THE ECONOMY ON ICE

MEETING THE ECONOMIC CHALLENGES DURING AND AFTER THE COVID-19 CRISIS

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Abstract

The purpose of this article is twofold. Firstly, it argues that it is doubtful that the currently announced policies will achieve their targets while they create substantial obstacles to the recovery of the post-crisis economy. Secondly, it proposes an alternative plan that its aim is (a) to ensure that everyone in the UK has the means to survive the crisis and, (b) to facilitate economic recovery by preserving the productive capacity of the economy and, hence, its ability to sustain a high employment rate.

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Responding to the threat that the COVID-19 crisis poses on the economy, the UK government has announced an estimated £330 billion stimulus package that includes a variety of measures aiming to ameliorate the impact of the crisis on businesses and workers. Concurrently, the government has imposed tight restrictions on the mobility of people outside their houses in order to curtail the growth rate of new cases.

Nobody knows exactly how long this crisis will last. According to Imperial College researchers[1] there is likely to be a cyclical pattern in new cases where periods of relaxation in the constraints to be followed by the reinstatement of stricter isolation measures which, in turn, will result in a decline in the number of cases followed up by a relaxation of isolation measures. One thing that the study makes clear is that the isolation measures are set to become a semi-permanent feature of the landscape.

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1. *Current Government Response*

With very few exceptions (e.g. utilities, food and drink, health care) the latest isolation measures announced on March 23 will affect the entire economy. There are few services that can still function sustainably by having workers completely working from home (e.g. news and media, higher education, some government services) but such

[1] Imperial College COVID-19 Response Team, 'Impact of non-pharmaceutical interventions (NPIs) to reduce COVID19 mortality and healthcare demand', 16 March 2020; DOI: https://doi.org/10.25561/77482

adjustments do not suit the manufacturing and retailing sectors (including on-line retailers if distribution centres have to close). Around 30% of worker can work on a sustained basis from home.

The crisis is affecting firms in both direct and indirect ways. Their ability to bring goods and services in the market is affected by disruptions in their supply lines and the restrictions imposed on the mobility of people that includes their employees. At the same time, they face a sharp drop in the demand for their products and services as their customers are either not allowed to buy them (e.g. travel and leisure, restaurants) or are tightening their belts. Without any financial assistance the majority of firms will be unable to meet their financial obligations to their suppliers and their creditors and will close down. This, of course, means that many workers will lose their jobs further exacerbating the impact of the looming crisis on government finances.

The current government proposals[2] try to solve the above problems using brute force. Some measures offer direct assistance. For example, small businesses are offered up to £25,000 while the COVID-19 Corporate Financial Facility buys short-term debt from large firms. Other measures offer loans to firms to cover their short-term obligations. For example, the Coronavirus Business Interruption Loan Scheme offers loans of up to £5 million to Small and Medium-Sized Enterprises (SMEs) through the British Business Bank. Among the measures to support workers who temporarily lose their jobs the government will cover 80% of furloughed wage costs, up to a cap of £2,500 per month. Further government measures will include support for those self-employed who lost their jobs.

[2] Source https://www.gov.uk/government/publications/guidance-to-employers-and-businesses-about-covid-19/covid-19-support-for-businesses

Additional support for the economy is provided by the Bank of England. The Monetary Policy Committee (MPC) voted unanimously to reduce Bank Rate by 50 basis points to 0.25%. Furthermore, they will continue their policy of quantitative easing whereby the buy non-financial investment grade corporate bonds and will also support the government by purchasing government debt.

Under the supposition that the predictions of the Imperial College research are reasonable, in which case the economy will be to great extent shut down for the next 12 to 18 months the above measures might not only prove inadequate but also catastrophic. It is going to be impossible for the government to cover the liabilities (including not only debt obligations but also wage costs) of a large part of the economy without having either/both the national debt jumping possibly to unsustainable levels or/and creating a hyper-inflation when all this newly created liquidity will be injected in the economy.[3] In the worst case scenario there may be financial panics including runs on the banking system.

