

COVID-19 and its Consequences



GÁBOR SZENDRŐI
IMAP Hungary
gabor.szendroi@imap.com



LEVENTE MERCZEL
IMAP Hungary
levente.merczel@imap.com

The global emergence of the Coronavirus pandemic has significantly changed the course of literally everything – the way we live, work, move and relax. As the initial shock wears off, more and more people are starting to think about what our world will look like when we finally leave quarantine. In this special COVID-19 edition of Creating Value, Gábor Szendrői and Levente Merczel share their perspective and reflections on the unfolding crisis.



This article does not aim to predict the course of the pandemic. Significant uncertainty still surrounds economic forecasts, as well as the impacts on human health. Rather, our aim is to summarize where we stand, the potential consequences of current events and how they could possibly affect companies and related transactions. This pandemic will no doubt shape the economy for the following decades and we can already foresee some of the resulting issues:

- New economic uncertainties and resulting greater risks will last for a long time.
- The business model for global economic factors will change permanently:

- a. Focus will be on resilience at the expense of efficiency, resulting in redundancies and declining profitability, which will lead to a slow economic recovery.
- b. Real interest rates, unlike in war times, will fall on a 10- 20-year horizon due to decreased demand for capital and subdued economic growth.

Current Economic Repercussions

Global supply and demand shock came with abruptness never before seen in history

Sudden outages spilled over into a mutually reinforcing, simultaneous supply and demand shock, resulting in a vicious cycle for the whole economy. Due to the pandemic, production has been shut

IMAP CREATING VALUE - CORONAVIRUS SPECIAL COVERAGE
 THE CRISIS AND ITS CONSEQUENCES

down or significantly limited: output and sales are in freefall and companies are facing difficulties, workers losing their jobs or receiving reduced salaries, and consumption declines. As a result, company sales are further diminishing, more workers are laid off and less products and services are ordered from supporting industries, resulting in them slowing down or even stopping work. Hence, a vicious cycle is set in motion and we don't know when it will stop. The accompanying chart shows the PMI (Purchasing Managers' Index) of several European countries, demonstrating that in expectation of a cataclysm, managers have cut back their purchases to unprecedented levels.



Though a supply shock hit the economy, production infrastructure and capacity still exist, meaning a relatively quick production recovery is possible following the crisis. However, low consumption and slow recovery for any other reasons mean most of these capacities will remain untapped, leading to lower price levels – although there is extensive debate as to whether inflationary or deflationary pressure is stronger at the moment.

All industry is affected by the current crisis, the only question is which will be the least affected:

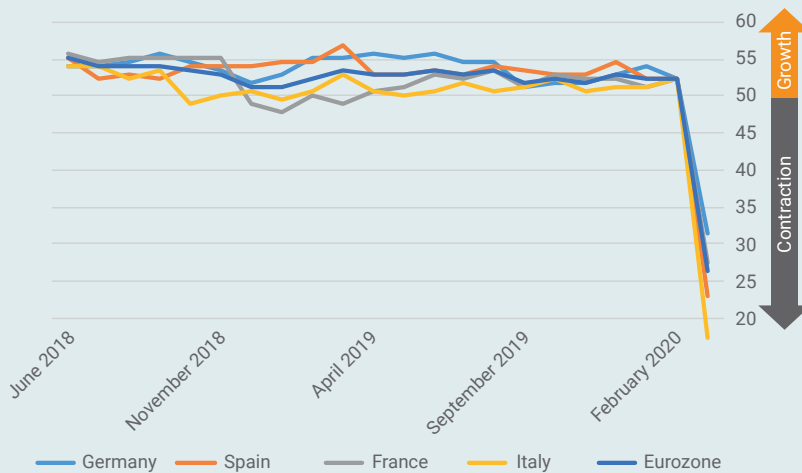
1. Tourism and related industries, as well as industries embedded in global value chains are the most severely affected.
2. White-collar jobs with no special infrastructure requirements are least affected.

3. Key technology industries are soaring right now; particularly pharmaceutical and medical device manufacturers.
4. Several industries became temporarily prosperous, experiencing an unprecedented boom (e.g. toilet paper and durable food factories), however, this short-term positive effect of early consumption is expected to backfire later turning into lack of demand and stockpiled inventories.

Plummeting demand for labor not only eliminated labor shortages, but also induced unemployment crises. In the US, the number of jobless claims has risen to more than 30 million in a period of just 6 weeks since mid-March and is still increasing. Since 1970 and during even the most severe recessions,

EUROZONE'S ECONOMIC ACTIVITY HAS COLLAPSED

Purchasing managers' index, services, June 2018 - March 2020



Source: dueglobaleconomy.com



“Global value chain management is expected to shift towards crisis management, despite the currently dominating “efficiency first” logic. This will also mean deteriorating profitability, lower valuations and declining or slowly rising stock market indices. If this really happens, it will go against the business logic of recent decades and potentially launch a process of ‘de-globalization’”.

this figure has barely been higher than half a million per week. In Norway, unemployment has risen to unprecedented levels since World War II in just 2 weeks. Unemployment is now growing 10-20 times faster than during the global financial crisis of 2008. According to some analysts, this crisis will deal a more severe blow to the world economy than the Great Depression in 1929.

