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TRADE AND DEVELOPMENT REPORT UPDATE

The coronavirus shock: a story of another global crisis foretold and what policymakers should be doing about it

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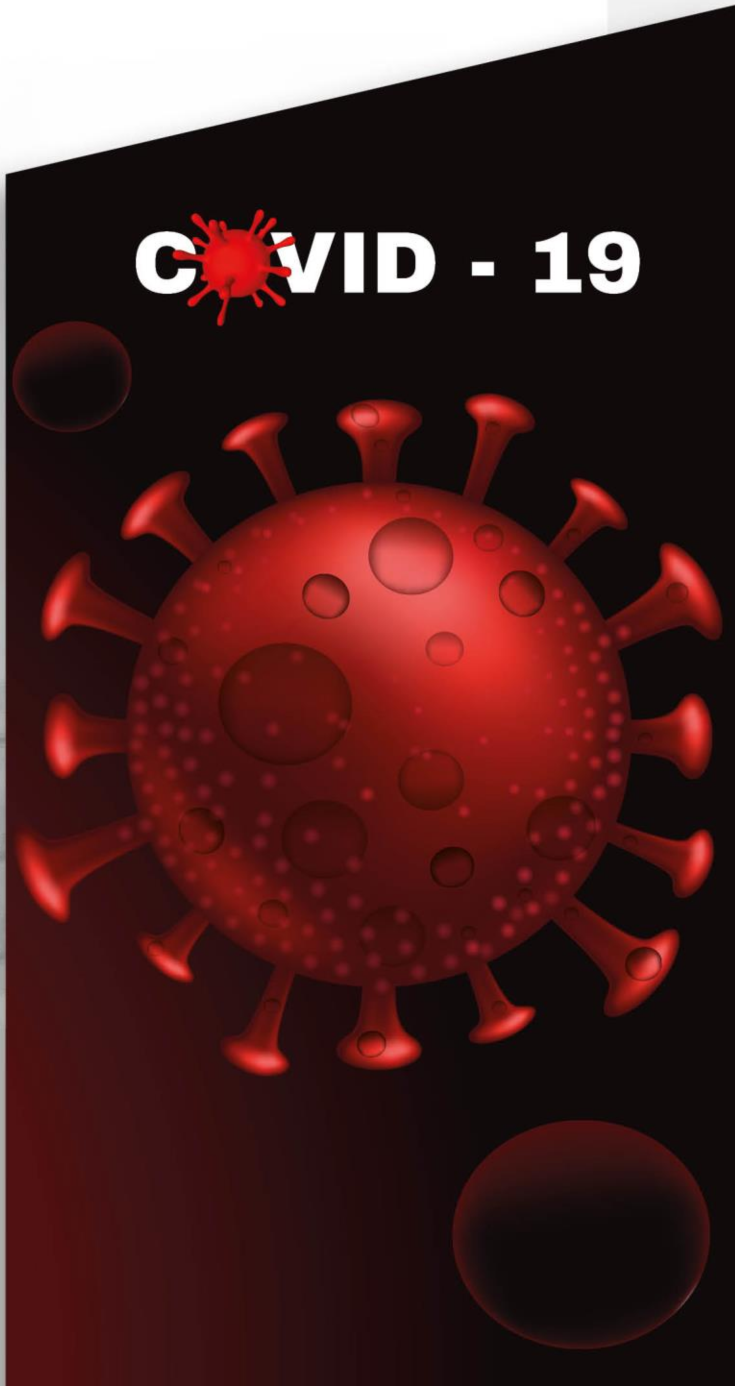

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A year of living dangerously

The coronavirus crisis is first and foremost a public health threat, but it is also, and increasingly, an economic threat. The so-called "Covid-19" shock will trigger a recession in some countries and a deceleration of global annual growth to below 2.5 per cent -- often taken as the recessionary threshold for the world economy. The resulting hit to global income compared with what forecasters had been projecting for 2020 will be around the trillion-dollar mark; the bigger question is could it be worse?

