The COVID-19 Crisis: an unprecedented shock

ABSTRACT

The global spread of the coronavirus is having a devastating human toll and will represent an unprecedented shock for the world's economy, temporarily plunging it into recession. However, once the much needed pandemic containment measures are withdrawn, a rapid recovery should follow. To ensure a rapid normalisation of economic activity, we are confident the governments of the main countries will take the necessary steps to ensure the impact of COVID-19 on the economy quickly peters out once the pandemic is over. The response they are already making is along the right lines, although further action is likely to be needed both at a national and, above all, European level. We must not make the same mistakes as last time: it is essential, and urgent, to move decisively towards a fiscal union. The action taken by central banks will also be crucial. The ECB and the Fed have already announced massive injections of liquidity, and they will also purchase large amounts of public debt, which will help to finance public deficits. If the measures taken are sufficiently ambitious and effective, the rise in public deficits will be considerable this year but the spike will be temporary; 2021 should see a strong recovery in activity and public debt should resume the downward trend observed in recent years.

A GLOBAL SHOCK OF THE FIRST DEGREE

Although uncertainty is very high, given that the modern era has seen no comparable situation, the global coronavirus pandemic will most probably end up having economic consequences of an unprecedented scale in the short term, as suggested by the few indicators published since the start of the pandemic. In China, where the outbreak began, radical containment measures were applied and have seen success after two months, although the rate of activity has also been severely affected. Chinese GDP is estimated to have fallen by around 10% in the first quarter compared to the previous quarter (a figure that is not annualised). As China was the first country to be affected, we should take this data as an indication of what may happen in the rest of the economies.

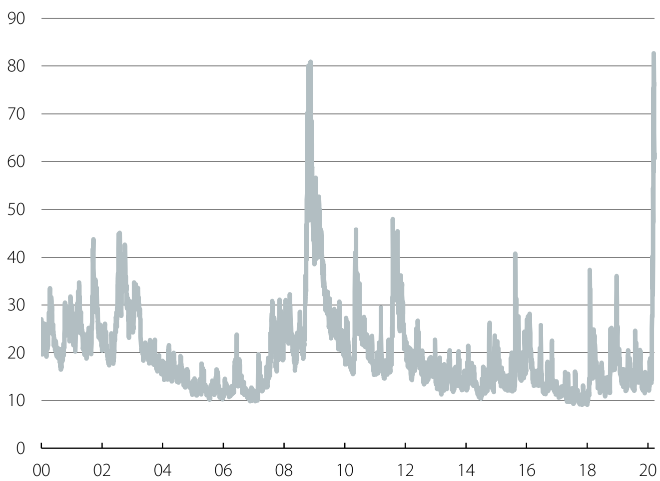
Of course, how severely the virus will affect each country will depend on many factors, such as its health system, its own particular demographics (a young society in an emerging country is not the same as a country with an older population), its geographical structure (countries with a high urban density *versus* others that are less urbanised) or its degree of development.

But the pandemic's evolution to date suggests that no country will escape being directly affected. Moreover, all economies are exposed, to a greater or lesser extent, to the slump in global demand, which began to be felt in China at the beginning of the year in the wake of the pandemic and will intensify in the coming months as it spreads to the rest of the world. Nor will any economy be able to emerge unscathed from the disruptions experienced by global supply chains, as well as from the restrictions imposed on people's movements internationally. In addition to all this is the deterioration in the financial environment, which is reflected in the historic losses posted in recent weeks by all the world's stock markets.

We are clearly going through the second great economic and financial crisis of the 21st century. However, unlike the Great Recession of 2008, decision-making is now proceeding much faster. Generally speaking (at least in the world's leading economies), the foundations are being laid for an exceptional response.