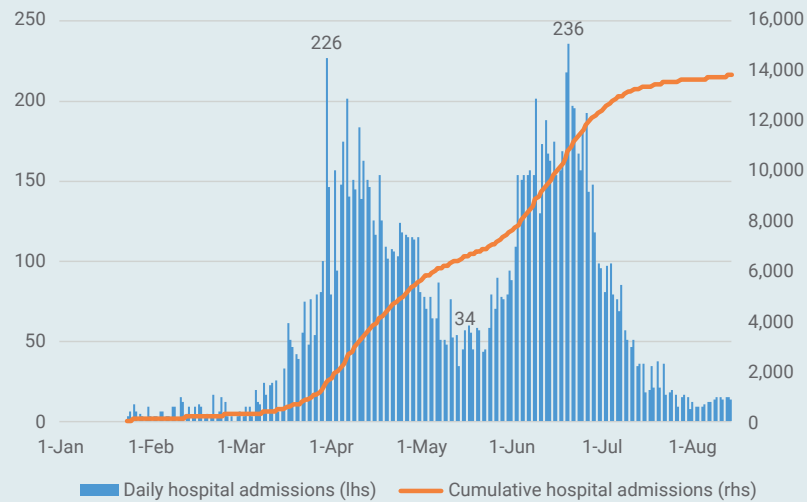
In order to cope with the immediate shock, digitization, excluding manufacturing automation, has been accelerated wherever possible globally. Until now, the sluggish transition aimed to offset shrinking labor supply and achieve efficiency gains. Today, companies must figure out how to guarantee the necessary safe distance among employees at work. This could prove particularly difficult, for instance in education, causing serious long-term damage. The white-collar private sector however, may see positive benefits, with employees capable of being productive even from home. The question arises as to whether these newly introduced solutions will add or destroy value at a company and macro level during the next 1-3 years.

Future Economic Repercussions:
Extreme uncertainty surrounds the consequences of the epidemic as it has barely begun

Throughout history, there has been nothing similar to the effects of the coronavirus, and therefore, there are only guesses as to what awaits us. Capital markets, which act as a kind of litmus test for the state of the economy and the economic outlook, are

SYDNEY EXPERIENCED TWO SEPARATE WAVES OF SPANISH FLU PANDEMIC DURING 1919...

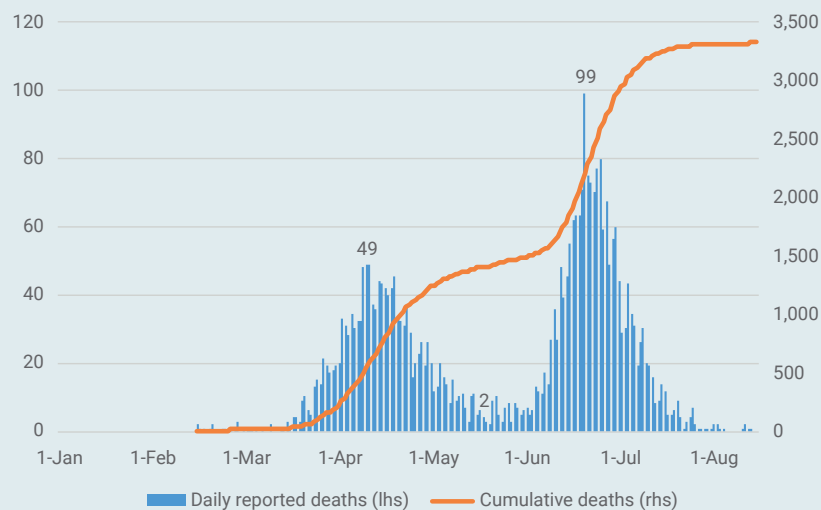
Influenza cases admitted to hospital, Sydney, 1919



Source: McCracken & Curson (2003), Macquarie Research (2020)

... AND THE MORTALITY RATE OF THE SECOND WAVE WAS HIGHER

Influenza deaths, Sydney, 1919



Source: McCracken & Curson (2003), Macquarie Research (2020)

extremely volatile. Furthermore, we expect this high volatility to persist, as it is likely that market prices do not reflect all the data on the epidemic due to its delayed effects.

