IOE Paper on Economic Advocacy: Fiscal and Monetary Policies

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International Organisation of Employers | Organisation Internationale des Employeurs | Organización Internacional de Empleadores

Economic advocacy: fiscal and monetary policies
What matters most in the sustainability of companies

The Covid-19 emergency has expanded from a public health crisis to a severe economic one with serious consequences for the labour market. Together, with the reduction in demand, the disruption in the production of goods and services has pushed the world economy into an unprecedented downturn. Governments have been forced to take urgent measures aimed at mitigating the economic impact and avoiding a long-lasting economic depression.

The ILO in April 2020 estimated that potentially 195 million jobs could be lost. This situation has repercussions on incomes and a subsequent reduction in consumption which, in turn, could have serious consequences for companies and their sustainability.

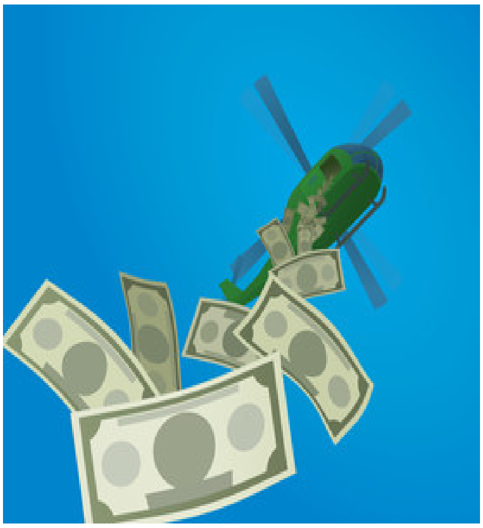
It is vital to break this vicious circle; failing to do so will result in a more severe socioeconomic deterioration. In this context, governments seek policies aimed at stimulating the economy and the demand for employment to prevent a long-lasting economic recession.

While a limited number of sectors have experienced a temporary increase of demand, e.g. the healthcare industry, other sectors like tourism are among the worst hit. Uncertainty about how the crisis will evolve is also leading to widespread psychological unease, deferring investment and consumption. In this respect, there is a need to compensate for the damage to the productive sector and to anticipate its recovery, ensuring the sustainability and financial conditions of companies as well as short and long-term production.

Active fiscal policies, implementing a flexible monetary policy, loans and financial support for specific sectors are some of the measures that governments are undertaking and assessing to alleviate the crisis. However, these exceptional measures also bear certain risks and major challenges. Whether these measures are effective, opportune and sustainable is still unknown. The same applies to the appropriate way of deploying resources in a balanced and effective manner, ensuring that the most vulnerable populations benefit from these efforts.

Helicopter money and other measures

Much has been said about the monetary policy based on Milton Friedman's theory from 1969, which portrayed the concept of short-term expansive monetary policy through the image of a helicopter dropping money for people to scoop up and spend within a given timeframe. Ben Bernanke used this image in his capacity as president of the United States Federal Reserve. It appears to be an effective policy that would boost demand in the short term at least and, inasmuch as the productive activity keeps functioning, it can favour production before any impact on prices. If it were perceived as one-off, it would not introduce insurmountable distortions to the labour market. Nevertheless, it is worth assessing the risks of such monetary policy.



First, it must be clear that an increase in demand will not lead directly to an immediate increase in supply. This will depend on the possibilities of the productive system in the wake of the pandemic, such as: rebuilding of the global supply chains; the adequacy of workers in all critical positions within companies; overcoming bottlenecks in supplies, staffing, partner companies and administrative bureaucracy; availability of credit to finance production; the release of deferred administrative costs and tax burdens (certificates, taxes, reporting of accounting and administrative documents).

Therefore, an expansive demand policy that is not accompanied by a supply policy that ensures the maintenance and, if possible, the expansion of production capacity may lead to undesirable inflationary effects. In this context, it may be important to allow at least for a minimum level of production capacity.

Secondly, such a policy could be targeted at immediate consumption, durable goods, debt relief and specific consumption for particular sectors or business sizes. However, it raises uncertainties about substitution effects between sectors and and companies, as well as between consumption and savings that may render the policy ineffective. Similarly, the replacement of the financial system by a policy of helicopter money may result in a negative impact and higher recovery costs. Likewise, the criteria around the targets of the helicopter money may also be put into question. Which social groups will benefit from this? Which sectors?

Thirdly, the implementation of the helicopter idea would imply a public debt growth. The temptation to simply increase the money supply of central banks, printing money without support, may further strain an international monetary system based on trust.

The helicopter money formula should be implemented only through a mixed monetary and fiscal policy, as well as by reducing administrative procedures and improving the productive environment. In some countries with limited fiscal capacity, expanding financing vehicles from savings to productive investment should also be considered.

Fourthly, the expansionary policy must be accompanied by an improvement in the institutional framework, which not only includes the overall governance regulations, but also the practical implications of public sector activity on businesses. In this respect, the administrative processes that represent a charge for enterprises need to be reviewed in order to determine which ones can be removed. This reduction of unproductive administrative costs would go some way towards compensating for the inflationary effects of the expanding money supply by increasing business competitiveness and efficiency in the use of resources.

Fifthly, the stability and credibility of financial systems and institutions must be safeguarded at all cost.

And yet, central banks in developed countries have implemented quantitative easing measures, keeping money flowing within the financial circuit of companies and avoiding potential inflationary effects.

However, the measures are not purely demand-related policies but rather mixed, as they seek to improve the profitability of companies in a context of a strong contraction in demand by, for example, facilitating the payment of wages or loans at rates below market rates.

It is expected that the current expansionary policies will generate limited levels of demand and production in a context of enormous fragility for companies rather than an excess of demand that puts pressure on price levels.

