Written evidence submitted by the UCL Institute for Innovation & Public Purpose (UCL IIPP)

Economy, public finances, and monetary policy

Is the economy's recovery likely to be shallow or sharp?
What economic challenges may arise as the public health and social distancing policies are lifted and the economy begins to recover?
What preparations can be made to manage these challenges?

1. With the recession looking to be materially more severe than the financial crisis, we consider that the economic recovery is more likely to be prolonged and shallow. Uncertainty over the length and severity of social distancing measures will continue to dampen confidence, impeding a recovery in consumer and business spending. With one fifth of consumer spending involving social interaction, low confidence will undermine a sustained recovery even if lockdown measures are eased.
2. Furthermore, the UK is facing significant job losses.[1] 297 million individuals have made a claim for universal credit since 1st March,[2] whilst over 8.4 million have been furloughed over the same period.[3] Taken together, these figures indicate that over a third of the UK workforce is at risk of unemployment. Future job losses look likely to hit the most furloughed sectors, especially hospitality and retail which also employ the lowest paid workers.[4] More than one fifth of UK companies expect to lay off staff in the coming months, and hiring intentions remain at all-time lows.[5]
3. We consider that the recovery is further threatened by significant longer-term headwinds. Firstly, what started as a liquidity crisis is now threatening to evolve into an insolvency crisis. The already-elevated corporate debt burden (see Chart 1) is increasing as more firms rely on pandemic emergency loans (see Chart 2), whilst more than 1.8 million households have been forced to apply for a mortgage payment holiday. Future defaults and bankruptcies, if widespread, will threaten the health of the banking sector and lead to a balance sheet recession – for example, the latest Bank of England figures show an £8bn contraction in consumer credit, the largest on record.[6] In this scenario, households and firms focus on deleveraging at the expense of spending and investing, undermining the economic recovery and potentially leading to deflation. An increasingly indebted and weakened private sector is unlikely to be able to absorb the millions of unemployed that will emerge after the end of the Job Retention Scheme.
4. Secondly, and relatedly, the rise of job losses and spare capacity is likely to lead to 'scarring effects' on the economy, as prolonged periods of weak demand give rise to structural unemployment and a permanently lower capital stock. Analysis has shown that the 1.6 million people at the highest risk of becoming unemployed are more likely to be young, non-white, and female.[7] The loss of skills and confidence within these long-term unemployed risks exacerbating existing gender, age, and racial economic inequalities in the UK.
5. Thirdly, the climate crisis poses significant risks that are likely to weigh on the longer-term health of the UK economy. Although the timing and magnitude of its impacts remain unknown and impossible to predict, the UK economy remains fundamentally under-prepared for both the emissions mitigation

