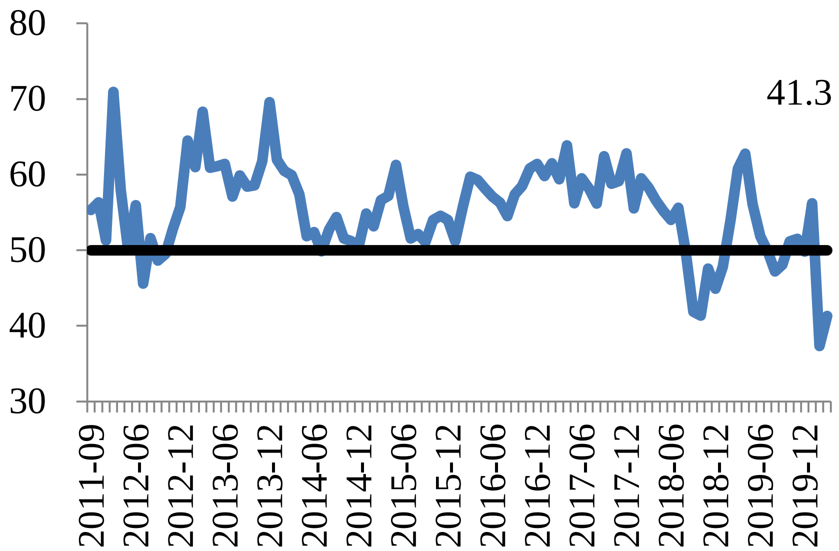
Triple global economic shock from COVID-19

Commentary on the March 2020 CKGSB Business Conditions Index

Written By Professor Li Wei

Last month, the CKGSB Business Conditions Index (BCI) hit rock bottom at 37.3, and this month, as people have begun returning to work, a rebound of sorts is reflected in the improved score of 41.3 (Figure 1). However, in light of the ongoing and evolving pandemic, which means the impact of government policies in various places will experience a time lag, the rebound remains minimal.

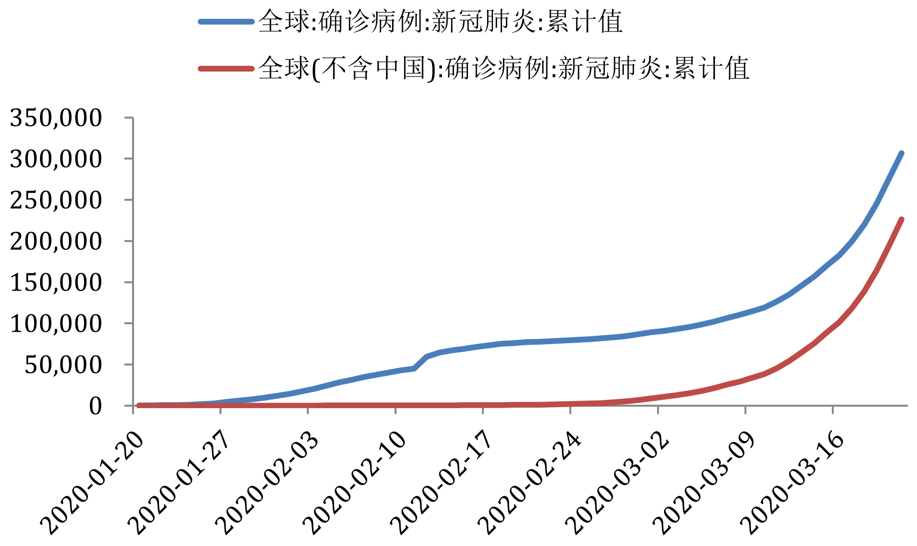
Figure 1 **Business Conditions Index (BCI)**



Source: CKGSB Case Center and Center for Economic Research

With China's novel coronavirus outbreak appearing to ebb away, overseas infection rates have intensified and states of emergency have been called across the world. The WHO has labeled the Covid-19 outbreak a "global pandemic."

