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BRIEFING PAPER

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Coronavirus: Effect on the economy and public finances

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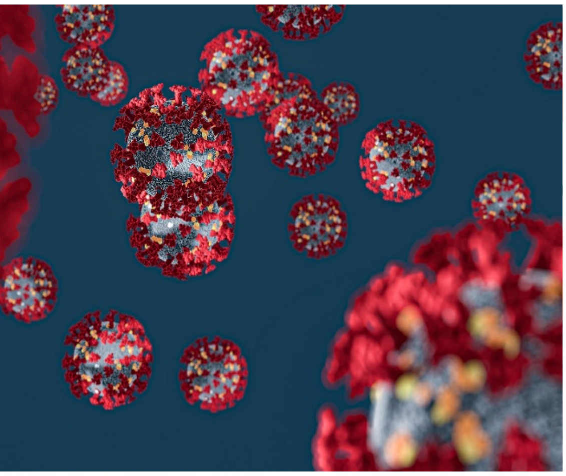

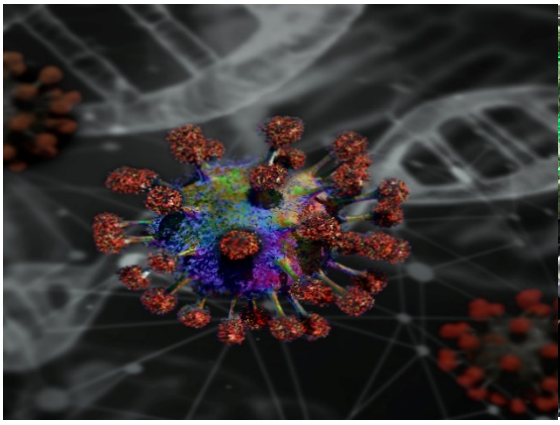

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Summary

This briefing was last updated on 23 March. This is a fast-moving crisis, so please be aware that information may have changed since the date of publication. The Library intends to update this briefing.

The coronavirus outbreak has impacted the economy in a number of different ways.

Supply and demand shocks

The initial disruption was to supply chains (particularly from China, the origin of the outbreak). As the outbreak spread around the world and into the UK, public health measures to slow the outbreak mean fewer people are able to work and businesses in some sectors are shut down entirely.

In addition to these supply shocks, there are also shocks to demand in the economy. Consumers are being advised not to leave their homes and with many businesses struggling to survive, unemployment will likely rise. Consumer spending will likely fall.

There is also a great deal of uncertainty associated with the crisis and how long it will last. This will likely lead to consumers being more cautious in their spending decisions and businesses holding off on investing.

Policy response

Governments and central banks around the world have scrambled to introduce policies that will mitigate at least some of the negative economic impacts from the coronavirus outbreak.

In the UK, a number of policies have been announced by the Government and the Bank of England in order to support businesses and workers. The first package of measures was announced on the day of the Budget, 11 March 2020. Since then, more extensive interventions have been made.

The intention of these measures is to keep businesses afloat and, in turn, as many people as possible employed. The measures seek to financially support businesses, workers and the wider public during the outbreak, as well as attempting to reduce the economic uncertainty.

Public finances

The public finances will be significantly affected by the economic shock of the coronavirus outbreak. The Government's budget deficit will increase as tax revenues fall and government spending increases. Government debt will, therefore, increase. At this stage no one can say by how much.

The Government has announced over £40 billion of direct tax and spending measures to support workers, businesses and the economy. The longer the crisis continues, the more this cost to government will rise. The Government will also provide support through loans and guarantees.

1. How coronavirus is affecting the economy

The coronavirus outbreak has impacted the UK economy in a number of different ways. The initial disruption was to supply chains (particularly from China, the origin of the outbreak). As the outbreak spread around the world and into the UK, public health measures to slow the outbreak mean fewer people are able to work and businesses in some sectors are shut down entirely.

In addition to these supply shocks, there are also shocks to demand in the economy. Consumers are being advised not to leave their homes and with many businesses struggling to survive, unemployment will likely rise. Consumer spending will likely fall.

