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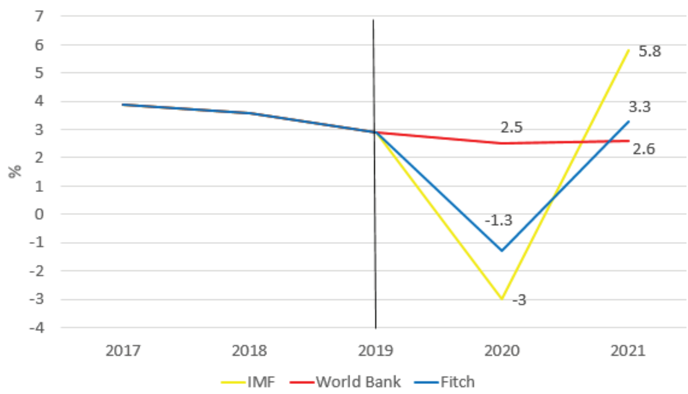
The Covid Crisis: Markets In Turmoil and Fractured Trade Flows

BY ©SHANKARAN NAMBIAR

The global economy has never faced an outbreak in recent times such as the Covid-19 and this will lead to repercussions on the economy of an unprecedented scale. In all likelihood the impact on the global economy will be worse than that faced during the 2008 crisis.

Most growth forecasts have been pessimistic. Fitch has put global growth for 2020 at negative 1.3 percent (Fig. 1). OECD in its interim economic assessment (as of 2 March 2020) forecasts annual global GDP growth to be 2.4 percent, but expects growth to go down to 1.5 percent if the outbreak intensifies. More recently, Goldman Sachs has revised its global growth estimates downwards to -2 percent. IMF's Chief Economist, Gita Gopinath, has projected a negative 3% global growth for 2020. Technically, the IMF defines a recession as an annual growth rate below 2.5 percent, indicating that it is not so much a matter as to whether there will be a recession or not, but how deep and long it would be.

Figure 1: Global GDP growth forecast



Source: IMF, World Bank, Fitch Ratings

It is not surprising that a global recession should emerge given the multiplicity of factors at work. The crisis is unprecedented in so far as it has provoked a deglobalisation response, in so far as countries have closed their borders to foreigners, shipments have halted, the aviation industry has come to a standstill, and the movement of raw materials, intermediate goods, and labour is severely restricted.

Another feature of the Covid crisis is the simultaneous disruption of production and a constrained demand due to wage shrinkage. The world's leading engines of growth have been affected, in particular, the US, China, EU and Japan.

Dr. Shankaran Nambiar, Head of Research at MIER, explains that, "The Covid-19 pandemic has roiled global financial markets and this has serious consequences for Malaysian trade and investment. Even as we are working out strategies to contain the incidence of the disease in Malaysia we have to plan for the recovery of the economy which will be damaged as has not been experienced so far. We will also have to think how we will adapt to the post-Covid global realignment that might see the rise of stronger nationalistic tendencies and a shying away from free trade policies."

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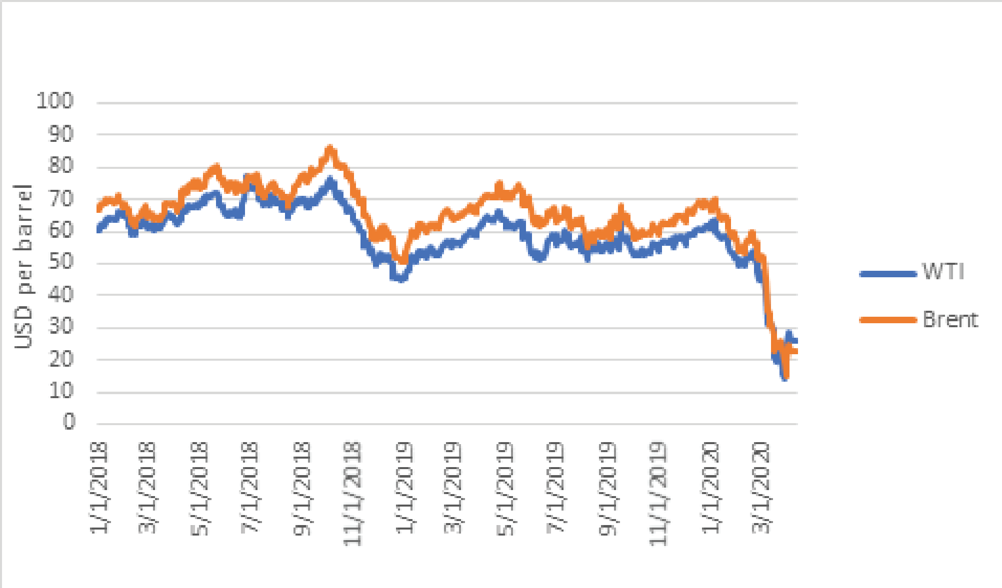
These countries can be seen as nodes of growth which generate trade flows and global demand for goods and services, affecting the economies that they are linked to. This can be expected to reduce the flow of goods across nations as well as the demand for inputs. The lower demands for goods has had an effect on commodity prices and the decline in the price of oil (Fig. 2) to an 18-year low is symptomatic of this.