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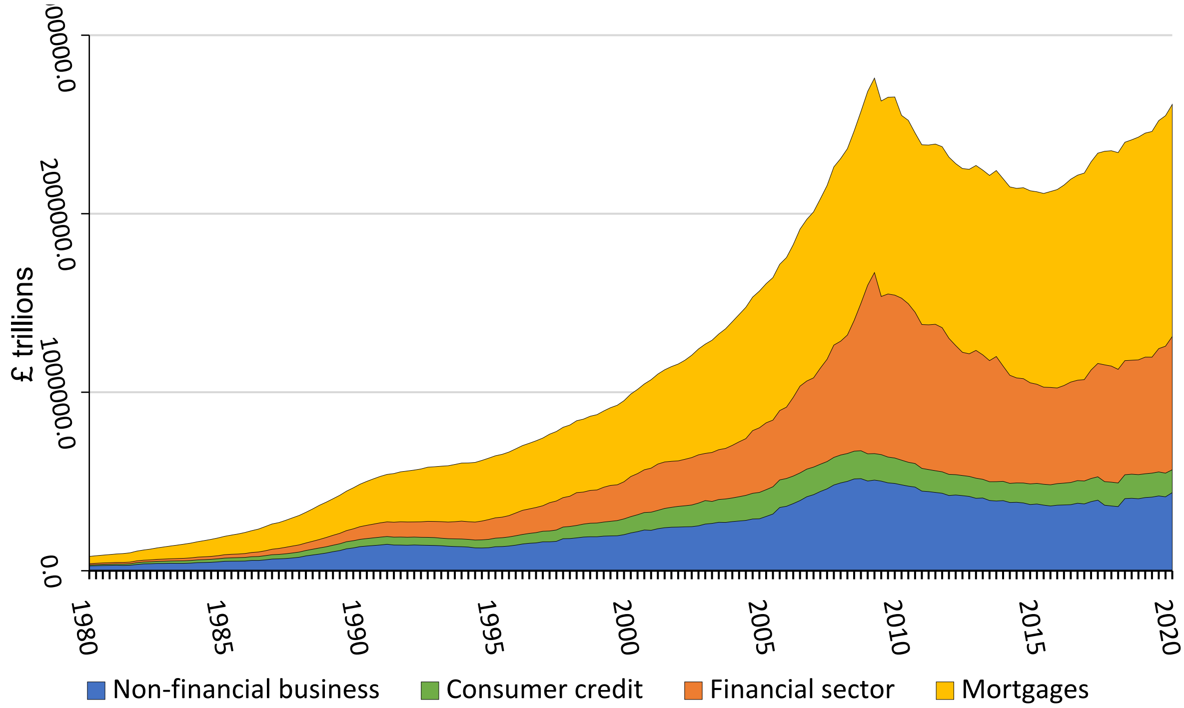
[1] UCL IIPP. Inequality, unemployment, and precarity. IIPP Covid-19 Briefing Paper, May 2020 (link).
[2] Department for Work and Pensions. Universal Credit declarations (claims) and advances: management information (link).
[3] BBC News. UK furlough scheme now covers 8.4 million workers. 27 May 2020, (link).
[4] Resolution Foundation. Launching an economic lifeboat: the impact of the Coronavirus Job Retention Scheme. April, 2020 (link).
[5] SP Global Market Intelligence. 22% UK companies planning redundancies by July, survey finds. 18 May 2020, (link).
[6] Bank of England (2020), Statistics, Household credit, a visual summary, available online at https://www.bankofengland.co.uk/statistics/visual-summaries/household-credit
[7] Stirling, A., Arnold, S., and Krebel, L. Only a minimum income can ensure support for everyone. *New Economics Foundation,* May 2020 (link).

challenge ahead, and the need to adapt our infrastructure to withstand future impacts that are already 'locked in'. The COVID-19 crisis has revealed the devastating consequences of failing to prepare for systemic threats. Indeed, the pandemic and the climate emergency resemble each other in several ways, both involving negative externalities, complex system interactions, and action that hinges upon decisive state interventions.

6. Amidst this backdrop, fiscal support will continue to be needed, even after social distancing measures are phased out. There is a strong case for the government to launch a Job Guarantee Scheme, directly employing all workers who cannot find conventional employment.[8] By acting as employer of last resort, the government can avoid 'scarring' effects, by building skills and confidence within the labour force and can direct employment towards investment projects that stimulate the economic recovery.
7. A Job Guarantee Scheme should be steered towards delivering a New Deal style investment programme aimed at accelerating the transition to a green economy.[9] A well-targeted green investment programme can offer a greater multiplier effect than conventional stimulus.[10] Shovel-ready projects such as building retrofits and EV charging network installation are labour-intensive and required training will be a boost to productivity[11]. Furthermore, green jobs are additional and well-distributed across the UK. It has been estimated that required green jobs may equal as much as half of the pre-crisis unemployed in some regions.[12] The orientation towards a green recovery is already being actively pursued in the EU, where the European Green Deal is now being harnessed as a motor for the European Commission's Recovery Plan.[13]
8. Finally, there is a need to ensure future fiscal recovery measures maintain and reinforce recent increases in spending on public services. Well-resourced health and social systems are essential to protect citizens from future threats, including those posed by the climate crisis. Investing to rebuild public capacity in critical services such as adult social care could also provide future employment via a Job Guarantee Scheme.

