

The Great Lockdown: What to expect when you are expecting an economic crisis

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Abstract

As the COVID-19 pandemic has imposed restrictions on mobility all over the world, more and more analysts are referring to this process as the beginning of an unprecedented crisis which repercussions are still to be endured. This crisis has already been labeled by the International Monetary Fund as the Great Lockdown. This exceptional nature has become a source of great anxiety on what can be expected in years to come. Still, as we move forward, lessons from previous crises can be learnt since many comparisons across crises episodes can be identified, even when their particular causes for and timing may be different. Therefore, in this context, it is useful to look back and try to prevent, as much as possible, its negative effects. In this sense, the present work reviews some of the key lessons learnt from the 2008 crisis and its aftermath, so decision makers and stakeholders can develop preemptive strategies for the months and years to come. By doing so, the paper analyses the role of financial assets, debt and regulation in understanding a crisis prone economic environment and points out that even before the COVID-19 outbreak there were many warning signs in the international scene.

Key words: Economic crisis, COVID-19, Great Lockdown, Financial assets, Debt.

El Gran Confinamiento: ¿Qué esperar frente a esta crisis económica?

Resumen

A medida que la pandemia de COVID-19 ha impuesto restricciones a la movilidad en todo el mundo, cada vez más analistas se refieren a este proceso como el inicio de una crisis sin precedentes, cuyas consecuencias todavía no pueden ser evaluadas. Esta crisis ha sido etiquetada por el Fondo Monetario Internacional como: el Gran Confinamiento. La naturaleza excepcional de esta crisis se ha convertido en una fuente de gran ansiedad sobre lo que habrá de ocurrir en los próximos años. Si bien es cierto que existe una gran incertidumbre, también es verdad que existen lecciones de anteriores procesos de crisis que pueden servir como guía. Aún cuando cada proceso tiene contextos, causas y circunstancias particulares, a partir del análisis es posible identificar elementos comunes entre distintos episodios de crisis. Por lo tanto, en este contexto, es útil mirar hacia atrás y tratar de prevenir, tanto como sea posible, sus efectos negativos. En este sentido, el presente trabajo revisa algunas de las lecciones clave aprendidas de la crisis de 2008 y sus secuelas, para que los tomadores de decisiones y las partes interesadas puedan desarrollar estrategias preventivas para los meses y años venideros. Al hacerlo, el documento analiza el papel de los activos financieros, la deuda y la

regulación en la configuración de un entorno económico propenso a crisis y expone que incluso antes del brote de COVID-19 es posible identificar señales de advertencia en la escena internacional.

Palabras claves: Crisis económica, COVID-19, Gran Confinamiento, Activos financieros, Deuda.

1 Introduction

As the COVID-19 pandemic has imposed restrictions on mobility all over the world, more and more analysts are referring to this process as the beginning of an *unprecedented crisis* which repercussions are still to be endured. This crisis has already been labeled by the International Monetary Fund as the *Great Lockdown*. This exceptional nature has become a source of great anxiety on what can be expected in years to come. Still, as we move forward, lessons from previous crises can be learnt since many comparisons across crises episodes can be identified, even when their particular causes for and timing may be different. Therefore, as the world is running towards the Great Lockdown it is useful to look back and try to prevent, as much as possible, its negative effects. In this sense, the present work reviews some of the key lessons learnt from the 2008 crisis and its aftermath, so decision makers and stakeholders can develop preemptive strategies for the months and years to come.

2 Is a crisis coming? What warning signs to look out for in a seemingly stable economy

In the economy as in health compromised systems, those with preexisting conditions, will always get hit harder by external shocks. Here are some of the warning signs that have been identified throughout different crises episodes (Claessens et al., 2013).

When asset prices go high the economy goes low

Over the years analysis and observation have shown that a sustained increase in the price of various economic assets can precede a crisis episode. An economic asset is any item that can store value and from which its owners can derived economic benefits by holding, using or terminating it, over a period of time (OECD, 2001). Although the specific sector experiencing a boom can vary across crises, asset price booms are common to all of them.