The duration and depth of the crisis will depend on three variables: how far and fast the virus spreads, how long before a vaccine is found, and how effective policy makers will be in mitigating the damage to our physical and economic health and well-being. The uncertainty surrounding each of these variables is adding to people's sense of anxiety, which is a fourth variable that will shape crisis outcomes.

There are two possible readings of the economic consequences of the Covid-19 shock. The consensus view is that the shock has the potential to upset what was a spluttering but otherwise well-aligned global recovery that had set in during the second half of 2017, with the policy task at hand to nullify the new threats to a renewed economic confidence that had underpinned a string of optimistic growth forecasts for the coming years.

From this perspective, if the outbreak is short-lived, a familiar mix of accommodative monetary policies (ideally limited to cuts in the central bank's rate but possibly involving more unorthodox measures to lower long-term interest rates) and automatic fiscal stabilizers should be sufficient to save the day, with the recovery assuming the "V" shape that followed, for example, the SARS virus shock of 2003.

If, however, the crisis is more long-lasting, most likely due to disruptions on the supply-side of the economy through crippled production networks and squeezed profit margins, hopes of recovery will hinge on more sustained and coordinated liquidity injections by Central Banks, more active fiscal policies (where space is available) and by renewed efforts to bolster free trade and foreign investment. The recovery will then more likely assume a U-shape, like the oil shocks of the 1970s, with some serious economic casualties along the way, but with the organizing principles of the world economy preserved… until the next crisis!

On a second reading, the economic consequences linked to the virus are less a matter of time and confidence and more a matter of the (political) leadership and (policy) coordination needed to stem the waves of economic pathogens released by the crisis from crashing in to an already fragile and highly-financialized world economy. Losses of consumer and investor confidence are the most immediate signs of spreading contagion, but asset price deflation, weak aggregate demand, heightened debt distress and a worsening income distribution pose greater policy challenges. The East Asian financial crisis might offer parallels, but that crisis occurred when China had a smaller economic footprint and the advanced economies were in reasonably good economic shape which is not the case today.

From this alternative perspective, an effective response to the economic consequences of the Covid-19 will require not only active and targeted macroeconomic measures, but a series of remedial policies and institutional reforms needed to build a robust, sustained, equitable and climate-friendly growth trajectory that would reduce the chances of a subsequent economic breakdown.

Sluggish growth, extreme inequality and recurrent shocks: the new abnormal.

A spluttering recovery in the North and a general slowdown in the South have been hanging ominously over the global economy since the 2008-09 financial crisis; combined with heightened market volatility, a fractured multilateral system and diminished room for policy manoeuvre, the past decade has been marked by a growing sense of economic anxiety.

Behind this lies a more prolonged period of sluggish investment and growth, punctuated by intermittent booms and busts, and underpinned by rapid private debt accumulation, stable prices and low interest rates, which emerged well before the financial crisis in the advanced economies and has characterised much of the rest of the global economy since then.

Sluggish growth and a heightened economic anxiety have been closely associated with an unprecedented rise in inequality, across almost all countries, reflecting a combination of wage suppression, corporate rentierism and wealth concentration. Financial boom-bust cycles generated by attempts to overcome sluggish growth by monetary easing and financial deregulation has exacerbated the inequality-stagnation nexus by creating waste and distortions on the supply side and reducing potential growth.

During the booms, the financial sector tends to crowd out real economic activity while cheap credit misallocates capital, diverting resources to low-productivity sectors such as real estate and personal services in the “gig economy”. The resulting misallocation of resources is exposed during crises, after which the economy should shift back to more productive sectors and companies, but this is often impeded by credit crunches and deflationary pressures. These cycles also aggravate the demand gap by increasing inequality, with austerity measures adopted in response to the bust further impoverishing working families, while the top one per cent capture much of the incremental growth in the recovery.