There is also a great deal of uncertainty associated with the crisis and how long it will last. This will likely lead to consumers being more cautious in their spending decisions and businesses holding off on investing.

1.1 Supply shocks

The initial focus on the economic impact of coronavirus was on China, the source of the outbreak. China plays a big role in the global economy, being a large source of demand for goods and services of other countries and being heavily integrated into global supply chains.[1]

As the outbreak spread across the globe, the scope for economic damage widened considerably.

Public health measures are being introduced in many countries in order to limit the spread of the virus. The economic impact of these measures is potentially very large, at least in the short term.

Some of the key ways the coronavirus outbreak and the public health measures are affecting the capacity of the UK economy include:

- **Supply chain disruption** – the globalised and complex nature of some businesses' supply chains means that it may be difficult for them to source the parts (car makers for example), or inventories (retailers for example) they need. For instance, all major UK and European car plants have announced shutdowns.[2]
- **Workers being off sick** – a number of workers may need to take time off work, or are advised to, if they or their family members show symptoms of Covid-19. This will limit the amount of work businesses are able to conduct.
- **Closing schools** – the enforced closure of schools for most pupils means that many parents will have additional childcare

[1] OECD Interim Economic Assessment, Coronavirus: The world economy at risk, 2 March 2020

[2] "Every major UK and European carmaker to stop or cut production", Guardian, 20 March 2020

responsibilities. As a result, many will not be able to work as much as normal.[3]

- **Shutting down businesses** – unprecedented measures to close businesses entirely – either by government direction or by their own initiative – will have a severe economic impact, particularly on sectors in hospitality and travel, but also others.

In summary, the combination of supply chain disruption, workers not being able to work and the closure of businesses in some sectors, will restrict what the economy can produce and sell.

1.2 Demand shocks

The coronavirus outbreak is also affecting the demand for goods and services in the economy. Initially this was first felt in the travel and tourism sectors.

Since then, additional public health measures designed to slow the spread of the virus have been implemented. For example, advice to the general public not to leave their homes will clearly have a serious impact on many businesses, especially in the hospitality and entertainment sectors.

Many businesses are seeing a big decline in revenues, but still have fixed costs such as rents and staff wages. Even if the disruption is temporary and demand will rapidly return once the outbreak is over, firms still face cash flow issues in the meantime; bills still have to be paid.

Some businesses may have a sufficiently large amount of cash reserves to make these payments, or the ability to borrow what is necessary. Some may not. This means some companies risk going out of business and others will lay off staff.

A **rise in unemployment** and the associated fall in incomes will further reduce consumer demand in the economy.

1.3 Uncertainty: how long will it last?

There is a huge amount of uncertainty over how long this crisis lasts. Will the public health measures introduced, such as school closures and advice to stay at home, last for weeks or months? From an economic perspective, will the damage done be temporary, leading to a full recovery maybe later in 2020 or 2021? Or will there be permanent damage to the economy?

There are many questions.

The uncertainty in and of itself is will affect consumer and business confidence and behaviour. Consumers will likely be more cautious in their spending, perhaps holding off on making larger discretionary purchases. Businesses will likely cut back on, or at least postpone, their plans for investment.

[3] Simon Wren-Lewis, mainly macro blog, "The economic effects of a pandemic", 2 March 2020

While these are typical responses to a recession, this is not a typical recession and therefore it is difficult to say how much behaviour will change.

The Secretary-General of the Organisation for Economic Co-operation and Development (OECD) has warned that the pandemic has caused a "a major economic crisis that will burden our societies for years to come."[4]

[4] Angel Gurria, OECD Secretary-General, "COVID-19: Joint actions to win the war", OECD, 23 March 2020

2. Policy response

Governments and central banks around the world have scrambled to introduce policies that will mitigate at least some of the negative economic impacts from the coronavirus outbreak.

In the UK, a number of policies have been announced by the Government and the Bank of England in order to support businesses and workers. The first package of measures was announced on the day of the Budget, 11 March 2020. Since then, more extensive interventions have been made.

2.1 Broad goals

The nature of the economic crisis means that for many firms, revenues have fallen sharply. This might make it difficult for many to be able to pay some or all of their costs, such as rents or wages.

