Global Counsel

Coronavirus: how to assess the economic and business impact

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Summary

There are three main channels through which coronavirus will impact on economies: disruption, threats to resilience and confidence. Disruption may mean that some markets do not function normally and require quantity rationing, creating unfamiliar dilemmas for businesses and governments. Threats to resilience may be compounded as businesses seek to protect themselves from losses and provide justifications for government interventions, based on political as well as economic calculations. The demand side of the economy may be affected by falling confidence, although this is likely to lag the impacts of disruption and threats to resilience on the supply side, making the timing of interventions by central banks important. There may also be long-term implications for businesses and government policies. The key to assessing these is to consider how the crisis may impact on commercial and political relationships. There are opportunities as well as risks for businesses and investors.

Coronavirus is a complex economic shock of uncertain magnitude, which will require a range of calibrated responses by both policymakers and businesses, if its economic effects are to be contained. The uncertainty stems not only from the spread of the virus, but also from how people respond in different circumstances. The complexity is magnified because it is impacting on both the supply and demand sides of the economy, and in ways that are desynchronised, making the timing of policy interventions especially important.

There are three main channels through which the economic shock is being felt: disruption; threats to resilience; and confidence. The first two impact on the supply side, while the third impacts on the demand side, although they will interact with each other, as illustrated in Figure 1. Economic policymakers need to take a systematic and differentiated approach to mitigating the economic impact through each channel. Businesses also have important roles to play, out of commercial self-interest as much as anything else. In some cases, businesses may need to consider taking actions that would not normally be regarded as orthodox, reflecting the unusual circumstances.

Figure 1: three channels through which coronavirus impacts on the economy

The coronavirus has the potential to be hugely disruptive to relationships, much more so than any recent economic or financial crisis. There is likely to be disruption of the relationship between governments and citizens; between producers and their suppliers; between exporters and importers; between businesses and their customers; and between creditors and debtors. The key to thinking about the enduring impact of the crisis, once the supply and demand shocks abate and a new normal for economic activity is resumed, is to identify where disruption to these relationships might lead to permanent changes in behaviour. The path through the crisis will matter. These enduring implications create risks and opportunities for businesses, investors and governments.

Disruption

The most immediate and direct economic impact of the virus is through the disruption to normal economic activity. This includes the impact on supply chains, continuity of services (both public and commercial), the availability of staff, transport and logistics. This is the result not only of illness or the impact of containment measures that are imposed, but also the way that people or businesses react to circumstances.

The risk is that markets stop functioning normally, with staff shortages, services disrupted, or goods not supplied. In normal circumstances, established relationships, sometimes underpinned by contracts, are robust enough to allow disruptions to be resolved without significant additional cost. And where they are not, alternative solutions can typically be found by procuring on the open market. If staff are ill, you hire temps; if a supplier lets you down, you buy from a competitor; if demand from customers is unserved, they go elsewhere.

In more extreme circumstances, these mechanisms may no longer function. There may be no price that clears the market for the supply of a component, a consumer good, or some services. And while some price adjustment can always be expected, quantity rationing is inevitable.

Quantity rationing is already a pervasive feature of the disruption in China, as businesses must decide which of their customers to supply when production volumes are down. And even in other countries that have reported only a few coronavirus cases, there are examples where retailers have had to ration products where there has been a surge in demand, such as hand sanitiser.

Businesses and governments in most countries are not used to dealing with quantity rationing except in a small number of areas, such as in some public healthcare systems. This means that many businesses may be confronted with a new set of decisions that they are not accustomed to making. Which contracts should you prioritise? Do you just let the shelves run dry? What demands can you reasonably make on staff covering for others, or perhaps struggling with additional childcare needs when schools are closed?

This is essentially a large-scale coordination problem. Stress in one part of the system exacerbates stresses in other parts. China is in the teeth of that problem now as it attempts to restart business activity after an extended pause, following the lunar new year. That problem is particularly severe as the Chinese took a draconian approach to containment, which other countries may or may not follow, and it remains to be seen whether the Chinese approach has resulted in a sustainable drop in infection rates.

A minority of businesses may benefit from disruption. This includes businesses that provide products or services that help mitigate the effects, such as online service providers, or businesses that see demand increase as consumer behaviour changes, with more people staying at home than socialising in public or travelling abroad.

Threats to resilience

Disruption could threaten the resilience of public services or private companies and potentially lead to the failure of some businesses. In the UK, which has seen only modest disruption so far, the regional airline Flybe is already a casualty of reduced demand and has been put into administration. Many other airlines around the world are reported to be under financial pressure as they are among the most directly affected by travel restrictions and changes in consumer behaviour.

The threat to the resilience of some operators in the most exposed sectors may be compounded by the way in which other businesses react, as they seek to protect themselves from the effects of disruption and financial exposure to companies at risk of failing. Suppliers operating at reduced capacity will have an incentive to prioritise the orders of customers with the highest capacity to pay. The most exposed businesses may therefore encounter additional problems with suppliers or cash flow as a result, further testing their resilience.

The problems may be compounded by legal uncertainties. For example, it is unclear under what circumstances, if at all, insurance companies might pay out for disruption caused by the virus. It is also unclear whether suppliers failing to fulfil contracts will be held liable, particularly as they will likely choose to fulfil some orders but not others, for the reasons described above.

Threats to resilience may create an economic or a political rationale for government interventions to support businesses or individuals. This may be to stop the collapse of some businesses from compounding the economic disruption from the crisis, or to avoid permanent damage to the productive capacity of the economy. Or it may be for reasons of fairness, as some businesses or individuals may be perceived to be bearing more cost through no fault of their own.

