ARTICLE FOR THE EDGE

COVID-19 CRISIS: WHAT NOW FOR REGIONAL ECONOMIES?

The Covid-19 crisis has turned out to be far worse than we thought only a month ago. It has spread further and is now a global crisis – not just a mainly Chinese one. With the virus causing dislocations in major economic centres such as South Korea, northern Italy and now the United States, Asian economies will suffer from a broader drop in overall global demand. This will be more damaging than the initial hit, which was mainly caused by a weaker Chinese economy.

Going forward, the economic impact on Asia will depend on a number of factors. First, the patterns in the disease itself such as how many more new infections are likely before they peak and whether better treatment regimes and a vaccine will make the virus appear less frightening to ordinary folks. Second, the effectiveness of policy responses, both globally as well as in individual Asian economies? And, third, will the abrupt and unexpected nature of this economic downturn trigger other problems that might compound the economic damage?

Virus will spread much further before it eventually fades away

Even as the number of new infections in China slows dramatically, infections are spreading rapidly in other countries. South Korea has been badly hit with more than 5,000 cases while Japan has seen almost 300. Italy now has more than 2,000 cases and many countries bordering it have also reported infections. Iran has reported just above 2,000 infections and 77 deaths but many believe the true numbers to be frighteningly higher.

There are several reasons why this recent spread is bad news:

- First, it is now too late to prevent the virus from escalating into a global pandemic. It is spreading from the initial clusters to neighbouring countries which mostly lack the capacity to control its further spread. The virus is now present in many parts of the Middle East, Latin America and Africa.

- Second, the virus is only in its early stages of causing dislocations in major economic centres. In Italy, the area affected most generates more than a third of the country's economic output. South Korea is one of the world's great manufacturing hubs. But, the most worrying country is the United States, where policy failures in the early stages of the disease mean that the virus now being discovered in more and more parts of the country. Because little testing of potential cases is being done, the true number of cases is probably much more than the 122 reported (as of 3rd March).

Eventually, the virus could burn itself out as virtually all other epidemics have in history. Moreover, as China has shown, with the right measures in place, the rise in new infections can be brought under control. The more developed countries such as Japan, South Korea and Italy have the state capacity to implement the restrictions and healthcare measures needed to contain the virus. But this is not the case in many other countries.

So, the key now is whether healthcare systems can respond quickly. The fatality rate for COVID-19 outside China is just 0.18%, not much more than the 0.1% for the normal flus. But, the disease seems to require a much higher rate of acute or even critical care than the normal flu. This imposes a heavy burden on healthcare systems. Where acute and critical care capacity is not sufficient, the death rate could be very high, as we are seeing in Iran where the reported fatality rate is about 3.4% - and probably much higher in reality.

The next big question is whether effective treatment regimens can be devised to reduce the fatality rate and prevent infected victims from deteriorating to the point where acute or critical care is needed. Here, the news is much better - in China and Japan, for example, there has been good progress in working out the combination of drugs that can treat the infected victims quite effectively. There has also been progress made in developing a vaccine but it will take many months before this is available for safe and widespread use.

The right policy responses are vital

The critical need when economies suffer a shock like this is to ensure that the initial shock is not amplified and that there are sufficient shock absorbers in the system to mute the initial impact. In most cases, the shock is amplified by three factors.

- One is when companies facing a collapse in demand lay off workers - which then causes demand to fall even further.

- Another is when distressed companies suffering weak cashflows are unable to pay their loans and default, hitting banks' balance sheet and causing banks to curtail much-needed credit to small and medium enterprises in particular.

- And a third is when governments fail to provide the confidence needed to calm the public and does not supply essential public goods and services - things that individuals or private companies are unable to procure for themselves. In the United States for instance, a failure to provide sufficient test kits may have allowed the COVID-19 virus to gain such a strong foothold in the country that it is now probably spreading rapidly. Media reports of the true number of cases being hidden have reduced trust in the government - and without trust, there tends to be more panics, which then cause more economic damage.

