Could Pandora's box be the extremely opened economy?

A virus first appeared on a remote continent will cause a global economic crisis

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Due to worldwide quarantines imposed by authorities or voluntary self-isolation, the global supply chain is in dire situation, causing both supply and demand shocks. The difficulties faced by real economy are generating anxiety in the financial sector, which is further aggregating the real economy. Managing the economic crisis is expected to become increasingly difficult

On Friday, the 13th of March, the new coronavirus has officially become a determinant factor of the European Union's economy. Widespread global measures to slow down the spread of the virus cause serious economic losses for the Union. So much so that the president of the Eurogroup, Mário Centeno believes that the eurozone's economy is facing difficulties similar to "warlike times."

By the time China had succeeded in curbing the spread of the virus, Europe had become the epicenter for the pandemic. China announced on March 12th that it had managed to contain the virus, only to have the President of the World Health Organization (WHO) officially announce on March 13th that most new cases were reported by in Europe.

Measures aimed at slowing down the spread of virus include the closure of borders, temporary suspension of factories, plants, cinemas, cultural institutions, restaurants and cafes, postponed cultural and sports - in other words the restriction of the free movement of persons and services. This is causing on the one hand a fragmentation of global supply chains, on the other hand a sudden rise in the unemployment spiraling into an economic crisis – not just in the European Union.

As a result of voluntary self-isolations or quarantines imposed by the authorities, factories have closed, services have been shut down, which are all blocking the global supply chain, resulting in a *supply shock*. In the case of supply shocks, for selected products and services higher prices should be expected. In similar cases, economic policy does not have many tools at its disposal. Despite providing subsidies to companies, they are still unable to carry out their usual activities due to labor shortages. Should the authorities relax the restrictions regarding the free movement, the supply shock could be reduced. However, that would be at the price of increasing the proportion of the population exposed to the life-threatening virus. The longer the forced or voluntary isolation, the more serious the economic problems will be.

Additionally, to the above-mentioned supply shock, the world economy is facing a sudden decline of interest in transport, tourism and entertainment services. All this decreases the demand for raw materials as well, impacting the commodity markets as well, causing a *demand shock*. The problems caused by the shortage in demand may be somewhat balanced by fiscal and monetary policy instruments such as tax cuts or interest rate cuts, but there is a risk that loose monetary policies will eventually lead to inflation.

The simultaneous supply and demand shock linked to measures aiming to stop the pandemic will undoubtedly lead to a worldwide recession. The purpose of this analysis is to outline the processes leading to the coming global economic crisis and to present the measures taken by the US and the EU as major economies to offset the economic damage. Firstly, the study reports on the overall impact of the pandemic on China's economy, since statistical data is already available and can serve as a starting point for further analysis. The study then proceeds to present the most important economic measures taken by the United States and the European Union. Finally, it seeks to assess the extent to which all these measures can mitigate the economic shock's effects.

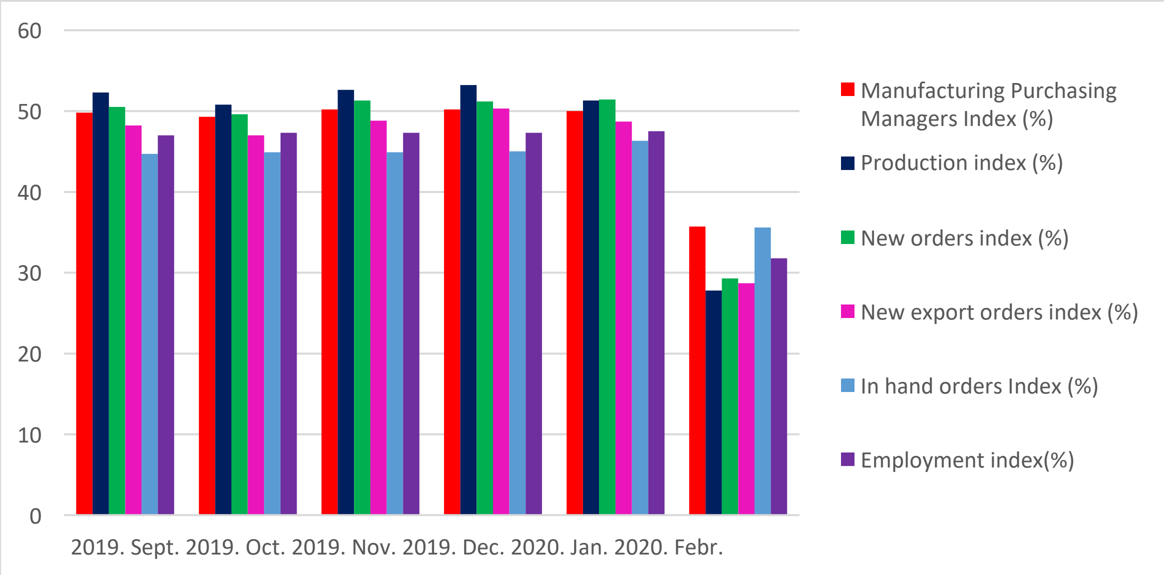
How it all started and where does it lead

