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**Research Report**

## Corona crisis: Liquidity takes priority

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# IW-Kurzbericht 21/2020

## Corona crisis - liquidity takes priority

Michael Hüther / Michael Grömling / Martin Beznoska / Markus Demary, 9 March 2020

**The Corona crisis has clearly become an economic challenge for Europe. The spread of the virus represents both a negative supply shock and a negative demand shock across the economy at large. Securing the liquidity of companies is of top priority. Employment and household income can be stabilised through short-time allowances.**

In China it became apparent how an epidemic can directly affect the production potential of an economy when large numbers of workers have to be quarantined. Through a variety of intermediate inputs in economies with a strong division of labour, this quickly leads to production restrictions in other companies and is ultimately detrimental to the smooth functioning of international value chains. However, Corona does not only affect direct supplies from China to German and European companies. There is also a risk of a negative cascade effect in the input interlinkages of industries, as recent developments in Italy have shown. In terms of the economy as a whole, these economic supply effects can be further intensified if central infrastructures become less efficient and reliable – also due to the absence of employees or intermediates.

This leads German companies to question how strongly they would come under pressure from weaker demand from China. With a share of more than 7 per cent of German exports, China is an important customer. German companies also produce in China; the drop in demand in China is having an additional impact on multinational companies and is putting a strain on balance sheets. In the meantime, the epidemic has also affected the global economy. According to the current OECD forecast, global growth will, at best, be half a percentage point lower in 2020. At the moment, it looks more like the economic crisis will last longer and spread more widely. In this case, global economic growth can halve this year to 1.5 per cent. The economies in Europe are clearly feeling this.

If one looks at the identified and combined supply and demand shock, digital infrastructure and networks offer an opportunity for compensation. This is because many processes can be maintained where the decoupling of the business model from space is effective. We have, of course, no experience of this yet. But the digital infrastructure, collaborative platforms and social networks clearly help to maintain production and adapt quickly.

Thinking in terms of supply and demand can be the starting point for economic policy measures. At present, both shocks are overlapping, and this combination reduces the scope for economic policies. The categorically recorded macroeconomic effects will primarily be felt in corporate finance through liquidity bottlenecks with shrinking sales and ongoing costs. That is where economic policy must start.

Special depreciations only work if an emerging demand gap can actually be filled on the supply side from domestic production. The same applies to classic economic stimulus programmes, which should boost overall aggregate demand in a timely manner. Measures such as consumer vouchers or infrastructure investments only work if there is idle capacity in the relevant industries that can be easily accessed.

So what can be done on the economic policy side?

- **Stabilise corporate liquidity.** The Corona crisis is causing a decline in production and demand among many different types of companies. On the one hand, these are highly international companies such as airlines, but on the other hand, they are regionally active companies such as in the hospitality industry. There are dependencies in certain industries because inputs are only available from certain economies. If the epidemic were to take hold in Germany and Europe, supply chains would be even more directly affected. Some of these companies could face serious liquidity problems that would threaten their continued existence. In economic policy terms, this means securing corporate financing quickly and efficiently. With regard to Germany, for example, this can be organised through the Kreditanstalt für Wiederaufbau (KfW), in cooperation with the development banks run by the federal states. Funding should be secured through the federal budget.
- **Stabilise financial market liquidity.** Increased corporate demand for emergency liquidity assistance could arise in the euro area as a result of the virus spreading. The European Central Bank (ECB) can already help alleviate liquidity problems with

the existing targeted longer-term refinancing operations (TLTROs) and also decide on a new TLTRO. This would allow banks to borrow money from the ECB more cheaply if they lend to solvent companies facing Corona-related liquidity difficulties (but with sufficient collateral). However, it would have to be ensured that the problems of the real economy do not affect the banks, i.e. where a liquidity crisis in banks would result from a liquidity crisis in companies. It is therefore important to check that only solvent companies with Corona-related liquidity bottlenecks receive emergency financing and not companies that were previously struggling. General interest rate cuts – like the recent preventive one by the Fed – are of no help in this situation.

- **Stabilise corporate liquidity through tax deferral.** A more generous granting of investment deductions would offer a tax deferral option for the widest range of companies and provide additional liquidity. This measure was introduced in Germany during the corporate tax reform of 2008 and it reduces the current taxable profit by taking into account 40 per cent of the anticipated acquisition costs of investments planned for the next three years. The amount is currently limited to 200,000 euros per year and to companies with business assets of up to 235,000 euros. A temporary significant increase in both limits would have a noticeable tax deferral effect. The accuracy of the measure is, of course, limited. Thus, companies with no liquidity problems would benefit while companies that are currently not making any profits would not benefit. The latter includes start-ups and companies in a restructuring phase, which may be particularly affected by liquidity shortages.
- **Stabilise employment and labour income through short-time allowance.** On the supply side, the Corona crisis is having an adverse effect on production with the risk of extensive layoffs. A non-bureaucratic and adaptable use of short-time work stabilises employment and income. This reduces crippling uncertainty in private households. We know little about the duration of the epidemic, let alone the duration of its economic consequences.

Anything that increases flexibility on the job helps to overcome the crisis. Short-time allowances can be paid because absence from work is based on an inevitable event. The statutory length of time in Germany should be sufficient (12 or 24 months). It should be verified whether the remaining social security contributions (80 per cent) are paid by the state in order to protect the liquidity of the companies.

These measures should help to stabilise employment and company liquidity during a temporary crisis. There are no budgetary restrictions in Germany because the debt brake allows borrowing for "natural disasters or exceptional emergencies beyond the control of the state". However, it is required that appropriate repayment provisions be put in place at the same time. Again, we can only speculate about the duration and severity of the health and economic effects. However, this also limits the economically viable scope for action that can be used. It is therefore important to anchor expectations by addressing the plausible economic consequences of a Corona crisis with a certain degree of accuracy. This is responsible economic policy at the current stage of the crisis.

## References

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