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Covid-19 and the global economy

Confirmed cases of the novel coronavirus (COVID-19), which first appeared in China at the end of last year now exceeding 115,000 as of March 10 and are likely to climb significantly higher. While over two-thirds of the total confirmed cases are in mainland China, the vast majority of new cases reported since February 25 have occurred outside the country. What was initially seen as a largely China-centric shock is now understood to be a global crisis. The virus’s spread has regrettably borne out analysts’ downside scenarios, with investors digesting the implications of disrupted supply chains, official containment measures, and spillovers from the real economy to financial markets. A decision by two of the world’s largest energy producers to maintain current levels of production, despite falling energy prices, has further unnerved investors while questions about governments’ abilities to mount an effective and coordinated response linger. The increased uncertainty has led to financial market volatility last seen during the global financial crisis.

The extent of the damage will depend on how quickly the virus is contained, the steps authorities take to contain it, and how much economic support governments are willing to deploy during the epidemic’s immediate impact and aftermath.

Early indications of COVID-19’s impact on the Chinese economy are worse than initially forecast. Surveys of China’s manufacturing and services sector plunged to record lows in February, automobile sales sank a record 80 percent, and China’s exports fell 17.2 percent in January and February. The official data confirmed a widespread slowdown in economic activity foreshadowed in low pollution levels and depressed shipping traffic, among other informal barometers. Analysts have sharply revised down estimates of Chinese growth, with many now predicting a drop in first quarter GDP, the first contraction since China began reporting quarterly data in 1992. As COVID-19 spreads, China’s economic recovery will be challenged as demand from other countries drops as they cope with the virus.

Although the outbreak appears to have slowed in China, COVID-19 and its impacts have gone global. Infections are mounting in Europe, South Korea, Iran, the United States, and elsewhere, with authorities implementing increasingly restrictive measures to contain the virus. Europe and Japan are likely already in recession territory given their weak fourth quarter performance and high reliance on trade. While the United States entered the crisis with a tailwind, some analysts are forecasting a contraction in U.S. GDP in the second quarter. Estimates of the global impact vary: early last week, the Organisation for Economic Co-operation and Development (OECD) predicted that COVID-19 will lower global GDP growth by one-half a percentage point for 2020 (from 2.9 to 2.4 percent); Bloomberg Economics warns that full-year GDP growth could fall to zero in a worst-case pandemic scenario.

The COVID-19 outbreak has generated both demand and supply shocks reverberating across the global economy. Among major economies outside of China, the OECD forecasts the largest downward growth revisions in countries deeply interconnected to China, especially South Korea, Australia, and Japan. Major European economies will experience dislocations as the virus spreads and countries adopt restrictive responses that curb manufacturing activity at regional hubs, including in Northern Italy. As a result of depressed activity, the United Nations projects that foreign direct investment flows could fall between 5 and 15 percent to their lowest levels since the 2008-2009 global financial crisis.

At the sectoral level, tourism and travel-related industries will be among the hardest hit as authorities encourage “social distancing” and consumers stay indoors. The International Air Transport Association warns that COVID-19 could cost global air carriers between $63 billion and $113 billion in revenue in 2020, and the international film market could lose over $5 billion in lower box office sales. Similarly, shares of major hotel companies have plummeted in the last few weeks, and entertainment giants like Disney expect a significant blow to revenues. Restaurants, sporting events, and other services will also face significant disruption. Industries less reliant on high social interaction, such as agriculture, will be comparatively less vulnerable but will still face challenges as demand wavers.

Economic slowdowns generally lead to lower energy demand, and the fallout from COVID-19 has proved no different. Often, producers respond to demand slumps by cutting supply to buoy prices. Last week, members of the Organization of the Petroleum Exporting Countries (OPEC) and a few other major oil producers met to discuss an additional cut of 1.5 million barrels per day through the end of June in response to the outbreak. When the agreement collapsed, Saudi Arabia cut prices and lifted output, ostensibly to harm Russia for refusing to agree to production cuts. Following the Saudi decision, Brent Crude fell more than 20 percent , the sharpest one-day drop since 1991, with analysts predicting further declines ahead. The damage from the Saudi-Russian price war sends an unsettling signal to markets hungry for a coordinated policy response to the epidemic, especially considering Saudi Arabia’s current role as G20 president.

In response to the price shock, large oil producers, including U.S. firms, could pare back investment and production, with heavily indebted firms in particular at risk of layoffs, consolidations, and even bankruptcy. Investors are well aware that energy companies account for more than 11 percent of the U.S. high yield (below investment grade) market, with rollovers nearly impossible under current market conditions. In theory, lower oil prices should help oil-importing countries, but depressed activity due to COVID-19 could limit that benefit. In addition, the boom in domestic U.S. energy production in recent years means the United States is exposed to price declines in a way not seen in previous economic downturns.

Fears of a broader outbreak and its economic impact spread to financial markets last month, and most international indices are nearing bear market territory (declining at least 20 percent from the 52-week high) as investors process the lower corporate earnings that will result from the virus. The S&P 500 fell 7 percent to open the March 9 session, triggering a “circuit breaker” that briefly suspended trading for the first time since 1997. Overall, the index is down about 17 percent from its record high on February 19. Amid the equity rout, investors have fled to safe haven assets such as U.S. Treasury bonds, leading to record low yields. Low yields translate into low borrowing costs for the U.S. government, but low interest rates may not benefit private companies or individuals (or even all sovereigns) who may find financial markets too risk adverse to extend credit in light of such uncertainty. The longer the virus spreads, the more economic and company performance will be impacted, raising concerns about debt sustainability, especially for highly indebted countries and companies, absent official support.

Thus far, national governments have announced largely uncoordinated, country-specific responses to the virus. In China, the epicenter of the outbreak, officials announced billions in special-purpose loans to companies facing liquidity constraints as well as financial support to specific sectors such as aviation. In the United States, the Federal Reserve cut the policy rate in an emergency action on March 3, and on March 9, in coordination with other U.S. bank regulators, it encouraged financial institutions to “meet the financial needs of customers and members affected by the coronavirus,” a move aimed at supporting financial conditions to prevent the growth shock from turning into a broader financial crisis. On March 9, the Federal Reserve Bank of New York also announced expanded overnight repurchase operations by $50 billion to avoid a deeper credit crunch.

The European Central Bank and Bank of England are expected to take action when their monetary policy committees meet later this month. On the fiscal front, President Trump previewed his administration’s plans to seek a payroll tax cut and assistance for impacted hourly workers and industries. Countries announcing fiscal measures just this month include Japan ($9.6 billion, or 0.19 percent of GDP), South Korea ($9.2 billion, 0.56 percent of GDP), and Italy ($4.1 billion, 0.20 percent of GDP). The adequacy of such spending will depend on the virus’s path as well as the effectiveness of other measures to contain negative spillovers from the growth shock.

In terms of coordinated action, on March 6, the G20 finance ministers and central bank governors pledged to take “appropriate” fiscal and monetary measures but made no specific commitments. On a March 3 phone call, G7 finance ministers reaffirmed their “commitment to use all policy tools” but did not outline specific steps. For their part, the International Monetary Fund and World Bank last week announced the availability of $50 billion and $12 billion in financing, respectively, to support low income and emerging market economies’ responses to the virus.

Scientists do not yet have a clear understanding of the virus’s behavior, transmission rate, and the full extent of contagion; uncertainty will be part of the backdrop for the foreseeable future. Coherent, coordinated, and credible policy responses provide the best chance at limiting the economic fallout from what is already and sadly a human tragedy.