NEW ECONOMIC REALITY AND OUR RESPONSE

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The world and Armenia are facing a new reality, which arrived within a few days. The threats of coronavirus pandemic have forced many countries to introduce unprecedented preventative measures that severely restrict the overall economic activity. Early forecasts of international organizations have estimated global economic growth slowdown only by 1-2 percentage points, whereas according to current estimates in moderate impact scenarios the advanced economies may record even double-digit annual economic decline (3 months of 40% contraction equals to 10% of annual contraction). In the worst-case scenarios, the decline will be much more significant.

Contractions in economic activity started with supply shocks, aggravated by disruptions in supply chains, and now rapidly transforming into demand shocks. The financial shock, originating from the chain of non-payments, is yet to come. If that happens, it will reduce the aggregate demand, the vicious loop will be closed, and we will enter into the "perfect storm".

On a positive side, since such economic restrictions are the result of intentional administrative decisions, and current social-distancing measures will be removed as the rate of virus transmission slows down. The biggest unknown is the time period required until ease of the restrictions can be put into effect without triggering any major public health risk. As a desirable scenario, the logic of current public policy and the intervention measures should be based on the hypothesis of fast recovery of economic activity (V-type recovery). If a different behavior is observed, the policy should be rapidly adapted accordingly. Nevertheless, even if in retrospect we would know that the probability of other type of behavior is higher, the logic of initial economic interventions will be the same. The only certainty is that the current situation is exceptional; the economic, social and secondary public health risks stemming from it can be immense and in many cases irreversible. Therefore, the orthodox economic approaches are not relevant now; the response to the unprecedented situation implies unprecedented interventions, both in terms of size and instruments.

Macroeconomic changes

The only way mitigating this situation is large-scale state support and interventions. There is a broad consensus on this thesis shared by many countries. The size of intervention should be in line with the amount of expected loss of economic value. The stimulus packages of advanced countries imply unprecedented measures reaching up to 9% of GDP in Spain, 10% in the US, 15% in the UK, 20% in Italy and 22% in Germany. Small-scale interventions are, a priori, considered ineffective.

The stimulus package of AMD 150 billion in total size announced by the Prime Minister of Armenia stands at 2% of GDP. Important to note that the largest share of the total package (AMD 80 billion) is formulated as “support for innovative companies and projects that will prepare Armenia for the new post-coronavirus world”. Hence, it is not clear how this part of the package will be relevant to address the challenges of the current “coronavirus phase”.

In Armenia, the need for state stimulus packages may reach up to 10% of GDP, making around AMD 650 billion. In order to finance it, both external and internal debt levels should be increased. Given that Armenia is among the moderately indebted countries (with 54% of public debt/GDP ratio), there is still a potential of increasing the debt further. It is likely that the legal cap on government debt / GDP ratio (60%) will need to be amended (current level is 50%).

Hereby the following actions are recommended:

1. Large-scale government borrowings from both internal and external sources

Currently, borrowing through government bond is quite realistic since there is liquidity in the banking system, and banks will prefer to direct funds towards less riskier assets. In addition, any opportunity to attract external debt should be prompty captured. In particular, the World Bank announced $12 billion funds available in immediate support to respond to the coronavirus impacts. We should definitely take advantage of such opportunities.

2. Introducing quantitative easing in the scope of the monetary policy

Quantitative easing is a type of monetary policy, whereby the Central Bank increases money supply through large-scale purchases of governmental and other types of bonds. It is a non-traditional monetary instrument, which the advanced economies widely used during the global financial crisis in 2008 and started to apply now to deal with the current COVID 19 crisis. What was allowed to developed countries, was not allowed to developing ones for a long time. This extreme situation can be used for changing this logic. Depending on how things unfold, it should not be ruled out that at some point the so called monetary financing of the fiscal deficit will be needed, which would imply a temporary abolition of the legal restriction on the Central Bank’s direct financing of government debt. Formerly known as "heretical", this approach now has many reputable supporters, such as the former chairman of the Financial Services Authority of the UK, Adair Turner. Today, the central banks are taking unprecedented measures; in particular, on 23rd of March, the Federal Reserve announced the launch of an extensive loan scheme directed towards various economic agents, including municipalities, firms and employees.

Armenia has a low inflationary environment for long time. Moreover, the risk of inflation is not high due to the sharp reduction in aggregate demand.

The risk that the money supply may flow to the foreign exchange market and increase the pressure on the exchange rate of Armenian dram is also manageable. Given the Central Bank of Armenia has accumulated significant foreign exchange reserves, it can stabilize the market through large, one-off injections, making a speculative demand useless and at the same time sterilizing the money supply that is not working in the real economy. But the most important lever here is that the extra money supply will be channeled to the targeted social groups in order to compensate for the lost income.