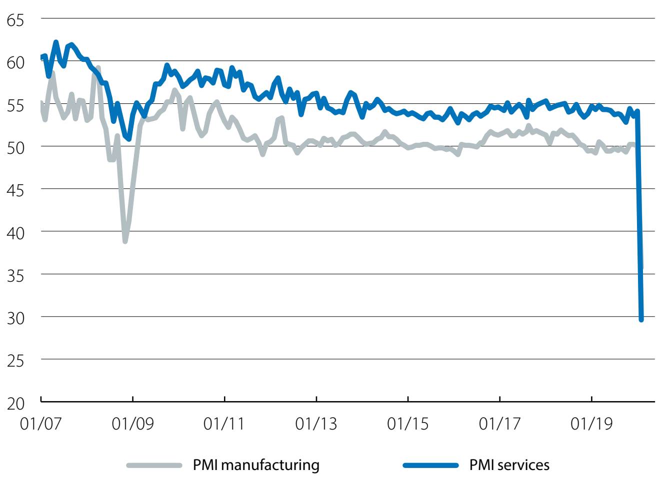
The increase in volatility and historical collapse of stock markets and activity indicators in China suggest we are facing the second great economic and financial crisis of the 21st century

VIX: volatility of the US stock market
Index



Source: *CaixaBank Research, based on data from Bloomberg.*

China: PMI activity indicator
Level



Source: *CaixaBank Research, based on data from China's National Statistics Office.*

EXTRAORDINARY MEASURES ARE UNDERWAY

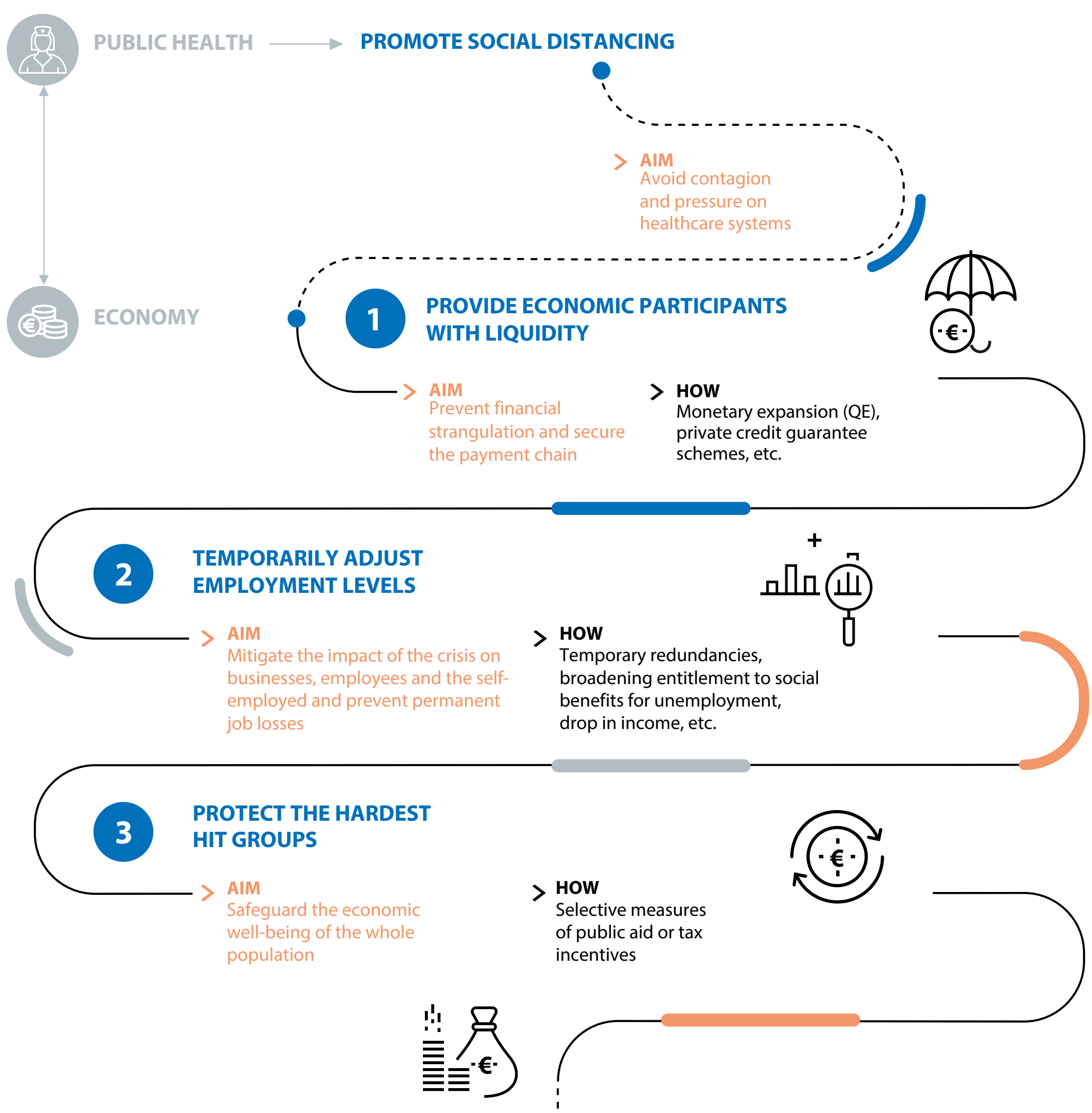
Measures are already being implemented apace, in the area of public health as well as those of a strictly economic nature. Both are necessarily related. The actions being taken globally in the first of these two areas are focusing on containing the spread of the coronavirus (through more or less restrictive forms of social distancing) in order to flatten the curve of contagion and thereby minimise pressure on countries' healthcare systems. This strategy, first implemented in China, will probably become widespread, to a greater or lesser extent, in practically all the world's countries, leading to a global supply and demand shock.