In the 2007–09 crisis, the most publicized asset price rise was that of the housing market, which by 2006 had reached an all-time of 206.65 points in the Home Price Index (Figure 1)¹. Rising home values were a real boost to consumption for many years, fueled by speculative behavior that pushed the market until early 2008. In this year foreclosures rose to over a million, while home builders kept trying to slash their inventory of unsold homes. The official inventory statistics understated the problem as they did not account for canceled sales, so many people continued to invest in this market sustaining relatively high prices.

1 Figures in this paper present recession years/periods in blue vertical lines.



Figure 1: 20-City U.S. Composite Home Price Index (Source: <https://fred.stlouisfed.org/series/SPCS20RSA>)

However, not just house prices experienced a sharply increase before the meltdown, it also happened with other assets such as gold, oil and stocks. Since 2001, the price of gold has skyrocketed from a level of US\$ 250 per troy ounce to its highest level ever of US\$ 1,900 in August 2011, before falling substantially to around US\$ 1,200 at the end of June 2013 (Białkowski et al., 2015:2). This upsurge started even before the 2008 financial crisis and continued in the following years, as many investors consider gold a safe haven.

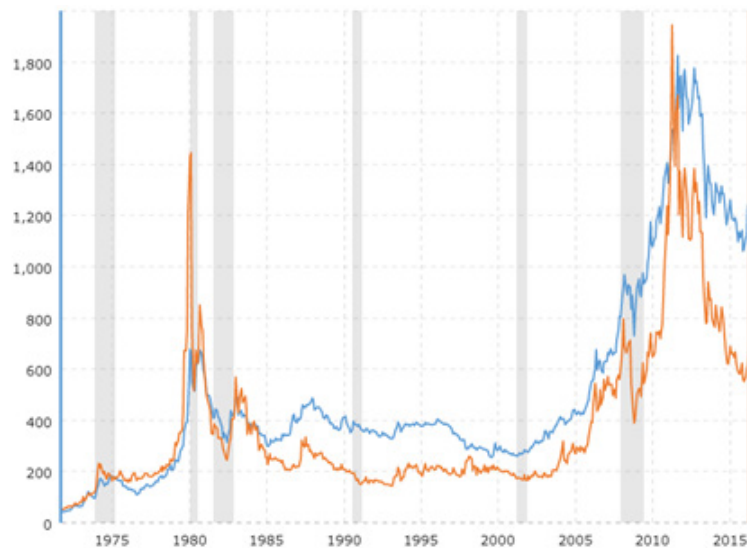


Figure 2. Gold vs Silver Prices 1970-2015 (Macrotrends, 2020).

Another key asset is oil which price is usually a major factor in how fast the global economy grows, as well as to determine prospective inflation levels. Even further as shown in Figure 3 a rise in oil prices precedes all recessions.



Figure 3. Crude oil prices vs S&P500 1980-2015 (Macrotrends, 2020).

If an increase in asset prices is a sign of an upcoming crisis, since 2017 many red flags can be identified as there has been a skyrocketing upsurge of many assets such as, gold and silver (Figure 4), oil and blue-chip U.S. equities (Figure 5), Bitcoin and other crypto-assets prices (Figure 6), as well as home values and rentals in many of the world's top-tier cities.



Figure 4. Gold vs Silver Prices 2015-2020 (Macrotrends, 2020).



Figure 5. Crude oil prices vs S&P500 2015-2020 (Macrotrends, 2020).



Figure 6. Bitcoin prices in US dollars 2015-2020 (Source: <https://es.cointelegraph.com/bitcoin-price-index>)

Furthermore, a growth pattern is clearly identifiable in the net worth level of households in the U.S. associated to the different asset bubbles over the past 20 years that can easily be associated with economic recessions (Figure 7).

Usually, consumer spending is driven by job growth, which keeps wages rising. As job growth has been slowing down over time and most economists expect it to slow further. It can be said that in the current economy is the growth rate of households that determines the growth of consumption. Based on these analyses it seems clear that this tendency clearly points out to the building up of a new economic crisis in the past three years, even before the Covid-19 outbreak. Immediately after the beginning of the lockdown there was a slowdown and even a decrease in the price of economic assets. Nevertheless, since July 2020, it seems to be a new upsurge in prices in different markets, such as oil and stocks (Figure 8), including emerging

market assets (Figure 9). This behavior has been celebrated as it has been mistakenly interpreted as economic recovery ignoring, once again, the warning signs.