Figure 2 **Accumulated Covid-19 infections**



Date accessed: March 21, 2020
Note: globally infected (blue) and globally infected not including China (red)
Source: Wind

There are currently two main issues of concern to most people. The first is how long this coronavirus outbreak will last, and the second is what impact it will have on the economy and what we can do about it? Regarding the first question, this is to a large extent the work of medical scientists, especially epidemiologists, and outside the author's remit. However, on the second question, as an economist, the author is keen to dig deeper.

This pandemic will likely have a bigger impact on the global economy than the financial crisis of 2008. At that time, the US unemployment rate soared to 10% (according to figures recorded in October 2009). Before the WHO labeled the novel coronavirus a global pandemic, the unemployment rate in the US was low. But as epidemic spreads, more and more companies are announcing will find it hard to turn a profit, and layoffs and pay cuts will inevitably mount. Our February BCI survey recorded a devastating drop to China's private economy. March's data is slightly more positive, but most analysts have underestimated the impact of Covid-19 on the global economy.

I believe coronavirus has thrown three devastating punches at the global economy. The first hit is on the supply side, forcing a large number of companies to stop work and their employees to remain at home. The second hammered the demand side, with investment demand shrinking sharply, and consumer demand for non-essential items (such as new cars) ceasing to exist. While the real economy was hit by both demand and supply side curveballs, the financial markets and institutions are bearing a third blow due to panic: subsequent liquidity runs have seen companies granted emergency credit lines as well as investors sell off their liquid assets in crisis margin calls. Global financial markets were exceptionally fragile last week, with all types of assets being sold off in a rush, including gold, bonds and stocks.

Will the current crisis evolve into something as immense as the Great Depression of the 1930s? In what was probably the worst disaster in modern economic history, US unemployment reached 25%. In general terms, the world is not in as bad a state as during the Great Depression, but we caution this by reminding readers that unemployment rates have a tendency to lag. The financial system is spooked, and there is considerable uncertainty about how the economy will shift going forward. Even if we don't end up with another Great Depression on our hands, we still need to take precautions.

Aftershock therapy

Across the world, pandemic responses and their results have varied widely. In the earliest severely affected areas of China, the number of patients has now dropped significantly, and new cases are largely imported. The number of patients has since increased rapidly in Europe and the US, with huge numbers of cases stemming from northern Italy.

How should we deal with this situation? First of all, a humanitarian attitude is key. If a city needs to be locked down, or a person quarantined, this has to happen. After all, in the face of life-threatening danger, all other goals are relegated to second place. However, the side effects of locking down cities are massive, which makes precision isolation a better solution. It is preferably for all those in close contact with a Covid-19 patient to self-isolate rather than for everyone in a certain city to be forced to stay put.

However, the premise for precision isolation is that there must be reliable detection methods that can quickly and easily screen the population for carriers, so that different treatment measures can be implemented. Europe and the US have not done a good job in this regard, underestimating the impact the virus would have. While Hubei was in the thick of it, Europe and the United States could have invested in research and development and mass production of testing reagents.

What can governments do now? In addition to diagnosing and treating patients and isolating close contacts, they really should be promoting the development and production of vaccines. On this issue, governments may need to play a larger role, as the public will be very price-sensitive regarding vaccines. If the price is too high, too few people will be vaccinated, and the goal will not be achieved. If the price is too low, companies will lack motivation to carry out research and development. Vaccines are public health products, so government subsidies may be needed to increase company incentives and encourage public buy-in.

It wasn't until we were able to control smallpox and the plague before economic development took off and the disease spectrum changed dramatically. Epidemics that had raged in the past have been replaced by chronic diseases such as cardiovascular and cerebrovascular diseases, cancer, and Alzheimer's as the main causes of death. The scientific development has therefore turned its attentions to chronic diseases, as infectious diseases rarely invade our lives so persistently.

Occasionally, such as with SARS, we have confronted an outbreak, won, and relaxed afterwards. COVID-19 reminds us that calamitous infectious diseases are never far beneath the surface of our regular lives, and at least some of our resources should be used to solve this.

