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Coronaperspectives

Coronavirus infects the global economy: The economic impact of an unforeseeable pandemic

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- The economic impact of COVID-19 is far worse than that of the 2008 financial crisis. The shockwave has hit almost every industry, sector and region in Germany, as well as its major trading partners.
- The virus will change Germany and the rest of Europe, including its regulatory structures. More than ever, the state is being called upon to act as crisis manager. In particular, governments are attempting to slow the spread of the pandemic and taking steps to limit its economic fallout.
- Unconventional measures are needed to avoid a prolonged shutdown of the German economy. However, in the medium-to-long term, it is important to ensure these measures do not damage liberal democracy or distort the social market economy.
- Despite uncertainty about the progression of the pandemic, we have to keep hold of our economic and political compass.
- As soon as this public health catastrophe has been contained, the global community must take steps to return the economy to its pre-crisis level.

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1. Introduction

Few countries have been spared the disruption caused by the rapid spread of the novel coronavirus (COVID-19), from its source in China. Germany and Europe face sudden and pressing economic, social and political challenges.

The impact of this unforeseen shock is far more serious than that of the 2008 financial crisis, in part because it is more widespread. Then, the focus was on preventing financial contagion spreading to the real economy. Moreover, the effect of this on Europe was asymmetric. Propped up by relatively healthy EU economies, the European Central Bank (ECB) was able to raise manageable debt that it then loaned to harder-hit EU countries with lower ratings in order to provide much-needed liquidity. Just as then, when disasters strike, they normally do not affect the whole country, so different regions can help each other in similar ways.

The coronavirus pandemic is unusual because it affects every sector simultaneously.

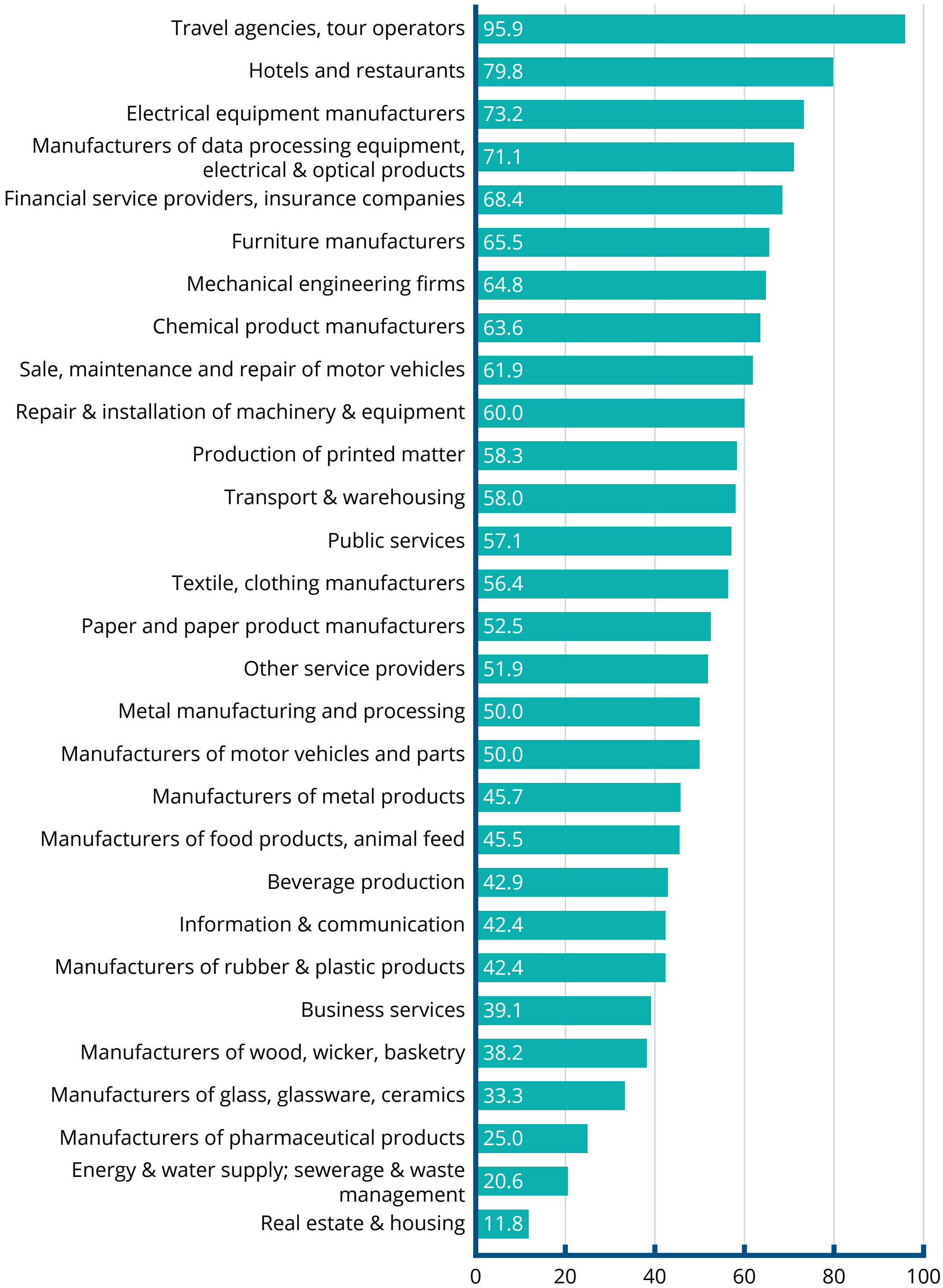
But this crisis has affected every industry, sector and region simultaneously (see chart). It is an almost symmetrical shock that is affecting the German economy as a whole. This is the first time in 70 years that we have faced such a situation. We have to expect a very significant loss of prosperity and a considerable slowdown in the global economy.

