate, and the automatic fiscal stabilisers should be allowed to operate fully. The initial broad support to the whole economy will need to evolve towards more targeted support to the hardest-hit sectors as the recovery progresses, facilitating labour and capital reallocation from sectors facing structural demand weakness.

Box 1.1. The American Rescue Plan

In December 2020, a package of measures worth USD 900 billion (4% of GDP) was introduced, which boosted household incomes and, to a smaller extent, consumer spending at the start of 2021. The American Rescue Plan of USD 1.9 trillion (about 9% of GDP), which passed Congress in March 2021, provides a considerably larger additional stimulus that should raise aggregate demand substantially in the United States, with welcome spillovers for activity around the world. The main provisions of the Plan are:

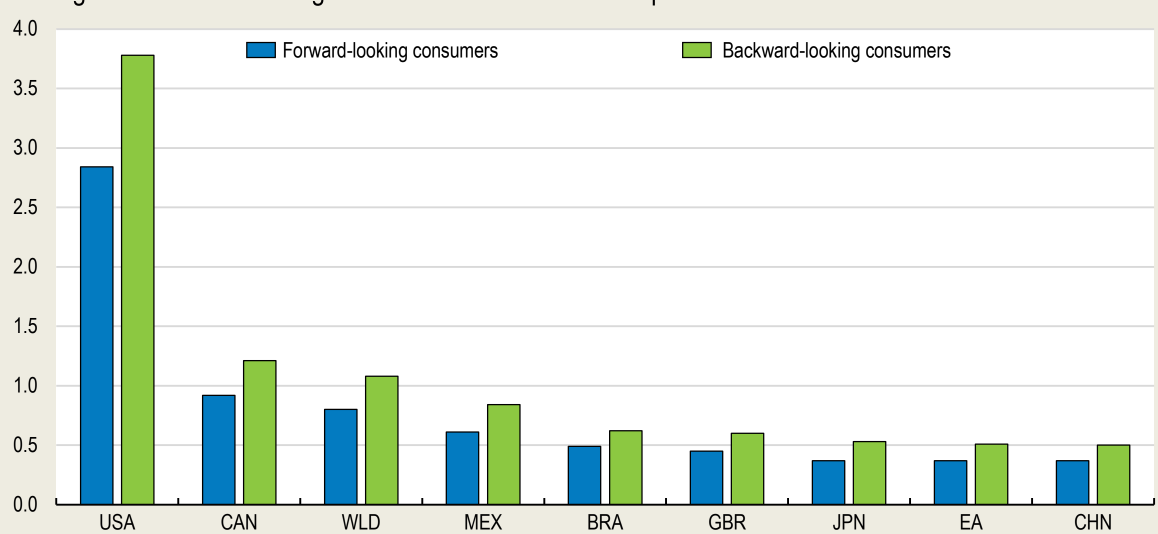
- Direct USD 1400 payments to households. The payments will phase out above earnings of USD 75,000 for individuals and USD 150,000 for a couple. Initial total costing: USD 425 billion.
- Financial aid to state and local governments. Initial total costing: USD 370 billion.
- Supplementary unemployment benefits of USD 300 per week will be extended until 6 September. Initial total costing: USD 290 billion.
- Childcare and schools support. Initial costing: USD 357 billion.

Illustrative simulations on the NiGEM global macroeconomic model suggest that the measures in the American Rescue Plan could raise US output by around 3-4 per cent on average in the first full year of the package (from 2021Q2 to 2022Q1) (OECD, 2021[1]). The US upturn also helps to stimulate demand in all other economies, and would boost global GDP by around 1% during this period.

The near-term impact of the US fiscal package is relatively large with backward-looking consumers, reflecting the greater sensitivity of their spending to current income developments and the impact of higher government transfer payments. In contrast, forward-looking consumers, more focused on the lifetime income path of incomes and the potential budgetary offset from higher tax payments in the future, spend less of the stimulus. Nonetheless, in both scenarios, there are substantial near-term gains to US output, and the risk of lasting supply-side damage from a slow recovery from the COVID-19 pandemic has been reduced considerably.

