1 Macroeconomics of the flu

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Remember last time you had the flu? Likely, along with the fever, tiredness and the pain, there was a feeling that the world was really miserable and deeply unfair. Then one morning it was all gone. After a brief feeling of relief and gratefulness, the world went back to normal and you quickly forgot all about the episode.

This is roughly the way we might think about a temporary 'health disruption' to an economy. A 'macroeconomic flu' – i.e. a temporary negative supply and demand shock – causes output to fall for a little while, only to then lead to a quick recovery and possibly a full catch-up on the shortfall. The growth rate in one quarter may be lower, but in the next it will be higher and even fully compensate the shortfall in output. There is no reason for policy to get nervous or be active. Just do what the classic conservative monetary policymaker does best: wait for more data. But that is a normal flu, or rather a macroeconomic sneeze – not a pandemic, not a panic.

COVID-19 may still turn out like this, with a few weeks of disruption and then a lot of catching up of lost production and consumption. But that is becoming quite unlikely. Indeed, it is becoming more likely that the disruption will be large, global, and possibly persistent. At least that seems to be what markets have concluded (somewhat belatedly) as of last week.

The impacts on global and regional growth of such a scenario are still highly uncertain, but some early estimates suggest large downsides. Take the most extreme scenario of a severe, temporary global pandemic presented by Warwick McKibbin and Roshen Fernando in their contribution to this eBook: the average GDP loss is 6.7%, with an 8.4% loss for both the US and the euro area.

A global shock of scale, duration, and persistence?

The size of the shock will be determined mostly by the measures taken to avoid large-scale contagion and to limit the area of spread. As is well known by now, this virus is extremely contagious but not especially fatal. It appears that in the majority of cases, it is no worse than the seasonal flu. Thus, the containment measures – the disruption to work processes, the limitations on meetings and travel – will be a larger negative supply shock than the number of deaths, even if the latter could still turn out to be large.

Full or partial lockdown, like in China, is one of the most extreme measures and can bring production and consumption almost to a standstill. Such extreme measures are likely to remain restricted to certain areas and will be difficult to maintain for a long time.

Less extreme measures, such as cancelling large-scale events, are likely to remain in place for longer. This week, the French government banned all events of over 5,000 people and the Swiss government banned events of over 1,000 people (why the difference is unclear). Some of these events can be postponed, but many cannot. Also, as of this week an increasing number of companies have put in place global restrictions on international travel that is not absolutely business critical, have moved to postpone client events or hold them remotely, and are introducing shift work (with A and B teams alternating between working from home and in the office). Such measures could also be in place for longer because it will be difficult for decision makers to declare the coast clear as long as the number of infected is still increasing.

Supply chain disruptions may also turn out to be larger and more extended than is currently evident. Maersk, one of the world's largest shipping companies, has had to cancel dozens of container ships and estimates that Chinese factories have been operating at 50-60% of capacity.[1] Shipping goods to Europe from Asia via sea takes about five weeks, so at the moment goods are still arriving from pre-virus times. The International Chamber of Shipping estimates that the virus is costing the industry $350m a week in lost revenues. More than 350 000 containers have been removed and there have been 49% fewer sailings by container ships from China between mid January and mid February.[2]

1 https://www.nbc-2.com/story/41749179/maersk-operates-massive-container-ships-its-canceled-50-sailings-over-coronavirus

2 https://ec.europa.eu/info/live-work-travel-eu/health/coronavirus-response/economy_en

How about the shock to demand? Clearly, the first casualties are the transport and hospitality industries. Ports and terminals are facing at the same time a sharp drop in income, higher costs from yard congestion due to the build up of empty containers, and requests from customers to waive storage charges due to ‘force majeure’. IATA estimates that the aviation industry could face a loss of 29 billion US dollars of passenger revenues if they extrapolate the SARS pattern of impact on air travel.[3] Ultimately, the size of the demand shock will be only partially determined by objective dangers of infection or by official measures for social distancing. Fear and uncertainty will dictate caution – in case of doubt, meetings will be canceled rather than running the risk of being stuck in the isolation of home quarantine.

China has become a major source of demand in the world economy and many core European industries are highly dependent on the Chinese market. Sales in China account for up to 40% of the German car industry’s revenues, for example, and they have collapsed over the last weeks. This would seem to be an example where the demand shortfall is more likely to be temporary; a new car is usually not an essential item and the purchase can be delayed until the situation normalises.