The government must encourage pharmaceutical companies to develop vaccines and transfer resources to fight infectious diseases. So what should companies do? They simply need to resume work as soon as possible. The experience of many countries has shown that the economy is not a light switch to be turned on and off at will. Once an economy has stalled, restarting it takes time. For one, it's hard to bring back workers, and hard to match your upstream and downstream industries following a shutdown. In short, the economy as a whole cannot simply be restored as soon as things are safe again.

My doctoral dissertation in the 1990s focused on the upheavals of the Soviet Union. The Soviet Union adopted a shock therapy reform method and made a drastic transition from a planned economy to a market economy. Massive supply side chaos ensued. Companies that had only managed production in the past, handing their goods over to the national planning departments for distribution, were suddenly responsible for price setting. When these shock therapy reforms started, firms thought they could ask for prices like a monopolist. As a result, a lot of negotiations broke down and the supply chain fell apart. With these attempts at reform, the value of the Soviet Union economy fell by between 30% and 50%.

From this example, we know that a supply chain cannot simply change from one state to another, as it will contain a large number of explicit and hidden costs. Fixing a broken supply chain can be achieved, but at considerable cost.

We are now seeing a similar situation in China. To maintain the health of workers and prevent the recurrence of the epidemic, the government has put a lot of pressure on companies, which simply responded by shutting down work. This will inevitably damage the supply chain and result in even later company reopenings. The more companies remain closed, the greater the confusion and losses incurred.

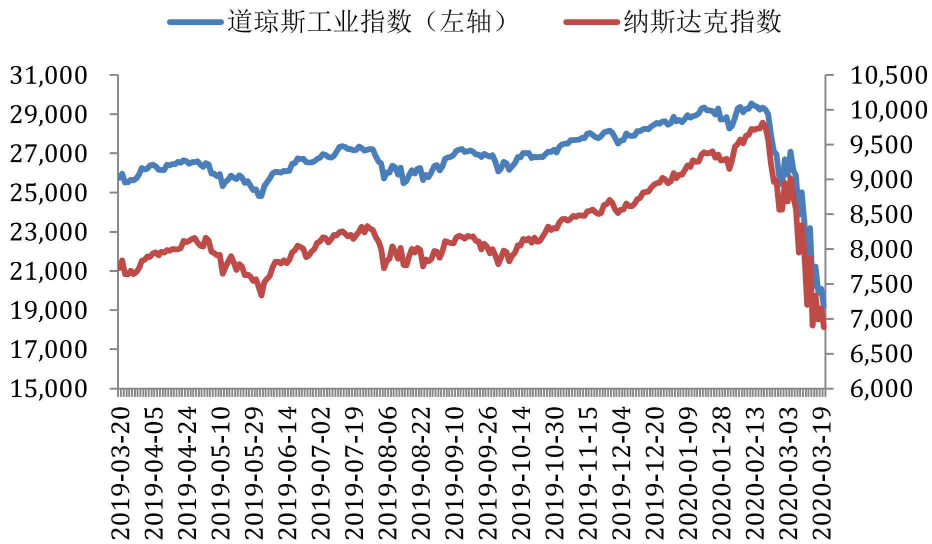
The government has its own ideas and companies have their own pressures. It is hard to say who is right and who is wrong. Is it possible to change mechanisms to solve such problems? For example, a third party mechanism could be introduced to transfer risk to a third party through insurance, so that the cost of the risk is reflected in real time on the price tag, and minimized.

From the demand side, lockdowns and other measures have directly hit economic development. In this regard, we are now facing a double blow of supply-side and demand-side shocks. We clearly have a serious situation on our hands.

Financial crisis

Financial markets have also attracted much attention. Stock market crashes in the last month are on the scale of a major financial crisis (Figure 5, Figure 6).