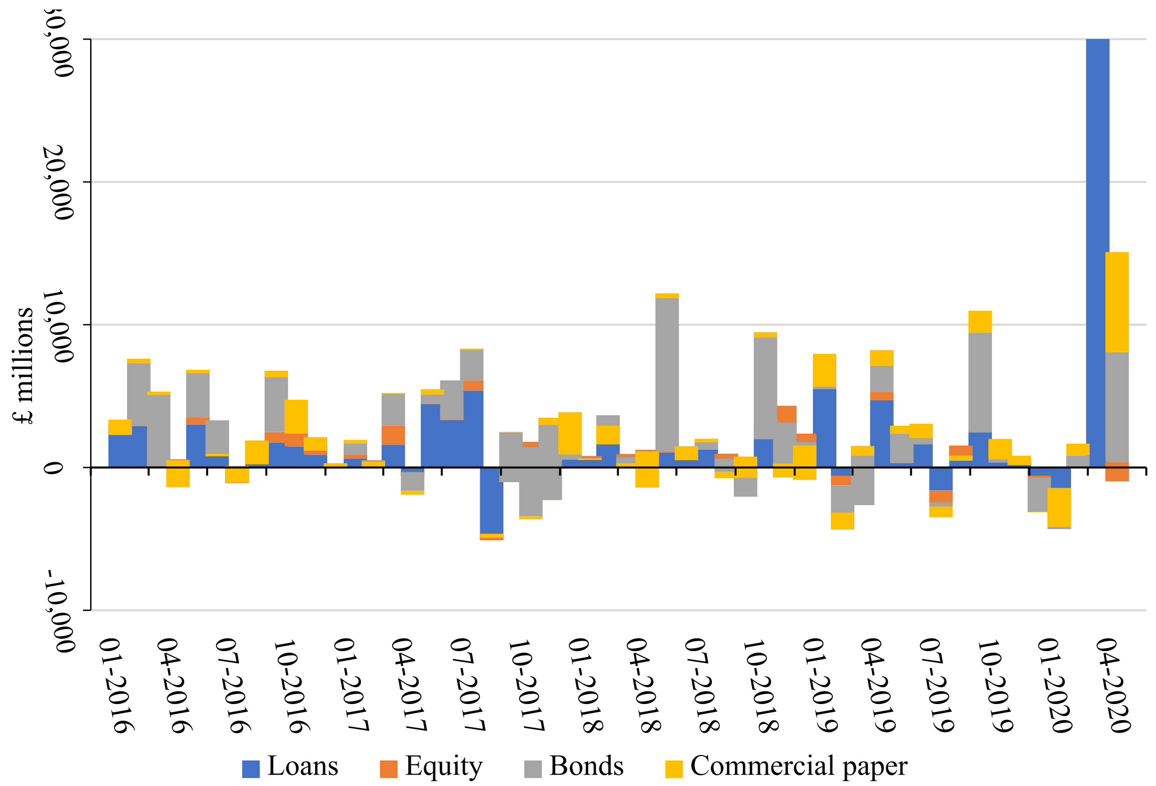
[8] Petrie, K. and Shepherd, J. A new safety net: guaranteeing jobs and training after the crisis. *Social Market Foundation report,* May 2020 (link).
[9] Mazzucato, M., Dibb, G., McPherson, M. 2020. The path to COVID recovery: the urgent need for the EU Green Deal and a new approach to Industrial Strategy. IIPP Blog (link).
[10] Hepburn, C., O'Callaghan, B., Stern, N., Stiglitz, J., and Zenghelis, D. Will COVID-19 fiscal recovery packages accelerate or retard progress on climate change? *Oxford Review of Economic Policy 36(1).* (link).
[11] New Economics Foundation. Recession Ready: a green plan to beat tomorrow's downturn. 2020. (link).
[12] Ibid.
[13] European Commission. The EU Budget: Powering the Recovery Plan for Europe. May 2020 (link).

Chart 1. Quarterly amounts outstanding of banks' net lending to the private sector.



Source: Bank of England

Chart 2. Net finance raised by businesses.



