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POLICY NOTE

What Can We Do to Manage the Economic Consequences of COVID-19?

1. INTRODUCTION

A century after the 1918-1920 Spanish flu, we are facing a similar global outbreak. On the one hand, the battle against the disease continues, on the other hand, we are in a situation which requires us to measure the economic impacts and put forward precautionary steps for liberalizing the decision-making process.

Currently, in order to curb the spread and take time saving measures for those managing the process, "social distancing" has been suggested by the authorities as a precaution; consequently, slowing the rate of COVID-19 while a vaccine to control the outbreak can be found. In terms of health, this is the only measure that we have now. Correspondingly, this measure also causes negative economic consequences.

Due to the implementation of social distancing, some workplaces, especially those in the service sector, are closing. Employees have already or are now faced with the risk of losing their jobs. A spontaneous decline in demand is found in hotels, restaurants, public transportation, and civil aviation amongst numerous other portions of the service sector. Likewise, it is clear that there is a high risk of failing to meet mutual obligation in value chains. This is the first point.

And for the second point, no one, including business owners, knows yet how long the social distancing measures would last during the global pandemic. We know it is temporary; however without a final end date for the time being. As a result, nobody can plan ahead or knows how to assess if they can endure the period.

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As for the third point, if this decline in demand is neglected, via the failure to fulfill mutual obligations, then profound contraction and loss of employment will spread across the economy.

This policy note discusses the extraordinary measures that can be implemented in order mitigate and isolate the aforementioned negative economic consequences of COVID-19.

2- DURATION PROBLEM

Significant uncertainty of the outbreaks duration and spread is apparent (Pueyo, 2020a and 2020b), in tandem, so is the uncertainty on the extent of economic loss and issues meeting mutual obligations due to the social distancing methods.

The news coming in from every corner of the world suggesting that the outbreak will soon lose its effect points to an optimistic expectation. And, for the sake of argument, let us assume that the pandemic would be short and the policy of social distancing would be over after a month, and let this period be between the second half of March and the first half of April.

For Turkey, about 22 percent of the Gross Domestic Product (GDP) is created in the first quarter, and 24.5 percent in the second quarter. Let us assume that the GDP created in the first two quarters are evenly spread over the months. As such, this period we are discussing is roughly 7.8 percent of the annual GDP. In this context, if the GDP decreases by 10 percent during this period, there will be a loss of 0.8 percent of annual GDP, and if it decreases by 20 percent in this period then there will be a loss of 1.6 percent of annual GDP. If the annual GDP was to increase by 5.5 percent compared to the previous year in the period excluding this month, the annual growth rates for this period would be as follows: a 10 percent decrease in this period results in 4.3 percent annual growth rate, 20 percent loss results in 3.5 percent annual growth rate, and a 66 percent loss indicates no annual growth at all.

The first result of these rough estimations: Even one-month economic impact on the annual growth rate is at a size that cannot to be neglected. Nevertheless, continuing on positive assumptions, we will assume that a 10 percent GDP loss for this one month period will occur while the rest of the year performs as expected at 5.5 percent growth. Meaning that the annual GDP growth rate would actually be 4.3 percent instead of 5.5 percent. In this context, the current measures of Turkey against the economic consequences of the COVID-19 outbreak will be sufficient, besides the issue of unemployment benefits. If additional measures focusing on unemployment benefits can be taken into consideration, then we can assume that there would be a limited economic loss. In fact, this optimistic comment will be valid for the scenario with an expectation for a 20 percent downturn in GDP.

From the rough calculations above, there is a point to consider when increasing the duration of social distancing policies: There is an “exponential” effect of GDP loss each extended monthly (weekly) period. In other words, the losses witnessed in the previous month will further escalate losses in the following month.

At this point the question emerges: What happens as GDP loss would worsen month after month as social distancing measures are elongated?

3. THE GOVERNMENT AS THE "BUYER OF LAST RESORT"

Due to the scale of the outbreak, accommodative fiscal policy should be designed by taking value chains into account together with the classic crisis measures of monetary policy-increasing and cheapening liquidity support. It is also necessary to consider that whether targeted financial support can be provided as well as whether quantitative easing is an option for financing and how the latter could be designed.