Figure 5 2019-2020 stock index values

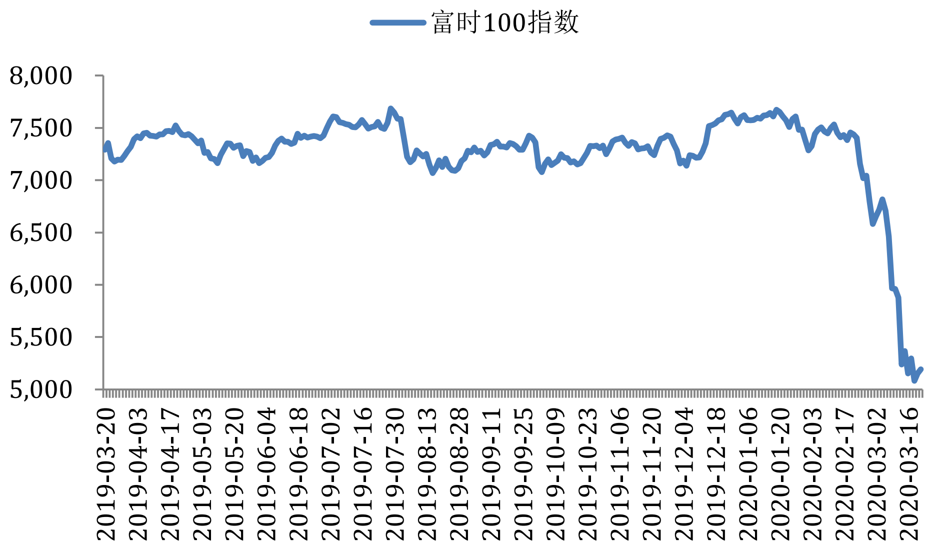


Note: Dow Jones (blue line); NASDAQ (red line)

Data accessed March 20, 2020

Source: Wind

Figure 2 Forbes 100 Index

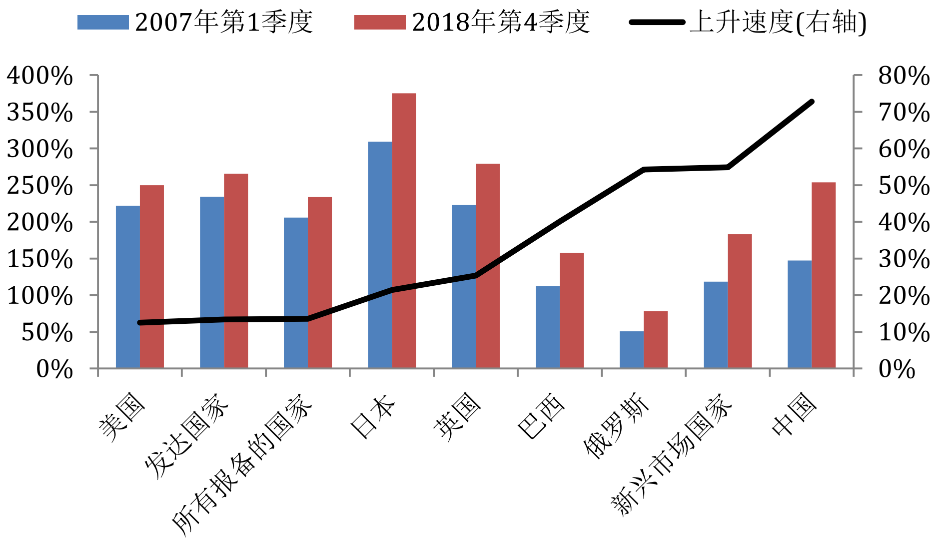


Data accessed March 20, 2020

Source: Wind

The financial freefall is unprecedented, but today’s problems were actually sown a while ago. After the global financial crisis in 2008, in order to confront the negative effects of the crisis on the economy, governments across the world employed major stimulus policies. This mean significantly increased leverage ratios in each country, especially China (Figure 7).