To cope with this double shock, a battery of economic measures of extraordinary breadth and depth is being rapidly deployed. Albeit with variations, the measures being implemented share the same overall goal: to prevent a temporary shock from having any long-lasting negative effects.

With this aim, action is being taken mainly in two broad areas. Firstly, the major central banks and fiscal authorities are taking measures to provide all segments of the economic system with enough liquidity, prevent financial stress and thereby ensure the payments system continues to operate as it should. In many countries, and in particular in the US and EU, expansive monetary measures (QE) have been reintroduced, in the US the benchmark interest rates have been significantly lowered, private credit

Fiscal policy should be in line with the size of the shock

Measures to contain the COVID-19 crisis



guarantee schemes have been introduced, taxes have been deferred and social transfers and benefits have been brought forward or made more flexible. At present, the solvency and liquidity position of banks is strong and they are expected to play an important role in passing on these policies aimed at meeting the financing needs of businesses and households.

A second line of action aims to mitigate the impact on employees and the self-employed. In this key area, the measures taken in many countries focus on allowing a temporary adjustment of employment levels without permanently destroying jobs, for instance by making temporary redundancy measures easier to implement (such as the ERTE in Spain). On the one hand, these help companies to cope with the shock whilst also strengthening the link between firms and their employees, essential for a rapid return to normality once the current situation has been overcome. Similarly, the requirements to be entitled to social benefits related to unemployment (in the case of employees) or a reduction in activity (for the self-employed) have been reduced to minimise the disruption to people's incomes.

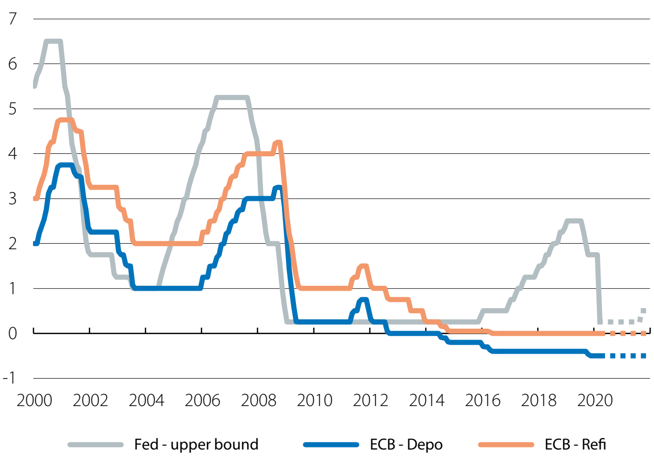
The ultimate goal is to safeguard, as far as possible, the economic well-being of the population and also the production capacity. Therefore, in addition to these measures, and depending on how much the COVID-19 will eventually impact economic activity, it is likely that supportive measures will have to be further adapted or extended, for instance through direct public aid or tax incentives for the hardest hit groups. The US has already announced a comprehensive package of measures in this respect.