Some researchers envision further waves of the epidemic due to the early lifting of restrictions,

with many believing the virus will appear each year implying recurring restrictions. Moreover, if a second wave does come, it is unclear what course it will take or whether it will be milder or worse. If we take a look at the course of the 1919 Spanish flu in Australia, we can see that the mortality rate of second wave was in fact higher than the first time around.

The business model of global economic actors will change permanently

Countries have dealt with the pandemic and its potential risks differently, each hoping that the economic course will be V-shaped: a sharp decline followed by a quick upswing. But so far this assumption seems unjustified, with forecasts projecting a U-shaped curve with no explicit bottom and recovery not immediately noticeable either. The most pessimistic forecasts show an L-shaped curve, meaning that the recession will stay with us for a long time.

According to the San Francisco Fed's analysis based on data dating back to the 14th century, real interest rates fell following epidemics, yet moved in a positive direction after wars. The trend is not short-term, but valid for the next few decades after the triggering event. This assumes that the return on assets and general wage level will be lower in the future. Two main reasons are highlighted as causing long-term interest rate decreases: the higher average invested capital per employee due to a reduced workforce, and the higher savings rate resulting from the higher demand for security reserves. Of course, the average working age in the previous thousand years was significantly lower, so epidemics typically decimated the working-age population aged under 60.

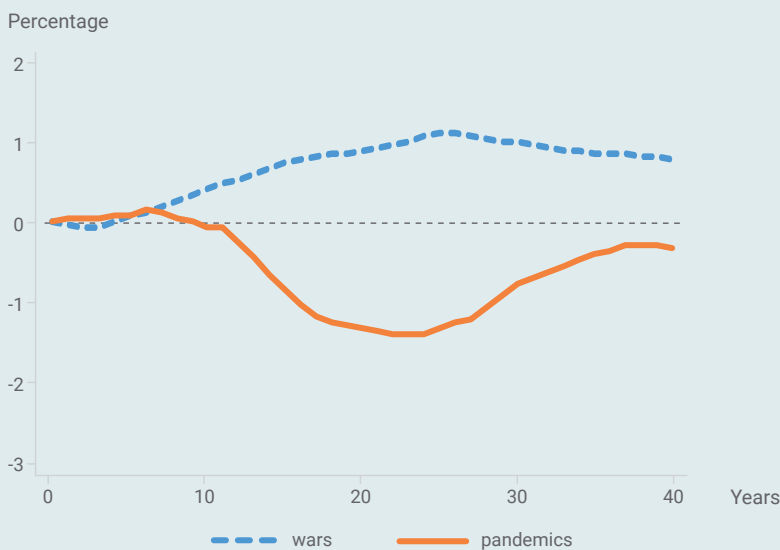
Consequently, analysis suggests that this time may be different.

However, the potential long-term impact on inflation is unclear. We were in a special situation before the virus, when oversupply of liquidity and low inflation were present at the same time. There is a fierce ongoing debate in the world; whether the risk of deflation or inflation is greater, and what economic phenomenon will follow. After all, the response to the crisis will be money printing, implying the risk of inflation; however, at the same time, internal economic processes project a disinflationary effect. The consensus among experts on global economic developments is that deflation is expected in the short term, as there is no indication as to what may drive up prices during mass unemployment and diminishing consumption, but the risk of inflation remains. However, others suggest that even large-scale money printing does not necessarily mean inflation in the long run, such as Bernie Sanders, who subscribed to and embraced the Modern Monetary Theory (MMT).

In the following period, due to severe disruptions and extreme uncertainties, global value chain management is expected to shift towards crisis management, despite the currently dominating

REAL INTEREST RATES DECREASE FOLLOWING PANDEMICS ACCORDING TO THE DATA OF THE LAST THOUSAND YEARS

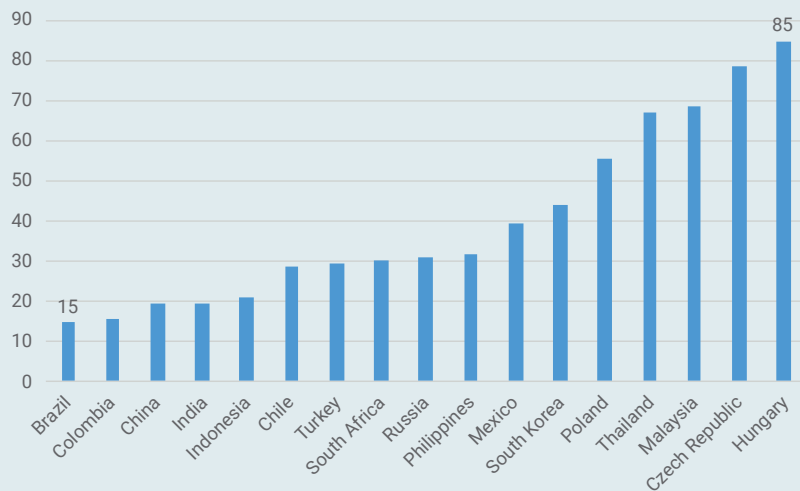
Real interest rates in Europe following pandemics and wars, from 14th century