Figure 2: Daily crude oil price movement.

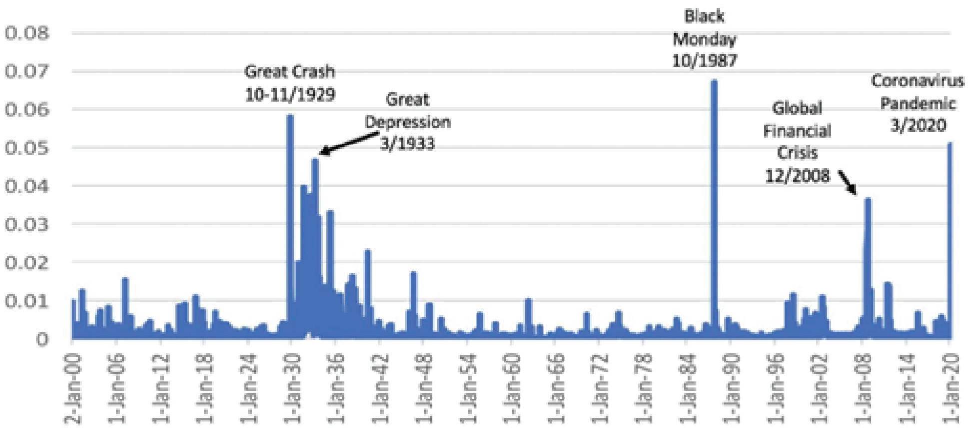


Source: Energy Information Administration, United States.

Further, there will be a sharp decrease in government spending across countries as they divert expenditure to health care, measures to contain the outbreak and on fiscal packages to counteract the effects of the disease. Consumption expenditure will go down due to the sharp downturn in household income.

These influences do not produce a vibrant economic environment, compounded by the nature of Covid-19 which is not a well-studied virus and for which a vaccination is yet to be developed. The kind of trajectory that the spread of the disease will take is unclear as is the appropriateness of containment strategies. The global economy is, understandably, in a state of uncertainty that is captured by fluctuations in the manufacturing and services indices. This is underscored by a high volatility index (Fig. 3). The outbreak has dampened consumer sentiments and weak business confidence.

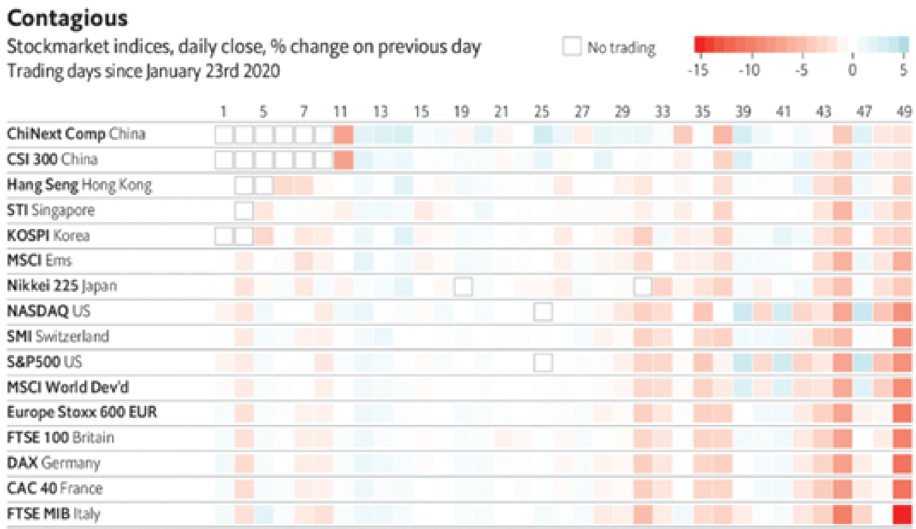
Figure 3: Volatility index (VIX)



