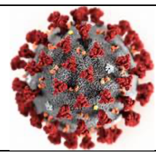
National COVID-19 Science Task Force (NCS-TF)



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Title: Tackling weak investment with an adjustment to the COVID-19 credit programme[1]

Summary of request/problem

The corona crisis is increasingly manifesting itself in a pronounced and prolonged weakness in investment, which is making the return to economic normality with a low unemployment rate more difficult. How can the government support investment activities of companies and in that way foster the recovery of the economy and structural change?

Executive summary

With an adjustment of the COVID-19 credit programme through a refocusing on investments and a progressive guarantee reduction, economic activity and structural change can be supported without most likely placing a heavy burden on the government budget.

[1] This version is largely based upon Gersbach et al. (2020).

Recovery of consumption

The COVID-19 pandemic has seen the economy contract, in Switzerland and around the world, to a much greater extent than, for example, during the global financial crisis. The Swiss federal government reacted quickly and effectively. Around 20 percent of all small- and medium-sized enterprises (SMEs) made use of the new COVID-19 credit programme for which firms could apply until the end of July. The total volume of loans granted currently stands at 16.8 billion Swiss francs. So far, the program has helped to prevent a wave of bankruptcies and to save jobs (Eckert et al. 2020 and Kaufmann 2020). Additionally, the extended short-time work regime and compensation for lost earnings of independent workers and small business owners have prevented a sharp rise in unemployment for the time being. The purchasing power of the average household has thus been largely preserved.

Stimulus measures to speed up the economic recovery after the lockdown

Internationally, most governments have implemented a broad range of measures to help the economy recover from the (first) COVID-19 infection wave and the associated broad-based lockdown measures. Often these measure come in form of investment plans and extra-spending for specific areas. For instance, Germany decided on extra-spending for the digitization of the economy, public security, e-mobility and railway infrastructure. France has issued a plan to support start-ups and innovative firms, has increased public spending for the aerospace and aeronautical industries, military, civil security and climate preservation. The United Kingdom announced extra-support for energy-saving transitions of houses and for construction projects during this and next year. Further measures come as investment incentives. For example, Germany supports private investment by a temporary increase in corporate depreciation rates for moveable fixed investment goods during this and next year. France gives bonuses for purchasing electric vehicles until the end of 2020. Temporary tax reductions are another way to support the kick-start of the economy. Germany has temporarily reduced its VAT tax rate until December 2020; the United Kingdom did so for selected goods until January 2021.

Persistently weak investment

Whereas consumer spending in Switzerland, due to the preservation of purchasing power, is well on its way to rapidly recover from its low in spring (Eckert and Mikosch 2020), machinery and equipment investment remains weak and according to the June forecast of KOF reduces its share in GDP from 15.1% in 2019 to 13.7% in 2020. It initially collapsed to an extent comparable to private consumption, but no quick recovery is currently foreseen for the second half of 2020. According to the latest KOF Investment Survey, companies have considerably reduced their investment plans for equipment and for research & development. The hesitancy to invest is even more pronounced among SMEs than among large companies. In its June 2020 economic forecast, the KOF expects overall investment in machinery and equipment to fall by around 13 percent this year, while private consumption is likely to decline by about 2½ percent.

There are four reasons for the weakness in investment: First, export-oriented firms are investing less due to the expected decrease in foreign demand. Second, uncertainty about both immediate and long-term economic development is high at the moment. No one knows whether a second wave of the pandemic will occur – and if so, how severe it will be. And even without any second wave, it is difficult to predict how the economy will develop. In times like these, companies postpone investments or abandon their investment plans altogether. Third, profits have tumbled in the wake of the coronavirus. Since Swiss companies finance their investments to a large extent through retained earnings, they are now reducing their investment activity. Fourth, companies that already had to bridge liquidity bottlenecks with loans will no longer invest to the same extent as before to avoid even higher debt levels.

The weakness in investment not only puts a short-term drag to overall economic growth; it also has negative long-term consequences by limiting the build-up of the capital stock and the production potential. In addition, weak investment has negative repercussions on the labour market: when firms accumulate less physical capital, they generally hire fewer workers.[2]

Adjustment of the COVID-19 credit programme

In its old form (the programme ended on July 31st), the COVID-19 credit programme did not counteract the weakness of investment, because these loans could only be used to cover operational costs. Firms were prohibited from using them for new investments in fixed assets. We recommend supporting the recovery of investment activity by reviving and adjusting the COVID-19 credit program.[3] Specifically, we propose the following:

1. Given the prolonged weaknes of business investment, the COVID-19 credit programme can be extended by for instance one year, i.e. until 31 July 2021. The total maximum amount of CHF 40 billion approved so far for the programme can remain as a ceiling.
2. All newly approved loans can also be used for investment, such as machinery, equipment, construction and research & development.[4]
3. All newly approved loans are only partly guaranteed by the federal government. The rest of the credit risk should fall to the credit-issuing bank. In addition, the portion of the guarantee borne by the state should decrease over time. For example, the state might bear 70 percent of the risk for the program "COVID-19 Credit" until the end of 2020, and then 50 percent in 2021.[5]
4. The credit-issuing bank must maintain its already existing, unsecured exposure to the borrowing company in full until a given date.

