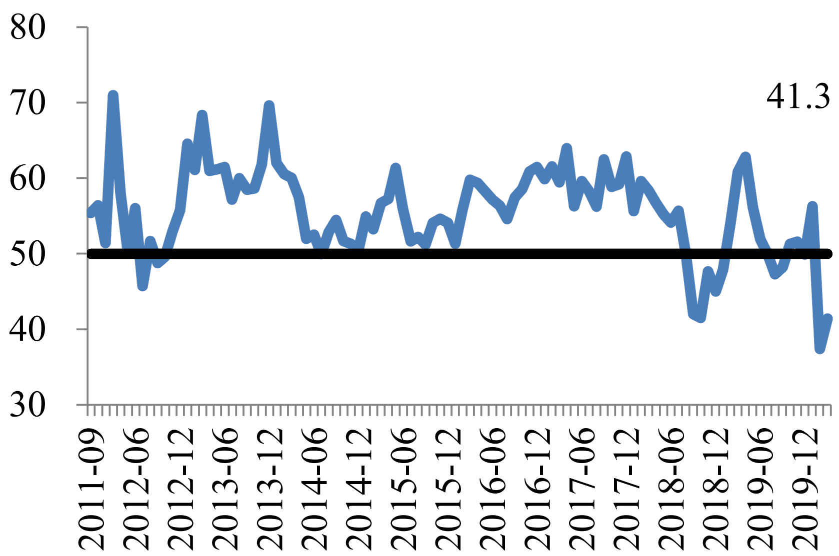
Triple global economic shock from COVID-19 - Commentary on the March 2020 CKGSB Business Conditions Index

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.

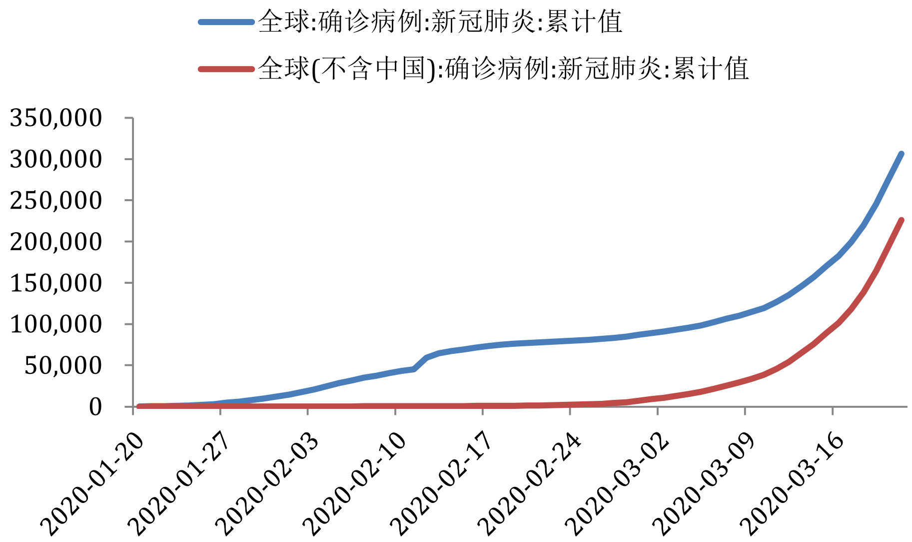
Figure 1 **Business Conditions Index (BCI)**



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 changed its terminology to label the outbreak of Covid-19 a global "pandemic."

Figure 2 **Accumulated Covid-19 infections**



Date accessed: March 21 2020
Note: global sick (red) and sick outside China (blue)
Source: Wind

There are currently two main issues of concern to most people. The first is how long this new coronavirus outbreak will rage, and the second comprises 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.

We should be clear from the outset that 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% (October 2009). It is low in the US at present, but as the epidemic spreads, more and more companies are announcing fire sales. It will be hard to turn a profit, and layoffs and pay cuts will inevitably mount. Italy has it even worse than the US. Our February BCI survey faithfully recorded the devastation to China's private economy of Covid-19. March's data is slightly more positive, but most professional analysts have up to now underestimated the power of Covid-19, especially its impact on the economy.