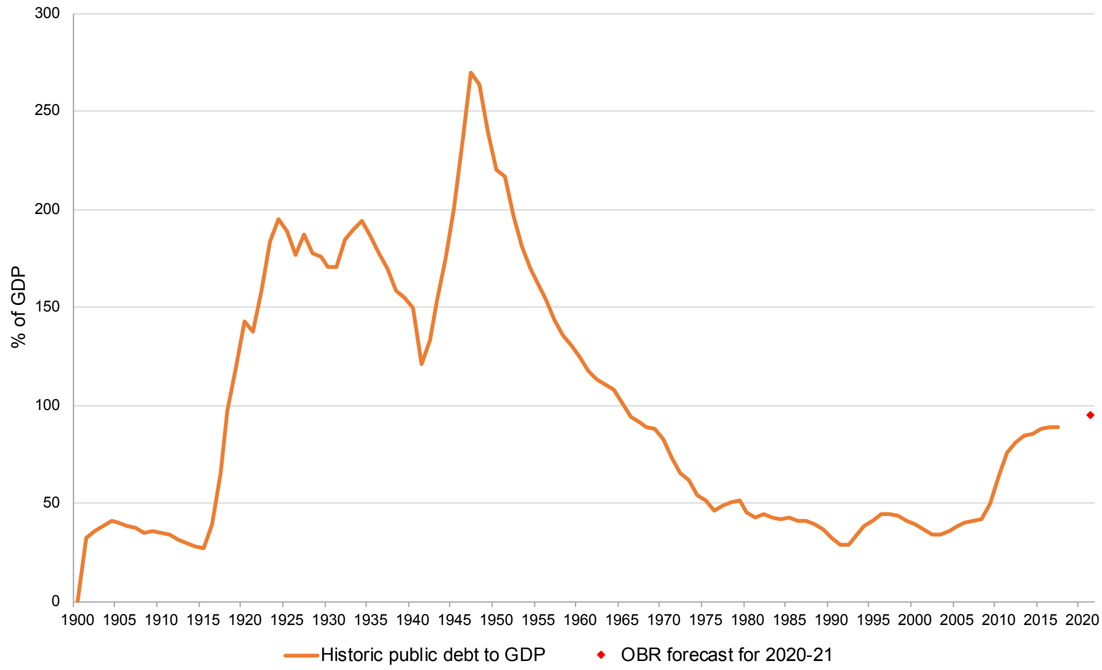
Source: Bank of England

What will be the impact on the public finances?

9. Recent fiscal measures are estimated to take public sector net debt to historically high levels, though still well below the record highs reached during the two world wars (see Chart 3). However, for a number of reasons, we do not consider the projected loosening in public finances to represent a significant threat to the UK economy.
10. Firstly, the Bank of England has significantly increased gilt purchases under its QE programme (£190 billion), a presence in the gilt market that will effectively absorb all of the DMO's projected gilt issuance between May and July (£180 billion). Justifying such purchases as necessary to minimise disruption in financial markets, Governor Andrew Bailey has also acknowledged that the central bank's intervention has enabled fiscal expansion whilst keeping gilt yields at historic lows. It is our view that monetary financing is effectively underway and is both appropriate and necessary under the current circumstances. With governments urgently required to use fiscal firepower to resolve the public health crisis and mitigate a historically large recession, the central bank's balance sheet is a critical tool that must be used to help manage the impact on public finances going forward.
11. Secondly, and thanks to the Bank of England's interventions, investors are showing no signs of losing faith in UK PLC – being prepared, for example, to purchase a new 3-year gilt issue at negative yields on 20th May. With yields at historic lows across the curve, the current juncture presents a unique opportunity for the government to lock in its borrowing costs at extremely low interests for long maturities.
12. Thirdly, the question should not be what the government can afford to spend, but how its spending should be deployed to most effectively accelerate the recovery. As discussed above, a strategic green investment programme has the potential for a high multiplier effect, creating significant employment and facilitating the transition to a green economy. Far from crowding out, government spending crowds *in* private demand by 'de-risking' and establishing a long-term path of certainty.[14]
13. Ultimately, ensuring strong, sustainable, and inclusive growth will manage public finances far better than fiscal consolidation (given growth erodes the real value of future debt repayments). Indeed, with the pandemic revealing critical deficiencies, there is a need to ensure fiscal recovery measures maintain and reinforce recent increases in spending on public services. Well-resourced health and social systems are essential to protect citizens from future threats, including those posed by the climate crisis, which shares many parallels with the current pandemic.