However, this is just one aspect of the pandemic. The virus will change Germany and Europe fundamentally, in particular by changing its structures and regulatory foundations. We still have little idea what the post-crisis world will look like or whether the political decisions currently being made will be sufficient to combat the crisis. We can only guess at the collateral damage that will be caused by government measures.

One thing is certain. The steps being taken by governments are truly unprecedented. All over the world, governments and central banks are making strenuous efforts to combat acute social and economic uncertainty, as well as the other effects of the pandemic. In the US, the government has passed a trillion-dollar economic stimulus package and the Federal Reserve has both cut interest rates and bought government bonds. In Europe, the European Commission, the Eurogroup and the ECB have reacted in a similar way in the hope that it will allay the worst of the economic impact.

All over the world, strenuous efforts are being made to counter uncertainties.

Coronavirus: slowdown of the German economy
Proportion of businesses feeling a negative impact (in a survey conducted by the Ifo Institute)
percent



Source: Ifo business surveys, March 2020. Own chart.

In Germany, undreamt-of sums are being mobilised to protect the economy and the workforce. The strength of the German economy and its recent boom leave it with substantial economic leeway. This has been significantly aided by the controversial 'Black Zero' policy – a federal budget that is fully balanced or 'in the black'. Its economic and fiscal situation distinguishes Germany from its neighbours, which have been harder hit by COVID-19 and are beset by much tougher economic conditions.

The social market economy is essentially crisis-proof and its institutions are capable of dealing with distortions.

However, Germany will soon be facing the same challenges as other EU countries, such as Italy, Spain and France, due to the dynamics of the economic and monetary union. We can therefore expect a deep European and global recession, which will place a heavy burden on businesses, the labour market and public finances. The Ifo Institute expects the German economy alone will shrink between 7.2 and 20.6 percent, depending on the duration of current containment measures. In a special report, though it used more optimistic assumptions and consequently predicted lower losses and a comparatively rapid recovery, the German Council of Economic Experts came to a similar conclusion. Moreover, the euro, the eurozone's common currency, is likely to feel the strain of soaring levels of European sovereign debt. In the short term at least, the economic outlook is very bleak.

