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COVID 19: Rescuing & Preserving the productive capacity of the economy is a priority

By Ravi Ratnasabapathy

Around the world governments are now gradually easing lockdowns - a policy that slowed the spread of the virus - but at a heavy price. Sri Lanka lifted the curfew on the 26th of May 2020; but the crisis is far from over.

Although the health impact of the pandemic seems to be coming under control, at least for the moment the economic fallout is still in its early stages. Markets are gradually opening but the pace of the recovery will be hamstrung by the physical distancing measures and travel restrictions that will need to be maintained for months to come.

Economic Climate

In terms of the economic effect, initial data points to the worst slump since the Second World War. According to official data China's GDP in the first quarter contracted 6.8% year on year (and 9.8% quarter on quarter)[1]. Western nations seem set to fare worse, the UK's Office for Budget Responsibility sees a decline of 35% in the second quarter and a decline on 12.8% for the year[2]. The OECD estimates reductions of 15% or more in the level of output throughout the advanced economies and major emerging-market economies, and in the median economy, output would decline by 25%."[3]

This is bad news for Sri Lanka's exports because our major markets are the US (26%), the EU (16%) and Britain (16%). The optimistic view is that this will bottom out by mid-year leading to the so-called V shaped recovery, however the pessimistic, nonetheless perhaps more realistic one, is that the recovery may be similar to the Western rebound from the global financial crisis, which was anemic, at best.

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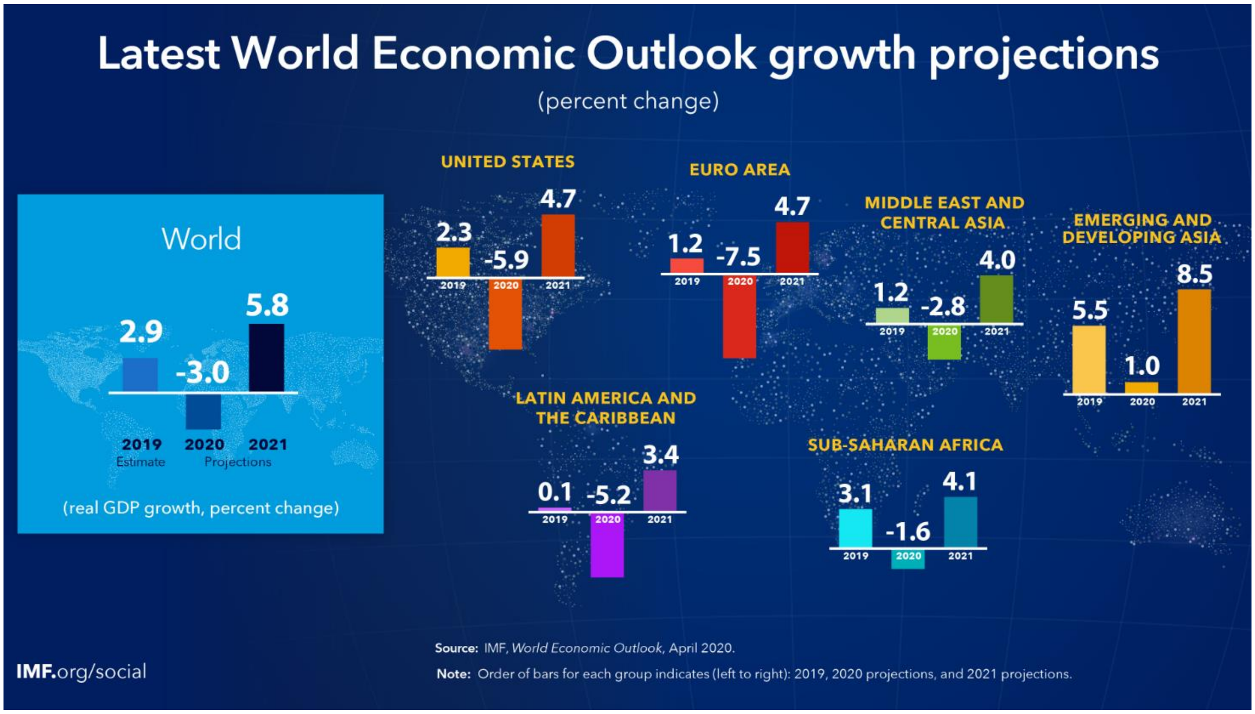
[1] National Bureau of Statistics of China. 20 April 2020. Preliminary Accounting Results of GDP for the First Quarter of 2020. [ONLINE] Available at: http://www.stats.gov.cn/english/PressRelease/202004/t20200420_1739811.html. [Accessed 5 May 2020].