The spread of the new corona virus started in China's Wuhan province in December 2019. The Communist Party of China initially tried to cover up the epidemic, but when it became apparent that the virus had a fatal outcome and spreads faster than expected, strict measures were put in place to contain it. As a result of the measures, the Chinese authorities have quarantined some 50 million people but the forced shutdown for months has hit the Chinese economy badly. According to National Bureau of Statistics of China, the country's production and industrial activity index fell by 13.5 percent in January and February, as compared to last year's measures which is well below the expected 3 percent. Retail sales fell 20.5 percent, also much lower than the 4 percent decline forecasted. The 24.5 percent drop in fixed capital investment was even stronger than the expected 2 percent.

While these figures seem daunting, in the long run, the Chinese economy will be more affected by the dramatic decline in exports. Due to the quarantine, the transportation system was partially shut down, travel bans were imposed, factories and small businesses closed, and almost entire cities shut down. Domestic delivery time has increased, and the supply chain of manufacturers was fragmented as factories have encountered several difficulties in procuring parts and supplies. All this resulted in a dramatic decline in exports.

This decline can be illustrated by the Headline Manufacturing Purchasing Managers Index (MPMI). The index is an indicator of the economic status of a nation or region, and consists of five main indicators: new orders, output, stocks of purchases, supplier's delivery times, and employment. If the value of the index is 50, it shows stability as compared to the previous month, a number below the index means a decrease, while the number above 50 is a sign of an increase. According to the official website of the Chinese National Bureau of Statistics, there has been a drastic decline in manufacturing and exports in recent months.

Figure 1. Manufacturing Purchasing Managers Index



Source: Chinese National Bureau of Statistics

Figure 1. shows that while in the previous months individual indices were relatively stable, the economic impact of closures was felt by February. The interruption of the supply chain has reduced the production by almost a half, with new products and new stocks of purchases having been cut as well. All this results in a fall of existing orders and employment indices. Such a decline in production not only affects the Chinese economy but has a major impact on the trading partners' economies as well.

As China's most important trading partner is the United States, the US economy will also be affected and since the European Union imports most of its products from China, it will not be an exception. Faced with the paralyzed Chinese partners, many companies are expected to be relocating their plants from China or be found looking for other suppliers. All of this may accelerate the reshoring trend that began in 2019, when, as a result of the US-China trade war, more US-based giants such as Apple, Dell, Nintendo decided to relocate some of their manufacturing facilities to the United States.

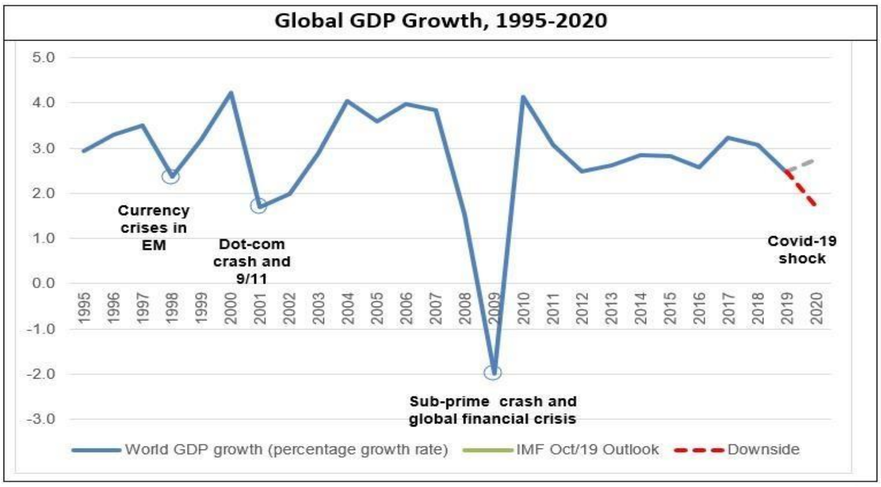
The long-term consequences of a temporary disruption of the supply chain are highlighted in an analysis of the Clingendale Institute. The author recalls that at the beginning of the twentieth century, the world's economic center was Europe. However, the outbreak of the First World War interrupted the supply chain existing at that time, and during the war, non-European countries sought and established new trade relations. By the end of the War, they had already stabilized the new trading partnerships, and Europe was cut out. According to the analysis, there is a possibility that China may lose its leading position in the world economy, similarly how Europe has lost its own, about a century ago. However, the three-month shutdown is unlikely to have such a fatal impact on the Chinese economy. Still, it is not yet known how all this will affect the Chinese economy in the long run. Currently it appears that the forced shutdown will lead to a fall of almost one percent of the GDP growth rate compared to the projected one. This is the first slowdown in the communist state's thirty years' long stable economic growth. The downward path of the Chinese economy, however, will not end with the stoppage of Chinese manufacturing processes and the consequent loss of orders from US and EU – the outlook is much grimmer.