However, the social market economy, Germany's economic and social model, is to some extent crisis-proof. Thanks to its institutions and the automatic stabilisers provided by the welfare state, it is well capable of coping with economic shocks. Nevertheless, this stable foundation does not release the German state from its responsibility to help maintain stability and it must remain resolute in its maintenance of law and order.

Specifically, the state must do what it can to slow the spread of the virus and take steps to contain the economic damage. In the short term, unconventional measures may be necessary if the German economy is to avoid a prolonged shutdown. In the medium-to-long term, it is important to ensure that these measures do not distort the social market economy or, worse still, damage German liberal democracy.

Unconventional measures must not be allowed to distort the social market economy or damage our liberal democracy.

The Konrad-Adenauer-Stiftung is committed to addressing fundamental questions on democracy, the rule of law and the social market economy. Despite the difficulties and uncertainty of the near future and the complex effects of the coronavirus pandemic, we seek to put forward economic policy proposals that transcend short-term policies made in 'crisis mode'.

2. The post-coronavirus economy – what lies ahead?

- **Address uncertainties, set realistic expectations**
  Ludwig Erhard said that fifty percent of economics is psychology. For this reason, the measures adopted by the ECB, the government, and the ministries of finance, economy and labour go a long way to address uncertainty. But promising all things to all people does not constitute coherent policy. It sets unrealistic expectations that can only be disappointed.

  The economy will experience friction, challenging Germany's business model with its strong focus on manufacturing and export. German manufacturing is already struggling. Since 2018, it has been in a recession, which is now likely to deepen. Policymakers need to provide a roadmap for medium-term economic and structural policy in 2020 and 2021 to address challenges such as these. Manufacturing, as well as other sectors, urgently need help to anticipate and plan for their future. To this end, this roadmap should involve prompt scrutiny of corporation and energy taxes.

It is vital to avoid raising expectations that the state will shoulder the financial burden alone. The economic shutdown has to be reversed quickly.

- **Do not abandon regulatory policy fundamentals**
  Given the scale of the crisis, the state would be overburdened if it attempted to help every sector and person affected. After initial short-term policies to guard against economic collapse, it is important not to set expectations that the state can compensate for all losses resulting from the crisis. Therefore, though it has been necessary to reassure voters and markets, it is important to emphasise that fiscal policy alone will not be enough to salvage the situation.

In both the short and long term, there is a danger that the state will overestimate its capacity in this respect. The federal budget, including the massive supplementary budget of March 2020, amounts to just under seven weeks of economic production[1]. Despite its top credit rating, therefore, the German state is unable to provide comprehensive short-term assistance to all the 3.5 million businesses in Germany. Among other reasons, this is because of lengthy administrative procedures, lack of targeted delivery due to distortion by interest groups, target and competition conflicts, and problems with free riders. The state is also not able, on its own, to support lasting, long-term growth through financial stimuli, as this also requires injection of private capital by businesses. The vast majority of capital for innovation and investment comes from the private sector. From this problem, fundamental questions of competition and nationalisation will arise.

It should also be noted that some political players are using the crisis to introduce dubious economic proposals, such as 'corona bonds' and a universal basic income, some of which are attracting political attention. It is important to distinguish necessary emergency measures from separate political agendas. We have to resist the temptation to give in to ideological proposals. An assessment of corona bonds, for example, fails to convince, as they are unsuitable as a short-term instrument for addressing the crisis and in any case would need to pass a lengthy vetting by the European Parliament. Spending political capital on their introduction would be inefficient. Existing European instruments, such as the ESM, EIB and ESI funds, are already capable of facilitating the rapid mobilisation of low-interest capital that is required by the crisis.

› **Temporary measures must remain an exception so draw up exit roadmaps and prepare to reinstate suspended rules**

Businesses and consumers are more obviously and directly affected now than they were during the global financial crisis twelve years ago. The government has had to take action and abandon their aim of a balanced budget. In an emergency, the 'debt brake' explicitly allows the state to respond with expansionary fiscal policy in this way. However, experience over the past decade has shown that fiscal discipline is a necessary condition for successful economies in the long run. The Black Zero policy of a balanced federal budget should remain the reference point once the crisis is over. This will secure a sound future credit rating for Germany.