These are extraordinary times that demand extraordinary measures. Below we propose an alternative plan that attempts to meet the same objectives but, hopefully, avoids the above pitfalls.

2. *Some Useful Facts*

The following statistics on the UK populations and average monthly household expenditure on some necessities will be useful for the calculation of the cost of the plan.

[3] See, for example, Goodhart and Pradhan, 2020. https://voxeu.org/article/future-imperfect-after-coronavirus

According to the Office of National Statistics[4,5] in mid-2018 the population of the UK was 66.4mn. The proportion of the population aged 65 and over was 18% and that for those aged from 0 to 15 was 18.9%. In 2019 there were 19.8mn families (2.9 million lone parent) and 27.8 households.

According to statistics provided by the Department of Environment, Food and Rural Affairs[6] in 2017/18 the average expenditure on food and non-alcoholic drinks per person per week was £27.54.[7] Moreover, according to the Money Advice Service[8] as of mid-2019 the average household monthly expenditure on utilities (excluding any additional TV packages) was equal to £227.86.[9]

Before I go into the details of the plan I present the following back of the envelope calculation. There are approximately 16 million[10] persons below the age of 21 and 12 million persons aged 65 and over. This leaves approximately 40 million person of normal working age. Suppose that each person of working age is on average financially supporting one child.[11] We also suppose that each person over the age of 65 does not provide financial support to anybody else. Given the above calculations

[4] Source: https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/articles/overviewoftheukpopulation/august2019

[5] Source: https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/families/bulletins/familiesandhouseholds/2019

[6] Source: https://www.gov.uk/government/publications/family-food-201718/family-food-201718

[7] If the amounts spent on alcoholic drinks and eating out at restaurants are also included the figure is raised to £45.31.

[8] Source: https://www.moneyadviceservice.org.uk/blog/what-is-the-average-cost-of-utility-bills-per-month

[9] The complete breakdown is as follows: Water £34.58, Gas and Electricity £104.45, Phone £45.60, Broadband £30.30 and TV Licence £12.88.

[10] The above number was obtained by simple extrapolation of the information offered above about the proportion in the population of those aged 15 or below.

[11] Clearly, this is an overestimation but it will make simpler the implementation of policies. Making adjustments in the right direction will decrease the cost of the policies proposed below.

a policy that would offer £600 per month to every person of working age and £500 per month to every person aged 65 and over would be more than sufficient to cover the food and utility expenses of every household in the UK.[12] The cost of such a policy would be £30 billion per month, around 1.3% of GDP per month, where £24 billion would be distributed among those adults of working age and £5 billion would be distributed among those aged 65 and over. The above example, calculates the cost of the measures described below under the worst case scenario where every single job is lost. Notice that the £330 billion that the government has promised to inject in the economy according to its current proposed measures would cover 11 months of the above plan but much of this is in the form of guarantees.[13]

3. *The Economy on Ice*

Isolation restricts considerably not only our ability but also our need for spending money beyond necessities. In the meantime, many people (in the millions) will be unable to work and a great proportion of them will need to be financially supported in order to be able to buy necessities. The amounts calculated above to be distributed to those without any income are sufficient to allow the average person to more than cover the cost of those necessities for the duration of the crisis. For example, those amounts would allow a household to pay for a TV package one of the few available entertainment possibilities during these times and some insurance costs.

For better understanding how the different plan measures work together I first provide a description of all measures and then I proceed with explaining their potential impact during and after the crisis.

[12] The calculations intentionally ignore rent, mortgages and debt obligations.
[13] See A Switch to Active Fiscal Policy: NIESR response to Budget 2020. https://www.niesr.ac.uk/publications/switch-active-fiscal-policy

4. The Plan Proposals

- **All balance sheets are to be put on ice**

1. All debt obligations are carried forward till the end of the crisis. That means if the crisis will officially be over in 6 months then an obligation that is due one month from now will, under the new policy, be due in 7 months (similar rules will apply to options, forward contracts, etc.) The policy includes all liabilities in the balance sheets of firms and households. Specifically, it includes any type of loan (business bank loans, bonds, mortgages, rents, pensions, etc).

