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Coronavirus: The unknown and unprecedented risk

Financial markets and the global economy are still in the stranglehold of a real global shock that doesn't stop at borders and can't be tamed by words or negotiations: Covid-19

Healthcare workers in protective clothing check passengers' temperatures at an airport in Northern Italy

Uncertainty continues to grow

The outbreak of the new coronavirus comes at a time when the global economy was about to gain traction again on the back of the Phase One Deal between the US and China, a turning inventory cycle and a bottoming out of global manufacturing. Instead, the virus, along with its impact on economies and markets, is posing an unknown and unprecedented risk. Economic forecasts are surrounded by even more uncertainty than normal, including our own.

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There are still many unanswered questions regarding the real nature of the virus and its spread and impact on human health. For once, it is not economists who are struggling to come up with a common all-encompassing analysis of a problem but virologists. Ways to record the number of infected people differ across countries; it also hinges on people's willingness and ability to actually see a doctor or get to a hospital. Also, the fact that humans can carry the virus without showing symptoms suggests that the actual number of infected could be much higher than those currently reported. Although 'upside' is perhaps not the best word to use, it is true that if the number of infections is underreported, the death rate would automatically drop.

It's almost impossible to predict credibly what the economic impact will be of such an unprecedented and still evolving event but still it is our task to give some guidance.

A supply and demand shock

Several institutions have recently come out with estimates of how much damage the virus could do to the global economy. The OECD, for example, presents two different scenarios. A mild, base-case scenario in which growth would be reduced by 0.5 percentage points; and a risk scenario, in which the virus spreads more widely, which would shave off 1.4 percentage points of growth. In 2006, researchers at the World Bank investigated the impact of several historic flu waves and concluded that a mild flu outbreak could lower world GDP by less than one percent. These are just ballpark figures, nothing more nothing less.

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However, let's not forget that the world has become much more integrated since then, which means that any predictions based on past experiences should be taken with a large pinch of salt. In fact, it is currently not so much the virus itself but the policies trying to prevent it from spreading which are having a significant impact on economic activity. This impact is an unprecedented combination of both a supply and demand shock: a demand shock as illustrated, for example, by the record drop in Chinese car sales in February (-80% YoY), cancelled trips and vacations to Europe or the US or a general fear across all countries to go out. But also a supply shock, given the important role China plays in global supply chains and the impact of preventative policies in Europe and the US to keep employees at home or to cancel business meetings.

Gauging the impact of Covid-19 on our own growth scenarios is, therefore, a snapshot and work in progress rather than a perfect or final analysis. It is like steering in the dark; cautious and step-by-step. We currently use the working assumption that the spread of the virus will slow during the northern hemisphere spring and that the global economy will start to stabilise and gradually rebound during the summer months, notwithstanding clear differences across countries and regions.

Calls for action

It currently looks as if any overshooting in economic activity, which often appears after natural catastrophes, will not materialise; at least not to the same extent. The recent market turmoil reminds me of the financial crisis and explains why there are now so many calls for coordinated action. Why shouldn't what worked back then work right now? While G7 finance ministers came out with a statement that they stand ready to act (a phrase too often used in Europe), the Fed cut its policy rate by 50bp after an emergency meeting.

Some other central banks also eased policies and small countries even saw 'helicopter money'. The other major central banks, such as the ECB, BoE and BoJ, however, remain on the sidelines at least for now. This reluctance to act is mainly driven by two factors: i) very limited room for manoeuvre given the already very accommodative monetary policies and adverse effects, and ii) the awareness that any policy action can only tackle the economic effects but not the root cause. To be blunt, no fiscal or monetary easing could have the same impact as a vaccine against Covid-19.

Increasing pressure on central banks and governments

As the economic impact from Covid-19 and the measures to isolate it become more visible, pressure on central banks and, above all, governments to act is likely to increase. Think of monetary easing, targeted at credit easing, but also of temporary VAT cuts, state guarantees for SMEs to prevent foreclosures, subsidised short-time work schemes or simply plain-vanilla investments.

The eurozone particularly will be at the centre of international attention once again. Will Covid-19 finally be the trigger to get significant fiscal stimulus, which goes beyond some flexibility in the interpretation of the fiscal rule? And, will the ECB under the leadership of Christine Lagarde continue Mario Draghi's 'whatever it takes' policy or will it return to the Duisenberg and Trichet era when the ECB's preferred option was to wait-and-see. Lots to talk and think about.

Our monthly update tries to give some answers and to provide some guidance on the possible impact from the coronavirus on the global economy. But don't forget, this is a fast-moving environment. To use an often-heard phrase: we will continue to monitor the situation very closely.

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