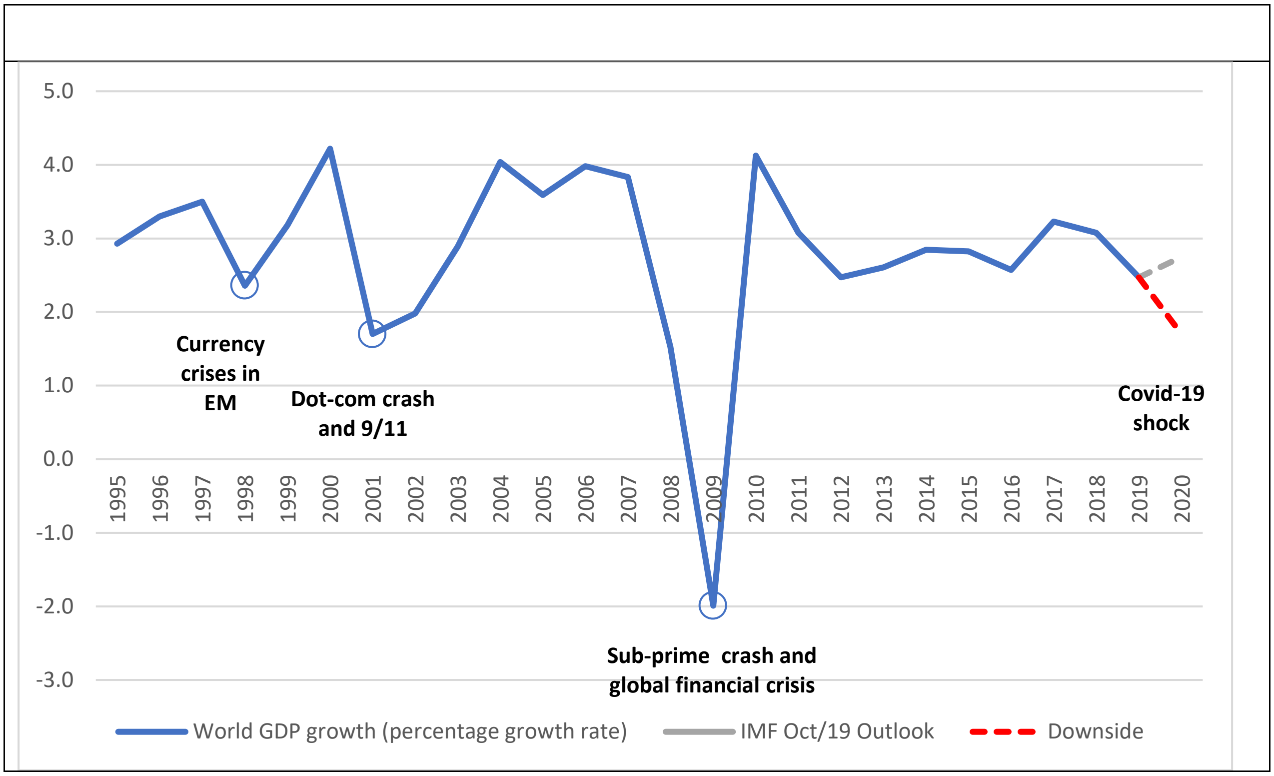
Given this heavily financialized, fragile and deeply interdependent global economy contagion from shocks has become a persistent worry for policy makers, particularly in developing economies where reserve accumulation has been the protective measure of choice. While the most vulnerable economies are rarely the source of the financial pathogens that spread contagion, the multilateral system, tasked with ensuring stability, has been too slow in reacting to the threat of financial contagion and too aggressive in dealing with its economic consequences.

Over the second half of 2019, and before the outbreak of the Covid-19 crisis, it became increasingly clear that the global economy had entered more troubled waters with slower growth across all regions and a number of economies contracting in the final quarter. Still, and despite the (self-fulfilling) talk of limited room for policy manoeuvre, there was a widely shared expectation that things would gradually improve in 2020, led by the large emerging economies, with a return to potential global growth by 2021.

The gap between the reality on the ground, which was calling for bold and concerted policy action, and a persistent belief in sound fundamentals and a self-correcting world economy, stigmatized suggestions of a need for bolder policy interventions, deferring instead to monetary tweaking and “structural reforms”.