- **All Trading Exchanges will close down during the crisis**

2. The measure includes all financial transactions (both over- and under- the counter).

- **All retired persons will receive £500 per month**

- **All persons above the age of 21 formerly employed and without a job and not retired will receive £600 per month**

- **All persons fully employed either in the public or the private sector will receive from their employers £900 per month.**[14]

- **All taxes (national and local) and fees are deferred.**

[14] Notice that in the back of the envelope calculation the assumption is that the government pays £600 to everyone between the ages of 21 and 65. But according to the plan it will have to pay £900 to every government employee. However, the government will not have to pay anything to those employed by to private sector. Then as long as there are two workers employed by the government for each worker employed by the private sector our example works. According to the Office of National Statistics approximately one out of 6 workers is employed in the public sector. Assuming that public sector employment stays the same as long as private sector employment does not drop by more than 90% the cost of the proposed plan will be lower than the cost in the example. Source: https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/publicsectorpersonnel/bulletins/publicsectoremployment/december2019

Aims and Impact

4.1. Preserving the economy's productive capacity

The most important measure is the freezing of the balance sheets. Postponing (not cancelling) all debt obligations means that no firm will go bankrupt during the crisis. This will preserve the physical capital of the economy allowing it to be utilised when the crisis is over. We cannot do too much about the economy during the crisis but we need to make sure that economy can take-off again after the crisis.

4.2. Avoiding Panics

In normal times trading exchanges play an important role in allocating resources. However, these are not normal times. Under the above plan there is no need for traditional finance.[15] Having their resource allocation role been eliminated trading exchanges do not have a useful role to play during the crisis. Actually, as economic activity falls it is more likely that they will crash spreading panic not only among investors but also to the rest of the economy. Runs on the banks and buying sprees at the supermarkets will become unavoidable.

4.3. Survival of pension funds

The sustainability of many pension systems requires that contributions continue irrespectively of the state of the economy. The current crisis threatens their survival and by freezing both contributions and obligations during the crisis enhances the chances that will be able to perform normally after the crisis. Moreover, the freezing of the exchanges preserves the current valuations of investments irrespectively of the type of pension fund (i.e. pay-as-you-go vs defined contributions). For those persons

[15] The exception here is insurance services. We address this and other shortcomings of the plan at the end.

already retired the plan imposes a cost similar to all other adults out of work, however, it ensures that their pension will come back to normal levels after the crisis. For those before retirement they will have to postpone retirement by a period equal to the length of the crisis.

4.4. Sustainability of government debt and avoidance of hyper-inflation

During isolation our spending opportunities are limited. Unfortunately, we cannot avoid a sharp decline in economic activity and by aligning incomes with current needs ensures that (a) all of us have the means to survive the crisis, and (b) the government finances stay healthy. The limits on the compensation of those still at work mean that the government's spending on wages for those employed in the public sector will be greatly reduced. Furthermore, the compensation for those out of work is less generous relative to the existing plan. According to the latter plan the government is ready to compensate 80% of the wages of those workers who lose their jobs during the crisis up to a limit of £2,500 per month. It is paramount that liquidity in the economy does not explode which could lead to highly inflated prices for necessities during the crisis and extending to other goods and services after the crisis.

4.5. Incentives to work

For those still at work the compensation must be set higher than those without a job in order to preserve incentives to work. The amount above is set at 50% higher but it is only suggestive. Employers of those workers who quit their jobs are under no obligation to hire those workers back after the crisis.[16]

[16] Some flexibility is needed for those firms that are willing to employ workers part-time. Once more, we address this issue at the end.

