Coronavirus: economic threat, political response and implications

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Theme
What will be the economic impact of the coronavirus and what economic policy responses are required by this unprecedented situation?

Summary
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Analysis
Introduction
It is still too early to know the final economic impact of the COVID-19 global pandemic. The impact will depend on whether the virus can be brought under control in the second quarter of the year or whether its effects will be longer lasting, accompanied by further economic complications, particularly in the financial sector. The first scenario will result in a softer V-shaped impact, which would only see global production fall by a few tenths of a percentage point. However, the impact under the second scenario could be much more complex, as anticipated by the OECD, which notes that global growth for 2020 could be halved, falling to 1.5%. It now seems increasingly likely that this figure will be revised downwards.

So far, economic news on the virus has remained focused on the spectacular fall in stock markets and the urgent analysis of the macroeconomic impact, which will necessarily be highly speculative in light of the current radical uncertainty. On this point, there is little more to add: financial markets exhibit herd behaviour and fear drives cascading sell-offs and the flight to safe-haven assets such as gold and US Treasuries, accompanied by a strengthening dollar and falling prices of oil and other commodities. However, if we can prevent these effects from spreading or take measures to bolster confidence, we may see movements in the opposite direction, all of which means we should prepare for high levels of volatility over the coming weeks. Regarding the negative impact on growth, unfortunately it is already clear that even a V-shaped recovery (in contrast to a U-shaped one) will have profound and lasting effects. Any future rebound will not fully compensate for the fall in activity we are seeing and it is becoming increasingly clear that the most critical phase will last longer than initially envisaged.
Unsurprisingly, the slowdown will first be felt in China— the origin of the epidemic— and will be strong, given the Asian giant’s enormous influence on its neighbours (and beyond), which stems from the key role it plays as a supplier of intermediate and final goods throughout the world (China is the source of 12% of global exports, a four-fold increase over the last 15 years). It is likely that the economic impact on the EU, the US and other countries will be uneven and felt later, in the second and third quarters of 2020. It is probable that Italy (and perhaps Germany) will enter into recession, while the impact on economies like Spain, which were growing faster but are more dependent on tourism (a sector that will be badly hit), remains to be seen. The final economic outcome will depend on the effectiveness of confinement measures (quarantines, social distancing and the closure or cancellation of public gatherings and events), the challenge of managing fear among the public and the effects of the fiscal and monetary measures that are being taken. It will be especially important to avoid serious problems for financial stability and business solvency, particularly restrictions on business loans and increases in sovereign borrowing, similar to those experienced during the euro crisis and the various crises in emerging countries in recent decades. Finally, cooperation and responsible behaviour by the public will help reduce the impact of the pandemic and the cost of failing to take it seriously (as has been the case with the Trump Administration) will be high.

The difficulties of reacting to a black swan event

Under normal conditions, economies have cycles, which are often smoothed by countercyclical monetary and fiscal policy. This means that short-term macroeconomic forecasts are generally reliable (give or take a tenth of a percentage point), since they indicate a trend. At the start of 2020, the global economy was experiencing a mild slowdown and many of the risks to growth that marked 2019, such as the trade war and the risk of a disorderly Brexit, appeared to have subsided. This resulted in a broad consensus among macroeconomic analysts that 2020 would be a year of growth, albeit at a slower pace than in previous years.

However, when faced with a black swan event, forecasting models often break down. As Nicholas Taleb explains in his seminal book in 2007, black swan events are extremely hard to anticipate and have a major impact, meaning they cause us to rethink the forecasts of our predictive models. The fall of the Berlin Wall and the Soviet bloc in 1989, the September 11 attacks in 2001, the financial crisis of 2008 and the impact of the current COVID-19 pandemic are all examples of black swan events (although it can be argued that the risk of a global pandemic is always present, it is impossible to predict when such an event will occur). None of these risks were foreseen, not even with a low probability, but they have all changed the course of history in one way or another. This is not to say that we should abandon predictive models but we must remember that they are always subject to uncertainty and on occasions like the present, need to be placed in quarantine.

The greatest difficulty is knowing when the current phase of radical uncertainty will end and when it will once again be possible to trust macroeconomic models. For example, the September 11 terrorist attacks resulted in relatively short-lived episodes of panic and uncertainty, causing a minor economic shock, despite major geopolitical implications,
such as the ‘war on terrorism’. In contrast, the macroeconomic impact of the 2008 financial crisis was much greater. Once the uncertainty surrounding the potential collapse of the global financial system had subsided, the real economy fell into a protracted recession, which almost claimed the European single currency among its victims and left deep scars of unemployment and inequality in southern Europe.