To mention just one example, the IMF’s January Outlook repeated such sentiments albeit with a small growth downgrade from its October figures because of a slower return to normal in leading emerging economies. Still, the combination of an almost constant growth rate of 6% in China, an easing of trade tensions and a presumed acceleration of major commodity-exporting countries was expected to push global growth in 2020 up to 2.7 per cent, despite the continued weak growth performance of developed economies (Figure 1). Now that the Covid-19 shock has changed the scenario all forecasts for 2020 are being revised downward.

Figure 1. Global GDP Growth, 1995-2020



Source: UNCTAD calculations based on IMF, WEO, October, 2019

With a percentage point drop in global growth costing some $900bn in lost income, most forecasts have wiped a trillion dollars of global income for this year and if growth comes in at 1.7 per cent the cost of the virus will be closer to 2 trillion dollars.

Channels of economic disruption

To understand the potential damage from the virus it is useful to distinguish three main channels of disruption: demand, supply and finance.

On the demand side, a combination of declining income, shifting sentiment (fear of contagion) and the absence of a vaccine can be expected to negatively impact private spending, particularly in the service sector, with tourism and entertainment being more affected, especially in activities associated with large public events and catering services. Reduced working hours, possible layoffs will, other things being equal, reduce household spending and increase economic insecurity for those who do not have access to a social safety net. The increase in uncertainty about the effects of the shock will also delay private investment, but government demand can go up in many countries, to fight contagion through emergency health-assistance initiatives. Despite the latter, the net demand effect of the Covid-19 shock is generally assumed to be negative in the short run.

On the supply side, a sudden stop of manufacturing activity in the most affected regions will cause bottlenecks in global value chains. Inventory decumulation can support supply for a while, but with today's just-in-time globalized production structures, it seems reasonable to assume that the duration and magnitude of the Covid-19 outbreak has already exhausted inventory stocks. Such disruption will in turn trigger widespread factory closures for lack of intermediary inputs, even in zones still immune to the virus.

The concern is that exports of both manufactured final goods and of commodity inputs will begin to weaken sharply, further affecting earnings and employment. Despite all unknowns, a moderate hypothesis is that profits will be initially hit and, if the crisis persists, employment and wages will also decline. The consequences of disruptions on the supply side can therefore contaminate aggregate demand, reinforcing the first channel mentioned above, as well as threatening financial stability, as laid out below.

The increase in risk aversion since the Covid-19 shock and the usual flight to liquid assets in face of uncertainty have already pushed equity markets into correction territory. In some cases, the immediate “corrections” were as intense as during the Global Financial Crisis (GFC) and volatility has also sky-rocketed. Following safe-haven bets, bond markets have exhibited sharp reversals. In the foreign exchange market, sharp fluctuations are still to be expected both for emerging-market currencies, as the risk-premium of primary exporting and financially-fragile countries move up, and the exchange rates between the world’s main reserve currencies adjust to the response of monetary policy.

As discussed extensively in previous Trade and Development Reports, the shock is coming after an unprecedented splurge in borrowing, both public and (particularly) private, with total debt stocks reaching $229 trillion at the end of 2018, over two and a half times global GDP, and up from $152 at the onset of the global financial crisis.

Heavily-indebted commodity exporters are likely to be on the front-line of debt-related economic stresses from the spread of the virus, particularly where foreign exchange reserves have been on a falling trend. But loans to the corporate sector have been a prominent feature of the post-crisis period, including to firms in emerging economies, and with so-called leveraged loans – characterised by a very high debt to earnings ratio – which have doubled in size over their pre-crisis peak becoming a growing source of concern, particularly in advanced economies. According to the OECD, the global outstanding amount of non-financial corporate bonds reached USD 13.5 trillion, more than double their (real) value at the end of 2008, with non-investment grade issuance reaching 25 per cent of total issuance. Profit warnings and adjustments in the horizon of returns on investment by highly leveraged firms will likely trigger margin calls, tighten borrowing conditions and increase the risk of a stampede to sell those assets not hit in the first round of heightened risk aversion. This is likely to be particularly stressful in sectors and for firms caught up in the disruption to supply chains caused by the virus spread.