[2] Office of Budget Responsibility. 14 Apr 2020. Coronavirus analysis. [ONLINE] Available at: https://obr.uk/coronavirus-analysis/. [Accessed 6 May 2020].

[3] OECD. 15 April 2020. OECD updates G20 summit on outlook for global economy. [ONLINE] Available at: https://www.oecd.org/newsroom/oecd-updates-g20-summit-on-outlook-for-global-economy.htm. [Accessed 6 May 2020].



Impact to Businesses

In normal times, business insolvency is an ordinary and essential feature of a functioning economy, helping to maintain discipline, weed out inefficient firms and reallocate resources - it is poor policy to insure every unlucky entity in the economy against misfortune it cannot have foreseen.

However in these extraordinary times there is a case for support for businesses. Rescuing existing firms and industrial ecosystems makes sense because they drive the value creation process and generate employment and incomes for households.

This is particularly relevant in the export sector because these firms were globally competitive and face problems not because of underlying financial weaknesses or uncompetitive operations, but due to the closure of overseas markets. Moreover, the jobs that are imperiled in the export sector are among the most productive and best paying in the economy. It would be a tragedy if these were lost for good.

The contrasting experience of France, Italy and Germany during the 2008 financial crisis illustrates the problem:

> *"In both France and Italy, the crisis caused a massive exodus of firms from the electrical machinery and equipment industry, accelerating the reduction of employment. The loss*

of firms and jobs inflicted long-term, if not permanent, damage on the industry and made it difficult for this key manufacturing industry to recover to its pre-crisis level of production. By contrast, Germany managed to minimize the damage to firms and their exit from the industry, allowing the electrical machinery and equipment industry to recover quickly from the crisis".

(United Nations Industrial Development Organisation, April 2020)

If many businesses are wiped out, the economy may prove incapable of rebounding, even when global markets recover.

The collapse of firms can have extensive impacts on lives beyond those who are directly employed. It affects supplier and customer firms, resulting in reduced wages and employment, as well as lower household incomes. Suppliers of packaging material, accessories and services such as transport, security, cleaning and staff meals are all impacted. Unemployed workers will reduce their spending on domestic services and food which affects a host of others in the informal sector, from vegetable vendors to trishaw drivers.