As a result of the pandemic, forced closures have been applied in the United States and the European Union. Consumer spending will fall dramatically while unemployment is expected to rise sharply both in the EU and the US, and investments will slow down radically. All this will have a dramatic impact on the Chinese new orders, hence, its exports.

Since both the US and the EU have outsourced a significant portion of their production, local closures are unlikely to cause the same dramatic drop in American or European Manufacturing Purchasing Manager Index, but it is assumed that the two largest economies' Purchasing Manager Index values may face a similar drop. Production indicators will decline, services and orders will decrease, and the employment index will fall.

Although statistics are not yet available, UN analysts estimate a global GDP decline of about $ 2 trillion, roughly the full-year gross domestic product of Brazil or Italy. By comparison, Hungary's gross domestic product in 2019 was only $ 161,182 million, equivalent to 0.16 trillion. Figure 2. shows a UN analytical team forecasting a global economic crisis similar to the one caused by the dotcom crisis.

Figure 2. Global GDP growth



Source: UN

What measures have been taken

The paralysis of the economy has triggered a series of extraordinary measures in both the United States and the European Union. Thus, the Federal Reserve (Fed) has set interest rates close to zero and resumed buying bonds. Another extraordinary measure was the agreement by which the Fed, Canada's, the UK's, Japan's, and Switzerland's central banks and the European Central Bank signed a USD-liquidity swap agreement to ensure the solvency even during an economic crisis. These extraordinary measures have had the opposite effect on international money market players, with stock market prices falling even deeper, setting a negative record in the history of the US stock market. The Fed has encouraged US banks to be ready to ~~lend to business and~~ households, considering the accumulated $ 1.3 trillion in common equity and $ 2.9 trillion in high quality liquid assets since the 2008 world crisis. In addition, the Fed has established a Commercial Paper Funding Facility (CPFF) to support the flow of credit to households and businesses. Commercial paper markets directly finance a wide range of economic activities, providing credit and finance for loans and mortgages, and assuring liquidity to meet the operational needs of many companies.

In other words, the Fed has put in place specific financial instruments to provide liquidity to households and small and public corporations as an attempt to prevent companies from stalling in the long term. Hopefully, these measures will contribute to fighting severe unemployment and reduce the accompanying prolonged economic crisis. Additionally, President Trump has signed a bill of $ 8.3 billion emergency fund to be used for mitigating public health crisis. The fund is available for the healthcare sector and can be used for measures aiming to prevent the spread of the virus and to develop vaccines. The measures introduced by the United States are trying to alleviate the international investors' concerns very sensitive to financial markets. Currently, it seems all these measures are unsuccessful in assuring price stability and easing the demand shock.

Unlike the United States, the EU's economy is not as exposed to financial markets and their severe losses, therefore, their crash are not felt as heavily in the real economy of the euro area. Therefore, European Central Bank's (ECB) measures to mitigate the expected economic crisis are somewhat unique. The ECB did not reduce its key interest rates, but on March 12th conducted longer-term refinancing operations in order to provide liquidity support to the euro area financial system, primarily for preventive purposes. The measure primarily supports banks' lending to small and medium-sized enterprises (SME) and provides a refinancing facility below the average interest rate. In addition, the ECB will increase its net asset purchase program to EUR 120 billion by the end of the year in order to stipulate private sector purchase programs. Another measure of the ECB focuses on banks' capital instruments allowing for more flexibility and offering significant capital reductions. Again, the measures of the ECB also seek to mitigate the demand shock by providing liquidity. The latest measure of the ECB was the launch of a large quantitative easing program, the Pandemic Emergency Purchase Program with an envelope of €750 billion until the end of the year. With the €120 billion decided upon on March 12th, this amounts to 7.3% of euro area GDP.