This raises the prospect of a credit crunch in a period of high indebtedness, declining global growth, falling foreign exchange earnings and despite very low-interest rates.

Depending on how far this pattern is stretched out and how policies respond, the projected growth and financial forecasts could range from a curbing of financial exuberance through to a deflationary panic to another ‘Minsky moment’ and subsequent global financial crisis.

The looming threat to indebted developing economies

Over the past decade, developing countries have experienced deepening financial and debt vulnerabilities against a backdrop of tepid economic growth, slowing trade, sluggish real investment, including greenfield FDI, and growing income inequalities. From Buenos Aires to Beirut, and from Maputo to Islamabad, developing countries across different income categories and with very different structural features are struggling with unsustainable debt burdens. Almost half of poorer economies, eligible to its Poverty Reduction and Growth Trust (PRGT), have been assessed by the IMF to be at high risk of sovereign external debt distress or already in debt distress at the end of 2019.

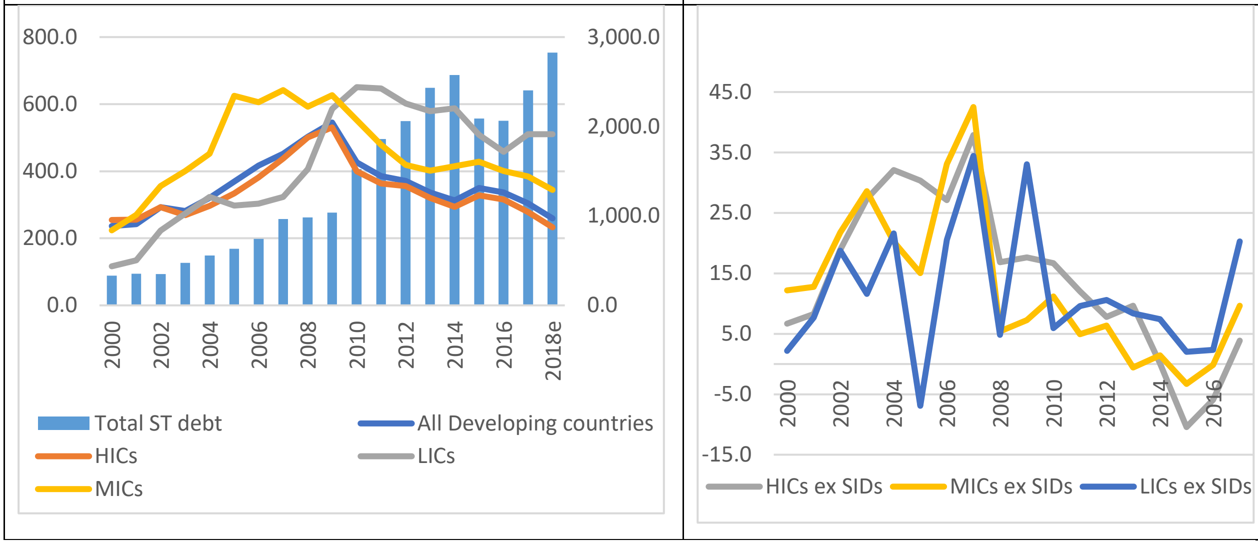
In 2018, the total debt of developing countries – private, public, domestic and external - reached 191 per cent of their combined GDP, the highest level on record. As a result, fast growing developing country indebtedness has come with specific features that do not bode well for their ability to withstand another external shock, such as caused by Covid-19. First, much of the increase comes from the spectacular explosion of private corporate indebtedness, primarily in high-income developing countries but by no means limited to these. Second, the growing share of sovereign debt owned by foreign shadow financial institutions has entailed rising debt service costs and a wall of outstanding sovereign debt repayments on international bonds with short maturities due over the next decade, in particular in sub-Saharan Africa.