All these measures will substantially increase public sector borrowing. For this reason, and to remove any doubt about the sustainability of public debt, central banks, and in particular the Fed and the ECB, have activated massive asset purchase programmes that implicitly cover the higher financing needs of the public sector.

The sharp rise in public spending will count on the support of central banks

ECB and Fed interest rates

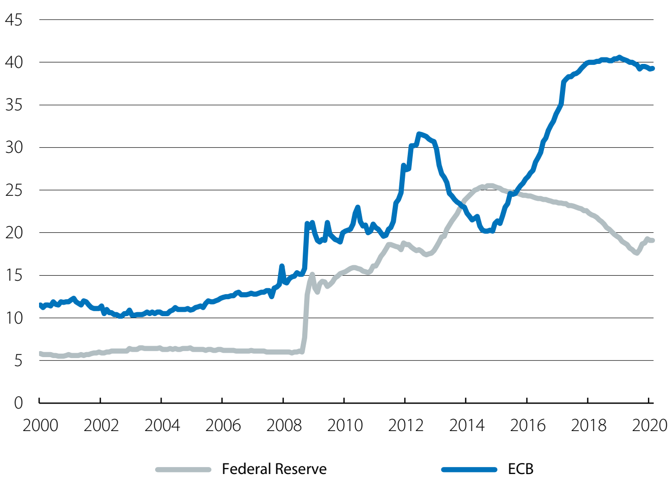
(%)



Note: *The dotted lines represent forecasts.*
Source: *CaixaBank Research, based on data from Bloomberg.*

Central bank balance sheets

(% of GDP)



Source: *CaixaBank Research, based on data from Bloomberg.*

ECONOMIC SCENARIO

In the scenarios below, produced with unusual levels of uncertainty, there is a palpable belief that the measures being taken are necessary, ambitious and appropriate, so that the recession will be very severe but not long-lasting.

Specifically, we already expect a hugely negative impact on the rate of activity in the short term, depending on the country, in the first or second quarter of this year and then a rebound, also strong, in the second half of 2020 and in 2021. Consequently, globally we expect activity to fall by 0.4% in 2020, so the impact of the coronavirus on this year's growth will be around 3.5 pp, but by 2021 we expect growth to recover and exceed 5%. By comparison, during the Great Recession, GDP fell by 0.1% in 2009 and recovered strongly the following year, posting 5.4% growth.

At a European level, we believe the euro area is entering a brief but severe recession on the first half of this year, with a widespread decline by country that will leave growth for 2020 as a whole at –3.1%. However, the recovery, which we expect to start as early as the second half of this year, will culminate in strong growth in 2021, which could exceed 4%.

The Spanish economy will most likely follow a pattern similar to Europe as a whole. We estimate the fall in GDP in the first half of the year may exceed 10%, mainly due to the slowdown in activity that will be experienced by those sectors directly affected by the containment measures, such as the restaurant and hotel industry, commerce, leisure and transport, among others, accounting for around 25% of Spain's GDP. The impact on most other sectors will also play a role. The profound effect of the measures taken to date can already be seen in the turnover of CaixaBank POS terminals. In the third week of March (the week following the declaration of the state of emergency), these recorded a 55% drop year-on-year in card expenditure among residents (despite the notable upturn in spending on food and basic necessities) and 84% in spending by foreign tourists. In any case, once the pandemic is over, we are confident the measures taken by the authorities (which should be extended, if necessary) will stimulate a rapid economic recovery during the second half of the year, so that GDP growth for 2020 as a whole could end up being around –3.6% (5.1 pp less than we expected before the shock), and it may exceed 5.5% in 2021.