Addressing these cashflow issues is one of the main things new policy measures are seeking to do; offering a bridge over this temporary shortfall. If businesses can be kept afloat, they either will not have to reduce their workforce by as much or be in a better position to get going again following the crisis.

Financially supporting workers who face unemployment, or the loss of income following a reduction in working hours, may also help to reduce the impact of lower consumer spending on the economy. This may also help with public health. If people are faced with a large reduction in income if they adhere to public health advice, they may choose to ignore it and continue to work.

Intervention by the authorities may also help to reduce the economic uncertainty associated with the outbreak.

Nevertheless, these interventions will have an impact on the public finances (as is discussed in the next section) and will not be able to completely alleviate the economic downturn.

It also worth remembering that many of the public health policies attempting to contain the outbreak will, by design, worsen the economic downturn.[5] For example, shutting down restaurants and advising people to avoid going out where possible.

2.2 Monetary policy and the financial system

In response to the coronavirus outbreak and its impact on the economy, the Bank of England and its Monetary Policy Committee (MPC) has announced a series of emergency measures.

Background

Heading into the coronavirus outbreak, interest rates were at 0.75%. The MPC's quantitative easing (QE) programme – where the Bank of

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[5] CEPR policy portal (VoxEU.org) ebook, *Mitigating the COVID Economic Crisis: Act Fast and Do Whatever It Takes*, 18 March 2020, p6

England creates additional money and uses it to buy financial assets – stood at £445 billion. Of this, the Bank owned £435 billion in UK government bonds (these are essentially loans to government), with a further £10 billion in corporate bonds. The QE programme had been unchanged since the aftermath of the EU referendum in summer 2016.

Crisis measures

The MPC held emergency, unscheduled meetings on 11 March and 19 March 2020, with additional measures announced at different times.

Interest rates have been cut in two stages to 0.1% - the lowest they have ever been. On 11 March they were cut from 0.75% to 0.25% and then again to 0.1% on 19 March.

On 19 March, the MPC also **expanded its quantitative easing programme by £200 billion**, taking the total value of assets it can own to £645 billion. This additional money was to be electronic created (as central bank reserves). The Bank won't buy these additional assets – which are to be mostly government bonds – in a single move. Instead it said it will buy them "as soon as operationally possible".[6]

The MPC said this measure was to support the economy and the functioning of the bond market, which had shown some signs of stress.

This additional capacity to buy government debt will make it easier for the government to borrow.

(The Bank of England does not buy these bonds directly from government when they are issued. Rather, the Bank purchases them from others, such as asset managers, in the so-called secondary market.)

The MPC also announced the introduction of a number of schemes designed to provide cheap loans to banks, so they have additional capacity to lend to businesses.[7] This includes a new **Term Funding Scheme** designed to ensure banks pass on the interest rate cuts to businesses and consumers by giving them access to cheap loans from the Bank of England.[8] The amount they can borrow is linked to the amount they lend to households and firms (especially small- and medium-sized ones).

The Bank of England's Financial Policy Committee (FPC) **lowered the amount of reserves banks are required to hold**, in order to free up this money for lending to businesses. On 11 March, the FPC reduced the UK countercyclical capital buffer rate to 0% of banks' exposures to UK borrowers. The rate had been 1% and had been due to reach 2% by December 2020. The FPC said it expects the rate the remain at 0% for at least 12 months.[9]

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[6] Bank of England, Monetary Policy Summary for the special Monetary Policy Committee meeting on 19 March 2020, 19 March 2020

[7] Bank of England, Bank of England measures to respond to the economic shock from Covid-19, 11 March 2020

[8] The scheme is formally called the Term Funding Scheme with additional incentives for lending to SMEs (TFSME)

[9] Bank of England, Bank of England measures to respond to the economic shock from Covid-19, 11 March 2020

On 17 March the Government announced the creation of a lending facility run by the Bank of England called the **Covid-19 Corporate Financing Facility** (CCFF) that will provide loans to larger businesses to help with cashflow problems.[10] The Chancellor said the government would provide loans and guarantees to the scheme. For more on this see the section below.