Source: Jorda et al (2020)

EXPORT-ORIENTED ECONOMIES ARE VULNERABLE TO GLOBAL DEMAND SHOCKS

Export of goods and services, 2018, as % of GDP



Source: World Bank

“efficiency first” logic. This will also mean deteriorating profitability, lower valuations and declining or slowly rising stock market indices. If this really happens, it will go against the business logic of recent decades and potentially launch a process of ‘de-globalization’, which could have a significant impact on countries that are heavily exposed to global trade.

If the globalization of value chains reverses, peripheral countries, in which higher value-added production may have been installed, will be damaged - but only temporarily, as these may be the basis for reconstruction. Peripheral countries that have generated lower added value are less likely to be replaced as suppliers - as they can be replaced at any time later. However, if de-globalization becomes significant, they could be seriously damaged in the long run. Of course, transitional or less drastic solutions may be applied, which could even have a positive impact on regions such as the CEE region in Europe:

- 1. Nearshoring** – Meaning the relocation of the value chain within a region, i.e. the relocation from the cheapest and furthest countries, to the nearest but less expensive countries. Central Eastern Europe (CEE) as a region may not be damaged or could even benefit, but at a country level, it may trigger a shift to the north and west.
- 2. Supplier Diversification** – Companies may attempt to increase their existing supplier diversification. As the CEE region is very strong in the service and supporting industries, this can be a positive development at both a regional and country level.
- 3. Redundant production** - Shifting from lean production, i.e. from extreme efficiency to surplus production, may give rise to stockpiling to create reserves for crises. Again, this could also be a positive outcome for the CEE region and countries.

“The white-collar private sector may see positive benefits, with employees capable of being productive even from home. The question arises as to whether these newly introduced solutions will add or destroy value at a company/macro level during the next 1-3 years”.

Changes in human behavior – can we even be optimistic at the micro-level?

We also need to consider the extent of changes which may be observed in human behavior comparable to the changes listed above. This crisis is a very personal experience: it affects everyone, regardless of age, gender, denomination or skin color. Some of the key issues we see related to potential changes in human behavior are:

- Will consumption change when life returns to normal? Will we:
 - a. Consume differently and will weights change in the structure of consumption? How?
 - b. Consume more ‘normally’ i.e. more durable and/or sustainable products?
 - c. No longer need certain products and services - and will we have new needs?
- Will our attitude to travel and free time change (thinking about leisure in general, but also how culture, entertainment, hospitality will change)? What will be the ‘new norm’ in tourism? Once we rediscover our own close environment during the isolation, will we aspire to travel to distant places again?
- How will our relationship with our environment and nature change? Now that it is becoming a common experience for all of us to see what effect the exploitation of our living environment has; will we have a more forward-looking attitude to the world in which we live? Will we be open to spending on sustaining our environment and not just draining it?
- Our cities and villages are being emptied as a result of the crisis. What will it look like when our common spaces are repopulated? Will there be more cycling, use of public transport, people walking? Or will we take back the roads with our cars, creating traffic jams?
- What will our interactions look like? Education has become digital; postal, banking and public administration have been significantly simplified and many of our interactions have been pushed into the digital space. We have been talking about the need for digitization for years and although we introduced it imperfectly and urgently, it turns out that many systems still work, so what can we keep from this?

- How will commuting and working change? As a result of the virus, workers have begun to revolt against common workspaces and are crying out for more personal space. Who will be able to work permanently from home? How many personal meetings will we have in cyberspace?

Of course, we are under no illusions about the expected outcome arising from the above questions, but we do hope that we will see positive answers to at least some of them during the upcoming years. If that happens, even though it is likely that for many, their lives will become economically more difficult, perhaps at least psychologically, they could be more uplifting.

Adapting to the new “Normal”

So, what can we take away in terms of how the COVID-19 pandemic is changing the world as we know it? We still can’t predict the course of the pandemic, or the full extent to which it will affect us long-term from a business and economic perspective or even in terms of human health for that matter as so much uncertainty remains. However, it’s clear that we are already seeing the results of the grave effect it has had on the global economy. The sudden shutdown in economic activity across the globe as a result of containment measures mean that the short-term economic effects of COVID-19 look likely to surpass those of previous epidemics.

As events continue to unfold, there is also no doubt that the pandemic will shape our economy for the following decades and the business model of global economic actors will change forever. There will be a new normal, we just don’t know quite what that is yet.

