CHARLOTTE STREET PARTNERS

COVID-19 AND THE ECONOMY
"WHAT IS GOING ON HERE?"
AND WHAT WILL HAPPEN NEXT?

17 April 2020

FROM A DIFFERENT PLACE

FOREWORD

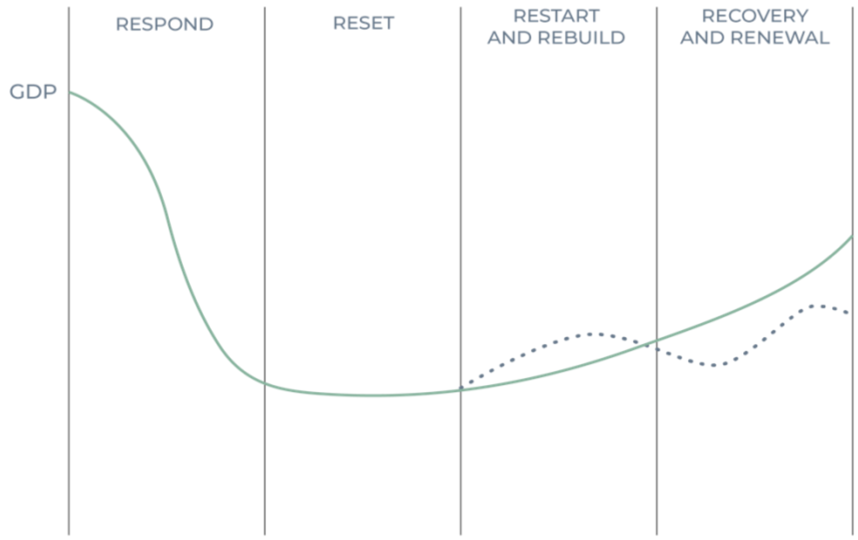
This week the public conversation in the UK has begun to balance economic considerations alongside the health emergency. As forecasts of the economic impact emerged, we also have the first articulation from the EU of what the lifting of restrictions may look like and their potential phasing. No such picture has yet emerged from the UK government.

We thought it was therefore a useful point at which to offer our own analysis of what is going on in the economy, what we think will happen next, and the implications for strategies being considered by policymakers, business leaders, and others. Much of the framing of this paper was inspired by a conversation we facilitated this week with John Kay and Mervyn King on their book *Radical Uncertainty*. They encouraged us all to eschew spurious forecast precision and simply ask the big question: “What is going on here?” We have tried to do just that.

ANDREW WILSON
Founding Partner

THE CHARLOTTE STREET PARTNERS FORECAST FOR THE UK ECONOMY

No numbers or dates are used because no one can possibly know them.



This chart illustrates nothing more than the phasing and shape of how we are thinking about what happens next and our understanding of how governments are considering things. We believe that any dates or numbers would be spurious because there are too many variables that are impossible and therefore pointless to predict. Numbers in this context can be ascribed too much power. So we focus on shape and phasing.

There could be fewer or more phases but we think the curve above captures the essence of what we can expect to experience as we navigate the weeks and months ahead. The length of each phase could be very different from one another.

We feel we must avoid a fifth phase: retribution. Mistakes are always made in a crisis. It is best that they are owned transparently and that we move on to what matters. There will be no point judging with the benefit of hindsight errors that were made under duress but with the best intentions. Indeed, it will be both unwise and distracting to do so, and we will only succeed in driving everyone who should be leading the recovery into defensive mode if we spend time trying to prove they were wrong. We should learn what can be learned, apply what can be applied, and focus on what will make the recovery and renewal as fast and sustainable as possible for everyone.

The city forecasters (indeed almost all economic forecasters) are largely disagreeing with this shape and predicting a 'V-shaped' recovery where a sharp contraction is followed by a rapid bounce back in 2021. The Office for Budget Responsibility's scenario published this week even envisages a UK economy in 2021 that is larger than in 2019. The only circumstance in which we think this is remotely possible is if a vaccine is distributed globally within the next few months, as opposed to the 12-18 month timeframe that is more widely anticipated.

