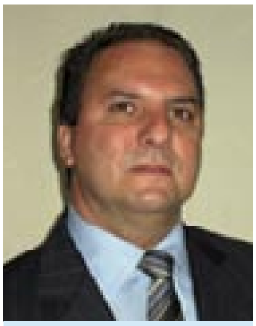
Time to stay calm and act rationally

French economist Jocelyn Martel gives his personal views on the COVID-19-related financial and economic crisis



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In January 2020, the world woke up facing a phenomenon that some had predicted but few wanted to hear about or were prepared for: a global pandemic, now commonly called the COVID-19 crisis. Immediately, many economists were convinced that the world was heading for a stock market crash and an economic crisis.

They were right. The stock market sank, and all countries that imposed strict lockdown measures face a significant contraction in their GDP.

Clearly, this is not the first nor the last time that the world faces a stock market crash and a recession. Yet, this is the first time in our generation that a recession results from a pandemic. In addition, the speed and the magnitude at which this is happening is unprecedented. The S&P 500 lost 34% between 20 February and 23 March (which then increased by almost 30% by 8 May) and all countries are expected to lose many percentage points of GDP this year only. In a majority of countries, confinement policies forced most of the population to stay home to reduce the spread of the virus. Although teleworking was highly encouraged, millions of workers in every country have been laid-off, at least temporarily. National governments, who have learned from the last financial crisis, decided to step in to stop the bleeding. Massive recovery plans were adopted to help workers and companies to survive the crisis. At the same time, Central banks around the world announced a historical debt repurchase plan in order to support the economy.

But this situation was untenable. In early May 2020, many countries decided to loosen up on their confinement policies. Economic activity is slowly recovering in some industries while others are expected to continue suffering from the crisis for years to come. I think that there are three key aspects of this COVID-19 pandemic crisis that, unfortunately, our society will have to accept, at least for some time: mass unemployment, bulging government deficits and record bankruptcies.

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Falling GDP

First, GDP has already dropped and unemployment around the world is expected to increase significantly. France's GDP went down by 6% in Q1 2020 and its unemployment rate could increase to more than 12%. However, I believe that the drop in GDP has two components.

The first one is transitory. Because of the uncertainty, consumers have significantly increased their savings and postponed many expenditures, especially for durable goods. Most of these expenditures will occur when uncertainty goes down and the economy recovers.

The second one is permanent and is lost forever. Services such as a meal in a restaurant or a haircut cannot be postponed to a future date, although some of the savings can be reported on future consumption. Although there is no empirical estimation of the relative importance of each component, I suspect the transitory part to dominate. This could explain why the stock markets have erased part of their losses over the last two months. In spite of the uncertainty, financial markets seem to have integrated the gravity of the crisis, including the zones of turbulence to come. They are now looking forward for the increased consumer spending and economic recovery.

A second aspect of this crisis is that governments' deficits have gone off the roof. For instance, the debt to GDP ratio of France is expected to go from 100% to 116% before the end of the year. This significant increase in deficits is mainly explained by the governments' decisions to preserve the purchasing power of individual workers and to save firms from bankruptcy. Given that many countries can now borrow at close to zero, if not negative interest rate, this may be a sound policy in the short run. Whether or not this is a sound policy in the long run is open to debate, but it would be wise to remain cognisant of the deleterious effects bulging government deficits have had on economies following other crises, as the first and the second oil price shocks.

A third aspect of this COVID-19 crisis that relates to the drop in GDP is the number of bankruptcies. Historically, bankruptcies lag variations in GDP and unemployment by a few months and no one doubts that the number of bankruptcies will shortly rise. A number of laid-off workers will default on their mortgage or personal loans and the number of consumer bankruptcies is expected to surge. Large firms may find their way out through restructuring, but many SMEs are bound to disappear. Many national governments have announced a series of measures that attempt to avoid this future wave of bankruptcies. The French government even declared that it would not let any firm go bankrupt because of the crisis.

Urgent changes

Further, some insolvency professionals are calling for urgent changes to bankruptcy legislations to prevent what can be commonly called "COVID-19 bankruptcies". Whether or not this is necessary is open to debate but in my view, this is getting into dangerous territory. As argued by Jackson (1986), "the basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors as a group when there are not enough assets to go around. Because creditors have conflicting rights, there is a tendency in their debt-collection efforts to make a bad situation worse."

Bankruptcy law is designed to handle the resolution of financial distress irrespective of the state of the economy. There is no bankruptcy law either for boom periods or for recessions. It can be amended to respond to structural changes in the economy, but not to economic cycles. Doing so would open the door to continuing demands by creditors and corporations to modify the law at their convenience. In addition, bankruptcy is a natural phenomenon in a market economy and some firms would have disappeared even without the COVID-19 crisis. The objective of the government should be to offer the necessary breathing space to viable firms faced with short term liquidity problems rather than trying to save all firms at all cost. I believe that some of the measures announced by the governments represent a strong signal in this direction and that nothing justifies adopting a new "COVID-19" bankruptcy law.

From a financial perspective, financial markets will continue to exhibit high volatility. Risk averse investors have become more sensitive to information and many are desperately looking for good news. Of course, one should not overlook the fact that the drop in the stock market could translate into significant losses for investors. The sudden drop in the stock market is akin to systematic risk inherent to investment activities. Thus, long term investors need to be patient. Although we are likely to observe a rise in the market risk premium that will impinge on a full market recovery, the current circumstances may offer good investment opportunities to investors who are willing to accept some additional risks.

Surviving the crisis

Finally, the last century has seen numerous economic and financial crises, among which the 1929 Great Depression, the 2000 internet bubble and the 2008 Global Financial crisis. To put things into perspective, the CAC 40 (French stock market index) lost 65% of its value from its peak to its lowest value following the internet bubble. Following the 2008 financial crisis, the S&P 500 lost 55% of its value between January 2008 and March 2009. Needless to say, all these indices have recovered, some ending up at their all times high just before the COVID-19 crisis. On the unemployment front, the US unemployment rate went from 4.5% early 2008 to 10% by 2010. It was at 3.5% at the end of 2019. Thus, the world has been through terrible crises in the past and there is no doubt that it will survive this one too. But how long will this take? No one really knows. Although there is little doubt about the fact that the national unemployment rates will rise in the coming two quarters and could stay above historical levels for some time, economists debate on whether the economy will evolve in a V-shape, a W-shape or a U-shape. The shape of the recovery may well depend on whether or not we get hit by a second wave (or a series of waves) of the pandemic. In the meantime, my recommendation would be to stay calm and act rationally in the face of heightened uncertainty. The cost that the society will have to bear for the series of measures taken by governments around the world is a serious concern. Alternative economic decisions could have been taken. But they were not. Time will come for a complete cost-benefit analysis of these decisions (confinement, increased leverage, unemployment, queuing, but also innovation, technological leapfrogging, European integration, …) and hopefully we will learn from it.

But today, we need to look ahead and to be confident. Consumer and investors' confidence will be essential to surmount this crisis and to find a path to recovery. Any crisis represents its own challenges with its risks and opportunities.

We now know the risks. It is our duty to seize these new opportunities. ■

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