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Global Economy in the COVID-19 Era. The Impact of the Pandemic on the Economic and Financial Systems

Narciz BĂLĂȘOIU[1]

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Abstract

The transition from pandemic shock and adaptation to the new normal was gradual, affecting the social, political, but especially the economic spectrum. The global business was the first to adapt to the new situation and operate in a new paradigm. The spread of COVID-19 in the first part of 2020 affected all emerging markets, although some of them show more economic resilience than others. The impact has been determined or influenced by the form and magnitude of fiscal and monetary incentives, as well as the health systems efficiency. We are witnessing the emergence of obstacles to the free flow of capital, labour and trade. We are also witnessing a relocation of supply chains, a different complexity of US-China trade tensions and an increased risk of public debt among cloistered markets, resulting in an increased risk of default on sovereign debt.

Keywords: pandemic, economic crisis, financial risk, supply chains, systemic transformation.

JEL Classification: F01, E44.

1. Introduction

The pandemic started at the end of 2019 with the evolution of a new strain of coronavirus. At the social level, it is obvious that the shock of March and April 2020 was felt by the citizens of all states around the world, who not only seem to be accustomed to the idea of a pandemic, but also accepted the fact that they will have to live with the virus for a long time.

The transition from pandemic shock and adaptation to the new normal was gradual, perpetuating the social and political spectrum, and especially the economic one. The global business was the first that had to adapt to the new situation and operate in a new paradigm (Battistini, Stoevsky, 2021).

[1] Bucharest University of Economic Studies, Bucharest, Romania, narciz.balasoiu@rei.ase.ro.

At the same time, politicians have also adapted to the new pandemic context, and the coronavirus has become a favourite subject of electoral rhetoric. The responsibility or irresponsibility of some of the decision-makers influenced both the infection curve and the economic contraction. But the most important factor in this transformation was the perception and reaction of public opinion.

COVID-19 was certainly a "black swan" that no analyst, no matter how skilled in his field, could predict. And even if one did foresee it, no one could anticipate the profound impact it had on all the social, political and economic corners. It is also obvious that this "black swan" has determined (Pramod, 2021), at least in the short term, a new global order and paradigm, which will determine social, political, geopolitical and economic relations. Globalization, an extremely popular phenomenon in recent decades, was one of the first victims of the pandemic. Critics of globalization were active for several years now and gained a boost in 2020. The pandemic and the measures taken by national or regional authorities raised new questions about nationalism and cooperation with large implications over economic and financial systems.

2. Problem Statement

For many analysts, the reactions of nationalist isolation since the beginning of the pandemic have been a wake-up call to how a withdrawal from multilateralism would threaten the global capacity to take action against the pressing risks facing the world.

The COVID-19 pandemic has shown us that individual well-being is more recently intrinsically linked to the well-being of an individual on the other side of the globe. A virus in one of the many markets of a Chinese city has turned into a global pandemic in just three months. Therefore, governments need to ensure that beyond political resentment, they are able to implement processes that allow for the exchange of information and good practice. At the same time, they must protect the personal data of individuals, which is a great challenge for the future.

China's role in the future configuration of the international system has been strongly influenced by the pandemic. Throughout the crisis, China has set out to play a more prominent role, thus trying to hide its role in triggering the disaster. In recent months, there have been several attempts at cooperation between China and a number of states, whether we are talking about critical equipment, medical collaboration, or the exchange of experience. The Chinese economy appears to be recovering faster than the rest of the economies, so Beijing will play an important role, not only as an anchor for demand for raw materials, but especially as an anchor for liquidity for emerging economies and developing countries. However, China will have to play a positive role in multilateral cooperation formats in order to successfully establish itself as a major power.

The pandemic is likely to play a significantly different role for another major power in the international system. Preliminary data suggest that we will witness a relative decline of the United States and other states' desire to align with Washington on economic issues. At the same time, Brexit and the approach of the future US administration have the capacity to influence the future of globalization.

Technological and cyber partnerships will be very different from geographical partnerships and will relate differently to economic partnerships.

3. Literature review

The spread of COVID-19 was expected to slow the global economy. According to preliminary forecasts of the International Monetary Fund (2020a), the global economy will contract by at least 3 percent. The contraction is expected to reach a higher pace than the 2008-2009 crisis. The report cites a number of reasons for such a development: (i) maintaining social distance with the same perseverance; (ii) significantly low activity during lockdown periods; (iii) very low productivity of companies trying to operate under lockdown conditions.

The economic situation during the pandemic as well as the response of governments have been a concern for many research centres and institutions. The developments are also confirmed by the National Bureau of Economic Research (NBER) in the United States, which in an analysis conducted in mid-2020 reveals the growing interest among profile publications to assess the economic situation generated by the pandemic. Also, a number of 60 publications were launched between March and May 2020 by IZA - Institute of Labour Economics, Germany.