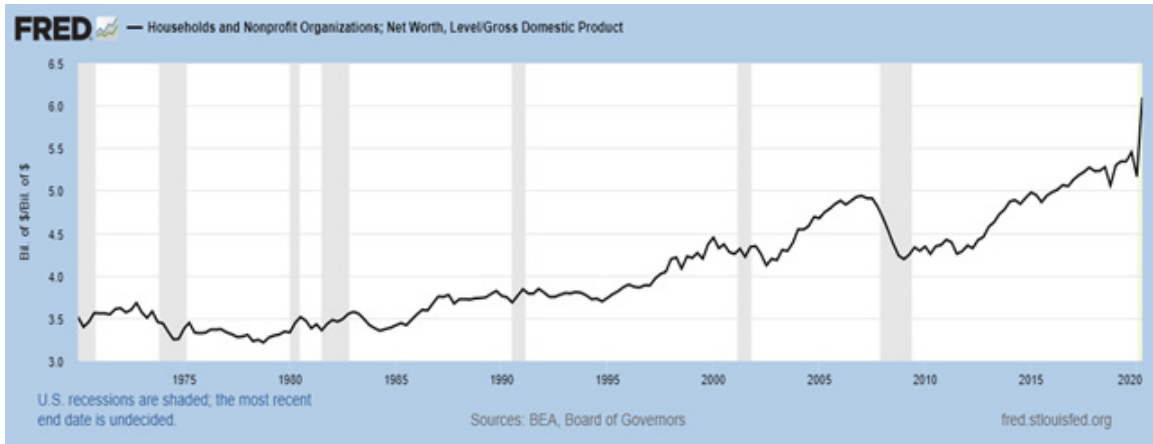


Figure 7. Households and Nonprofit Organizations Net worth level/GDP 1970-2020 (Source: <https://fred.stlouisfed.org/graph/?g=dGy#0>)

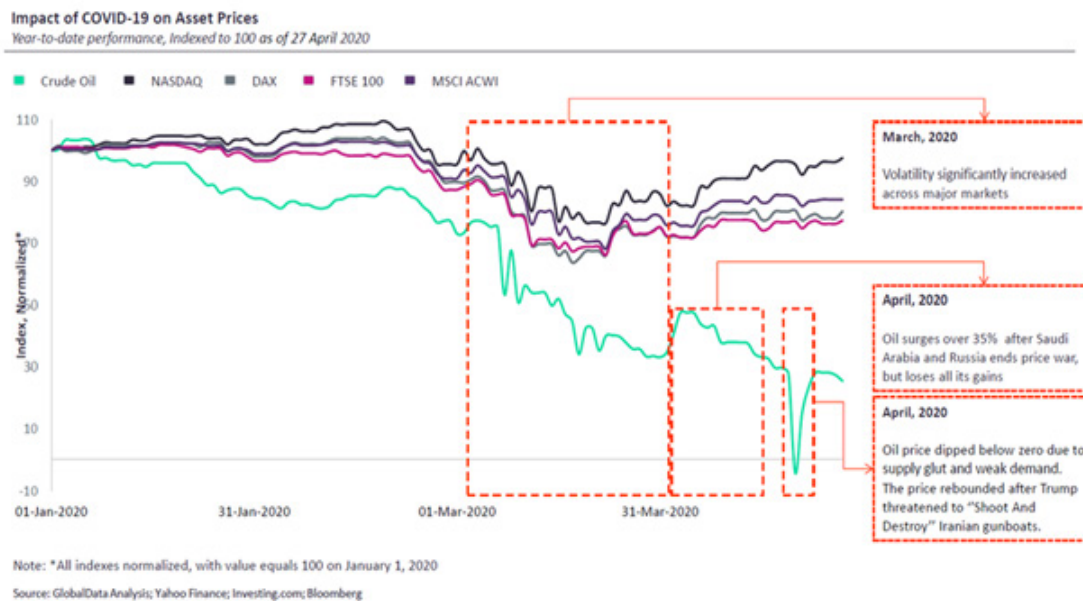


Figure 8: Impact of COVID-19 on assets prices (Source: https://designbuild.nridigital.com/design_build_review_jun20/covid-19_executive_briefing_globaldata)

