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Recession. The Coronavirus threatens to create an economic meltdown that neither politicians nor central banks can prevent. Soon, we risk paying a high price, says Harvard economist Jeffrey Frankel.

A crisis without cure By Rasmus Egmont Foss

On Wednesday, February 19, stock markets reached new heights in most of the Western world. Jeffrey Frankel wondered about the timing: How could everyone look increasingly bright at the future while an erratic virus paralyzed one of the world's most important economies?

It was dis-connected, he thought. The 67-year-old Harvard professor shared his skepticism with the rest of the world in a post with leading online project *Project Syndicate*, warning that "the risk of a global recession has increased dramatically," a rare point of view at that time. A few days later, the markets started a week with the biggest losses since the financial crisis in 2008. In the US, the S&P 500 fell by 11.5 percent, and Danish equities lost a tenth of their value in just five days.

It was hardly Frankel's clamor that did the trick. But as a macroeconomist at Harvard University for 20 years and former financial advisor to the Clinton administration, he is one to listen to. Today, he continues to warn against taking on too easily the financial threat from the coronavirus:

'The financial markets were completely oblivious until very recently. In a way, it's understandable, because when it comes to the economic impact, epidemics have traditionally been similar to natural disasters such as earthquakes and hurricanes: typically a high price is paid in the short term, after which the economy returns strongly. When the year is over, you can't always tell the difference. It has been patterned again and again, but this time there are a number of new circumstances that make it look worse than before," he says.

Not only is the global economy more vulnerable than usual. Politicians and technocrats also run the risk of facing an unfortunate union of problems that have not been seen before: private companies have record debt. The global supply chains, on which they are heavily dependent, crack down on the reaction to the virus. And at the same time, the saviors of the economy are running out of funds to fight the rising threats.

“There are elements of a classic recession where consumption is falling, but above all, this is a supply crisis. When production is down, it does not help to stimulate demand as normal, and neither governments nor central banks can create more production to correct it. It worries me about the prospects of a global recession. "

Does the bubble burst?

COVID-19 is more contagious than previous viruses such as SARS and Ebola, and fear has quickly spread to most of the globe. The reactions have been rampant with authorities who have gone to great lengths to contain the disease.

First closed many Chinese factories, which have now been completely or partially empty for weeks. Since then, several cities are subject to quarantine, a number of which are rising as the virus spreads across the European continent. In Japan, politicians are so worried about this summer's Olympic Games that they have even closed all the schools for the month.

Attempts to stop the infection are affecting the economy on several fronts: Sales have dived promptly in the most vulnerable sectors, especially in tourism-dependent companies. Airlines are bleeding, it became clear when Norwegian lost half of its market value last week. But early signs also indicate that people go less often to a restaurant, to the cinema and to work.

In addition, many companies do not receive the components they need to produce their goods. As soon as stocks are empty, they cannot sell as usual. The supply crisis has hit car manufacturers especially hard, and several large tech companies, including Apple, Microsoft and Samsung, have also been announcing shortages of goods in recent weeks.

"You never know when a bubble will burst, but a shock like this one could very well make it happen."

Jeffrey Frankel, professor of economics, Harvard University

Still, one may be tempted to believe that the crisis will be short-lived like in previous epidemics, and that sales will rise again as soon as people are back to work and can move freely. If that happens, the virus will "simply" reduce global growth by half a percentage point, the OECD estimated on Monday.

But according to Jeffrey Frankel, it's an unlikely scenario. For the shock to hit at a time when the world economy is particularly vulnerable, he believes. First and foremost, he points to the threat from the financial markets, with prices peaking sharply up to the turning point last week. In the United States, the stock market has swelled by 20 percent over the past year despite ongoing warnings of an upcoming recession.

“I would argue that the market had reached a stage where you could well describe it as a speculative bubble. You never know when such a bubble will burst, but a shock like this could very well make it happen,” he says, letting us understand that we haven't seen the worst yet.

This week, investors have been crazy. On Monday, US equities fell four and a half percent following the central bank's announcement to stimulate the economy.

But as The Federal Reserve lowered interest rates on Tuesday, investors must have taken it as a different sign of seriousness, because here the shares fell by nearly three percent again. Despite the losses in recent weeks, the market was still higher than in the autumn and can easily dive further.

Dependent and vulnerable

We have nothing to compare with when we need to understand the scale of the supply crisis that is unfolding now. Previous epidemics did not gain the same global scope, and when we came closest to a similar situation with the 1970s oil crisis - where exporters deliberately lowered raw material production - the economy was different.

So far, China, which Frankel calls a particularly tender point, has been worst hit. An epidemic originating here is a bigger threat today than we are used to. The country breeds much of the growth of the global economy and has the status of the globe as Chinese companies produce many of the components included in the world's products. For example, almost all PCB PCBs, a cornerstone of virtually all electronics, come from China.