The interventions being considered by some governments include delaying tax payments or incentivising the availability of credit. These help to address cash flow difficulties, but not the impact on profitability and balance sheets of reduced revenues or higher costs that the most exposed businesses may face. That would require more direct fiscal support by governments, which is costly and may be politically harder to justify.

The politics is made more complicated as the choices of governments could be the primary source of threat to the resilience of some companies. For example, many European governments have now placed limits on the size of public events, which could threaten the viability of some event organisers. Governments may also take decisions which pass costs around the system, such requiring businesses to provide better sick pay.

Many of these questions boil down to one simple question – who pays? Which sectors? Which companies? Small or large enterprises? Taxpayers or shareholders? The way in which governments address these questions will be partly motivated by efficiency, but inevitably also by politics.

In any situation where commercial outcomes are influenced by the discrete policy choices of government – as in this case – investors have a strong interest in those decisions, as they can have a direct and immediate impact on valuations. For reasons described above, both the economic and political rationales for interventions of different sorts must be considered when assessing the likelihood of different interventions.

Confidence

Coronavirus is both a supply and a demand shock to the global economy. Efforts to reduce disruption and threats to resilience are attempting to mitigate the supply shock. They may also help to avoid damaging confidence. If confidence is hit, that is a demand shock, as households will spend less and business will hold back on investment, not just in the sectors most directly affected, but across the board, with sectors that are most exposed to cyclical changes in demand being the most vulnerable. This creates a potential rationale for central banks (and perhaps also finance ministries) to ease policy to offset the demand shock.

Confidence effects on demand are likely to lag the impacts of disruption and threats to resilience on the supply side. They are also more uncertain. If there is a widespread expectation that the impact of the virus will be temporary and the interventions by governments effective in minimising disruption and threats to resilience, then the impact on confidence may also be small. On the other hand, if there is a concern that the central banks or governments are ill-equipped or otherwise incapable of maintaining confidence, this can make a confidence problem much worse. The latter is a particular concern now as the room to ease monetary or fiscal policy is limited in many countries.

In these circumstances, communications by central banks and governments are crucially important, as are the timings of actual interventions. The immediate priority for central banks should be to set out what tools they have available and the circumstances in which they will use them, rather than acting pre-emptively, particularly as that may further limit the room to act later.

The decision by the US Federal Reserve to cut interest rates this week is questionable for this reason. The immediate priority for the US authorities should be to ensure they are doing all they can to minimise disruption and threats to resilience. It is not clear that they are. Instead, the Fed is using scarce policy space to offset a possible demand shock when the nature, magnitude, timing and durability of that shock is uncertain. At best, the Fed may be getting ahead of the curve; at worst, it is muddled and wasteful.

There are confidence issues for businesses to consider too. For example, confidence in their financial capacity to pay, or in how they treat their customers or suppliers or staff in difficult times. These are important to minimise the cost of disruption and potential threats to resilience. They could also have enduring implications for brands. Some businesses may emerge with stronger brands because of how they treat their customers, suppliers, or staff, while others may be damaged, depending on how they handle these key relationships, as described below.

Longer-term consequences

One way to assess the longer-term economic and commercial implications of the coronavirus is to focus on the supply shock elements and to recognise that there may be hysteresis in the system, with enduring implications for consumer behaviour, business models, and government policies. The key to understanding that is to consider how the crisis might impact relationships of different sorts: between governments and citizens; between producers and their suppliers; between exporters and importers; between businesses and their customers; and between creditors and debtors.

Short-term disruption can lead to permanent changes in behaviour, creating opportunities as well as risks for businesses. Reliable nodes in a network under stress are likely to be rewarded in future. More efficient routes to supply may be identified. New ways of working round problems, including staffing, may be discovered. Consumers may try new products and not switch back to previous consumption patterns. In each case, existing relationships are stressed while new relationships are formed, which may prove to be durable. Businesses seeking opportunities from this crisis should protect their most valuable relationships and find opportunities to establish new relationships that may endure once the crisis is over.

Policymakers, businesses and investors may become more risk averse in future and more aware of systemic risks. There will inevitably be more focus on pandemic risks. This will have implications for health-related regulations and that in turn could directly impact on certain types of business. Governments tend to improve their readiness for the last crisis, so more demanding health regulations are likely, just as we saw more stringent regulation of the financial sector after 2008. This could also impact on trade agreements between countries, with a more direct clash between the science-based approach and the precautionary principle, which has been at the heart of EU-US differences for several years.

These policy changes are driven in large part because citizens may have different expectations of their governments in future and as such, they are also examples of relationships changing. This may have implications for wider policy. It is conceivable, for example, that there may be less public tolerance for risks associated with pollution or the environment in future.

Other aspects of the government-to-public relationship may also be tested. Expectations about transparency may change permanently. There may be an impact on how societies and governments view health data versus privacy concerns. Expectations about the balance of public or private provision of certain services may change, if some systems are perceived to be more robust than others. Employment practices may also change. Governments that provide workers with new entitlements now may not be able to remove these later.

This Global Counsel Insight note was written by Dr Gregor Irwin, Chief Economist at Global Counsel.

To contact the author, email:
g.irwin@global-counsel.com

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A: 5 Welbeck Street, London, W1G 9YQ
T: +44 (0)203 667 6500
E: info@global-counsel.co.uk
www.global-counsel.co.uk
@global_counsel