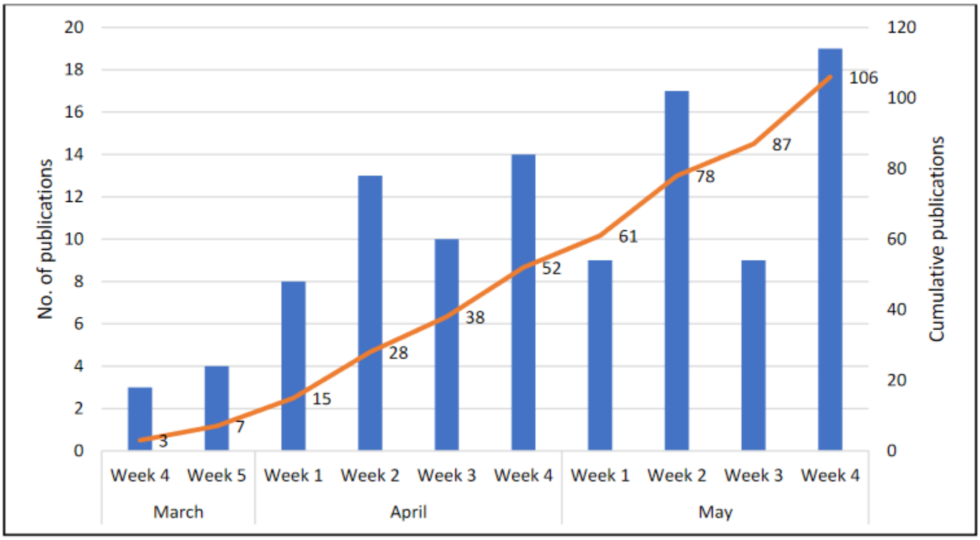

Figure 1. Index NBER on COVID-19 economic publications (March – May 2020)

Source: Created by authors.

4. Research methods

The problems analysed in this research are both pressing and topical, therefore the international experts and academics are making important efforts to keep up the research closely connected to the dynamics of pandemic-related issues. For this paper I have used the deductive method, while corroborating public data and information provided by European institutions, European Central Bank, World Bank, US government, rating institutions, official reports and reputable research centres.

At the same time, the research represents a qualitative (synoptic) analysis regarding the authorities' reaction to the COVID-19 pandemic, in order to see to what extent the promptness and the trans-regional cooperation ensured an optimal response. The research also aims to highlight the degree to which inappropriate political decisions on one aside, and intrinsic response actions related to the dynamics of international markets, on the other side, have significantly contributed to the alteration of different economic and financial processes.

5. Findings

5.1 The economy at the confluence of the pandemic with politics

The spreading of COVID-19 in the first part of 2020 affected all emerging markets, although some of them have shown more economic resilience than others. It comes in different forms and has been determined or influenced by the form and magnitude of fiscal and monetary incentives, as well as by the different quality of the health systems.

The impact of the pandemic on emerging market businesses is major: we are witnessing the resurgence of obstacles to the free flow of capital, labour, and trade. We are also witnessing a relocation of supply chains, a different reaction to the US-China trade tensions, and an increased risk of public debt among border markets, resulting in an increased risk of default on sovereign debt (Herrera, Konradt, 2020).

It is extremely possible that the sovereign debt default will become more likely, despite the G20 moratorium on interest rates on these debts. Rating agencies threaten to downgrade the rating of those states that do not accept the moratorium on the grounds that taking into account debts to private creditors will increase the overall credit risk (Correia, Luck and Verner, 2020).

If we turn our attention to the individual states that can cause chain reactions, we see that Zambia, Ecuador, or Laos have begun the first steps towards debt restructuring. At the same time, countries such as Senegal and Mongolia, both at risk of accumulating more debt in 2021, will pose a significant risk starting in the last quarter of this year. At the same time, Nigeria, Angola, Tunisia, and Libya are also at risk (Jones, 2020), due to an additional shock on top of the pandemic generated by the dramatic drop in oil prices (See Figure 2).

Specialists expect a slower and longer-term recovery of the emerging markets. At the same time, any scenario is based on the expectation that the second wave of COVID-19 infections in the second half of 2021 will create less damage than the first, as governments and healthcare institutions become more experienced in managing the pandemic and its effects. According to current data and the assumption that the existing trend will continue, Asia will have the fastest recovery due to the faster onset of the pandemic in this region and more efficient institutions in general.

Latin America, on the other hand, is at the other end of the spectrum and expects a slow and difficult recovery due to the poor health care systems and the inadequate response to the pandemic.

In Europe, only one country is at a higher risk in the second half than in the first half of the year. North Macedonia is in a difficult situation due to political disputes. A significant increase in COVID cases last summer has led to massive protests against the apparent Government's mismanagement of the pandemic. The Macedonian parliament recently approved a new governing coalition, after more than a month of political vacuum in the midst of a pandemic.