The International Monetary Fund (IMF) also published its global outlook this week. It forecast $9 trillion of lost GDP (salaries and profits) in the global economy – the equivalent of losing more than Germany and Japan's outputs combined. The IMF too predicts a bounce back in 2021 (on its central scenario) but suggests the UK will not recover to beat 2019 levels. However, it noted rather soberly that "all of the risks are to the downside".

EXPLAINING OUR VIEW OF THE PHASES AND THE OUTLOOK FOR THE ECONOMY

Respond

From our perspective, the current 'respond' phase describes the partial shutdown of the market economy in the UK and most of the rest of the world.

In this phase, the economy drops to a degree which is currently impossible to measure. In fact, it won't ever be properly measured because the method of raising statistics such as inflation (where statistical shoppers literally go pricing in the shops) is on lockdown as well. In this phase, the health emergency is the focus of policymakers although governments have moved to partially secure incomes and sought to mobilise funds from the Central Bank and government to banks, businesses and people. Whether the respond policy of shutdown was correct, overshot, too early or too late is now largely a moot point. Scientists don't seem to universally agree so the government has made its choice and must make it good.

The main economic worry in this phase is that policymakers have come down too hard on the economy and damaged its ability to recover, both in general terms but certainly in competitive terms. Again, the counterfactual will be difficult to prove. But we know that poverty and inequality lead to death and suffering, just as a virus does.

The other core concern here is the potential gap between intent and implementation. The UK does seem to struggle with the creation of effective 'plumbing' systems, that are the means by which funds are distributed from the centre to their intended target. For example, the wage support furlough scheme was announced on 20 March. Thus far it is not possible for organisations to even apply for the money let alone for it to flow. The policy is still working in one respect however, for the anxieties it eased in so many. If it had not been announced, we can only guess at the cost the piercing worry would have brought by now. But we should not kid ourselves that it has happened in a practical sense yet (it hasn't), that it will be enough (it may not), or that its benefits will be as enduring as we hope they might. Meanwhile, businesses are failing now and we expect this to accelerate.

Reset

In this phase, which we hope will come sooner rather than later, the economy bottoms out and the decline levels off. Conversations begin on how the lockdown will be gradually released, by demography (age and vulnerability), sector and region.

So, for example, we might expect schools to re-open more quickly than cafes, bars, concert and sports venues, and so on. Borders may remain closed between regions. The EU suggests they will open internally first and then externally. In this phase, the beginnings of activity will appear like the shoots of snowdrops in the last days of winter. And like the flower, late frosts can kill the most nascent of stabilisations.

A further factor here will be the potential impact of testing, 'contact tracing', and the ability of authorities to use digital footprint data to identify people's exposure to risk and impose quarantine. The opposite may also apply, in that certification might be provided to those who have had Covid-19 and recovered to immunity and non-infectious status. Those 'lucky' people could lead relatively normal lives. However, at this stage this is little more than conjecture. We await the science and its potential for policy implementation and will consider the implications if and when that emerges.

Restart and rebuild

In this stage the grass has started to grow again – patchily, yes, but with clear signs of activity beginning to pick up. For us, this phase could be some time off and we do not expect a rapid bounce back for three main reasons.

First, any containment release will be gradual and therefore so must economic activity. Yes, government interventions can kickstart things, but the debate about what that could look like has not yet begun in the UK. To date, the interventions have been about halting the plummet and getting through phases one and two, but we believe that debate should have started already.

Second, we know that the overall market of the world will be much smaller and it follows that the market for goods and services must be too.

Third, we have already lost capacity. Businesses that have failed cannot bounce back. Yes, owners can go again but many risk bearers (entrepreneurs) have lost everything - including their appetite for the fight - or they will. Those that have the spirit and the means may start again but with less resources, a smaller end market and far greater conservatism in their mind. Maybe in future there will be greater general appreciation of the women and men who accept risk and put their all into starting businesses and creating employment opportunities. This would be a welcome development.