The problem lies in anticipating how long the phase of radical uncertainty will last and the damage it will do to the system. It is clear that, at some point, the COVID-19 epidemic will be brought under control at the global level. At this point, economic activity will cease to fall, international trade and the prices of financial assets will rebound and there will be some sort of recovery. However, the fact that the disruption is in an area as sensitive as public health significantly increases the difficulty of designing an effective strategy to minimise its duration. It also increases the probability of making mistakes in the response and complicates European and international coordination, which is essential to bring the problem under control and avoid additional tension and distrust among countries. Moreover, the longer it takes to bring the health situation under control, the more likely it is that there will be additional effects on the economy, such as protracted slowdowns in investment (reducing the potential for growth and causing a collapse in international trade) and even more serious financial problems with unforeseeable consequences.

How to respond: political leadership, coordination, liquidity and stimulus

We are facing an extremely complex situation. Panic in the financial markets and the fear of paralysed consumers require strong political responses and leadership, since technical solutions alone will not be sufficient to restore confidence. Nonetheless, the technical judgement of doctors and epidemiologists is essential (and sometimes more important than political judgement) in responding adequately to the pandemic. It is imperative for public institutions to send a message that ‘somebody is in control’ of the economic response (as was the case in September 2008, with the collapse of Lehman Brothers). However, this message may not be sufficient on its own, given the uncertainty of the public health outlook. In short, we need strong leadership that is able to incorporate the criteria of specialists and coordinate an economic response to minimise the damage of COVID-19 in all areas. In contexts such as the Eurozone—an incomplete monetary union with the risk of each country acting alone—a coordinated response by the different member states and European institutions is especially important, a feat we know is not easy to achieve.

Economic policy will have to respond first to a supply-side shock, followed by a shock to demand. Both are cause for concern and require different responses. Firstly, there is the disruption caused by the closure of factories (beginning with China and gradually followed by other countries), supply problems and complex disruption to supply chains, which have also become much more intense compared to the SARS epidemic (Severe Acute Respiratory Syndrome) in 2003. The Chinese economy is now four times larger and companies throughout the world are even more dependent on Chinese components and intermediate inputs, above all in the automotive, electronics and chemicals sectors. However, this shock to supply, which recalls the shortages of the 1970s oil crises and which may return to normal in the second quarter of 2020, is complemented by a fall in demand, which primarily affects the transport, tourism, trade fairs and events sector and
means an extremely high level of uncertainty that will slow consumption and paralyse activity. To reduce this fear, which is understandable but sometimes exaggerated and irrational, it is essential to inform the public correctly, avoiding exaggeration and sensationalism, and put in place adequate contingency plans. As Keynes famously remarked ‘markets can remain irrational for longer than you can remain solvent’ and herein lies the greatest risk: the panic results in a fall in activity that inflicts damage on the economy from which it will be hard to recover.

Cushioning the impact of this double shock will require imaginative economic policy. As has been the case in China and more recently in Europe, the payment of certain taxes and social security contributions can be deferred and the debts and lines of credit of businesses suffering a temporary drop in sales can be refinanced. However, the commitment of the financial system to refinancing must be accompanied by extraordinary injections of liquidity by central banks to avoid credit crunches. It is important to ensure that any instances in which liquidity dries up—whose greatest effects will be on small and medium businesses—do not give rise to insolvency (which increases unemployment), all of which means providing liquidity to the system, ensuring banks refinance the debts of customers facing difficulties in making payments.

A monetary policy response based on lowering interest rates is unhelpful, since rates are already at record lows and such a course of action is unlikely to incentivise the public to increase consumption if people are worried about the future. As such, well-defined and carefully targeted support is essential. The surprise rate cuts of half a percentage point by the US Federal Reserve and the Bank of England at the start of March, which aimed to shore up confidence, do not seem to have worked. Moreover, they have the potential to result in a currency war if other countries perceive them as a form of devaluation. A coordinated response by the world’s main central banks (European Central Bank, Federal Reserve, Central Bank of China, Bank of Japan and Bank of England) would almost certainly have been more effective. Concerted action would have sent a much more powerful signal that political authorities are willing to provide a strong response, avoiding competitive devaluations and helping prevent global deflation caused by the collapse in demand, which would be extremely dangerous given the high levels of debt.

