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A Shock to the Global System

The sharp economic downturn caused by the COVID-19 pandemic has created "a crisis like no other." Advanced economies now need to overcome national reflexes and help developing countries.

By Thieß Petersen and Thomas Rausch

On New Year's Eve 2019, the World Health Organization's Beijing office stumbled across reports of several cases of viral pneumonia in the city of Wuhan. What seemed like a minor footnote at the end of the old year very soon developed into the overarching theme of the new one—and more than likely well beyond. After being largely confined to China during January and February, COVID-19 rapidly spread across the globe in March and April. On March 11, the WHO officially labelled it a pandemic. By mid-November, the Johns Hopkins Coronavirus Resource Center has counted more than 53 million cases and more than 1.3 million deaths globally.

A Different Kind of Beast

COVID-19 has been re-shaping politics, economics, and society around the world profoundly, with the most immediate effect on national economies and the global economic order. Compared to previous economic downturns, the coronavirus crisis stands out in three important ways:

First, its causes are rooted both in the supply and the demand side of the market. While the crisis of 2008/09 started as a financial crisis that swiftly triggered a slump in demand, the COVID-19 pandemic has hit supply and demand right from the start. Lockdowns to contain the spread of the virus and thus mitigate the public health hazards resulted in both a severe disruption of supply chains and fewer options and opportunities to consume. Production and shipping of new cell phones, television sets, and T-shirts came to a halt, but so did personal shopping; what's more, consumers grew reluctant to spend money, since they could not be certain about their future income. This time a financial crisis may not have prompted the downturn, but it remains open whether it could be one of its results.

Second, the service sector took a big hit. While services have seen only minor losses in previous economic crises, such as the dotcom bubble in the early 2000s, they have been front and center in this one. Many services are still non-digital and need to be performed in person—which runs counter to the very idea of social distancing. Instead of acting as

an important stabilizer of economic activity, services became a major reason for its steep decline. Unlike buying and running a car, which can easily be delayed, a cup of coffee, a haircut, or a visit to the cinema need to be consumed right away. In services, we are also unlikely to experience big catch-up effects that could make up for previous losses once the crisis eventually subsides.

Third, the resulting recession was a synchronized global shock. While the financial crisis of the late 1990s originated in Asia and took considerable time to create ripple effects through the global economy, the lockdown measures brought about by the pandemic created a global downturn within a few weeks. Since no region was spared, none could act as a counterweight to offset the negative effects of the crisis. Increasing global integration of supply chains and consumption patterns may have helped improve pre-crisis living standards but in 2020 the flipside of the ever-closer economic integration coin came out heads: international economic interdependences transmitted shockwaves from region to region.

Thieß Petersen
is a Senior Advisor at the Bertelsmann Stiftung.

Thomas Rausch
is a Senior Project Manager at the Bertelsmann Stiftung. Both authors blog about global economic dynamics at https://ged-project.de.

"A Crisis Like No Other"

The COVID-19 crisis has been dubbed "A Crisis Like No Other" by the International Monetary Fund in its June 2020 World Economic Outlook. A glance at some key macroeconomic figures for its short-term effects reveals why this assessment is as true as it is dire: In the first quarter of 2020, China, which has been used to growth rates between 6 and 10 percent for decades, saw its quarterly GDP decline by almost 7 percent compared to the same quarter of the previous year. For all other economies, the stock market crash foreshadowed the recession to come. Between March 9 and March 16, the Dow Jones Industrial Index recorded three daily drops of more than 2000 points, the three highest point drops in its history. In terms of percentage change only October 19, 1987 ("Black Monday") saw a higher daily loss than that of March 16. The most extraordinary testament to slowing economic activity came about one month later: After the oil price had taken a steep dive, April 20 became known as the first day in history when the price for one US oil futures contract (WTI) turned negative.

Only "Black Monday" in 1987 saw a higher loss on Wall Street than March 16, 2020

In the second quarter, all the other G20 economies reported major GDP downturns compared to the previous quarter. According to OECD data, they ranged from 3.2 percent in Russia and Korea to 19.8 and 25.2 percent in the United Kingdom and India respectively, with most of the G20 economies losing between 7 and 14 percent of GDP. Industrial production in the EU, for instance, fell by 10 percent in March compared to February, in April it fell another 17 percent compared to March—these were by far the steepest downturns in EU history. The financial crisis with 3 to 4 percent declines at the end of 2008 and beginning of 2009 pales in comparison. In April, the US recorded an unemployment rate of

14.7 percent—the highest figure since reporting began in 1948. World trade volume fell by a record 14.2 percent in April 2020 compared to the previous month.

