AVOIDING THE UPCOMING COVID-19 GREAT RECESSION: *BRIEF ANALYSIS OF SITUATION AND POLICY ADVICES*

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The outbreak of the coronavirus (Covid-19) pandemic is still spiraling out of control and hasspread in 201 countries. The virus has infected more than 740,235 people worldwide, and the number of deaths is around 35,035. The Covid-19 has affected the world economies and financial market brutally. The outcome that anyone can hope for is a recession deeper than that following the 2008 financial crisis. The clouds of a severe recession across the world are becoming clearer and clearer with the passage of time. During the last two months the world has witnessed a sharp decline in the world trade and foreign investment. It had halted the global supply chains, trade and investment flows. But given the flailing policy response so far by the world, the probability of a far worse outcome is increasing with the passage of time.

Various financial and economic indicators show that the Covid-19 shock impact on the world economy is faster and deeper than the shocks the world had ever witnessed. Certainly, the impact of the 2008 shock had everlasting impact on the world economy. The world stock markets seen a collapse of more than 50%, the credit markets frozen up and massive bankruptcies were followed. The world GDP crunched and unemployment rate soared by more than 10% per annum. But all this took the period of about three years or more. However, currently the world has witnessed a major breakdown in global supplies chain, trade, financial crunch and dire macroeconomic situation in just three weeks. In the current crisis we are very close just in three weeks to the situation we have seen in 2008 crisis in the period of about three years. It is evident in figure 1 in terms of stock market indices.

Eelier this month, all major stock market around the world went into their bear territory just in few days. It just took 20 days for the US stock market to plummet into bear territory (a 40% decline from its value in early March 2020) – the fastest such decline ever (figure 1 and 3). The decline in

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world index, UK and Pakistan has a similar pattern. Now, the world markets are down 41%, credit markets have seized up, and credit spreads (like those for junk bonds) have spiked to 2008 levels. Even mainstream financial firms such as Goldman Sachs, JP Morgan and Morgan Stanley expect US GDP to fall by an annualized rate of 6% in the first quarter, and by 24% to 30% in the second. US Treasury Secretary Steve Mnuchin has warned that the unemployment rate could skyrocket to above 20% (twice the peak level during the 2008 crisis). Bloomberg is anticipating that the Covid-19 could cost the Global Economy $2.7 Trillion.

Keeping in view the situation around the world and the integration of Pakistan's markets with the world largest market in Figure 1 and Figure 2, the Pakistan's economy seems in extreme trouble.

The Covid-19 curve in Pakistan is steepening with every passing day even under the partial lockdown. Businesses are operating at less than half of their normal capacities. The stock market has experienced a plunge of about 40% just in three weeks. A sell-off will leave companies short of liquidity. Insufficient cash flow as a result of slowing demand and with the policy rate at 11% will make it hard for businesses to breathe normally.

The data shows that aggregate demand and all its components consumption, investment and exports has a sharp decline that is never seen before even in 2008 crisis around the world. It is clear that we have entered a recession that seems to be worse than in 2008 following the global financial crisis. The economists and market experts are anticipating that the downturn will have a V-shape– with output falling sharply for one quarter and then rapidly recovering the next – however, it seems that it the COVID-19 crisis will be something entirely different. At the moment, the contraction that Pakistan is experiencing seems to be neither V- nor U- nor L-shaped, but has a mirror image of J shape - a vertical downward line but stabilizing.

In Pakistan the bulk of economic activity are the brink of sinking as we have observed in China during last two months and now in USA and Europe. Almost 60% of Pakistan's exports are textiles that contributes significantly to the foreign reserves. The problem with this sector is that the majority of the raw materials are coming from China. Due to the closure of Chinese industry and lockdown like situation in the export destinations this sector is hardly to survive. Furthermore, due to the huge fiscal stimulus packages in the USA and Europe markets are becoming safe havens for the investors. Since, the last quarter of the 2019-20 fiscal year and the following 2 quarters of fiscal years 2020-21 will bring unprecedented levels of economic problems as investors have started moving into safe-haven stocks, gold and dollars. The rise in gold and dollar price in the market are pointing towards this consequence.

