Coronavirus crisis and its effects on the economy

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Abstract

Unlike the global financial crisis of 2007-2009, the current economic turmoil turns to be more severe and lasting being aggravated by the epidemiological uncertainties. This fact is mainly due to the specifics of the crisis in terms of its main transmission channels (via demand, supply, finance and expectations) and its likely consequences, including technological shift, varying the direction and volume of trade flows, adjustments of structural proportions and relative prices and most of all – socio-cultural change bringing about the increased role of the state and de-globalization deepening. These post-crisis effects and the uncertain prospects of recovery are considered in the article.

Keywords

COVID-19, financial crises, recovery, anti-crisis policies, crisis shocks, hysteresis, post-crisis economy, deglobalization

JEL codes: E20, F01, F60, G01, H12

The most impressive event of recent decades in the world economy was undoubtedly the global financial crisis of 2007-2009. Then the joint, albeit largely unorthodox efforts of the developed economies, accompanied by massive monetary injections, proved to be sufficient to calm the markets, restore the normal functioning of the payment and credit system and relaunch the temporarily stalled mechanisms of the global economy. Despite major regulatory changes – however, mainly affecting the operating environment of financial companies – the global economy quickly returned to nearly its previous state and even resumed moderate growth.

The economic recovery, which resembled the Latin letter “V” rather than “U”, was a strong confirmation of the “spontaneity” of the crisis (largely explained by the “financial perversions”), as well as the evidence of the adequate measures undertaken afterwards. The only, perhaps, symbolic and disturbing reminder of the turmoil were bloated balance sheets and
low policy rates of the world’s leading central banks. Despite the overall normalization of the situation, they were so terrified by the narrative about the “secular stagnation” that they could not withdraw the policy of “quantitative easing” launched in the crisis (massive purchase of government securities, and, in fact, – “printing money”). In addition, central banks also did not dare to raise interest rates to pre-crisis levels; these rates are stuck in the area of low positive or even negative values. Regulators’ behavior is understandable: their old “demon” – inflation, in fact, ceased to pose any serious threat, so formal reasons to change low rate policy – so comfortable to borrowers, financial investors and politicians – were not found. Moreover, Ben Bernanke, head of the Federal Reserve System in 2006-2014, the “author” of the unorthodox set of monetary policy measures, made it clear speaking earlier this year (Bernanke 2020) that these now represent a “new normality” and should be used onwards.

But the sustained post-crisis development of the world economy has, apparently, come to an end. Unlike an abrupt breakdown of the past crisis, when the shock impulse created in the financial sphere was transferred to the real sector of the economy, we face a fundamentally different type of crisis. The impact of the coronavirus epidemic will now be so powerful and pervasive that the social and economic systems will make a “quantum leap” in many areas and reverting to the previous state will no longer be possible.

Although the bursts of the previous pandemics (the Spanish flu of 1918, the Asian flu of 1958, the Hong Kong flu of 1968 and SARS of 2002) were mainly characterized by V-shaped post-crisis economic recovery (Carlsson-Szlezak et al. 2020), it is hardly conceivable that the situation will repeat this time. This conclusion is based on the specific character of the course of the crisis and its likely consequences.

Channels of the coronavirus crisis

We can outline four main channels of the transmission of economic crises’ effects: the demand channel, the supply channel, the financial channel and the expectations’ channel (for description of various channels see (UNCTAD 2020)).

A combination of the general decline in incomes and consumer activity will be translated through the demand channel. Contraction of expenses will also occur as a result of the adopted quarantine measures, which sharply limit and primitivize the range of goods and services consumed. In addition, the scare of getting infected that may persist after the end of the first and possible subsequent outbreaks of the pandemic will also lead to a more cautious model of economic and social human behavior. In other words, the return to the pre-crisis pattern of consumption can be extremely slow, if at all possible. Tourism and entertainment industry, including commercial sports, festivals, concerts and other mass events, as well as catering and personal services will be affected most severely. Reduced working hours and possible layoffs will, all other things being equal, reduce household costs and increase the economic insecurity of those who are not protected by the social safety net.

Regarding the supply channel, widespread restrictions on the movement of people and cargo, as well as the stoppage of production activities in the most affected regions will lead to bottlenecks in global value chains. For a while, it is possible to maintain the normal functioning of these chains due to accumulated inventory, but sooner or later it will run out. Then many companies will be forced to close, striking the suppliers, consumers of their
products and their own employees. In any case, the result will be a reduction in profits and wages, and thus the supply channel intertwines with the demand channel, and their effect is mutually enhanced.