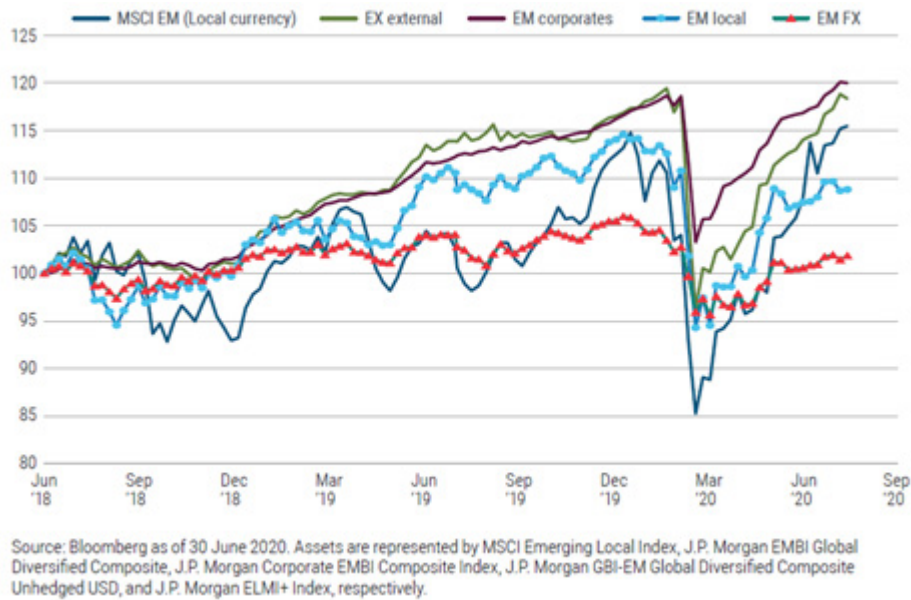


Figure 9. Emerging market assets- total returns June 2018- September 2020 (Source: <https://europe.pimco.com/en-eu/insights/viewpoints/emerging-markets-asset-allocation-opportunities-in-a-time-of-uncertainty>)

Credit booms and crises the story of an unhappy marriage

Rapid credit growth episodes generally coincide with large cyclical fluctuations in economic activity. After a series of crises, it has been established that public debt follows a prolonged and recurrent boom-bust cycle; the bust phase involves a markedly higher incidence of sovereign debt crises. Public sector borrowing surges as the crisis nears. In the aggregate, public and private debts continue to rise after default, as arrears accumulate and GDP contracts markedly. Specifically, rising debts ahead of the crisis usually refers to surges in capital inflow in any kind of debt (Reinhart and Rogoff, 2011).



Source: IIF, BIS, IMF, National sources

Figure 10: Global debt topped \$258 trillion in Q1 2020 (Source: https://www.iif.com/Portals/0/Files/content/Research/Global%20Debt%20Monitor_July2020.pdf)

The 2007–09 crisis was the result of the rise of household indebtedness in the United States driven largely by increased mortgage financing, along with contributions from historically low interest rates and financial innovation. In the first quarter of 2020, many alarms went off as the world’s debt rose from \$246.5 trillion in 2019 to a total (private and public) global debt to \$258 trillion (Figure 10). This situation has been worsened by the pandemic as governments across the world implemented stimulus packages to support companies and citizens, many of these programs were in the form of short-term loans. Additionally, firms also acquired debt to face the consequences of the lockdown. This resulted in an increase of the global debt load of \$15 trillion in the first three quarters of 2020 and now stands above \$272 trillion and it is expected to reach \$277 trillion by the end of the year (Institute for International Finance, 2020).

Another sign: the dramatic expansion in margin loans

A margin loan is a secured line of credit that allows you to borrow funds to invest. When a rapid growth in financial markets is connected to a decline in lending standards it leads to the creation of marginal assets that are viable only as long as favorable economic conditions last. In 2007, the spread between the London Interbank Offered Rate (LIBOR) and the Overnight Indexed Swap (OIS) expanded, due to concerns about solvency among lenders. Consequently, short-term credit markets on which companies depend on for their immediate money needs constrained access to credit, as a result firms could not trade commercial paper at any price. Whereas, others were unable to get funding from banks because banks were protecting their reserves (Figure 11)².