[14] Deleidi, M., Mazzucato, M., & Semieniuk, G. (2019). Neither crowding in nor out: Public direct investment mobilising private investment into renewable electricity projects. *Energy Policy* available online at https://www.sciencedirect.com/science/article/pii/S0301421519307803?casa_token=6yiaulJWpqUAAAAA:WaUCmOMfj1qsRDYJjMrLEJQjCtZBgOZ2LjdT1lL1Mjr5WsscleCwWvWpuO0vmtMib5MzpGhfkv0

14. **Chart 3.** Public sector debt as % GDP, historic levels.



Source: IMF and OBR

What are the differences and similarities between this shock and the Great Financial Recession of 2008 and also the economic demand management and demand suppression policies pursued during the Second World War?
What lessons can be learnt from these past shocks and the recoveries that ensued?

15. The Pandemic is an enforced shock to both supply and demand at domestic and global levels, whereas the 2008 recession was more demand-oriented and not as global in its impact. The UK Government has taken aggressive action to try and prevent permanent damage to the supply-side of the economy with the Job Retention Scheme and various loan schemes to firms. Whether these will be successful will depend very much on whether demand in the economy is able to return to pre-pandemic levels.
16. Demand in the economy can come from 3 sources: the domestic private sector, the overseas sector or domestic government. The first two of these sectors have taken a very severe and likely long-lasting hit. Even with lock-down lifted, it is not clear households will return to pre-pandemic levels of spending given fears and uncertainty around the prevalence of the virus. Certain sectors such as hospitality, catering and retail may take years to return to previous levels. There is therefore a need for government to step up and create new jobs in those areas of the economy where they are most needed as discussed in the previous section.
17. On this, the post-WWII recovery period is informative. After 1945, advanced economies faced an epic recovery challenge, with public debts even higher than those predicted to arise this year (the UK's debt-to-GDP ratio reached almost 250% in 1947 (Chart 3). But rather than focussing on public debt levels, post-war macroeconomic policy was focussed on full employment and the financing of strategically important sectors of the economy. Fiscal policy, monetary policy and industrial policy were tightly coordinated. "Credit guidance" policies were employed to steer finance into priority sectors – including exports, manufacturing, housing and transport infrastructure – and away from more speculative sectors.[15] State-owned development banks channelled both

government and household savings into infrastructure and innovative high-growth sectors.[16] Financial rents – profits from interest, speculation and capital gains – were minimised via the imposition of capital controls which restricted speculative foreign inflows and the maintenance of low rates of interest on government debt.[17] These low rates enabled aggressive government spending programmes, which enabled full employment.

18. In western economies, these policies supported job growth, corporate investment, industrial transformation and modernisation to such an extent that the period become known as the "golden age" of capitalism.[18] By keeping nominal growth (ie, GDP plus inflation) above the rate of interest on government debts, such policies also effectively deflated away the public and private debt piles that had built up.
19. Today, in response to the economic crash caused by the pandemic, we have seen governments expanding fiscal policy to support existing firms on a large scale. The Bank of England has initiated the COVID Corporate Financing Facility where, by printing money to purchase commercial paper directly from large corporations, the Bank of England is effectively acting as a 'fiscal arm' of HM Treasury.
20. But, so far, directing credit to support industrial policy objectives and strategic sectors of the economy has not occurred. This is particular problem as many for the sectors that are being given financial assistance may not be viable firms, in particular in the sectors already mentioned: aviation, fossil-fuel energy firms, hospitality and catering. Some of these sectors that are currently receiving financial support.
21. A large state investment bank could take equity stakes in such firms and support them to transition their business models (e.g. to be aligned with the UK's targets are zero-carbon transition) while saving jobs. Currently the UK does not have a major state investment bank and there is little public discussion about creating one. This is despite Britain losing access to the sizeable spending of the European Investment Bank due to Brexit.
22. This has two important implications. Firstly, as discussed above, where such support is directed is as important as how much of it is given. Monetary policy deployed in this way should be accompanied by active fiscal policy that can ensure public support generates long term public value. Secondly, and more fundamentally, the prominent role of the Bank of England as a frontline responder to this economic crisis reflects the implicit expansion of its mandate since the financial crisis.19 Given the Bank is now operating far beyond its narrow remit of inflation control, there is a need for public debate on the appropriate role for central banks in society today, if and how mandates should be updated to reflect future societal challenges, and how these powerful institutions should be held to account within democracy.