The author believes this novel coronavirus has thrown three devastating punches at the global economy. In order to effectively block the spread of the virus, governments across the country have closed down towns and villages to break social contact chains. Industry, construction, and offline services have virtually ceased. The global economy has suffered two blows in a short time: the first hit the supply side, forcing a large number of companies to stop work and their employees to remain at home doing nothing. The second hammered the demand side, with investment demand shrinking sharply, and consumer demand for non-essential items (such as new cars) either stopping or being postponed. 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 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 take-up.

It the long run, we should look at precedents: it took until we had smallpox and the plague under control before economic development shot up 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 science of the cure 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 calamatous infectious diseases are never far beneath the surface of our regular lives, and at least some of our resources should be used to solve the kinds of problems they dredge up.

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.

The author wrote his doctoral dissertation in the 1990s and read a lot of articles describing the upheavals of the eastern 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 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 eastern 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 not starting 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 caused.

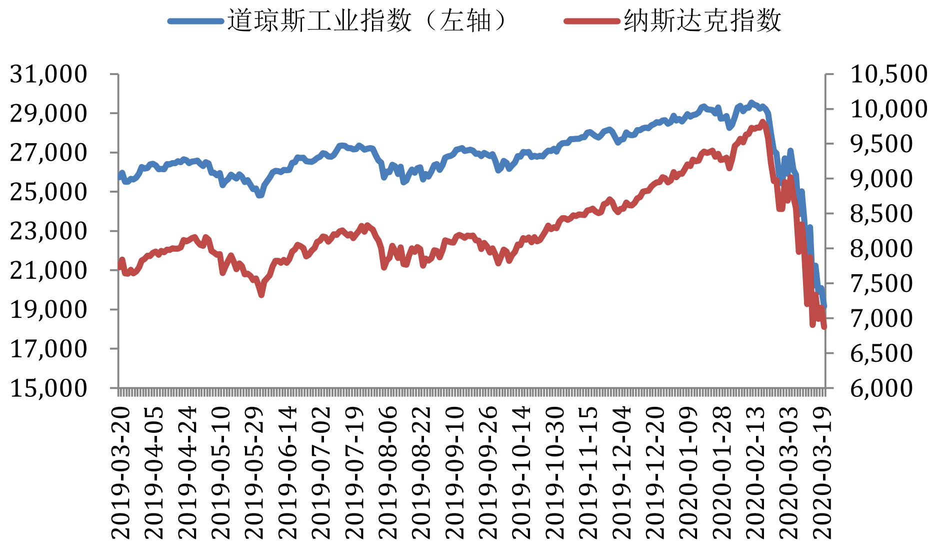
The government has its own ideas and companies have their own pressures. It is hard to say who is right and who is wrong. Is it possible to change mechanisms to solve such problems? For example, a third party mechanism could be introduced to transfer risk to a third party through insurance, so that the 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 and lost a large number of products their market direction. 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 attracted any leftover attention once all the coronavirus pandemic news is absorbed. As they should. 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: Blue line: Dow Jones; Red line: NASDAQ