Figure 11: TED Spread - Historical Chart (Macrotrends, 2020)

2 TED Spread - Historical Chart. This interactive chart tracks the daily TED Spread (3 Month LIBOR / 3 Month Treasury Bill) as a measure of the perceived credit risk in the U.S. economy. LIBOR measures the interbank lending rate so as the spread between LIBOR and the T-bill rate increases, it shows an accelerating lack of trust between banks and a corresponding tightening of credit for all other counterparties.

Margin debt hit a record high, again, in May 2018 and started a rapid descend from there signaling a negative development for US equities (Figure 12). Explicitly, the \$93.8 billion drop in NYSE margin debt levels, for the last quarter in that year, was the largest drop since the \$66.6 billion decline in October 2008 after Lehman Brothers filed for bankruptcy.

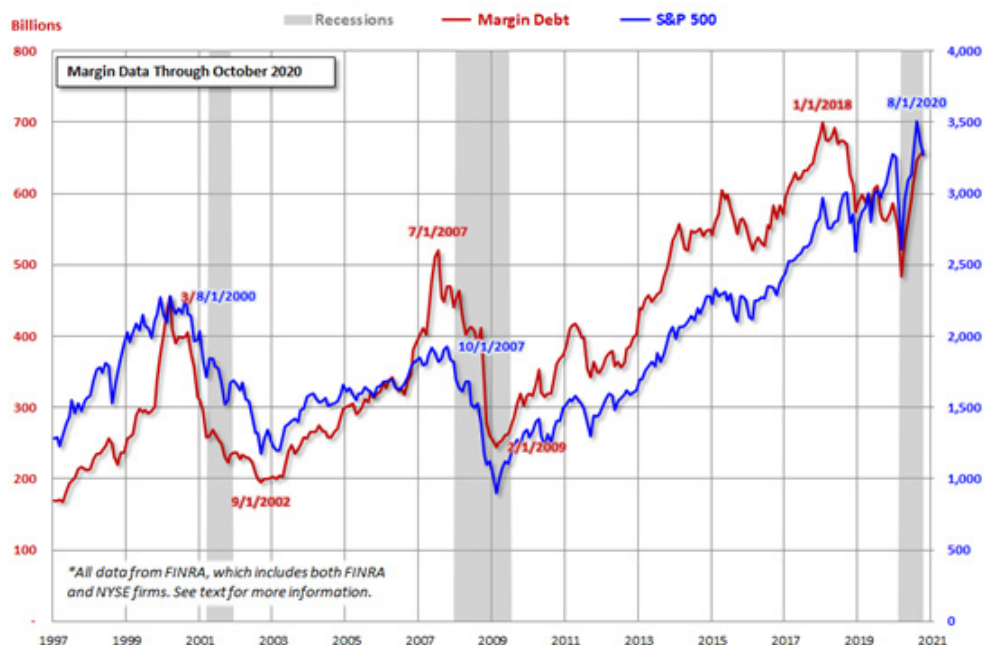


Figure 12: FINRA³ Margin Debt and the S&P 500 in real values (Source: <https://www.advisorperspectives.com/dshort/updates/2020/11/30/margin-debt-and-the-market-up-0-8-in-october>)

There is nothing magic about regulations, but yes too little is bad

Economic expansion supported on poor regulations and financial liberalization usually leads to crises. Capital account liberalization attracts large capital inflows that increase the pressure on loosely regulated domestic financial systems incapable of preventing currency and maturity mismatches or effectively managing credit risks. The 2008 Financial Crisis Inquiry Commission Report (United States, 2010: 414) concluded that ... *widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets* [and that] ... More than 30 years of deregulation and reliance on self-regulation by financial institutions... *had stripped away key safeguards, which could have helped avoid catastrophe.* [As well as] ... *dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis.*

Since 2017 analysts at the C-20 Communiqué Financial Architecture Policy Briefing (2017:4) have been recommending to G-20 countries a stricter regulation of the market-based finance sector (shadow banking) as a growing element of financial instability. They have stated: *it is necessary to coordinate measures of regulatory authorities. This includes limiting risk activities by banks and other finance institutions... push for full, timely and consistent implementation of these measures aimed at ending 'too-big-to-fail' financial*

3 FINRA is a government-authorized not-for-profit organization that oversees U.S. broker-dealers.

institutions. Further expansion of securitization of financial assets and derivatives trading has to be strictly monitored for systemic risk, controlled, regulated and limited. So far, deregulation has continued and many of the provisions set after the 2008 crisis such as Dodd-Frank have been stripped down.