While the rapid growth of low-quality corporate debt has become a major concern for advanced economies, by 2018 the share of private debt in overall debt was higher in developing countries – constituting some 73 per cent of their total debt -- than in advanced economies; as corporate debt in some developing countries is also expanding much faster than investment in physical capital this would suggest a low-quality (or speculative) bias here too. Moreover, with the exception of China where corporate bonds are primarily domestically owned and the government retains considerable fiscal space, around one third of private non-financial corporate debt in developing countries is estimated to be held by external creditors and is foreign-currency denominated.

A major concern is therefore that developing countries, already facing deteriorating debt positions, will not have the reserve cushion to withstand a temporary but possibly pronounced impact of the COVID-19 shock on their real economies. As Figure 2 shows, international reserves as a share of developing countries' short-term debt rose in all income groups until the outbreak of the global financial crisis, with forex reserves overall growing at a higher annual rate than short-term debt. This trend towards effective self-insurance did not prevail however, with the ratio of international reserves to short-term debt falling pronouncedly after 2009 and in particular in the wake of the onset of commodity price slumps since 2011. Despite a pick-up since 2016, in general, the current levels of reserves would, on average, cast a question mark over the ability of developing countries to stave off the Covid-19 shock, in particular where reserve accumulation has occurred through borrowing rather than (or in addition to) export earnings.

Figure 2. Foreign exchange reserves indicators

Reserves as a ratio of ST debt	*Reserves growth, Y-on-Y[a]*



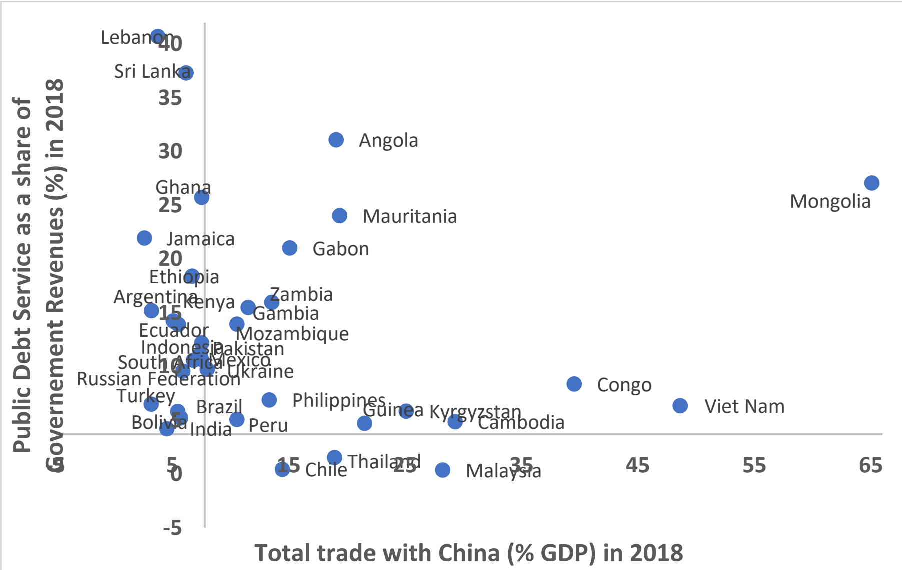
Source: UNCTAD secretariat calculations based on World Bank, IMF and national sources

Note: a. Excluding Small Island Developing Countries (SIDs) whose change in reserves tend to reflect climate shocks.

How large the real COVID-19 shock to debt-ridden developing economies will be, and therefore the extent to which they may or not be able to sit this out by liquidating their rather meagre reserve cushions, is also a function of their economic integration with China.

Figure 3 below maps out data for the trade openness of economies to China (exports plus imports to GDP) representing a proxy for the depth and extent of real ties to China, together with debt servicing on publicly guaranteed debt to government revenue as sources of vulnerability facing developing countries since the viral outbreak. We use trade in goods (both exports and imports) in an attempt not only to capture the importance of China's share of export demand but also the role of imports affecting global values chains.

Figure 3. Vulnerabilities in the wake of the Coronavirus outbreak



Source: UNCTAD Secretariat calculations, IMF Global Debt database and COMTRADE. The graph is centered with average values for all developing countries.