In addition, there has been **coordinated action from world's leading central banks** to ensure the smooth functioning of the global financial system. This was undertaken to increase the amount of US dollars – which have been in high demand – in circulation across the world.[11]

2.3 Government measures

A series of measures designed to the economy have been announced by Government in response to the coronavirus outbreak. Rishi Sunak, the Chancellor, has committed to do "whatever it takes" to get through the crisis.[12]

Over £40 billion of direct tax and welfare measures have been announced so far, which is roughly equivalent to 2% of GDP. The cost of some measures is not yet known and will depend on take-up and the duration of the crisis.

The most significant measures directly affecting government spending and taxes include:

- The **Coronavirus Job Retention Scheme**. Workers of any employer placed on the scheme can keep their job, with the Government paying 80% of their wage. There will be a cap of £2,500 per worker each month. The cost to the Government will depend on take up and how long the scheme runs for. The Resolution Foundation – a think tank – estimates that "should the scheme support one million employees it would cost around £4.2 billion over the initial three-month period the government has set out it will run for."
- **Funding for NHS and other public services.** The Government set initial funding at £5 billion. This covers the cost of treating patients, funding local authorities to support social care services and funding other public services as needed. It also provides money to research Covid-19.
- A **holiday from business rates** in 2020/21 for those businesses in the **retail, hospitality or leisure sector.** Those operating in smaller properties[13] will also receive grants of £25,000.
- 700,000 **small businesses**[14] will receive a cash grant of £10,000.

[10] Bank of England, HM Treasury and the Bank of England launch a Covid Corporate Financing Facility (CCFF), 17 March 2020 and Bank of England, Covid Corporate Financing Facility (CCFF): information for those seeking to participate in the scheme, 20 March 2020

[11] Bank of England, Coordinated central bank action to further enhance the provision of global US dollar liquidity, 20 March 2020

[12] HM Treasury, Speech, "Chancellor of the Exchequer, Rishi Sunak on COVID19 response", 17 March 2020

[13] With a rateable value over £15,000 and below £51,000

[14] Those in receipt of small business rates relief or rural rates relief

- The Government will cover the cost of statutory sick pay for companies, who would normally pay this, with fewer than 250 employees (for up to 14 days).
- **VAT payments** due between now and the end of June will be **deferred**.
- **Self-assessment income tax payments** due in July 2020 will be **deferred** to January 2021
- The **HMRC Time To Pay** service will be scaled up, allowing businesses and the self-employed to defer tax payments over an agreed period of time;

The Government has increased the availability and generosity of some parts of the welfare system:

- Those diagnosed with Covid-19, or those advised to self-isolate, will be eligible for **statutory sick pay** from day one (instead of day four).
- It will be quicker and easier for individuals who can't claim statutory sick pay – such as the self-employed – to access other benefits.
- £500 million in funding is available to local authorities to help vulnerable residents. Most of this is to be spent on **council tax relief.**
- The standard rate in **Universal credit and Tax Credits** will be **increased** by £20 a week for one year from 6 April 2020.
- The **minimum income floor in Universal Credit will be suspended** for everyone "affected by the economic impacts of coronavirus". This means that the self-employed can access Universal Credit at the same rate as Statutory Sick Pay for employees

The Government is providing loans and guarantees to businesses, including:

- Loans for small businesses through the **Coronavirus Business Interruption Loan Scheme**;
- The **Covid-19 Corporate Financing Facility** (CCFF): specifically aimed at supporting cashflow amongst large firms, many of whom had reported problems (see above).[15]

Further information on policy measures

- Library briefing paper. Support for businesses during the Coronavirus (covid-19) outbreak, 23 March 2020
- Library briefing paper, Coronavirus Bill: Overview, 23 March 2020
- Library Insight, Coronavirus: Employment rights and sick pay (update), 17 March 2020
- Library Insight, Coronavirus Bill: Statutory Sick Pay & National Insurance Contributions, 20 March 2020
- Library Insight, Budget 2020: Measures to limit the economic impact of coronavirus, 11 March 2020

15 FT, Bank of England offers unlimited QE for large company financing, 18 March 2020

3. Public finances

The public finances will be significantly affected by the economic shock of the coronavirus outbreak. The Government's budget deficit will increase as tax revenues fall and government spending increases. Government debt will, therefore, increase. At this stage no one can say by how much.