3 How to make sure the crisis is really over

A rise in food prices and scarcity usually follow every crisis episode

The United Nations Food and Agricultural Organization (FAO) Food Price index started rising in the year 2000 and went from 91.1 up to 117.5 during the financial crisis of 2008. Even when there was a significant drop in 2009, down to 90.3, a new surge in prices took place in 2011: corn 63%; wheat 84%; soybeans 24% and sugar 55%. taking the index up to a peak of 131.9 (Figure 13).

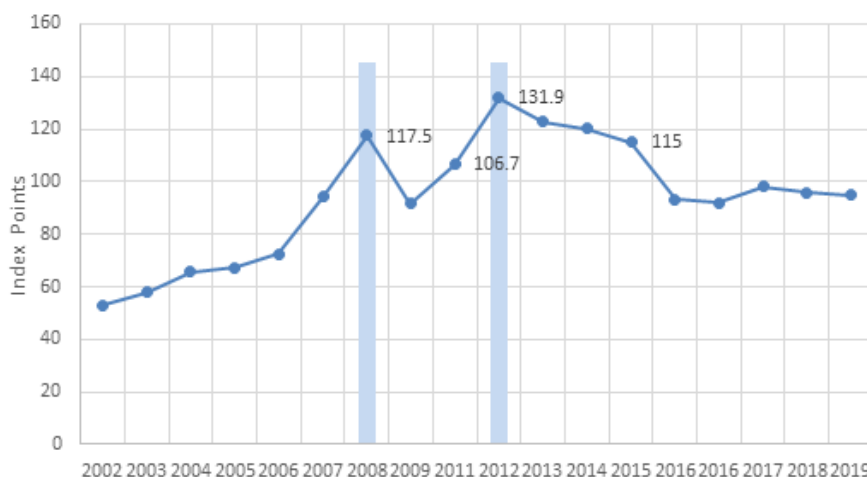


Figure 13. Food Price Index 2002-2019 (FAO, 2020).

This was the result of a move from the subprime mortgage crisis in the United States extended to international finance from mid-2007, investors relocated from uncertain financial markets to mineral and food markets, looking for security in real assets, while contributing to and taking advantage of the “commodities super cycle”. Such new investors acquired large quantities of futures and options contracts, transforming the role of commodity futures markets.

The consequences were catastrophic as the price of wheat set a record high in many countries in 2011. Annual food inflation rate in India went up to an 18-percent, generating protests. Food riots propagated across African countries, including Algeria and Egypt. Russia was importing grain to feed its cattle herds, as China was looking abroad to buy substantial quantities of cereals and; the Mexican government was buying corn futures to surmount tortilla price rises (Bellemare, 2012).

According to FAO (2011:35), *the macroeconomic impacts of commodity prices are important because they affect the level of per capita income, which ultimately is a key determinant of living standards for individuals and families...Different types of studies provide further support for the idea that high food prices hurt*

the poor, and in more ways than just pushing them below the poverty line...Thus, high food prices tend to worsen [...] food insecurity and malnutrition.

Starting in April 2020 we can observe the same behavior in the Food Price Index as the one experienced after the 2008 financial crisis, reaching in October 100.9 points (Figure 14). This is very important in terms of economic recovery, since agricultural inputs, production, marketing and even trading in agricultural futures and options are dominated by transnational agribusinesses (Díaz-Bonilla, 2016), small farmers and consumers, particularly the poor, are forced to trade in a less competitive environment in conditions of asymmetric power (Jurenas, 2015).

