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Finance and businesses in the time of Corona

By Prof Phillip Burger

The Covid-19 crisis has brought much of the world economy to a sudden stop. Millions upon millions of people are in lockdown across the world, preventing them from working, buying, producing and selling goods and services. Global and local supply chains are interrupted, and small and large companies see a collapse in income. Households are under similar pressure.

In South Africa, as elsewhere, this is causing enormous liquidity crises and, while some larger corporations might for a while have the financial reserves to cushion this, others don't have such reserves. As a result, liquidity crises threaten to turn into solvency crises that could put many companies out of business – causing large-scale unemployment. While the health shock might be temporary (albeit massive), it could have long-lasting economic implications if company and individual balance sheets deteriorate severely (or worse, are destroyed due to bankruptcy).

This article focuses on one aspect: a specific proposal on how to support large and small formal-sector businesses to deal with the financial fallout and ensure that a liquidity crisis does not turn into a solvency crisis. On a macroeconomic level the objective is to protect income and jobs by slowing down the rate at which aggregate supply and demand contract.

The nature and severity of the problem

The Covid-19 crisis is in the first instance a health crisis that threatens the health and life of thousands of South Africans. South Africa's public health system is much weaker and less comprehensive than health systems in Europe and the US (even when adding private health capacity) – and the crisis is overwhelming the health systems in many of these countries. Thus, the pressure that the health budget places on the fiscus is set to increase fast (we are talking days and weeks, not months). Indeed, Finance Minister Tito Mboweni has even mooted the possibility of borrowing money from the World Bank and IMF to finance health-related expenditure (Joffe 2020; Stone & Masondo 2020).

In the second instance, the Covid-19 crisis will be an economic crisis, potentially causing a surge both in business bankruptcies and the unemployment rate. In the 2008/09 crisis South

Africa's GDP contracted by 1.5%. Though very difficult to predict, a contraction of 5% in 2020 due to the Covid-19 crisis would not be surprising. Both aggregate supply and demand are shrinking as a result of the control measures to contain the pandemic. Lockdown measures prevent companies from making sales, but they still need to make payroll and cover their other financial commitments. The crisis threatens a severe deterioration in company balance sheets. Large and small companies alike will take a knock, though the impact on SMMEs will likely be more severe. In an effort to contain costs and remain solvent, businesses will start laying off employees, causing a large increase in the unemployment rate.

A three-week standstill in production will deprive many companies of almost a month's income. Although some of the production can be caught up later, the production of others will cease as they go out of business. Moreover, there is the real possibility of continued lower production if the national lockdown is extended beyond the initial three-week lockdown.

In the 2008/09 global financial crisis almost a million South African workers lost their jobs. Importantly, that impact was not temporary: the increase in the unemployment rate proved to be lasting. We never again saw the 21% unemployment rate that existed prior to the global financial crisis. The impact of the Covid-19 crisis on South Africa promises to exceed that of the global financial crisis by far – while the unemployment rate stood at 29% before the crisis.

Current policies to address the economic fallout of the crisis

Several EU countries, the UK and the US have announced comprehensive fiscal and monetary programmes to deal with the economic fallout of the crisis. President Donald Trump has signed an economic relief bill that comprises a package of programmes to directly support businesses and households in excess of $2 trillion (Werner, Kane & Debonis 2020), while the US Federal Reserve pumped $1.5 trillion into the short-term interbank markets to support financial markets after stock prices dropped in the wake of the fast-spreading virus (Heath, Telford & Long 2020). The Bank of England has announced a monetary stimulus of close to 10% of GDP, while the UK government has announced fiscal measures to support businesses and households, valued at between 7.5% and 10% of GDP. The EU has announced the creation of a Pandemic Emergency Purchase Programme to purchase additional assets equalling 7.3% of its 2019 GDP to stabilise financial markets in the wake of the crisis (Buiter 2020).

President Cyril Ramaphosa recently announced a set of programmes when he proclaimed the national lockdown. Government plans include R500 million of direct support for SMEs (administered by the Department of Small Business Development) and another R200 million for SMEs in the tourism sector. The bulk of the support, though, is R30 billion for

unemployment insurance (Fin24a 2020). The Minister of Employment and Labour, Thulas Nxesi, created the COVID-19 Temporary Employer and Employee Relief Scheme (C19 TERS) under the Unemployment Insurance Fund. It provides for cases where companies cannot pay employees as a result of the lockdown. Minister Mboweni also announced a number of tax-relief measures. These included a tax subsidy of R500 for employees for four months, the monthly payment of employment tax incentive reimbursements instead of twice a year, delaying 20% of companies' employee tax liabilities and some provisional corporate income tax payments (Fin24b 2020).

The South African Reserve Bank (SARB) recently reduced the repo rate by one percentage point and announced a programme to buy government bonds in the secondary market to inject liquidity into the market (but will do so at market-related rates). The SARB action seem to have been primarily aimed at stabilising financial markets after a sharp increase in the government R2030 bond rate (from roughly 9% to 12.38%) following the onset of the crisis. The SARB action has only managed to get the rate down to 11.32%, though (Bishop 2020).