Given this, it seems to us that policy makers in many parts of Asia are learning to do the right things. In China, the government is rolling out measures to ensure the continued flow of credit to small businesses. Banks have been told to defer loan principal repayments that have matured since 25th January while interest payments can be deferred to the end of June, with no penalties for late interest payments. In Singapore, the Job Support Scheme will help prevent layoffs by extending an 8% subsidy on wages paid by companies. In most cases, Asian countries have the policy space for monetary and fiscal stimulus, as seen in the multiple rate cuts already announced in the region and the growing fiscal measures as well. Overall, policy makers have reacted methodically and credibly, which has helped to arrest the sense of panic that initially erupted.

The trouble, however is that the policy response at the global level is not yet effective. The conference call of G7 policy makers on 3rd March ended with a statement promising actions by individual countries but not the kind of aggressive and coordinated action needed to calm consumers, businesses and financial investors.

Worse still, in the United States, the Federal Reserve Bank's 50 basis point rate cut fell flat – the 10-year bond yield plunged to a record level of below 1% while equity prices tanked. Interest rate cuts have a role to play – in signalling policy support and lowering borrowing costs. But it is not the policy response the United States needs right now. All the rate cuts will do is to worsen the moral hazard in American financial markets without providing effective succour to the economy – knowing that the Federal Reserve will always underwrite asset prices is sure to encourage even more bubbles and mal-investment. What the American economy needs now is the sort of shock absorbing measures that China and Singapore are enacting – but the political system does not seem capable of providing that response.

Beware the unexpected

As the COVID-19 impact on the global economy is deepening, the last thing the world needs is for other risks to crystallise. Unfortunately, there are a number of potential downsides we need to prepare ourselves for.

First, there could be more financial stresses:

- There are legal and financial consequences once the COVID-19 crisis is formally recognised as a pandemic. For example, there could be a case for insurance companies to be absolved from paying out insurance claims made by companies and individuals that suffer losses from the virus. Moreover, Chinese companies are already declaring *force majeure* and reneging on commitments to purchase products – even in cases where the products have already been shipped to Chinese ports. Banks which issued letters of credit could be on the hook in these cases and suffer losses. Suspicions on the part of exporters outside China that they may not be paid could lead to even more disruptions to international trade.

- In addition, the virus shock is unfolding in a world which has seen years of ultra-low interest rates and massive quantitative easing. This has produced a huge surge in debt levels all over the world. Almost certainly, investors have been encouraged to indulge in new financial products that are risky and whose damaging consequences usually appear only in a sharp downturn which no one expected.

Second, while the virus has been hogging the headlines, geo-political risks have been escalating, especially in the Middle East. In Syria, an ugly confrontation is brewing between Syria and its Russian and Iranian allies on one side and Turkey. In exasperation, Turkey has let loose on Europe thousands of migrants who had been kept in check in Turkey. This means Europe now faces another migrant crisis, just as it is struggling to manage the COVID-19 crisis.

In Iran, the failure of the clerical regime to competently manage the virus crisis has further undermined its legitimacy, raising the possibility of protests and instability. North Korea has taken advantage of the world's pre-occupation with COVID-19 to test more missiles. In India, clashes between Hindus and Muslims allegedly stoked by politicians affiliated with the ruling coalition have caused communal tensions to reach dangerous levels.

We could go on … it really is quite a nasty picture and there are many things that could aggravate an already bad situation.

The bottom line for Asian economies

Putting all this together, it is clear that economic growth in most parts of Asia will take a severe drubbing. The OECD and other global agencies are forecasting global growth to weaken to its slowest pace since the aftermath of the global financial crisis in 2009. Just as Chinese economic activity begins to return to normal in coming weeks, global demand will dip for Asia. In effect, we can write off economic expansion in the first half of this year, which is likely to see a contraction in the first and second quarters for many economies.

After that, if – as we think likely – (a) China succeeds in returning to normality and enjoys a sharp rebound by mid-2020; (b) the spread of the COVID-19 virus is contained by then and better treatment regimes calm nerves; (c) policy easing in Asia begins to feed through to economic activity; and (d) the unexpected political and financial after-effects are limited, we could see a strong revival in regional economic growth in the second half of the year.

In other words, the next few months could be nasty but things should begin to turn up after that. We should be concerned and alert but neither should we be unduly pessimistic.

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