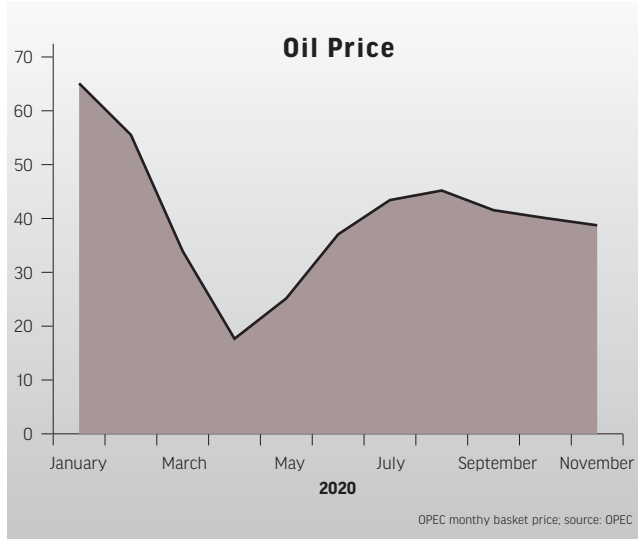
A downturn on this scale leaves no actor or part of the economy unscathed. Private households suffer income losses due to unemployment or furloughs. At least for low-income and middle-income households, or those households with few savings or a lot of debt, this can only mean less consumption. Companies lose orders, contracts, and proceeds. They must take on new debt to cover their fixed costs. Small- and medium-sized enterprises are hit particularly hard as they are more labor-intensive, have smaller liquidity reserves, and few financial alternatives to borrowing from local banks. Governments suffer from massive losses in tax income. As low-income countries often rely heavily on tariff revenue, they also suffer from declining international trade—critically in commodities.

Governments to the Rescue

Still, governments were the only actors that could mitigate the economic fallout.

In doing so, they needed to adjust their crisis response playbooks to live up to the unique challenges of a recession caused by a pandemic. Having ordered widespread lockdowns to reduce infection rates to a manageable size, governments had to help ensure the supply of basic goods and income. They guaranteed purchases and imposed export quotas for basic goods or medical equipment, such as eye protection, face masks, and disinfectants. In addition, governments extended unemployment benefits or funded furlough schemes for employees; they made available credits and loan guarantees for companies.

It was only when infection rates had declined and restrictions on public life could be (partially) lifted that governments could turn to their typical first move in any economic crisis: stimulate demand. But options for doing so via monetary tools were limited. As many central banks had already set interest rates at close to zero and engaged in large-scale quantitative easing after the financial crisis, they had



little room for maneuver left. In mid-March, the US Federal Reserve slashed the target range for the federal funds rate from 1.5 percent to between 0 and 0.25 percent. Only three days later, the European Central Bank announced its "Pandemic Emergency Purchase Program," or PEPP. Under this mandate, the ECB can purchase assets totaling €750 billion (in June extended by another €600 billion) to reassure investors that there is a buyer-of-last-resort for their bonds.

In addition, governments resorted to expansionary fiscal policies. In order to increase trust among market participants many had already announced comprehensive measures during the lockdown period. They included a combination of tax relief,

investment programs, loan guarantees, direct income transfers to private households, extended unemployment benefits, emergency aid for the self-employed, and even (partly) taking over companies. With the exception of China, all major economies have passed bigger stimulus packages than during the Lehman Brothers crisis. Amounting to about 11 percent of national GDP, the US Coronavirus Aid, Relief and Economic Security (CARES) Act virtually doubles the amount of spending in the 2009 ARRA stimulus bill in relation to GDP.

A Recovery on Shaky Grounds

These measures were successful in stopping the steep downward momentum and initiating a tepid recovery.

Over the second and third quarter, several major economic indicators have started to point to a clear improvement compared to previous months. A key reason has been China's early and rapid bounce-back from the crisis with a GDP growth rate of 3.2 percent in the second quarter and 4.9 percent in the third quarter, compared to the same quarters of the previous year. Industrial production in the EU also started to recover rather quickly, moving up by 11.6 percent in May, 9.6 percent in June, and another 4.9 percent in July. While the US unemployment rate is still way above pre-crisis levels, it has embarked on a continual decline since its peak in April. In October, it stood at 6.9 percent.