Data accessed March 20, 2020

Source: Wind

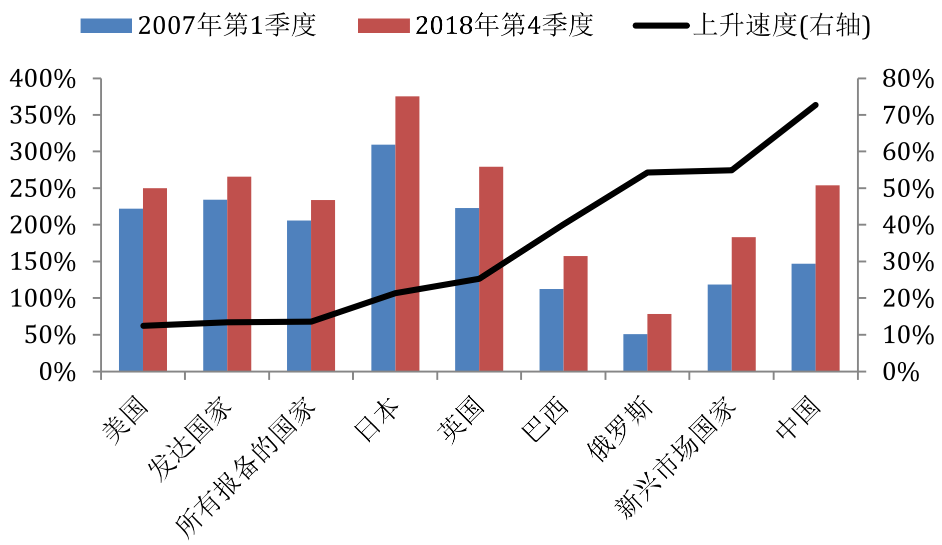
Figure 2 Forbes 100 Index

Data accessed March 20, 2020

Source: Wind

The financial freeze 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



Blue: Q1 2007; Red: Q4 2018; Speed of increase (right axis)

US

Developed Countries

Other reporting countries

Japan

UK

Brazil,

Russia

New Developing Countries

China

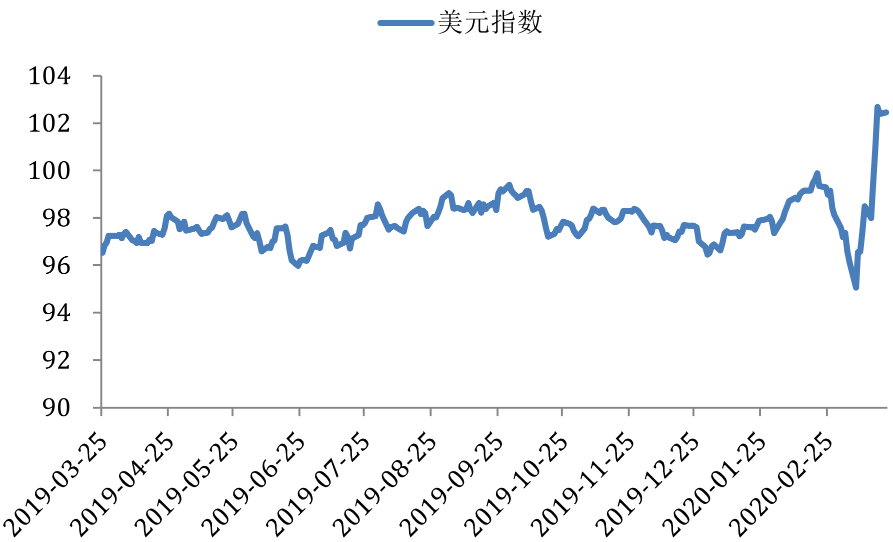
The vertical axis on the left shows the ratio of total public debt to GDP. China is not the absolute highest, but it is rising the fastest.

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 entitites such as hedge funds have adopted aggressive trading methods, growing the market bubble yet future. Hedge funds are usually sound, but they are afraid of encountering a black swan incident once in 50 years or even 100. A black swan is encountered, such as a trading strategy that is likely to trigger a chain reaction, like Long-Term Capital Management (LTCM) in 1998, which 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 rise dramatically (Figure 4).

Figure 4



US Dollar Index – the higher the index, the higher then exchange rate, and vice versa.

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, because if they settle in US dollars, they will earn more. But not every Chinese company is happy. For example, many issued a lot of US dollar debt overseas while the US dollar bond interest rate was low. Now that the US dollar has appreciated, the 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 company gets in trouble for poor management, there is no reason to drag it out of danger, but if a decent company has a liquidity crisis, there should be help close at hand.

Obviously, the recent turmoil in the financial market is largely due to the pandemic. Panic has been manifested in a lack of liquidity in the financial market, because everyone has been after cash or its equivalents. 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. At present, the United States has not introduced any relevant fiscal policies. 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, then the government has to provide funding.

Combined with the above, at present there has been a shock on the supply side and a decline on the demand side, coupled with a financial crisis, and such a combination is extremely rare. In the scope of my reading, I have not seen such a complicated and huge economic storm in modern economic history. Therefore, no matter how calm the epidemic is now in China, we remain on guard. Increased infections from overseas, and China's position as a highly open economy, mean that if we drop our guart we may lose our earlier successes.

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

March 2020