First, it should not be forgotten that this is not a permanent, rather a temporary, attempt at maintaining the current system and preventing increases in bankruptcies and unemployment. Second, we have to underline that this strategic measure is aimed at compensating the negative economic consequences of the response strategies for the global outbreak. Third, these measures are difficult to implement, therefore requiring healthy debates to kick start a discussion on a forward looking plan.

During the social distancing period, in order not to inflict a major break in economic activity, leading to increasing unemployment rate, disruptions in the payment systems, and securing the vitality of businesses, extraordinary measures are required. These measures are in line with the recommendation of David Moss (2004) in which the major recommendation is on the role of "government as the ultimate risk manager."

A framework recently introduced by Saez and Zucman (2020) argues that in order to prevent the overall decline in demand due to the COVID-19 outbreak, the government has to temporarily be engaged with purchasing guarantees as the "buyer of last resort." Note that our system has a lender of last resort arrangement with no buyer of the last resort mechanism to backstop severe decline in economic activity. The basic idea here suits our current plight: For example, if the number of empty seats in an aircraft is increasing, the government purchases the vacant seats. This way, the entire value chain continues its operations without causing any major disruptions, the civil aviation crisis does not leap into other sectors that provide inputs or benefits from its services- thereby, mitigating loss of employment that would catapult a greater drop in overall demand. If the contraction caused by the decrease in demand in the services sector is 20 percent of the national income, then the government comes forward with purchasing guarantees.

Yet, how can this idea be actually implemented?

We already know that the services sector will be one the sectors most negatively impacted by social distancing measures. When approaching the service sector from the perspective of the value chain, it is possible to depict that the decline in demand at the final goods and services end of the value chain, will ultimately negatively impact the activity volumes in various sectors that are operating on that value chain. Let us further take the tourism industry as an example. This sector's value chain is provided below in Figure 1. As observed, various sectors are vital parts of one big value chain from transportation to food industry, from agriculture to manufacturing industry.