It is also worth highlighting the challenge of reaching recipients. In such a complex, overwhelming situation in the short term, a well thought out but poorly implemented policy is likely to be a bad policy. Speedy response is crucial. An efficient state is more necessary than ever.

This means that it would make more sense to implement a combination of monetary and fiscal policies in order to channel aid to the people and companies that need it most, taking advantage of the financial system.

In this framework, central banks have reacted in various ways, such as:

- The Federal Reserve (The Fed, United States of America)
  - Interest rates reduced to 0-0.25%
  - Quantitative easing programme with the purchase of treasuries, mortgage-backed securities, short-term municipal bonds and corporate bonds

- European Central Bank
  - Quantitative easing (Pandemic Emergency Purchase Programme - PEPP)
  - €750 billion (19 March) plus €120 billion (12 March) until the end of 2020

- Bank of Japan
  - Quantitative easing – pledge to buy risky assets at twice the current rate
  - 16.6 billion reserve for additional purchases of commercial paper and corporate bonds
  - The interest rate remains unchanged at -0.1%

- Bank of England
  - Interest rates dropped to a new all-time low of 0.1%
  - Quantitative easing: £200 billion in bonds

At the same time, some governments have implemented fiscal policies according to their capacities and priorities, such as:

The United States of America: cash transfers at $1,200 equivalent for a large portion of the population; $500 for most children; $367 billion loan programme for small businesses; $500 billion fund for industries, cities and states; $150 billion for states and local stimulus funds; $130-150 billion for hospitals.

Hong Kong: cash transfers to each citizen of EUR 1,200 equivalent to EUR 8.5 billion.

Germany: short-term employment schemes; liquidity support; tax deferral; subsidies for businesses; simplified access to social security systems; EUR 156 billion in new loans.

The United Kingdom: subsidies for businesses (retail, restaurants, tourism); tax deferral; £20 billion in subsidies and tax cuts for companies in difficulty.

Consult other examples on IOE's platform dedicated to Covid-19 and the business response.

Other proposals from experts include the implementation of measures recently adopted in the context of other crises. One example is the expansion of the monetary policy through contingent convertible bonds (CoCos) with perpetual maturity by governments. This measure has been applied in the Eurozone, especially in Greece, Portugal and Ireland, to alleviate the impact of the 2008 financial crisis.

Convertible bonds are generally hybrid bonds – combining both debt and equity – with high coupon rates and no maturity date, meaning that banks do not need to pay the principal. Additionally, there is an option to convert these bonds into shares of the company or bank that issued them if the lender breaks certain viability thresholds. This is a way of improving the capitalisation of the issuing entity.

The disadvantage for the investor is that the conversion is forced, and they do not have the possibility to prevent it. In addition, since the contingencies forcing the conversion usually happen when the issuer's capital is below a certain level, **debt is converted into equity at the most difficult time for the entity**.

In view of the above, the issuance of perpetual contingent convertible bonds must be done on an exceptional, one-off basis; and issued to the markets with a purchase guarantee by the central banks, as well as within the secondary market. The CoCos should increase the balance sheet of the central banks to equal that of the debt securities issued and bought, in order to quantify and qualify the increase of the monetary offer, as well as its eventual rhythm of restitution to adequate levels linked to those of the real production.

Other governments are considering methods previously implemented and proven effective in boosting the economy in the short term and resulting in broad social benefits in the long term, such as investment in infrastructure.

The World Economic Forum (WEF) highlights that investment in advanced, sustainable technology and resilient infrastructure can facilitate post-Covid-19 economic recovery. According to WEF's estimates, middle-income countries could have a return of $4 for every dollar spent on infrastructure focused on long-term resilience.

It is often said that infrastructure is the backbone of the economy. However, we must keep in mind the new realities and infrastructure needs for the future. To this end, the involvement of businesses in the assessment of opportunities at the local level is crucial to the success of any infrastructure investment.

The development of infrastructure projects must, in any case, be adaptable and replicable, as well as the innovation that is required to face the future.

Along these same lines, a policy of deficit reduction is considered to be toxic. The pandemic calls for substantially increased spending rather than belt tightening, especially when it comes to healthcare services.

On the other hand, many countries have facilitated access to credit for companies, either directly or indirectly, through national investment banks or other institutions. Also, governments have often identified certain taxes, fees or social security contributions that will not be levied or will be deferred to facilitate the cash flow of enterprises.

Other countries offer specific subsidies to cover business costs. In some cases, these have specific purposes, such as paying workers' salaries; in other cases, these are simply generic contributions.

In conclusion, there is no one-size-fits-all solution for all economies. Each country has a national and business context that should be considered when identifying appropriate solutions. We can, however, highlight the following policy approaches that may result in more effective measures:

➢ Policies must be comprehensive, decisive, ambitious and coordinated

- They must seek to avoid permanent economic damage.
- Identify safe ways to allow the continuation of some economic activities to help soften the impact of the crisis on the economy.
- Focus on targeting financial support to beneficiaries; make funds available to businesses, especially through the financial services' sector, and to workers through social security agencies.
- Debt must be sustainable in the medium term (non-repayable debt).
- They must be timely, temporary and focused.
- They must stabilise expectations.
- They must be implemented rapidly and efficiently.

➢ Insolvencies may be inevitable but the sustainability of businesses must always be the ambition.

➢ The crisis started in the real economy, so the demand stimulus would not work in the current environment by itself.

➢ Health management must be assessed in balance with the economic damage that equally impacts people's well-being.

➢ Policies should be based on the idea of a managed and combined supply-side and demand-side recession.

➢ Helicopter money is a radical option; if untargeted, its effects may not be beneficial for all economies.

For more information, visit IOE's platform on Covid-19, or contact our Senior Adviser, Luis Rodrigo Morales (morales@ioe-emp.com).

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