This data, for some 117 developing countries, shows that around a fifth of these economies are highly vulnerable to direct impacts of the COVID-19 shock due to a combination of deteriorating debt sustainability (captured by a growing share of public revenues going to service public debt obligations) with high exposure of their economies to trade and wider economic relations with China, including Mongolia, Angola, Gabon, Philippines, Mozambique, Vietnam, Cambodia and Zambia. These developing economies are closely linked to the Chinese economy through their participation in Chinese-led global value chains and also are reliant on commodity exports to China.

In addition, China has become an important source of financing for developing countries, with loans to emerging market and frontier economies increasing 10-fold (from US$ 40 billion in 2008 to US $ 400 billion in 2017). For countries like Zambia, Mongolia, Ecuador, Venezuela, Angola, Kenya, Pakistan, Sri Lanka, Bolivia and Jamaica, China is now the largest official creditor. China's official flows do not mirror those of private investors in search of high short-term returns on speculative investment, and even provide a possible shield against the mercurial movement of private cross-border capital flows. Still, recipient countries may be affected in future should the COVID-19 shock to the Chinese economy prove to have prolonged consequences, including for its ability to maintain long-term lending into developing countries. For low and lower-middle income developing countries, in particular, and despite unprecedented global liquidity post the global financial crisis, access to Chinese loans has been a crucial source of longer-term and developmental financing. The largest part of China's lending goes to public entities, with loans to private entities accounting for less than 10% of the total. Given China's role, and its Belt and Road Initiative, there is some speculation that China may be the lender of last resort for countries with relatively low credit ratings. If the domestically-oriented focus expected from China in the year to follow subdues new credit provision to developing countries, those with strongest financial links to China might be amongst the slowest to recover from the economic consequences of the COVID-19 virus.

Ingredients of a sensible policy response

It should be clear that if a virus outbreak in a food market in Southern China, significant as it is in terms of public health, is causing such global disruption, the most fundamental flaws in the current economic system cannot be any longer ignored.

The policy responses can be usefully identified from the channels listed above (demand, supply and finance), however, the challenge should not be framed as simply overcoming a disruptive shock and returning to an otherwise desirable pre-crisis growth path. Rather, it is necessary to align the responses to the Covid-19 shock in a way that reorients the world economy in a more caring, inclusive and financially stable direction.

If the Covid-19 crisis has negative impacts on household and corporate spending, governments can avoid a slump by increasing their own demand, especially for goods and services that aren't in short supply, such as construction and social services.

A temporary boost to emergency health spending – with free care for those affected by Covid-19 – is an obvious response, and the same holds for emergency cash transfers for those hit by a sudden loss of income, especially in the informal economy. **The welcome announcement by the IMF to provide $50bn to mitigate the effects of the crisis should take the form of grants for the most vulnerable countries, and zero interest loans for others.**

Calls for increased public spending always raise fears of profligacy and financial trouble down the road. These are inappropriate in the face of massive waste for macroeconomic mismanagement (fiscal austerity stunting growth and eroding tax revenues), central banks' bail-outs of private banks, fossil fuel subsidies and the scale of international tax evasion and avoidance. As discussed in our 2019 Trade and Development Report, **reducing some of this waste would be enough to launch a Global Green New Deal including improvements to public health systems**.

Governments who are willing to do "whatever it takes" to stabilize the economy have to increase their spending until private-sector demand and employment return to healthy growth rates. The lessons of the previous decade are clear: the combination of aggressive monetary policy and timid fiscal interventions leave private investors in a 'wait-and-see' limbo and encourage speculative spirits. In the current crisis, there is also the additional risk that a slow fiscal response could increase the high risk of contagion; **governments should give a clear signal that public debt concerns are secondary to public health concerns.**

Calls for relaxing fiscal positions should not be constrained by the argument that more spending is ineffective if businesses face bottlenecks in their supply chains. While bottlenecks exist, the real constraint faced by the global economy is spending, especially for investment in physical and social infrastructure as well as in public-funded research and innovation. Furthermore, technical progress (and productivity growth) is held back by low spending in these areas.