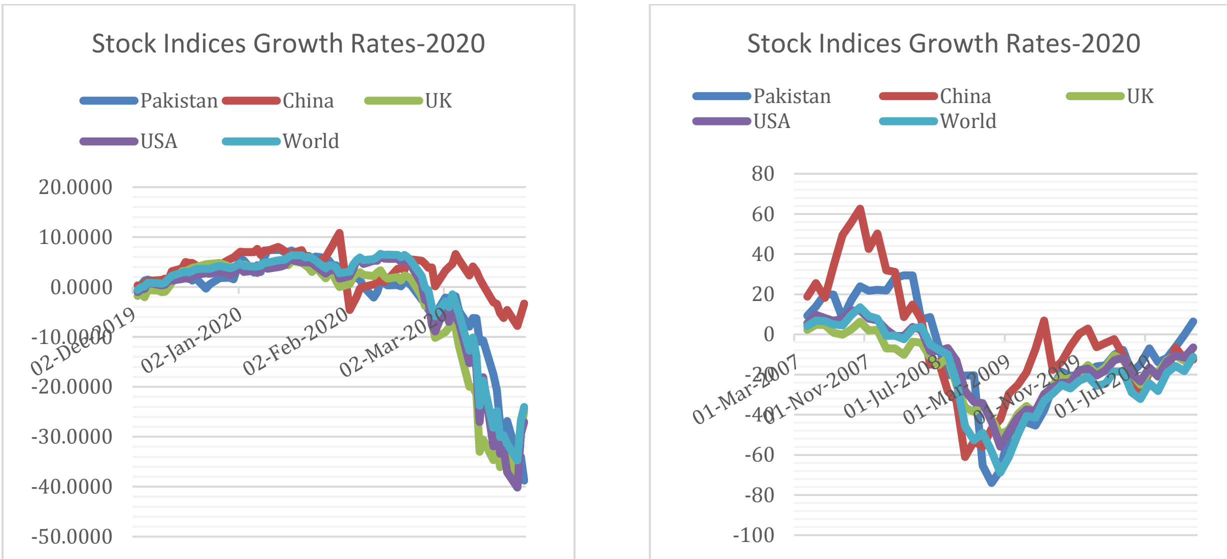
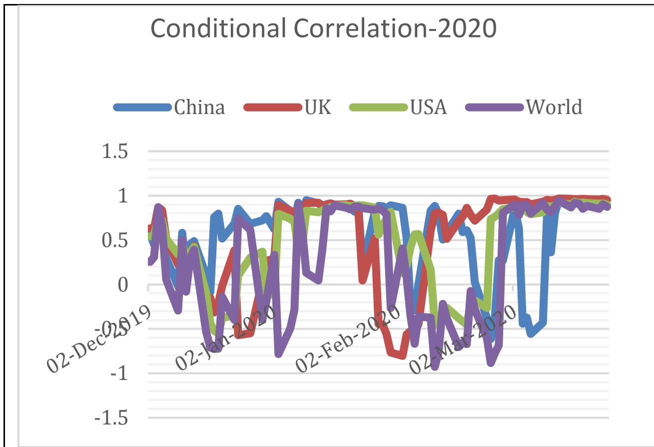


Figure 1: Growth Rate of Stock Markets Indices: Continuous compounded growth rate computed as $\log P_t - \log P_s$, where P_s is set equal to index value on December 02, 1999 for 2020 crisis and March 01, 2007 in case of 2008 crisis.

CASE I:

The best-case scenario would be a V or U shape downturn but more sever that the crisis of 2008. It will be a rapid downturn but shorter-lived. In this case the markets would start recovering when the clouds of COVID-19 become clear. But the best-case scenario assumes several conditions.

First, monetary policy authorities – who have already done in two weeks is very small. A 225-basis-point reduction in the policy rate at a time when at least a 500-600-point reduction is necessary to induce consumption and investment demand is nothing. The US Federal Reserve practices during the last two weeks to enhance dollar liquidity shortage in global markets set an example for the rest of world central banks. The policy rate should be further reduced to enhance liquidity and encourage banks to lend to illiquid small and medium-size enterprises in order to enhance the economic activity.



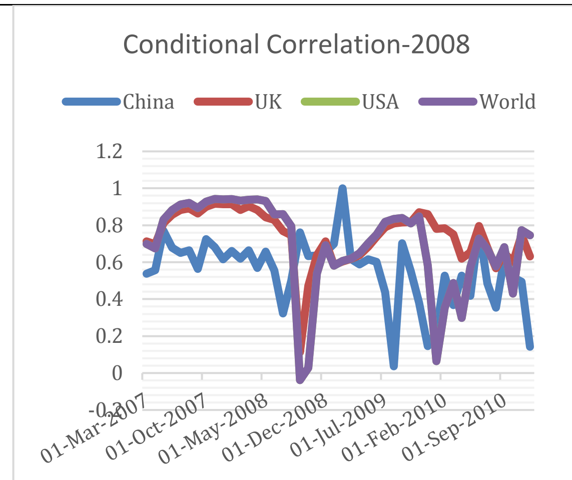
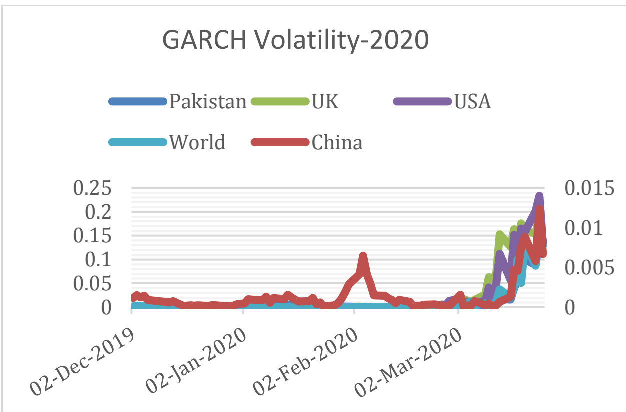


Figure2: Dynamic Conditional Correlation of Pakistan's Stock Market with other Markets: DCC-GARCH based conditional correlation of PSX is computed with Chinese, USA, UK and world index using daily data during 2008 crisis and Covid-19 crisis. The figures show the integration of PSX with other large markets. It should be interpreted as spell over effect of other markets on Pakistan's economy.