If the measures announced in the US, EU and the UK are anything to go by, much more may be needed. The R30 billion package put together by government represents about 0.6% of GDP, falling far short of what other countries did. Unfortunately, South Africa's fiscal position is in such a precarious state that it will not be able to provide a fiscal stimulus similar to those of the US and the UK. Even before the crisis struck, the February 2020 budget of Minister Mboweni budgeted for a deficit of 6.8% for the 2020/21 fiscal year, and the debt-to-GDP ratio was set to increase from 61% currently to 71% in 2022/23 (see Burger & Calitz on Econ3x3). That projection did not factor in a drop in government revenue due to a Covid-19-induced shrinkage in GDP, or a sharp increase in public health expenditure. With investor money looking for safer shores (the sharp increase in the demand for dollars has already weakened the rand significantly), the government may also be unable to run a larger deficit simply because it may fail to find buyers for newly issued government bonds.

At the time of writing the government is reportedly also busy putting together a package to support the poor against the fallout of the Corona crisis via the grant system (De Lange 2020). The extent of the support and how the government intends to pay for it was not yet clear. However, a significant constraint exists on government's borrowing capacity given the deteriorating condition of public finances even before the crisis, the junk status of South Africa's bonds and higher levels of risk aversion among international investors (observable in the rising interest rates on government bonds). This means the scale of such government support will be severely limited and will largely depend on its ability to reallocate expenditure towards health and additional grants on a large scale.

With respect to health expenditure this reallocation will have to occur fast. Retrofitting existing buildings for hospital beds and buying respirators, medicines, test kits and other items will require urgent attention to deal with the exponential rate at which the disease potentially spreads. The government may very well have to submit an additional budget to legislate the changes into action. But reallocation will require cuts somewhere else in the budget and will certainly have to include reassessing some of the financial support budgeted for insolvent SOEs in the 2020 budget. The scale of additional health expenditure demands is apparent in Minister Mboweni's comments that the government may need to approach the World Bank and IMF for financial support in this regard. However, the above list of support measures will probably be as much fiscal support as the government can afford, given the fiscal constraints under which it operates. More ambitious lists typically are not fiscally feasible.

The proposal: monetary policy and bank loans

The bulk of support will have to come from the monetary authorities in the form of quasi-fiscal measures. Thus, instead of the government paying a subsidy to companies to survive, the SARB together with the banks should set up a cheap loan system, whereby the SARB provides low-interest-rate loans to banks, which the banks in turn use to extend low-interest-rate loans to businesses in distress. These loans should be repayable over a relatively long period of time, say five years, to contain repayment pressure on businesses.

There are various ways in which the central bank can get the finance to the banks. To ensure that the funds ultimately get to businesses in distress may require facilities created specifically for this purpose. A variation on the proposal by Bank of International Settlements General Manager Agustín Carstens may very well address the problem directly (Carstens 2020). Carstens argues for government-guaranteed loans extended by banks to SMEs, equal to the amount of taxes these SMEs each paid last year. He calls these 'tax deferral loans'. Once extended, the banks can securitise and refinance these loans at the central bank, with losses borne by the government.

A system where South African companies in Corona distress could borrow from banks, with the banks able to securitise and refinance these loans at the SARB, provides a solution to get cheap loan funding to companies fast. However, linking the size of the loan to the amount of taxes paid last year may not be a solution for South Africa. Weak economic conditions mean that large numbers of companies have paid little or no such taxes and were already restructuring their businesses to restore profitability (i.e. prior to the crisis they may have been solvent but not making a taxable profit in the last fiscal year). Instead, the size of the loan for

which they qualify could be linked to a percentage of their turnover, their accounts payable or accounts receivable.

The criteria for companies to obtain such loans from banks – defining a class of loans that banks could securitise and refinance at the SARB – should be very clear. This would ensure that these loans are ring-fenced for dealing with the impact of the Corona crisis on company balance sheets and are limited to companies in need. Only companies that were solvent prior to the crisis should be considered. Banks will also have to apply some stress tests to applicants' balance sheets to ensure that their solvency is likely ensured even if their income suffers during a protracted recession.

The benefit of using the banking system is that banks already know their clients and have an established relationship with them. The banks will therefore already know which clients may need such assistance, ensuring a fast rollout of the assistance.

These measures can also help finance steps such as mortgage repayment holidays of companies and other loan repayment obligations of companies with banks. There will be bad debts in this system, a risk that the SARB (and thus government) and banks should ideally share. (Sharing the risk prevents adverse selection problems and improves the allocation of loans.) The government's commitment can be made explicit through a guarantee to make good for SARB losses and is the basis for the securitisation of the loans.

Conclusion: how large?

How large should the assistance be? Using the examples of the EU, the US and the UK, such help may have to be around 5% to 10% of GDP. (In 2019, total domestic credit extended in South Africa was roughly 80% of GDP, so the proposed support would equal roughly 1/16th to 1/8th of total domestic credit extended.)

Will such money and credit creation not be inflationary? Under normal circumstances one would expect very low interest rates and the accompanying money and credit creation to be inflationary – extra money finances an expansion in aggregate demand, hence the inflation. However, we are not in normal circumstances. Instead, we are dealing with a shrinkage of both aggregate supply and demand. These measures will only slow the rate at which supply and demand is shrinking – it would flatten the shrinkage curve, with no inflation risk.