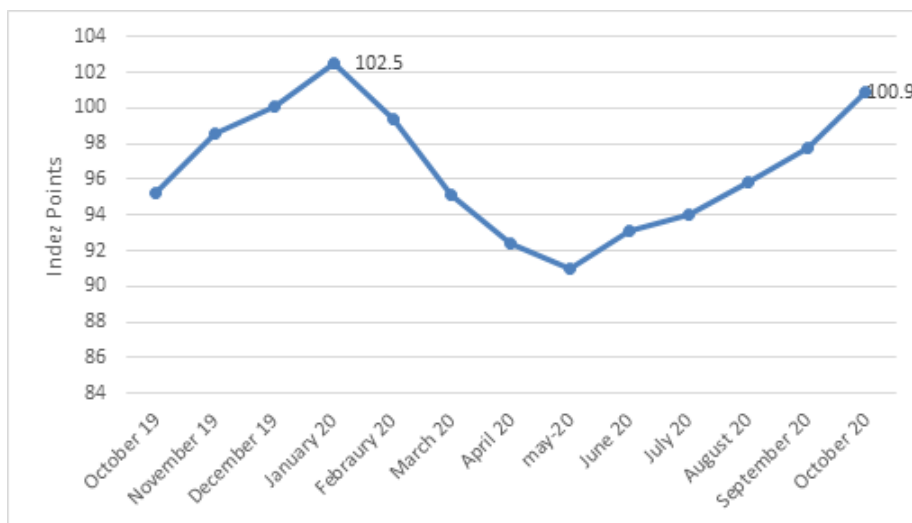


Figure 14. Food Price Index October 2019–October 2020 (FAO, 2020)

Food prices are, therefore, a key issue in terms of economic, political and social stability in a post-crisis environment. It is important that global food security remain an international priority in terms of global policy attention and resource allocation.

Beware of the domino effect of unfolding crises

Another lesson from recent crisis episodes has been that one crisis can easily unfold into a different one, the role of public policy is crucial in preventing or fostering this effect (Farnsworth and Irving, 2011). In this context a series of crises scenarios can be play out as a result of different interactions. In the case of a debt crisis it can become a growth rate crisis if debtors are unable to make timely payments of interests and principals, the debt burden makes it virtually impossible for them to raise new loans to make debt repayments. Additionally, difficulties in rolling over short-term debt could squeeze the liquidity available within the economy, reduce aggregate investment, economic activities and shrink the level of economic activities leading to a sharp decline in real outputs (Fischer, 1989).

In another scenario, if banks cannot honor their immediate contractual obligations, the increased liquidity associated with a government bailout of the banking system will have a negative effect on the exchange rate. A currency crisis can also occur if banks' liabilities exceed their assets and agents decide to substitute domestic assets for foreign ones. This can also lead to capital flight due to a loss of confidence in domestic

financial institutions. With devaluation adversely affecting the balance sheets of their clients and with a rise in non-performing loans, banks may roll back their lending activities or go bankrupt. A disruption in the flow of credit to households and enterprises could reduce investment and consumption, possibly forcing viable firms into bankruptcy driving the country into a recession (Ishihara, 1995).

If a large part of the liabilities of domestic firms are denominated in foreign currency, a sudden devaluation leads to an overnight increase in their debt burden and the probability of default on such debt, producing a debt crisis. A loss of reserves will lead to a credit crunch and increased bankruptcies undermining the confidence in a country's financial sector. As banks borrow abroad, when capital inflows become outflows and asset markets crash, the banking system can collapse (Kose et al.,2020). If a current account deficit fuels an attack against the domestic currency, foreign investors can become doubtful about the ability and the will of the economy to pay back, producing an abrupt depreciation of the currency (World Bank, 1999). Figure 15 illustrates these processes of unfolding crises. As these scenarios are built based on the analysis of previous crises and their dynamics it is crucial that actions are set in place to prevent this unfolding.