Government support to the economy is largely aimed at ensuring that the effect on the economy – and the Government's budget deficit – is temporary, rather than permanent.

3.1 Public finances before the shock

Government borrowing: the budget deficit and current budget deficit

In 2019, the Government's budget deficit (the amount it borrowed to make up the difference between its spending and revenues from taxes and other sources) was equivalent to 1.9% of GDP. This is a fairly typical level and is below the average for the 20 years leading up to the 2007-2008 financial crisis.

Government borrowing has fallen since 2010

Budget and current budget deficit, rolling four quarters, % GDP

The Government was planing on increasing borrowing in the coming years to pay for more investment spending.[16]

Government debt

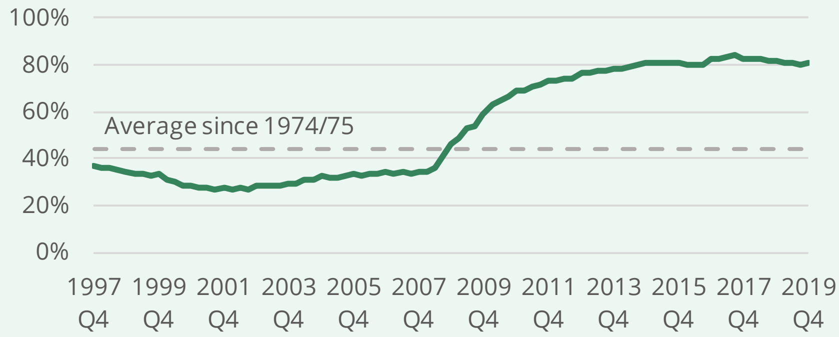
Government debt[17] is the overall level of government indebtedness, built up over many years. Broadly speaking, it is the stock of borrowing arising from past budget deficits.

Before the 2007-2008 financial crisis, public sector net debt was around 34% of GDP. Following the crisis, debt increased sharply. The debt-to-GDP ratio was a little over 80% of GDP at the end of 2019. Debt was last consistently higher than 80% of GDP in the mid-to-late 1960s,

[16] See Spring Budget 2020: a summary for more
[17] Formally – public sector net debt

when it was still recovering from reaching over 200% of GDP during World War II.[18,19]

Government debt remains higher than the 45 year average
Public sector net debt, % GDP



Government debt of over 80% of GDP isn't uncommon in the UK's history. War has commonly been the main cause of large increases in debt. For instance, debt rose to over 100% of GDP during the War of American Independence and grew further during the Napoleonic wars.[20]

Government's spending on debt interest

In 2019, the Government spent around £36 billion servicing the interest on its debt. The Government's debt interest costs have remained low in recent years, relative to its level of debt.

Despite significant increases in its debt, government debt interest has been low. Government debt interest, % GDP

The Government has been able to borrow at historically low interest rates and has benefited from the Bank of England owning more than one fifth of its debt. The effective interest rate paid on the debt held by the Bank of England is lower than would be paid if the debt were owned by the private sector (see Box 1).

18 OBR. [Public finances databank](), February 2020
19 The OBR has produced a [summary of post-World War II debt reduction]()
20 See House of Commons Library. [The public finances: a historical overview](), March 2018

Box 1: Effect of Bank of England holding government debt

Government's debt interest cost are lower than they otherwise would have been because the Bank of England has purchased government debt, through its Asset Purchase Facility.