The upward trajectory increased confidence among important market participants. Purchasing Manager Indices measure how managers in manufacturing expect the business climate to evolve over the coming months. While their outlook remained rather gloomy in individual economies, such as Mexico or Russia, thanks to clear improvements in the United States, China, and Germany the overall global outlook turned positive over the months of August and September.

Looking ahead, the IMF's most recent World Economic Outlook, released in mid-October 2020, revised its projections upward for yearly GDP in 2020 and 2021. It estimates the global decline of 2020 GDP at about 4.4 percent compared to 2019. World trade volume is forecasted to decline by "only" about 10 percent. For 2021, the IMF predicts that the world economy will bounce back by 5.2 percent. These projections, however, come with a huge caveat: the forecasts do not include the economic fallout of the second wave of massive COVID-19 infections that has hit mostly Europe and the US since October.

As the policy evaluation of the pandemic is only in its infancy, we can only state that these measures have been successful in the short-term but not how they will compare in the long run and which measures were most successful.

If we had to offer educated guesses, however, we would settle for three candidates as critical so far and going forward. The first measures are furloughs and short-time working allowances (*Kurzarbeitergeld*). After being seen as a major reason why Germany managed to

The pandemic has exacerbated problems for developing countries

avoid high unemployment in the wake of the financial crisis, many other European countries adopted similar schemes. In the coronavirus crisis, short-time working allowances have been imperative in avoiding layoffs. The measure increases the confidence of consumers in a stable income trajectory, preventing further drops in demand. In addition, it allows companies to retain valuable expertise and know-how for a rapid restart.

The second measures are public investment in research, development, and education. Just as short-term working allowances help stabilize expectations among consumers, so does public spending for companies. It offsets at least some of the losses incurred by lower private demand. Given already high debt levels in most advanced economies, it is important to gear public spending toward the longer-term perspective. So, investment in digital skills and technologies, which increase the competitiveness of individuals and sectors, or in the green transition, which reduces the carbon footprint of economies, should have priority as they benefit both current and future generations.

The third measure is liquidity assistance for companies, most importantly SMEs and the self-employed. Many companies have suffered from steep declines in revenues as a result of lower demand. It is all but certain that we will see a significant rise in insolvencies and bankruptcies that will threaten the livelihoods of millions of people. Public assistance can help overcome short-term liquidity squeezes so that companies can stay afloat. However, targeted measures are critical here, too, in order to avoid the spread of "zombie firms." Businesses pursuing economic models that are no longer viable and overburdened by debt should not be put on life support.

It may be tempting for advanced economies to solely focus on their own welfare, but this would be self-defeating.

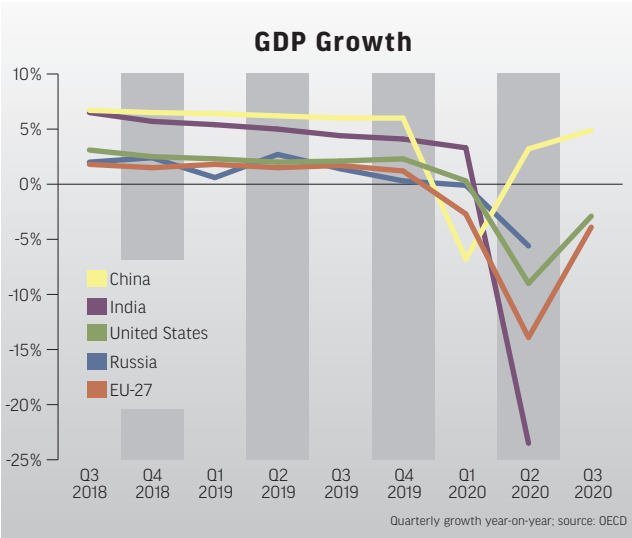
Help the Poor!

According to the IMF's latest projections, advanced economies are expected to experience a decline of 5.8 percent in GDP in 2020. Emerging and developing economies will see losses of 3.3 percent on average. So, at first glance the former seem to be the bigger losers from the pandemic. These mere aggregate figures, however, suggest a less grim picture for emerging and developing countries than is the reality. Many developing countries had already been in a tight economic and fiscal spot before the outbreak of the pandemic. The COVID-19 crisis has exacerbated these problems via multiple channels, resulting in decreasing commodity prices, declining exports, higher external indebtedness, and a flight of foreign direct investment toward countries deemed less risky and more robust in handling shocks.