Following the actions of the European Central Bank, the European Commission has proposed coordinated European responses, also aimed at countering the economic impact of the pandemic.

Firstly, the Commission encourages all member state initiatives supporting small and medium- sized enterprises and households. These include wage subsidies, suspended corporate and value added taxes or social security contributions, financial support to consumers, assistance to businesses facing liquidity shortages and urgent rescue aids, including airlines and tourism sectors. While member states are primarily responsible for alleviating damages of SMEs, the Commission will redirect EUR 1 billion from the EU budget in the coming weeks as a guarantee to the European Investment Fund encouraging banks to provide liquidity to SMEs. This measure is expected to help some 100 000 European SMEs.

Another step of the Commission is to ensure the full flexibility of the EU budgetary framework in order to allow Member States to implement the measures needed to contain the pandemic and mitigate its adverse socio-economic impact. Accordingly, in the event of a significant decline in economic activity, it will be possible to have the necessary the budgetary adjustments expected from member states. The Commission plans to provide additional support of EUR 179 million through the mobilization of the European Globalization Adjustment Fund to support workers and the self-employed.

The Commission proposes to spend € 37 billion under the Cohesion Policy to combat the economic crisis caused the pandemic. According to the suggestion, Member States would be exempt from reimbursement of the unspent pre-financing funds, which amount to some EUR 8 billion. In the case of Hungary, the Commission estimates that EUR 855 million should not be reimbursed to the EU budget this year and that, therefore, approximately EUR 5.6 billion could be mobilized. The amendment to the regulation makes it clear that the funds must in any case be used for purposes accelerating investments related to combating the pandemic. However, it is not yet clear how this will apply to countries that have already committed their full allocation for 2014-2020, such as Hungary.

The measures taken by Hungary's Central Bank are in line with the decisions described above. On the one hand, its measures aim to provide forint liquidity by raising the central bank's swap stock by HUF 150 billion and by regularly announcing additional liquidity-enhancing swaps. On the other hand, it aims to support the domestic business sector and the population with their liquidity and solvency. All these measures are needed because SMEs and households can face liquidity problems very quickly, with a high likelihood to become a solvency problem and further aggravate supply and demand shocks.

Just like in the case of USA, the economic policies of the European Union are targeting measures that would ease the demand shock. While these policies can somewhat stimulate local production and the local economy, due to markets' dependency on the global supply chain, the local solutions may not always offset the damage caused by globalized economy. Moreover, the economic slowdown in the US and the EU will diminish demands for Chinese exports, further slowing its economic growth. Without its partners' usual supply order, the Asian country will not be able to reach its past economic performance.

The prolonged economic slowdown and financial uncertainty may lead to a deterioration of business confidence, which is expected to reduce worldwide demand for consumption and investment. Again, this has a negative impact on the financial system, aggravating the economic crisis. Considering all this, the global economic crisis projected by UN analysts seems a very optimistic estimate. The reason for this over-optimism might be a disregard of the fact that the root causes of both the dotcom and the 2007 crisis was not a challenge of the real economy. Both crises have originated in the financial sector and have had a severe impact on the real economy. It is much easier to alleviate a recession caused by the crisis in the financial sector while relying on a relatively stable and functioning economic environment. The cause of the current crisis lies in the real economy, to which the financial markets are responding, and its spill-over effect leads to a vicious circle.

The relocation or onshoring of some of the companies could help with the disruption of the supply chains and could somewhat offset the damages of the real economy. This process has already been started a few years ago, with a few of the biggest US companies, such as Apple, General Motors or Boeing moving some of their manufacturing processes back to the US. Similarly, companies of the European Union could once again start to produce or assemble in one of the member states or relocate their plants from Asia to a country closer to its borders. The economic crisis caused by the pandemic could reinforce this process, as well as the re-nationalization of some companies, as we have seen in the case of Alitalia.

As a conclusion, the few months of quarantine in China and then in the EU and USA will have very serious economic consequences. The fragmented global supply chain has resulted in both a global supply and demand shock, putting put the financial sector into a crisis. Most of the measures taken by governments seek to offset the emerging demand shock, to provide liquidity for their own currency, but there are no adequate instruments to respond to the supply shock. The loose monetary policies aiming to stimulate the economy may even lead to inflation. Considering all this, it seems that the Eurogroup president's "warlike times" metaphor was not a mere exaggeration.

19.03.2020.