Given this situation, the unemployment rate is expected to rise sharply to over 20% in the second quarter, then fall rapidly in the second half of the year in line with the recovery in economic activity, to around 14.5% in the fourth quarter. As in the other major European economies, we expect the necessary fiscal stimulus measures will push up the public deficit, which this year could rise above 5%, as well as public debt, which might reach 105% of GDP. We insist, however, that, given the situation, effective and ambitious action is recommended in order to minimise the impact of the pandemic on households and businesses. By ensuring the foundations of the recovery are strong now, we also reduce the likelihood of public sector spending increasing in the future.

The uncertainty surrounding this scenario is unusually high. Ultimately, the impact of COVID-19 on the economy will depend, above all, on how long the strategies implemented to contain the virus are kept in place. If, finally, these are required longer than expected, the economic impact could be greater. For example, if containment measures have to be extended until the summer, or very gradually withdrawn, the drop in GDP could be around 7% this year in many developed countries. Nevertheless, the support measures for households and businesses announced so far are also likely to be strengthened, both in fiscal and monetary terms. This is, in fact, one of the main risks: that the fiscal policy response does not match the size of the shock. If the impact of COVID-19 on economic activity amounts to 5 pp of GDP, the fiscal measures should be comparable. In other words, if its impact were to double, the fiscal response should also be doubled. Only in this way can the effect of the shock on households and businesses be sufficiently cushioned and the country prepared for rapid recovery once the pandemic is under control.

Faced with a challenge of this magnitude, the EU must take decisive steps. We cannot repeat the mistakes of the last crisis and allow doubts to emerge regarding the sustainability of any member country's public debt, let alone about the future of the euro. To avoid this, it will be necessary to move decisively towards a fiscal union, developing common financing mechanisms such as Eurobonds and the development of an EU-wide tax capacity, so that we can take full advantage of the EU's combined potential for public expenditure. If we don't do this when faced with a humanitarian crisis such as the present, when will we do it? It is true that the institutional developments required cannot be carried out quickly but European institutions have shown themselves to be fast-moving in times of difficulty. Above all, a firm commitment to an ambitious roadmap in this direction could be of great help in such circumstances.

Particular attention will also have to be paid to developments in emerging or developing countries, as they are more vulnerable. In addition to their healthcare systems having fewer resources, several major emerging economies have accumulated macroeconomic and financial imbalances that may limit their capacity to respond to the crisis. Moreover, some of them were already in a fragile political and social situation before the outbreak of the virus, and a high degree of social cohesion is particularly vital at times of difficulty such as the present. In this respect, all the support they can be offered by more developed countries could be crucial.

