The Recession and Covid-19: Cause or Trigger?

by

William White

One thing that is perfectly clear is that the advanced economies will face a very serious recession in the near future. Indeed, it has likely already begun. What remains unclear is how severe and long lasting that recession will be. In an optimistic scenario, the only economic costs will be those **caused** by the pandemic itself, and also with the "social distancing" that seems to be the chosen policy response to it. However, in a more pessimistic scenario, further costs will emerge as the recession **triggers** an unwinding of the many economic and financial "imbalances" built up over the last few decades.

In the optimistic case, the pandemic and the associated "social distancing" reduce both aggregate supply and demand. The former falls as parts ordered "just in time" fail to arrive, as workers fall sick, cannot get to their jobs, or have to stay home to care for family. The latter falls as incomes decline, saving pools prove inadequate to stabilize consumption, and as non-essential shops close. As consumption declines, fixed investment generally follows. However, the crucial point is that these painful effects are likely to be temporary and can to some extent (discussed below) be alleviated by fiscal, regulatory and central bank policies. Then, as the pandemic naturally recedes, both supply and demand will recover and a "V" shaped recovery might be expected. This profile of recession and rapid recovery is obviously very different from that seen in the years following the recession of 2008-9.

The pessimistic case begins with the recognition that the 2008-9 recession was caused by accumulated "imbalances" within the economy. Excessively easy monetary policies in the world's largest economies, and particularly the United States, caused a credit "boom" that culminated in a credit "bust". Unfortunately, the underlying problems have not been resolved but have worsened over the last ten years. Still more exaggerated versions of the same policies have led to similarly exaggerated side effects. Should an initial recession, caused by the pandemic, unleash these underlying and disruptive forces once again, then a more serious downturn would surely follow.

Evidence of this inherent fragility is not hard to find. The ratio of global debt (government, corporate and household) to GDP is now well above that seen prior to the previous crisis. Moreover, the increase has been driven in large part by increases in emerging market economies. Whereas they were part of the solution to the 2009 crisis, they are now part of the problem. Stability in the financial sector is now threatened by lower profit margins at regulated financial institutions, a migration of business to unregulated and highly levered lenders, an explosion of lower-grade corporate credit, and increasing signs of disorder in key markets like those for U S Treasuries. Finally, there is growing evidence that ultra easy monetary conditions have actually lowered potential growth by reducing investment (to finance share buybacks) and by encouraging the misallocation of capital on a grand scale.

These problems have built up over decades and cannot be easily reversed. That said, we should begin seriously to reflect on the measures needed to make the system more robust over time; not least, better insolvency procedures for both the private sector and governments. However, what can still be done, to buy time for such reflection, is to take robust measures to reduce the immediate fallout from the pandemic itself. Here, there are some grounds for optimism. Concerted efforts by central banks to reliquify financial markets, in particular to provide US dollars to those in need of them, seem to be working. Government support for companies and workers, to allow them to maintain jobs and spending, is being announced on an unprecedented scale. Finally, financial regulators are making it easier for financial institutions, especially banks, to make emergency loans to those that need them.

To avoid triggering a downward tipping point, it is important that announced measures are implemented quickly, and that they be scaled up if circumstances deteriorate further. However, the trade-off between urgency and longer run effectiveness must also be recognized. Targeted fiscal measures are likely to work better, and to have fewer costs than universal programs, but should companies or people be the targets? Further support for companies that are already “zombies”, or seem likely to have no viable business model in a post-pandemic world, hardly seems optimal. Preparing plans for the future renormalisation of monetary and fiscal policies, when the need for emergency support is over, would reassure financial markets and lessen the risk of a potentially dangerous flight to cash.

For policymakers to take a little time to think about such longer- term issues might seem a luxury in current circumstances. However, the precariousness of our current situation largely reflects their failure to do so in the past. Trade-offs can be made differently at different times, but it is a dangerous delusion to say they can be avoided altogether.