Figure 1.11. The GDP impact of the American Rescue Plan will be sizeable

Percentage difference on average from baseline over first four quarters



Note: The chart shows the average percentage difference in GDP relative to baseline over the first full year of the package (2021Q2-2022Q1). Simulation of the planned fiscal stimulus in the United States set out in the American Rescue Plan. The new measures are worth up to USD 1.9 trillion (around 8 ½ per cent of baseline GDP). Measures are assumed to take effect over 2021Q2-2022Q2. Policy interest rates remain unchanged in the United States and other advanced economies until mid-2022, but are endogenous in the emerging-market economies.

Source: OECD calculations using the NiGEM macroeconomic model.

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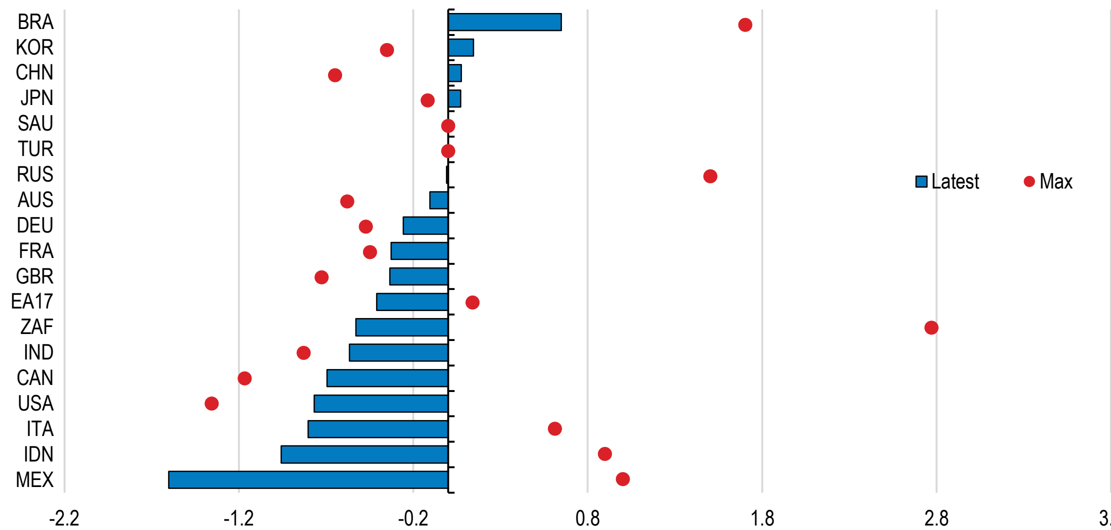
Figure 1.12. Accommodative monetary policies pushed down 10-year government bond yields during 2020

Percentage points change



Note: “Latest” refers to the change between end-2019 and the latest available data up to 20 February. “Max” refers to the maximum change since end-2019. Based on a 10-day average of daily observations.
Source: Refinitiv; and OECD calculations.

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1.5. The outlook highlights the risk of divergence across economies

The successful development and gradual deployment of effective vaccines has improved prospects for a durable recovery significantly, provided steps are taken to ensure that such vaccines are deployed fully throughout the world, and supportive fiscal and monetary policies continue to underpin demand. Nevertheless, uncertainty is still high, with the virus and its variants continuing to spread across the globe, and the possibility of further targeted restrictions on mobility and activity being implemented as new outbreaks occur. Such restrictions would check the pace at which the most affected service sectors and tourism-dependent economies can rebound.

The March 2021 OECD Interim Economic Outlook projects global GDP growth of 5.6% for 2021 and 4% for 2022. However, the recent signs of increasing divergence across economies may persist. Many factors could lead to diverging outcomes across regions: differing pace of vaccination deployment; varying degrees of policy support; uneven scope to lower accumulated saving; and the sector specialisation of economies.