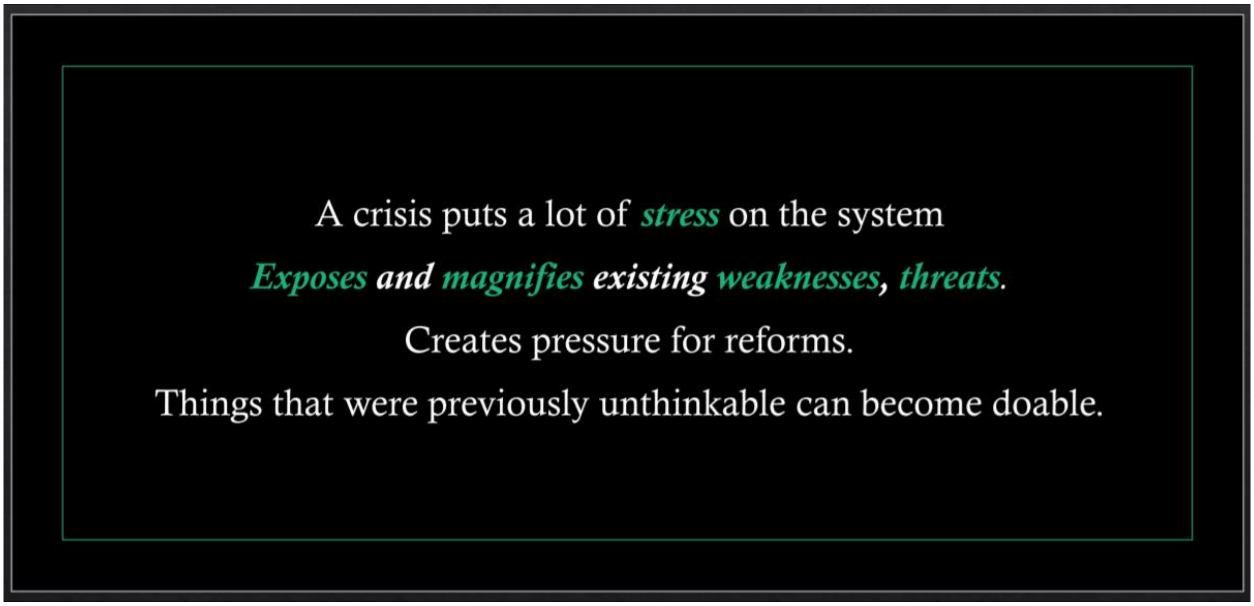
The collapse of firms at the micro level would, in total, reduce aggregate demand for goods and services in the economy and lead to an increase in non-performing loans and liquidity constraints in the financial market. If macroeconomic conditions deteriorate this could then add pressure on companies that are already in dire straits and could create a snowball effect of mass bankruptcy and unemployment.

Fiscal Policy Response

In terms of policy responses, given this huge, unanticipated shock, developed nations have resorted to massive fiscal and monetary stimulus. Unfortunately, Sri Lanka entered the crisis with a shaky economy, pummeled by numerous crises. Floods and droughts in 2016 were followed in 2017 by the worst drought in forty years that battered agriculture and the rural economy. In 2018 the constitutional crisis damaged confidence and lead to capital outflows. This was followed by the 2019 Easter Sunday bombing and the associated fall-out.

Given the weak state of finances it is understandable that the relief measures offered by Sri Lanka's government have been limited; working capital loans and debt moratoria, mostly directed at SMEs.

But more needs to be done if businesses are not to collapse.



What form should government support take?

A scheme of loan guarantees would be an idea to explore. The government does not provide cash but instead guarantees a loan from a bank. The business uses the guarantee as collateral for a loan that is used to subsidise its workers and maintain its factories. The details would need to be discussed but a possible outline is described below.

1. The loans would need to be for a longer period, perhaps about six years.
2. The government guarantee would cover a significant portion of the loan, perhaps 80% of the loan.
3. During the half of the term, the interest rate would be low perhaps, 4-5 pa%
4. During the second half the interest rate would rise significantly, to offset the concession during the first half and capital repayments would begin.
5. During the first half of the term firms would pay a subsistence allowance of perhaps 60%-70% of normal salaries in lieu of the normal salary and EPF/ETF contributions. In the second half the normal salary and benefits would be restored.

The rationale for the scheme is as follows:

The recovery from the pandemic will take many months, so the loan needs to be long term, to give the firm enough breathing space to survive. The current loan schemes suffer from the fact that businesses are sometimes not able to offer collateral, the government guarantee solves this problem.

The guarantee covers the majority of the loan but not the entire loan, which means the bank has an incentive to make a proper assessment of the productive capacity of the firm. A normal cashflow forecast is not possible when sales have collapsed but if past records show the firm to have been efficient then the bank will have confidence of eventual recovery when markets normalise. The idea is to support firms that are efficient - not to prop up those that were dying anyway.

The interest rate is structured so that while the firm pays a low rate in the first half, a higher rate kicks in during the second half to enable the bank to make a reasonable overall return. Replacing the normal salary with a subsistence allowance reduces the strain on the business but provides a reduced but secure monthly income for the workers.

The details must be discussed with stakeholder but it is very important that Sri Lanka should try to preserve as much productive capacity in the economy. If the industrial ecosystem is permanently damaged, which can happen if many firms in sector collapse, it will cripple the eventual recovery.

The writer is an Independent Consultant consulting with the International Trade Centre (ITC) and the Asian Development Bank (ADB).