Tourism Value Chain

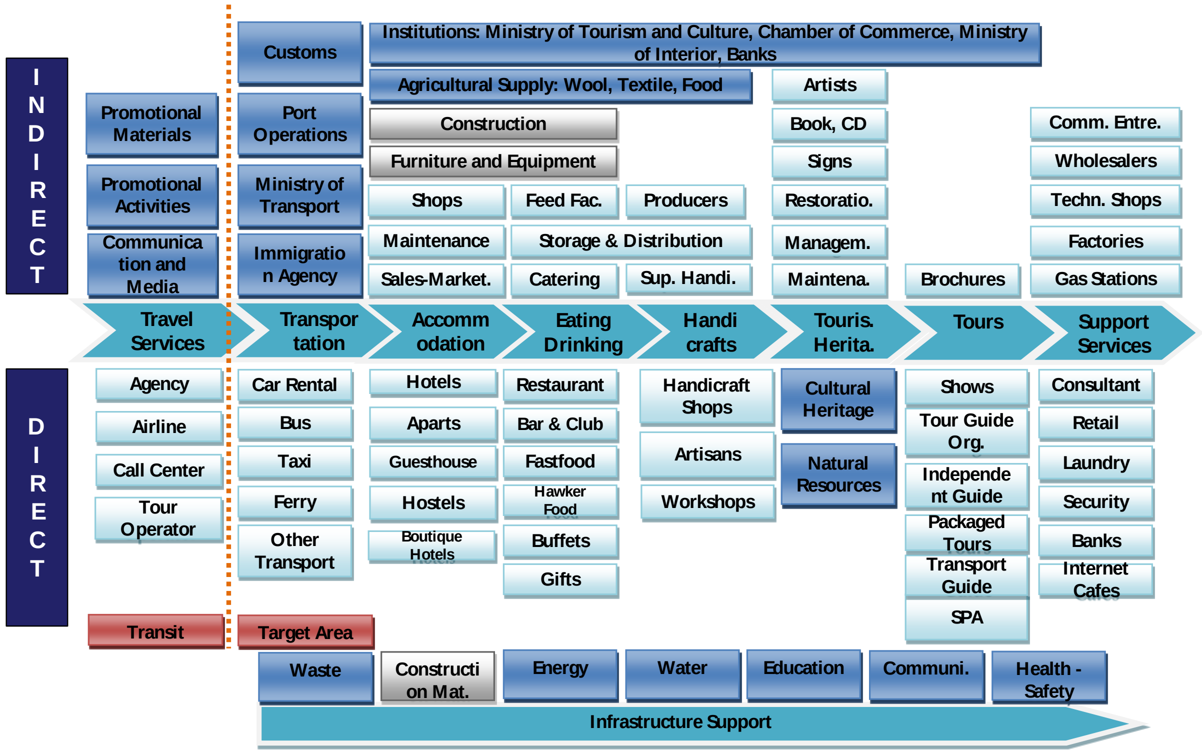

Figure 1. Tourism value chain as an example

Consequently, for example, for hotel management in the tourism sector, a purchase guarantee could be provided to rooms that would under normal circumstances be filled, resulting in the undisturbed operations and enabling the entire value chain to remain intact. So, how can this purchase guarantee be given and where would the funding source come from?

Let us assume that 10 percent of the national income is transferred as a purchase guarantee to those that need it in order to compensate for the overall decline in demand. To finance this, the Ministry of Treasury and Finance may issue Treasury Bills up to 10 percent of GDP. As a result, the T-Bill stock will increase by that much as well and these government securities can be sold to the Central Bank by making a temporary change in the law. Thus, adding this to the Central Bank's balance sheet and resulting in the Ministry of Treasury and Finance being indebted to the Central Bank for a certain period of time. The monetary resources obtained from the Central Bank given to the Ministry of Treasury and Finance in return would then be transferred to the final producers of goods and services, enabling them to get through this troublesome period of decreasing demands. This transfer can be made by all public banks or state banks, or the Development Bank of Turkey. Companies would then be given purchase guarantees, taking into account the magnitude of drop in demand for goods and services they produce. To an extent, with the purchase guarantees, the uncertainty caused by COVID-19 on companies will be alleviated.

So, how should the public resources be transferred to companies? If all companies are guaranteed, it would be impossible to manage just a few times the size of the GDP. The basic principles to be considered are as follows:

a. The purchase guarantees could be given to companies at the final stage of the value chain
b. Granting these guarantees must be subject to certain conditions: Companies must continue their normal activities or act ‘as if they are running.’ Likewise, they would not be allowed to reduce their employment and are required to pay their suppliers. It is essential not to disrupt employees’ wages and/or bills.
c. Those who produce tangibles continue their activities and produce goods.
d. Providing support to intangibles appear to be more problematic. Here, it is necessary to focus on the difference between the normal activity volume and the current activity volume- similar to the number of seats on a plane example by Saez and Zucman (2020). For this difference, the ‘as if continuing to operate’ approach should be adopted: payments to employees and suppliers be made without a disruption.

4. WHAT TO DO WITH SMALL AND MEDIUM SIZED ENTERPRISES (the SMEs)? FOCUS ON TRADE CREDITS

The “feasibility” and sound operation of government procurement guarantees brought to the final producers of goods and services at one end of the value chain depends primarily on the ability of the government to ensure the conditions ‘b, c, and d’ above. It is clear that this requires a detailed and precise plan. It is consequential to make and follow a forward thinking plan in a short amount of time.

In this situation, focusing on trade credits within the system is essential, especially when micro enterprises and the SMEs are considered. Obviously, the prevalence of trade credit practice is due to the access to finance problems of MSMEs in Turkey.

From a schematic perspective, larger companies can finance their activities through loans from domestic or foreign banks or even from their own financial resources. On the other hand, micro enterprises and the SMEs (MSMEs) continue their activities via trade credits provided by large companies due to their lack of access to finance. Trade credits are in the form of bills and checks (in fact, postdated checks to be cashed in at the agreed upon date despite legislation contrary). For example, in the case of delivery of the goods from a large company to its distributors, instead of the cash payment, the distributor provides a bill to divide its total payments with a certain maturity time. “Postdated check” would float firms that have problems with access to asset financing and, thus, revive the economic process. Trade credits appear on the company’s balance sheet as a receivable. If the amount of trade credits increases, the “receivables” will actively grow on the balance sheets. Also a large company can also take commercial loans from a small company which is part of its supply chain.

Due to the decrease in demand for goods and services resulting from the COVID-19 outbreak, reduced resource inflows may lead to postponed payments leading to a crisis in this outmoded payments system. In order to avoid this, the government needs to provide procurement guarantees to final producer firms of goods and services so that the latter should continue their regular payments. In this situation, as a forward-thinking step, procurement guarantees will allow the functioning of the entire value chain.