Toolkit for stimulus package

The main instruments utilized by a range of countries include:

1. Government loans or guarantees to firms
2. Income or wage subsidies
3. Delayed tax payments
4. Delayed social insurance contributions or their subsidies
5. Tax holidays
6. Helicopter money

The Government of Armenia has announced the first initiative for mitigating the economic impact caused by the outbreak of coronavirus. It is a governmental loan scheme (the 1st type in the list above). This is definitely an important measure; however, the resources will be directed through the banking system, which means that the lending decisions will be made based on clients' creditworthiness assessment. This will probably help the companies that are least affected by this situation, and the refinancing tool will be the most demanded one. If the firm loses its customers due to physical constraints (i.e. in the case of hotels and restaurants), then a firm's rational decision is to cut costs, rather than keep them at the same level through a loan, even if that loan has a zero interest rates. Otherwise, it may lead to a chain of bankruptcies. On the other hand, if employees are fired, they will reduce their consumption, which in turn will adversely affect the entire economy. Hence, this measure initiated by the government can be helpful for protecting certain sectors of the economy, but it is not sufficient, as it will not address the sectors that are most affected by this economic shock.

In addition to broader economic incentives, more targeted and effective incentives are needed. In these circumstances, financial support tools for retaining the employment level, either through tax holidays or wage subsidies, are more than justified. In the Armenian context, the second option is more preferable, for two reasons: (1) tax holidays do not sufficiently compensate for the loss and (2) create a negative precedent for maintaining taxpaying discipline (although some countries apply both).

Consequently, the best alternative in such a situation is wage subsidies for employees that are subject to redundancy or being fired. In effect, the state overtakes the role of a buyer of last resort for firms temporarily compensating for the suddenly disappeared demand and at the same time protecting the employees. Many countries use this tool (i.e. Germany, which expanded its short-time wage allowance scheme called Kurzarbeit, Canada, Australia, and Singapore). Probably the most ambitious version was announced in the UK: subsidizing 80% of salaries (up to £ 2,500) of all employees of all firms that are subject to being furloughed.

Given that cross cutting application of this measure in Armenia is not possible, this approach should be applied either to SMEs or only to those sectors that are mostly affected by the direct administrative restrictions (i.e. restaurants, hotels, travel agencies, non-grocery retailers and producers, consumer goods and service providers), by applying 2/3 and AMD 500,000 limits for both full and part-time redundant employees. This means that the redundancy costs foreseen by the RA Labor Code are temporarily (1-3 months) borne by the state instead of the employer. If this applies to half of the employees of SME companies (with less than 250 employees), the average monthly financial cost will account for around AMD 17 billion, and around AMD 52 billion for three months.

The social protection toolkit should also be substantially expanded. Unemployment growth is inevitable; job opportunities are extremely limited during the acute phase of the epidemic. Therefore, it is preferable to revise and expand the state benefit system, rather than untargeted distribution of money to general population (this approach was applied in Hong Kong; the Trump administration was also considering such an initiative). This can be done either by reintroducing the notion of unemployment benefit (which was abolished in 2014) or redefining the category of emergency assistance to include the unemployed individuals, who lost their jobs as a result of this shock (the latter being "forced" unemployed). It is also evident that the economic structure will undergo major changes during the pandemic; therefore, it is important to extend the state's employee training programs.

The complexity of the ongoing crisis requires a variety of mitigation tools. The complex economic system and the needs of economic agents are diverse. Therefore, some innovative tools need to be introduced as well.

Revenue-based financing (income participation loans) assumes that loan repayments depend on the borrower's income level (for example, as a percentage of the turnover). In this context, loans can be provided at zero interest rates. The advantage of this tool is that it is in line with the borrower's financial flows (riskier from a lender's point of view).

In extreme uncertainty of the current crisis resulting from the pandemic, this tool may have high demand among the businesses that are attractive in the long-term, but are too risky in the short-term to carry the credit burden of fixed payments. The provision of such loans can be implemented through a state financial institution and complement the resources channeled through commercial banks.

The second direction is direct lending by a state financial institution for projects with large-scale social impact. This refers to the category of loans that will not be provided by commercial banks during the current crisis, despite the state co-financing and interest subsidies. Armenia had a similar experience, when the loan program of “SME Invest” Credit organization was launched (currently, “Development and Investment Corporation of Armenia”) in 2009. These capabilities can now be exploited by redirecting the resources to support large-scale social projects. In this case, the loans can have longer maturities and the allowable limits for non-performing loans should be higher.

Concluding remarks

The speed at which interventions are designed and implemented is critical. This also refers to the speed at which mental models typical of the world that existed two or three weeks ago shall be changed. Now we live in another world. The key to our success is our collective ability to adapt and find dynamic solutions to the new challenges.

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