Recovery and renewal

The final phase could be called simply ‘recovery’, but we think that would be a mistake because we will never recover to exactly the way things were. Before this virus even took hold the world knew that its trajectory was unsustainable. Climate change, demographic challenges, automation and technological transformation already presented the status quo with existential challenges to varying degrees of urgency. The growing inequalities by geography, generation and gender added a crisis of legitimacy in the established economic and democratic norms. This pandemic accelerates all of this.

What emerges, therefore, must be a rapidly evolving economy in the UK and, indeed, internationally. The acceleration of policy responses to the challenges we mention above can ensure that we reach a new equilibrium that is both sustainable and satisfies the needs of the population and our societies. However, getting there - the transition - is fraught with policy and political risks that we would do well to consider now.

The lessons of history are that crisis responses can either improve the progress of aneconomy or society or make them dramatically worse. History also offers a clue to some of the themes that should inform the recovery and renewal strategy. That is a far bigger topic for the future. Here, we will therefore set out what we expect the features of the new equilibrium to mean for government and its role and the approach taken by businesses and other organisations. But first, the risks.

The real risk: a jaggy unlocking ahead of a vaccine

Our dotted line on the graph above simply represents the risk that as restrictions are lifted further outbreaks could force their return. This is evident already in some parts of Asia. The obvious point here is that this, along with the length of the lockdown, will further damage business, economic capacity and recovery. As capacity is lost, so is the long-term growth potential of the economy. In truth, the economic world is now smaller.

The tail risk: inflation is sleeping and a banking crisis would be a bad idea

We won’t dwell on this for long because we believe the risk is small and could remain so. However, if a populist political resurgence dominates the aftermath these risks will increase. In simple terms, if central banks are put under political pressure then their core purpose could be undermined. This is not a risk now as we seek to escape the grips of a massive deflationary event, but as the economy emerges - and if emergency actions are normalised - then inflation could awaken with destructive vengeance.

If politicians prefer printing money to borrowing or raising taxes in normalising times, then the risk of hyperinflation materialises. This is self-evident, although not in the crisis phase. What may seem politically attractive in the short term, risks destroying hard fought central bank independence and focus. At the same time, politicians may see a benefit in ever looser restrictions on bank capital requirements as they urge them to pump more and easier debt into the economy. Interventions that are urgent now in a crisis, could become dangerous in more normal times.

But in a world of soaring unemployment, lower incomes and burgeoning inequality, the message of a free and easy route to salvation could be preferable to voters than a longer grind back to recovery. This should be watched carefully.

What will be going on when the recovery and renewal phase completes?

A lesson of this crisis learned by many already is that running a business on vapours is far too risky for a world where pandemics remain possible. So, we expect balance sheets will be strengthened in the way regulation required for the banks post the financial crisis. Pay-outs, whether by bonus, dividend, or share buybacks, will initially have a lesser priority than ensuring the resilience of the organisation. Cash at bank will become more important for all, but especially for SMEs.

For businesses, resilience and robustness could trump efficiency and productivity

Simultaneously, the benefits of just-in-time supply chains may be, at the very least, balanced by the growing importance of supply security and stock holding.

This will not be easy, especially for listed companies. The average tenure for chief executives is about five years. The average tenure of a shareholder, meanwhile, is around six to nine months. So, if resilience may benefit a company in the long term but cost it in the short term, who will be able to lead such a strategy successfully?

The same phenomenon can be seen when considering payment terms. If large companies have a mismatch between what they expect from their debtors and what they offer their suppliers, they can make money. Unsustainably, certainly, but successfully. Collectively, however, by improving their own resilience in this way the largest of organisations risk the resilience of their supply chain and therefore the economy overall. We believe this issue will be very important going forward.

Finally, to the 'modularity' question identified by John Kay and Mervyn King in *Radical Uncertainty*. Can organisations internally shield different parts of themselves from failures elsewhere? Much as the banks have been forced to ringfence safer activities from riskier ones so they are protected if the latter blow up, can other organisations do the same through subsidiarisation and so on? We are soon to find out

The gradual unlocking – what to do when?

Before we even get to the new equilibrium, the handling of the transition back will be a difficult one. What businesses lead the unlocking process and which are at the tail end? What does this mean for who survives and how? How will government help and invest? Will that be fair?