In addition to lacking fiscal options to mitigate the crisis, developing countries face at least two more important problems that impede their ability to battle a national health emergency. First, their medical infrastructures are often so rudimentary that they cannot handle even moderate infection rates, let alone major outbreaks. Second, they do not have social security systems that allow people to reduce economic activity or adhere to social distancing while they try to sit out an infection wave. Therefore, they rely more than ever on financial support, debt relief, and knowledge transfer from advanced economies.

The COVID-19 Vaccines Global Access (COVAX) initiative could be imperative in mitigating developing countries' health plights. It brings together more than 170

countries to discuss an equitable distribution of effective and licensed vaccines. However, two important players, Russia and the US, have so far stayed at the sidelines.



While the World Bank has increased its financial assistance to developing countries, this will hardly suffice. The G20—a coordination group that showed great promise as a crisis management executive committee in 2008/09 but has failed to live up to expectations so far—should not only consider debt payment extensions and restructuring for developing countries, but also grant write-offs and cancellations for the most severe cases. Without assistance from advanced economies, many developing countries, particularly those in Africa, could face a humanitarian disaster that may well lead to another wave of northward migration.

A Crisis to Reinforce All Other Crises?

While the short-term consequences would make the crisis stand out in its own right, it is the long-term repercussions that could truly turn it into a "crisis like no other."

One reason for the muted response from the G20 and other international institutions so far is the underlying current of increasing great power rivalry between China and the United States. Given China's swift economic ascent and its more authoritarian course under President Xi Jinping as well as the Trump administration's openly zero-sum approach to the world economy, it is no surprise that trust between the two countries has eroded.

China's opaque handling of the outbreak and the Trump administration's aggressive buck-passing have only intensified this trend. As an economic crisis of massive proportions could re-calibrate the relative power balance between both countries, they will each be keenly watching who loses or wins (or rather: loses less) from the fallout of the pandemic—that is also true for a Biden administration. That is certainly not a boon to international collaboration. It only adds to the ongoing erosion of multilateral rules for the global economy.

One of the clearest manifestations of the intensifying Sino-American rivalry had been their on-and-off trade war in the months preceding the crisis. Both the resulting tariff and counter-tariff hikes—and even more so the uncertainty surrounding them—have caused losses to the world economy in the hundreds of billions of dollars. Protectionism is therefore on the rise again across the globe—another worrying trend the coronavirus crisis could easily reinforce.

So far, its impact has been mixed: on the one hand, countries have implemented measures to facilitate trade; on the other, they have also initiated new ones to restrict it. The second wave of coronavirus infections might tilt the balance in favor of greater protectionism as more

countries race to keep their personal protective equipment only for themselves or scramble to protect important but tattered industries from foreign competition.

Finally, when it comes to climate change, there appears to be a silver lining to the coronavirus crisis. Global CO_2 emissions have decreased noticeably since the start of the pandemic. During the first half of 2020, lower economic output resulted in 8.8 percent fewer emissions compared to the same period in 2019, with lower use of ground transportation during lockdowns being the most important contributing factor. However, there were also strong rebound effects. Once countries began to open up their economies again, emission levels quickly came close to their pre-crisis levels. So, while the pandemic may have slowed down the process of global warming a tiny bit, it has not altered its fundamental trajectory. It might even lead to an "economics first, climate second" approach where policymakers soften climate goals in order to speed up the recovery.

The G20 should consider debt payment extensions and grant write-offs

A Global Challenge

Rather than acting as the final wake-up call to set aside national posturing in the face of multiple global economic and governance challenges, the pandemic has brought about more concerns, at least so far. But it does not have to be this way. Policymakers in Brussels could take talk of a "geopolitical EU" seriously and try to strive for a bigger role in international affairs, not least to help balance out the rivalry between the US and China. Europeans could refrain from more protectionist measures, in particular for agricultural goods, to set an example for international commerce and show that globalization can be a solution rather than a problem. And certainly, the EU stimulus package could include higher public investment in technologies that boost European competitiveness and speed up the ecological transition to a zero-carbon economy.

Finally, for the next steps in fighting the pandemic, it is fundamentally important to avoid a discussion stuck in the trade-off between public health and economic recovery—because there is no such thing. Quite the opposite: both can and should go together. Bringing down infection rates is a necessary precondition for sustainable economic growth and beating a pandemic, in turn, which is only possible with an adequate supply of basic goods and services. This is not just a national but a global challenge —one in which advanced economies bear a responsibility to look beyond their narrow national interests and support developing countries. IP

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