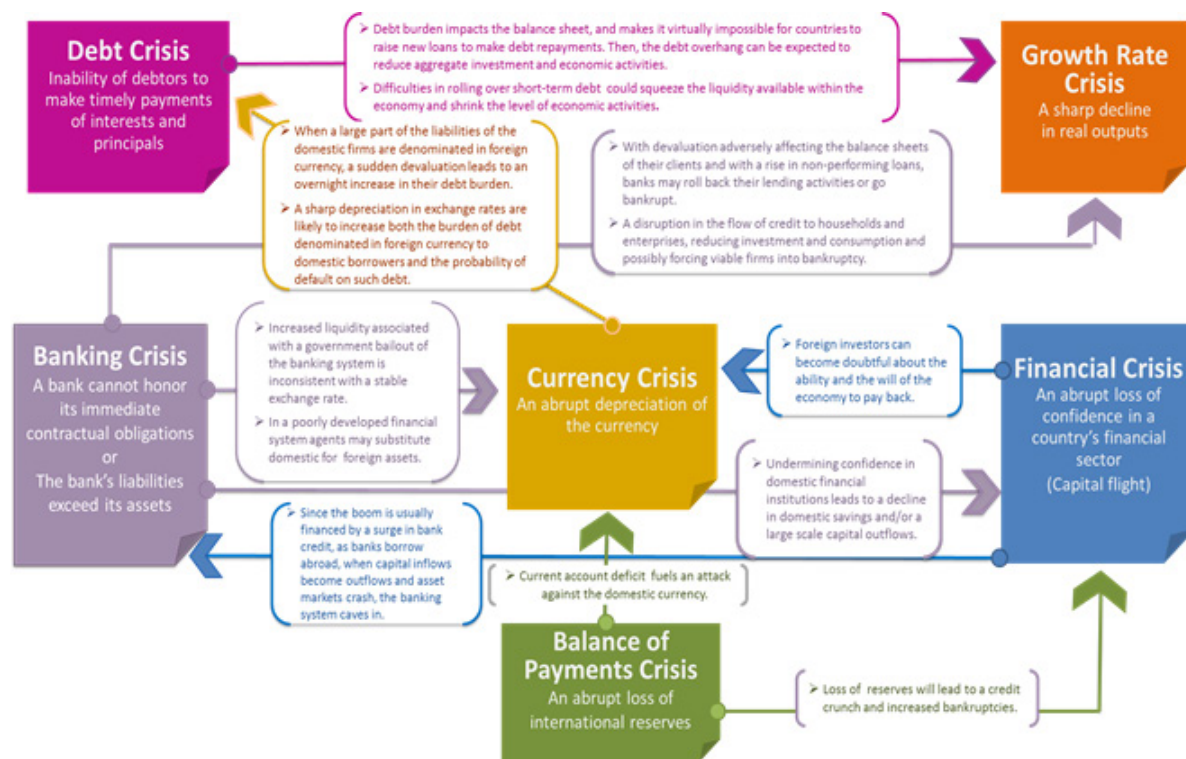


Figure 15: Unfolding Crises Dynamic Explained (Source: Author's own elaboration)

4 Anticyclical measures, as we know them, have not been working for a long time

In sum, it can be stated that even if the COVID-19 pandemic and the following lockdown have had negative consequences in the world economy, it is also true that, at least since 2017, there were many signs of a looming economic crisis. Some of these trends started to slow down at the beginning of the 2020, but have recovered

their pace as economies started to reopen. It is important to remain vigilant as the foreseeable consequences of a post-pandemic crisis, presented in this article, could be devastating. Even more, this slowdown of the economy can be used as an opportunity to overcome structural imbalances and build a “new economic normal” focused on a more resilient and sustainable development model that can work for people and planet, moving to unorthodox policy making.

Since the financial crisis, we have seen a consistent reduction in interest rates, which has only increased indebtedness without economic growth. American public corporations have been using their borrowings to boost their stock prices through share buybacks, dividend increases, and mergers & acquisitions, fueling capital concentration and inequality. Timely and targeted actions by governments could turn what would be a deep and lasting slump into an economic booster. At this time, an effective countercyclical policy should mainly be on the fiscal side through more government spending and innovative stimulus that can better ease the financial burden of addressing the pandemic and speed recovery in developing countries, such as the allocation of Special Drawing Rights (SDR). This solution will not just strengthen the budgets of low and middle-income countries alike -without the conditionality of debt- but will open the door for fiscally strapped donor countries to increase their support for development assistance (Herman, 2020).

Finally, another key element to overcome the crisis is international coordination. The response to the 2007-2009 financial crisis was based on the coordinated actions of the G-8 and the creation of the G-20, together with tailored efforts of international agencies. This level of cooperation is still missing and urgently needed to address the current situation and prevent the adverse scenarios analyzed in this paper.

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