The financial channel's mechanisms of transmission have been described quite well after the global financial crisis of 2007-2009. In particular, these include a striking downfall of markets and a noticeable increase in their volatility, margin calls' problem, liquidity outflow from risky assets (“flight to quality”), credit crunch for a wide range of borrowers who suddenly become unable to refinance and service their debts. The suspension of lending and other liquidity channels is a serious threat to the private sector in the face of downturn in economic activity.

It should be noted that according to the Institute of International Finance (IIF 2020), global debt at the end of the 3rd quarter of 2019 approached $253 trillion, two thirds higher than at the beginning of the previous global financial crisis ($152 trillion). Current debt levels, at a record 322% of the global GDP, represent an important financial risk factor, both for borrowers and lenders at the micro-level and, regarding the buildup of a bad debt overhang turning the recession chronic according to the “Japanese” scenario (balance sheet recession) (Koo 2011) at the macro-level.

Finally, we highlight the expectations channel, as households and businesses anticipate negative developments and adjust their behavior respectively, exacerbating the crisis. Thus, the additional savings made by fearful individuals for precautionary motives lead to a further contraction of consumer activity. Growing uncertainty of the effects of the shock will also terminate well-prepared business projects and hold on the investments, deferring and slowing down the recovery. At this time these standard processes of negative expectations' formation are further spoiled by the factors of sanitary-epidemiological and structural uncertainty.

**Post-crisis dynamics**

In other words, unlike the events of the last decade, the world economy’s developments after the end of the acute phase of the crisis is bound to change markedly. This kind of transitions are best described by a nonlinear hysteresis model (Belke et al. 2014), when the system cannot undo the changes after their direct cause has ceased to exist.

In this case, the non-linear nature of transformation is determined by the following circumstances:

- Technological shift

Crises often stimulate the adoption of new technologies and business models. For example, even the limited SARS outbreak in 2003 accelerated the spread of online shopping among Chinese consumers, which contributed to the rapid growth of the delivery services and, in particular, Alibaba company. This time, fears (allegedly false) of contamination via cash have already led to a leap in the use of contactless payments in China and similar effects will be surely observed worldwide. Forced use of online technologies during quarantine in education, healthcare, trade and customer service, as well as in management practices cannot but contribute to their accelerated adaptation, which could otherwise take years. Of course, we do not expect a universal transition to online formats, but the search for a “golden mean” in the business processes of each industry will unfold from a completely different starting point.
• Changes in the direction and volume of trade flows

Uneven recovery of national economies, transport and logistics bottlenecks, in addition to the desire to avoid elevated risks, will lead to greater localization of production processes and technological chains, changing the structure of international trade and, ultimately, country specializations, as well as the volumes and directions of movement of people and cargo.

• Change of price and structural proportions

As a number of key industries (transport in particular) have been forced to a significant extent to close down, their gradual recovery as the epidemiological situation normalizes under changing consumer behavior may be characterized by entirely new commercial parameters and, consequently, volume-price characteristics of material production and provision of services. Accordingly, companies will need to seriously adjust the structure of their production assets and employment. There will also be a major change in intra-industry and cross-industry relative prices, which, together with technological shifts, implies the inevitable restructuring of several industries and a noticeable increase in the number of bankruptcies with the redistribution of market shares.

• Socio-cultural change

As always, predicting the changes of human behavior and the corresponding shift of the consumer, savings, communication and social patterns having the most profound long-term impact in all areas of life, is the most complicated task. It is difficult to foresee what individual and social responses will prevail by the end of the period of the restriction of freedom of movement under the expected transformation of the economic environment. It should also be borne in mind that the new economic realities will require a different quantity and quality of workers, perhaps radically different from the pre-crisis standards, which also cannot but create social and, possibly, political tensions.

• Role of the State

The state will be forced to assume new responsibilities, including the maintenance of education, health care and social protection systems in the new environment. Most likely, as in the aftermath of the previous crisis, direct government involvement in a number of sectors of the economy will also be required and may last for a long time. Employment (often excessive) in the public sector of the economy, and, consequently, the fiscal burden on the population and business will increase.

• Political deglobalization

Structural changes in the world trading system will be reinforced as a result of the political trend to protect national interests and strengthen national borders. The importance of cross-border projects and international cooperation in the economic sphere will fall under these conditions; higher unemployment and increased burden on the social system will further suppress international migration and its role in shaping labor markets.

Conclusion

Today we can confidently conclude that, having entered the current crisis, the world will once again emerge from it in a completely different shape. The detailed characteristics of the new socio-economic reality are not obvious yet, one can foresee only its general contours. Undoubtedly, it makes sense to immediately start contemplating the future state of the social and economic environment to initiate without delay the policymaking process aimed at alleviating the most negative consequences of the crisis.
**Reference list**


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