What are the lessons that society can learn for the future e.g. reducing carbon emissions, increased home working, business resilience?

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[15] Bezemer, Ryan-Collins, van Lerven & Zhang (2018). "Credit where it's due: A historical, theoretical and empirical review of credit guidance policies in the 20th century". IIPP Working Paper 2018-11 (Link)

[16] Macfarlane, Laurie, and Mariana Mazzucato. "State investment banks and patient finance: An international comparison." *UCL Institute for Innovation and Public Purpose Working Paper 2018* 1 (2018).

[17] Epstein, G. A., & Jayadev, A. (2005). The rise of rentier incomes in OECD countries: financialization, central bank policy and labor solidarity. *Financialization and the world economy*, *39*, 46-74.

[18] Epstein, Gerald, and Juliet Schor (1988) "Macropolicy in the Rise and Fall of the Golden Age.", in Marglin, Stephen A., and Juliet B. Schor, eds. *The golden age of capitalism: reinterpreting the postwar experience*. Oxford University Press, 1991, available online at https://ageconsearch.umn.edu/record/295567/

[19] Ryan-Collins, J. Central banks must change course if they are to lead us out of the coronavirus crisis. *The Guardian,* 26 May 2020 (link).

23. COVID-19 has revealed a number of vulnerabilities within both private and public sectors that must be addressed to ensure our society is resilient enough to withstand the future impacts of climate change and other societal challenges.
24. Within the private sector, many firms have been unable to deliver vital goods and services due to a reliance on disrupted global supply chains. While this is partly a result of the UK's structural shift towards a deindustrialised economy over recent decades, the effects have been further exacerbated by the lack of spare capacity or 'slack' within many businesses. Efficiency-focused 'just-in-time' operations have removed the buffer zones needed to withstand shocks, and financialised business models have increased vulnerabilities. The 100 largest non-financial UK firms paid out £400 billion in dividends and £61 billion in share buybacks between 2011 and 2018, equivalent to 68% of total net profits[20]. The normalised erosion of corporate cash reserves in the name of shareholder value maximisation must be challenged in order to ensure firms are resilient enough to weather future crises.
25. In the public sector, COVID-19 has revealed critical deficiencies in key public services. Austerity has weakened both preparedness and responses to the pandemic. Public health funding today is £850 million lower in real terms compared to five years ago.[21] Local authority government funding fell by 49.1% in real terms between 2010 and 2018.[22] As in the private sector, public services have also been increasingly managed with an efficiency-focused, cost-saving mindset which has eradicated critical buffer capacity. The UK's pandemic stockpile, for example, fell 40% in value terms between 2013 and 2019.[23]
26. Beyond funding cuts, the pandemic has also revealed evidence of diminished public capacity.[24] From difficulties encountered in sourcing PPE and ventilators, to the deployment of contact tracing and testing services, the dynamic capacity of the public sector to respond to shocks has been called into question. Indeed, the government has relied heavily on private contracts to deliver much of the critical coronavirus response, despite many of the chosen contractors being involved in prominent failures in the provision of previous public contracts. It has also been striking how the government has struggled to coordinate production from the many UK companies who responded to a request to supply PPE. The inability to mobilise available resources in times of crisis is a critical failure of public capacity.