Second, the governments need to deploy massive fiscal stimulus. The central government should intervene to prevent the private sector collapse. Given the size of the shock, gap between revenue and expenditure should be widened, but this gap should be fully monetized. It should not be financed through bond or bank loan, because the use of standard government debt tools will rise interest rate sharply and the recovery path will disappear in the darkening skies of crisis. Particularly, the measures proposed by the Modern Monetary school should be implemented in full spirit to achieve the objectives of fiscal stimulus. A strong fiscal stimulus of $8 to $ 10 billion is the need of the hour. Assuming $4 per day as the basic requirement for a household of 7, with 10 million deserving households, this means $40 million per day, or $1.2 billion per month. Businesses and financial sector losses are even larger than this. Health sector also need huge financial support to fight with the deadly covid-19. However, this fiscal stimulus could also lead to a high inflation level if the massive deficits are monetized, particularly, if the attack of virus shock prevailed for the longer time period.

Third, the government should roll out widespread Covid-19 testing, tracing, and treatment measures, enforced quarantines, and a full-scale lockdown of the type that China has implemented. They should tighten social distance rules to combat coronavirus.

Fourth, the international financial institutions should play its role and take fast and bold steps to reduce the severity of the upcoming Covid-19 recession. Particularly, it requires to provide massive funding to developing nations to save the humans suffering from corona virus, lack of food, lack of health facilities and psychological pressures. The intervention by the global financial institutions should be fast and more otherwise the developing world will suffer a lot before we have a vaccine for Covid-19.



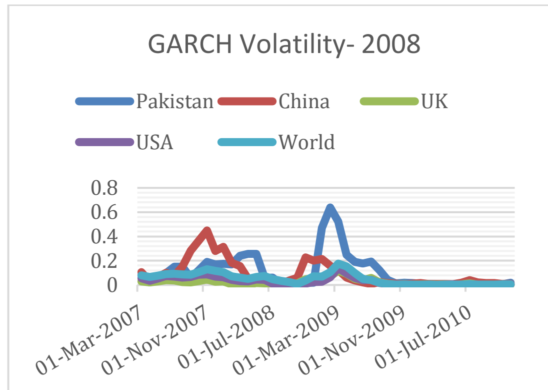


Figure 3: GARCH Volatility of Stock Markets Indices: GARCH (1,1) based conditional volatility of stock market indices during 2008 crisis and 2020 crisis periods

CASE II:

The second scenario would be to have a mirror image J or L shape downturn. It will be a rapid downturn but prolonged lived. In this case the markets would start recovering when the pandemic and lockdowns prevails for long term. Besides the demand it will hurt the supply side of economy.

CASE III:

The worst-case scenario would be an I shape downturn but more sever that the crisis of 2008 and even the great depression of 1929.

To avoid the last two scenarios some hard steps must be taken. China gives us a lesson that success comes at the price. Containing the virus comes at the price of slowing social and economic activity as it is evident in figure 4. Social distancing and reduced mobility will be enforced in order to have V or U shaped economic slowdown. Policymakers should implement strict mobility constraints, both at the national and local level—for example, at the height of the outbreak, many cities in China enforced strict curfews on their citizens. Despite much help from the rest of China, Hubei province suffered heavily while helping to slow down the spread of the disease across the nation.

Mitigating the impact of this severe shock requires providing support to the most vulnerable. Policymakers should target the most vulnerable households and look for new ways to reach smaller firms—for example, by waiving utility bills, and tax reliefs and channeling credit. The authorities should quickly arrange subsidized credit to support scaling up the production of health equipment and other critical activities involved in the outbreak response.

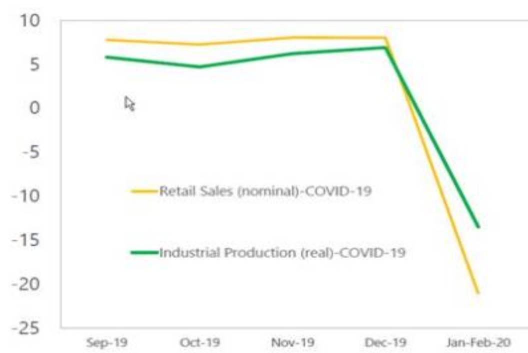


Figure 4: Sudden Halt: Industrial Production and Retail Sales Suffered Historic Drops

Industrial production and retail sales in Mainland China, in percent change from the year ago

Source: Haver and IMF staff calculation