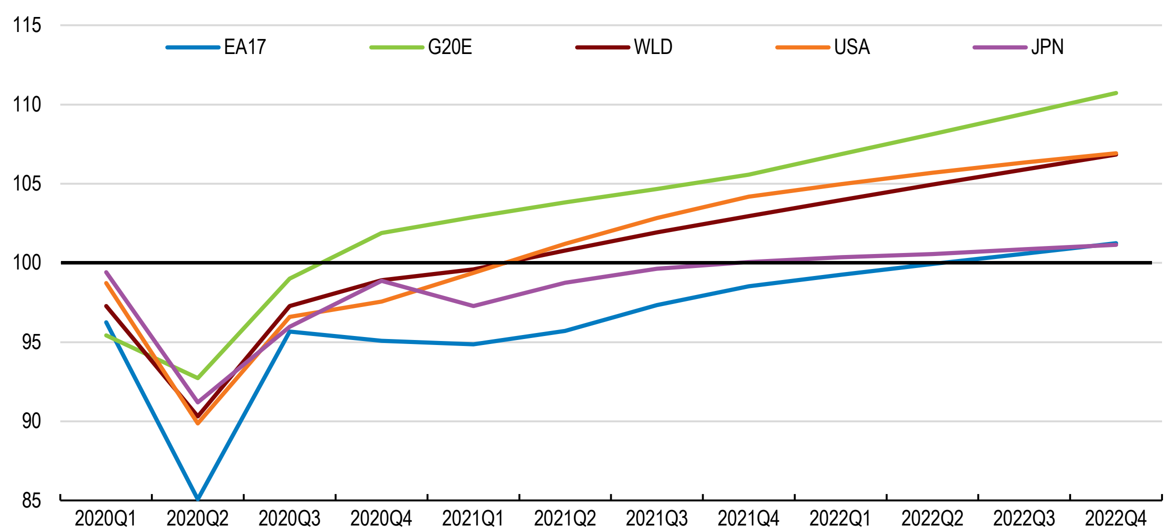
Overall, the global economy is expected to recover to its pre-pandemic output level by mid-2021 (Figure 1.13). This milestone was attained in the fourth quarter of 2020 for the G20 emerging-market economies as a whole, thanks to the strong recovery in China and Turkey. In contrast, GDP in some economies, may only surpass the fourth quarter of 2019 level at the end of 2021 or well into 2022. The economic impact of the pandemic and its aftermath remains well contained in many Asia Pacific economies, reflecting effective public health measures, and the significant regional boost provided by the upturn in industrial activity and the rebound in China. Additional fiscal support will also help the recovery in Japan and India. In the United States, strong fiscal support should strengthen demand substantially and enable a stronger recovery from the pandemic, with beneficial spillovers for other economies, particularly

Canada and Mexico. A more gradual upturn appears likely in the major European economies, reflecting continued containment measures in the early part of 2021 and more limited fiscal support, although the acceleration of vaccine deployment should help momentum to build, particularly in the United Kingdom. Emerging-market economies in Latin America and Africa are also facing a renewed resurgence of the virus, and the slow pace of vaccine deployment and limited scope for additional policy support is likely to moderate the recovery.

The longer the period before the adult population is vaccinated in all countries, the longer the global crisis will last, accentuating economic costs and the risk of lasting scarring effects. Vaccination rates vary greatly across countries, slowing the pace at which their economies can fully reopen (Figure 1.14). A faster pace of vaccination will allow restrictions to be lifted earlier for some countries, such as Israel, the United Kingdom and the United States, while easing is expected to come later in 2021 for others, notably in continental Europe. The global deployment of vaccinations is crucial if all restrictions to mobility and social interactions are to be lifted entirely.

Figure 1.13. Economies are projected to rebound at different rates

Real GDP relative to 2019Q4



Note: EA17: Euro area (17 OECD countries). G20E stands for emerging-market economies that are G20 members.
Source: OECD Economic Outlook database.