“During the 2003 SARS epidemic, China's economy accounted for four percent of world GDP. Today it is 17 percent. But even more important is the way trade between China and the rest of the world is screwed up in long supply chains, "says Jeffrey Frankel. »Only one link in the chain must break before the entire production breaks down. That's what we're starting to see now. "

The fact that China is filling up so much also means that we have to worry more about the country's internal problems and the risk of local crises becoming infected. In recent years, analysts in particular have warned against a growing burden of bad debt, which is at risk of being lost. Last year, The Economist called it "a shadow of the world economy". The longer cities like Wuhan have stalled, the greater the likelihood that the debt will not be repaid. It could start a new debt crisis, a scenario that the Chinese state is now struggling diligently to avoid by providing banks with new funds and a more restrictive framework.

But the same danger lurks in the United States as well. US companies have never had more debt than today, accounting for nearly 80 percent of GDP. A significant and growing portion is in the risk zone and is trading speculatively: Just as *subprime loans* were sold in obscure bundles up to the 2008 financial crisis, the market for so-called *collateralised loan bonds* that collect corporate debt has risen sharply in recent years. If highly leveraged companies are unable to produce and sell their goods, a chain of bankruptcies threatens to require government intervention as in 2008 - a scenario Frankel describes as a "very worrying" option.

Now we pay the price

While China and the United States are burdened by bad debt, Europe, in turn, is most vulnerable to failing supplies.

»The supply crisis mainly affects the manufacturing sector, and here Europe is more exposed than the rest of the world. You are more open and deal more than others," says Jeffrey Frankel.

Europe's politicians also have the smallest capacity to contain a possible crisis. The European Central Bank has already fired most of its efforts at stimulating the economy. Over the past five years, interest rates have been at a negative level, and they can hardly fall any deeper. Soon, the central bank may even hit the ceiling for its major acquisition programs, known as *quantitative easing* (QE), as it must not own more than a third of its Member State debt. The effect of cheap money is waning - and it is particularly limited during a supply crisis.

"Monetary policy has simply reached its limits, even when it comes to stimulating demand - especially in Europe."

The European states have even paved the way for a crisis situation like this: the Union's budgetary rules require strict government spending, and this gives politicians a tight framework. Italy, which is hardest hit by the virus in Europe, has long flirted with the border and must now ask technocrats in Brussels for permission to cross it.

What can states do when neither fiscal nor monetary policy draws to help? On Tuesday, the leaders of the G7 countries met for crisis meeting to discuss the options. They promised to cut interest rates and use 'all appropriate tools' to avoid a recession. Communication is important, but according to Frankel, it can hardly prevent a crisis without cure:

"In recent years, people have had an idea that we can fight any recession with looser monetary policy. It's already optimistic, but in a supply crisis it's much less likely," he says. "It can't be fixed by monetary policy."

Frankel believes that we are now paying the price for a failing economic policy over the past decade. It began in the wake of the 2008 financial crisis, with many European nations saving on spending, precisely when there was the greatest need to stimulate a weak economy. Since then, governments have remained reluctant to spend. In their absence, the central banks took responsibility for the well-being of the economy, and it now backslides:

“For the past decade, we have been overly dependent on monetary policy. The classic fiscal policy that governments have is much more effective, especially if it is adapted to the business cycle. But every time we have faced a new problem, we have become accustomed to asking what the central banks can and should do. Instead, we should have saved some of our ammunition for future crises. "

The consequence is that the authorities must now use unproven tools. For example, leading economists today are debating whether central banks should provide insurance to vulnerable companies so that they avoid bankruptcy, or even provide funds directly to banks and businesses to secure liquidity. No one knows yet whether this kind of grip falls under the "all appropriate tools" category.

Others turn the conversation upside down, accusing politicians of causing an unnecessary crisis. They raise the question of whether the reaction has been too harsh when the virus spreads despite consistent attempts to stop it and when the mortality rate appears to be lower than initially thought. Should we treat COVID-19 as a common flu to save the economy?

"No," Frankel states. “Even if the coronavirus does not become the catastrophic pandemic we fear, the next virus can become very serious. Today, our state health systems are woefully unprepared for that scenario. We do not have enough research, enough planning or enough emergency capacity. If the virus is a wake-up call that makes us better off in an upcoming pandemic, the sharp reaction will have served its purpose. "

Trade is inevitable

Most obvious is that the supply crisis has made everyone realize how dependent we are on China. These days, business leaders are questioning the way they have distributed production around the world, and politicians are working to dampen Chinese power in strategically important areas. The landslide is not new, but already began when Donald Trump launched a trade war in 2018 with the growing superpower. The Coronavirus has highlighted the same underlying issues and "can accelerate the process by which Western companies move parts of manufacturing out of China," says Jeffrey Frankel:

“For a long time, it seemed as if globalization was an unstoppable trend. At first, it was paused with Trump's isolationism, but until recently, I actually thought it would be a temporary slowdown. Now it seems to be a long-lasting phenomenon. It is a negative development, "regrets Frankel, who throughout his career has been a prominent advocate of international trade.

However, he warns against exaggerating the importance of the virus to global supply chains. US and European companies have long moved production home or to China's neighboring countries because local wages had risen significantly. And globalization still has great benefits, he insists:

"Some would think that this shows that we should not be so dependent on China anymore. I do not agree with that. International trade is inevitable, although it may change character."