Given the risk of a jaggy unlocking where further outbreaks lead to the further imposition of restrictions, businesses will need to be sure of their approach to safe return and be able to articulate their thinking for employees, customers, investors, government, and the media.

Accounting for crisis conduct

We also believe businesses should be thinking now about how they articulate the support they took advantage of across all four phases and what this means for other balancing actions they are taking. Considering now what the court of public opinion may conclude in the new world is a worthwhile use of time.

The role of government – transformed once again

One of the great imponderables in all this is what model of government will emerge and why. Again, this will need careful consideration and will be informed by the very recovery and renewal strategies that policymakers choose. However, a few line items strike us as obvious:

1. **The size of government will be much bigger:** the amount of money required to support the four phases and beyond will significantly outstrip the global financial crisis and could see debt levels return to historic averages and even towards post-war levels. This can be paid down in a combination of ways, including controlled inflation and raised revenues (from either taxes or new forms of revenues), or it can simply be tholed as long as rates remain low on longer term sovereign debt.
2. **But it will have to be reshaped:** the shape and conduct of the public sector will need to be considered along with every other aspect of life. The crisis makes a necessity of reforms in all directions from education to health to local government and beyond.
3. **The new corporatism?** The post war consensus of close partnership between business, government and trade unions was broken in the US and UK in the 1980s and 1990s. Will this crisis bring a return, or the birth of a new version? If other countries (e.g. Austria or Germany) can be seen to have proven both more resilient and with better ‘plumbing’ it may ensure a closer bond between the constituent parts. In any event, whatever strategy we agree on will require just that: agreement.
4. **Don’t repeat past mistakes, don’t unlearn the lessons of enlightenment:** by this we mean that economic nationalism - the erection of barriers and the substitutions of import and export for domestic consumption - will make everyone poorer. Short-term steroids do long-term damage. Long-term steroids even more so. It will be tempting, and in some areas such as energy and food security it may be partially necessary. But the longer term costs must be articulated.

Everyone is talking about a Universal Basic Income: well, not everyone, but when the Pope supports it publicly and many more are thinking it, the idealism may become a practical reality. We won’t rehearse the arguments here. Suffice to note that the plumbing lubrication it provides alone may be seen as an antidote to the gap between policy intent and implementation we mention above. Take this item as policy shorthand for action on inequality. Whichever way you look at it, we are handing future generations a bad inheritance. That will need remedied.

And what about the third pillar?

Of growing importance will be the role and function and funding of the third sector. For the delivery of so much of the new economy and society a transformed third sector will need to be created alongside the renewed public and private sectors.

We have begun some conversations with leaders in this field around the sustainability of funding, the improvement of collaboration and structural reform. A simple point, but so many charities rely on local government funding which was already under severe pressure. Either local government changes or that dependency will have to.

This crisis has caused many to ponder anew on why we depend so much on the third sector to fill the gap in public policy provision, or at least to contemplate why, in a well-functioning society, we have marginalised the value of community and the delivery of critical social services to our most vulnerable.

It seems to us that the crisis is a challenge to almost everything we know, but presents the opportunity to accelerate reforms as well. Intelligent evolution would allow far greater collaboration and perhaps the combination of charities engaged in similar purposes. At the same time, the intelligent channelling of funds would maximise their impact for good.
And the resilience point made above applies every bit as much in the third sector. Charities were often wary of building reserves because they worried funders would conclude that they didn't need more money. That logic would dictate that funds therefore flow to the least financially sustainable organisations, rather than the strongest. That position looks neither sustainable nor sensible now.

Similarly, the sustainability of organisations living hand-to-mouth on annual funding rounds requires attention now too. Endowments are hard to come by, especially in the UK culture. But is there a way that can be found for the third sector to access the historically low cost of long-term sovereign borrowing as well as the public sector? A little imagination applied here could be transformative.

These are just some initial thoughts and there will need to be many more. We will look out for the emerging recovery and renewal plans here and around the world. We will update our thinking as the facts emerge and change. We will report our views and encourage others to engage us with theirs.

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We hope that this note provides a useful frame for considering your own thinking and strategy for what we face next.

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