Other aspects of the COVID-19 credit program should also be re-examined and adjusted when needed. For example, the conditions for the solidarity guarantee and the refinancing by the SNB might need to be adapted.

Rationale for the adjustment

There are four reasons why the COVID-19 programme should be adapted:

First, banks cannot fully diversify macroeconomic risks, such as those caused by uncertain epidemiological and economic developments. They therefore demand higher risk premiums for loans, or do not offer them at all. Companies anticipate this and therefore often do not even apply for loans in the first place. A partial guarantee from the state can boost demand for lending.

[2] The positive correlation between physical capital accumulation and labour force expansion applies, provided that labour-saving investments do not dominate.
[3] In a similar way, the guarantee scheme for start-ups could also be adjusted.
[4] We also suggest that already-approved but not yet fully-utilized loans can now be used for investments. There is anecdotal evidence that some of the loans issued have not been fully used.
[5] For the revised programme COVID-19 Credit *Plus* (loans in excess of CHF 500,000), a lower state guarantee share should be chosen; we suggest 60 percent in 2020 and 40 percent in 2021.

Second, in case of severe underutilization of economic capacity, it is more worthwhile for a company to invest if many other companies also invest. This triggers demand and supply impulses. Such externalities are typically not taken into account by private actors. As a result, at the aggregate level, not enough bank-financed investment is taking place (Gersbach and Rochet 2017). A partial government guarantee for loans can help correct such underinvestment.

Third, the value of collateral that banks typically require for issuing loans is currently subject to great uncertainty, which jeopardizes bank lending. A partial guarantee by the state can mitigate this collateral problem.

Fourth, the pandemic is changing consumer and firm behaviour, which requires spending on research & development and investment in new business models. However, at the same time firms are overly cautious during times of great uncertainty (Bloom et al. 2018 and Dibiasi et al. 2018). Partial government guarantees can increase the willingness of firms to invest.

To summarize, there are good reasons why temporary partial guarantees from the state can accelerate the economic recovery. Moreover, the proposed gradual reduction in government guarantees, once uncertainty has been reduced, should ensure that worthwhile investments are made sooner rather than later.

Concerns

We propose a simple, targeted and temporary federal measure to promote investment activity. Nevertheless, regulatory concerns must be taken seriously.

Economic freedom is not restricted by our proposal. After all, the choice of investment projects is left solely to private actors. Moreover, because banks also bear part of the credit risk, incentives remain in place to finance only investment projects for viable business models. Companies that do not have sustainable business models will therefore not benefit from the program. The program will not impede the desired structural change, but rather promote it.

The federal budget will only be significantly affected in the event of loan defaults. The risks for the federal budget are reduced by the fact that, until a date to be determined, the credit-issuing bank has to maintain its already existing credit exposure to the borrowing company, which is not secured by the federal government. This prevents the transfer of earlier default-endangered risks to the state. A more rapid recovery in innovation activity may even ensure that the adjustment of the program is self-financing.

Of course, the government might provide guarantees for loans that would have been granted anyway. But this is not necessarily problematic: if the bank had granted the loan without state guarantee, the risk of default is small. The partial guarantee by the government will then simply reduce the cost of the loan and not burden the federal budget.[6]

[6] In that sense, this programme can be seen as an effective interest rate cut for firms. In case the SNB would have been in a position to further reduce interest rates, it would have probably already have done so. Interest rate cuts implemented by monetary policy face the same kind of deadweight effect.

Efficacy

If, despite the proposed adjustments, an ongoing investment crisis were to occur, further temporary measures would have to be considered. Conceivable are tax relief, such as an extension of the possibility of offsetting current losses against profits from previous years, faster depreciation options for investments and financial support for research & development expenditure. However, since these measures would generate direct revenue losses, they would be much more expensive for the government than the adjustment of the existing credit programme we are proposing. An alternative could be the use of equity-like instruments through which the government would participate more strongly in both future profits and losses of a firm. This could be achieved through an adjustment of profit taxes.

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