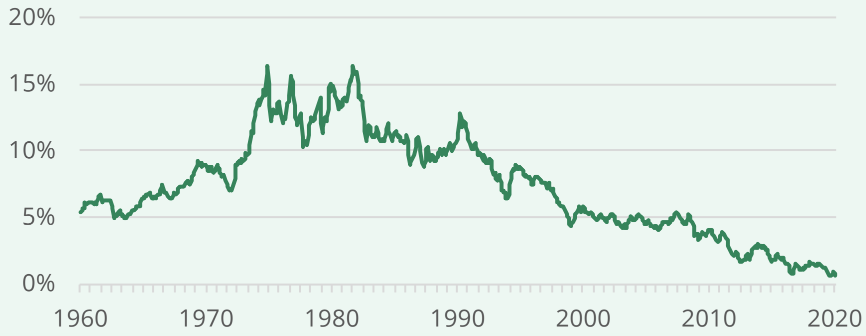
The Asset Purchase Facility (APF) was set up for the Bank of England (BoE) to carry out quantitative easing, which aimed to stimulate the economy. The BoE bought government bonds through the APF from private investors such as pension funds and insurance companies to get money into the economy.

While the bonds remain in the APF it means that government net debt interest is lower than it otherwise would have been. This is because the BoE is in the public sector, so when the government makes debt interest payments for the bonds held in the APF it is making them directly to another public sector body – this is a transfer within the public sector and the net effect is £0. This means that the actual cost to the public sector of holding the debt in the APF is the cost to the BoE of raising the funds used to buy the debt, which is the Bank rate and it is lower than the debt interest.

The BoE has carried out further quantitative easing in response to the coronavirus pandemic (see section 2.2).

The rate at which government can borrow is at historic lows

Ten-year government bond yields, %



Preparing for shocks to the public finances

Economies cannot avoid economic shocks and recessions. The Office for Budget Responsibility says that the chance of a recession in any five-year period is around one in two.

The underlying risk of recession cannot be avoided, but the Treasury has taken steps since the 2007-2008 financial crisis to mitigate some of the potential risks arising from an economic shock.

The Treasury's focus has largely been on reducing the level of government borrowing, returning government debt to sustainable levels and managing the stock of debt to minimise risks from inflation and interest rate increases.[21]

While the debt-to-GDP ratio has started to fall, the Treasury was – in 2018 – concerned, based on international evidence, that the level still risked "constraining government's ability to stabilise the economy in the event of a shock".[22]

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21 The Treasury's approach is comprehensively explained in Managing fiscal risks. The document is the government's response to the 57 risks outlined by the OBR in their 2017 fiscal risks report. Broadly speaking, the mitigating steps are covered in the Executive Summary and Chapter 2.

22 HM Treasury. Managing fiscal risks: government response to the 2017 Fiscal risks report, July 2018, para 2.39

Stepping away from the public finances, other steps taken by government, since the financial crisis, to help the economy deal with shocks include the following:

- The Bank of England (BoE) has been given more flexibility around its inflation target to respond to shocks;
- The BoE has more tools to enable it to support the economy when interest rates are close to zero, including purchasing assets such as gilts, corporate bonds, loans and mortgages.
- The BoE's Financial Policy Committee is using new macro-prudential tools to limit bank lending to highly-indebted borrowers;[23]
- The Financial Conduct Authority has been given regulatory powers to protect borrowers.

3.2 Public finances during the coronavirus shock

Automatic stabilisers

'Automatic stabilisers' are built into the public finances. These are elements of the tax and public spending system which fluctuate over the ups and downs of the economy (the economic cycle) in a manner which, without active policy decisions, dampen fluctuations in the economy. For example, in an economic downturn, unemployment benefit payments will rise, mitigating the decline in household incomes, and moderating the slowdown. Conversely, during an upswing, tax receipts will rise as incomes increase, and this will act to mitigate the increase in disposable incomes and hence act to dampen the cycle.

The automatic stabilisers are "automatic" as they do not require any policy change, such as alterations to tax rates or planned public spending.

Government policy measures: impact on the public finances

Measures taken by the government affect the public finances in different ways.

Broadly speaking, measures which lower tax receipts or increase department's spending (such as providing grants) increase the Government's budget deficit. The borrowing required to fund the deficit in turn increases the Government's debt.

Loans – which are financial transactions – don't directly increase the Government's budget deficit, but when the loans are paid they increase the Government's debt. Repayments of the loans lower the Government's debt. Guarantees have no immediate effect. They only impact on the public finances if the guarantee is called upon.