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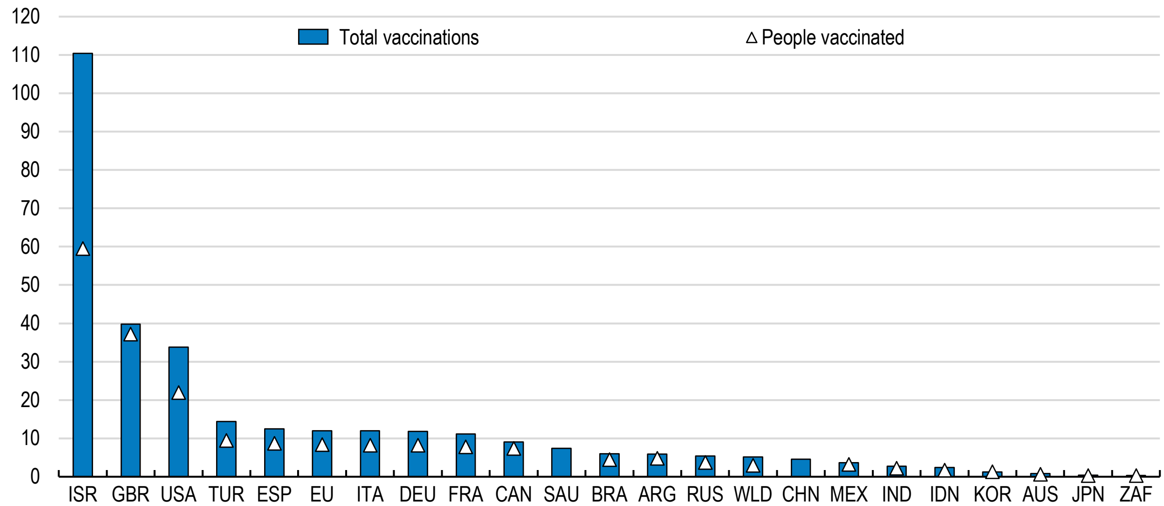
Detailed scenarios highlight the large risks around the growth outlook. If vaccine production and deployment are not fast enough to stop virus transmissions, global GDP growth could be reduced by close to 1 percentage point in 2021 and 1¼ percentage point in 2022. Confidence would remain weak for longer and spending would slow, especially if renewed restrictions during the latter half of 2021 were to be required. This downside scenario would raise the chances of long-lasting costs from the pandemic. Alternatively, on the upside, a faster pace of vaccination production and deployment would hasten relaxation of containment measures, boost consumer and business confidence, and lift global GDP growth by 1½ and 1 percentage point in 2021 and 2022 respectively, taking it to 7% and 5%.

Figure 1.14. The pace of COVID-19 vaccination deployment differs substantially across countries

Per hundred people, 17 March 2021 or latest available



Note: 13 March for Australia; 15 March for France; and 16 March for Germany and the United Kingdom.
Source: Our World in Data vaccination database, accessed March 18, 2021.