Responding to a crisis with expansionary fiscal policies is certainly appropriate, but we urgently need an exit strategy.

The COVID-19 pandemic is a simultaneous supply- and demand shock – that is to say, a crisis of supply chains, production and consumers – and therefore it is unlikely to be helped by monetary policy measures. Even before the pandemic, the Bundesbank's instruments had been pushed to their limits. In the wake of massive government interventions in social and economic life, politicians now need to rapidly draw up a workable scenario for the medium term.

› **Adjust the European agenda**

Dramatic developments in Italy and Spain have put European integration and the euro in acute danger. The European Commission will have to adjust its political priorities accordingly over the coming months. This does not mean abandoning, for example, its ambitious goals on climate change and sustainability but will mean revising its goals in order to keeping them in line with countries' capabilities in real economic terms. Consolidating the monetary union will remain an ongoing task. Germany plays a key role in this and ultimately has to show greater financial and political commitment to Europe. It will also be necessary to take a good look at the distribution of competences between the EU and member states in the wake of the crisis, particularly with reference to the principle of subsidiarity.

As many of its European neighbours are in dire straits, Germany must throw its whole weight behind Europe.

In addition, it will be important to demonstrate European solidarity to affected countries in order to avoid jeopardising European unity and deepening rifts caused by the euro and sovereign debt crises. There are many ways to achieve this, including the latest proposal to establish a European Crisis Management Centre. However, 'European solidarity' increasingly sounds like an empty phrase so must be brought to life with tangible action. This entails the use of economic instruments and, as far as possible, mobilising healthcare resources for our European neighbours, including teams of experts, the Bundeswehr, capacities, and infrastructure. China should not be remembered as being the main source of assistance in this emergency.

› **Collective action at the European level**
After taking time to reflect on and assess the situation, the European Union has reacted with speed. In contrast to the economic crisis of 2008-09, when it took more than three weeks to present its proposed solutions, it took only a few days to act in response to the pandemic. Key proposals include the suspension of the Stability and Growth Pact, temporary state aid to support the economy, and financial support through 'cohesion policy', which is focussed on providing liquidity and flexible support.

Nevertheless, the measures that have been taken so far seem to lack coherence. The vast array of ideas and proposals, including using the European Stability Mechanism (ESM) in various ways, utilising the European Investment Bank (EIB) as a "European credit institute for reconstruction" and issuing the above-mentioned corona bonds, along with the systematic but legally dubious actions of the ECB, illustrate the EU's struggle to respond to the individual problems of member states.

There is currently no coherent European strategy for dealing with the pandemic – too many countries are going their own way.

The problem stems from differing competencies among member states but also from an evident lack of willingness to cooperate on various long-standing issues. For example, the crisis has made it even more difficult to pass the Multi-annual Financial Framework (2021-2027), the 'EU budget'. This has major implications for the German presidency of the European Council, which is set to begin on 1 July 2020. There needs to be a debate on whether comparatively strong European economies should temporarily pay the minimum funding requirement contributions of countries that have been worst-affected by the pandemic.

› **Strengthen the eurozone as a geopolitical instrument**
The crisis has increased the urgency to reforming the eurozone. This process has been at a virtual standstill since 2014. Recent deliberations on abolishing the post of Eurogroup president are worrying. Instead, the euro area should be strengthened by improved coordination. The ESM should also be used more intensively, permanently and within a democratically legitimised framework. Strengthening the euro as a geopolitical instrument – for example, in trade policy – would support the demands of the EU Commission President for Europe to "learn the language of power".

The euro is likely to come under pressure in light of the soaring sovereign debt in the eurozone.

› **Seize the opportunities to increase digitalisation and reduce weaknesses**
Despite all its difficulties, the COVID-19 pandemic also provides opportunities. Above all, the potential of the internet as a social space has been highlighted. Rapid changes are taking place in just about every area of human coexistence, especially the online space, and these could become part of our daily lives. Work has rapidly gone online, including an increasing amount of decentralised teamwork. There has been a shift towards e-learning in schools and universities and online cultural offerings have increased. Digital transformation of companies has often been hampered by full order books but has now become vital for businesses' survival. The debate on digital payment mechanisms is also likely to intensify.