Source:
https://insight.kellogg.northwestern.edu/article/what-explains-the-unprecedented-stock-market-reaction-to-covid-19

The pandemic is likely a long-drawn affair involving the twin challenges of minimising the spread of the disease as well as the macroeconomic impacts. The degree of uncertainty is high for several reasons and these include an uncertain treatment protocol, the possibility of a second wave of infection looms large, the lack of masks and ventilators and an over-burdened healthcare system. Market anxieties over these concerns have caused a tremendous dip in stock markets (Fig. 4).

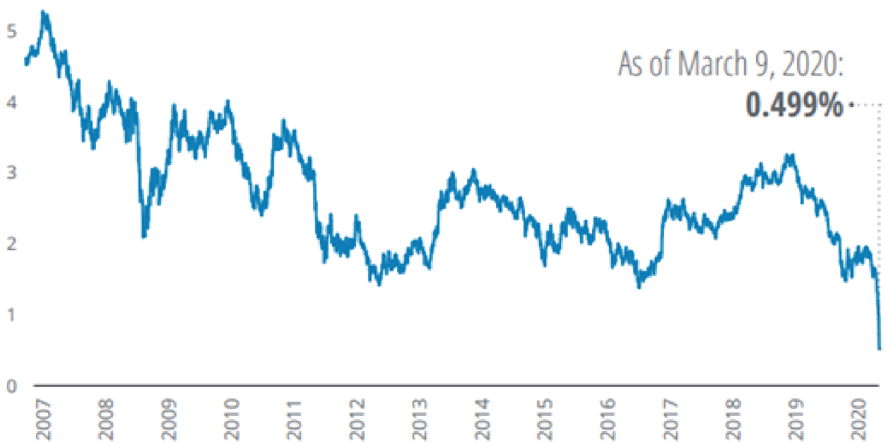
Figure 4: Stock market indices performance



Source: The Economist.
https://www.economist.com/graphic-detail/2020/03/14/control-of-the-coronavirus-gives-china-the-worlds-best-performing-stockmarket.

The US bond market has reflected these worries (Fig. 5). It is significant that the entire US bond yield curve had fallen below 1 percent in March. By 22 March 2020, the 10-year Treasury note recorded an inverted yield due to fears of an impending recession. Late in March, the 10-year Treasury note yield was 0.73 percent as against the 30-year bond yield which was 1.35 percent. The attractiveness of US government bonds is a function of several factors. One, the 10-year notes are seen as a safe haven that other classes of investment are not able to offer. Second, there is high demand from East Asia, particularly Korea and Japan. The earlier is not necessarily positive because it means real investments are deprived of funds. If the rate of inflation were to be factored into the yields, then it is possible that the real yields are negative, a point that indicates how strongly security is favoured over return. Financial markets in developed countries are in a state of flux and could progress to turmoil should the spread of the virus attack not be swiftly contained.

Figure 5: US 10-year Treasury note yields



Source: Federal Reserve Bank of St. Louis. Deloitte Center for Financial Services

There are widespread expectations global trade could seriously suffer from the current scenario. The WTO has developed a model for different scenarios assuming that the global economy could be affected through three channels. The model assumes a. reduced labour supply, b. reduced demand and supply for goods and services, and c. rising trade costs. Three scenarios are envisaged. The first scenario is an optimistic one, where there is V-shaped recovery. The second is less optimistic and it presumes U-shaped or a less swift recovery. Finally, the third scenario posits a pessimistic L-shaped recovery.

The WTO study forecasts that ASEAN is likely to demonstrate a -9.3 percent change in real exports for 2020 relative to the benchmark without the pandemic (Table 1). Assuming a less pessimistic scenario, there would be an 18.2 percent contraction in real exports; and a drastic -22.1 change against the benchmark should recovery be L-shaped. The superpowers, specifically, China, EU-28, Japan and the US are likely to have a decrease of about 9 percent at best and a change that is close to -21 percent in a pessimistic scenario. The global changes are equally pessimistic.