The recession will be very strong but not long-lasting

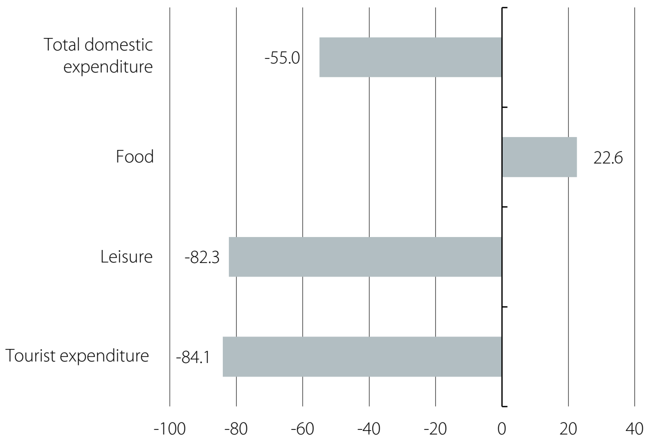
Growth forecasts (%)	2019	2020		2021	
		Current	*Pre-shock*	Current	*Pre-shock*
World economy	2.9	–0.4	*3.2*	5.6	*3.4*
Advanced economies	1.7	–2.0	*1.5*	3.5	*1.6*
US	2.3	–1.7	*1.8*	3.4	*1.8*
Euro area	1.2	–3.1	*1.1*	4.4	*1.3*
Germany	0.6	–3.1	*0.7*	4.1	*1.5*
France	1.2	–2.7	*1.4*	4.5	*1.5*
Italy	0.2	–4.6	*0.5*	5.0	*0.7*
Spain	2.0	–3.6	*1.5*	5.7	*1.5*
Portugal	2.2	–3.4	*1.7*	5.9	*1.6*
Emerging & developing economies	3.8	0.5	*4.4*	6.6	*4.5*
China	6.1	2.5	*5.5*	11.0	*5.7*

Source: *CaixaBank Research.*

The Spanish economy is entering a severe recession from which it can quickly recover

CaixaBank POS terminal expenditure

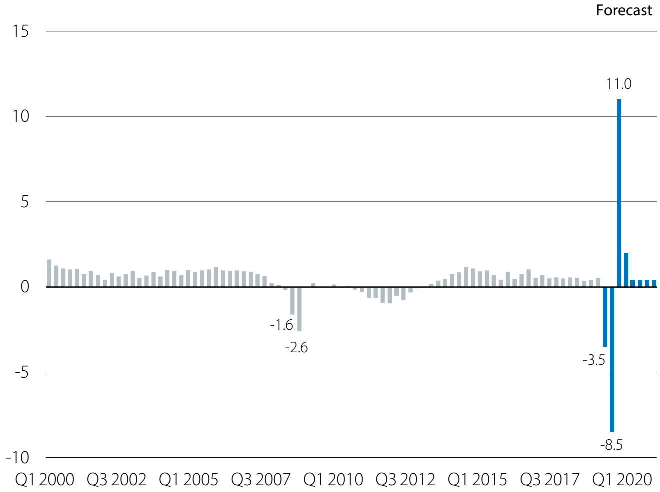
Year-on-year change (%) 3rd week of March



Note: *Food includes domestic expenditure in supermarkets, hypermarkets and pharmacies. Leisure includes domestic expenditure on restaurants, transport, leisure and accommodation.*
Source: *CaixaBank Research.*

GDP Spain

Quarter-on-quarter change (%)



Source: *CaixaBank Research, based on data from the Spain's National Statistics Institute.*

A CRISIS OF UNPRECEDENTED SCOPE THAT WILL CHANGE THE WORLD

Although we are still immersed in the acute phase of the COVID-19 crisis, we have two firm beliefs. The first is that we will overcome this crisis. The second is that, despite its presumably temporary nature, the shock is likely to have structural repercussions. Crises on this scale can accelerate latent changes or bring about unexpected ones.

Surely, in the wake of this crisis, we will strengthen our healthcare systems and reassess the role of experts, who have become so vital recently. It is also likely that, from the point of view of production, new ways of organising ourselves will emerge, both globally and locally, either by shortening value chains in exchange for making them more resilient or with the proliferation of different forms of telework. Such changes will also help to speed up the economic transition to a more sustainable and environmentally friendly system.

And, surely, in the wake of this crisis we will also reassess the role of international coordination and leadership. On this global front, the EU is likely to come under unprecedented pressure. The EU's history tells us that crises have acted as an incentive to move towards greater integration provided there have been adequate institutional and political foundations. This is precisely the situation at present: the institutional and political instruments acquired by the EU during the Great Recession could take another step forward in terms of European integration; something we would have considered unrealistic before the shock. This certainly should be the case.

In short, the world is going to change and it is up to us to decide whether a crisis, in addition to generating threats, can also be a source of opportunities.

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