Figure 2. Oil price evolution during pandemic crisis (USD/barrel)
Source: World Bank oil market overview.

5.2. The impact on foreign exchange markets

The US dollar has suffered the sharpest decline in trading since January 2018. The declining dollar reflects both recent concerns about the potential path to US economic recovery (Garcia-Herrero, 2020), and concerns about the political response to the rise in the number of cases, mainly accentuated by the last elections.

Regardless of the causes, this decline must be seen in the context of the pandemic, political changes, and changing paradigm of the global economy. We must not forget that before the pandemic, the dollar appreciated by more than 30% in nominal terms since 2011.

The explanation for the depreciation of the dollar may come from the fact that many emerging market currencies have lost extremely much during this period. The long-term question is actually different, namely whether the depreciation of these currencies will be stopped, at least to a certain extent, in order to support those fragile economic activities of these economies (Dahlhaus and Lam, 2019).

Another important question is, if the depreciation of the dollar continues (especially if it persists or even worsens), what will be the economic and political consequences for the emerging states in this case. Current data and economic studies radiographing currency fluctuations and currency exchange show that any short-term gains from the weakening of non-dollar currencies are at most limited. This is especially true in the case of emerging markets.

Figure 3. US dollar Index – Evolution in pandemic context (USD Index/EOD is settled against six component currencies: Euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc)

Source: JP Morgan Asset Management statistics (April 2021).

Indeed, instead of using domestic currencies for transactions (local or international), companies in the above-mentioned economies prefer to invoice exports and imports in foreign currencies. The dollar is chosen according to the trading patterns in the region (Putnam, 2020). This new trading pattern leads to what could be a new paradigm for understanding the fluctuations of currencies and exchange markets, as well as economic activities. In the coming years, based on the return of economies to the new normal and businesses adapted to the post-pandemic context, we will be able to see which will become the dominant currency for invoicing and for foreign direct investments.

An important implication of the increase in invoicing in US dollar would translate into a strengthening of the US currency, which may cause a contraction effect on trade, meaning the opposite of the effect expected by traditionalist theory. If we look at the broader spectrum of exchange rates and how they fluctuate and impact the real economy, it is primarily determined by the way in which companies set their prices in domestic currency. So every time domestic currencies are weakened, the goods and services produced in that economy become cheaper for foreign trading partners.

On the other hand, cheaper prices translate into weaker domestic currency and higher export demand. And, as the economy operates on the basis of supply and demand, the whole phenomenon causes an increase in exports.

Conversely, when a currency depreciates, imports become more expensive in terms of domestic currency, inducing local consumers to import less, substituting as much as possible the purchase of goods and services from abroad with locally produced goods.

Following the same traditionalist rhetoric, we can see how a weaker currency can support the domestic economy by facilitating the growth of net trade. The growth comes following as a double-edged sword, both by inhibiting imports and, especially, by promoting exports. Of course, this is to some extent a reductionist approach, without taking into account the root cause of the weakening of the currency and ignoring the likelihood that the momentum of domestic spending will be fully offset by the damage sustained by the purchasing power caused by the exchange rate effect on inflation. Especially since the impact on the exchange rate can come from several sources, particularly from the existing tensions in the political spectrum.

6. Conclusions

The traditionalist approach needs to be rethought since academic studies and data analysis reveal shortcomings. The first element that shows inconsistency is how most global trade is invoiced in a few international currencies, especially in US dollars, (the euro is also on the rise) and not in domestic currencies. As the studies show, the global economic shock is likely to generate both crises and opportunities for certain global players. China is challenging the United States so that petrodollars are no longer a force, while China is trying to speculate as much as possible on the vulnerability of other players on the global stage to maximize its gains and dominance.

From a financial point of view, the in-depth analysis of the US dollar and Euro dynamics shows three obvious trends that seem to continue at least in the medium term, if not on the long run also. First, the dollar and the euro are increasingly used for billing, even though the share of global trade for the dollar and the euro has declined. Second, the euro is used as a trade currency in parts of Africa. Last but not least, US dollar or euro invoicing states tend to experience a higher exchange rate between their domestic currency and the euro/dollar in terms of import prices.

These exchange rate fluctuations affect the sensitivity of trade volumes. It also appears that the increasing use of the euro has initially reduced the dominance of the dollar globally, while other reserve currencies are playing an increasingly limited role. The dollar depreciation hypothesis is gaining momentum, and the phenomenon is not purely contextual, so the pandemic has done nothing but accelerate a trend that studies have shown some time before the onset of this health crisis.

When it comes to assessing the broader picture, beyond the current emotions fuelled by the worrying number of daily infections and analysing based on existing empirical evidence, as well as conservative estimates of short-term developments, it can be inferred that the short term economic and political situation is still quite stable and predictable. The danger of a deeper crisis is not completely overcome, but the current financial data reveal a situation that may allow a return to a positive dynamic.

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