Table 1: Change in real exports (yearly per cent change for 2020 relative to benchmark without pandemic)

	V-shaped	U-shaped	L-shaped
ASEAN	-9.3	-18.2	-22.1
China	-8.3	-16.0	-19.3
EU-28	-7.3	-16.1	-20.4
India	-12.0	-23.5	-28.0
Japan	-9.8	-18.5	-21.8
US	-14.3	-27.8	-33.9
World	-8.1	-16.5	-20.4

Source: World Trade Organization (2020). Methodology for the WTO trade forecast of April 8 2020. Economic Research and Statistics Division

The outlook for global exports at the sectoral level is equally dismal. Aside from the pharmaceutical industry, all other exports are expected to decline (Table 2). Of relevance to Malaysia are fossil fuels and petroleum products, both of which will contract by 5.5 percent and 7.7 percent, respectively. It is forecast that computer and electronic products will decline in the optimistic (-10.5 percent) and pessimistic (-22.6 percent) cases. Global exports from the manufacturing sector such as electrical equipment and machinery do not have an encouraging outlook either.

Table 2: Per cent change of global real exports per sector in 2020

	V-shaped	U-shaped	L-shaped
Fossil fuels	-5.5	-10.8	-13.4
Petroleum product	-7.7	-13.8	-16.3
Pharmaceutical product	6.6	7.9	8.7
Computer, electronic and optic	-10.5	-19.0	-22.6
Electrical equipment	-8.8	-18.9	-24.1
Machinery and equipment	-8.7	-15.8	-18.8
Air transport	-18.2	-33.5	-34.9

Source: World Trade Organization (2020). Methodology for the WTO trade forecast of April 8 2020. Economic Research and Statistics Division.

The global economy is plagued with a confluence of negative factors, ranging from uncertainty in dealing with the pandemic, to depressed consumer and business confidence and including turmoil in global financial markets besides fractured trade flows. Several cautionary policy suggestions arise out of these issues.

First, the government will have to target the export-oriented manufacturing sector in the aftermath of the MCO. Those industries that contribute to Malaysia's exports in products from the electrical and electronics, petroleum and petroleum-based chemical and machinery and equipment sub-sectors should receive targeted support.

Second, government agencies should attempt to enhance trade linkages with the US, EU and the UK since those countries that are most hit by the pandemic will present more opportunities for Malaysian companies as they attempt to re-build their economies.

Third, post-Covid the tensions between the US and China will deepen. It will do well for Malaysia to maintain its neutrality and not commit itself to a policy of favouring trade and investment opportunities from the East over the West. Japan is encouraging its companies to pull out from China. There will be more stringent investment screening in developed countries some of which may be aimed at excluding China's investment in their countries. This makes it all the more necessary for government policy to be sensitive to these issues.

Fourth, there are likely to be nationalistic tendencies that de-prioritise trade as the more badly affected countries will try to shield themselves from competition. Malaysia should maintain its stance of being a pro-trade nation and continue to support pro-trade movements. At the same time, it would be sensible to develop high technology agriculture and encourage more technology-intensive industries that are indigenously created.

Fifth, in reconstructing the Malaysian economy more attention should be directed at industries that have wider local linkages, that increase technology content and technology transfer. For example, it would be more useful to promote the automobile industry which can support 400 vendors than to participate in mega infrastructure projects that will yield returns only over the longer term. This is certainly not to suggest that infrastructure or connectivity projects should be discontinued but only to recommend that projects with shorter gestation periods be prioritised in the next six months to a year. Projects that empower women and agriculture cash crops are also worthy of attention.

Finally, the financial stability of the economy should be considered in the face of possible financial contagion effects from developed economies. It is necessary to provide for adequate reserves and liquidity in the system. The advisability of quantitative easing should be evaluated as well as the consequences of lowering the OPR, an eventuality which may be necessary to contain bankruptcy and insolvency cases.

The Covid-19 pandemic has roiled global financial markets and this has serious consequences for Malaysian trade and investment. Even as we are working out strategies to contain the incidence of the disease in Malaysia we have to plan for the recovery of the economy which will be damaged as has not been experienced so far. We will also have to think how we will adapt to the post-Covid global realignment that might see the rise of stronger nationalistic tendencies and a shying away from free trade policies.