Figure 3



Note: Q1 2007 (blue bars); Q4 2018 (red bars); Speed of increase (black line)

Horizontal axis from left to right: US, Developed Countries, Other reporting countries, Japan, UK, Brazil, Russia, New Developing Countries, China

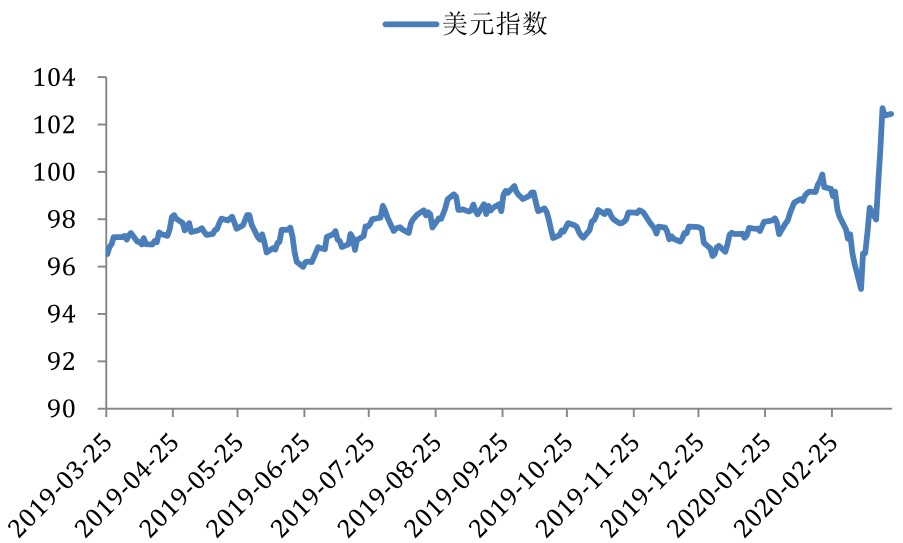
Vertical axis on the left shows the ratio of total public debt to GDP. China is not the absolute highest, but it is rising the fastest.

Source: Bank of International Settlements.

This is true of public and private institutions as well as enterprises. Because the bull market in the US has been ongoing for a while now, shadowy entities such as hedge funds have adopted aggressive trading methods, growing the market bubble. Hedge funds are usually sound, but they are afraid of encountering a black swan incident once in 50 years or even 100. Once we encounter a black swan event, it will eventually cause large fluctuations in asset prices. We are now seeing sharp fluctuations in oil prices, which may be the effect of a reversal of trading strategies.

With the stock market plummeting, the dollar is once again a safe-haven asset, and its value has risen dramatically (Figure 4).

Figure 4



US Dollar Index

Data accessed March 23, 2020

Source: Wind

The surge in the dollar is actually bad for the US economy, because it hurts US export competitiveness and indirectly damages employment in related industries. This is good for Chinese exporters. But not every Chinese company will be happy especially those who issued a lot of US dollar debt overseas while the US dollar bond interest rate was low. Now with the appreciation of the US dollar, there is added pressure on those with US dollar debts to repay principal and interest. For example, some domestic airlines have been hit by both the epidemic itself, and by the appreciation of the US dollar. Real estate companies such as Evergrande are in the same boat. The problem of US dollar debt has not yet become a crisis, but we must not take it lightly, as debt has always been a pain point for developing countries.

The key issue now is to avoid a liquidity crisis. If a decently run company gets in liquidity trouble, there should be help close at hand.

Obviously, the recent turmoil in the financial market is largely due to the pandemic. Panic has manifested due to a lack of liquidity in the financial market because everyone is hoarding cash. In this case, the central bank must play its role as the lender of last resort and inject sufficient liquidity into the market as soon as possible.

Another point is fiscal policy. The United States has just passed the largest stimulus bill ever seen in history. The key is to use fiscal policies to subsidize companies and individuals that have lost their income due to a market liquidity freeze, so they can avoid bankruptcy. If bad debts break out, the stability of the financial system will be affected. If it is not a question of poor management but simply of liquidity, and the government has to provide support.

The combination of supply side paralysis, demand side decline, coupled with a financial crisis, is extremely rare. I have not seen such a complicated and huge economic storm in modern economic history. Therefore we must remain on guard.

This is a commentary on the CKGSB BCI report for March 2020. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

CKGSB Professor Li Wei

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