4.6. Incentives to create jobs

Under this plan, firms that can stay open and employ workers, thus, reducing the burden on the government budget can benefit by £600 per employed worker. Their reduced payroll costs offers an incentive to stay active. The freezing of balance sheets implies that the government does not have provide any further support for firms. Under the proposed plan, those firms that are not profitable will become inactive but do not become insolvent. When the crisis is over they can become active again rehiring the workers who lost only temporarily their jobs.

> <u>Example</u>: One well known restaurant chain announced that without any government support will have to go under administration which will result to the loss of 2,000 jobs. Clearly, under current rules the company cannot stay open during the crisis. Without any revenues the company will not be able to cover its obligations (leases, accounts payable, debt service). Having the government picking up the bill makes no sense. The company might still prefer to go to administration rather than further increasing its debt. The best way to preserve the company's organisational capital and post-crisis employment is to freeze its balance sheet and become inactive.

4.7. Self-employed

Same rules apply as for self-employed workers who are temporarily unemployed.

4.8. Impact on banks

Banks need to provide the usual services to households. The freezing of their balance sheets implies that they will not earn any income from their assets during the crisis. Therefore, unless their obligations to their customers is limited by the amount of positive changes in their accounts, banks can run into liquidity problems. Given that during the crisis the demand for liquidity by households will generally be low (unless there is a panic) any excess demand can be facilitated by the Bank of England. If the crisis deepens the government might have to impose limits on withdrawals, especially from savings accounts, but making clear that these are not haircuts; only a temporary suspension of convertibility. Under this proposal many bank employees will become temporary unemployed. Nevertheless, banks will need funds to cover the wages of those workers still in employment (according to the plan £900 per worker per month). Keeping in mind that should these worker lose their jobs would receive £600 from the government the additional cost is insignificant relative to the cost of bail-outs.

4.9. Impact on landlords

The treatment of rents and leases is similar to all other debt obligations. This measure implies that the government will be able to cover the needs of unemployed at a much lower cost. The freezing of balance sheets implies that the obligations of landlords to their creditors are also postponed. Landlords who do not have other sources of income will be offered £600 by the government.

4.10. Government services

While the plan implies that the majority of the population will be unable to increase their savings during this crisis period (isolation implies that spending opportunities are limited) it ensures that the government will be able to keep supporting all essential services. The primary concern, of course, is healthcare but funds are also needed for the military and police, court system, education (all levels), waste management, public transport and social services.

While, according to this plan, the government will not be collecting any taxes and fees during the crisis the budget will get a boost by the decline in the compensation of government employees. It is important to note here that taxes are not cancelled only deferred. Those companies that remain active will still have to pay their taxes obligations arising from their earnings during the crisis.

5. *Shortcomings of the plan*

Below is a list of some of the issues that also need to be addressed for a successful implementation of the plan:

5.1. *International collaboration:* Given that the UK economy is well-integrated with the rest of the world the freezing of balance sheets will not be successful unless international obligations are also taken into account. Ideally, given this is a global crisis, this issue can be resolved through international collaboration. Alternatively, the central bank might be able to provide temporary bridging loans in order to cover any imbalances.

5.2. *Insurance:* Freezing the balance sheets of insurance companies can be problematic. For example, even during the crisis home owners and car owners would like to be covered. One possibility is for insurance companies to accept monthly payments that most probably can be covered by the above compensations. Other solutions need to be found for professionals whose compensation will be reduced.

5.3. *Partially employed:* Suppose that a worker is 50% employed. Then, according to this scheme he/she should receive £450 from his/her employer and £300 from the government.

Post-crisis

Ideally, at the aftermath of the crisis we would like to be able to restore our lives at the pre-crisis level. The objective of the proposed plan is to achieve this as closely as possible while at the same time allowing everyone to have the means to survive during the crisis. There is a lot of talk in the press about the possibility of very deep recession during the crisis that potentially will be followed by a slump similar to that of the Great Depression after the crisis. The current policies while are giving a temporary boost to financial markets are creating huge imbalances that risk not only the financial system but also the future ability of the economy to sustain a high rate of employment. I believe there is an alternative way.