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The Coronavirus Epidemic: Economic Consequences and the Need for Political Action

The current coronavirus crisis is plunging Germany into a complex economic crisis, the dimensions of which many people still underestimate. It is exposing the German economy to a simultaneous supply and demand shock. In addition, there is a risk that the supply of credit to the economy will be disrupted and that the sovereign debt crisis in the euro area will return. In terms of economic policy, the right response involves a combination of massive support measures that must be targeted precisely and enacted quickly.

Impaired Supply of Goods and Slump in Demand

The supply of goods and services is impaired as a result of companies' workforces being decimated by illness and quarantine. Many companies have ceased production due to the risk of infection or due to a lack of intermediate products.

At the same time, demand is collapsing across all sectors of "social consumption": trade fairs and conferences as well as cultural and sporting events have been canceled, and people are canceling vacation trips. Hotels and restaurants are empty. This has dramatic consequences: for many self-employed people and small and medium-sized enterprises, sales are falling to zero.

But it is not only in social consumption that demand is suffering. The car market in China shrank by 80 percent in February. Many people are expecting a loss of income and putting off purchases of cars and other major items; companies are putting investment projects on hold.

The Economy is Crashing

The economy will collapse during the acute period of epidemic control. At the beginning of the year, the German government was still expecting growth of 1.1 percent for 2020. If economic activity falls to 65 percent of normal levels for just two months and then returns to growth as expected, this will shrink economic output for the year as a whole by 5 percent. That would be comparable to the slump in 2009, the year of the financial crisis. But things may well get much worse.

What is to be done now? A conventional economic stimulus package to support overall economic demand through tax cuts and higher government spending is not the answer – or at least, not at the current stage of the crisis. When it comes to social consumption, for as long as the priority is on combating the spread of the virus, any attempt to prop up demand will be counterproductive.

Cushioning the Side Effects

For the whole period that the measures to contain the epidemic require a "freezing" of the economy, it is essential to combat the harmful side effects of this freeze. More generous rules for the short-time work allowance have already been adopted. There is an urgent need for people who are losing their income to receive additional support. Liquidity assistance and state guarantees can avert a wave of insolvencies. The fact that this will also benefit foreign banks must not be allowed to hamper these moves. International cooperation is crucial here. For small businesses and self-employed people most affected by the crisis, all tax payments should be suspended for a few months.

Ensuring the Supply of Credit

At the same time, the supply of credit to the economy must be prevented from collapsing. It is inevitable that some borrowers will default. If banks lose equity as a result, capital regulations could force them to call in other loans as well, exacerbating the crisis. Banking supervision should therefore temporarily expand banks' scope for action.

Preventing the Return of the Euro Sovereign Debt Crisis

Public finances in the euro area are under imminent threat. In the case of highly indebted countries, this could lead to a collapse in confidence. At the end of February, interest rates on ten-year Italian bonds were still below 1 percent; in a matter of days, they have risen to over 2 percent. Euro-area countries, and also the ECB, must send a clear signal that there will be systematic support for all countries and that there is no chance of sovereign defaults.

One could object to such massive aid for companies and states by pointing out this could lose taxpayers money, that sovereign debt is rising, that solvency is the responsibility of companies themselves, and that banks might once again be tempted to take excessive risks. In a normal situation, these objections would be compelling. But in view of the acute crisis, they are not. Drastic measures are now called for to prevent the economy from sliding into a downward spiral of collapsing companies, job losses, and panic in the financial sector. Once the crisis is over, demands for less national debt and more provisioning by banks can go back on the agenda. But not before.

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