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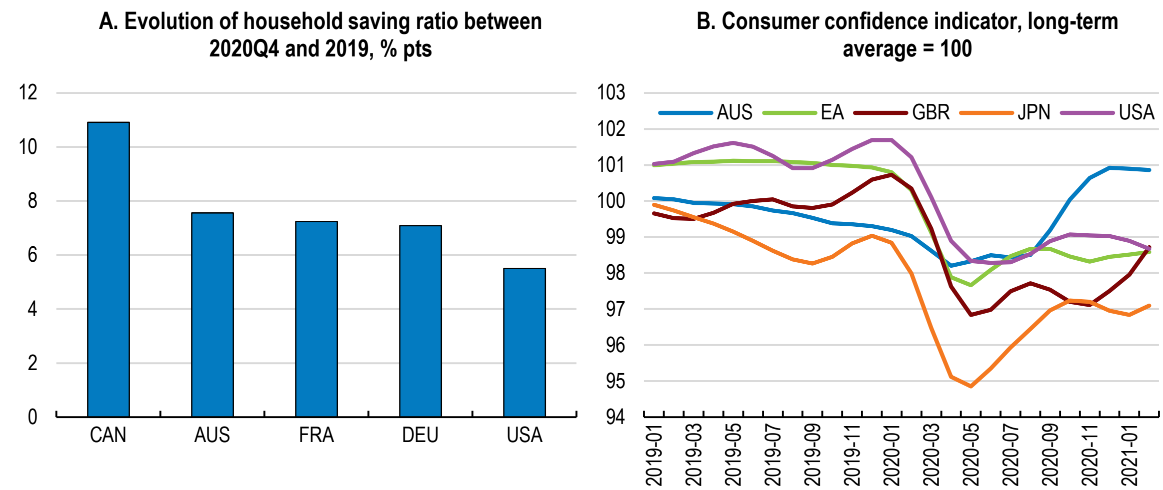
1.6. Prospects for a full recovery depend on restoring consumer confidence

One condition for the recovery to fully materialise is the use of cumulated household saving for consumption. Household saving rates in 2020 rose well above pre-crisis levels (Figure 1.15, Panel A). The rise was due both to precautionary – standard in a period of crisis – and involuntary factors, with spending, notably for certain services, constrained for several months. There are also delays before stronger government income support to households feeds into higher consumption.

At the beginning of 2021, consumers remained cautious, in part due to continued confinement measures in many countries, and confidence was still below pre-pandemic levels (Figure 1.15, Panel B). The deployment of vaccines should gradually restore confidence as the pandemic eases, helping to reduce precautionary saving and free pent-up demand, but the pace at which this will occur is uncertain. This highlights the need for a fast and worldwide vaccination rollout.

Figure 1.15. Higher household saving can translate into higher future demand if confidence rises



Source: OECD Economic Outlook database; Insee; and OECD Main Economic Indicators database.

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1.7. Headline inflation receded during the crisis but cost pressures have recently increased

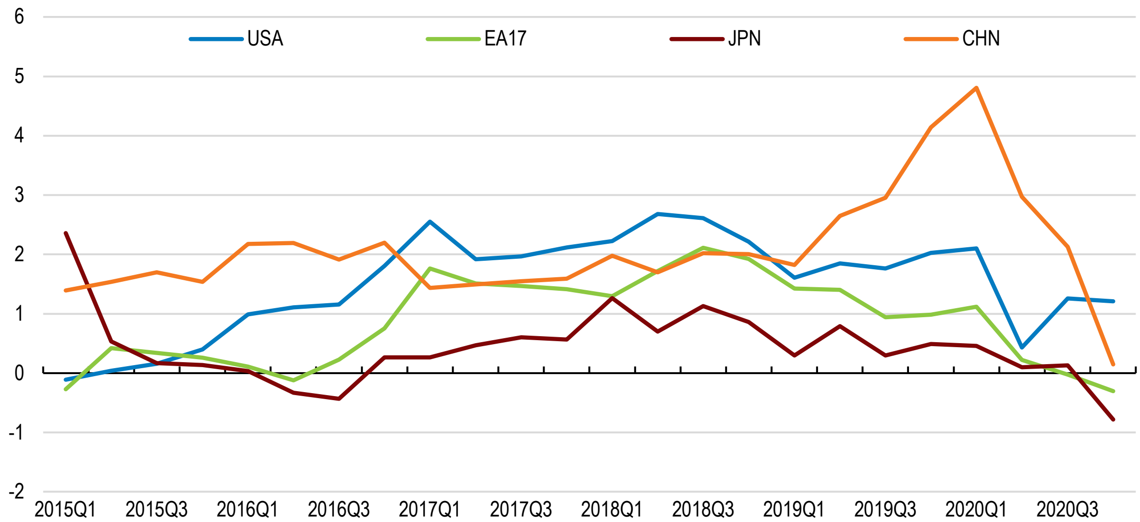
The annual headline inflation rate eased during 2020 and by the end of the year was zero or negative in China, Japan and the euro area, and 1% in the United States (Figure 1.16). Although supply disruptions associated with the pandemic were apparent in the prices of some goods and services, the forces weighing on aggregate demand around the world dampened underlying price pressures through most of 2020. Global commodity prices were also at low levels throughout much of 2020 as well.