The advantages of focusing on trade credits is to preserve the value chain, thereby paving the way for a viable resolution model involving the MSMEs.

5. WHAT TO DO WITH INCREASING UNEMPLOYMENT AND CLOSURE OF SMALL BUSINESSES?

In a short period of time, especially in the services sector, many businesses are closing or trying to change the way they operate. Turkey does not have a strong means tested and central social protection net that incorporates the entirety of the unemployed for this period. Steps to be taken to expand the scope and implementation of the short-term unemployment allowances may be a good starting point to initiate discussions. It should not be forgotten that 4A insured who are still working at a business with a work contract can benefit from the short-term employment allowance. Those who are unemployed, on unpaid leave, or are in unregistered employment will be out of scope. In the present case, it should be taken into consideration that only a small portion of approximately 14 million insured would comply with the 600-day premium payment obligations. Comprehensive regulations are necessary, especially considering the turnover rate in the services sector. In addition, there is no national mechanism to enable the MSMEs that want to change the way they operate and turn towards digitalization. In this context, an accommodative fiscal package should be created to incorporate those who recently became unemployed and companies that had to shut down for the time being. Therefore, it may be necessary for the government to undertake covering a significant portion of wages that would be otherwise regularly earned by the now unemployed.

Within this framework, the coverage of the Unemployment Insurance Fund can be extended to provide income transfers to households in general. To generate funding sources, the proposed framework in this study, “issuing T-Bills to be purchased by the Central Bank to create a temporary monetary expansion,” can be extended.

CONCLUSION

Apparently, without the comprehensive intervention of the government to directly compensate the decline in demand, partial measures based on market mechanism do not provide a clear way to overcome the deep economic contractions caused by the global pandemic of COVID-19. The main goal of government intervention is to prevent firms from an indefinite period of recess and to keep them operating within their own value chains.

Important takeaway: We must consider unusual measures when managing a new process for a problem we are unaccustomed to. Two types of approaches can be followed against such a global problem: First, to wait for the completion of the event as if in an earthquake and then afterwards focus on the revitalization of economic life. Second, to keep in mind of the ongoing global pandemic, compensate the possible economic consequences in a timely fashion, and ensure that businesses operate during this process as if nothing has happened. Waiting around for the outbreak to pass as if it is an earthquake may cause further damage that will be increasingly difficult to repair. Every company that sinks will take many other businesses within its value chain with it. Therefore, a solution based on keeping all businesses in the value chain running is needed.

The aforementioned system examined in sections 3, 4, and 5 of this study needs to be carefully considered as a whole. The required resources for the operation of this system will be provided by the Central Bank’s monetary expansion. Of course, we are aware that this threatens to increase the perception of risk related to our economy, yet we are living in an unprecedented era where it is time to take unprecedented measures. Our monetary expansion policy should be explained as an unprecedented move and it should be stated that after a while this will be revoked with a plan.

The point that we must not forget is that shortly after the 2001 financial crisis, the T-Bills or government bonds issued by the Treasury were converted into money by the Central Bank to support mostly state banks- resulting in a significant monetary expansion in the system. At the time, because monetary expansion emerged as a part of the reliable economic program, no confidence issues arose. The lesson from that experience is that an economic program as a response to the extraordinary cases can also be designed and implemented in a way that does not create a problem of trust.

Unprecedented economic response programs should be fair and just. In this context, the proposed system here requires companies to have the precondition of protecting employment. Furthermore, this system provides income support for those who were working for businesses forced to close and are now unemployed.

On the other hand, a different approach is required if social distancing measures become more widespread due to COVID-19, especially for employees at organizations that produce tangibles. At that stage, the basic principle will be to ensure the lives of those in value chains rather than maintaining the volume of the economic activities as much as possible. The government will then have to undertake a certain portion of the labor payments and capital gains of the MSMEs for a certain period of time. Other measures suggested above can be applied for this case, as well. Nevertheless, it is also apparent that further research on the program design will be necessary for dealing with a more severe scenario.

This policy note draws a conceptual framework. For the implementation of these concepts, a more detailed study must be prepared in a timely fashion. The overall takeaway: Developing a set of measures to quickly manage the possible economic consequences of the global pandemic will make life easier to those who are to take the necessary measures against the global pandemic.

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