Digital transformation is a powerful tool to cushion the impact of the coronavirus pandemic.

In this respect, the crisis is relentlessly exposing digital weaknesses and testing ways of handling them. This is the case in private companies but even more so in the public sector, with its often anachronistic, analogue work processes and administrative procedures. By the time we return to normal working life, regulatory incentives should be in place to encourage organisations to continue their digital transformation.

› **Refute unjustified criticism of globalisation and capitalism, examine supply chains**
Critics will use the opportunity to shift blame onto globalisation, capitalism and the social market economy, using the pandemic as an excuse to call them into question. At the same time, businesses and governments will use the dependencies that have become apparent as an opportunity to review and adapt their supply chains. This will intensify the existing tendency towards deglobalisation.

The trend towards deglobalisation will intensify, with protectionism resulting in a loss of prosperity.

The positive effects of globalisation, such as a broad choice of goods, cheaper production costs and greater prosperity, should be emphasised. Simultaneously, it is important to reveal dependencies and raise awareness of political risks. This requires a European response. The EU Commissions' industrial strategy from March 2020 marks a first step towards strengthening Europe's industrial and strategic autonomy.

› **Examine China's role as a global player and demand accountability**
It will be necessary to discuss China's responsibility for the outbreak, along with its management, information transparency, containment and the development of antidotes to the coronavirus pandemic. A decade after the financial crisis that began in the US, China – the world's second largest economy – has presented a challenge for healthcare systems and economies that is unique in its depth and scope.

› **Reactivate and promote the G20 as a crisis management tool**
The next G20 summit is scheduled to take place in late autumn 2020 under a Saudi presidency. Key members should push for an earlier meeting, given the global problems caused by the COVID-19 pandemic. The global economy is in desperate need of coordination and steps against protectionism. New trade barriers and other impairments of the rules-based trading system under the World Trade Organisation (WTO) could endanger the global economic recovery in the long term.

We need the G20. Its annual meeting should be brought forward by the urgent need to coordinate the global economy.

› **Don't neglect other urgent issues**
Other important issues are currently being neglected, particularly the 2030 Agenda, the ongoing refugee crisis at Europe's borders, and the challenges posed by the growth of emerging and developing economies. Moreover, the COVID-19 pandemic has not yet fully erupted in large parts of Asia, Africa and South America. Many of these countries have informal labour markets, rudimentary healthcare and weak state infrastructure – a potentially explosive combination.

The coronavirus eclipses many issues. However, policies on climate change and migration also need attention.

3. Conclusion

Despite the crisis caused by the COVID-19 pandemic, governments can shape the future through a range of policy options. The interconnected world is not a thing of the past. Rather, the looming loss of prosperity caused by its sudden disruption reveals how the global community benefits from economic interconnection. Once the public health catastrophe has been contained, the global community will have several options open to it to restoring economies to pre-crisis levels.

The first route will be to enter a new era of resilience. This could succeed if it involves developing greater sensitivity towards the common tasks of humanity and facilitating cooperation between strong global institutions. The crisis has highlighted weaknesses in this respect but each of these can also be viewed as an opportunity. In specific areas, such as digital transformation and the climate agenda, including the move towards low-carbon economies, this will require greater openness towards new policies. It is also important to raise awareness of the global economic and political dangers of authoritarian political systems, such as China's.

The global community should enter an era of resilience that emphasises global institutions and multilateral cooperation.

The second route would be to reverse globalisation but the long-term damage caused by this option would far exceed any anticipated gains. The wide range of unilateral national policy responses must not be used to hide the fact that international cooperation and multilateral action are key to dealing with challenges such as this crisis.

Above all, the above hypotheses cover a broad area of economic activity and require definite political action.

1 Supplementary budget 2020 of 25 March 2020: 484.5 billion euros (German Finance Ministry), GDP per week in 2019: 66.1 billion euros (Destatis).

Imprint

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