Some of these factors have started to unwind as the recovery has progressed, and headline inflation has begun to pick up. By February 2021, the headline inflation rate reached 1¾ per cent in the United States and 1% in the euro area (year-on-year). Commodity prices as well as survey-based measures of input prices have recently risen (Figure 1.17). Oil prices are now broadly in line with their 2019 average, and food and metals prices have reached levels last seen in the early 2010s. Supply shortfalls have emerged in some sectors, as the global recovery was faster than anticipated while it takes time to restore full capacity. Shipping prices in certain regions have increased sharply especially from China.

Some sectors, notably semi-conductors, have also experienced difficulties in meeting the demand from the rapid and global recovery in manufacturing. Nonetheless, underlying price pressures still generally remain mild in the advanced economies, reflecting sizeable spare capacity and still weak labour markets, and temporary price pressures in particular sectors should gradually abate. Amongst the emerging-market economies, inflation is expected to increase more in net commodity importers. Price pressures could also increase if domestic currencies were to depreciate due to higher capital inflows attracted by rising relative returns in the United States.

Figure 1.16. Headline inflation decreased through 2020

Year-on-year percentage change



Note: EA17: Euro area (17 OECD countries).
Source: OECD Economic Outlook database.

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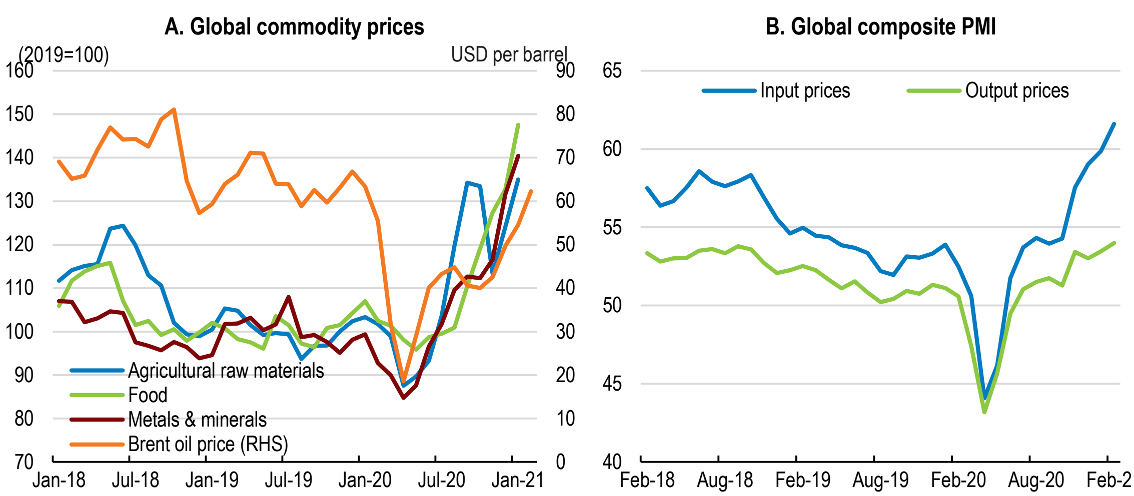
Figure 1.17. Cost pressures have recently begun to increase



Source: Refinitiv; and Markit.

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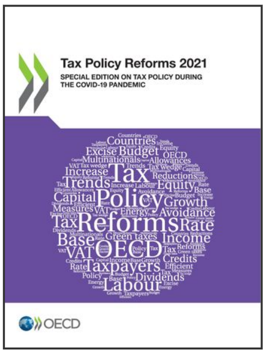

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