ARTICLE FOR THE EDGE

CORONAVIRUS CRISIS: WHAT ARE WE MISSING?

The coronavirus crisis has continued to deteriorate. Not only are new infections rising exponentially, so is the panic induced. As a result, governments are rolling out massive stimulus policies at a stunning pace. The question then is what net effect these trends will have on the duration and impact of the crisis. Our take is that, first, it is reasonable to conclude from the stringent measures being implemented that, by April or May the pace of new infections and associated panics should subside in the key economies, thus allowing a global recovery to begin in the third quarter of the year. Second, it is also important to look beyond the immediate crisis because there are likely to be substantial changes that the crisis will bring about.

The pandemic will eventually burn out … as all other pandemics do

In virtually all cases throughout history, even the most severe pandemics eventually burn out. In the past, some pandemics took more than a year to dissipate. However, the current coronavirus is likely to take a shorter time to do so, going by the experience in China and South Korea. In both those countries, stringent restrictions on travel, social mingling and large-scale events succeeded in reducing new infections to a small number within a month to a month and a half. There are some tentative signs in a few towns in northern Italy, that such restrictions have helped to bring down the rate of new infections.

With similar measures being put in place across Europe in the past week and now in the United States and other parts of Asia including India, it is likely that the pace of new infections will peak by April or May in North America, Europe and East/Southeast Asia – and then subside. It is, of course, possible that another wave of infections will be seen in regions such as South Asia, Africa and Latin America but their health authorities would have the benefit of knowing from best practice in Asia, Europe and the United States what measures can best contain the virus. India, for example, is ramping up restrictions on social mingling and travel which could help contain the spread of the virus there.

Also helping is the speed with which effective treatment regimes are being devised, with the help of experience in China and South Korea for instance. Once improved treatment of the disease induced by the virus becomes more widely available, the fatality rate will fall while the proportion of victims needing acute care would also diminish. That would reduce the sense of fear which greets the virus.

But things could get pretty bad first before a recovery sets in

In the meantime, there are a number of reasons why the economic and financial damage caused by the virus will deepen.

First, the extreme restrictions such as total lockdowns being put in place across the world are like a punch in the gut of the global economy. In several parts of the world, such as the business and technology hub of Silicon Valley, some parts of India, Malaysia and the industrial and service hubs of Europe, people are virtually confined to their homes, all non-essential businesses have shut and inbound travellers banned. Even with the option of online purchases, it is more than likely that consumer spending will collapse. Moreover, there will be almost no capital spending or hiring by businesses in these vital centres of global economic activity for several weeks, maybe even a month or two. The data for January and February in China showed that the economic contraction caused by the lockdowns there was far worse than initially expected - fixed asset investment fell by a quarter while retail sales were down by a fifth.

Second, the combination of the virus shock and the abrupt plunge in oil prices could well aggravate financial imbalances in the global economy and so amplify the initial shock into something much worse. The past few days have seen stresses in the commercial paper market in the United States, a key source of funding for American businesses. There are growing signs that a spike in defaults is likely across the United States and Europe. Investors are worried about the impact of the oil price collapse on shale oil producers in the United States while many airlines are teetering on the brink of bankruptcy as a result of the collapse in air travel in the past few weeks. Many indebted oil producing countries will probably need to go to the International Monetary Fund for help soon. Indicators of potential financial difficulties such as the LIBOR-OIS spread are hinting at building problems in financial markets. Widening spreads also point to growing risks in Chinese corporate debt.

Central banks have been quick to address this risk by providing extra liquidity but this alone may not be enough. The global financial system has features which could amplify shocks rather than help absorb them. There are reports that private banks are withdrawing lending to their clients and so forcing them to unwind leveraged trades and so cause asset prices to fall even more. Insurance companies are said to be liquidating financial assets as they keenly need to raise cash in the face of likely virus-related claims, even when those assets' prices are falling. Another example is how some analysts believe that the implementation of the accounting standard called IFRS 9 has pro-cyclical effects, reinforcing a shock rather than mitigating it as banks have to take provisions more aggressively when faced with a loan going bad.