Some effects may be more persistent, however. The disruptions that companies, individuals and governments are experiencing imply that globalisation and integration may be at risk from such health shocks. Firms will probably take into account the lesson they are learning that global supply chains can be abruptly broken by a health shock. Indeed, Covid-19 may end up doing more for reshoring than the mercantilists in the US government. Financial intermediaries and regulators are also likely to incorporate pandemic shocks into their risk assessments and stress tests. How governments deal with the crisis may have lasting consequences for stability and trust. Responses to an outbreak in a neighbouring state – for example, by closing the border and suspending trains, as Austria did with Italy – may promote stigmatisation and disintegration. Racial and national discrimination have already reared their ugly heads. And in times of rising nationalism and populism, people’s fears and suspicions of ‘others’ might become a force for disintegration – worse than Brexiteers. Finally, the virus might become endemic, meaning that it continues to circulate in people; it would be the fifth endemic human coronavirus.[4]

3 https://www.iata.org/en/iata-repository/publications/economic-reports/coronavirus-initial-impact-assessment/

4 https://www.statnews.com/2020/02/04/two-scenarios-if-new-coronavirus-isnt-contained/

How could policymakers respond to a recession?

Although the virus is only starting to spread in the US, the Federal Reserve has already reacted with an emergency rate cut to reassure investors. Other mayor central banks have less room for cutting rates, but they should stand ready to provide liquidity in case of market disruption or stress on financial intermediaries and keep lending to small businesses. They should signal readiness to dip into their toolbox one more time in case there is indeed a long-term shortfall in demand and do so in coordination with other central banks.

But fiscal policy would clearly be the better tool should the severe scenario materialise. Fiscal measures could quickly be deployed as targeted help for those affected by quarantine and income shortfalls. For example, Italy has already announced a series of relief for its most affected communities and firms, using similar instruments to those that would be deployed in the wake of natural disaster. The German government is talking about 'Kurzarbeit' – a state-subsidised scheme to protect employment which was used during the global financial crisis. It has also signalled its readiness to consider a fiscal stimulus package. China, Hong Kong and Singapore have decided on substantial fiscal measures to stimulate demand and boost confidence (almost 2% of GDP in the case of Singapore).

The measures to stem the spread of COVID-19 are still focused on a few ground-zero countries, but may soon amount to a global and common shock comparable to the Lehman shock. Then, the world's leaders came together to announce a common response to a common crisis. The coordinated fiscal stimulus and financial packages were the high mark for the G20 and clearly contributed to dampening the shock to the world economy. Today's leaders are facing a similar stress test and they will be measured by their ability to deal with this common threat in an effective fashion. This is particularly true for Europe. The petty divisions that are currently plaguing the Union should be put aside to demonstrate the will and the ability to act together and to show solidarity with those that have been stuck. Beyond using the flexibility of the European fiscal rules to increase room for spending, the EU should also consider a common disaster relieve fund to help affected regions and people. Jean Monnet's famous words that Europe will be forged in crisis might ring true once more.

In a similar vein, governments and policymakers should be very careful to send a message of cohesion, responsibility and leadership to prevent fear and panic. They can learn from Singapore in this respect. Singapore has been battling the disease since Chinese New Year; it is highly connected with China and had a surge of cases early on, but seems to have been quite successful at containing the spread.[5] From the outset, the government communicated extensively and called for citizens to be behave responsibly and respectfully towards each other. At the same time, it was transparent and honest about the measures that would have to be taken in case of further escalation of the threat level. An example of how social cohesion matters can be found in the government providing a few masks for every household but discouraging the use of masks except by those who are feeling sick (or by health workers). The problem is relatively simple when you think about it: there is one state of the world where everybody rushes to hoard masks (as well as food, toilet paper, and so on) and uses them to protect themselves, finding that there are not enough masks for every healthy person in the world. There is another social equilibrium in which masks are used by those who may be transmitting germs (Covid-19 or others) to protect the rest. The latter is clearly the better social outcome but it requires trust, which governments should be helping to build through their own actions.[6]

Overall, much will depend on how governments handle this sudden close encounter with nature and with fear. It could become an economic crisis of global dimensions and a threat to globalisation, or it could be a moment when policymakers manage a common crisis response and even manage to rebuild some trust.

About the author

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5 See the numbers at https://www.moh.gov.sg/covid-19

6 In this spirit, the leadership of Singapore took a one-month pay cut in solidarity with those suffering income shortfalls and has awarded a one-month bonus to all health workers on the front line.