Support to business and financial services, and other government interventions

How effective is the Coronavirus Corporate Finance Facility, Coronavirus Business Interruption Loan Scheme, and the Coronavirus Larger Business Interruption Loan Scheme? In particular, are these measures succeeding in preventing viable businesses from potentially going under during the Coronavirus lockdown?
Should the Government intervene more actively in terms of state aid, bail-outs and its industrial strategy?

27. We need to be careful that the unprecedented levels of government support flowing into the economy does not entrench dysfunctional business practices and prop up legacy industries.[25] Strategic conditionalities should be used to align corporate behaviour with the needs of the public.[26] This is

[20] Partington, R. £400 billion paid in dividends by UK companies before coronavirus crisis. *The Guardian,* 17 April 2020 (link).
[21] Cooper, K. A public health resurgence. *British Medical Association,* 1 May 2020, (link).
[22] Housing, Communities, and Local Government Committee. Local government finance and 2019 spending review. (link).
[23] Davis, H. et al. Revealed: value of UK pandemic stockpile fell by 40% in six year. *The Guardian,* 12 April 2020 (link)
[24] Mazzucato, M. and Quaggioto, G. The big failure of small government. *Project Syndicate*, 19 May 2020 (link).
[25] Mazzucato, M. The Covid-19 crisis is a chance to do capitalism differently. *The Guardian,* 18 March 2020 (link)
[26] IIPP. Stakeholder capitalism during and after Covid-19. *IIPP Covid-19 Briefing Paper*, May 2020 (link).

especially needed given that excessive financialised business practices have left many major corporations without the resilience to weather the current storm.

28. In the short term, conditions should prioritise preserving employment and maintaining corporate solvency whilst preventing firms from channelling public funding to financial markets. It is encouraging to see the Bank of England has restricted dividends and excessive executive compensation within firms who seek to borrow from its COVID Corporate Financing Facility for longer than one year. We consider that such conditions, extended also to include limits on share buybacks and the use of tax havens, should be applied to all government support offered to the private sector.
29. Public support should also be conditioned upon the requirement to ensure the creation of long-term public value. Certainly, not all businesses will survive, and the unprecedented levels of government support now flowing into the economy must not be used to prop up unviable firms. The role of state support in this crisis requires not just an expansion in capacity, but also a reimagination of its direction and purpose. Governments do not just exist to fix problems when they arise, they also have the capacity to actively create and shape markets to advance longer-term societal missions.[27] At the current juncture, state support should aim to rebuild the resilience of the economy to future shocks and in doing so accelerate sustainable and inclusive growth.
30. We consider that the government should make greater use of equity financing as a tool to support viable and strategically important firms. The recently announced £500 million Future Fund, which offers convertible loans to UK start-ups, is an encouraging move in this direction. As we move increasingly towards an insolvency crisis, more loans and guarantee schemes cannot meaningfully aid recovery within the corporate sector. Equity financing is more suited to situations of high risk and high uncertainty, as is well-accepted within financial markets, and gives governments the opportunity to potential upside benefits (future returns on their investments) in return for taking on private sector risk.
31. Importantly, equity states also give the state oversight into how strategic industries are managed for public value. This is especially important in the context of carbon intensive industries, where the need to maintain employment must be balanced with the longer-term challenge of transitioning industries towards the green economy. The Future Fund is being administered by the British Business Bank, yet – being unable to lend or invest itself directly – it lacks the institutional capacity needed to match this challenge. We call for the creation of new institutions to enable the UK government to deliver such vital support. A national state investment bank, or a network of regional state investment banks, can manage strategic equity investments, as well as loans, at an arm's length from short-term political decision making and for the long-term national interest.
32. For SMEs, equity-like instruments (such as grants with some limited repayment through future taxes) should be explored as a more suitable means of support. Such instruments would not require the relinquishment of ownership (which is anathema to many small firms) but would offer support without adding to the threat of insolvency.

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[27]Mazzucato, Mariana, and Josh Ryan-Collins. "Putting value creation back into 'public value': from market-fixing to market-shaping." (2019). IIPP WP 2019-05, available at https://www.ucl.ac.uk/bartlett/public-purpose/sites/public-purpose/files/public_value_final_30_may_2019_web_0.pdf