Our base case is that more financial stresses will emerge. Central banks will be forced to step up their liquidity injections and to agree to regulatory forbearance whereby banks will not have to adhere strictly to regulations on recognising bad loans and mark-to-market accounting rules. If the right measures are taken in time, the adverse impact of these financial stresses can be contained.

The net effect: global economy is likely to contract in second quarter before rebounding

We estimate that the Chinese economy contracted by around 7% in the first quarter over a year ago, giving us a sense of the scale of the economic damage that these restrictions can

have. However, the limits on activity in the United States, Europe and elsewhere are much less stringent than China's so the contraction in the second quarter in the big developed economies should not be so severe. If we hazard a guess, it would be for a contraction in the United States, Japan and Europe (G7 economies) in the second quarter of around 2% over a year ago – just as the Chinese economy would be starting a modest rebound. In the third quarter, we expect China to begin to see a stronger pick up while the G7 economies stabilise. In the fourth quarter, we are likely to see very strong rebounds across the world as the restrictions reverse, confidence returns, pent-up demand is released and the lagged effects of policy stimulus feed through.

In short, the next few months will be unpleasant for the world economy. That means that the countries in our region which are heavily exposed to world trade such as Malaysia, Singapore, Thailand and Vietnam will see their economies contract modestly. The decline in capital spending by companies in the developed economies will have a particularly severe impact – our analysis shows that the region's manufactured exports are well-correlated with capital spending in these countries. However, the second half should then see a recovery, one which is likely to be quite strong by the final quarter of the year.

There will be substantial longer term consequences

In this scenario, everyone is likely to be pre-occupied with the immediate economic and financial difficulties, it is still necessary to think through some of the longer term implications of this crisis. We can discern a few:

First, too many countries and companies did not take sufficiently to heart the simple but important nostrum that economic diversification is necessary. Supply chains were overly reliant on China for sure. Singapore turned out to be far more dependent than was optimal on the roughly 300,000 Malaysians who commute daily to work in Singapore. After this crisis, businesses will probably accelerate the reconfiguration of supply chains that had been instigated by the US-China trade war. Production facilities will be relocated out of China at a faster pace now. This should benefit Southeast Asia but companies will also want to diversify to some extent from Asia so some part of the relocation could also benefit central and eastern Europe, for example, or Mexico.

Second, regulators need to update or improve on existing financial and other regulations, taking care in particular to amend rules and standards which tend to reinforce a shock. There has to be a wholesale rethink of financial regulation, targeting well-intentioned policies that are having unintended effects – such as IFSR9 mentioned above. Companies will probably be asked by government to re-jig their business contingency plans to take account of lessons learnt during this crisis.

Third, governments have to reconsider the tools they have for counter-cyclical policy. There has been an excessive reliance on central banks' monetary policy in the past decade since the global financial crisis. These monetary tools are proving less and less effective while potentially creating financial imbalances in the long term. By default, and because they have

little choice, governments are resorting to fiscal stimulus. Over time, more consideration will need to be given to administrative tools. Singapore's use of government subsidies to protect employment and wages could be more extensively used elsewhere, for instance. Similarly, there could be more use of risk-sharing schemes in a downturn, whereby governments encourage banks to keep lending to small businesses by agreeing to take a share of loan losses.

Fourth, there may be long-lasting political implications. In the United States, for example, the dogmatic version of free market economics which has dominated the discourse since the 1980s is likely to be questioned even more intensively. Clearly, its excessive zeal for reducing the role of the state in the economy and for tax cuts while neglecting basic things like access to affordable healthcare and paid sick leave has left the United States in a poor position. Questions were already being asked before this crisis because of the backlash against globalisation and social problems caused by increasingly unaffordable housing. This ideological shift could now speed up. If so, it would help the Democrats in the November elections – not just in the presidential election where the likely Democratic nominee Joseph Biden looks better-positioned now to take on President Trump, but also in the battle for control of the Senate and House.

Conclusion

It started out as a nasty virus-induced disease but COVID-19 has now snowballed into a global crisis which will slow the global economy while also producing significant political, regulatory and business changes. Still, it is important to put things in perspective. It will be nasty for financial markets and the economy in the next two to three months, there will be a lot of fear and scare-mongering. But by the second half of the year we should be seeing a recovery and the crisis will ease – as crises in the past have.

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