[23] The macro-prudential tools are discussed in Box 3.5 of the OBR's Economic and fiscal outlook - December 2012

Tax and spending measures

It's hard to put a definitive cost to the package of tax and spending measures announced by the Government so far. The cost will depend on duration and take-up, this is particularly the case for the Coronavirus Job Retention Scheme.

The Government estimates that they have announced £39 billion of measures for which they can put a broad cost to (£12 billion in the Budget, £20 billion on 17 March and £7 billion on 20 March). These are equivalent to a little less than 2% of GDP.[24]

Government's direct tax and spending measures are equivalent to around 2% of GDP.

The Coronavirus Job Retention Scheme could come with a significant cost, depending on take-up and duration, and this isn't included in the £39 billion estimate. If the scheme supported one million employees over the initial three-month period it would cost around £4.2 billion. Supporting the same number of employees for six-months would cost around £8.4 billion.

There may be some increases in public spending in response to the emergency legislation (laid out in the Coronavirus Bill) to strengthen the Government's response plans.[25] At this stage it isn't clear what costs may arise.

Loans and guarantees

Loans – such as the £330 billion of bridging loans – will increase Government debt when they are paid, but will decrease it as they are repaid. So long as they are repaid, the loans can be thought of as having only a temporary effect on the public finances. As Chris Giles, Economics editor at the FT, puts it, they can be viewed as "fiscal insurance rather than fiscal stimulus".[26]

Paul Johnson of the Institute for Fiscal Studies (IFS) noted that "as loans that need to be paid back, the long-term value and viability of businesses taking up the loans will be reduced. This could still leave some which would otherwise have been viable for the long run no longer viable without refinancing. The long run costs of these loans for the public finances is highly uncertain".[27]

As the Bank of England is in the public sector, the loans it will offer to banks through the new Term Funding Scheme – to ensure they pass on interest rate cuts to businesses and consumers – will affect government debt in the same way as those provided by the Treasury.

24 OBR. Public finances databank [accessed on 20 March 2020]
25 DHSC, Emergency bill to strengthen coronavirus (COVID-19) response plans, 17 March 2020
26 FT, Sunak bins Budget first aid kit for far stronger treatment, 17 March 2020
27 IFS, Chancellor adds substantially to the coronavirus measures, but he will need to come back with more, 17 March 2020

Measures taken by the Bank of England: direct impact

Purchasing government bonds

The Bank of England is purchasing government bonds to get money into the economy in what is widely known as quantitative easing (see section 2.2)

As is explained in Box 1 above, this means that government's debt interest costs will be lower than they would have been if the bonds remained in the private sector. The effective rate paid on them by government is the Bank's main interest rate – the Bank rate.

The objective of the Bank's purchases is to get money into the economy. The lowering of government's debt interest costs is a consequence of the decision rather than the aim of it.

The Bank's bond purchases also effect the measure of government debt to the extent that the Bank pays more or less for them (the market price) than the nominal value at which they are recorded in the public finances. Presently, this 'valuation effect' means that the official measure of government debt is increased by the bond purchases. The OBR explain the 'valuation effect' in their explainer on the consequences of unconventional monetary policies on the public finances.

Lowering interest rates

The Bank of England's decision to lower its main interest rate (Bank rate) lowers the effective interest rate the government pays on the government bonds held by the Bank.

3.3 Wider impact on the public finances

The steps taken by the Government won't prevent a wider slow-down in the economy. Nor are they necessarily designed to do so. The measures aim to help ensure that inevitable negative effects on the economy are temporary, rather than permanent.

As the economy slows, less will be collected in taxes and government spending – in areas such as unemployment benefits – will increase. The Government will have to borrow more to fund its deficit and this will get added to its stock of debt.

At this stage it isn't clear how much government borrowing will increase, but it's fair to say that the longer that parts of the economy are closed, and consumers are told to 'socially distance' the more government borrowing will increase. Chris Giles – economics editor at the FT – says that the indirect effects are likely to "dwarf" the amounts being pledged by the Government to support the economy.[28] He estimates that the government's deficit could exceed 10% of GDP in 2020/21.

28 "How is Rishi Sunak aiming to avert an economic meltdown?", *FT*, 20 March 2020

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