Addressing economic inequalities should be a central part of the policy response with a recognition of both short and long-term benefits. Growing inequalities over several decades have eroded most households' spending power since long before the Covid-19 outbreak, and they now pose serious headwinds against a robust post-outbreak recovery. By supporting employment growth, government spending stimulates wage growth as well. Stronger labour market regulation is important too as it supports earnings (e.g. with minimum wages), income security (e.g. with pensions, unemployment insurance and sick-pay benefits) and income earning abilities (e.g. with healthcare provisions, education and more).

The above should include special attention to people affected by the virus. Societies with universal health insurance coverage are best positioned to protect themselves from the consequences of a pandemic since people incur no cost to be tested for the virus, and those infected can be treated by the public system with little income loss. **The restrictive business practices of large international pharmaceutical companies should be subject to independent examination to assess any potential obstacles they might pose to addressing the health emergency.**

Central banks should do “whatever it takes” in the face of the Covid-19 including **directing credit for production and employment creation** (rather than financial speculation or bailouts), reinforcing public infrastructure and development banks, providing tailored credit lines for financially distressed SMEs. And, at the international level, multilateral institutions like the IMF should offer concrete low-cost hedging mechanisms for governments of developing countries to manage exchange-rate risks coming from international shocks, averting the boom-bust financial cycles of recent decades and putting the global economy on a sustainable path.

The financially reckless tendency of reducing corporate tax rates and marginal rates paid by the wealthy will need to be reversed. Reverting to progressive taxation and reducing reliance on Value Added taxes that erode private spending is viable financially, economically desirable and socially fair. **The need to implement the recommendations of independent bodies such as the UN Committee of Experts on International Tax Matters and the Commission for the Reform of International Corporate Taxation has become urgent.**

For many debt-distressed developing countries already spending up to one third of government revenue on debt servicing **an immediate moratorium is merited when a health emergency on this scale is declared**. Beyond that, more permanent mechanisms to resolve entrenched debt problem, as discussed in previous UNCTAD documents, are required.

Box 1: A preliminary impact assessment

A tentative two-step empirical assessment of the impact of the Covid-19 on the global economy using the ***United Nation's Global Policy Model*** can indicate the countries and regions that could experience the most disruption. The first step implies an approximate quantification of macroeconomic changes, such as through closures of factories at the core of some GVCs, drops in travel and tourism, asset price gyrations, changes in commodity prices, etc. If these were contained quickly and slowly reversed over the course of this year, some economies will still experience growth downgrades. For example, China and the United States will likely record in 2020 growth rates of 5.6 and 1.7 respectively, and this will have small-order reverberations in other economies, developed and developing.

A second step projection would imply a slightly more lasting chain of macroeconomic impacts. In this case, a (still conservative) set of assumptions include:

a) a continuing, even if moderate pace of factory closure in the main global production centers, which, even with limited job dismissals, will have effects on domestic activity including on 'informal' and service-sector activities;
b) a slightly sharper effect on imports of commodities, energy and intermediary manufacturing products
c) additional stress in financial markets with wealth-effects on consumption in the major economies

Translating these assumptions into growth numbers, could suggest an additional deceleration of growth in China and Japan of about 0.5 per cent, in the US of 0.4 per cent, and in the European Union of 0.5 per cent.

The implications of such growth downgrades on the rest of the world depends on a variety of factors, including the extent of trade and manufacturing production linkages with such centers, the sensitivity to price and volume changes on energy and primary commodities, and the current strength of their economies, especially regarding their ability to draw from a robust domestic demand.

In a scenario of this kind, where the major developed economies will lose an average of 0.5 per cent of GDP, the world economy will experience a further deceleration of about 0.6 per cent of GDP. Overall, developing countries (excluding China) would register an income loss over the year of $220bn.

The most badly affected economies will be oil-exporting countries, but also other commodity exporters, which will be losing more than one percentage point of growth, and those with strong trade linkages to the initially shocked economies. Countries like Canada, Mexico and the Central American region, in the Americas; countries deeply inserted in the GVCs of East and South Asia; and countries in proximity of the European Union will likely experience growth decelerations between 0.7 and 0.9 per cent.