It remains to be seen if the communiqué by the G7 leaders in March to bolster confidence will be matched by coordinated policies in the coming months. One of the best outcomes would be for the G20 to design a fiscal stimulus package like the one used to fight the Great Recession in 2009. However, this seems unlikely while the Trump Administration continues to downplay the full scale of the pandemic. If fiscal expansion is designed to allow money to quickly reach the real economy (which would require increased spending and not tax cuts), it could cushion the blow to GDP over the coming months. However, it is advisable for countries with higher fiscal margins to spend more to prevent increased debt undermining the sustainability of public accounts in countries facing difficulties, as was the case during the financial crisis. Regardless, given the need to include fiscal policy in the response to the pandemic, there is justification for the EU to launch an emergency catastrophe plan with resources from the European budget. The €37 billion announced must be genuine additional funds, over and above existing budgets, and must be invested at a federal European level, coming from projects by the European Investment Bank (EIB) and private financing from the European Stability Mechanism.
(ESM), which could use their precautionary lines of credit or be used imaginatively (which may require modifications to their regulations) to generate pooled resources. All this means we will need to rethink certain elements of the fiscal rules of the Stability and Growth Pact, which are already being revised to address their excessive complexity and tendency to incentivise pro-cyclical policies. At the national level, it is necessary to ensure there are is no reluctance to use public funds to purchase medical equipment and recruit health workers due to fears of reprimands from Brussels, although it is even more important to design a coordinated European response based on solidarity. Just as Brexit has finally come to pass, the EU has the opportunity to show it can step up to the mark. Perhaps this crisis will give new impetus to European monetary union.

Long-term outlook

Beyond the immediate economic impact, there will be a number of lessons for the future of globalisation and its governance as a result of the COVID-19 crisis. First, it leaves no room for doubt that in a highly interdependent world, in addition to being ineffective, unilateral action is often counter-productive. Multilateral cooperation, coordinated responses and trust in institutions with knowledge and experience (in this case the World Health Organisation) are essential, making the isolationist tendencies and improvisation that have characterised the Trump Administration especially dangerous.

Secondly, we must reflect on whether the advance of globalisation and the deepening of global supply chains have occurred in a disorderly fashion, leaving European countries exposed to intermediate medical supplies from China. It may be time to increase the geographic diversity of sources of supplies and take advantage of 3D printing to give a new impetus to domestic industrial production. This is not to deny the advantages of international specialisation and division of labour. Instead, it means taking advantage of lower costs from new technology to reduce our dependence and increase our autonomy without reducing our capacity for consumption and well-being.

Third, the EU (especially the Eurozone) risks a rerun of its lack of coordination and slow reaction to the global financial crisis in 2008 and the euro crisis in 2013. Moreover, in a context of growing international geopolitical rivalry and the crisis of multilateralism and cooperation, the EU is more necessary than ever at a time when critical situations have the potential to exacerbate divisions. In such an environment, it is imperative to refrain from unilateral action (eg, the restrictions on the exports of medical material announced by Germany, France and Austria) that can open up divisions that can be exploited by external powers to weaken the EU. Moreover, as mentioned, crises of this nature show the need to make progress in integration, both in terms of economic and monetary union and issues related to migration policy, security and the support for European champions in strategic sectors, avoiding Franco-German hegemony.

Fourth, the pandemic will have major geopolitical implications that are still largely unforeseen. We do not know if COVID-19 will strengthen or weaken China. Its apparently effective response to the pandemic (still to be confirmed) may provide a boost for its government. However, if the economy falters or its management of the crisis proves to be less successful, the opposite may occur. The Chinese economy is set to contract in the first quarter of 2020 for the first time since the Cultural Revolution in 1968.
Moreover, the economic crisis triggered by the pandemic may jeopardise the sustainability of public and private debt in some emerging countries, which are experiencing significant capital outflows and weakening currencies, with the associated political and social impacts. Finally, oil prices remain low due to the fall in demand, there will be a significant transfer of revenues from producer countries to consumer countries (including Spain), in addition to major economic issues from the increased vulnerability of exporting countries.

Fifth, and on a positive note, the crisis may have important lessons for the potential and effectiveness of remote working, allowing us to test many of the tools offered by new technology. Learning to harness their full potential will help reduce journeys in cities, reducing greenhouse gas emissions and supporting the fight against climate change. However, this will require leadership and determination from the authorities once the crisis has passed.

**Conclusions**

Governments face a difficult choice between halting economic activity and stopping the pandemic. The sooner strict measures are imposed to halt the spread of the virus and the more drastic they are, the greater the short-term economic impact, although the pandemic will be contained faster. Measures to contain the spread of the virus, such as restrictions on mobility and confinement must be imposed regardless (in the worst case when the health system collapses but ideally before).

The economic impact for Europe in the second quarter of 2020 will be severe. However, a relatively swift recovery is still possible if the shutdown is restricted to a few months, requiring a strong economic policy response at both the fiscal and monetary levels and sufficient leadership and coordination to control panic among the general public. More cohesive and civic societies are better placed to tackle the threat, since an excess of individualism over the coming months could lead to disaster.

Finally, this crisis highlights some of the risks of hyper-globalisation, incomplete economic and monetary union and an EU that lacks sufficient political integration. All of this makes it another wake-up call for Europeans.